

Fraud and the UN Convention on Independent Guarantees and Standby Letters of Credit

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This paper considers the approach and adoption of the fraud exception to the principle of autonomy by the United Nations Convention on Independent Guarantees and Standby Letters of Credit (Convention). The Convention incorporates a forthright and shrewd definition of fraud whilst simultaneously avoiding the use of the word “fraud.” The drafters succeed in finding a test for fraudulent behavior in easily understandable terms, whilst maintaining flexibility in application and adhering to the spirit of international banking practice and experience. The paper further considers the background, nature and internationality of the Convention to place its treatment of the fraud exception in context.

Introduction

The Convention was adopted on December 11, 1995 by the General Assembly of the United Nations,¹ specifically the Working Group on International Contract Practices at its thirteenth to twenty-third sessions.² The Convention became effective on January 1, 2000 having been ratified, accepted, approved or acceded to by the minimum five nations, the required

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¹ See also Filip De Ly, *The UN Convention on Independent Guarantees and Standby Letters of Credit*, 33 INT'L LAW 831 (1999); James E. Byrne, *Independent Guarantee Convention*, in 1999 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 93 (James Byrne ed., 1999); John F. Dolan, *The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?*, in 1999 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 97 (James Byrne ed., 1999).

² See 1990 UNCITRAL Y.B. XXI, U.N. Doc. A/CN.9/330, U.N. Sales No. E.91.V.6 (1990); 1991 UNCITRAL Y.B. XXII: U.N. Doc. A/CN.9/342 and A/CN.9/345, U.N. Sales No. E.93.V.2 (1991); 1992 UNCITRAL Y.B. XXIII: U.N. Doc. A/CN.9/358 and A/CN.9/361, U.N. Sales No. E.94.V.7 (1992); 1993 UNCITRAL Y.B. XXIV: U.N. Doc. A/CN.9/374 and Corr.1, U.N. Sales No. E.94.V.16 (1993); 1994 UNCITRAL Y.B. XXV: U.N. Doc. A/CN.9/388 and A/CN.9/391, U.N. Sales No. E.95.V.20 (1994); 1995 UNCITRAL Y.B. XXVI U.N. Doc. A/CN.9/405 and A/CN.9/408 (1995); The deliberations of UNCITRAL on the Convention, 28th Sess., 1995 Official Records of the General Assembly, 50th Sess., Supp. (No. 17), ¶¶ 11-201, U.N. Doc. A/50/17.

number of nations. To date eight nations have ratified or acceded to the Convention.³

The Convention is designed to facilitate the use of independent guarantees and standby letters of credit. It toughens general principles and features that are common to independent guarantees and the standby letters of credit.⁴

The overwhelming majority of the world's independent guarantees and standby letters of credit are subject to three rules of practice: the Uniform Customs and Practice for Documentary Credits (UCP), the International Standby Practices (ISP98) and the Uniform Rules of Demand Guarantees (URDG). These rules of practice are incorporated into the transaction by agreement between the commercial parties.

Where a nation has acceded to or ratified the Convention, then the Convention applies by force of law since the rules of private international law determine the proper law of the transaction. The Convention drafters were cognizant of the need to settle rules and practices into law relating to independent undertakings, independent guarantees and standby letters of credit.

Background

The history of the Convention indicates that the drafters recognized a need to settle rules and practices into law relating to independent undertakings. Notably, the drafters included specific provisions for a prime exception to the principle of autonomy: the fraud exception.⁵ The Convention aims to provide greater legal certainty by making a single legal regime available for both independent guarantees and stand-by letters of credit. The official Explanatory Note to the Convention states that the Convention supplements the operation of the UCP, the ISP98 and the URDG by dealing with issues beyond the scope of such rules, in particular

³ Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The United States of America has signed the Convention but, as of 1 November 2010, not yet acceded to it.

⁴ See generally Byrne, *supra* note 2, at 93; De Ly, *supra* note 2, at 831; Dolan, *supra* note 2, at 97.

⁵ See John F. Dolan, *supra* note 2, at 97, 99.

fraudulent or abusive demands for payment and the subsequent judicial remedies.⁶

Limited application and acceptance has meant that the Convention currently has little practical importance to most commercial parties. Nevertheless, the Convention has provided an opportunity for bankers, lawyers and interested participants to address and redress issues that the UCP, ISP98 and the URDG were unable to tackle. The nature of the UCP, ISP98 and URDG is such that the parties are unable to define the level of fraud, which may apply or be acceptable in a given transaction. At the common law level, principles of contract would not permit a party to contract out of fraud, or to redefine the level of fraud applicable.

The UCP600, ISP98 and URDG are non-mandatory rules. Each is intended to standardize the conditions applicable to documentary credits, standby letters of credit and for the URDG, demand guarantees. The rules do not have force of law though bankers, merchants and customers in the vast majority of countries use these extensively, often with great reverence. However, some commentators have argued that the UCP is so well known and accepted that it has the force of law⁷ and should be considered a truly universal norm.⁸ According to former UNCITRAL Secretary Gerold Herrmann, the purpose of the Convention is “to codify the principle of independence ... in a legally binding manner and not merely rely on the non-binding rules of the ICC set out in the UCP500 or the URDG.”⁹

As specified in Article 2(1) of the Convention, it is intended to apply to independent guarantees and standby letters of credit. The former are sometimes referred to as demand, first demand, simple demand or bank guarantees. Both independent guarantees and standby letters of credit share a wide area of common use, and are legally indistinguishable.

⁶ See UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, cmt. 8, U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccess-ods.un.org/TMP/9645256.html> [hereinafter Explanatory Note].

⁷ Gerold Herrmann, *The UNCITRAL Draft Convention on Independent Guarantees and Stand-by letters of Credit*, in ATTORNEY GENERAL'S DEPARTMENT AND LAW COUNCIL OF AUSTRALIA TWENTY FIRST INTERNATIONAL TRADE LAW CONFERENCE 325 (1994).

⁸ Boris Kozolchyk, *Bernard Spencer Wheble (1904-1998) In Memoriam*, in 1999 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 18, 21 (James Byrne ed., 1999).

⁹ Herrmann, *supra* note 7, at 326.

The autonomy principle is a prominent feature of the Convention. The official Explanatory Note to the Convention refers to the independent undertakings as “basic tools of international commerce.”¹⁰ The drafters were concerned that “there has been a lack of uniformity internationally in the understanding and recognition of that essential characteristic” in relation to undertakings of the type covered by the Convention.¹¹ Article 3 clarifies that the primary undertaking is independent from any underlying transaction (performance, financial or otherwise), counter-guarantees or confirmations. The Convention specifically clarifies and defines counter-guarantees and confirmations as primary undertakings.¹²

The independence appropriately extends to terms or conditions not appearing in the undertaking. In documentary credit parlance, non-documentary conditions are to be disregarded. Specifically, an undertaking should not be subject to any future, uncertain act or event other than the actual presentation of documents. This approach is consistent with the line of authority that the role of the guarantor and issuer is “one of paymaster rather than investigator.”¹³

As a corollary to the autonomy principle, is the fact that the undertaking, the guarantor’s or issuer’s obligation, is documentary in nature. Hence, letters of credit are typically referred to as documentary credits. The guarantor’s and issuer’s obligation is to examine documents when presented with the requisite demand. The duty of the guarantor and issuer is to only deal with the documents. One consequence is that non-documentary conditions are beyond the scope of the Convention.

The specific intent behind the Convention is to deal with the independent relationship between the guarantor (in the case of the independent guarantee) and the issuer (in the case of the standby letter of credit) with the beneficiary. Because the independent commitments under

¹⁰ Explanatory Note, *supra* note 6, cmt. 3.

¹¹ *Id.* cmts. 17-18.

¹² United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, art. 6(c), (e), U.N. Doc. A/RES/50/48 (Dec. 11, 1995) [hereinafter The Convention]. As with commercial letters of credit the beneficiary has the option of demanding payment from the counter guarantor or confirmer.

¹³ Explanatory Note, *supra* note 6, cmt. 18.

the Convention are given to a beneficiary, the focal point of the Convention is on this relationship. Conversely, the relationship between the guarantor or issuer with and the corresponding customer (the principal in the case of an independent guarantee, or the applicant in the case of a standby letter of credit) generally is not a matter for treatment by the Convention.¹⁴ Notably, the Convention does not apply to accessory or conditional guarantees, such as, guarantees where the obligation to pay involves more than just the examination of documents. In summary, the Convention is concerned with the independence of the obligation between the guarantor and issuer with the beneficiary.

Commercial and Standby Letters of Credit

The Convention envisages applicability to commercial letters of credit, at the option of the parties. Article 2 defines the type of undertaking to which the Convention is intended to apply, specifically: “an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit.” However Article 1(2) provides that the Convention “applies also to an international letter of credit not falling within article 2 if it expressly states that it is subject to this Convention.” These “opt-in” provisions provide an opportunity for the parties in commercial letters of credit to incorporate international law, potentially creating a unified standard, for such issues as fraud, abusive drawings and jurisdiction. The power of the Convention is the ability to supplant deficiencies in rules such as the UCP and ISP. These rules of practice are highly restricted and proved durable time and time again. The deficiencies are merely their inability to deal with the issues of law available to the Convention.

Application of the Convention

The Convention can apply in three circumstances. First, the Convention applies to an “international undertaking” if: (a) the place of business of the guarantor or issuer at which the undertaking is issued is in a Contracting State, or (b) the rules of private international law lead to the application of the law of a Contracting State.¹⁵ Despite a minor controversy, the parties to the undertaking may exclude the application of the

¹⁴ *Id.* cmt. 6.

¹⁵ The Convention, *supra* note 12, art. 1(1).

Convention in this manner.¹⁶

Second, the Convention applies to other international letters of credit where the letter of credit expressly states that it is subject to the Convention. Article 1(2) permits the parties to letters of credit other than standby letters of credit to “opt into” the Convention. The drafters of the Convention have stated that there is “broad common ground between commercial and standby letters of credit,” and “in view of the occasional difficulties in determining whether a letter of credit is of a standby or commercial variety” parties to commercial letters of credit may “in their own judgment” take advantage of the convention.¹⁷

Third, and independently of Article 1(1), Articles 21 and 22 of the Convention provide that the undertaking is governed by the choice of law stipulated in the undertaking, demonstrated by the terms and conditions of the undertaking or agreed elsewhere by the parties.¹⁸ In the absence of such a choice of law, the law of the State where the guarantor or issuer has its place of business at which the undertaking was issued governs the undertaking.

Internationality of the Undertaking

The Convention clearly applies to international undertakings¹⁹ and international letters of credit²⁰. Strictly, the Convention cannot be applied to

¹⁶ The controversy centered around, what has been described as a scrivener’s error. In the draft Convention, the exclusion provision appears on a new line and would apply appropriately to both paragraphs (a) and (b). In the initial officially published Convention, the words in the Article were identical, however, the exclusion provision appears to be part of paragraph (b). More than one commentator noted the apparent “confusion.” See John F. Dolan, *supra* note 2, at 97, 99; Paul S. Turner, *The New UN Convention on Standby Letters of Credit: How Would it Affect Existing US Letter of Credit Law?*, in LETTERS OF CREDIT REPORT 1 (Nov./Dec. 1996). However, the draft Convention was adopted by the General Assembly without amendment. Moreover, the official Explanatory Note provides that “(f)ull freedom is given to parties to exclude completely the coverage of the Convention.” Explanatory Note, *supra* note 6, cmt. 11. Clearly, there was no intention to change the draft, and the expression “scrivener’s error” is accurate.

¹⁷ Explanatory Note, *supra* note 6, cmt. 16.

¹⁸ The Convention, *supra* note 12, arts. 21, 22.

¹⁹ *Id.* art.1(1), (3).

²⁰ *Id.* art. 1(2).

purely domestic letters of credit. However, the need and subsequent use of letters of credit purely domestically is minimal and the Convention's definition of internationality is quite broad. Article 4(1) provides that an undertaking is international if the places of business, as specified in the undertaking, of any two of the guarantor/issuer, beneficiary, principal/applicant, instructing party or confirmer are in different States. Where the undertaking lists more than one place of business for a given person, the relevant place of business is that which has the closest relationship to the undertaking. Where the undertaking does not specify a place of business for a given person but does specify the "habitual residence" that residence is relevant for determining the international character of the undertaking.²¹

Nature of the Undertaking

The Convention defines the applicable undertaking as an independent commitment, known in international practice as an independent guarantee or as a standby letter of credit. The undertaking is given by a bank, other institution or person (termed the guarantor or issuer):

to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.²²

The language attempts to isolate the common characteristics of independent guarantees and standby letters of credit as instruments of finance. In the words of the official Explanatory Note,²³ the Convention "solidifies recognition of common basic principles and characteristics shared" by the two instruments.²⁴ Indicative of this common understanding,

²¹ *Id.* art. 4(2).

²² *Id.* art. 2(1).

²³ The official Explanatory Note to the Convention was prepared by the secretariat of UNCITRAL for informational purposes. It is not an official commentary on the Convention. Explanatory Note, *supra* note 6, n.1.

²⁴ *Id.* cmt. 2.

the Convention uses the neutral expression “undertaking” to refer to both instruments.

Independence of the Undertaking

At the actual heart of the Convention is the concept of independence—the autonomy principle. The official Explanatory Note describes the independent undertakings covered by the Convention as “basic tools of international commerce.” The Convention drafters believed there had been a lack of uniformity internationally in the understanding and recognition of the autonomy principle in relation to undertakings of the type covered by the Convention.²⁵ One stated aim of the Convention is to promote international uniformity. The Convention defines “independence” in Article 3, which clarifies that the undertaking is independent from any underlying transaction (performance, financial or otherwise) and also from any counter-guarantee or confirmation.²⁶ The Convention recognizes counter-guarantees and confirmations. Both terms are defined in the Convention²⁷ in a similar manner to a primary undertaking. As with commercial letters of credit the beneficiary has the option of demanding payment from the counter guarantor or confirmer.

The Convention is designed to be consistent with the parties’ use of the UCP, the ISP98 and the URDG. The Convention supplements these rules of practice by dealing with additional issues beyond the scope of such rules applying as law, described thus: “important questions confronting users, practitioners and courts in the daily life of these instruments are beyond the power of the parties to settle contractually.” Hence the drafters of the Convention could engage in debate and consideration of issues beyond the scope of the drafter of the rules of practice: vis-à-vis fraud.

²⁵ *Id.* cmts. 17-18.

²⁶ The Convention, *supra* note 12, art. 3 (“For the purposes of this Convention, an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not: (a) Dependent upon the existence or validity of any underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate); or (b) Subject to any term or condition not appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within a guarantor/issuer's sphere of operations.”).

²⁷ *Id.* art. 6 (c), (e).

Relationship between the Convention and Rules of Practice

The Convention provides that rights and obligations arising from the undertaking are determined by the terms and conditions in the undertaking. Specific reference is made to applicable rules of practice such as the UCP, URDG and ISP98. Article 13(2) provides:

In interpreting terms and conditions of the undertaking and in settling questions that are not addressed by the terms and conditions of the undertaking or by the provisions of this Convention, regard shall be had to generally accepted international rules and usages of independent guarantee or stand-by letter of credit practice.²⁸

The Convention's approach maintains maximum flexibility for the parties in preparing the undertaking. This ensures that the Convention will remain a living instrument, and that the emerging and developing practices under the UCP, URDG and ISP98 are necessarily incorporated. For example, at the time the Convention was finalized the ISP98 was in its infancy. Nevertheless, the flexible approach necessarily permits the incorporation of these new rules. As the Explanatory Note details:

(the) approach ensures that the Convention will remain a living instrument, sensitive to developments in practice, including future revisions of rules of practice such as UCP and URDG and the development of *other international rules of practice*.²⁹

This flexible approach of linking the Convention to the needs and evolving usages and standards of commercial practice is also dealt with in other parts of the Convention. For example, the interpretation provisions³⁰ and the standard of conduct of the guarantor or issuer.³¹

The Convention supplements other rules of international practice, but is able to take questions of applicable law further. Rules of practice are adopted by parties as terms in a contract. As terms of the contract, rules of

²⁸ *Id.* art. 13(1).

²⁹ Explanatory Note, *supra* note 6, cmt. 36 (emphasis added).

³⁰ The Convention, *supra* note 12, art. 13(2).

³¹ *Id.* art. 14(1).

practice may give rights and impose obligations on the parties; however, the parties cannot contract to permit a fraud. In part because the Convention can address questions of applicable law, it goes further than rules of practice in addressing the question of fraudulent or abusive demands for payment and judicial remedies. In this case, the applicable law may be UCC Revised Article 5-109 or the UN Convention Article 19.³²

The Fraud Standard

Fraud is a major factor for any bank that handles letters of credit and demand guarantees. Any attempt to reduce the ability to perpetrate a fraud should be applauded and changes in practice introduced.³³

As mentioned, jurisdiction and fraud are two matters that the rules of practice cannot deal with. These are matters, which by necessity should be left to the law because government and public policy issues are involved. In the matter of the fraud exception the law must take the lead. There are a few examples where the law has taken a lead and a fraud standard has been mandated, such as Uniform Commercial Code Revised Article 5, Section 109 and the Chinese Supreme Court Letter of Credit Rules.

Exemption clauses cannot operate to exclude or restrict liability for fraud by the perpetrator of the fraud.³⁴ This statement implies that the point is clear, but the fact that commercial parties have inserted such clauses may go to the factual and practical situation of reliance and subsequently to the proof of misrepresentation. In *Walker v Boyle*³⁵ the English High Court held that a clause stating, “[t]he properties are believed to be correctly described and any incorrect statement, error or omission in the particulars shall not

³² James E Byrne, *The Official Commentary on the International Standby Practices* 20, (James G. Barnes ed., 1998).

³³ Gary Collyer et al., *How to Revise the UCP: DWC Experts Give Their Suggestions*, DOCUMENTARY CREDIT WORLD, May 1999, at 19.

³⁴ ELIZABETH MACDONALD, EXEMPTION CLAUSES AND UNFAIR TERMS 300 (Butterworths 1999). See also *S. Pearson & Son v. Dublin Corp* (1907) AC 351, 362, 365 (House of Lords); *Scheider v. Heath* (1813) 3 Camp 506; *Garden Neptune Shipping Ltd. v. Occidental Worldwide Inv. Corp.* (1990) 1 LI Rep 330; *Skipskredittforeningen v. Emporor Navigation* (1997) CLC 1151, 1165.

³⁵ (1982) 1 All ER 634, 641.

annul the sale” could “have no operation where the description was to the knowledge of the vendor incorrect” in that it was “fraudulent.”³⁶

According to Debattista, the principle of autonomy has been impaired by the Convention in two respects. From the point of view of unfair calls, the Convention renders it “more difficult for an unfair call to succeed.”³⁷ In determining whether a call is justified, sub-Articles 19(1)(b) and (c) and 19(2)(a), (b), (c) and (d) all require the issuer/principal to look to the underlying transaction for good cause for payment. Second, Debattista argues that “by repeatedly insisting on the exercise of good faith,” sub-Article 15(3), the tailpiece of sub-Article 19(1) and sub-Article (19)(2)(e), put both the beneficiary and the issuer/principal on notice that payment needs to be justifiable by good cause.³⁸

*Sztejn v J Henry Schroder Banking Corporation*³⁹ is regarded as the leading case on the fraud exception to the autonomy principle,⁴⁰ although interestingly, the case proceeded on an underlying procedural assumption.⁴¹

³⁶ See also *Thomas Witter v TBP Industries Ltd* (1996) 2 All ER 573.

³⁷ Charles Debattista, *Performance bonds: the ICC Rules and the UNCITRAL Convention*, 2 DOCUMENTARY CREDITS INSIGHT 4 (1996) (referring specifically to articles 15 and 19).

³⁸ *Id.*

³⁹ 31 N.Y.S.2d 631 (N.Y. App. Div. 1941).

⁴⁰ See generally, E.P. ELLINGER, DOCUMENTARY LETTERS OF CREDIT - A COMPARATIVE STUDY 190-196 (1970); JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT - COMMERCIAL AND STANDBY CREDITS 4.14-4.15 (2d ed. 1991); BROOKE WUNNICKE, ET AL., STANDBY AND COMMERCIAL LETTERS OF CREDIT 159-160 (1996); Adam Johnson and Daniel Aharoni, *Fraud and Discounted Deferred Payment Documentary Credits: The Banco Santander Case* 15 JIBL 22 (2000); Juliet May, *Letters of Credit - The Fraud Exception*, 3 Verulam Buildings Banking Law Newsletter (2000).

⁴¹ The *Sztejn* case was a procedural matter, a motion by the defendant on the grounds that the facts did not disclose a cause of action. The court had to assume the facts to be true for the purpose of the hearing. This included the fact that the “Advising Bank” (the correspondent bank, namely Chartered Bank) was not a holder in due course. So whether or not it would be, or should be was not argued or examined. It may well be that the bank must be a holder in due course and that it should be paid as such notwithstanding the fraud. However, the matter remains moot and the case remains pivotal in letter of credit legal history and development. Justice Shientag noted, “For the purposes of this motion, the allegations of the complaint must be deemed established and ‘every intendment and fair inference is in favor of the pleading’ . . . it must be assumed that Transea was engaged in a scheme to defraud the plaintiff and Schwarz, that the merchandise shipped by Transea is worthless rubbish and that the Chartered Bank is not an innocent holder of the draft for

Chester Charles Szejn was a buyer based in the United States. He negotiated with Transea Traders Ltd., of Lucknow India, to purchase a quantity of hog bristles. Szejn applied for an irrevocable letter of credit to be issued by Schroder. Transea Traders Ltd. loaded fifty cases of material on board a steamship and secured a bill of lading and the usual invoices. The Chartered Bank located at Cawnpore, India, was the correspondent bank. Transea Traders Ltd. delivered the required documents to Chartered Bank. The crates were not filled with hog bristles, but with “cowhair, other worthless material, and rubbish.”⁴² Prior to payment being made to the Chartered Bank by Schroder, Szejn applied for declaratory and injunctive relief.

Justice Shientag of the New York Supreme Court first restated the importance of the autonomy principle. His Honor considered the principle to be “well established” and that the Issuing Bank makes agreement “to pay upon presentation of documents, not goods.” Justice Shientag regarded the principle as “necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade.” His Honor prefaced the subsequent statements recognizing the fraud exception, by stating that any interference with the autonomy principle would be “most unfortunate” as it would impact on a chief purpose of the letter of credit to furnish the seller with prompt payment for the merchandise. His Honor expressed specific concern to protect business transactions and avoid going behind the documents or entering into controversies between the buyer and the seller regarding the quality of the merchandise shipped.⁴³

Justice Shientag further distinguished the case before him as one involving fraud by the beneficiary and appropriately noted the case was not a mere breach of warranty. His Honor ruled that where the seller’s fraud has been called to the bank’s attention before the drafts and documents have

value but is merely attempting to procure payment of the draft for Transea’s account.” *Szejn*, 31 N.Y.S.2d at 633.

⁴² *Id.*

⁴³ *Id.*

been presented for payment, the autonomy principle⁴⁴ should not be extended to protect an unscrupulous seller.⁴⁵

Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving an intentional fraud on the part of the seller which was brought to the bank's notice with the request that it withhold payment of the draft on this account. The distinction between a breach of warranty and active fraud on the part of the seller is supported by authority and reason.⁴⁶

The Supreme Court of Canada in *Bank of Nova Scotia v Angelica-Whitewear Ltd.*⁴⁷ noted that the English and American decisions differed on the extent to which the fraud exception to the autonomy principle applied. In the English authorities, the letter of credit must be honored unless the beneficiary fraudulently presents false documents and the fraud is clearly established to the knowledge of the Issuing Bank at the time of the presentation of documents.⁴⁸ In the American authorities the principle has been expanded to include fraud in the underlying contract, for example where rubbish is delivered in place of the contract goods and the letter of credit is still called on. The Supreme Court of Canada agreed with the American approach that the fraud exception should extend to fraud in the underlying transaction. The court stated that the fraud exception applies in the underlying transaction where it is "of such a character as to make the demand for payment under the credit a fraudulent one."⁴⁹ In the court's

⁴⁴ Justice Shientag uses the expression "principle of independence." *Id.* at 634.

⁴⁵ *Id.* Justice Shientag repeated his view on fraud as an exception in *Ashbury & Ocean Grove Park Bank v Nat'l City Bank of New York*, 35 N.Y.S. 2d. 985, 988 (N.Y. App. Div. 1942).

⁴⁶ *Id.* at 634-635.

⁴⁷ [1987] 36 D.L.R. 161 (Can.)

⁴⁸ For example see *Bank Russo-Iran v Gordan Woodroffe & Co.* (1972) The Times 4th Oct. (unreported) ("In my judgment, if the documents are presented by the beneficiary himself, and are forged or fraudulent, the bank is entitled to refuse payment if the bank finds out before payment, and is entitled to recover the money as paid under a mistake of fact if it finds out after payment," per Browne LJ).

⁴⁹ *Angelica-Whitewear*, 36 D.L.R. at 176.

view “the fraud exception to the autonomy of a documentary credit should extend to any act of the beneficiary of a credit the effect of which would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud.”⁵⁰

By setting the standard and presenting examples, the Convention is able to redress the inadequacies of the rules of practice approach. The evolution of the customs and practice of letters of credit ignored the fraud exception. The UCP, URDG and ISP98 cannot define predetermined fraud standards whereby the guarantor or issuer is entitled to withhold payment. The UCP makes no attempt to deal with the fraud exception at all, leaving the matter to the courts. The ICC Banking Commission has debated the issue on several occasions and made the conscious choice to leave the matter to the courts.⁵¹ The URDG similarly leaves the question of the fraud exception to the courts. The ISP98 expressly provides that it does not define or otherwise provide for defenses based on fraud, abuse, or similar matters and that these matters “are left to applicable law.”⁵²

The UN Convention the drafters chose to avoid the term “fraud.” Instead, the Convention sets out categories of conduct and then the standards for obtaining court remedies.⁵³

Fraud

*Ex turpi causa non oritur actio*⁵⁴

*Men were deceivers ever ...
The fraud of men was ever so,
Since summer first was leafy ...*⁵⁵

⁵⁰ *Id.* at 177.

⁵¹ *Documentary Credits UCP 500 and 400 Compared*, International Chamber of Commerce [ICC] Publ'n No. 511, 2, 49 (Charles del Busto ed. 1993).

⁵² *See The International Standby Practices 1998 (ISP98)*, R. 1.05, ICC Publ'n No. 590 (Jan. 1, 1999) [hereinafter ISP98].

⁵³ *See* The Convention, *supra* note 12, arts. 19, 20.

⁵⁴ *See* *Holman v. Johnson*, (1775) 98 Eng. Rep. 1120, 1121 (“from a dishonorable cause an action does not arise”).

⁵⁵ WILLIAM SHAKESPEARE, *MUCH ADO ABOUT NOTHING*, Act II, Scene III (A. Wilson Verity, ed., Rivingtons 1890) (1600).

The backbone of the letter of credit is the autonomy principle, dictating that banks deal with documents and are not concerned with nor bound by any underlying contract.⁵⁶ The doctrine of strict compliance compliments the autonomy principle providing the standard of compliance of the documents presented.

Nevertheless, banks face a dilemma when they receive a compliant presentation but conflicting pressure or instructions from the applicant not to honor that presentation. What is fraud? What should be a bank's response where the applicant, in all likelihood the issuing bank's customer, inform the bank of an irregularity in the underlying contract and instruct the bank not to honor the presentation? Assume further that the documents presented complied with the terms of the letter of credit. To what extent should it matter whether the complaint relates to quantity, such as a 1% or 10% shortfall, or the delivery of empty containers? Should the bank be concerned about the quality, such as an inferior but usable product, or perhaps complete rubbish? Should it matter to the bank whether the beneficiary was involved in these irregularities, knowing or otherwise? Does the doctrine of strict compliance require the bank to pay, thus

⁵⁶ The principle is well established in common law, rules of practice and rules of law. For example, UCP600 Articles 4 and 5 contain the embodiment of this principle that credits are separate from the sales or other contracts on which they may be based: "4(a) A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract ... 5 Banks deal with documents and not with goods, services or performance to which the documents may relate." *The Uniform Customs and Practice for Documentary Credits (UCP600)*, ICC Publ'n No. 600 arts. 4, 5 (July 1, 2007). ISP98 provides "[a]n issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant under any applicable agreement, practice, or law." ISP98, *supra* note 52, R. 1.07. The Uniform Commercial Code provides that "[r]ights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of a contract or arrangement out of which the letter of credit arises" and "[a]n issuer is not responsible for ... the performance or non-performance of the underlying contract, arrangement, or transaction." U.C.C. §§ 5-103(d), 5-108(f) (1995). The UN Convention on Independent Guarantees and Standby Letters of Credit is headed "[i]ndependence of undertaking" and provides "an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not ... dependent upon the existence or validity of any underlying transaction, or upon any other undertaking" The Convention, *supra* note 12, art. 3. The URDG provides that "(g)uarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based, and Guarantors are in no way concerned with or bound by such contract(s)" *Uniform Rules for Demand Guarantees (URDG458)*, ICC Publ'n No. 458 art. 2(b) (1993).

rewarding the perpetrator and perhaps amounting to unjust enrichment? The answer to this last question must be emphatically in the negative.⁵⁷

As early as 1765⁵⁸ the courts recognized the fraud exception to letters of credit. However, the value of a letter of credit as an instrument diminishes if the exception is used too readily or abused.⁵⁹ The courts have been sensitive to this concern and have kept the exception within certain bounds. Unfortunately, various jurisdictions have taken different approaches. The courts have used a broad spectrum of words to describe the level of fraud necessary to attract relief, such as: proven, gross, material, established, clearly established, outright, obvious, egregious, clear, of such a character, strong and prima facie, sufficient, sufficiently grave, intentional, active, actual and serious.

Fraud unravels all. This maxim is rooted in common law and equitable tradition. In the letter of credit case of *United City Merchants v. Royal Bank of Canada*⁶⁰ Lord Diplock stated:

The exception of fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, 'fraud unravels all.' The courts will not allow their process to be used by a dishonest person to carry out the fraud.

Fraud "vitiates everything" including judgments and orders of the court.⁶¹ Where a transaction has been spoiled by fraud, that fraud will

⁵⁷ See WUNNICKE ET AL., *supra* note 40, at 158.

⁵⁸ See *Pillans v. Van Mierop* (1765) 3 Burr 1663, 97 ER 1035.

⁵⁹ The autonomy principle and related doctrine of strict performance form the foundation of what makes the letter of credit a valuable commercial instrument. Lord Denning in *Power Curber Int'l Ltd. v Nat'l Bank of Kuwait* (1981) 1 WLR 1233 describes that value stating, "[i]t is vital that every bank which issues a letter of credit should honour its obligations. The bank is in no way concerned with any dispute that the buyer may have with the seller ... It ranks as cash and must be honoured." The purpose of utilizing banks is to secure mutual advantage to both parties to be of advantage to the seller to be given "what has been called in the authorities a 'reliable paymaster'" who can sue, and of advantage to the buyer in that he can make arrangement with his bankers. Justice McNair in *Soproma SpA v Marine & Animal By-Products Corp.* (1966) 1 Lloyd's Rep. 367, 385.

⁶⁰ (1983) 1 AC 168, 184.

⁶¹ Denis Lane McDonnell and John George Monroe, *Kerr on the Law of Fraud and Mistake* 3 (7th ed. 1952).

continue to taint the transaction for as long as negotiations continue and into whatever ramifications it may extend.⁶² The courts will prevent the fraudster and even innocent persons from deriving any benefit, unless such innocent persons have given consideration.⁶³ This approach is applicable to the letter of credit.⁶⁴

The classic statement of fraud, from the common law world, comes from *Derry v. Peek*⁶⁵ that fraud exists “when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or not.”⁶⁶ Fraud includes equitable fraud. In equity, the term “fraud” not only embraces actual fraud, but also other conduct that falls below the standard demanded in equity. There is no exhaustive definition of equitable fraud although the field is applicable to fields of undue influence and unconscionability.

In 1893 Lord Esher in *Leivre v Gould*⁶⁷ held “a charge of fraud is such a terrible thing to bring against a man that it cannot be maintained in Court unless it is shown he had a wicked mind.” Specifically, in letters of credit context, Ventris considers that an accusation of fraud “is one of the most serious which can be made in English litigation and has to be specially pleaded.”⁶⁸

⁶² See *Reynell v. Sprye* (1852) 1 DM G 660, 697; *Smith v. Kay* (1859) 7 HLC 750, 775.

⁶³ See *Scholefield v. Templer* (1859) Johns 155, 4 D & J 429; *Tophamp v. Duke of Portland* (1863) 1 DJ & S 517, 569 per Turner LJ; *Morley v. Lougham* (1893) 1 Ch 736, 757; *Schneider v. Heath* (1813) 3 Camp 506; *Boyd v. Forest* (1911) SC 33, 61; *London and Gen. Omnibus Co. Ltd. v. Holloway* (1912) 2 KB 72, 81; and *Lazarus Estates Ltd. v. Beasley* (1956) 1 QB 702.

⁶⁴ See James E. Byrne, *Commercial Fraud: An Overview*, in 1996 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 34 (1997); and Joseph A. Colleran, *Letter of Credit Fraud -- Who Suffers? How Can it be Overcome?*, in 1996 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 40 (James Byrne ed., 1997).

⁶⁵ (1889) 14 App. Cas. 337, 374.

⁶⁶ In *Peek v. Gurney* (1873) LR 6 HL 377, 403 Lord Cairns considered that fraud existed where there was a partial statement of fact in such a manner that the withholding of what is not stated “makes that which is stated absolutely false.”

⁶⁷ [1893] 1 QB 491, 498.

⁶⁸ F.M. Ventris, *Bankers Documentary Credits* 155 (3d. ed. 1990).

These cases refer to the common law concept. Within the common law system, the distinction is made between common law fraud and equitable fraud. Fraudsters operate within all systems, for example tortious and criminal. In many civil law countries, the concept is known as Rechtsstaat. In the Chinese Rules on Letters of Credit, there were two separate Chinese words used, both of which loosely translated into the word "fraud." Both the common law lawyer and letter of credit lawyer would, on reading the English translation, be pleased with the use of the word "fraud," but could not be certain that the Chinese usage conveyed the same meaning.

Fraud as a Concept

Much if not most of the success of the UCP is due to its ability to reflect the best banking practices rather than litigation inspired rules. The success of its remedy of strict preclusion is due to the underlying soundness of the practice of crediting and debiting accounts of correspondent banks. In contrast, the success of UCC Revised Article 5 and of the Convention depends upon the effectiveness of their remedies.

Few provisions of the Convention make substantive changes to the relatively acceptable level of custom, practice and interpretation currently experienced under the applicable international rules of practice for both independent guarantees and letters of credit. Central to the Convention's ideology is treatment given to allegations of fraud or abuse in demands for payment in undertakings. One stated main purpose of the Convention is to establish greater uniformity internationally in the manner in which guarantors, issuers and courts respond to allegations of fraud or abuse in demands.⁶⁹ Fraud has been a topic that has been "particularly troublesome and disruptive" in practice.⁷⁰ Notwithstanding numerous cases of actual fraud, often allegations of fraud are a fallback strategy for the guarantor or issuer where a dispute has arisen in the underlying contract. The differing approaches and interpretations taken by various jurisdictions complicate the area.⁷¹ The official Explanatory Note to the Convention expresses this concern in the following terms:

⁶⁹ See Explanatory Note, *supra* note 6, cmt. 45.

⁷⁰ *Id.*

⁷¹ *Id.*

That difficulty and the resulting uncertainty have been compounded further because of the *divergent notions* and ways with which such allegations have been treated both by guarantor/issuers and by courts approached for provisional measures to block payment.⁷²

Allegations of fraud and abusive demands threaten the integrity of the undertaking and jeopardize the commercial viability of the undertaking. The Convention aims to ameliorate the problem by the inclusion of circumstances in which courts may order that payment to be blocked. Although the word “fraud” is not used in the Convention, the exceptions to the payment obligation parallel the accepted fraud exception.⁷³

The precise exceptions contained in Article 19 are designed to deal with specific instances and acts. Such an approach is to be welcomed considering the divergent opinions expressed by various jurisdictions.⁷⁴ The article encompasses fact patterns covered in different legal systems by notions such as “fraud” or “abuse of right.” The Convention deliberately avoids the use of the more nebulous term “fraud” and avoids the multiplicity of definitions, interpretations and complications inherent in the case law.

There are two circumstances in which the fraud exception may be relied upon. In the words of the Scottish Court of Sessions in *Royal Bank of Scotland v Holmes*:⁷⁵

The authorities disclose two situations in which (the fraud exception) may be relied upon. It may be deployed in support of an application for interdict to prevent the bank from meeting a demand made by the beneficiary in the letter of credit or guarantee, where the bank’s customer is in a position to satisfy the court that there is a *prima facie* case that the beneficiary is acting fraudulently in making the claim, and that the balance of convenience favours *interim* interdict... The fraud exception may also be deployed as a defence to a claim for reimbursement by the

⁷² *Id.* (emphasis added).

⁷³ See The Convention, *supra* note 12, art. 19.

⁷⁴ See Explanatory Note, *supra* note 6, cmt. 45.

⁷⁵ (1999) Scot CS 10, 29, (1999) SLT 563.

bank against its customer in respect of sums paid in response to the demand of the beneficiary in the letter of credit or guarantee.

The latter situation arises where the confirming or issuing bank has decided that the material brought before it, otherwise in support of applying the fraud exception, was insufficient to withhold payment. Where the issuer wishes to avoid reimbursement to the bank, the issuer must show that a fraud has been committed by the beneficiary, and contrary to the bank's position, the material was sufficient evidence of fraud to justify the bank refusing payment.

The Convention appropriately refers only to the right of the guarantor/issuer to withhold payment. There is no need for the Convention, or any ancillary rules applicable to letters of credit or demand guarantees separately to deal with the second situation as enunciated in the *Holmes* case. Although there are no cases to date due to the recent and limited application of the Convention, where circumstances arise in which the guarantor/issuer declines to exercise the right, as granted by Article 19(1), the principal/applicant correspondingly would question why the guarantor/issuer failed to exercise the right. The contractual relationship between the principal/applicant and guarantor/issuer would impliedly, if not expressly, require the latter to act in good faith and in the best interests of the former. Whilst the guarantor/issuer has an obligation to the beneficiary to make payment on due presentment, this obligation is contemporaneous with the contractual obligation to the principal/applicant to act in the interests of the latter where fraud arises, or more specifically an Article 19(1) situation arises. Just as the guarantor/issuer should consider the position of the principal/applicant where discrepant documents are presented, the guarantor/issuer can be held contractually liable if the right to withhold payment is not exercised to the detriment of the principal/applicant.

Article 19(1) strikes a balance between the competing interests and considerations of the parties involved. The Explanatory Note to the Convention explicates that by giving the guarantor/issuer a right and not a duty and by requiring a good faith component, the Convention is "sensitive to the concern of guarantor/issuers over preserving the commercial reliability of undertakings as promises that are independent from underlying transactions."⁷⁶

⁷⁶ See Explanatory Note, *supra* note 6, cmt. 48.

The Convention does not annul any rights that the principal/applicant may have in accordance with its contractual relationship with the guarantor/issuer to avoid reimbursement of payment made in contravention of the terms of that contractual relationship.⁷⁷

Where the right arises under article 19(1) the Convention affirms that the principal/applicant is entitled to provisional court measures to block payment. The level of fraud typically required for court intervention in similar circumstances under the UCP, ISP98 and URDG is fraught with inconsistent judgments and considerations. Article 20 spells out the circumstances, in which the parties agree to the issue of provisional court measures.⁷⁸

The standard of proof is established in Article 20. Orders may be made where it is shown that there is a “high probability” of the Article 19(1) fraudulent or abusive circumstances “on the basis of immediately available strong evidence.” Additionally, the court must also consider whether the principal/applicant would be “likely to suffer serious harm” in the absence of the provisional measures. In this regard, the court may require the applicant for the order to furnish security. Notably, Article 20(3) adds that the provisional court orders blocking payment or freezing proceeds may also be made in the case of use of an undertaking for a criminal purpose.

⁷⁷ *Id.* cmt. 49.

⁷⁸ Article 20 provides “(1) Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19 is present, the court, on the basis of *immediately available strong evidence*, may: (a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or (b) Issue a provisional order to the effect that the proceeds of the undertaking paid to the beneficiary are *blocked*, taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm. (2) The court, when issuing a provisional order referred to in paragraph (1) of this article, may require the person applying therefor to furnish such form of security as the court deems appropriate. (3) The court may not issue a provisional order of the kind referred to in paragraph (1) of this article based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19, or use of the undertaking for a criminal purpose.” The Convention, *supra* note 12, art. 20 (emphasis added).

Balancing Competing Principles

The fraud exception has been fashioned even from the *Sztejn* decision, not to violate the autonomy principle. The courts have kept a balance between maintaining the integrity, certainty and stability of the letter of credit as an international tour de force, with ensuring that rogues do not profit from their actions and that the letter of credit is not used as a vehicle to facilitate fraud.⁷⁹

In *Dynamics Corporation of America v Citizens & Southern National Bank*⁸⁰ the court, without coming to a conclusion, wrestled with the competing views of considering the plaintiff's "chance of winning this suit." "There is as much public interest in discouraging fraud as in encouraging the use of letters of credit."⁸¹ Too few courts have recognized the need to balance the competing interests, in particular, appreciating the importance of maintaining the integrity and credibility of the letter of credit.

Bernard Wheble sardonically states: "(t)he way to avoid fraud is to avoid dealing with a rogue."⁸² Wheble is referring to circumstances where fraud cannot be avoided. Leaving the matter purely to actions at law based on the underlying contracts will prove inadequate. Only attacking the disease at the root will accord a sense of justice. This has been recognized since at least *Derry v. Peek* and adopted and used by courts dealing with letter of credit issues.

In the context of the fraud exception, the UN Convention removes the uncertainties of terminology and provides a sound strategy and basis.

⁷⁹ Hence the well respected statement, "[i]t is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks," made by Judge Kerr in *R D Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.* (1977) 2 All ER 862, 870, (1977) 3 WLR 752, 761. See also Greg A. Fellingner, *Letters of Credit: The Autonomy Principle and the Fraud Exception*, 2 J. OF BANKING AND FIN. LAW, 4, 7 (1990) (concluding that "the utility of letters of credit in international transactions no longer presents a compelling rationale for upholding a strict autonomy rule"); and Nicholas Thodos, *Mareva Injunction, Attachment and the Independence Principle: Balancing the Interests*, 6 J. OF BANKING AND FIN. LAW AND PRAC. 101 (1995).

⁸⁰ 356 F. Supp. 991 (N.D. Ga. 1973).

⁸¹ *Id.* at 1000.

⁸² Bernard Wheble, ICC Publ'n No. 411, UCP 1974/1983 Revisions Compared and Explained (Documentary Credits) 15 (1984).

This assists banks and commercial parties in determining circumstances in which Articles 19 and 20 apply to know when payment ought to be withheld. When put to the test in litigation the Convention will succeed in its stated aim:

A main purpose of the Convention is to establish greater uniformity internationally in the manner in which guarantor/issuers and courts respond to allegations of fraud or abuse in demands for payment under independent guarantees and stand-by letters of credit.⁸³

⁸³ Explanatory Note, *supra* note 6, cmt. 45.