FRAUD AND DOCUMENTARY CREDITS:

THE APPROACH OF THE ENGLISH COURTS

By

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I Introduction

The impact of fraud in relation to documentary credits is seen in one specific context: a dispute as to whether a bank is obliged to pay a documentary credit in circumstances where fraud is alleged in connection with the underlying contract.

Such disputes are likely to come before the Courts in three situations:

(1) where the applicant / buyer wishes to stop the paying bank making payment on the grounds that the beneficiary / seller has been guilty of fraud.

(2) where the beneficiary / seller is suing the bank on the basis that the bank has refused to make payment on the grounds of fraud.

(3) where the paying bank has already made payment and recovery is sought on the ground of fraud in relation to the documentation presented in support of payment.

This Chapter considers the approach of the English Courts to what has come to be known as "the fraud exception"; looks at fraud in the context of the UCP and the ICC's DOCDEX Rules; and looks at some lessons which banks can learn from the cases decided in the English Courts.

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II Payment Under Documentary Credits - generally

The view of the English Courts is that banks must honour their obligations to pay documentary credits (and honour their obligations in relation to performance bonds or guarantees, where similar principles apply).

This view is based on two separate but related matters.

First, the autonomy of the credit. The documentary credit transaction is separate from the underlying contract: banks are concerned with documents, not goods. Therefore, if for example the buyer / applicant alleges fraud by the seller / beneficiary in connection with the sales contract, the banks involved in the documentary credit transaction can properly claim that the obligation to honour the credit is unaffected by the allegation of fraud in connection with the underlying contract.

Second, the need to support the integrity of the banking system. Commerce - and particularly international commerce - would suffer if businessmen and others engaged in commerce could not rely upon the obligation of banks to make payment under the documentary credit system.

III The Fraud Exception

The strict obligation of banks under the concept of the autonomy of the credit - banks must pay - is to some extent counter-balanced by the rights of banks to refuse payment where the documentation tendered in support of an application for payment under a credit is not strictly in compliance with the requirements of the credit.

But provided the documents are, on their face in conformity, the bank has an obligation to pay.

However, there is an exception to the doctrine of strict compliance. Notwithstanding the fact that the documents tendered are on the face in strict compliance with the terms of the credit, payment can be refused under the "fraud exception" where:

(1) there is clear evidence of fraud, and

(2) the bank has clear notice of this evidence of fraud, and

(3) the bank's awareness of the fraud was "timely".

Bearing in mind that, where fraud is alleged, the procedural machinery likely to be used is the injunction, there is a fourth element involved where what is sought is a pre-trial injunction: the "balance of convenience"[1]. The English Courts will only

[1] In *American Cyanamid Co v Ethicon* [1975] 1 All ER 505, the House of Lords, laid down various tests for the grounds of a pre-trial (or interim) injunction. These included (1) if a claimant were to succeed in establishing his right to a permanent injunction at trial, could he be adequately compensated in damages for refusal of an injunction? If not (2) if the defendant were to succeed, could he be compensated in damages for the grant of the pre-trial injunction? (3) if there is doubt as to the

grant an interlocutory injunction where, amongst other things, the balance of convenience is in favour of granting an injunction restraining payment.

The fraud exception will operate to stop payment only in "*exceptional circumstances*". The position is summarised in a passage in the judgement of Sir Michael Kerr in the *Harbottle* case, which has often be cited in subsequent decisions of the English Courts over the past 20 odd years:

"It is only in exceptional cases that the Court will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contract by litigation or arbitration……. The courts are not concerned with their difficulties to enforce such claims: these are risks which the merchants take. In this case, the Plaintiffs took the risk of the unconditional wording of the guarantees. The machinery and commitment of banks are on a different level. They must be allowed to be honoured, free from interference by the Court. Otherwise, trust and international commerce would be irreparably damaged."[2]

What follows in Section IV is a brief history of the fraud exception cases in the English Courts in the last quarter of a century, together with some recent cases of particular importance.[3]

IV A Short History of the Fraud Exception Cases in the English Courts - and Some Recent Cases

The development of English case law in relation to the fraud exception is based on an American case: *Sztejn v. Henry Schroder Banking Corporation*[4] This was a decision of Judge Shientag. The applicant for credit sought an injunction against the issuing bank in order to prevent that bank from paying on documents which had been presented. The seller was a merchant in India. The applicant alleged that what had been shipped was not the sale goods but packing cases filled with rubbish.

In the New York Court of Appeal, Judge Shientag stated that it was well established that a Letter of Credit is "*independent of the primary contract of sale between a buyer and a seller. The issuing bank agrees to pay upon presentation of documents not goods. This rule is necessary to preserve the efficiency of the Letter of Credit as an instrument for the financing of trade".*

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adequacy of the respective remedies in damages, where does the balance of convenience lie, having regard to the general prudence of preserving the *status quo?*

[2] RD Harbottle (Mercantile) Limited v. National Westminster Bank Limited [1978] QB146 at pages 155/156

[3] See generally on the fraud exception "Documentary Credits", by Raymond Jack (2nd Edition), Butterworths

[4] 31NYS 2d631(1941)

The Judge went on to say that, on the particular facts of the case, the situation was different because: "*on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principal of the independence of the bank's obligation under a Letter of Credit should not be extended to protect the unscrupulous seller."*

That decision of an American Court given some 60 years ago has been often quoted in the English Courts. Indeed, Lord Diplock in the *United City Merchants* case referred to *Sztejn* as "*the landmark American case*".

(1) Discount Records v Barclays Bank [1975][5]

The plaintiff buyers said that cartons shipped by the French sellers contained only a small quantity of the goods ordered. The containers were otherwise empty or stuffed with rubbish. The plaintiffs sought a pre-trial injunction against the bank restraining it from paying the French company under letters of credit.

However it seems that the allegedly fraudulent sellers had already been paid by the discounting of a draft which had not yet fallen due. In those circumstances, all that the grant of an injunction would do would be to prevent the bank from honouring its obligations. An injunction was refused.

(2) Harbottle v National Westminster Bank [1978]

Reference has already been made to this decision of Sir Michael Kerr.

The English plaintiffs entered into contracts for sale with Egyptian buyers. Each contract provided that the plaintiffs should provide a guarantee confirmed by a bank. The guarantees covered 5% of the purchase price in favour of the buyers. The plaintiffs said that the buyers had demanded payment under the guarantees without any justification. Mr Justice Kerr stated that the plaintiffs "*now even go so far as to say that the buyers' demands were fraudulent.*" The Judge rejected that contention and later in his judgement stated that it was only in "*exceptional cases*" that courts would interfere with the irrevocable obligations assumed by banks.

(3) Edward Owen Engineering v Barclays Bank [1978][6]

The Court of Appeal approved the decision of Sir Michael Kerr in the *Harbottle* case. The fraud exception was described in these terms by the Master of the Rolls, Lord Denning:

> "*that case (the Sztejn case) shows that there is this exception to the strict rule: the bank ought not to pay under the credit if it knows that*

[5] Discount Records Limited v. Barclays Bank Limited [1975] 1 All ER 1071
[6] Edward Owen Engineering Limited v. Barclays Bank International Limited [1978] 1All ER 976

the documents are forged, or that the request for payment is made fraudulently in circumstances where there is no right to payment" (page 982).

In the same case, Lord Justice Brown, referring to the fraud exception, stated:

"*that exception is that where the documents under the credit are presented by the beneficiary himself and the bank knows when the documents are presented that they are forged or fraudulent, the bank is entitled to refuse payment"(page 984).*

Lord Justice Geoffrey Lane at page 986 said that :

"*the only circumstances which would justify the bank not complying with the demand ……..is this, if it had been clear and obvious to the bank that the buyer had been guilty of fraud".*

(4) United City Merchants v Royal Bank of Canada [1982][7]

The documents presented to the Defendants, the confirming bank, contained a material mis-statement namely, that the bill of lading showed that shipment had been made on 15th December 1976 (the last date for payment of the credit) when in fact shipment was on 16th December. The Defendant bank refused to pay.

The case went to the House of Lords.

The leading judgement was given by Lord Diplock. He described the autonomous nature of the documentary credit: disputes as to the goods are irrelevant to the seller's right to payment. However, he stated that:

"*to this general statement of principle as to the contractual obligations of the confirming bank and the seller, there is one established exception: that is, where the seller for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue."*

Lord Diplock referred to the *Sztejn* case and continued:

"the exception for 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 a fraud."

[7] United City Merchants (Investments) Limited v. Royal Bank of Canada [1982] 2 All ER 720

(5) Tukan Timber v Barclays Bank [1987][8]

In this case, the Plaintiff sought an injunction against its own bank to prevent payment out under a letter of credit. The bank had already twice rejected a demand on the grounds of forgery. Mr. Justice Hirst was prepared on the evidence to accept that the beneficiary's fraud, and the bank's knowledge of that fraud, had been sufficiently proved. Nevertheless, he refused to grant an injunction on two grounds. First, because he did not consider that there was any danger that the bank would pay out at any third attempt by the beneficiary to obtain payment. Secondly, on the basis of the balance of convenience as considered in the *Harbottle* case by Sir Michael Kerr, the Judge stated that the Plaintiff would have a "*cast-iron claim…..for breach of contract against the bank if it did pay".*

(6) Themehelp v West [1995][9]

This is one the few reported cases where an injunction has been granted against a beneficiary on the grounds of fraud. The case concerned a performance guarantee (the same principles apply as in the case of a documentary credit).

The injunction was granted on the grounds that, first there was a clear case of fraud which had been sufficiently shown for pre-trial purposes, and secondly, the beneficiary had not yet made a demand under the guarantee. A majority of the Court of Appeal regarded those facts as being sufficient to entitle them to take this exceptional step. Lord Justice Waite stated that, in the opinion of the Judge at first instance, the case was exceptional "…….*in that here the relief was sought at an earlier stage - that is to say a restraint against the beneficiary alone in proceedings to which the guarantor is not a party, to prevent the exercise by the beneficiary of his power to enforce the guarantee by giving notice of the other party's alleged default in discharging the liability which was the subject matter of the guarantee."*

Lord Justice Evans gave a dissenting judgment, and considered that Mareva relief would have been appropriate:

> *"the present case cries out for Mareva relief. This could extend, if necessary, to requiring payment into Court of whatever sums are due from the banks".*

It may be that *Themehelp* is one of only two known reported cases where injunctions had been granted in inter-parties proceedings on the basis of the fraud exception. The other is in *Kvaerner John Brown Limited v. Midland Bank plc*[10]. In that case Mr Justice Cresswell refused to discharge a pre-trial injunction restraining Midland Bank from making a payment under a letter of credit on the grounds of the beneficiary's manifest fraud in certifying to the bank the giving of a required notice to the Plaintiff when it had not done so.

[8] Tukan Timber Limited v. Barclays Bank plc [1987] 1 Lloyd's Report 171
[9] Themehelp Limited v. West [1995] 4 all ER 215
[10] [1998] CLC 446

(7) Deutsche Ruckversicherung v. Walbrook Insurance [1996][11]

Lord Justice Staughton pointed out that the distinction between restraining a beneficiary from drawing on a credit and restraining a bank from making payment under such credit was contrary to established doctrine. He said:

> *"the effect on the lifeblood of commerce would be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment."*

(8) Turkiye Is Bankasi v. Bank of China [1996][12]

This case concerned a final trial in which the Bank of China (BOC) resisted Turkiye's claim on a counter-guarantee, after Turkiye had paid out under its own performance bond. The claim succeeded on the ground that BOC had failed to bring itself within the fraud exception, namely that it had failed to show that Turkiye knew of the beneficiary's fraud as at the time of Turkiye's payment.

It seems to have been the case that it was an implied term of the counter-guarantee either that Turkiye's bond would not be paid, or Turkiye had clear proof of the beneficiary's fraud, or that BOC's counter-guarantee would not operate in such a case.

The Bank of China case is of particular interest because the fraud exception is considered in the context of a final trial: most of the cases are concerned with pre-trial applications.

Mr. Justice Waller had the following comments to make in relation to a bank's position where fraud allegations are made: do the banks have to carry out their own investigations?

> *"it is simply not for a bank to make enquiries about the allegations that are being made one side against the other. If one side wishes to establish that a demand is fraudulent it must put the irrefutable evidence in front of the bank. It must not simply make allegations and expect the bank to check whether those allegations are founded or not……..It is not the role of a bank to examine the merits of allegations…….for breach of contract. To hold otherwise would place banks in a position where they would in effect have to act as Courts in deciding whether to make payment or not. Of course, if a beneficiary were to admit to the bank that it had no right to make the demand, then a totally different situation would arise."*

[11] Deutsche Ruckversicherung AG v. Walbrook Insurance Company Ltd [1996] 1 All ER 791
[12] Turkiye Is Bankasi AS v. Bank of China [1996] 2 Lloyd's Report 611

(9) Czarnikow v. Standard Bank London [1999][13]

The Plaintiff, Czarnikow, sought to maintain a pre-trial injunction against the first defendant, Standard Bank, to prevent it from paying out to two Swiss Banks at maturity the proceeds of three letters of credit. Standard had opened the credits at the request of its customer, Rionda. The Swiss Banks had at Standard's request advised and confirmed the credits. Rionda sought an injunction on the basis of the fraud exception, even though (1) it claimed no relief against the Swiss Banks themselves; (2) the Swiss Banks had already discounted the proceeds of the letters of credit either directly to the beneficiary, or indirectly under back-to-back letters of credit issued to the beneficiary's suppliers; (3) such discounting had taken place well before any question of fraud was raised; (4) the documentary sales in respect of which the letters of credit were opened had been performed and (5) the shipping documents in connection with such sales had already long before been negotiated to and accepted by Standard.

Mr. Justice Rix posed the questions: can such a situation be brought within the fraud exception? Is a pre-trial injunction just and convenient?

It emerged during the course of argument that, if an injunction is possible, then Counsel in the case were only aware of two occasions, both of them recent, where *inter partes* injunctions had been granted. One was the *Themehelp* case and the other was *Kvaerner John Brown v. Midland Bank*.

Counsel for Standard Bank submitted that the "*iron grip of Kerr J's analysis can be broken by the realisation that the basis of the fraud exception is not a cause of action against the bank, but the Court's willingness to interfere to prevent the furtherance of fraud. On that basis, if once a case of fraud is established sufficiently for pre-trial relief, then the Court ought, as a matter of balance of convenience, to be prepared to grant an injunction in any case where either the bank, if it pays, may find it difficult to recoup its payment from its customer, or the customer, if it is forced to indemnify the bank against payment, may find it difficult to recover against the fraudster. In this connection Themehelp Limited v. West becomes not merely a welcome if rare example of the exercise of the jurisdiction to interfere, but a guide to its exercise……"*

Counsel for Standard Bank also made a submission which is of interest in relation to the *Banco Santander* case which is considered later, namely that the Swiss banks were not authorised to discount the proceeds of the letters of credit in advance of their maturity dates:

> "*…….if they did so, they acted without authority under their mandate from Standard and stand in the shoes of the beneficiary……."*

[13] Czarnikow-Rionda Sugar Trading Inc v. Standard Bank London Limited [1999] 1 All ER (Comm) 890

The fraud in this case related to sugar cane and alcohol. Sugar cane which should have been in a warehouse did not exist and tanks which ought to have contained alcohol contained only water. Indeed it was said that the presence of water in the tanks have been admitted in order to forestall an inspection which would have shown that the tanks had been built in such a way as to enable false readings of alcohol to be taken by supervising inspectorates. Rionda feared that it may have been defrauded of security to an estimated value of US$25 - 30million.

Mr. Justice Rix reviewed authorities relating to the fraud exception and held that where a bank issued a letter of credit at its customers's request, a Court would not normally grant the customer an interlocutory or pre-trial injunction restraining the bank from making payment under a letter of credit on the basis of the fraud exception. In such a case, either the balance of convenience would be in favour of the bank, or the Court would have no jurisdiction to grant the injunction. If a customer had a claim against the bank, it would have an adequate remedy in damages. If it had no such claim, there would be no basis for granting the injunction. Further, even if the Court could grant such an injunction in the absence of a cause of action against the bank, the importance of maintaining the integrity and autonomy of banking commitments out-weighed the demands of the allegedly defrauded claimant who could obtain Mareva relief against the alleged fraudster. Therefore on an inter partes application for such an injunction, the balance of convenience would be in the bank's favour in the absence of exceptional circumstances. On the facts of the particular case, the injunction was discharged.

The reference to "*exceptional circumstances"* is a reference to the judgement of Sir Michael Kerr in the *Harbottle* case:

> "*It is only in exceptional circumstances that the Courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life blood of international commerce."*[14]

(10) Banco Santander v. Bayfern [2000][15]

This decision of the Court of Appeal is important in relation to deferred payment letters of credits and how the fraud exception affects such letters of credit.

Mr. Justice Langley at first instance had decided certain preliminary issues in favour of the third defendant, Banque Paribas. That judgement was appealed. In the Court of Appeal, Lord Justice Waller said that the preliminary issues "*….raised important questions in relation to the operation of a confirmed 'deferred payment' letter of credit, a creature of relatively new invention and how the 'fraud exception' operates in relation to such instruments. The*

[14] The author's experience as Counsel is that it is difficult - if not almost impossible - to persuade a Judge in the High Court in England to grant a pre-trial injunction on the basis of the fraud exception: even where the bank concerned has indicated that it has no objection to such injunction being granted.
[15] Banco Santander SA v. Bayfern Limited [2000] 1 All ER (Comm) 776

questions arise on the assumption that the following was the sequence of events."

Lord Justice Waller then set out those events: Paribas issued a deferred payment letter of credit on 5th June 1999 in favour of Bayfern, requiring presentation of documents at the counters of Banco Santander in London at any time until 15th September. The deferred payment was promised at 180 days from Bill of Lading. The letter of credit was subject to the Uniform Customs and Practice for Documentary Credits (1993 Revision). It was expressly provided that the Paribas undertook *"at maturity……to cover Santander in accordance with their instructions."*

Bayfern was advised of the letter of credit by Santander by advice dated 8th June 1999. Santander had been asked by Paribas to add its confirmation to the letter of credit and did so by the same advice. That advice also offered the possibility of discounting, and by letter dated 9th June 1998 Bayfern requested Santander to discount the full value at the rate offered by Santander.

By 15th June 1999 Bayfern had presented documents at the counters of Santander in London. Those documents were found on their face to comply with the terms of the letter of credit and, for the purposes of the preliminary issues, it was assumed that they were entitled to make such a finding. That therefore crystallised an obligation on the part of Paribas and Santander to pay Bayfern US$20.315m on 27th November 1998 in accordance with the letter of credit, i.e. 180 days of the Bills of Lading.

On 16th June Santander confirmed to Bayfern that they had discounted and had credited the sum of US$19.667m. They also asked for a letter from Bayfern "*requesting discount and assignment of proceeds under the above mentioned Letters of Credit".* On 16th June Bayfern produced that letter and requested the discounting of "*your deferred payments/acceptance undertaking to us"* and confirmed that in consideration they thereby irrevocably and unconditionally assigned their rights under the letter of credit.

No notice of the assignment was given to Paribas and in the meantime documents had been passed to Paribas by Santander.

On 24th June Paribas informed Santander that the documents presented and accepted by Santander included false or forged documents. Lord Justice Waller stated that it had to be assumed for the purposes of the preliminary issues that Bayfern had been guilty of fraud, that one or more documents were forged, and that thus prior to 27th November, both Santander and Paribas had notice of "*established fraud"*.

Santander obtained freezing orders (*Marevas)* on Bayfern's account at the Royal Bank of Scotland. The Court was not informed what demand was made by Santander on 27th November 1998, but whatever it was, Paribas refused to pay on the basis that Santander could have no greater right to payment than Bayfern. Lord Justice Waller stated that in the absence of fraud "*it would appear to be common ground that the position would have been as*

follows: (1) Santander would have had no claim to be paid by Paribas anything until 27th November 1998. (2) On 27th November 1998 they would have been paid the sum of US$20.215m."

The Court of Appeal considered whether defences which would have been available against Bayfern were available as against the assignee, Santander. The arguments put forward by Counsel for Santander were summarised by Lord Justice Waller:

> *"There are two types of letter of credit which contemplate presentation of documents and an acceptance of an obligation to pay in the future. There is the ' acceptance credit' used for many years which involves the confirming bank accepting a draft in favour of the beneficiary; and there is a newer instrument the 'deferred payment' letter of credit which involves the bank promising payment at a future date, as in this case. It seems that this latter kind of letter of credit may have come into use because if drafts were produced, the result was that in many countries stamp duty had to be paid. But drafts did have this advantage. A negotiable instrument was produced which could be discounted or sold in the forfait market. To such drafts Section 38 of the Bills of Exchange Act 1882 applies."*

Amongst other things, that Section provides that a "*holder in due course*" holds the bill free from any defect of title of prior parties. Lord Justice Waller continued:

> *"Thus holders in due course can sue on the drafts even if fraud is discovered prior to the maturity date of the draft. Furthermore, if a confirming bank who has accepted the bill becomes the holder and holds the bill at maturity, the bill is discharged by virtue of Section 61 of the 1882 Act….. So the argument runs, with the deferred payment letters of credit there has grown up a practice of discounting the promise in the forfait market. It will curtail the beneficial use of the deferred payment letter of credit if something equivalent to Section 38 is not put in place to protect innocent assignees".*

Reference was then made to an article which appeared in "*Insight*" following the decision of Mr. Justice Langley. The article suggested that it was now "*difficult to see the future for the deferred payment L/C at least in this jurisdiction".*

Lord Justice Waller said that the Court had been informed that "…….*in another jurisdiction, France, in a case to which Santander were a party, a blow similar to that apparently dealt by Langley J had been dealt to 'deferred payment' letters of credit'…… So the reference to 'this jurisdiction' alone may be a little harsh, and indeed (Counsel for Paribas) submitted that since their use apparently continued following the Paris Court of Appeal's decision the prediction may be somewhat exaggerated"*

The reference to the French decision was a reference to an unreported 28th May 1985 decision in the case *Banco de Santander v. Caisse Nationale de Credit Agricole*.

Lord Justice Waller stated that, in bringing this new type of instrument into operation, "*it seems it has not been thought necessary to make express provision in the UCP to cover the situation, or to make express provision in the letters of credit themselves. So far as the UCP is concerned, that seems to be true even following the decision of Langley J in this case, as we were informed by (Counsel for Paribas) who produced a Banking Commission Statement on the Future of UCP 500 revision produced by the International Chamber of Commerce……I have ultimately concluded that if parties agree for whatever reason that they will not provide a negotiable instrument, and do not provide by terms of the trade or even by the express terms of the instrument itself, the protection for assignees that a negotiable instrument will provide, they must live with the consequences.*

I thus do not think it is open to the Courts simply to make an exception to what would otherwise be the clear rule that a defence which would have been available as against the assignor should be available against the assignee.

If I am right so far, that…..is in fact the end of this appeal. Santander's claim is as assignee, and they are defeated by the defence that would have been available as against Bayfern".

However, in case he was wrong in the conclusion which he had reached, Lord Justice Waller then went on to consider the relevant terms of the UCP:

> Article 2: the meaning of credit
>
> Article 9: the liability of issuing and confirming banks: if the credit provides for deferred payment - *"to pay on the maturity date(s) determinable in accordance with the stipulations of the Credit*".
>
> Article 10: types of credit: all Credits must clearly indicate whether they are available by sight, by deferred payment, by acceptance or by negotiation:
>
> Article 13: the standard for examination of documents:
>
> Article 14: discrepant documents and notice.

In this case, what precisely had the issuing bank requested the confirming bank to do, and what had the issuing bank promised to do if the confirming bank did what is requested of it? The answer, according to Lord Justice Waller, is that the issuing bank "*has requested the confirming bank to give its own undertaking to pay on 27th November 1998, in addition to that of the issuing bank, and has promised to reimburse the confirming bank when it pays on that deferred payment undertaking i.e. pay US$20,315,796.30 on 27th November 1998. There is no request from Paribas that Santander should*

discount or give any value for the documents prior to the 27th November 1998, and albeit it may not be a breach of mandate for Santander to do so, it is up to Santander whether it does so or not".

Considering the matter from the point of view of the UCP Rules, Lord Justice Waller concluded that the position was that:

> "*Santander had no authority to negotiate from Paribas to discount and it did not seek it. It was something that they were entitled to do on their own account. If they had not chosen to discount and had waited until 27th November, they would have had a defence, and it is in those circumstances not open to them to claim reimbursement from Paribas.*
>
> *If a confirming bank in the position of Santander wishes to be free to give value for documents when it accepts the documents, it can do so either by insisting on the use of an acceptance credit, or by insisting on obtaining authority to negotiate and confirmation of reimbursement if it does. European Asian Bank AG v. Punjab and Sind Bank No. 2 [1983] 2 All ER 508…..seems to me to demonstrate how, if Santander had informed Paribas that it had discounted, and had received confirmation from Paribas that Paribas would still reimburse on 27th November 1998, Paribas would not be able to raise the fraud exception because they would be estopped from disputing Santander's authority to discount".*

Lord Justice Mummery and Lord Justice Morritt both agreed with Lord Justice Waller that the appeal should be dismissed.

This decision of the English Court of Appeal raises serious questions in relation to deferred payment letters of credit under the UCP Rules in connection with the fraud exception where (1) the deferred payment letter of credit is discounted by the paying / confirming bank and (2) where the agreement of the issuing bank is not obtained. As mentioned earlier, the point was raised in the *Czarnikow* case: Counsel for Rionda had argued that the Swiss banks were not authorised to discount the proceeds of the letters of credit in advance of their maturity dates.

(11) Standard Chartered Bank v. Pakistan National Shipping Corporation [2000][16]

This case is of importance in that it relates to the possible liability of a bank to contributory negligence in a case where false documents are tendered in support of an application for payment of a documentary credit, in circumstances where payment could have been refused in any event on unrelated grounds.

[16] Standard Chartered Bank v. Pakistan National Shipping Corporation & Others (No. 3) [2000] 2 All ER (Comm) 929

The case is also unusual in that Standard Chartered Bank claimed repayment from Incobank on the basis of a false statement that the documents were presented to Standard in time.

In previous proceedings before the English Court, Standard Chartered Bank (Standard) had established a good cause of action against the Defendant Company, Pakistan National Shipping Corporation (Pakistan Shipping). Pakistan Shipping had issued a Bill of Lading which to its knowledge bore a false shipment date. The Bill of Lading was presented to Standard under a letter of credit issued by Incobank of Vietnam and confirmed by Standard. The shipping documents were presented to Standard late, but Standard nevertheless paid the credit without the authority of Incobank, and claimed repayment on the basis of a false statement that the documents had been presented on time. In the event, Incobank refused payment because of entirely unrelated discrepancies. In the previous proceedings, the Court had held that Standard's decision to claim the indemnity from Incobank on a false basis was a cause of the loss which it had suffered in making payment under the letter of credit and failing to recover the indemnity from Incobank. Pakistan Shipping contended that the damages due to Standard were liable to be apportioned because of Standard's negligence in failing to notice the discrepancies, or in its attempted deception of Incobank or both, and that the Court could and should reduce the amount payable under the provisions of Section 1 of the Law Reform (Contributory Negligence) Act 1945.

The Court of Appeal held that the natural meaning of the definition of "false" in Section 4 of the 1945 Act required that the negligence be actionable. In the present case Pakistan Shipping's claim for reduction of the damages payable had to depend upon it establishing that Standard's act had given rise to the defence of contributory negligence. However, it was inconceivable that the deceitful conduct of Standard would have afforded Pakistan Shipping a defence: the attempted deceit of Incobank was not causative of any part of the damages suffered by reason of Pakistan Shipping's deceit and it therefore could not complain about the actions of Standard. In any event, a Defendant found liable in deceit could not establish a defence based upon the contributory fault of a Claimant. There were therefore no grounds for reducing the damages recoverable by Standard Chartered Bank on the basis of contributory negligence.

The Court of Appeal was scathing in relation to the part played by Standard Chartered Bank in this case. Lord Justice Ward referred to Standard Bank's "*scandalous attempts to deceive the issuing bank on the basis of a false statement that the documents were presented to them in time."* (page 948). Later he referred to his "*…..distaste for the bank's conduct. They have brought dishonour upon themselves and upon the City. It is quite another question whether the dishonest shipowners can benefit from the attempted fraud".* (page 958).

Notwithstanding the fact that Standard Chartered "*does not emerge as a shining innocent"*, Lord Justice Ward stated that it was nevertheless necessary to focus on the extent to which Standard's loss "*suffered as it was by the*

defendant's deceit, should be apportioned for its share in the responsibility for the damage. In my judgement the responsibility for the damage is wholly that of the defendant. It was the defendant who set out to deceive and succeeded in deceiving. The mixed motives of the Claimant do not mitigate that dishonesty. Commercial fraud must be condemned. It can only be properly condemned by an award of the whole of the damage which the Defendant intended to cause. Highwaymen in commerce forfeit the right to just and equitable treatment. In my judgement in the law of deceit, there is to be no apportionment. If the parties were in pari delicto then the Claimant would fail to recover anything. In this field it is all or nothing. In my judgement the Claimant is entitled to recover all its damage ……"

The Appeal was dismissed and permission to appeal to the House of Lords was refused.

V Fraud and the ICC: the UCP and DOCDEX

The UCP

No mention is made in the UCP of fraud.[17] This is evidently deliberate, given the differing views taken by national courts in relation to fraud and documentary credits. On the strict construction of UCP 500, fraud would not be a relevant consideration in relation to the examination and rejection of documents: Articles 3 and 4. What is clear is that letters of credit are separate transactions from the underlying contracts and banks are concerned only with the documentation which represents the goods. The banks are not concerned with the goods themselves.

It might be said that this doctrine of the autonomy of the credit in Articles 3 and 4 is to some extent counter-balanced by the doctrine of strict compliance contained in Articles 13 and 14: although banks are not concerned with the underlying contract, nevertheless they are only obliged to pay on the credit if the documents presented are in strict compliance with the requirements of the credit.

However, it is clear, at any rate from the English and American cases, that the doctrine of strict compliance is subject to the fraud exception: if there is fraud in relation of the underlying contract a bank may be entitled to refuse payment of the credit.

It seems that the ICC intend that allegations of fraud be dealt with by the national courts and not under the UCP Rules. For example, one query put to the ICC Banking Commission related to the rights of recourse to the beneficiary in the event of fraud. The terms and conditions of a letter of credit were complied with and the beneficiary was paid. The relevant documents were despatched to the overseas bank for acceptance. One day before payment was due, a telex was received from the issuing bank stating that an injunction had been granted by the local court "*forbidding us to*

[17] It is important to remember that the fraud exception is a principle which arises out of the common law. Although many of the English cases are concerned with the ICC's Uniform Customs and Practice, the fraud exception does not arise out of the UCP.

pay the proceeds to you, because the applicant, Company A, had brought a charge against the beneficiary for the business of fraud."

Various questions were put to the ICC Banking Commission, including the question whether, in view of the fact that Article 4 of UCP 500 states that banks deal in documents and not goods, the issuing bank was obliged to make payment notwithstanding the court injunction.

The ICC Banking Commission replied:

> *"that these questions cannot be answered by a 'Yes' or 'No'.*
>
> *It is true:*
>
> *That UCP 500 Article 3 emphasises that credits are separate transactions from underlying contracts.*
>
> *That Article 4 stresses that in credit operations all parties deal with documents and not with goods, and*
>
> *That pursuant to sub-Articles 10(d) and 14(a) nominated banks are entitled to be reimbursed if they acted in compliance with the terms and conditions of the credit.*
>
> *However, there is an exception to these provisions in many jurisdictions, namely abuse of right, or fraud. The ambit of this exception and the ensuing consequences for the beneficiary and/or the nominated bank may differ from one local jurisdiction to another. It is up to the Courts to fairly protect the interests of all bona fide parties concerned".*[18]

DOCDEX

In October 1997 the International Chamber of Commerce published the DOCDEX Rules: the "*Rules for Documentary Credit Dispute Resolution Expertise".* The Rules were the ICC's response to a "*clear call from the International Banking Community for a rapid, cost-effective, expert-based dispute resolution mechanism for documentary credit practice, including bank-to-bank reimbursement issues".*

To a large extent, the need for such a system in relation to documentary credit disputes arose because some banks were refusing to pay letters of credit on the ground of alleged "*discrepancies*". Charles del Busto of the ICC's Commission on Banking Technique and Practise was quoted as saying:

> *"We all recognise that the Documentary Credit is part of the life blood of international commerce. If this practise of avoiding or delaying payment were to become widespread, the Documentary Credit would lose its integrity, independence and thereby its raison d'être."*

[18] "*Opinions of the ICC Banking Commission 1995-1996" ICC Publication No. 565 at page 22*

Can a DOCDEX panel take into account allegations of fraud? Article 3 of the UCP makes it clear that letters of credit constitute transactions which are separate from the underlying contract. For example, the buyer / importer alleges fraudulent behaviour on the part of the seller / exporter, as a result of which the buyer seeks to argue that payment should not be made by the bank. Could a DOCDEX panel take into account the underlying contract in such circumstances?

As in the case of the UCP, there is no reference to fraud in the DOCDEX Rules. Furthermore, a DOCDEX panel is not in a position to investigate allegations of fraud.[19] There is no right to a hearing under the DOCDEX Rules. Fraud allegations invariably take time to investigate and may involve expert forensic evidence and the cross-examination of experts and witnesses as to fact.

Again, the answer must be that fraud allegations should be dealt with in the national courts.

VI Banks and the Fraud Exception: Some Conclusions

The English cases show that, where the fraud exception applies, banks may be justified in refusing to make payment (and have a defence if they are sued by the beneficiary or other party tendering documents).

The basis of the fraud exception is that the Courts will not permit their processes to be used by fraudsters in pursuit of their fraudulent activities.

What lessons can banks learn from the decisions of the English Courts?

(1) Basically, banks can feel safe in England. Although the Courts will not permit their processes to be used in furtherance of fraud, nevertheless, save in "*exceptional circumstances*", the integrity of the banking system must be upheld.

(2) Given that many cases come before Court at a pre-trial stage, banks have the further benefit that the "*balance of convenience*" is likely to be in their favour.

(3) The position of banks is further supported by the view expressed in at least one decided English case that, where fraud is alleged, it is not for a bank to investigate such allegations.

(4) Rather than interfere with the bank's obligations under the Documentary Credit system, where fraud is alleged it is open to an English Court to grant a

[19] At one stage, the author took a different view on whether or not a DOCDEX panel could consider allegations of fraud. However, experience of the DOCDEX system since then suggests that it is not possible to deal with fraud allegations under the DOCDEX system. See "DOCDEX: the ICC's Rules for Documentary Credit Dispute Resolution Expertise", *Butterworths Journal of International Banking and Financial Law*, November and December 1998, Volume 13 No. 10 at page 472 and Volume 13 No. 11 at page 523. See also "Documentary Credits: a Dispute Resolution System From the ICC" by Anthony Connerty: *Sweet and Maxwell's Journal of International Banking Law*, March 1999, Volume 14 at page 65.

Mareva injunction (now re-named "*Freezing Injunction*") and if appropriate to order also that the monies due under the documentary credit be paid into court pending determination of the fraud allegations at trial.[20]

(5) Even where a bank has itself been guilty of making a false claim against another bank, apportionment of loss will not be made by way of contributory negligence in circumstances where false documentation is tendered in support of an application for payment.

(6) However, one area where banks must take care is in relation to the discounting of deferred payment letters of credit: the decision of the Court of Appeal in the *Banco Santander* case contains serious warnings to banks.

Will the International Chamber of Commerce consider making some provision by way of amendment to the UCP in the light of the comments of the English Court of Appeal?

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[20] The authors of the "Encyclopaedia of Banking Law" (Butterworths) take the view that the "*Mareva jurisdiction should have no application in relation to payments under letters of credit…*" Volume 2, paragraph F298.1