

**The Fraud Rule under the UN Convention on Independent Guarantees  
and Standby Letters of Credit: A Significant Contribution from an  
International Perspective**

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**Introduction**

Letters of credit are developed from international trade and have been said to be “the life blood of international commerce.”<sup>1</sup> Independent guarantees are synonyms of letters of credit in their legal nature. These instruments are widely used in varieties of international commercial transactions. Because of the highly international nature of letters of credit and independent guarantees, few individual countries in the world have introduced legislations governing them. Where there is any, so far with the exception of Article 5 of the Uniform Commercial Code (UCC) in the United States (US) and the *Rules of the Supreme People’s Court concerning Several Issues in Hearing Letter of Credit Cases*<sup>2</sup> (PRC LC Rules) in the People’s Republic of China (PRC), “it tends to consist of only a few provisions of a general nature.”<sup>3</sup>

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<sup>1</sup> R.D.Harbottle (Mercantile) Ltd. v. Nat’l Westminster Bank Ltd., (1978) 1 Q.B. 146, 155.

<sup>2</sup> The PRC LC Rules are a set of judicial interpretation. Judicial interpretations are made by the Supreme People’s Court of the PRC to provide practical guidance to all levels of courts in the PRC for the application of law with respect to a particular issue, a specific statute or an area of law if no statute exists therein. They are detailed, problem-solving orientated. Although they are not formally called as “law,” they are law in practical sense because they are cited in court decisions and legally effective. If there is no statute in an area, and a judicial interpretation has been made, that judicial interpretation has in fact become the only “law” in that area. The PRC LC Rules were promulgated by the Supreme People’s Court of the PRC in 2005 and became effective on January 1, 2006.

<sup>3</sup> The Secretary-General, Report of the Secretary General: Standby Letters of Credit and Guarantees, delivered to the Commission on International Trade Law, U.N. Doc. A/CN.9/301 (March 21, 1988).

The law of letters of credit has developed largely through customs of international trade.<sup>4</sup> Those customs have been mostly codified by the International Chamber of Commerce (ICC) in the *Uniform Customs and Practice for Documentary Credits* (UCP),<sup>5</sup> the *Uniform Rules for Contract Guarantees* (URCG),<sup>6</sup> the *Uniform Rules for Demand Guarantees* (URDG)<sup>7</sup> and the *International Standby Practices* (ISP98)<sup>8</sup>. Moreover, the United Nations Commission on International Trade Law (UNCITRAL) has introduced the *United Nation Convention on Independent Guarantees and Standby Letters of Credit* (the Convention).<sup>9</sup>

Letters of credit and independent guarantees are documentary transactions, which mean that what the presenter requiring payment under these instruments has to do is to produce documents on their face complying with the terms and conditions of the instrument. Because of their documentary nature, these instruments can be easily abused or are prone to the problem of fraud. As a result, over the years “a huge volume of case law concerning the issue of fraud has grown up. Legal writing on this topic is no

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<sup>4</sup> Boris Kozolchyk, *Letters of Credit*, 9 INT'L ENCYCLOPAEDIA OF COMPARATIVE LAW 10 (Jacob S. Ziegel ed., 1979).

<sup>5</sup> The UCP was first issued by the ICC in 1933 and has been revised six times ever since. The current version is known as “UCP600”, which was passed at the ICC Banking Commission meeting on October 25, 2006 and became effective on July 1, 2007. All texts referred to in this article are from UCP600, unless otherwise acknowledged. See *The Uniform Customs and Practice for Documentary Credits (UCP600)*, International Chamber of Commerce [ICC] Publ'n No. 600 (July 1, 2007) [hereinafter UCP600].

<sup>6</sup> *Uniform Rules for Contract Guarantees (URCG)*, ICC Publ'n No. 325 (1978).

<sup>7</sup> *Uniform Rules for Demand Guarantees (URDG458)*, ICC Publ'n No. 458 (1992). The URDG was recently revised effective after the date of drafting. All texts referred to in this article are from URDG458, unless otherwise acknowledged.

<sup>8</sup> *The International Standby Practices 1998 (ISP98)* ICC Publ'n No. 590 (Jan. 1, 1999) [hereinafter ISP98].

<sup>9</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit art. 5, Dec. 11, 1995, A/RES/50/48, available at <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> [hereinafter The Convention]. As of 1 November 2010, eight nations have ratified or acceded to the Convention: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The United States of America has signed the Convention but has not yet ratified it or acceded to it. United Nations Treaty Status Database ch. X § 15, <http://treaties.un.org/doc/Publication/MTDSG/Volume%20I/Chapter%20X/X-15.en.pdf> (last visited Nov. 1, 2010).

less voluminous.”<sup>10</sup> In other words, the fraud rule has been a topic in the law of letters of credit and independent guarantees in practice. Nevertheless, in striking contrast to the practice, all the rules made by the ICC are silent or nearly silent with the issue of fraud. In the international level, only the Convention has made an effort to deal with the issue.

The purpose of this article to demonstrate and argue that the Convention has made a unique and significant contribution to the law of letters of credit and independent guarantees as a result of its position to the fraud rule at the international level. To facilitate the discussion, Part II will briefly introduce the mechanics of letters of credit and independent guarantees. Part III will provide a short summary about the development and the tenor of the fraud rule in the law of letters of credit at both the national and international level. Part IV will focus in detail on the provisions with regard to the fraud rule under the UN Convention. Part V concludes the article.

### **I. Mechanics of Letters of Credit and Independent Guarantees**

As mentioned, the letter of credit has been developed through international trade, so a simple example of international trade easily illustrates the operation of a letter of credit. Assume a seller in Shanghai wishes to sell TV sets to a buyer in New York. The seller and the buyer are strangers. The seller is worried that, if it delivers the goods first, the buyer may become insolvent or refuse to pay upon arrival of the goods. If the buyer does not pay, the seller will have to go to great expense to sue the buyer in a foreign jurisdiction, and may also have to incur the costs of disposing of the goods in an unfamiliar territory. In turn, the buyer is worried that it may not receive the goods if it pays the seller in advance. To assuage the parties' legitimate fears, they agree to conduct the transaction through a letter of credit, a smart merchant creature.

Under the letter of credit transaction, the buyer is normally required to procure an irrevocable letter of credit from a bank of good reputation. If the bank agrees to issue the letter of credit, it will be committed to honor a draft made by the seller upon its proper presentment of the draft accompanied by the documents specified in the letter of credit evidencing the seller's performance of the sales contract, which usually include a bill of lading – a document of title signifying the seller's ownership of the goods. The seller under such a transaction retains the ownership of the goods until it presents

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<sup>10</sup> ROELAND BERTRAMS, *BANK GUARANTEES IN INTERNATIONAL TRADE* 335 (3d. ed. 2004).

the documents to the bank, at which time it is either paid in the case of a sight draft, or promised to be paid at the maturity of the draft by the bank through its acceptance of the draft in the case of a time draft. The buyer knows that its money will not be paid to the seller unless the seller produces documents indicating that the goods have been shipped. The bank pays the seller for the buyer by taking security (a pledge) over the documents to secure the advance made financing the transaction.

This simple letter of credit transaction involves three parties: (1) the buyer, known as the applicant or the account party under the law of letter of credit; (2) the seller, known as the beneficiary; and (3) the bank, known as the issuer. It also involves three transactions: (1) the sales transaction, known as the underlying transaction between the buyer and the seller; (2) the transaction or the application agreement between the buyer and the bank; and (3) the transaction between the bank and the seller, which is the letter of credit itself.<sup>11</sup>

There are two fundamental principles under the law of letters of credit: the principle of independence and the principle of strict compliance. Under the former, the transactions under a letter of credit arrangement are separate and independent from each other,<sup>12</sup> and the letter of credit is a documentary transaction, under which “[b]anks deal with documents and not with goods, services or performance to which the documents may relate.”<sup>13</sup> The issuer is

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<sup>11</sup> In practice, more often than not, more parties and transactions are involved. For example, the issuing bank notifies the seller, usually through a correspondent bank in the seller's country. The correspondent bank may be instructed to act as an advising bank, which is a mere intermediary transmitting information, or to add to its own undertaking as a confirming bank, or to participate in the transaction as a negotiating bank by purchasing the drafts drawn by the beneficiary. Sometimes, a letter of credit transaction may only involve two parties. This kind of letter of credit is known as two-party letter of credit. For illustrations of two-party letters of credit, see Gerald T. McLaughlin, *Two Party Letters Of Credit: Two More Problems Than Three*, 4 J.B.F.L.P. 226 (1993); Gerald T. McLaughlin & Neil B. Cohen, *Commercial Law*, 9 N.Y.L.J. 3 (1993).

<sup>12</sup> UCP600, *supra* note 5, art. 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, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.”).

<sup>13</sup> *Id.* art. 5.

required to pay the beneficiary, irrespective of any disputes or claims relating to the underlying transaction between the beneficiary and the applicant.<sup>14</sup> The issuer is entitled to make the payment in good faith with full recourse against the applicant, even if the seller's documents turn out to be forgeries or fraudulent.<sup>15</sup> The issuer's only concern is whether the documents tendered conform on their face with the terms and conditions of the letter of credit.<sup>16</sup>

Under the principle of strict compliance, every party to a letter of credit transaction wishing to receive payment has to tender complying documents. If the documents tendered are on their face in strict compliance with the terms and conditions of the credit, the party who is obliged to honor the obligation under the letter of credit must take up the presentation and honor its obligation.<sup>17</sup> If the documents are not in compliance with the terms and conditions of the letters of credit, the beneficiary may not get paid even

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<sup>14</sup> *Hamzeh Malas & Sons v. British Imex Industrials Ltd.* (1958) 2 Q.B. 127, 129 ("it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character."). *See also* Henry Harfield, *Quibbler's Corner*, *STANDBY AND COMMERCIAL LETTERS OF CREDIT* vi (2d. ed. 1996).

<sup>15</sup> UCP600, *supra* note 5, art. 34 ("A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance represented by any document, or for the good faith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person.").

<sup>16</sup> *Id.* art. 14(a) ("A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.").

<sup>17</sup> *Id.* art. 15 ("(a) When an issuing bank determines that a presentation is complying, it must honour. (b) When a confirming bank determines that a presentation is complying, it must honour or negotiate and forward the documents to the issuing bank. (c) When a nominated bank determines that a presentation is complying and honours or negotiates, it must forward the documents to the confirming bank or issuing bank.").

though it has fully performed the underlying contract.<sup>18</sup>

Modern letters of credit are divided into two basic forms according to their distinctive commercial function and usage: commercial letters of credit and standby letters of credit. Commercial letters of credit are the traditional form of letters of credit created as a payment and mechanism for international sales of goods, as illustrated above. Standby letters of credit are used as a default instrument to provide security to the beneficiary against the (hopefully) unlikely contingency of the applicant's defective performance or non-performance of the underlying contract. For example, a US construction company contracts with the Iraqi Ministry of Oil (IMO) to build an oil pipeline in Iraq. To guarantee the US contractor's proper performance of the construction contract, the IMO requires the US contractor to provide a standby letter of credit in its favor. In case the US contractor defaults on the underlying construction contract, the IMO will present the required documents to the issuer of the standby letter of credit for payment. This demonstrates that a simple standby letter of credit transaction also involves three parties (the applicant, the issuer and the beneficiary) and three transactions (the underlying transaction, the application agreement and the letter of credit itself). Although the commercial function of standby letter of credit is different from that of commercial letters of credit, standby letters of credit operate legally in the same basic framework as commercial letters of credit.<sup>19</sup>

Standby letters of credit are used in a wide range of transactions. They are particularly used in industries like construction, finance and the

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<sup>18</sup> *Id.* art. 16 (a). When a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate. However, discrepancies in the documents may be cured or waived. In 1987, a survey in the United States revealed that 90% of documents initially tendered contained discrepancies, but no more than 1% were incurable. See Boris Kozolchik, *Strict Compliance and the Reasonable Document Checker*, 56 BROOK. L. REV. 45, 48 (1990).

<sup>19</sup> James E. Byrne, ISP98, *supra* note 8, *Preface*.

international sales of goods.<sup>20</sup> In the words of Professor Dolan, “[t]here are virtually no limits to the variety of transactions that the standby credit can serve. In principle, standby credits can be used in any contract where the performance of one party is executory.”<sup>21</sup>

Independent guarantees<sup>22</sup> have similar commercial functions as standby letters of credit. That is to provide security against the possibility that some contingency may occur. A simple independent guarantee transaction has a similar mechanism to that of a letter of credit, involving three parties and

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<sup>20</sup> For more discussion on the use of standby letters of credit, see JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS*, 1, 1-24 (rev. ed. 2003 and 2006 Supplement No. 2, A.S. Pratt & Sons, 2006) (1984); Gordon B. Graham & Benjamin Geva, *Standby Credits in Canada*, 9 CAN. BUS. L.J. 180, 184 (1984); Cassondra E. Joseph, *Letters Of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816 (1977); Boris Kozolchyk, *The Financial Standby: A Summary Description of Practice and Related Legal Problems*, 28 UCC L.J. 327 (1996); Daniel E. Murray, *Letters of Credit in Nonsale of Goods Transactions*, 30 BUS LAW 1103 (1975); MICHAEL ROWE, *GUARANTEES, STANDBY LETTERS OF CREDIT AND OTHER SECURITIES* (1987); Reade H. Ryan, *Letters of Credit Supporting Debt for Borrowed Money: The Standby As Backup*, 100 BANKING L.J. 404 (1983).

<sup>21</sup> DOLAN, *supra* note 20, at 1-24. For a similar comment from another prominent letters of credit authority, see Boris Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 319, 320 (1982) (“the standby credit can encompass virtually every obligation known to man.”).

<sup>22</sup> This kind of guarantee has many other names: bank guarantee, first demand guarantee, independent guarantee, on-demand guarantee, performance guarantee, unconditional bond or performance bond. See Boris Kozolchyk, *Bank Guarantees and Letters of Credit: Time for a Return to the Fold*, 11 U. PA. J. INT’L BUS. L. 1, 13-14 (1989); UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, n.8, U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccess-ods.un.org/TMP/9645256.html> [hereinafter Explanatory Note]. For a thorough treatment of independent guarantees, see BERTRAMS, *supra* note 10; Roy M. Goode, *The New ICC Uniform Rules Of Demand Guarantees*, LLOYD’S MAR. COM. L.Q. 190 (1992).

three transactions.<sup>23</sup> Independent guarantees legally stand “on a similar footing to a letter of credit,”<sup>24</sup> or “governed by the same principles as letters of credit.”<sup>25</sup> The two fundamental principles of letters of credit have been consistently applied to independent guarantees by the courts.<sup>26</sup> They share the same legal character of a letter of credit, in that the issuer’s obligation of payment is triggered simply by presentation by the beneficiary of complying documents or a simple demand, and the issuer/guarantor<sup>27</sup> is not concerned with whether there has been actual default by the principal. Therefore, standby letters of credit and independent guarantees are synonyms in law. They are all separate, independent and documentary undertakings in legal nature, and can be used interchangeably in practice.<sup>28</sup>

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<sup>23</sup> In practice, like commercial letters of credit, standby letters of credit and independent guarantees normally involve more than three parties and three transactions, and they can be used interchangeably. This can be illustrated by cases decided by US courts in relation to dealings between US companies and Iranian agencies following the Islamic Revolution (Iranian cases). In the Iranian cases, almost all transactions involved four parties—a US company, an Iranian agency, an Iranian bank, and a US Bank. The US company contracted with the Iranian agency to provide goods or services in Iran. The independent guarantees were issued by the Iranian bank and counter-guaranteed by standby letters of credit issued by the US bank in favour of the Iranian Bank at the request of the US company. In the event of a dispute the Iranian agency would demand payment under the guarantee from the Iranian bank, the Iranian bank would demand payment under the standby from the US bank, and the US bank would in turn look to the US company for reimbursement.

<sup>24</sup> See *Edward Owen Engineering Ltd. v. Barclays Bank Int'l Ltd.* (1978) 1 Q.B. 159, 170-171. See also *Bolivinter Oil SA v. Chase Manhattan Bank, (C.A.)* (1984) 1 Lloyd’s Rep. 251, 257; *Deutsche Ruckversicherung AG v. Walbrook Insurance Co. Ltd.* (1994) 4 All ER 181, 194; *RD Harbottle (Mercantile) Ltd. v. Nat'l Westminster Bank Ltd.* (1977) 2 All ER 862, 870.

<sup>25</sup> Agasha Mugasha, *THE LAW OF LETTERS OF CREDIT AND BANK GUARANTEES* 21 (The Federation Press 2003).

<sup>26</sup> See e.g., *Edward Owen Engineering Ltd. v. Barclays Bank Int'l Ltd.* (1978) 1 QB 159; *Howe Richardson Scale v. Polimex-Cekop* (1978) 1 Lloyd’s Rep. 161; *RD Harbottle (Mercantile) Ltd. v. Nat'l Westminster Bank Ltd.* (1977) 2 All ER 862.

<sup>27</sup> The terms used for the parties under independent guarantees are slightly different from those under letters of credit: the applicant or account party under a letter of credit is known as the instructing party, the principal or the account party under an independent guarantee; the issuer under a letter of credit is known as the guarantor under an independent guarantee; but the party in whose favor the letter of credit or independent guarantee is issued is known as the beneficiary under both of the instruments.

<sup>28</sup> While standby letters of credit are originated and widely used in the US, independent guarantees are commonly issued by European institutions. Both of them are interchangeably used in other regions. Cf. Mugasha, *supra* note 25, at 19-20.



Therefore, in this article, commercial letters of credit, standby letters of credit and independent guarantees are used interchangeably.

## II. The Development and Elements of the Fraud Rule

As has been illustrated, under the law of letters of credit, the beneficiary requiring payment does not have to show the issuer that it has properly performed its duties under the underlying transaction. All it needs to do is to produce documents on their face complying with the terms and conditions of the letter of credit. This leaves a loophole for unscrupulous beneficiaries to abuse the system and defraud the other parties involved. A simple example in a commercial letter of credit transaction would be a situation where the seller is paid by the issuer upon presenting documents complying on their face with all the requirements set out in the letter of credit, but the buyer does not receive the goods because the documents are in fact pure forgeries. An action by the applicant on the underlying contract against the beneficiary would normally be ineffectual as the fraudster would normally disappear in such a case. To prevent unfair situations as such from happening, the fraud rule has been developed.<sup>29</sup>

The fraud rule in the law of letters of credit is recognized as the exception to the principle of independence, allowing the issuer or the court to view the facts behind the face of conforming documents and disrupting payment of a letter of credit. Under the fraud rule, although documents presented are on their face in strict compliance with the terms and conditions of the letter of credit, payment may be stopped if fraud is found to have been committed in the transaction before payment is made, provided that the presenter does not belong to a protected class, such as a holder in due course.

### 1. The Catalyst: the *Sztejn* Case

The landmark case with regard to the development of the fraud rule in the law of letters of credit is *Sztejn v. J Henry Schroder Banking Corp*<sup>30</sup> in the US. In this case, Sztejn and others contracted to buy bristles from an Indian company and asked Schroder to issue a letter of credit in favor of the

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<sup>29</sup> Greg A. Fellingner, *Letters of Credit: the Autonomy Principle and the Fraud Exception*, 1 J. B.F.L.P. 4, 6 (1990).

<sup>30</sup> 31 N.Y.S. 2d 631 (N.Y. App. Div. 1941).

seller. The seller shipped fifty cases of “cowhair, other worthless material and rubbish,”<sup>31</sup> procured the documents required under the letter of credit and drew a draft to the order of Chartered Bank, which presented to Schroder for payment. Before payment was made, Sztejn filed a suit to prevent the issuer from paying the draft. Sztejn also claimed that the presenting bank was merely a collecting bank, not an innocent holder of the draft for value. The presenting bank moved to dismiss the complaint on the ground that it failed to state a cause of action because “the Chartered Bank is only concerned with the documents and on their face these conform to the requirements of the letter of credit.”<sup>32</sup>

Justice Shientag assumed that all allegations in the complaint were true, rejected the Chartered Bank’s motion and ruled for the plaintiff. In reaching his decision, Justice Shientag stated:

[W]here the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. ... On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied. If it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud.<sup>33</sup>

The *Sztejn* case has established three crucial elements of the fraud rule: 1) payment under a letter of credit can be stopped in a case of fraud; 2) payment under a letter of credit can only be stopped when fraud is established; and 3) payment should be made, notwithstanding the existence of proven fraud, if demand for payment is made by a holder in due course.

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<sup>31</sup> *Id.* at 633.

<sup>32</sup> *Id.* at 632.

<sup>33</sup> *Id.* at 634-635.

*Sztejn* has been cited by many courts with approval outside the US<sup>34</sup> and the fraud rule it established has been recognized worldwide.<sup>35</sup>

## 2. Article 5 of the UCC

The fraud rule manifested in the *Sztejn* case has been codified and fine-tuned in Article 5 of the UCC in the US.<sup>36</sup> Section 5-109 of Article 5 of the UCC reads:

- (a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:
  - (1) the issuer shall honour the presentation, if honour is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honoured its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and
  - (2) the issuer, acting in good faith, may honour or dishonour the presentation in any other case.
- (b) If an applicant claims that a required document is forged or materially fraudulent or that honour of the presentation

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<sup>34</sup> For a UK case, see *United City Merchs. v. Royal Bank of Canada* (1979) 1 Lloyd's Rep. 267, (1981) 1 Lloyd's Rep. 604, (1983) A.C. 168. For an Australian case, see *Contronic Distribs. Pty. Ltd. v. Bank of New South Wales* (1984) 3 N.S.W.L.R. 110. For a Canadian case, see *Bank of Nova Scotia v. Angelica-Whitewear Ltd.* [1987] 36 D.L.R. 4th 161 (Can.).

<sup>35</sup> See BERTRAMS, *supra* note 10, at 335-447.

<sup>36</sup> Article 5 of the UCC was first issued in the 1950's and was revised in 1995. All texts referred to in this article are from the 1995 version.

would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the courts find that:

- (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
- (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
- (3) all of the conditions to entitle a person to the relief under the law of this State have been met; and
- (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honour does not qualify for protection under subsection (a)(1).

Section 5-109 of Article 5 of the UCC has restated the three basic elements of the fraud rule established by *Sztejn*: 1) payment can be stopped if fraud is involved in a letter of credit transaction; 2) payment under a letter of credit can only be stopped when fraud is established; and 3) payment should be made if demand is made by an innocent party such as a holder in due course. Moreover, section 5-109 of Article 5 of the UCC has improved the fraud rule in a number of respects. First, it clearly provides when fraud is found, payment of a letter of credit may be stopped by two ways: by the issuer's dishonor of the presentation<sup>37</sup> or by a court order to prevent payment by the issuer.<sup>38</sup> Secondly, it provides that the fraud rule can only be applied when "material" fraud is established,<sup>39</sup> setting up a clear standard

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<sup>37</sup> U.C.C. § 5-109(a)(2) (1995).

<sup>38</sup> *Id.* § 5-109(b).

<sup>39</sup> *Id.* § 5-109(a)-(b).

of fraud that can invoke the fraud rule.<sup>40</sup> Thirdly, it has listed four types of persons that may be immune from the fraud rule,<sup>41</sup> rather than one as indicated in *Sztejn*. Finally, it has stipulated four procedural conditions that must be met when a court considers an injunction.<sup>42</sup>

### 3. The PRC LC Rules

The PRC is the only other country, apart from the US, which has issued a full set of rules with regard to letters of credit. The fraud rule is the major focus of the PRC LC Rules. There are altogether eighteen articles in the PRC LC Rules, eight of which are devoted to the fraud rule. Having learned from the court practices of other jurisdictions, the provisions of Article 5 of the UCC and the Convention,<sup>43</sup> and having taken into consideration of the special nature of letters of credit and the practice of the Chinese courts in the past, the drafters of the PRC LC Rules have tried to make the rules as detailed and comprehensive as possible, covering both substantive and procedural matters of the law.<sup>44</sup>

Article 8 of the PRC LC Rules has first provided the type or the standard of fraud that can invoke the fraud rule by introducing the concept of “letter of credit fraud” to indicate that the fraud in the law of letters of credit is not entirely as the same as in general civil and commercial cases. Having in particular learned from Article 19 of the Convention, Article 8 of the PRC LC Rules has named four types of situations that can invoke the fraud rule, namely:

- (1) The beneficiary has forged documents or presented documents containing fraudulent information;

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<sup>40</sup> The standard of fraud has proven to be the most controversial issue in the application of the fraud rule. For a detailed treatment of the issue, see Xiang Gao & Ross Buckley, *A Comparative Analysis of the Standard of Fraud Required under the Fraud Rule in Letter of Credit Law*, 12 DUKE J. COMP. & INT'L L. 293 (2003).

<sup>41</sup> U.C.C. § 5-109(a)(1) (1995).

<sup>42</sup> *Id.* § 5-109(b).

<sup>43</sup> For details, see *infra* Part IV.

<sup>44</sup> For a thorough treatment of the PRC LC Rules, see Xiang Gao, *Fraud Rule in the Law of Letters of Credit in the PRC*, 41 INT'L LAW. 1067 (2007).

- (2) The beneficiary has intentionally failed to deliver goods or delivered goods with no value;
- (3) The beneficiary has conspired with the applicant or a third party and presented fraudulent documents whereas there is no actual underlying transaction; or
- (4) Other circumstances that constitute letter of credit fraud.

Similar to section 5-109(a)(1) of Article 5 of the UCC, Article 10 of the PRC LC Rules has named four types of situations in which the fraud rule cannot be applied, even if fraud is established in a letter of credit transaction. They are:

- (1) The nominated person or the person authorised by the issuing bank has paid in good faith in accordance with the instructions of the issuing bank;
- (2) The issuing bank or its nominated or authorized person has accepted the draft under the letter of credit in good faith;
- (3) The confirming bank has paid in good faith; or
- (4) The negotiation bank has negotiated in good faith.

The other six articles of the PRC LC Rules are all related to procedural matters. Among them, Articles 9 and 11 are the most important. Article 9 provides who can take a court action to prevent payment under the letter of credit, saying that “[t]he applicant, the issuing bank or any other interested party may apply to a competent people’s court for a ruling to suspend the payment ... .” Similar to section 5-109(b) of Article 5 of the UCC and Article 20 of the Convention, Article 11 of the PRC LC Rules has specified procedural conditions that must be met when a court considers measures to stop payment of a letter of credit, providing:

- (1) The people’s court receiving the application has the competent jurisdiction over the case;
- (2) The evidence rendered by the applicant has established the existence of the circumstances set out in Article 8 hereinbefore;
- (3) The applicant will suffer irreparable damage if a ruling to suspend the payment is not issued;

- (4) The applicant has provided effective and adequate security; and
- (5) The circumstances set out in Article 10 hereinbefore do not exist.

In particular, it is worthwhile to point out that, under Article 11(2) of the PRC LC rules, the fraud rule can only be applied when fraud is “established.”

#### 4. The ICC Rules

##### A. Uniform Customs and Practice (UCP)

The UCP is a compilation of internationally accepted banking customs and practice regarding letters of credit. It is the most successful harmonizing measure in the history of international commerce.<sup>45</sup> It is “the cornerstone of the law pertaining to letters of credit.”<sup>46</sup> It is virtually incorporated into every letter of credit.<sup>47</sup> However, the UCP is silent with respect to the fraud rule. “Both the content and the interpretation of the ICC uniform rules are influenced by the fact that their function is to serve as rules of best banking practice, not rules of law.”<sup>48</sup> As the fraud issue is traditionally considered as the province of the applicable law and of the courts of the forum,<sup>49</sup> the drafters of the UCP, who are aware of the fraud issue,<sup>50</sup> have deliberately left it out.<sup>51</sup>

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<sup>45</sup> Goode, *supra* note 22, at 190.

<sup>46</sup> E.P. Ellinger, *The Uniform Customs—Their Nature and the 1983 Revision*, (1984) L.M.C.L.Q. 578, 578. See e.g., James G. Barnes, *Internationalisation of Revised UCC Article 5 (Letters of Credit)*, 16 NW. J. INT’L L. & BUS. 215, 216 (1995) (“The UCP ... is incorporated into substantially all across-border commercial letters of credit, studied and observed by letter of credit bankers and users worldwide, and treated as quasi-law.”).

<sup>47</sup> S. Isabella Chung, *Developing a Documentary Credit Dispute Resolution System: An ICC Perspective*, 19 FORDHAM INT’L L.J. 1349, 1355 (1996); DOLAN, *supra* note 20, at 6-2; Ellinger, *supra* note 46, at 583.

<sup>48</sup> Roy M. Goode, *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, 39 ST. LOUIS U. L.J. 725, 727 (1995).

<sup>49</sup> Ross P. Buckley, *1993 Revision of the Uniform Customs and Practice for Document Credit*, 28 GEO. WASH. J. INT’L & ECON. 266, 302-3 (1995).

<sup>50</sup> John F. Dolan, *Commentary on Legislative Developments in Letters of Credit Law: An Interim Report*, 8 B.F.L.R. 53, 63 (1992).

## B. Uniform Rules for Contract Guarantees (URCG)

The URCG was published by the ICC in 1978.<sup>52</sup> The purpose of the URCG was to respond to the need for a set of standard rules to deal with ambiguities or inconsistencies in the field of “[g]uarantees given by banks, insurance companies and other guarantors in the form of tender bonds, performance guarantees and repayment guarantees in relation to projects in another country involving the supply of goods or services or the performance of work.”<sup>53</sup> Unlike the UCP, the URCG has attempted to tackle the issue of fraud in the context “unfair calling” of independent guarantees in some extent. Article 9 of the URCG provides:

If a guarantee does not specify the documentation to be produced in support of a claim or merely specifies only a statement of claim by the beneficiary, the beneficiary must submit:

- (a.) in the case of a tender guarantee, his declaration that the principal’s tender has been accepted and that the principal has then either failed to sign the contract or has failed to submit a performance guarantee as provided for in the tender, and his declaration of agreement, addressed to the principal, to have any dispute on any claim by the principal for payment to him by the beneficiary of all or part of the amount paid under the guarantee settled by a judicial or arbitral tribunal as specified in the tender documents or, if not so specified or otherwise agreed upon, by arbitration in accordance with the Rules of the ICC Court of Arbitration or with the UNCITRAL Arbitration Rules, at the option of the principal;
- (b.) in the case of a performance guarantee or of a repayment guarantee, either a court decision or an arbitral award justifying the claim, or approval

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<sup>51</sup> Katherine A. Barski, *Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits*, 41 LOY. L. REV. 735, 751 (1996).

<sup>52</sup> See URCG, *supra* note 6.

<sup>53</sup> *Id.* at 7; Cf. James E. Byrne, *Fundamental Issues in the Unification and Harmonisation of Letter of Credit Law*, 37 LOY. L. REV. 1, 4 (1991).



of the principal in writing to the claim and the amount to be paid.

The URCG has rarely been used in practice since its publication.<sup>54</sup> It has been said that the major hurdle to the acceptance of the URCG is its requirement of “the production of a judgment or arbitral award or the principal’s written approval of the claim and its amount”<sup>55</sup> as a condition for the beneficiary to obtain payment. Strictly speaking, provisions of Article 9 of the URCG are not the same as the fraud rule under discussion. The fraud rule is concerned with the circumstances under which payment of a letter of credit or independent guarantee can be disrupted. Article 9 of the URCG provides the conditions that trigger the payment of independent guarantees.

### C. Uniform Rule for Demand Guarantees (URDG)

As the URCG was rarely accepted and used in the market, the ICC decided to replace it with a new set of rules with regard to independent guarantees. The URDG takes a similar position to the UCP on the issue of fraud —basically to be silent and leave it to the courts of the various jurisdictions. It merely implicitly goes some small way towards putting restrictions on the beneficiary’s right of payment in Article 20 in order to prevent the beneficiary’s outright unjustified calling, saying:

- a) Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:
  - (i) that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of tender guarantee, the tender conditions; and
  - (ii) the respect in which the Principal is in breach.

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<sup>54</sup> Filip De Ly, *The UN Convention on Independent Guarantees and Standby Letters of Credit*, 33 INT’L LAW. 831, 835 (1999).

<sup>55</sup> Roy M. Goode, *Guide To The ICC Uniform Rules For Demand Guarantees*, ICC Publ’n No. 510, 6 (1992).

- b) Any demand under the Counter-Guarantee shall be supported by a written statement that the Guarantor has received a demand for payment under the Guarantee in accordance with its terms and with this Article.
- c) Paragraph (a) of this Article applies except to the extent that it is expressly excluded by the terms of the Guarantee. Paragraph (b) of this Article applies except to the extent that it is expressly excluded by the terms of the Counter-Guarantee.

Article 20 of the URDG requires the beneficiary demanding payment to state in writing both that there is some kind of breach of the underlying transaction and what type of breach is involved, thus giving the other parties some kind of protection by providing a ground for a claim of fraud. However, this provision is similar to Article 9 of the URDG, providing a kind of safety device for the trigger of the payment of the independent guarantee to prevent fraud, but differs from the fraud rule under discussion, which addresses what to do when fraud is found to have been committed.

#### **D. International Standby Practices (ISP98)**

The ISP98 is “specifically designed for standby letters of credit.”<sup>56</sup> It takes a similar approach to the UCP and expressly leaves the issue of fraudulent or abusive drawing or “defenses to honour based on fraud, abuse or similar matters ... to applicable law.”<sup>57</sup> Under Rules 4.16 and 4.17 of the ISP98, a demand for payment under a standby letter of credit is not required to indicate a default or other event in the underlying transaction if that is not required under the terms and conditions of the standby letter of credit. Therefore, it is even a step back from the position of the URDG, where the beneficiary is required to state that there is a breach of the underlying transaction and what type of breach is involved.

#### **5. The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (The Convention)**

The Convention was adopted by the General Assembly of the United

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<sup>56</sup> James E. Byrne, *The International Standby Practices (ISP98): New Rules for Standby Letters of Credit*, 32 UCC L.J. 149, 151 (1999).

<sup>57</sup> ISP98, *supra* note 8, R. 1.05.

Nations on December 11, 1995.<sup>58</sup> As of 1 April 2009, the UN Convention has been signed by nine countries and ratified by eight of them.<sup>59</sup> It came into force on January 1, 2000.<sup>60</sup>

The Convention applies to “an international undertaking”<sup>61</sup> such as an independent guarantee or a standby letters of credit,<sup>62</sup> where “the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State”<sup>63</sup> or “the rules of private law lead to the application of the law of a Contracting State, unless the undertaking excludes the application of the Convention.”<sup>64</sup> The Convention can also apply to commercial letters of credit if the parties expressly state that their credit is

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<sup>58</sup> See Explanatory Note, *supra* note 22, cmt. 6. See also UNCITRAL, <http://www.uncitral.org/uncitral/en/uncitraltexts/payments/1995Conventionguaranteescredit.html> (last visited Nov. 15, 2010). For further literature concerning the Convention, see Roger Fayers, *The latest UNCITRAL text raises some intriguing questions about the relationship of the Convention/Model Law with the UCP*, DOCUMENTARY CREDITS INSIGHT, Spring 1995, at 22-23; Eric E. Bergsten, *A New Regime for International Independent Guarantees and Stand-By Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, 27 INT'L LAW., 859-879 (1993); Henry Harfield, *Guaranties, Stand-by Letters of Credit and Ugly Ducklings*, 26 UCC L.J. 195-203 (1994); Glower W. Jones, *UNCITRAL Draft Convention on International Guaranty Letters*, INT'L BUS. LAW. 28-34 (1994); James E. Byrne & Harold Burman, *Introductory Note, United Nations Convention on Independent Guarantees and Stand-by Letters of Credit*, 35 I.L.M. 735-738 (1996); Lars Gorton, *Draft UNCITRAL Convention on Independent Guarantees*, 1997 J. BUS. L. 240-253; John Dolan, *The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?*, 13 BANKING & FINANCE L. REV. 1-23 (1998); De Ly, *supra* note 50.

<sup>59</sup> See UNCITRAL, [http://www.uncitral.org/uncitral/en/uncitral/texts/payments/1995Convention\\_guarantees/status.html](http://www.uncitral.org/uncitral/en/uncitral/texts/payments/1995Convention_guarantees/status.html) (last visited on Nov. 15, 2010).

<sup>60</sup> The Convention, *supra* note 9, art. 28. In accordance with Article 28 of the UN Convention, it will enter into force on the first day of the month following the expiration of one year from the deposit of the fifth instrument of ratification. Because Tunisia, the fifth state, deposited its ratification on December 8, 1998, it came into force on the date mentioned here.

<sup>61</sup> *Id.* art. 1(1). For the meaning of the internationality of the undertaking, see The Convention, *supra* note 9, art. 4.

<sup>62</sup> *Id.* art. 2(1).

<sup>63</sup> *Id.* art. 1(1)(a).

<sup>64</sup> *Id.* art. 1(1)(b).

subject to it.<sup>65</sup>

The Convention is basically modelled upon both the UCP and the URDG, but it is distinctive in that both the UCP and the URDG are drafted by the ICC, a non-government organization,<sup>66</sup> as voluntary rules or self regulation, whereas the Convention is drafted by the UNCITRAL, as a uniform law or official regulation<sup>67</sup> for those countries who adopt it. As a result, the Convention, “[i]n addition to being essentially consistent with the solutions found in the rules of practice, ... supplements their operation by dealing with issues beyond the scope of such rules. It does so in particular regarding the question of fraudulent or abusive demands for payment and judicial remedies in such instances.”<sup>68</sup> In other words, it has provisions with respect to the fraud rule. To void repetition and segmentation, the articles will be listed in Part IV below.

### III. Commentary on the Fraud Rule under the Convention

There are altogether three articles related to the fraud rule under the Convention. They are Articles 15, 19 and 20. In Article 15(3), the Convention first sets up a general requirement for the beneficiary demanding payment under a letter of credit or independent guarantee, providing:

The beneficiary, when demanding payment, is deemed to certify that the demand is not in bad faith and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph (1) of Article 19 are present.

This looks similar to Article 9 of the URDG and Article 20 of the URDG, providing a kind of safety device for the trigger of the payment of the instrument to prevent fraud, and differs from the fraud rule. However, unlike those provisions under the URDG and the URDG, Article 15(3) of the Convention does not only require the beneficiary to be “not in bad faith”

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<sup>65</sup> *Id.* art. 1(2). See Gorton, *supra* note 58, at 244 n.11 (“Some voices were raised to expand the Convention to also cover documentary credits generally, but they were in a very clear minority.”).

<sup>66</sup> See ICC, <http://www.iccwbo.org/id93/index.html> (last accessed Nov. 15, 2010).

<sup>67</sup> De Ly, *supra* note 54, at 835.

<sup>68</sup> Explanatory Note, *supra* note 22, cmt. 5.

when making a demand for payment, but also implies that payment has the potential to be disrupted if the elements listed in Article 19 exist in the demand. Following it, Article 19 of the Convention, with the heading of "Exception to payment obligation," provides:

- (1) If it is manifest and clear that:
  - (a) Any document is not genuine or has been falsified;
  - (b) No payment is due on the basis asserted in the demand and the supporting documents; or
  - (c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis,

the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment.
- (2) For the purposes of subparagraph (c) of paragraph (1) of this article, the following are types of situations in which a demand has no conceivable basis:
  - (a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;
  - (b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking
  - (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
  - (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;
  - (e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

- (3) In the circumstances set out in subparagraphs (a), (b) and (c) of paragraph (1) of this article, the principal/applicant is entitled to provisional court measures in accordance with article 20.

As can be seen, Article 19 of the Convention has clearly covered the substantive elements of the fraud rule. It first sets out the test of proof or the standard of fraud by providing that the fraud rule can only be applied when “manifest and clear” fraud is involved. This is the most important and controversial issue under the fraud rule of the letter of credit. It is important because the fraud rule is applied when fraud is found in the transaction. To apply the fraud rule, the first and foremost important question for courts hearing letter of credit fraud cases to decide is what is fraud under the law of letters of credit or what kind of fraud can invoke the fraud rule. It is controversial because fraud is an “inherently pliable concept”<sup>69</sup> and very hard to be defined. Some take the view that the fraud rule must be applied in a strict fashion, or in cases where only “egregious” fraud is involved.<sup>70</sup> Others favor a more flexible approach to the concept.<sup>71</sup> By requiring the “manifest and clear” standard, Article 19 of the Convention has set up a narrow and high standard for the application of the fraud rule. Further, instead of providing a general standard of fraud as what has been done in Article 5 of the UCC, Article 19(1) of the Convention has listed three

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<sup>69</sup> Gerald T. McLaughlin, *Letters Of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 OHIO ST. L. J. 1197, 1203 (1989).

<sup>70</sup> *E.g.*, N.Y. Life Ins. Co. v. Hartford Nat. Bank & Trust Co., 378 A. 2d 562, 567 (1977) (“Only in rare situations of egregious fraud would § 5-114 have justified the issuer, on the facts presented here, in going behind apparently regular, conforming documents; such fraud ‘must be narrowly limited to situations ... in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer’s obligation would no longer be served.’”) (citing *Intraworld Indus., Inc. v. Girard Trust Bank*, 461 Pa. 343, 336 A. 2d 316, 342-325 (1975)). *See also* Henry Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 603 (1978).

<sup>71</sup> *E.g.*, *Dynamics Corp. of Amer. v. Citizens & Southern Nat. Bank*, 356 F. Supp. 991, 998-999 (1973) (“The law of ‘fraud’ is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society ... [I]n a suit for equitable relief—such as this one—it is not necessary that plaintiff establish all the elements of actionable fraud required in a suit for monetary damages ... ‘Fraud has a broader meaning in equity [than at law] [sic] and intention to defraud or to misrepresent is not a necessary element. Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscious advantage is taken of another.’”) (citing *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 193-94 (1963)).

particular situations that can invoke the fraud rule, which is similar to, and has influenced of the formation, the provisions of Article 8 of the PRC LC Rules.

In addition, to assist courts and other parties in determining the existence of fraud, Article 19(2) of the Convention has provided five situations to explain what “no conceivable basis” mean in Article 19(1)(c). This list may not be exhaustive, but it is an impressive and encouraging way in which to define the kind of misconduct that can invoke the fraud rule. It undoubtedly stands as the most detailed provision so far as to the clarification of the misconduct that may bring the fraud rule into play. These provisions are “clear and narrow in scope and provide an excellent international standard.”<sup>72</sup> They will undoubtedly provide good guidance for courts to enhance their application of the fraud rule.

Finally, Article 19 of the Convention sets out what actions can be taken when “manifest and clear” fraud is involved in the transaction: (1) the issuer or guarantor can dishonor the presentation;<sup>73</sup> and (2) the applicant or principal can bring a court action to prevent the payment in accordance with Article 20 of the Convention if the issuer or guarantor is not prepared to dishonor,<sup>74</sup> which is similar to the format provided in s 5-109(b) of Article 5 of the UCC in the US. Then, in Article 20, the Convention, with the heading of “Provisional court measures,” 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

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<sup>72</sup> *Litigation Digest: Agritrade International Pte Ltd v Industrial and Commercial Bank of China [1998] 3 SLR [Singapore] 4 (3) DOCUMENTARY CREDIT WORLD 8, 13 (2000).*

<sup>73</sup> The Convention, *supra* note 9, art. 19(1). Since Article 19(1) of the Convention does not use the word “may” as does in Article 5 of the U.C.C. in the United States, some commentators have suggested that it implies certain duties on the issuer to make a judgment whether the demand for payment is warranted. *See* Gorton *supra* note 58, at 249. However, it seems that this interpretation is a bit too narrow, as the Article only says that the issuer/guarantor “has a right” to withhold or refuse payment, which does not mean that it must exercise that right. Due to the nature of letters of credit, the issuer should not be obliged to consider whether the demand is justified or not, but be allowed a discretion for honour or dishonour when payment is demanded.

<sup>74</sup> The Convention, *supra* note 9, art. 19(3).

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.

Article 20 of the Convention is similar to section 5-109(b) of Article 5 of the UCC, spelling out the procedural matters of the law when remedies are sought from courts as a result of fraud in a letter of credit transaction. As suggested by the heading, Article 20 of the Convention states that “provisional rather than conservatory measures are intended.”<sup>75</sup> With regard to provisional measures, the Convention is “strict enough with account parties while still being flexible enough to permit the application of provisional measures in exceptional cases.”<sup>76</sup>

The provisions of the Convention with regard to the fraud rule are by and large in accordance with current practice. They include most of the elements of the fraud rule that have been developed over the years by national courts and/or legislators and provide a detailed and helpful guide to users of letters of credit and the courts except one critical point: having failed to mention who should be immune from the fraud rule.

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<sup>75</sup> De Ly, *supra* note 54, at 843.

<sup>76</sup> *Id.* at 842.



#### IV. Conclusion

Letters of credit are products of international trade. Fraud in transactions of letters of credit and independent guarantees can be found anywhere across the globe. Therefore, dealing with fraud in transactions of letters of credit and independent guarantees are similar to dealing with the current financial global crisis: a unified global approach is needed.

However, through the examination of the law of letters of credit and independent guarantees at the national and international level, it has been revealed that currently the fraud rule has been provided in both the US and the PRC, the only two countries in the world having a detailed set of law with regard to letters of credit so far. However, at the international level, only the Convention has made an effort to address the issue of fraud. All the rules made by the ICC are silent or nearly silent with the issue, which is disappointing and puzzling.

Good commercial laws are those that can serve commerce best. Laws that can serve commerce best are those that can maximise certainty and predictability for the commercial community. To have such an effect, a law should give the best answers it can give to the problems that are predicted. It is questionable whether the rules made by the ICC can satisfy this standard without dealing with the fraud issue. The drafters of the rules of the ICC knew of the problem of fraud, but they chose not to address it, leaving users of letters of credit to national laws, laws which letter of credit users often have no familiarity with. To make matters worse, national laws are diverse and lacking clarity. Moreover, the law of letters of credit is a commercial specialty and complex. Even letter of credit specialists are sometimes perplexed by its complicated structure. Judges should be legal experts, but it is not practical to expect every judge to be an expert in the law of the letter of credit or to make good law within the short framework of time that a case is before it. The reality is that “[m]ost trial judges have had little experience with letter of credit matters.”<sup>77</sup> Under such an environment, when a fraud case of letter of credit goes to a court and a decision is made, that decision is often criticised by letter of credit experts for not having followed the practice of the letter of credit community or for being detrimental to the commercial utility of letters of credit.<sup>78</sup>

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<sup>77</sup> James E. Byrne, et al., *An Examination of UCC Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521, 1611 (1990).

<sup>78</sup> For example, the decisions of the Chinese courts were often the target of this kind of criticism before the PRC LC Rules were promulgated. See XIANG GAO, THE FRAUD RULE

Therefore, it is surely desirable for the drafters of the ICC rules of letters of credit and independent guarantees, well-known experts in the area, to address the issues known in practice, including fraud.<sup>79</sup> If a detailed set of rules is not practical, a simple guidance is better than nothing. In this respect, the Convention has sets a good example and made a unique and significant contribution to the development of the fraud rule and the law of letters of credit and independent guarantees as a whole from the international prospective. The “provisions constitute a good barometer of international consensus on the topic of fraud.”<sup>80</sup>

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IN THE LAW OF LETTERS OF CREDIT, A COMPARATIVE STUDY, 173-174 (Klumer Law Int'l 2002).

<sup>79</sup> Cf. Clive M. Schmitthoff, *Export Trade*, in J.BUS. L. 319, 321 (1982).

<sup>80</sup> Mugasha, *supra* note 25, at 138.