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LLM in Commercial Law Dissertation Titled

**‘TOWARDS A MORE FLEXIBLE APPROACH TO THE FRAUD  
EXCEPTION IN LETTERS OF CREDIT UNDER SOUTH AFRICAN LAW:  
A Comparative Analysis with Select Common Law Approaches and the  
UNCITRAL Convention.’**

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## **ABSTRACT**

The aim of this dissertation is to recommend an alternative approach to the fraud exception in South African law. The Current South African position as with the English law, places more weight on upholding the sanctity of the autonomy principle in letters of credit than preventing fraud. This is mainly because the courts have traditionally taken the view that protection of the autonomy principle is central to promoting the needs of trade and maintaining the integrity of the international banking community. Hence, this dissertation argues that an approach to the fraud exception in South African law that is more in line with that of the American law and/or the UNCITRAL Convention strikes a better balance in upholding the value of letters of credit and combatting fraud than the current South African position. Based on the comparative analysis of the position in the United Kingdom, United States of America and under the UNCITRAL Convention, the dissertation seeks to draw upon important lessons and principles pivotal to a preferable approach to the fraud exception in South African law that would enhance a better balance between the autonomy arguments and deterrence of fraud.

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## **CHAPTER 1 INTRODUCTION**

### **I Aim of the Dissertation**

The aim of this dissertation is to argue for an alternative approach to the fraud exception in South African law. The main argument of the dissertation is that an approach to the fraud exception in South African law that is in line with or more in line with, that of the American law and/or the UNCITRAL Convention strikes a better balance in upholding the value of letters of credit and combatting fraud than the current South African position.<sup>1</sup> In South Africa, as in England, the courts seem to have embraced the strict approach to the fraud rule. However, it is observed that the requirements of such a stringent approach to the fraud exception, which is heavily centred on maintaining the sanctity of the autonomy principle in letters of credit may in certain instances create undesirable situation of protecting fraudsters.<sup>2</sup>

The dissertation employs a comparative analysis of the South African position with the position in the United Kingdom, United States of America and under the UNCITRAL Convention with the objective of drawing important lessons and make recommendations for a preferable approach based on the American law and the UNCITRAL Convention that strikes a better balance in the application of the fraud exception than the current South African position.

### **II Background**

Historically, letters of credit have played a fundamental role as a payment method in the financing of international trade. The efficacy and commercial utility of letters of credit has been described by the judges as the ‘life blood of international commerce’.<sup>3</sup> The appeal of letters of credit lies in their inherent important nature being that they are independent of the underlying transaction on which they are based. This fundamental principle is known as the autonomy principle. In international sale transactions, the

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<sup>1</sup> In particular, article 19 and 20 of the United Nations Convention on Independent Guarantees and Standby Letters of Credit (‘UNCITRAL Convention’), issued by the United Nations Commission on International Trade Law (UNCITRAL). The Convention was adopted by the General Assembly of the United Nations at its fiftieth session by resolution No.48 on 11 December 1995 and entered into force on 1 January 2000. The Convention is designed to facilitate the use of independent guarantees and standby letters of credit, in particular where only one or the other of those instruments may be traditionally in use. The UNCITRAL Convention has a binding force of law only to parties in countries that are signatories and have ratified it.

<sup>2</sup> See X Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 98.

<sup>3</sup> *Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146 at 155.

immediate payment in exchange for goods is practically impossible. The letter of credit offers the seller with the means to reduce the risk of non-payment on the part of the seller by substituting the buyer's promise to pay for that of a bank, a more reliable and solvent paymaster in the seller's country.

However, the autonomy principle has been challenged with the problems of fraud. A case in point would arise in circumstances where the goods are not as per the contract of sale or the documents presented contain misrepresentation of facts. The fact that any one of these factors could vitiate the letter of credit raises very crucial questions that trenches upon the autonomy principle. Will the bank be allowed to refuse to pay under the letter of credit in these circumstances? Secondly, should the buyer be made to bear liability in the event of a fraudulent demand for payment by the beneficiary? Unfortunately, the UCP does not contain provisions that address the fraud issue.<sup>4</sup> As a result of this inactive position of the UCP, most jurisdictions have adopted different approaches in defining the limits and application of the fraud exception.

Central to the application of the fraud rule, is the need for a balanced consideration that 'there is just as much public interest in discouraging fraud as in encouraging the use of letters of credit.'<sup>5</sup> Thus, proper application of the fraud exception requires striking a particular balance between the two competing interests.<sup>6</sup> First, on the one hand, the need to preserve the autonomy principle of letters of credit, which advances the wider public interest of promoting international trade by facilitating the efficacy and utility of letters of credit. On the other hand, the assurance of payment that inherently flows from the autonomy principle in favour of the beneficiary exposes both the bank and the applicant to the risk of fraudulent demands for payment. Therefore a requirement of excessive strict adherence to the autonomy principle would potentially place the buyer in a position without any means of

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<sup>4</sup> The Uniform Customs and Practice for Documentary credits (UCP) are a set of uniform rules issued by the International Chamber of Commerce (ICC), designed to standardise the international banking practices relating to documentary credits. In its very nature, the UCP does not have the force of law because it is regarded as a general source of law that consist mercantile customs and practices. In accordance with article 1, the UCP rules will apply if the parties have expressly agreed to incorporate them into their contract. For the purposes of this dissertation, reference will be made to the current seventh version, UCP 600, which took effect on 1 July 2007.

<sup>5</sup> See *Dynamics Corporation of American v Citizens & Southern National Bank* 356 F Supp 991 (ND Ga 1973) at 1000.

<sup>6</sup> See Nelson Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 2.

protection against fraud by the beneficiary and ultimately creating a situation that conflicts with the general public interest in discouraging the proliferation of fraud.<sup>7</sup>

This dissertation focuses on the scope of the fraud exception to the autonomy principle in letters of credit. However, judicial authorities dealing with the fraud exception in the context of demand guarantees and standby letters of credit will be referred to wherever relevant in the dissertation.<sup>8</sup> Generally, the position of common law courts is that independent guarantees and standby letters of credit stand on a similar footing to letters of credit with respect to the autonomy principle, doctrine of strict compliance and the fraud exception despite the major differences between the two instruments and letters of credit.<sup>9</sup> One of the main similarities based on the autonomous nature is that independent guarantees and standby letters of credit share the legal character of a letter of credit, in the sense that the issuer's obligation to pay is independent of the underlying contract. Based on the similar treatment given to both letters of credit and independent guarantees with respect to the fraud exception, the dissertation also draws on certain principles in relation to fraud in the context of independent guarantees, particularly the approach to the fraud exception as demonstrated by the UNCITRAL Convention that relates to Independent Guarantees and Standby Letters of Credit.

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<sup>7</sup> Ibid.

<sup>8</sup> Generally, demand guarantees and standby letters of credit fall under the same family name known as independent guarantees since both instruments have the same legal nature and may serve the same commercial purpose.

<sup>9</sup> The main difference between letters of credit and independent guarantees can be found in their commercial purposes. In the case of a letter of credit, it constitutes a normal mode of payment upon performance of commercial obligations on the part of the beneficiary, whereas an independent guarantee is designed as a default instrument to provide security to the beneficiary in the event of non-performance on the part of the applicant. This means that while the issuer of a letter of credit expects to pay, the issuer of an independent guarantee does not normally expect to pay.

### **III The Structure**

The dissertation is composed of seven chapter outlined as follows.

Following the introduction in Chapter 1 is Chapter 2, which mainly discusses the general nature and operational framework of letters of credit. This chapter is mainly structured to enable the reader to understand and appreciate the nature, working system and fundamental principles of letters of credit.

Chapter 3 examines the narrow approach taken by the South African courts to the fraud exception. This chapter mainly seeks to demonstrate that the current South African position is unsatisfactory in the balance it strikes between upholding the autonomy principle in letters of credit and preventing the proliferation of fraud.

Chapter 4 examines the approach of the fraud exception in the case of the English law and it also attempts to show similarities in the application of the fraud rule with that of the South African law. The main objective of this chapter is to demonstrate that the approach of the English courts, like the South African courts is unsatisfactory in the balance it strikes between the two competing policy objectives in the context of the fraud exception.

Chapter 5, presents a contrasting position of South African approach to that of the American approach, which embraces a more expansive and flexible approach to the fraud exception. The main objective of this chapter is to demonstrate how such an approach reflects a better balance between the need to preserve the autonomy of letters of credit and the general public interest of combatting fraud.

Chapter 6 considers the UNCITRAL Convention's provisions and the balance it strikes in the context of the fraud exception.

Lastly, Chapter 7 contains the conclusions reached with respect to main issues discussed in this dissertation and recommendations based on the conclusions.

## **CHAPTER 2 OPERATIONAL FRAMEWORK OF LETTERS OF CREDIT**

### **I Introduction**

A letter of credit is generally defined as an undertaking by the bank, at the request of its customer (the applicant) or on its own account, to pay a specified amount to the beneficiary upon presentation of documents that comply with the requirements of the credit.<sup>1</sup> The international banking practice relating to letters of credit is standardised by the Uniform Customs and Practice for Documentary Credits (UCP). In terms of UCP 600, a documentary credit is defined as ‘any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.’<sup>2</sup> The fundamental principle that governs the letters of credit is that a credit transaction is independent of the underlying contract on which it based (‘the autonomy principle’). The courts have recognised the essential commercial value of letters of credit as being equivalent to cash in hand.<sup>3</sup> There is, however, one widely accepted exception to the autonomy principle, which involves fraud.

This chapter discusses the general operation framework of letters of credit. Part II outlines the parties involved in a letter of credit transaction. Part III looks at the series of legal relationships and the respective contractual obligations under a letter of credit. Part IV discusses the autonomy principle and its rationale. Part V discusses sources of the autonomy principle. Part VI deals with the fraud exception, its rationale, the competing interests that underpin the application of the fraud exception and different approaches. Part VII contains a summary of the main issues that form the subject of the chapter.

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<sup>1</sup> See Nelson Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 7; Andrew Borrowdale ‘Notes and comments: The autonomy rule and the fraud exception in documentary credits’ (1982) 99 *SALJ* 136.

<sup>2</sup> See art 2 of the UCP 600.

<sup>3</sup> *Power Curber International v National Bank of Kuwait SAK* [1981] 3 All ER 607 at 612.

## **II Parties to the Credit Transaction**

A letter of credit transaction involves a number of parties depending on the existing number of inter-banking relationships. The buyer who applies for the credit is known as the applicant. The bank that undertakes the issuance of the credit is known as the issuing bank. The seller in whose favour the credit is issued is known as the beneficiary. The correspondent bank located in the seller's country that gives notification of the opening of the credit is known as the advising bank. Also in certain cases the advising bank may assume the role of a confirming bank, if it adds its own promise to that of the issuing bank to pay the beneficiary. There may be another bank in the seller's country, known as the nominated bank to which documents are to be presented and payment received.

## **III Contractual Relationships**

The issuing of a confirmed letter of credit usually involves a series of five separate but interconnected contractual relationships. First, the underlying sales contract creates the rights and duties between the buyer and seller. Second, the credit agreement between the applicant and the issuing bank. Third, a contractual relationship exists between the issuing bank and the beneficiary. Fourth, a contract between the issuing bank and the bank correspondent bank, which advises or confirms the credit. Fifth, a legal relationship exists between the confirming bank and the beneficiary, where the correspondent bank also becomes the confirming bank. The above outlined series of contractual relationships are discussed in the sections below.

### *(a) The Underlying Contract of Sale*

This is a contract entered into between the buyer and seller. The underlying contract of sale gives the basis on which a letter of credit is issued. However, this contract is separate from and independent of the credit agreement.<sup>4</sup> The main purpose of the underlying contract to a letter of credit transaction is to stipulate the terms of the credit to be opened. Typically, the sales contract should include terms such as a description of the goods, the currency, the unit price, and the amount, the method of payment, the terms of delivery, and the time period for the shipment and presentation of documents.

Once the parties have settled on the terms of the sales contract, the buyer assumes the obligation to open a letter of credit with the issuing bank. This obligation on the

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<sup>4</sup> See art 4 (a) and art 5 of the UCP 600.

part of the buyer is regarded as a condition precedent to the shipment of the goods by the seller. This principle dictates that the seller assumes no obligation to performance of the contract until the letter of credit is opened. The point is well illustrated by Denning J in *Trans Trust SPRL v Danubia Trading Co Ltd* as the following extract makes it clear:

‘...In other cases a contract is concluded and the stipulation for the credit is a condition which is an essential term of the contract. In those cases the provision of the credit is a condition precedent, not to the formation of the contract, but to the obligation of the seller to deliver the goods. If the buyer fails to provide the credit, the seller can treat himself as discharged from any further performance of the contract and can sue the buyer for damages for not providing the credit.’<sup>5</sup>

*(b) Relationship between the Applicant and Issuing Bank*

This contract comes into existence when the issuing bank accepts instructions from the applicant to open a letter of credit. Generally, the nature of the legal relationship that arises from this contract is based on contract of mandate.<sup>6</sup> In this case, the issuing bank undertakes to perform a mandate or commission for the applicant.<sup>7</sup>

In principle, the issuing bank has the following obligations towards the applicant (buyer). First, the issuing bank has a duty to issue a credit which complies with the buyer’s instructions either by itself or through a nominated bank. Second, it must notify the beneficiary of the credit. Failure to fulfil this obligation on the part of the issuing bank constitutes a breach of contract with the applicant. Third, the issuing bank must examine the documents presented by the beneficiary and honour if they conform to the terms of the credit.<sup>8</sup> If the bank honours a non-complying presentation, the buyer will not be bound to reimburse the bank. In *Equitable Trust Co of New York v Dawson Partners Ltd*,<sup>9</sup> the House of Lords held that the applicant had no obligation to reimburse the bank as the bank had not complied strictly with the applicant’s instructions. Fourth, the bank must make payment to the beneficiary in accordance with terms of the credit.<sup>10</sup> Lastly, the bank assumes the duty to adopt a reasonable

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<sup>5</sup> [1952] 1 Lloyd’s Rep 348 at 355.

<sup>6</sup> See P Ellinger and D Neo *The Law and Practice of Documentary Letters of Credit* (2010) 84.

<sup>7</sup> See JP Van Niekerk and WG Schulze *The South African Law of International Trade: Selected Topics* 3 ed (2011) 282.

<sup>8</sup> Article 14 of the UCP 600.

<sup>9</sup> (1927) 27 LIL Rep 49.

<sup>10</sup> See art 7(b) of the UCP 600.

interpretation of ambiguous instruction given by the applicant to the bank. This was acknowledged in *Midland Bank v Seymour*, where the court held that ‘when an agent acts upon ambiguous instructions he not in default if he can show that he adopted what was a reasonable meaning.’<sup>11</sup>

There are three duties which the applicant undertakes to perform towards the issuing bank. The first one is the duty to accept from the bank the documents presented by the seller provided on their face conform to terms of the credit. Second, the applicant must reimburse the issuing bank for the amount paid to the seller. Lastly, the applicant has a duty to pay the issuing bank’s charges.

*(c) Relationship between Issuing Bank and Seller*

The issuing of an irrevocable letter of credit constitutes a binding contract between the issuing bank and the beneficiary<sup>12</sup>. This legal relationship comes into being when the advising bank provides notification of the credit and upon the receiving of the credit by the beneficiary. The issuing bank assumes an obligation to pay the beneficiary upon presentation of documents that comply with the terms of the credit and within the time period the credit is available.<sup>13</sup> If the bank wrongly rejects and refuses to pay against documents that comply with the requirements of the credit, the beneficiary can bring an action for damages against the bank for breach of contract.<sup>14</sup> On the other hand, if the beneficiary makes a non-complying presentation and bank decides to refuse to honour or negotiate, it must give a notice to the presenter within a reasonable time, not exceeding five banking days from the date of receipt of the documents.<sup>15</sup> Failure to give a notice precludes the bank from claiming that the documents do not constitute a complying presentation.<sup>16</sup>

The beneficiary has a duty to present documents that comply with the requirements of the credit, at the place stipulated in the credit and within the time that the credit is available.<sup>17</sup> If the beneficiary makes a presentation that does not conform to terms of the credit, the bank is entitled to reject them and dishonour. Also where

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<sup>11</sup> [1955] 2 Lloyd’s Rep 147 at 153.

<sup>12</sup> Article 7 (b) of the UCP 600.

<sup>13</sup> Article 7 (a) and 6 (e) of the UCP 600.

<sup>14</sup> See *Dexters Ltd v Schenker & Co* (1923) 14 Lloyd’s Rep 586 at 588.

<sup>15</sup> See art 16 (c) and (d) of the UCP 600.

<sup>16</sup> Article 16 (f) of the UCP 600.

<sup>17</sup> See art 6 (d) (ii) and (e) of UCP 600.

fraud is found on the part of the beneficiary, the bank is entitled to refuse payment despite the documents on their face conforming to the requirements of the credit.

*(d) Relationship between Issuing Bank and Correspondent Bank*

This contract comes into existence where the issuing bank gives instructions requiring a foreign bank located in the beneficiary's country to provide specific services. The engagement of a correspondent bank offers an advantage to the beneficiary to easily deal with a local bank rather than another bank in a foreign country.<sup>18</sup> The roles of a correspondent bank vary namely, advising bank, confirming bank, nominated bank and less commonly, a correspondent issuer.<sup>19</sup>

The role of the advising bank is to communicate the opening of the credit to the beneficiary without any undertaking to honour or negotiate. This arrangement entails that the obligation for payment under the credit solely remains on the part of the issuing bank. Essentially, the advising bank has two responsibilities towards the beneficiary in terms of article 9 (b) of the UCP 600. First, the advising bank has to satisfy itself as to the apparent authenticity of the credit. Second, the advising bank has to verify that the advice accurately reflects the terms and conditions of the credit.

The correspondent bank assumes the role of a confirming bank by adding its own undertaking to pay the beneficiary provided that complying documents are presented. If the credit transaction requires the engagement of a nominated bank, the confirming bank is under obligation to reimburse the nominated bank that has received complying documents and made payment to the beneficiary.<sup>20</sup>

The role of a nominated bank is to receive, examine the documents and pay the beneficiary.<sup>21</sup> A nominated bank is entitled to reimbursement from the issuing bank or confirming bank if it makes payment to the beneficiary against a complying presentation of documents.<sup>22</sup> One fundamental principle to the undertaking of a nominated bank is that unless a nominated bank is the confirming bank, it has no

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<sup>18</sup>See I Carr *International Trade Law* 5ed (2014) 439.

<sup>19</sup> The role of the correspondent issuer is outside the scope of this work as it is less common in practice, it will not be discussed further. For a detailed discussion, see Ellinger and Neo op cit (n6) 175-177; Enonchong op cit (n1) 28.

<sup>20</sup> Article 8(c) of the UCP 600.

<sup>21</sup> Article 12 of the UCP 600.

<sup>22</sup> See art 7(c) and 8(c) of UCP 600

undertaking to honour or negotiate, except when expressly agreed to by the nominated bank and so communicated to the beneficiary.<sup>23</sup>

*(e) Relationship between Confirming Bank and Seller*

This contract comes into existence when a correspondent bank in the beneficiary's country confirms a credit. In principle, the confirming bank's undertaking is in addition to, not a substitute for the issuing bank's undertaking.<sup>24</sup> The confirming bank undertakes the same obligations towards the beneficiary as does the issuing bank, which is primarily to pay the beneficiary against documents that comply with terms stipulated under a letter of credit.<sup>25</sup>

#### **IV The Autonomy Principle**

The fundamental principle that governs the operation of letters of credit transactions is that the payment obligations of the issuing or confirming bank are independent of matters arising from the underlying contract. This characteristic of letters of credit is known as the autonomy principle. The primary object of the autonomy principle is to provide assurance of payment to the beneficiary upon presentation of documents that comply with the terms of the credit. Central to the autonomy principle is that the obligations of the bank towards the beneficiary are in respect of the documents not in respect of the goods. This entails that as long as the documents presented appear on their face to conform to the terms of the credit, the bank must pay even though there may be disputes involving the performance of the underlying contract.

The autonomy principle is pivotal to maintaining the efficacy and commercial utility of letters of credit. In this regard, the courts have traditionally been reluctant to interfere with the autonomy principle. It is long established that the courts will not allow the applicant to interrupt payment under a letter of credit on mere allegations that the quality of the goods does not conform to the contract of sale.<sup>26</sup> Therefore the principle behind the operation of letters of credit is often referred to as 'pay now and sue later.'<sup>27</sup> In the event of a dispute arising from the underlying contract, the bank

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<sup>23</sup> Article 12(a) of the UCP 600.

<sup>24</sup> See Enonchong op cit (n1) 25.

<sup>25</sup> See As part II (c) in this chapter.

<sup>26</sup> See *Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146; *Intraco Ltd v Notis Shipping Corporation of Liberia*, (The 'Bhoja Trader' case); [1981] 2 Lloyd's Rep 256 *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941); *United City Merchants (Investments) Ltd v Royal Bank of Canada* (1983) AC 168.

<sup>27</sup> See Ellinger and Neo op cit (n6)139, Enonchong op cit (n1) 67.

must pay and the buyer has an option to seek redress against the beneficiary by bringing a separate action. However, the autonomy principle is not immune from the fraud exception, which has been widely recognised.

### **V Sources of the Principle of Autonomy**

The autonomy principle of letters of credit has been recognised in three broad sources namely, the Uniform Customs and Practice for Documentary Credits (UCP), statutes and case laws. These sources are briefly discussed in the sections below.

#### *(a) UCP*

The Uniform Customs and Practice for Documentary Credits (UCP), is a creation of the International Chamber of Commerce (ICC), which consists a set of uniform international contractual rules designed to harmonise the international banking practices in relation to documentary credits. However, the UCP does not have a binding force of law. This means that it will only apply subject to an express agreement between the parties to incorporate the UCP into their contract.<sup>28</sup> The UCP provides an international recognition of the principle of autonomy that applies to letters of credit. Article 4, establishes the autonomy principle on the basis of the independent nature of letters of credit from transactions giving rise to it. Article 5 reinforces the principle of autonomy on the basis of paper-driven nature of letter of credit, stating that ‘banks deal with documents and not with goods, services or performance to which the documents may relate.’

#### *(b) Case law*

The courts in most common law jurisdiction have long established that to allow intervention of payment under a credit would jeopardise certainty of payment associated with letters of credit. The sanctity of the principle of autonomy was first recognised in the American landmark case of *Sztejn v J Henry Schroder Banking Corporation*,<sup>29</sup> where Shientag J stressed that:

‘It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the 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. One

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<sup>28</sup> For more details, see (n3) in Chapter 1.

<sup>29</sup> *Sztejn* supra (n26).

of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise.’<sup>30</sup>

Under the English law, an early pronouncement of the autonomy principle is found the case of in *Hamzeh Malas and Sons v British Imex Industries Ltd.*<sup>31</sup> Jenkins LJ expressed the view that a letter of credit transaction ‘imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties (to the underlying contract of sale) as to whether the goods are up to a contract or not’.<sup>32</sup> A not dissimilar view was echoed in *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd*,<sup>33</sup> where the court acknowledged that ‘the obligation of the bank is to perform that which it is required by that particular contract,... that obligation does not depend on the correct resolution of the disputes as to the sufficiency of performance by the seller to the buyer or by the buyer to the seller.’<sup>34</sup> This case concerned a payment under a demand guarantee, however, the position in England and in other common law jurisdictions is that demand guarantees and letters of credits are treated in a similar manner in relation to the principle of and the fraud exception.<sup>35</sup> In *Power Curber International*, where Lord Denning MR, when considering the consequences flowing from the autonomous nature of contractual undertaking on letters of credit, expressed a view that ‘[i]t is vital that every bank which issues a letter of credit should honour its obligations. The bank is in no way concerned with any dispute that the buyer may have with the seller.’<sup>36</sup>

In the leading English case of *United City Merchants (Investments) Ltd and v Royal Bank of Canada*,<sup>37</sup> Lord Diplock explained, rather eloquently and succinctly, that:

‘The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract

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<sup>30</sup> Ibid at 633-4.

<sup>31</sup> (1958) 2 QB 127.

<sup>32</sup> Ibid at 129.

<sup>33</sup> (1978) 1 Lloyds’s Rep.161.

<sup>34</sup> Ibid at 165.

<sup>35</sup> See Ellinger and Neo op cit (n6) 143.

<sup>36</sup> *Power Curber International* supra (n3) at 1241.

<sup>37</sup> *United City Merchants* supra (n26).

of sale being used as a ground for non-payment or reduction or deferment of payment.’<sup>38</sup>

*(c) Uniform Commercial Code (UCC)*

In the United States, the autonomy principle is contained in a code, namely, the Uniform Commercial Code (UCC) with a similar scope to the provisions of the UCP 600.<sup>39</sup> The primary object of Article 5 is to allow the contracting parties to align the contractual terms of their letter of credit in accordance with the provisions of the UCP.<sup>40</sup>

The autonomous nature of letters of credit is encapsulated in the Revised Article 5 of the UCC, which expressly states that the issuer’s undertaking under the letter of credit is independent of the underlying transaction.

Article 5-103(d) provides that:

‘Rights and obligations of an issuer to a beneficiary or to a nominated person under a letter of credit are independent of the existence, performance, or non-performance of a contract or arrangement out of which a letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.’

In addition, article 5-108(f) reinforces the principle of autonomy and relevantly provides that:

‘An issuer is not responsible for the performance or non-performance of the underlying contract, arrangement, or transaction, an act or omission of others, or the observance of or knowledge of the usage of a particular trade other than the relevant standard banking practice.’

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<sup>38</sup> Ibid at 183-4.

<sup>39</sup> See Ellinger and Neo op cit (n6) 54.

<sup>40</sup> Ibid 55.

## VI The Fraud Exception to the Autonomy Principle

The inherent assurance of payment derived from the principle of autonomy carries with it the risk that the seller may abuse it and defraud the buyer by way of presenting fraudulent documents or in the underlying transactions.<sup>41</sup> For example, a seller may claim that he has shipped goods in accordance with the terms of the contract when in actual fact non-conforming goods or no goods at all were shipped, or the bill of lading had been backdated to convey the false message that shipment took place within the stipulated time.

In response to resolving the unsatisfactory situation that the beneficiary may unjustly benefit from its own fraudulent acts under a letter of credit transaction, common law courts established the fraud exception to address the problem of fraud and offer the legal protection for the buyers. Jurisprudentially, the American landmark case of *Sztejn* is of significance for Shientag J there provided a classic statement for the well-known formulation of the fraud exception, when he proclaimed that ‘the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.’<sup>42</sup> The overwhelming rationale for the fraud exception is to prevent unscrupulous beneficiaries from benefiting in the system. The fraud exception entitles the buyer by way of obtaining an injunction to restrain either the bank from making payment to the beneficiary or the beneficiary from receiving payment under a credit.

Similarly, in the leading English decision of the House of Lords in *United City Merchants*, Lord Diplock articulated, in an often cited passage, the legal basis for the fraud exception:

‘[t]he 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.*’<sup>43</sup>

This classical dictum has survived the ravages of time, and continues to provide the legal justification for the application of the fraud rule under the English law.

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<sup>41</sup> See RJ Lee ‘Strict compliance and the fraud exception: Balancing the interests of mercantile traders in the modern law of documentary credits’ (2008) 5 *MqJBL* 137 at 168.

<sup>42</sup> *Sztejn* supra (n26) at 634.

<sup>43</sup> *United City Merchants* supra (n26) at 184. Emphasis added.

Following the above illuminating statements from both the American and English leading decisions, it clear that the courts will not allow a seller to assert the autonomy principle in furtherance of an intention to defraud the bank and the buyer.

Although the fraud exception has been recognised in most common law jurisdiction, the courts in various jurisdictions have taken different approaches. The resulting situation creates the great concern of uncertainty in the area of the fraud exception. For example, the English courts have taken a narrow view of the fraud exception, applying it only to cases of fraud in the documents. The South Africa courts, like the English courts, have also followed the narrow construction of the fraud exception. On the other hand, the courts in the United States have taken a wide approach to the fraud exception, which includes both fraud in the documents and fraud in the underlying transaction. At the international level, the UNCITRAL Convention seem to have adopted the wide approach aimed at preventing unfair or fraudulent calls on demand guarantees and stand-by letters of credit. It is said that although the fraud rule has been established to deter the activities of fraudsters, its scope must be carefully applied so as not to jeopardise the commercial utility of letters of credit with which the prime object is to provide assurance of payment.<sup>44</sup>

## **VII Summary**

Letters of credit play a vital role as a payment mechanism that helps reduce certain risks to parties in international trade. The assurance of payment inherent in these instruments carries with it the risk of fraudulent demands by unscrupulous beneficiaries. The fraud exception was established as a cure to the problem of fraud. However, the courts in different common law jurisdictions have adopted different approaches. It is observed that a preferable approach to the fraud exception is one that strikes a better balance between two poles; the need for protection of the buyer from the beneficiary's fraud against the benefits gained by preserving the letter of credit as a commercial instrument and device.<sup>45</sup>

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<sup>44</sup> X Gao and RP Buckley 'A comparative analysis of the standard of fraud required under the fraud rule in letter of credit law' (2003) 13 *Duke J Comp & Int'l L* 293.

<sup>45</sup> EL Symons 'Letters of credit: Fraud, good faith and the basis for injunctive relief' (1979 -1980) 54 *Tul L Rev* 338 at 343.

## CHAPTER 3 THE SOUTH AFRICAN POSITION

### I Introduction

Under South African law, the development of the fraud rule has been predominantly based on case law. The fraud exception to the principle of autonomy of letters of credit has been considered or referred to in a few cases under South African law. The South African courts have clearly distinguished between fraud and innocent breach of contract.<sup>1</sup> In South Africa, as in England, the courts adopted the narrow construction of the fraud exception so as to allow the autonomy of letters of credit to be disturbed in the least possible of instances. This position is explained by the focus of the courts being on the need to preserve the efficacy of documentary credits and the needs of international trade.<sup>2</sup>

This chapter examines the application of the fraud exception under the South law with a view to search for reasons that justify the adopted approach and to find possible solutions that may enhance the application of the fraud rule with much more flexibility and certainty. The main issues discussed in this chapter lay a foundation for a comparative analysis with the approaches to the fraud exception as considered in chapter 4, 5, and 6 respectively.<sup>3</sup> To facilitate the discussion, this chapter is divided into eight main parts outlined as follows. Part II outlines a brief historical development of the fraud rule under South Africa law. Part III examines the standard of fraud adopted by the courts. Part IV looks at the standard of evidence required for the application of the fraud rule. Part V deals with issue of time at which knowledge of fraud is relevant both to the bank and the beneficiary. Part VI looks at the concept of fraud under South African approach. Part VII discusses the general law of interim interdicts. Part VIII contains a summary of the South of the key issues discussed.

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<sup>1</sup> JP Van Niekerk and WG Schulze *The South African Law of International Trade: Selected Topics* 3ed (2011) 302.

<sup>2</sup> *Loomcraft Fabrics CC v Nedbank Ltd* 1996 (1) SA 812 (A) at 816G-817G, the then Appellate Division dealt with the disastrous consequences to the international trade if the purpose of letters of credit were undermined. See also other South African and English cases cited at 816C-817E.

<sup>3</sup> See S Rodolfo 'Legal formants: A dynamic approach to comparative law' (1991) 39 *Am J Comp L* 1. The comparative study of law provides a better understanding not only in achieving uniformity, but also whenever ideas, principles or lessons are to be adapted from other foreign legal systems. See also J Gordley 'Comparative legal research: Its function in the development of harmonized law' (1995) 43 *Am J Comp L* 555. The law of an individual country cannot be thoroughly examined independently of the law of others, thus one must look beyond its horizons.

## II Historical Development of the Fraud Rule

The first South African case to refer to fraud involving letters of credit was *Phillips v Standard Bank of South Africa*.<sup>4</sup> In this case the court pronounced the principle that a mere breach of the underlying contract by the beneficiary will not entitle the applicant to enjoin the payment by way of an interdict against the bank. The case concerned the applicants who sought an interdict to restrain the bank from making payment under a letter of credit on the ground that a large number of the shoes delivered by an Italian manufacturer and exporter were materially defective. The court dismissed the application for an interdict on the ground that the applicant had not made out a case of fraud. Further, the court held that the allegations made by the applicants were quite consistent with an ‘innocent breach of contract.’<sup>5</sup> The important outcome of the judgement is that the court acknowledged the independence principle of letters of credit transactions and made reference to prominent cases in England and the United States.<sup>6</sup> However, the judgment of the *Phillips* did not consider in detail the issue of the fraud exception as the court expressly refrained from commenting on the extent to which, and circumstances under which, it would consider the fraud exception.<sup>7</sup>

In *Ex parte Sapan Trading (Pty) Ltd*,<sup>8</sup> the decision of the court clearly illustrated the importance of the principle of independence of letters of credit although the facts of the case were not directly concerned with the fraud exception.<sup>9</sup> The question for consideration by the court was whether the applicant would stop payment to the beneficiary by way of an attachment order of the beneficiary’s claim against the issuing bank in an action intended against the beneficiary. The court cited with approval the decision of the *Phillips* and other leading English cases, which acknowledged the principle of independence and stated that the agreement between the issuing bank and the beneficiary ‘is separate from, and independent of such

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<sup>4</sup> 1985 (3) SA 301 (W).

<sup>5</sup> Ibid at 303I–304A.

<sup>6</sup> See ibid at 304D–E.

<sup>7</sup> See A Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) 464; Van Niekerk and Schulze op cit (n1) 302.

<sup>8</sup> 1995 (1) SA 218(W).

<sup>9</sup> Oelofse op cit (n7) 465.

underlying contracts.<sup>10</sup> The Court of Appeal dismissed the application for an attachment order on the basis that plaintiff's failed to establish a prima facie cause of action.

In *Union Carriage v Nedcor Bank Ltd*,<sup>11</sup> the applicant sought an interdict to restrain the beneficiary (Siemens) bank from receiving payment under a standby letter of credit. On appeal, the court dismissed the application for an interdict on the ground that the applicant had not alleged fraud on the part of the beneficiary. Therefore the only question before the court was to determine whether the conditions for effecting the payment under a standby letter of credit had been fulfilled. In this regard, the court mentioned by way of an *obiter dictum* that had the beneficiary and the applicant entered into an agreement in terms of which the beneficiary undertook not to draw on the letter of credit and the beneficiary knowing that it had given such an undertaking, nevertheless, sought to extract payment under the letter of credit, it could conceivably be guilty of fraud.<sup>12</sup> It has been pointed out that the illuminating remarks made by the court support the view that the application of the fraud rule is not confined to fraud in the documents.<sup>13</sup>

The decision of the then Appellate Division in *Loomcraft Fabrics CC v Nedbank Ltd* is of significance in that in that the court provided illuminating guidelines on the limitation of the autonomy principle by the fraud exception.<sup>14</sup> There, the court had the first opportunity to provide the answer to the question concerning the autonomy principle and its possible limits in the context of letters of credit. The essential facts in *Loomcraft* were briefly these. Loomcraft, a South African company had contracted to purchase a quantity of fabric from Perfel, a Portuguese textile manufacturing company. Loomcraft applied to Nedbank to open a letter of credit for deferred payment in favour of Perfel. The expiry date of the credit was 18 May 1992 and the latest date for shipment was 8 May 1992. The goods arrived in Durban on 18 June 1992 and were received by Loomcraft in Johannesburg shortly afterwards. The goods arrived later

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<sup>10</sup> *Ex Parte Sapan Trading* Supra (n8) at 223. Here the court referred to the English judicial authority, in particular, the dictum of Griffiths LJ in *Power Curber International v National Bank of Kuwait SAK* [1981] 3 All ER 607 at 614f-g.

<sup>11</sup> 1996 CLR 724(W).

<sup>12</sup> *Ibid* at 735.

<sup>13</sup> See Oelofse op cit (n7) 477; Van Niekerk and Schulze op cit (n1) 305.

<sup>14</sup> *Loomcraft* supra (n2).

than Loomcraft had expected and it was further dissatisfied with the quality of the goods. On 4 August 1992 Loomcraft brought an application in the Witwatersrand Local Division for an interdict restraining Nedbank from making payment under the letter of credit. It alleged that the transport documents presented to Nedbank contained a fraudulent misrepresentation as to the date of shipment. The initial date stamped on the documents was 13 May 1992 with additional words reflecting on the documents 'actually on board'. Later, it was observed that 13 May was an incorrect date, since the goods were received by the carrier on 7 May 1992. The date of issue was then corrected to reflect 8 May, but owing to an oversight the words 'actually on board' were not deleted. Loomcraft's application was dismissed and it went on appeal.

On the facts before it, the then Appellate Division found that there appeared to be an error, rather than fraud, on the part of the beneficiary.<sup>15</sup> Further, it was held that mere error, misunderstanding or oversight, however unreasonable, could not constitute a case of fraud.<sup>16</sup> The court confirmed the widely recognised autonomy principle of the letters of credit, and stated that the bank's liability to honour its undertaking towards the beneficiary depended on the presentation of a set of documents that strictly conform to the requirements of the credit.<sup>17</sup> Furthermore, the court stated that where such conforming documents were presented, the bank could not escape its liability to pay, except in the most exceptional circumstances, for example, on proof of fraud on the part of the beneficiary.<sup>18</sup> The court also endorsed a similar view as of the English authorities that the beneficiary's fraud would have to be 'established clearly'.<sup>19</sup> In addition, the burden of proof required was the ordinary civil one that had to be discharged on a balance of probabilities and, 'as in any other case where fraud was alleged, fraud would not lightly be inferred.'<sup>20</sup> With respect to circumstances giving rise to the application of the fraud rule, the court stated that a court will grant an interdict restraining a bank from paying the beneficiary under a credit in the event that

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<sup>15</sup> Ibid 821E.

<sup>16</sup> Ibid at 822G–H.

<sup>17</sup> Ibid at 815H–J.

<sup>18</sup> Ibid.

<sup>19</sup> Ibid at 817G. Here the court endorsed the view that was echoed in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976 (CA) at 171-175.

<sup>20</sup> Ibid.

the beneficiary was a party to fraud in relation to the documents presented to the bank for payment.<sup>21</sup>

In comparison with other authorities previous discussed, the outcome of the judgment in *Loomcraft* bears the following pertinent observations.<sup>22</sup> First, it is said that the court in reaching its decision closely adopted the narrow view of the fraud exception as formulated by English courts.<sup>23</sup> Second, no special standard of proof was considered on the part of the applicant seeking an interdict to restrain the bank from making the payment under a letter of credit. However, it should be noted that the high-sounding pronouncement that ‘fraud would not lightly be inferred’ appears to have practical effect of requiring something substantially more than a mere balance of probabilities or a mere prima facie right. This position demonstrates that the question on the precise degree of proof is still unsettled under South African law.<sup>24</sup> Third, the court gave a strong indication that in appropriate cases where the applicant has shown the evidence of fraud to the satisfaction of the court, the court will be in a position to grant an interdict on the basis of fraud.

In a more recent case of *Casey v First National Bank Ltd*,<sup>25</sup> the judgment of the court of the first instance illustrated the traditional narrow approach, consistent with the approach taken in the *Loomcraft* case, where the decision of the court weighted more on the autonomy arguments rather than the prevention of fraud in letters of credit. In essence, the question before the court was whether prescription of the underlying debt does affect the obligation on the issuing bank to honour the claim presented by the beneficiary in accordance with the requirements of the stand-by letter of credit. In this case, the applicants alleged that the draw-down claim on the standby letter of credit by FirstRand Bank was fraudulent on the ground that debt had prescribed. The court of the first instance held that prescription of a debt does not affect enforceability of the standby letter of credit, which was dependent only on its own terms for its continued

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<sup>21</sup> Ibid at 816A-B and 821G-H. Here the then Appellate Division cited with approval the decision of the House of Lords in *United City Merchants (Investment) Ltd v Royal Bank of Canada* [1982] 2 All ER 720 (HL) at 725.

<sup>22</sup> See Oelofse op cit (n7) 472; Van Niekerk and Schulze op cit (n1) 303.

<sup>23</sup> In particular, Lord Diplock’s formulation of the fraud exception in the leading case of *United City Merchants* supra (n21).

<sup>24</sup> See Oelofse op cit (n7) 472.

<sup>25</sup> 2013 (4) SA 370 (GSJ).

validity.<sup>26</sup> On the facts the case, the court dismissed the application on the ground that the applicants failed to show proof that the respondent bank had not met the requirements for payment claim under the standby letter of credit. Similar to the previous cases, the court reiterated the autonomy principle by stating that a standby letter of credit similar to all letters of credit ‘is independent from the underlying contract...the buyer or borrower cannot go behind the document to stop or suspend the payment on the ground of a breach of the underlying contract by the seller,...’<sup>27</sup> The court also acknowledged the widely recognised concept of the fraud exception as established in other judicial authorities that ‘payment would not be permitted in circumstances where the beneficiary were a part to a fraud in the documents presented to the bank for payment under a letter of credit.’<sup>28</sup>

On appeal, the court unanimously affirmed the judgment of the court of the first instance and dismissed the appeal in holding that the alleged prescription of the underlying debt did not affect the obligation on the issuing bank to honour the claim presented by the beneficiary in accordance with the requirements of the irrevocable letter of credit, in the absence of fraud.<sup>29</sup>

### **III Standard of Fraud**

The then Appellate Division in *Loomcraft* adopted the meaning of fraud being material representations of fact that to the beneficiary’s or its agents are untrue at the time of presenting the documents to the bank.<sup>30</sup> The decision of the court in *Loomcraft* seems to follow the House of Lord’s narrow formulation of the exception in the *United City Merchants* case,<sup>31</sup> in holding that the only fraud necessary to invoke the fraud exception was that of the beneficiary himself or acting through its agents. In this sense, the fraud focuses on proof of the beneficiary’s knowledge or intention, thus excluding the fraud of a third party. The potential problem arising from this standard is that is an inquiry into the beneficiary’s state of mind is not likely to be easy and may require extensive investigation.<sup>32</sup> Undoubtedly, the burden of proof of the actual knowledge

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<sup>26</sup> Ibid at 377E-378B.

<sup>27</sup> Ibid at 375G.

<sup>28</sup> Ibid at 375C-D.

<sup>29</sup> See *Casey v FirstRand Bank Ltd* 2014 (2) SA 374 (SCA) at 379F-H and 380D-H.

<sup>30</sup> See *Loomcraft* supra (n2) at 817G-H.

<sup>31</sup> *United City Merchants* supra (n21) at 725g.

<sup>32</sup> HY Low ‘Confusion and difficulties surrounding the fraud rule in letters of credit: An English perspective’ (2011) 17 *JIML* 462 at 465.

results in unfair allocation of risk in favour of the beneficiaries.<sup>33</sup> As such therefore, it is argued that the scope of the fraud exception should not be confined the requirement of actual knowledge of the beneficiary.<sup>34</sup> In contrast, the United States under the revised Article 5 of the UCC has adopted the standard of fraud that looks more on the severity of the effect of fraud on the transaction.<sup>35</sup> It is correctly observed a proper standard of fraud is one that is formulated in accordance with the main function of the letter of credit; it ensures that neither the seller nor buyer has both cash and goods at the same time.<sup>36</sup>

#### **IV Evidence of Fraud**

In the *Loomcraft* case, the then Appellate Division endorsed the view as the English courts that the beneficiary's fraud would have to be established clearly. In addition to the showing of a case of clear fraud, the burden of proof required was the ordinary civil one, which has to be discharged on a balance of probabilities and, as in any other case where fraud is alleged, 'fraud would not lightly be inferred.'<sup>37</sup> However, it has been argued that the impressive phrase that 'fraud would not lightly be inferred' suggests having a practical effect of requiring something more substantial than a mere proof on a balance of probabilities.<sup>38</sup> This position is open to some doubts on the question concerning how much compelling the evidence of fraud must be, still remains uncertain under South African law.<sup>39</sup> In this regard, the approach adopted by the English courts may offer practical guidance. It is generally accepted by the English courts that the appropriate test to determine a case of clear fraud is that based on the 'material before the court, the only realistic inference is that of fraud.'<sup>40</sup>

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<sup>33</sup> Ibid.

<sup>34</sup> Ibid. See also Gao op cit (n29) 132.

<sup>35</sup> RP Buckley 'The 1993 Revision of the Uniform Customs and Practice for Documentary Credits' (1995) 6 *JBFLP* 77 at 97.

<sup>36</sup> Comment, 'Fraud in the transaction: Enjoining letters of credit during the Iranian revolution' (1980) 93 *Harv L Rev* 992 at 1009.

<sup>37</sup> *Loomcraft* supra (n2) at 817F-G.

<sup>38</sup> See Oelofse op cit (n7) 472; Van Niekerk and Schulze op cit (n1) 303.

<sup>39</sup> Ibid 480.

<sup>40</sup> See *United Trading Corporation SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554 at 561; *Themehelp Ltd v West and Others* [1996] QB 84 and *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446.

## **V The Time at Which Knowledge of Fraud Must be proved**

A survey of the South African judicial authorities in which the fraud exception was referred to did not deal with the issues concerning the material time at which the fraud had to be clear to the beneficiary and the bank. Hence, in the absence of authority on this issue, it is likely that the South African courts would align their view similar with the English courts.<sup>41</sup>

## **VI The Notion of Fraud: Narrow Sense and Wide Sense**

When dealing the question of where fraud must be located, one has to consider a distinction between fraud in the narrow sense and fraud in the wide sense. Fraud in the narrow sense relates to documentary fraud, which arises where the beneficiary present documents to the bank which contain material false representation. The notion of fraud in the wide sense refers to fraud in the underlying transaction, which arises where the beneficiary makes a demand for payment when he is not entitled to payment under the underlying contract and he has no honest belief that he entitled to payment.<sup>42</sup>

The then Appellate Division, in the *Loomcraft* case, closely followed the narrow construction of the fraud exception as formulated by the leading English authority.<sup>43</sup> The court seemed to have recognised the fraud exception to the case where the fraud committed by the beneficiary related to documents.<sup>44</sup> However, caution is given in respect to this conclusion because the facts of the case in *Loomcraft* concerned only alleged fraud in the documents and the applicant did not assert any fraudulent conduct on the part of the beneficiary outside the documents.<sup>45</sup> Therefore, it is argued that the decision of the court in the *Loomcraft* case cannot be taken as the authority to answering the question whether the scope of the fraud exception is confined to fraud in the documents or it extends beyond to fraud in the underlying transaction.<sup>46</sup> Further, it has been pointed out that the fact that the court in *Loomcraft* referred to the house of Lords decision with approval and took it as authority was neither here or there.<sup>47</sup> A better perspective on this argument is that the *Loomcraft* case was decided at the time

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<sup>41</sup> MK Louw, *Selective Legal Aspects of Bank Demand Guarantees* (unpublished LLD, University of South Africa) (2008) 385.

<sup>42</sup> See *United Trading Corporation SA V Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep.554 at 559.

<sup>43</sup> See Van Niekerk and Schulze op cit (n1) 304.

<sup>44</sup> Ibid.

<sup>45</sup> Ibid.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid.

when the *United City Merchants* case was still the leading authority and way before the recent English authorities were pronounced that dealt with the fraud exception in the underlying transaction.<sup>48</sup> In the light of this it could lead to another conclusion although open to debate, that had the judgment in *Loomcraft* been handed down after the recent English cases, probably the view taken by the then Appellate Division would have been different.

It is argued that the narrow view of the fraud exception is unsustainable with regard to the purpose of the fraud rule as well as the public policy aimed at control of fraud.<sup>49</sup> This is because under the narrow view, the application of the fraud rule is only referred to fraud in the documents, whereas fraud in the underlying transaction is does not fall within the scope of the exception. As a result, this position creates a loophole which may encourage unscrupulous beneficiaries to commit fraud in the underlying transaction.<sup>50</sup> In this regard, it is correctly observed that a wide approach to the fraud exception would be welcomed under South African in keeping with judicial developments in other jurisdictions.<sup>51</sup> For example, in the United States the fraud exception has been expanded to include fraud in the underlying transaction.

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<sup>48</sup> Ibid.

<sup>49</sup> X Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 112.

<sup>50</sup> Ibid.

<sup>51</sup> See Van Niekerk and Schulze op cit (n1) 305.

## VII Fraud and Interdicts

The South African courts have indicated that an interdict restraining a bank from paying under a documentary credit or a beneficiary from receiving payment under a letter of credit would only be granted in exceptional circumstances.<sup>52</sup> This would require the applicant to show proof of fraud on the part of the beneficiary to the satisfaction of the court. Although the question concerning the required standard of proof of fraud still remains uncertain under South African law, the most probable deduction could be that the courts would require the standard of clearly established fraud similar to the traditional approach applied by the English courts.<sup>53</sup>

Under South African law, an interdict can either be interim or final.<sup>54</sup> In the case of the former, the applicant will need to meet the following requirements:

- (1) a prima facie right;
- (2) a well-grounded apprehension of irreparable harm if the interim relief is not granted and the ultimate relief is granted;
- (3) a balance of convenience in favour of the granting of the interim relief; and
- (4) the absence of any other satisfactory remedy

However, as a matter of principle, the court retains discretionary powers to refuse the granting of an interim interdict despite the fact that all the requirements have been satisfied.<sup>55</sup> The general test for the granting of an interim interdict under the South African law is premised on the prima facie right applied together with the balance of convenience.

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<sup>52</sup> See *Union Carriage* supra (n11) at 732; and *Loomcraft* supra (n2) at 816 C-D and 817 E-F.

<sup>53</sup> See Van Niekerk and Schulze op cit (n1) 304. The reason for this deduction stems from the analysis of the decision in *ZZ Enterprises v Standard Bank of South Africa Ltd* 1995 CLR 769 (W). Here the court mentioned in passing that there would have to be case of 'clearly established' fraud to invoke the fraud exception.

<sup>54</sup> The focus of this chapter is on interim relief given by courts in the context of a letter of credit, hence the discussion will only consider interim interdicts.

<sup>55</sup> See Oelofse op cit (n7) 480.

*(a) Interdicts against the bank*

There are two reported South African cases where the applicants sought interdicts against the bank in the context of letters of credit. In both cases, the applicants were unsuccessful in obtaining interdicts to restrain the banks from paying. In *Philips*,<sup>56</sup> the court dismissed the application for an interdict on the ground that the facts of the case were a mere breach of the underlying contract by the beneficiary. In *Loomcraft*,<sup>57</sup> the court stated that the fraud on the part of the beneficiary had to be established clearly before an interdict could be issued. In this case the applicant was unsuccessful because the court found that fraud was not clearly established. However, in instances where fraud is found after the bank has effected payment in good faith, the applicant's avenue of justice lies in a civil action against the beneficiary.<sup>58</sup>

*(b) Interdicts against the beneficiary*

The first South African case which concerned with the application for an interdict against the beneficiary was the *Union Carriage* case,<sup>59</sup> where the applicant was unsuccessful in obtaining an interdict against the beneficiary. An important observation in the decision of this case is that South African courts are prepared to grant such interdicts in appropriate circumstances, but only in the most exceptional circumstances.<sup>60</sup>

It seems that the difficulties imposed on the applicants of such interdicts under South African law are generally similar to the difficulties an applicant would encounter under the English law in the context of letters of credit. To date, there are only two reported successful English cases and both concerned with performance bonds.<sup>61</sup> This outcome illustrates the point that although the courts in both jurisdictions apply slightly different tests for the application of interim interdicts (interlocutory injunctions under the English law), it is especially difficult to obtain an interdict or injunction in the context of letters of credit. In contrast, the United States has adopted a more relaxed approach that allows the court to issue an injunctive relief even on the basis of suspicion of fraud as a means to prevention of fraud.

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<sup>56</sup> *Philips* supra (n4).

<sup>57</sup> *Loomcraft* supra (n2).

<sup>58</sup> See Van Niekerk and Schulze op cit (n1) 305.

<sup>59</sup> *Union Carriage* supra (n11).

<sup>60</sup> *Ibid* at 732.

<sup>61</sup> For example, *Themehelp* supra (n40) ; *Kvaerner* supra (n40).

## VIII Summary

The implementation of the fraud rule in South Africa law is still developing due to the scarcity of case law in the area of letters of credit fraud. The most logical explanation for this position is that in developing countries such a case as South Africa, there is a minimal scale of international trade, resulting in little litigation in the law of letters of credit.<sup>62</sup> Thus, a situation that is different in developed countries where there is more considerable level of litigation.<sup>63</sup> Because of this position, most of the cases in which fraud has been considered, the South African courts have often found guidance from international jurisprudence, especially the decisions of the English courts.

In South Africa, as in England, the courts have highly embraced the narrow view of the fraud exception with strict requirements for the application of the fraud rule. The main justification for this approach, as revealed by case law is for the purpose of preserving the autonomy principle, which in turn advances the needs of international commerce. It seems that the South African courts are settled on the beneficiary's knowledge as the standard of fraud rather than an objective standard that directs an inquiry into the factual circumstances of the case. So far, there is no authority on the point whether fraud in the underlying transaction falls with the fraud exception. Also the issue regarding the precise standard of proof is still unsettled under South African law.

Throughout this chapter the relevant case law has illustrated that the South African courts' strict approach to the fraud exception gives more weight on the autonomy arguments than the prevention of fraud. It is respectfully argued that such a stringent approach can lend a compromise to the effectiveness of the fraud rule.<sup>64</sup>

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<sup>62</sup> See B Maripe 'The legal aspects of documentary credits in international trade: the case for Botswana' (1997) 30 *Comp & Int'l L J S Afr* 199.

<sup>63</sup> *Ibid.*

<sup>64</sup> See Gao *op cit* (n49) 98.

## **CHAPTER 4 THE APPROACH OF THE ENGLISH COURTS**

### **I Introduction**

The application of the fraud rule has developed as part of the common law system under the English law. Although the fraud exception is recognised in England, the courts have applied the fraud rule in a very restrictive way. Generally, the courts have imposed a high standard of proof on the plaintiffs requiring them to establish the existence of ‘clear’ or ‘obvious’ fraud also to the notice of the bank. In addition, the balance of convenience should be in favour of granting an injunction. The position of the English courts is that the fraud rule will only operate to stop payment in exceptional circumstances.<sup>1</sup> The reason for maintaining this position is based on two separate but related issues; the need to preserve the autonomy principle of letters of credit, which provides assurance of payment to the beneficiary and the need to promote international trade and the integrity of the banking system.<sup>2</sup>

This chapter examines the English courts’ approach to the fraud exception in the context of letters of credit. Part II discusses a brief historical development of the fraud rule under the English law. Part III examines the standard of fraud adopted by the English courts. Part IV looks at the issue of material time at which knowledge of fraud is relevant to the bank and the beneficiary. Part V discusses the concept of the fraud exception. Part VI examines the standard of proof required in applications for an interlocutory injunction and the application of the balance of convenience test. Part VII contains a summary of the main issues surrounding the application of the fraud under the English law and the way in which it weighs the balance between the competing interests that underpin the application of the fraud exception.

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<sup>1</sup> See *RD Harbottle (Mercantile) v National Westminster Bank* [1978] QB 146.

<sup>2</sup> *Ibid* at 870.

## II Historical Development of the Fraud Rule

The development of the English case law dealing with the fraud exception is based on an American case of *Sztejn v Henry Schroder Banking Corporation*.<sup>3</sup> The decision of the *Sztejn* case has been often cited with approval in the English Courts.

### (a) Early cases

The first English case that considered fraud as an exception to the principle of autonomy with the approval of the *Sztejn* case was *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International*.<sup>4</sup> In this case, the buyer showed evidence to the court that not only were the goods delivered later than the stated date on the invoice but also the inspection proved that out of the 8,625 records ordered, only 275 were delivered in accordance with the order and the rest were not as ordered, and were either rejects or unsaleable.<sup>5</sup> Relying on the decision of the Supreme Court of New York in *Sztejn*, the buyer attempted to enjoin the issuing bank from paying on the seller's draft, alleging that the seller was guilty of fraud. However, the bank had already paid the discounting value of the credit though that was not due at that time.

Megarry J rejected the buyer's claim, distinguished the case from *Sztejn* on two grounds. First, the court regarded the *Sztejn* case as a matter of 'established fraud'. However, in this case the court considered that it only involved an allegation of fraud and not 'established fraud'.<sup>6</sup> The court reasoned that it would be difficult to resolve the fraud issue the seller was not a party to the action.<sup>7</sup> Second, the court stated that judicial interference should not be invoked in this type of commercial transaction unless a 'sufficiently grave cause' is shown.<sup>8</sup>

The decision of the court in the *Discount* case illustrated the difficulty of meeting the high standard of proof required by the English courts. The criticism against the outcome of the judgment is that even though the buyer had obtained evidence in the presence of a third party, the issuer, which showed that a large proportion of the

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<sup>3</sup> 31 NYS 2d 631(1941).

<sup>4</sup> [1975] 1 All ER 1071.

<sup>5</sup> Ibid at 1073.

<sup>6</sup> Ibid at 1074.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid at 1075.

shipment was either rubbish or empty cartons, the court held that there was no established fraud, but merely an allegation of fraud.<sup>9</sup>

Later, the fraud exception was considered in two subsequent cases of *RD Harbottle v National Westminster Bank* and *Edward Owen Engineering Ltd v Barclays Bank International Ltd*.<sup>10</sup> The two cases concerned disputes of fraud in performance bonds. However, the position in England and in other common law jurisdictions is that demand guarantees and letters of credits are treated in a similar manner in relation to the principle of independence and the fraud exception. In the *Harbottle* case, the court dismissed the interlocutory injunction that had earlier been granted to restrain the banks from paying as it was found that there was no established fraud. The facts of the case that were relevant to fraud were briefly as follows. The English plaintiffs concluded a sale contract with Egyptian buyers. In the contract it provided that the plaintiffs should establish a guarantee confirmed by a bank in favour of the buyers. The plaintiffs contended that the buyers had demanded payment under guarantee without justification. This claim was rejected by the court in a key passage referring to the fraud exception, as Kerr LJ articulated the matter in this way:

‘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.’<sup>11</sup>

The court reaffirmed the importance of the independence principle of letters of credit transactions and stated that the court will enjoin the bank except in clear cases

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<sup>9</sup> X Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 49-50.

<sup>10</sup> *Harbottle* supra (n1); [1978] 1 QB 159.

<sup>11</sup> *Harbottle* supra (n1) at 155-156.

of fraud of which the banks have notice.<sup>12</sup> Also the decision of the court illustrated the reasons for the narrow construction of the fraud exception and unwillingness of the English courts to meddle in international commerce. Thus the narrow ambit of fraud is generally justified on grounds of commercial efficacy or ‘life-blood of commerce’.<sup>13</sup>

In *Edward Owen Engineering*, a seller sought an interlocutory injunction to enjoin its bank from paying a Libyan bank that had issued a performance bond in favour of the buyer in Libya. The seller alleged that the buyer’s demand for payment under the bond was fraudulent and it was to the knowledge of both the English and Libyan banks. The Court of Appeal endorsed the view of the court in the *Harbottle* case and discharged an interlocutory injunction that had earlier been granted to restrain the banks from paying under a performance bond as the court found that there was no established fraud. Accordingly, in the judgment delivered by Denning MR with whom other members of the court agreed, the applicant must show ‘clear fraud of which the bank has notice’,<sup>14</sup> that a claim of fraud must be ‘very clearly established’<sup>15</sup> and that it must be ‘clear and obvious to the bank’<sup>16</sup> that the beneficiary had been guilty of fraud.

*(b) The leading case: United City Merchants*

The leading English authority that provided some light on the parameters of both the autonomy principle and the fraud exception is the decision of the House of Lords in *United City Merchants (Investments) Ltd v Royal Bank of Canada*.<sup>17</sup> The question for consideration was whether fraud by a third party of which the beneficiary was unaware would fall within the scope of the fraud exception. The facts of the case relevant to fraud were briefly as follows. In 1975, Glass Fibres and Equipment Ltd, an English company entered into a contract selling glass fibre making equipment to a Peruvian company named Vitrorefuerzos SA (Vitro). Payment was to be made by an irrevocable letter of credit issued by the Banco Continental SA of Peru and confirmed by the Royal Bank of Canada. Glass Fibres and Equipment Ltd assigned their rights, entitlements and benefits under the credit to United City Merchants, and notice of the assignment was

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<sup>12</sup> Ibid.

<sup>13</sup> Ibid.

<sup>14</sup> Ibid at 171.

<sup>15</sup> Ibid at 173 (Browne LJ).

<sup>16</sup> Ibid at 175 (Lane LJ).

<sup>17</sup> [1983] AC 168 (HL).

given to the banks. The contract provided that the goods had to be shipped on or before 15 December 1976. However, an employee of the forwarder fraudulently predated the bill of lading to 15 December 1976 when shipment had actually been made on 16 December 1976. On presentation of the documents, the confirming bank refused to pay because it became aware the shipment had not been made as shown on the bill of lading. Before the court was the question whether the bank is entitled to refuse to pay against documents that apparently conform on their face, but where the goods had not been shipped within the time period stipulated in the sale contract.

The court of the first instance held that the defendant bank was not entitled to refuse payment under the credit on the ground of fraud committed by a third party. The trial court's decision was subsequently reversed by the Court of Appeal in holding that the applicant's mandate to the bank was to pay against genuine documents, and therefore that the bank would be entitled to refuse paying against forged documents. Further, it was held that the fact that the fraud had been committed by a third party could not prevent the bank from raising the defence of fraud against the beneficiary. In this sense, Ackner LJ expressed a view which has much to commend it, that 'it is the character of the document that decides whether it is a conforming document and not its origin.'<sup>18</sup> It should be noted that the decision of the Court of Appeal was centred on the nature of the documents irrespective of the perpetrator of fraud. The decision of the House of Lords is not left without criticism, as observed by one eminent academic, Professor RM Goode, 'a fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party.'<sup>19</sup> Another prominent commentator describes the decision of the House of Lords in this way:

'English law, however, appears to protect shrewd sellers who utilise the services of third parties discreet enough to keep their fraudulent practises to themselves. The law in effect encourages sellers not to inquire into the details of the activities of third parties involved in their transactions so long as the bills of lading appear valid, for any knowledge of wrongdoing would jeopardise the sellers' chances of being paid. A bank which receives firm evidence external to the documents of

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<sup>18</sup> [1981] 1 Lloyd's Rep 604 at 628- 629.

<sup>19</sup> RM Goode 'Reflections on letters of credit – I' (1980) *JBL* 291 at 294.

fraud by a third party does not even have the option of refusing to honour a credit governed by English law as stated in the *American Accord*.<sup>20</sup>

When the case went to the House of Lords, it reversed the decision of the Court of Appeal and upheld the decision of the court of first instance. The House of Lords reiterated the importance of the autonomy principle and held that the fraud exception did not extend to fraud by a third party. Lord Diplock first described the autonomous nature of the documentary credit that the parties to it “deal in documents not in goods” and emphasised that disputes as to the goods are irrelevant to the seller’s rights to payment.<sup>21</sup> His Lordship went on and recognised the fraud exception and stated:

‘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.’<sup>22</sup>

Lord Diplock further explained the legal basis of the fraud exception in the following often quoted passage that has survived the ravages of time:

‘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.’<sup>23</sup>

On the facts of the case, the House of Lords held that the fraud exception did not apply as the beneficiary was an innocent party and genuinely believed the goods have been shipped as required under the credit. Further, it was held that the bank, which had confirmed the credit, was bound to pay on tender of the backdated bill.

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<sup>20</sup> GW Smith ‘Irrevocable letters of credit and third party fraud: The American Accord’ (1983 -1984) 24 *Va J Int’l L* 55 at 70-71.

<sup>21</sup> *United City Merchants* supra (n20) at 182-183.

<sup>22</sup> *Ibid* at 183.

<sup>23</sup> *Ibid* 183-4.

### III The Standard of Fraud

Under the English law, the beneficiary's knowledge or intention seems to have been settled as the standard of fraud to invoke the fraud rule. Thus the fraud exception applies where there is representation of facts untrue to the knowledge of the presenter of the documents. The leading case on point is the decision of the House of Lords in *United City Merchants*. In accordance with Lord Diplock's formulation, the meaning of fraud consists of the following elements.<sup>24</sup> First, the documents must contain, expressly or by implication, material representations of fact that are untrue. Second, the beneficiary must fraudulently present documents for the purpose of drawing on the credit with the knowledge of such untruth.

Following the leading decision, there appears two propositions to be drawn in respect to the beneficiary's knowledge that falls within the fraud exception.<sup>25</sup> The first scenario is where the document created and presented by beneficiary and contains a material statement that is untrue. The second scenario is where the beneficiary, before presenting a document created by a third party, the beneficiary had knowledge that it contained a material false representation he will be guilty of fraud. However, it is observed that the problem with the standard of intentional fraud is that the degree of knowledge of fraud is primarily based on an inquiry into actual knowledge rather than constructive knowledge.<sup>26</sup>

In addition to the requirement of the beneficiary's knowledge, the element of material false representation is also required for the application of the fraud exception. Thus fraud arises where there exists sufficient evidence of a false statement made in a document.<sup>27</sup> However, it is observed that the decision of the House of Lords in the *United City Merchant* case provides very little light on the meaning of the word 'material' representation of fact.<sup>28</sup> With regards to the issue of materiality, Lord Diplock put the matter in this way:

'The answer to the question: "to what must be misstatement in the documents be material?" should be: "material to the price which the goods to which the

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<sup>24</sup> Ibid at 183G.

<sup>25</sup> See P Ellinger and D Neo *The Law and Practice of Documentary Letters of Credit* (2010) 142.

<sup>26</sup> Ibid.

<sup>27</sup> See R Goode *Commercial Law* 3ed (2004) 991.

<sup>28</sup> See Ellinger and Neo op cit (n26) 141; Nelson Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 104-105.

documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security".<sup>29</sup>

It is suggested that the word 'material' means material to the bank's duty to pay, so that if the documents stated the truth the bank would be obliged and entitled to reject the documents.<sup>30</sup> For example, in the *United City Merchants* case itself, if the bill of lading reflected the correct date of shipment, it would have been outside the credit period.<sup>31</sup> It is respectfully pointed out that this interpretation offer a far better statement of the principle even though it seems to be contrary to Lord Diplock's judgment, which is out of step with the wider law and the practice of letters of credit.<sup>32</sup>

#### **IV Time at which knowledge of fraud must be apparent**

When considering the application of the fraud exception, it is essential to establish the relevant time at which fraud must be clear both to the beneficiary and the bank. The relevant time for the beneficiary's knowledge of fraud is the time of presentation. It is to be noted that if the beneficiary becomes aware of the falsity of the document after presentation, his claim to payment cannot be defeated. In *Group Josi Re v Wallbrook Insurance*,<sup>33</sup> Staughton LJ observed that:

'It is nothing to the point that at the time of trial the beneficiary knows, and the bank knows, that the documents presented under the letter of credit were not truthful in material respect. It is the time of presentation that is critical.'<sup>34</sup>

The question concerning the relevant time at which fraud must be clear to the bank may arise in two different situations. First, if the bank has already paid on the credit and the applicant is refusing reimbursement. Secondly, if the bank has not paid out and is resisting proceedings by the beneficiary for payment under the credit. In the first situation, a bank that honours a presentation without requisite knowledge of the beneficiary's fraud is entitled to reimbursement. This principle was acknowledged in *Credit Agricole Indosuez v Generale Bank*,<sup>35</sup> where the negotiating bank which had paid the beneficiary claimed reimbursement from the issuing bank. Further, it was stated that the fraud has to be clear to the knowledge of the bank at the time of

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<sup>29</sup> *United City Merchants* supra (n17) at 186.

<sup>30</sup> See A Malek and D Quest Jack: *Documentary Credits* 4ed (2009) 254.

<sup>31</sup> *Ibid*.

<sup>32</sup> Gao op cit (n9) 89.

<sup>33</sup> [1996] 1 WRL 1152

<sup>34</sup> *Ibid* at 1161.

<sup>35</sup> [1999] 2 All ER (Comm) 1009.

payment.<sup>36</sup> In *United Trading Corporation SA v Allied Arab Bank Ltd*,<sup>37</sup> it was held that it is not open to contest that an applicant can rely on evidence of fraud not apparent to the bank at the time of payment.

In the second situation, if fraud is clear at the time of presenting the documents then the bank is entitled to refuse payment and it has a defence to a claim by the beneficiary. The most crucial issue has been whether the bank that has in the first place rejected the documents on the ground of non-conformity can later rely on the new evidence of fraud to its notice after the date of payment but before the time of the hearing. In *Balfour Beatty Civil Engineering v Technical and General Guarantee Co Ltd*,<sup>38</sup> the court observed the ‘absurdity’ that would result if judgment is entered against the bank because the evidence of fraud was not available to the bank at the time of payment.<sup>39</sup> In *Mahonia Ltd v JP Morgan Chase Bank*,<sup>40</sup> the court held that the availability of the bank’s defence does not depend on whether evidence of fraud is made available before or after time of presentation.<sup>41</sup> Here the decision of the court relied on the principle that the court should not lend its process to assist fraud. It seems that the more recent English decisions support the view that the bank can adduce the evidence necessary to establish fraud at whatever stage in the proceedings prior to the hearing.<sup>42</sup>

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<sup>36</sup> *Ibid* at 1015.

<sup>37</sup> [1985] 2 Lloyd’s Rep.554 at 560.

<sup>38</sup> [1999] 68 Con LR 180.

<sup>39</sup> *Ibid* at 189.

<sup>40</sup> [2003] 2 Lloyd’s Rep.911.

<sup>41</sup> See the subsequent trial in *Mahonia Ltd v JP Morgan Chase Bank* [2004] EWHC 1938 (Comm) at 209.

<sup>42</sup> See *Safa Ltd v Banque du Caire* [2000] 2 Lloyd’s Rep 600 (CA); *Solo Industries UK Ltd v Canara Bank* [2001] 1 WLR 1800.

## V The Notion of Fraud: Narrow Sense and Wide Sense

When dealing with the issue of the fraud exception the misrepresentation is either in the documents presented to the bank or in the underlying transaction. However, it is still unsettled among the English courts as to whether the exception extends beyond fraud in the documents to fraud in the underlying transaction.<sup>43</sup>

### (a) *Fraud in the documents*

In the leading English case of *United City Merchants*, Lord Diplock stated that the exception referred to documents that contain, expressly or by implication, material representation of fact that to the beneficiary's knowledge are untrue.<sup>44</sup> This seems to suggest that the fraud exception is confined to fraud in the documents themselves.<sup>45</sup> However, it is observed that it is not clear as to whether his Lordship referred to documentary fraud in relation in light of the facts of the case or he confined the fraud exception to documents only.<sup>46</sup> The decision of the House of Lords did not settle the question whether the exception extends to fraud in the underlying transaction.

### (b) *Fraud in the underlying transaction*

Fraud in the underlying transaction arises where the documents tendered by the beneficiary are truthful but there is fraud in the transaction on which the credit is based. As pointed out in the above section, there is no English case authority that expressly decides the point whether the exception extends to fraud in the underlying transaction in the context of letters of credit.<sup>47</sup> However, it is argued that Lord Diplock's maxim that 'the courts will not allow their process to be used by a dishonest person to carry out a fraud' appears to indicate the exception extends to fraud in the underlying transaction.<sup>48</sup> Also viewing it from the policy consideration that the fraud exception was established to prevent unscrupulous beneficiary from benefiting from his own fraudulent acts, it would seem to have sound justification in extending the fraud

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<sup>43</sup> See Malek and Quest op cit (n30) 254.

<sup>44</sup> *United City Merchants* supra (n17) at 183- 4.

<sup>45</sup> See Ellinger and Neo op cit (n25) 142; D Horowitz *Letters of Credit and Demand Guarantees: Defences to Payment* (2010) 25.

<sup>46</sup> See Ellinger and Neo op cit (n25) 142; Enonchong op cit (n28) 101.

<sup>47</sup> However, in the case of performance bonds it now settled that the exception extends to fraud in the underlying transaction. For example, in *Themehelp v West* [1996] QB 84, where fraud in the underlying transaction was deemed sufficient to support the application of the fraud exception. Also in *Solo Industries* supra (n42), where the bank succeeded in its defence that the performance bond was voidable on the ground that the bank was induced to issue by fraud on the part of the beneficiary.

<sup>48</sup> Horowitz op cit (n45) 25.

exception to fraud in the underlying transaction rather than limiting it to fraud in the documents.<sup>49</sup>

## **VI Interlocutory Injunctions and Standard of Evidence**

The English courts generally require a high standard of proof to succeed in proceedings dealing with the fraud exception. However, English courts have made distinction between the standard of evidence required to obtain an interlocutory injunction and the evidence necessary to entitle a bank to refuse to pay in proceedings under a summary judgment. In the former case, where an applicant may seek an interlocutory injunction either against the bank or beneficiary, it is a requirement that the fraud must be 'established' or compelling. In a case involving proceedings against the bank by the beneficiary in a summary judgment, all that a bank has to show is either the 'real prospect of successes or 'established fraud' depending on the locus of the beneficiary's fraudulent acts.

A party who alleges fraud may seek an application for an interlocutory injunction to restrain a bank from making payment under a credit or a beneficiary from receiving payment. The general guiding principles of the standard proof required for an interlocutory injunction were set out in the decision by the House of Lords in *American Cyanamid Co v Ethicon Ltd.*<sup>50</sup> The test formulated is whether there is a 'serious question to be tried'.<sup>51</sup> This is generally to be understood that the court had to be satisfied that the claim is not frivolous or vexatious.<sup>52</sup>

### *(a) Injunctions against the bank*

The issue concerning the fraud exception is like to arise primarily where the applicant seeks an injunction to stop the bank from making payment under a letter of credit. The result of the high standard of proof required of the plaintiff in order to convince the courts to grant an injunction on the basis of the fraud exception is that such injunctions are extremely difficult to obtain.

The difficulty of meeting this high standard of proof is illustrated in a number of cases. The case of *Discount Records* is one of the first reported English cases to consider the issue of when an interlocutory injunction could be granted to restrain a

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<sup>49</sup>See Ellinger and Neo op cit (n25) 143.

<sup>50</sup> [1975] AC 396.

<sup>51</sup> Ibid at 407.

<sup>52</sup> Ibid.

bank to pay under a credit where there the beneficiary had been fraudulent.<sup>53</sup> The applicant had clearly shown that not only were the goods delivered later than the stated on the invoice, but there was also evidence that 97 per cent of the goods delivered were not as ordered and were either rejects or unsaleable. Nevertheless, the court decided not to grant an injunction on the ground that there was no established fraud but merely an allegation of fraud.<sup>54</sup>

Later, a similar issue came up for decision in two subsequent cases involving performance bonds. In the *Harbottle* case,<sup>55</sup> the court rejected an interlocutory injunction that had earlier been granted to stop certain banks from paying under some performance bonds as the court found that there was no established fraud. Kerr J expressed the view that injunctions should not be granted '[e]xcept possibly in clear cases of fraud of which the banks have notice.'<sup>56</sup> A similar view was reaffirmed by the Court of Appeal in the *Edward Owen Engineering* case,<sup>57</sup> where the court discharged an interlocutory injunction that had been granted to restrain a bank from paying under a performance bond. The members of the court emphasised that the applicant must show 'clear fraud of which the bank has notice'.<sup>58</sup> On the facts of the case, the Court of Appeal held that the requirements of the fraud exception had not been met, payment could not be enjoined. In *Bolivinter Oil SA v Chase Manhattan Bank*, the Court of Appeal stated that '...the evidence must be clear, both to the fact of fraud and as to the bank's knowledge.'<sup>59</sup>

It is to be noted that the English courts in the preceding cases did not seem concerned that insisting on a high standard of established fraud was not in accordance with a lower threshold test set in the *American Cyanamid* case. Later, in *United Trading*,<sup>60</sup> the court formulated a more precise test, which was in accordance with the *American Cyanamid* principles. The standard of proof of fraud adopted was that a

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<sup>53</sup> *Discount Records Ltd* supra (n4).

<sup>54</sup> *Ibid* at 1074.

<sup>55</sup> *Harbottle* supra (n1)

<sup>56</sup> *Ibid* at 155.

<sup>57</sup> *Edward Owen Engineering* supra (n10).

<sup>58</sup> *Ibid* at 171 (Lord Denning MR, with whom others agreed).

<sup>59</sup> [1984] 1 Lloyd's Rep 251 at 257.

<sup>60</sup> *United Trading* Supra (n37).

‘seriously arguable case that the only realistic inference is fraud’.<sup>61</sup> The following extract from Ackner LJ’s judgment warrants particular attention:

‘We would expect the court to require strong corroborative evidence of the allegation, usually in form of contemporary documents, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud.’<sup>62</sup>

However, it is to be noted that in terms of the *United Trading* standard, it is not merely sufficient for the plaintiff to show a seriously arguable case. This was illustrated by the outcome of the case, where the Court of Appeal refused to grant injunction on the ground that even though the plaintiff succeeded in establishing a seriously arguable case that there is good reason to suspect that the demands on the performance bonds were not made honestly, they did not establish a good arguable case that the only realistic inference was fraud.<sup>63</sup> Ackner LJ went on and cautioned that insisting on a high standard of ‘established fraud’ was overly restrictive and that being the case, ‘impressive and high-sounding phrases such as “fraud unravels all” would become meaningless.’<sup>64</sup> He expressed his concern in light of the purpose for which the fraud exception was established.

In the context of letters of credit there are only a few English cases in which the applicant had succeeded in establishing fraud to the satisfaction of the court although injunctions were not granted based on the balance of convenience or other justifiable grounds. For instance, in *Tukan Timber Ltd v Barclays Bank Plc*,<sup>65</sup> where a demand for payment on a letter of credit was made with the support of a receipt bearing a forged signature. The applicant had successfully met the high standard of proof of which the court was convinced of the forgery and the bank’s knowledge. However, the court refused to grant an injunction considering that it was not necessary since the bank had

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<sup>61</sup> Ibid at 561.

<sup>62</sup> Ibid.

<sup>63</sup> Ibid at 565.

<sup>64</sup> Ibid.

<sup>65</sup> [1987] 1 Lloyd’s Rep 171.

already twice rejected the demand and it was not going to pay out on the credit anyway. In *Czarnikow Rionda Sugar Trading Inc v Standard Bank London Ltd*,<sup>66</sup> the court refused to grant an application to stop the bank from paying under letters of credit on the ground of the balance of convenience. Nevertheless, there was no objection by the court that such a fraud would fall outside the scope of the fraud exception.

*(b) Injunctions against the beneficiary*

Where the applicant considers that the beneficiary has made a fraudulent call on the letter of credit, the applicant may seek an injunction to restrain the beneficiary from receiving payment. However, there are a handful of cases in which the applicant had sought an injunction targeted at the beneficiary. It is to be noted that these cases were decided on the *United Trading* standard of a ‘serious arguable case that on the material available the only realistic inference is fraud’.

In *Group Josi Re v Walbrook Insurance*,<sup>67</sup> a case concerned with an interlocutory injunction against the beneficiary to restrain a demand for payment under a letter of credit, it was alleged by the applicant that the underlying contract was voidable on the ground of fraudulent misrepresentation on the part of the beneficiaries. The Court of Appeal rejected the applicant’s claim on the ground that there was no sufficient evidence of misrepresentation to avoid the underlying reinsurance contracts.

So far under the English law, injunctions have been granted in two rare cases, which both involved performance bonds rather than letters of credit. An injunction was granted in *Themehelp*,<sup>68</sup> where the sellers of the business were fraudulent in relation to the sale share agreement by withholding financial information in their possession from the buyers. An injunction was also granted in *Kvaerner John Brown v Midlands Bank Plc*,<sup>69</sup> where a beneficiary under a performance bond presented a certificate that written notice of default had been served on the applicant when in fact it had not done so.

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<sup>66</sup> [1999] 2 Lloyds’s Rep 187.

<sup>67</sup> *Group Josi* supra (n33).

<sup>68</sup> *Themehelp* supra (n47).

<sup>69</sup> [1998] CLC 446.

*(c) Balance of convenience test*

Under the English law, an interlocutory injunction will not be granted unless the applicant can, in addition to evidence of fraud, also satisfy the balance of convenience test. The balance of convenience test was considered in detail in the *American Cyanamid* case,<sup>70</sup> according to which the court has to determine whether one party bears the risk of being prejudiced in the event that an injunction is granted. The test requires consideration whether damages would be an adequate remedy for the applicant. In arriving at this conclusion, the court would need to weigh a number of factors for the granting or refusal of an injunction, taking into consideration of the harm to the plaintiff as compared to the harm to the defendant. It is pointed out that the test seems to offer an extra benefit to the banks because the test is usually weighted against the beneficiary.<sup>71</sup> Therefore this position indicates that even if the applicant succeeds in showing sufficient evidence of fraud, an injunction against the bank is likely to fail on the ground that damages will be an adequate remedy for any breach of duty by the bank.<sup>72</sup>

In *Harbottle*, Kerr J affirmatively stated that:

‘if the threatened payment is in breach of contract, then the plaintiffs would have good claims for damages against the bank. ... [t]he balance of convenience would in that event be hopelessly weighted against the bank.’<sup>73</sup>

In *Czarnikow*,<sup>74</sup> the Court refused to grant an injunction against the bank on the ground of the balance of convenience. The court took the view that where the court has at its disposal other means of protecting the defrauded claimant by way of Mareva relief, then ‘the public and general interests in maintenance of the banking commitments and in the autonomy of such commitments’ would always tip the balance against granting an injunction.<sup>75</sup> The decision of the court illustrated the position that the courts would have to consider the position of the bank in determining the balance of convenience.

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<sup>70</sup> *American Cyanamid* supra (n50).

<sup>71</sup> HY Low ‘Confusion and difficulties surrounding the fraud rule in letters of credit: An English perspective’ (2011) 17 *JIML* 462 at 465.

<sup>72</sup> Malek and Quest op cit (n30) 281.

<sup>73</sup> *Harbottle* supra (n1) at 155.

<sup>74</sup> [1999] 2 *Lloyds’s Rep* 187.

<sup>75</sup> *Ibid* 203-204.

## **VII Summary**

Traditionally, the English courts' approach to the fraud exception is more weighted on upholding the autonomy principle and the needs of trade than the need for prevention of fraud. In England, the courts will require the beneficiary's knowledge of fraud to invoke the fraud rule. Additionally, the crucial time for the determining the beneficiary's knowledge of the fraud is at the time of presentation and where there is lack of such knowledge on the part of the beneficiary the fraud exception would not apply. The granting of an interlocutory injunction would require the applicant to show proof of clear or obvious fraud. In the context of letters of credit, the issue regarding whether the scope of fraud exception extend includes the fraud in the documents or it extends to fraud in the underlying transaction is still unsettled under the English law.

Although the English courts have for a long time espoused the narrow view of the fraud for the purposes of preserving the autonomy principle and promoting the needs of international trade, their adopted narrow approach restricts the fraud exception to the extent of defeating the purpose for which the exception was established.<sup>76</sup>

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<sup>76</sup> See Gao *op cit* (n1) 50; Low *op cit* (n72) 462.

## **CHAPTER 5 THE POSITION IN THE UNITED STATES**

### **I Introduction**

In the United States, the fraud rule was recognised much earlier than other common law jurisdictions, as the fraud exception was first originated in America. The United States has a statutory legislation that contains provisions for the fraud issue in letters of credit, which is called the Uniform Commercial Code (UCC). The comprehensive regulation of letters of credit is embodied in the Revised Article 5 of the UCC of the 1995 version, which offers the courts a more relaxed approach to the exception. The United States' approach to the fraud exception is a standard specially designed to prevent proliferation of fraud in letters of credit<sup>1</sup>. The standard of fraud adopted under the Revised Article 5 of the UCC is that of 'material fraud'. Additionally, Article 5 of the UCC has adopted a wider view of fraud which refers to both fraud in the documents and fraud in the underlying transaction and it should be established. In terms of the Revised Article 5, the fraud rule could apply in two different situations either by the issuing banks might choose to dishonour the credit or the applicant may seek an injunction to enjoin the payment or presentation.

This chapter examines the United States approach to the fraud exception in the context of letters of credit. Part II discusses a brief historical development of the fraud rule in the United States. Part III examines the adopted standard of fraud in terms of the Revised Article 5 of the UCC. Part IV looks at the concept of the fraud exception. Part V discusses the general law of injunctive relief and the required standard of proof. Part VI contains a summary of the key issues pertinent to the application of the fraud rule in the United States and the way in which it weighs the balance between the competing interests that underpin the application of the fraud exception.

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<sup>1</sup> X Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 85.

## II A Brief Historical Development of the Fraud Exception

### (a) *The Landmark Sztejn decision*

The United States case of *Sztejn v Henry Schroder Banking Corporation* is widely recognised as the foundational authority on the fraud exception.<sup>2</sup> In this landmark case, the Supreme Court of New York County held that the issuing bank could properly refuse to pay and the applicant could properly obtain an injunctive relief where the documents, though partially complying, represented worthless material and rubbish. The relevant facts of the case briefly were as follows. Sztejn (Buyer) contracted to purchase hog bristles from Transea Traders Ltd (Seller), an Indian company. The buyer applied for an irrevocable letter of credit to be issued by J Henry Schroder Banking Corporation in favour of the seller. Transea Traders Ltd loaded fifty cases of material on board a steamship and secured a bill of lading and the invoices. The Chartered bank located at Cawnpore, India, was the correspondent bank. Transea Traders Ltd delivered the required documents to Chartered bank. Before payment had been made to the Chartered bank by Schroder, Sztejn applied for declaratory and injunctive relief, alleging that the beneficiary had in fact filled the fifty crates with ‘cowhair, other worthless material and rubbish with intent to stimulate genuine merchandise and defraud the plaintiff.’<sup>3</sup>

Shientag J first reiterated the importance of the autonomy principle:

‘It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the 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.’<sup>4</sup>

He went on and explained the generally accepted non-judicial interference with the bank’s independent payment obligations under a credit. The following extract is pertinent:

‘It would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped.’<sup>5</sup>

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<sup>2</sup> 31 NYS 2d 631 (1941).

<sup>3</sup> Ibid at 633.

<sup>4</sup> Ibid at 633.

<sup>5</sup> Ibid.

On the facts of the case before the court, Shientag J distinguished the case as one involving 'intentional fraud' by the beneficiary, and appropriately noted the case was not 'a mere breach of warranty'.<sup>6</sup> The court came to a conclusion that in such a situation where the seller is fraudulent, 'the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller'.<sup>7</sup> It was further established by the court that enjoining payment to a beneficiary who has substituted the merchandise 'not merely inferior in quality but consists of worthless rubbish caused no hardship' upon any party to the letter of credit.<sup>8</sup>

It is to be noted that the court in the *Sztejn* case did not enjoin payment solely out of consideration for the applicant but also in the interest of the issuing bank's security. Thus the issuing bank would suffer losses from the beneficiary's fraud, if the applicant failed to reimburse the bank after making payment under a letter of credit, leaving it with worthless rubbish. In such a case, Shientag J addressed the matter in this way:

'While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents.'<sup>9</sup>

The decision of the court in the *Sztejn* case is of significance in that it laid down three paramount principles.<sup>10</sup> First, payment under a letter of credit may only be interrupted in a case of fraud, thus a mere allegation of breach of warranty is not a valid defence warranting judicial interference to payment. Secondly, payment under a letter of credit can only be interrupted where fraud is established; in this case a mere allegation of fraud should not be an excuse for such an interruption. Thirdly, payment should be made according to the terms of the credit, regardless of the existence of

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<sup>6</sup> Ibid at 634.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid at 635.

<sup>9</sup> Ibid.

<sup>10</sup> See RP Buckley and X Gao 'The development of the fraud rule in letter of credit law: The journey so far and the road ahead' (2002) 23 *U Pa J Int'l Econ L* 663 at 680.

established fraud, if demand for payment is made by a holder in due course or a presenter in similar status.

Although the *Sztejn* case is regarded as the foundation stone in the development of the exception, its shortcomings are that the court did not consider other pertinent issues such as the burden of proof and the standard of fraud required to invoke the fraud rule.<sup>11</sup>

*(b) The Prior UCC Article 5*

The principles set out in the *Sztejn* case were first codified into Article 5 of the prior UCC of 1962 version. This legislation demonstrated a very important step towards the harmonisation and unification of the fraud rule in the law governing the letters of credit.<sup>12</sup> Furthermore, the codification of the *Sztejn* decision into a statute strengthened the position of law of the fraud rule involving letters of credit.<sup>13</sup>

The UCC Article 5, section 5-114(2) codified the *Sztejn* decision by providing that:

- (2) 'Unless otherwise agreed, when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-306) or is forged or fraudulent in the transaction:
  - (a) the issuer must honour the draft or demand for payment if honour is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-507) or a bona fide purchaser of the certificated security (Section 8-302); and
  - (b) in all other cases as against its customer, an issuer acting in good faith may honour the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honour.'

It is observed that the prior UCC Article 5 was a restatement of the *Sztejn* principles, which merely existed as draft for future development of the fraud rule.<sup>14</sup> This is because the legislation did not cast any light on the standard of fraud necessary to trigger the fraud rule and whether the rule should extend to fraud in the underlying contract. This led to a number of proposed standards by the courts in the application of the fraud exception in light of provisions under the first Article 5 of the UCC. The

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<sup>11</sup> Gao op cit (n1) 42.

<sup>12</sup> Ibid 44.

<sup>13</sup> Ibid.

<sup>14</sup> Ibid.

position under the prior UCC Article 5 led the courts to adopt different approaches to determine the standard of fraud to invoke the fraud exception, for example, ‘egregious fraud’,<sup>15</sup> ‘intentional fraud’,<sup>16</sup> ‘flexible standard’<sup>17</sup> and ‘a broader constructive approach’.<sup>18</sup>

(c) *The Revised UCC Article 5*

Although the prior UCC Article 5 demonstrated a significant step in the development and unification of the fraud rule, its application was still far from certainty. It left some issues unanswered and unregulated, which led to confusion among courts and the parties involved in letters of credit.<sup>19</sup> Following this uncertainty, Article 5, section 5-114(2) of the UCC was redrafted. The section now encapsulating the fraud exception is section 5-109 of 1995 version. The pertinent issues addressed by the Revised Article 5 including the following. The codification of the fraud exception has been amended to read that a court may enjoin payment under a letter of credit if ‘a required document is forged or materially fraudulent, or honour of the presentation would facilitate a material fraud.’<sup>20</sup> The Official Comment on section 5-109 has given an indication that ‘material fraud’ requires that the fraudulent aspect of a document be material to the purchaser of that document or the fraudulent acts be significant to the participants in the underlying transaction.<sup>21</sup> This further requires that the courts must examine the underlying transaction, when fraud is alleged in order to reach a conclusion whether a document is fraudulent to a material extent.<sup>22</sup> Secondly, the Official Comment sets out that fraud refers to both fraud in the documents and in the underlying transaction.

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<sup>15</sup> See *Intraworld Industries Inc v Girard Trust Bank* 336 A 2d 316 (1975). Generally, the egregious standard of fraud refers 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’ (at 324-325). See also *New York Life Insurance Co v Hartford National Bank & Trust Co* 378 A 2d 562 (Conn SC 1977).

<sup>16</sup> See *NMC Enterprises Inc v Columbia Broadcasting System Inc* 14 UCC Rep Serv 1427 (1974). An injunction was granted to restrain the bank from paying under a letter of credit on the basis of fraud in the underlying transaction.

<sup>17</sup> See *United Bank Ltd v Cambridge Sporting Goods Corp* 392 NYS 2d 265 (1976). The New York Court of Appeal established that the flexibility standard lies between ‘a breach of warranty and outright fraudulent practice’ (at 271).

<sup>18</sup> See *Dynamics Corp of America v Citizens & Southern National Bank* 356 F Supp 991 (1973). The court formulated a standard that included any conduct of the beneficiary which involves ‘a breach of a legal or equitable duty’ (at 998-999). However, threshold of this standard is too low and could lend the fraud rule to a risk of abuse as a defence to payment.

<sup>19</sup> Gao op cit (n1) 44.

<sup>20</sup> Revised UCC Article 5, sec 5-109 (a).

<sup>21</sup> Official Comment to Article 5 of the Uniform Commercial Code, para 2.

<sup>22</sup> Ibid.

### III The Standard of Fraud

The position under the Revised UCC Article 5, section 5-109 requires the standard of ‘material fraud’ for application of the fraud exception. Unlike the Prior UCC Article 5, the Revised UCC Article 5 seems to have adopted a unique standard of fraud that avoids the use of extreme concepts of fraud such as egregious and constructive fraud.<sup>23</sup> Although the Revised Article 5 of the UCC states that fraud must be proven to be ‘material’, it does not provide a clear definition of what material means.<sup>24</sup> Instead, the Official Comment on Section 109 provides an explanation as to the nature of fraudulent action that constitutes material to the other party.<sup>25</sup>

The fraud issue has arisen in the courts since the promulgation of the Revised UCC Article 5. In the context of letters of credit, the position of the Revised Article 5 of the UCC had been considered in a recent case of *Mid-America Tire v PTZ Trading Ltd Import and Export Agent*.<sup>26</sup> In this case, the appellate court interpreted ‘material fraud’ within the meaning of ‘fraud egregious’ where the demand for payment under the letter of credit ‘has absolutely no basis in fact’.<sup>27</sup> The facts were briefly that a dispute arose out of extensive negotiations for the purchase of Michelin tires by Mid-American Tire and Jenco from PTZ Trading Ltd through agents of PTZ, financed by a letter of credit. During the negotiations period, PTZ’s agents made specific representations to the buyers concerning the quality, quantity and the price of the tires. When the agreement was concluded, the quality, quantity and the price of tires all failed to conform to what had been promised. The buyers sought an injunction to prevent payment under a letter of credit. The trial court granted an injunction on the ground that the seller’s agents had made material misrepresentations to the buyers.

When the case went for appeal, the majority judgment reversed the decision of the trial court. The question before the appellate court was ‘how should “material fraud”...be interpreted’? The court reached a conclusion that material fraud ‘must be narrowly limited to situations of fraud in which ‘the wrongdoing of the beneficiary

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<sup>23</sup> Gao op cit (n1) 99.

<sup>24</sup> Ibid 84.

<sup>25</sup> Official Comment to Article 5 of the Uniform Commercial Code, para 2.

<sup>26</sup> 43 UCC Rep Serv. 2d 964 (Ohio App.2002).

<sup>27</sup> See similar approach first in taken in *Ground Air Transfer v Westate’s Airlines* 899 F 2d 1269, 1272-73 (1st Cir. 1990); *New Orleans Brass v Whitney National Bank and The Louisiana Stadium and Exposition District* 2002 LA. App. LEXIS 1764 (La. Ct. App. 4th Cir. 2002).

has...vitiated the entire transaction... and /or the demand for payment under a letter of credit 'has absolutely no basis in fact.'<sup>28</sup>

#### **IV The Notion of Fraud: Narrow Sense and Wide Sense**

The Prior UCC Article 5 did not provide a clear guide as to whether the court should only be allowed to investigate fraud in the documents or it should also be allowed to look to the underlying transaction. The controversy originated from the different interpretations of the language of section 5-114(2) which provided that the fraud rule should be applied 'when ...a required document ...is forged or fraudulent or there is fraud in the transaction.' The phrase 'fraud in the transaction' led to an open question among both the courts and the commentators as to whether it meant only the credit transaction per se or also included the underlying transaction as well. The majority of the courts and commentators favoured the broader view of fraud, which encompass the underlying transaction.<sup>29</sup> Proponents of the broader approach took *Sztejn* as the authority as fraud was established in the underlying transaction because the buyer would ultimately receive rubbish instead of the contracted goods.<sup>30</sup> However, some courts and commentators argued that the phrase of section 5-114(2) should be read narrowly so as to give effect to the application of the fraud rule only to situations where the beneficiary presented false documents to the issuing bank or where fraud is found in the credit transaction.<sup>31</sup> The main justification advanced in favour of the narrow approach is that the *Sztejn* case involved fraud in the transaction as the documents presented had a misrepresentation of the underlying transaction.<sup>32</sup>

The Revised UCC Article 5 provided a solution that addressed the uncertainty regarding the ambit of the fraud exception, expressly including fraud in the underlying transaction within the scope of the fraud exception. The language of the Revised UCC Article 5, section 5-109 reads that a court of a court may enjoin payment under a letter of credit if 'a required document is forged or materially fraudulent, or honour of the

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<sup>28</sup> Citing the standard which was established in *Intraworld* supra (n15) at 324-325.

<sup>29</sup> For example, cases that support the broader view of fraud: *NMC Enterprises* supra (n16); *Intraworld* supra (n15) ; *United Bank* supra (n17).

<sup>30</sup> F Monteiro 'Documentary credits: The autonomy principle and the fraud exception: A comparative analysis of common law approaches and suggestions for New Zealand' (2007) 13 *Auckland U L Rev* 144 at 155.

<sup>31</sup> For example, cases that support the narrow view of fraud: *Bossier Bank and Trust Co v Union Planters National Bank* 550 F 2d 1077 (1977); *O'Grady v First Union National Bank* 250 SE 2d 587 (1978).

<sup>32</sup> Monteiro op cit (n30) at 154-155.

presentation would facilitate a material fraud.’<sup>33</sup> In contrast with the language of the prior UCC Article 5, section 5-114(2), section 5-109 had changed the phrase ‘fraud in the transaction’ into ‘honour of the presentation would facilitate a material fraud’. The newly adopted language of the Revised UCC Article 5 clearly settled the issued that relief is available when fraud is established in the underlying transaction. Furthermore, the position of section 5-109 is reinforced by the Official Comment 1, which reads:

‘The courts must examine the underlying transaction when there is an allegation of fraud, for only by examining that transaction can one determine whether a document is fraudulent or the beneficiary has committed fraud, and, if so, whether the fraud was material.’<sup>34</sup>

Thus the courts the United States are settled that fraud in the underlying transaction falls within the scope of the fraud exception. The United States position is mainly focused on the prevention of fraud unlike the English courts who are persuaded by the need to protect the efficacy of documentary credits and the needs of trade.<sup>35</sup>

#### **V Fraud and Injunctive Relief**

Under the Revised UCC article 5 the fraud rule could apply into two different situations either the issuing banks may choose to dishonour the credit or the applicant may obtain an injunction to enjoin the payment or presentation. In a case of the second situation, the code stipulates four requirements that must be met when a court considers the granting of a relief in favour of the applicant on the basis of fraud.

Section 5-109 provides that:

- (b) ‘if an applicant claims that a required document is forged or materially fraudulent or that honour of the presentation 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 on if the court find that
  - (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;

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<sup>33</sup> Revised UCC Article 5, sec 5-109 (a).

<sup>34</sup> Para 2.

<sup>35</sup> Monteiro op cit (n31) 157.

- (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 1(a).<sup>36</sup>

It has been said that the above requirements have been set out for the purpose of minimising the frequency with which the fraud rule has been applied beginning the period of the late 1970s and, at the same time, it indicates that the standard for injunctive relief is high in terms of the Revised UCC article 5.<sup>37</sup> The United States position, unlike the English courts, seems to have made no distinction between the evidence required to obtain an interlocutory injunction and the evidence necessary to entitle a bank that has refused to justify its refusal in proceedings against it.<sup>38</sup> This observation draws its inference from the language of the Official Comment 5 on the Revised UCC Article 5, section 5-109, relevantly provides that:

‘Although the statute deals principally with injunctions against honour, it also cautions against granting ‘similar relief’ and the same principles apply when the applicant or issuer attempts to achieve the same legal outcome by injunction against presentation...interpleader, declaratory judgment, or attachment.’

However, the Revised Article 5 of the UCC seems to have adopted a more flexible approach in that courts are allowed to grant interim injunctions on the basis of strong suspicion of fraud and does not require proof of the beneficiary’s knowledge of fraud.

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<sup>36</sup> Revised UCC Article 5, sec 5-109(a)(1) provides a list of four parties immune from fraud: (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 a letter of credit which was taken after acceptance by the issuer or nominated person and; (iv) an assignee of the issuer’s 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.

<sup>37</sup> See Gao op cit (n1) 47.

<sup>38</sup> Ibid 51.

*(a) General requirements for interim injunctions*

In the United States, an applicant seeking an injunction will, in addition to proving material fraud on the part of the beneficiary, also have to show that:

- (1) irreparable injury and
- (2) either a probable success on the merits or
- (3) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships weighing in favour of the applicant.<sup>39</sup>

The above requirements are consistent with the Revised UCC Article 5, section 5-109(b) (3), which provides that ‘all of the conditions to entitle a person to the relief under the law of this State have been met.’

**VI Summary**

In the United States, letters of credit are regulated by a comprehensive statutory legislation called the Uniform Commercial Code (UCC). The UCC originated as an inspiration of the decision of the landmark *Sztejn* case. The Revised Article 5 of the UCC (1995 version) has adopted material fraud as the standard of fraud. This standard focuses on effect of the severity of fraud rather than on the intention of the fraudster. However, the precise meaning of the standard of material fraud has not been so certain despite some clarity found in recent case law. This is because ‘material’ is understood be a general term. The revised article 5 has also adopted a wide approach, which includes fraud in the underlying transaction. In addition, the United States approach is more relaxed in that it allows the courts to issue interim injunctions in appropriate circumstances as way of preventing fraud.

The flexible approach adopted by the United States is said to be specially designed to combat fraud in letters of credit, which demonstrates a substantial balance between the autonomy principle and the need for prevention of fraud.

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<sup>39</sup> See, for example, *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979); *United Technologies Corporation v Citibank NA* 469 F Supp 473 (1979).

## **CHAPTER 6 LESSONS FROM THE UNCITRAL CONVENTION**

### **I Introduction**

The United Nations Convention on Independent Guarantees and Standby Letters of Credit (the UNICTRAL Convention) is a creation of the United Nations Commission on International Trade Law (UNCITRAL), which was adopted by the General Assembly of the United Nations in 1995.<sup>1</sup> The most significant feature of the Convention is the treatment given to circumstances where there are allegations of fraud or abuse in demand for payment in undertakings. It is to be noted that the Convention avoids the use of the word fraud, instead the heading phrase of Article 19 ‘exceptions to payment obligation’ parallel the accepted fraud exception.<sup>2</sup> Similar to the United States, the Convention has also adopted a wide view of the fraud exception which includes fraud in the underlying transaction. The Convention contains detailed examples of types of misconducts that can invoke the fraud rule. In addition, the Convention affirms the entitlement of the applicant to the provisional court measures to block payment in accordance with Article 20.

The purpose of this chapter is to look at the provisions of the fraud rule in the Convention that may serve as useful guidelines to enhancing the application of the fraud rule by the national courts, including South Africa. Part II examines the standard of fraud, the detailed examples of fraudulent conducts and the provisional court measures as remedy to the applicant in circumstances where fraud is found to be committed by the beneficiary. Part III highlights the significant lessons to be drawn from the Convention in the context of the fraud exception. Part IV assesses the shortcomings of the Convention in relation to its sphere of application. Part V contains a summary of the key issues discussed under this chapter.

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<sup>1</sup> For further details, see (n1) in chapter 1.

<sup>2</sup> A Davidson ‘Fraud; the prime exception to the autonomy principle in letters of credit’ (2003) 8 *Int'l Trade & Bus L Ann* 23 at 51.

## II Provisions Relevant to the Fraud Issue

The risk of fraud and abusive demand is detrimental to the integrity of the undertaking and consequently hampers the commercial viability of the undertaking. In response to resolve such problems, the Convention expressly states its main purpose:

‘a main purpose of the Convention is to establish greater uniformity internationally in the manner in which guarantor/issuers and courts respond to allegations of fraud or abuse in demands for payment under independent guarantees and stand-by letters of credit... The Convention helps to ameliorate the problem by providing an internationally agreed general definition of the types of situations in which an exception to the obligation to pay against a facially compliant demand would be justified.’<sup>3</sup>

In terms of Article 15, the Convention provides a general requirement for the beneficiary demanding payment under a standby letter of credit or Independent guarantee. Article 15(3) provides that ‘[t]he 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 suggests that there is room to give effect to disrupt payment if the elements listed in Article 19 constitute the demand.<sup>4</sup> Article 19 provides for circumstances under which the guarantor or issuer may refuse payment and also enables the applicant to take appropriate court measures against a fraudulent beneficiary. Article 20 provides for measures available to the applicant in such a case where there is strong evidence of fraud on the part of the beneficiary.

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<sup>3</sup> See paras 45 and 46 of the explanatory note by the UNICITRAL secretariat.

<sup>4</sup> X Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 61.

*(a) Exception to payment obligations*

Article 19 contains exceptions to payment obligations, which are intended to deal with specific instances and acts. It is observed with merit that such an approach is to be welcomed in light of divergent judicial opinions expressed by different jurisdictions.<sup>5</sup> Furthermore, Article 19 is a reflection of fact patterns established in different legal systems by notions such as ‘fraud’ or ‘abuse of right’.<sup>6</sup> Article 19 encompasses three circumstances in which the guarantor or issuer, acting in good faith is entitled to the right not pay out to the beneficiary.

- (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.’

There are two pertinent observations with respect to the formulation of the second and third exception outlined above.<sup>7</sup> The second exception generally covers the literal defences, thus defences that are available and originate from the text of the guarantee / stand-by letter of credit of which the bank can deploy against the beneficiary. The third exception consists of a general formulation of fraud considering that different jurisdictions have used various descriptions (such as fraud, abuse of right, manifestly unreasonable demand) for the circumstances under which it is possible to reject payment under a guarantee / stand-by letter of credit.

Furthermore, for the purpose of clarity on the stated exceptions, paragraph (2) of Article 19 gives illustrations of situations in which a demand is deemed to have ‘no conceivable basis’:

- (a) ‘the contingency or risk against the undertaking was designed to secure the beneficiary has undoubtedly not materialized;

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<sup>5</sup> Davidson op cit (n1) at 51.

<sup>6</sup> Ibid. See also F De Ly, ‘The UN Convention on independent guarantees and stand-by letters of credit’ (1999) 33 *Int'l Lawyer* 831 at 842.

<sup>7</sup> De Ly op cit (n6) at 842.

- (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.’

*(b) Provisional measures*

Article 20 spells out provisional court measures and respective conditions that may be available to the applicant where the demand for payment is made under the exceptions listed in Article 19(1) (a), (b) and (c). In addition, the Convention requires the applicant to show proof of such abusive circumstances on the basis of immediately available strong evidence.

Article 20 relevantly provides that:

- (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 of (a), (b) and (c) of paragraph (1) of Article 19 is present , the court on the basis of immediately available strong evidence , may:
  - (a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor / issuer hold the amount of the undertaking, or
  - (b) Issue a provisional court order to the effect that the proceeds of the undertaking 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 therefore 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 of (a), (b) and (c) of paragraph (1) of Article 19, or use of the undertaking for a criminal purpose.’

### **III Significant Lessons from the UNCITRAL Convention**

The UNCITRAL Convention contains clear and detailed provisions that touch the issue of fraud. These provisions can to a large extent provide good guidance to the courts on their application of the fraud rule.<sup>8</sup> Most importantly, the Convention may be regarded as an inspiration to the development of the fraud rule under the national legal systems in the following areas.

First, the Convention clearly provided that the standard of fraud that may invoke the application of the fraud rule is that fraud must be ‘clear and manifest’.<sup>9</sup> Along with this standard of fraud, the Convention provides a detailed list of misconducts acts necessary to trigger the fraud rule.<sup>10</sup>

Second, the Convention expressly states the actions to be taken by victims of fraud that in circumstances where fraud is ‘manifest and clear’, such as the issuer’s has a right against the beneficiary to withhold payment,<sup>11</sup> and the applicant’s entitlement to a provisional court order to stop the issuer from paying out.<sup>12</sup>

Third, the Convention seems to taken a wider approach which brings fraud in the underlying transaction within the scope of the fraud exception.<sup>13</sup>

Fourth, article 20 of the Convention provides the necessary actions to be taken by courts when determining the application of the fraud rule.

Fifth, the Convention requires ‘strong evidence’ as the standard of proof misconduct.<sup>14</sup> However, it does not state that the intention of the wrongdoer must be proven, taking a similar approach to the United States approach but contrary to the English approach as well as the South African approach.

Lastly, it is observed that the approach adopted in Article 19 of the Convention reflects a balance between the competing interests and considerations of the parties involved.<sup>15</sup> On one hand, the Convention gives the guarantor/ issuer a right and not a

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<sup>8</sup> Gao op cit (n4) 97.

<sup>9</sup> Article 19(1) of the UNCITRAL Convention.

<sup>10</sup> Ibid subparagraph (a), (b) and (c).

<sup>11</sup> Ibid.

<sup>12</sup> See art 19(3) of the

<sup>13</sup> See Article 19(1) (a), (b) and (c) of the UNCITRAL Convention.

<sup>14</sup> See art 20(1) of the UNCITRAL Convention.

<sup>15</sup> Davidson op cit (n1) at 53.

duty to withhold payment. This position is aimed at preserving the commercial reliability of undertakings as promises that are independent from the underlying transactions.<sup>16</sup> On the other hand, the Convention recognises the rights of the principal/applicant arising from the circumstances set out under Article 19, and it expressly states that the principal /applicant is entitled to provisional court measures to block payment.<sup>17</sup>

#### **IV Drawbacks of the Convention**

Although the Convention is characterised by an international posture as the instrument that contains detailed provisions with respect to the issue of fraud, it has some gaps particularly in the context of letter of letters of credit.

First, the Convention directly applies to stand-by letters of credit and independent guarantees, as such the narrow scope of application weakens its sphere of influence at international level.<sup>18</sup> However, its application in the context of letters of credit is left as a matter of choice if parties wish to do so.<sup>19</sup> Second, it falls short of one broad element of the fraud rule that requires identification of innocent third parties which are immune from fraud.<sup>20</sup> Third, it is pointed out that the Convention fraud rules are defensible on the part of the banks and beneficiaries and toothless from the applicant's perspective.<sup>21</sup> This point is demonstrated by the Convention in the sense that it does not place an obligation on the bank to notify the applicant and delay the payment in a situation where the applicant has not yet obtained a legal remedy to stop the payment immediately.<sup>22</sup> Lastly, unlike the UCP rules, which have to be incorporated into the letter of credit as contractual terms to be effective, the parties to a letter of credit can only incorporate the provisions of the Convention if their countries are contracting member states and have ratified the Convention for it to take effect.

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<sup>16</sup> The Official Explanatory Note to the Convention Para 48.

<sup>17</sup> Article 19(3) of the UNCITRAL Convention.

<sup>18</sup> Gao op cit (n1) 63.

<sup>19</sup> See art 1(2) of the UNCITRAL Convention.

<sup>20</sup> Gao op cit (n1) 63.

<sup>21</sup> DE Ly op cit (n6) at 845.

<sup>22</sup> Ibid.

## **V Summary**

Despite the narrow scope of application, the UNCITRAL Convention approach to prevention of fraud demonstrates that it is in accordance with judicial developments in other jurisdictions, in particular the United States. It is observed that the detailed provisions of the Convention can offer practical guidance to national courts on the application of the fraud rule with much more certainty.<sup>23</sup>

The Conventions seems to strike a balance of the competing interests of the parties involved by maintaining a principle that payment still remains as rule while setting out exceptions in circumstances where a demand for payment is fraudulent or unjustified.

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<sup>23</sup> Gao op cit (n1) 97.

## CHAPTER 7 CONCLUSION AND RECOMMENDATIONS

### I General Conclusions

Letters of credit are regarded as a useful payment mechanism that reduces the risk concerns of both the seller and buyer through increased level of predictability and security in international trade.<sup>1</sup> The efficacy and commercial utility of letters of credit is derived from the autonomy principle, which insulates the credit transaction from extraneous matters arising from the underlying transaction. The prime object of this principle is to guarantee quick and reliable payment to the seller. However, the assurance of payment inherent in the usage of letters of credit carries with it the risk of fraudulent demands by unscrupulous beneficiaries for monetary gains. The problem of fraud has been described as ‘a cancer in international trade’.<sup>2</sup> In response to this undesirable situation, an exception to the autonomy principle has been established as a means to offer legal protection for the buyer against fraudsters. From the policy consideration standpoint, the application of the fraud rule requires striking an appropriate balance between the competing interests of preserving the autonomy principle and deterrence of fraud in letters of credit system. The underlying concern is that any deviation from the original purpose of the fraud exception may dilute the autonomy principle and consequently undermine the commercial utility of letters credit.<sup>3</sup>

Although the fraud exception has been widely recognised, the courts in different jurisdiction have adopted different approaches even within common law jurisdictions. This position stems from the fact that the standard of fraud is difficult to define.<sup>4</sup>

This dissertation sought to demonstrate how the current South African position is unsatisfactory in the balance it strikes between the need for protection of the autonomy principle and combating fraud. As alluded to earlier in chapter 2, the application of the fraud rule under the South African is heavily centred on preserving the autonomy principle as the courts take into consideration the prime object of this principle is to provide assurance of payment to the seller.

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<sup>1</sup> Leacock, SJ ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ (1984) 17 *Vanderbilt J Trans*’ L 885 at 886.

<sup>2</sup> *Standard Chartered Bank v Pakistan National Shipping* [1998] 1 Lloyds Rep 684 at 686.

<sup>3</sup> X Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 63.

<sup>4</sup> *Ibid* 98.

From the comparative perspective, the South African courts' approach to the fraud exception is very similar to the English courts' approach in a number of areas of the law relating to the development of the fraud rule, except in minor respects such as the test for the standard of proof. First, like the English courts, the South African courts seem to have embraced the strict approach with high standard, requiring the beneficiary's knowledge or intent as the standard of fraud. Therefore the fraud exception does not extend to fraud committed by a third party of which the beneficiary has no knowledge. Second, the then Appellate Division in the *Loomcraft* case seemed to have recognised the fraud exception to fraud in the documents. However, as pointed out earlier in chapter 3, the judgment of the *Loomcraft* case was based on alleged fraud in the documents, and as such it cannot be regarded as the authority in determining the question whether the fraud exception extends to fraud in the underlying transaction. So far, there is no authority on this issue. Nevertheless, the remarkable obiter dictum made in other relevant authorities provides an indication the South African courts will recognise fraud in the underlying transaction as a valid exception to the autonomy principle of letters of credit.<sup>5</sup> Third, both jurisdictions require a clear case of established fraud on the part of the beneficiary for the purposes of granting an interdict (injunction). Fourth, in both jurisdictions the standard of proof required is the ordinary civil one which has to be discharged on a balance of probabilities. However, the crucial issue concerning how much more compelling the evidence must be still remains unsettled under South African law.<sup>6</sup>

The narrow construction of the fraud exception favoured by the English courts was the subject of Chapter 4. The rationalisation for the narrow approach is explained by the need to preserve the autonomy principle of letters of credit and maintain the certainty of payment. From the autonomy view point, banks deal exclusively with documents, and thus the only kind of fraud a bank is entitled to consider as a defence to payment is that which is clear on the face of documents. The leading case on this point is the decision of the House of Lords *United City Merchants (Investments) Ltd v Royal Bank of Canada*,<sup>7</sup> which seem to have confined the exception to fraud in the documents. However, recent decisions have also seem to have accept that fraud in the

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<sup>5</sup> See *Union Carriage v Nedcor Bank Ltd* 1996 CLR 724(W) at 735.

<sup>6</sup> See A. Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) 480.

<sup>7</sup> [1983] AC 168 (HL).

underlying transaction especially in demand guarantees falls within the scope of the exception.<sup>8</sup> Generally, the English courts have been overly restrictive in the application of the fraud exception, requiring the applicants to show proof of ‘clear or obvious fraud’ to the knowledge of the beneficiary at the time of presentation of documents. Also the bank’s knowledge of fraud at the time of payment is a crucial element in an action where the applicant is refusing reimbursement against the issuing bank. However, in accordance with the current practice, the general accepted formulation for the standard of proof in an interlocutory injunction is that based on the ‘material available before the court, the only realistic inference is that of fraud.’<sup>9</sup> Additionally, the evidence of fraud must be immediately available without the need for lengthy and extensive investigation into the underlying contract.

As demonstrated in this dissertation, although the narrow view of the fraud exception mainly seeks to protect the autonomy principle, such arguments are not always commercially sustainable as it may unfairly allocate the risk in favour of the beneficiary and it may encourage unscrupulous beneficiaries to commit fraud in the underlying transaction.

The wide and flexible approach to the fraud exception favoured by the United States has been considered in Chapter 5. Unlike the English and South African courts which are impressed by the autonomy arguments and the needs of trade, the United States courts have adopted a wide approach to the fraud exception that seems to be justified by the need to prevent the proliferation of fraud, particularly fraud in the underlying transaction.

In the United States, the fraud comprehensive regulation of the fraud rule is codified in the Revised Article 5 of the Uniform Commercial Code (UCC). Section 5-109 of Article 5 spells out material fraud as the standard being required for the application of the fraud rule. In contrast to both the English and South African courts, the standard of ‘material fraud’ does not focus on the intention of the beneficiary but rather on the objective examination of the circumstances of the case to determine whether fraud has been committed. It has been observed that the United States court’s objective approach of looking at the factual circumstances of the case and not

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<sup>8</sup> See *Themehelp Ltd v West and Others* [1996] QB 8; *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446.

<sup>9</sup> See *United Trading Corporation SA v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Rep 554 at 561.

investigating into the beneficiary's state of mind is an indirect extension of the third party fraud with the scope of the fraud exception.<sup>10</sup> In this regard, the UCC takes a position similar to the UNCITRAL Convention which is more weighted on the nature of the documents, not the identity of the fraudulent party.<sup>11</sup> In addition, the United States position has widely defined the fraud exception to include the fraud in the underlying transaction. It is also worth noting that the Revised Article 5 of the UCC seem to have adopted a more flexible approach in which the courts are allowed to grant interim injunctions on the basis of strong suspicion of fraud and do not require proof of the beneficiary's knowledge of fraud.

The dissertation has also examined the flexible approach from the international perspective within the framework of the UNCITRAL Convention as discussed in chapter 6. Most importantly, the Convention contains detailed examples of the fraud exception provisions that can offer a substantial practical guidance to the national courts including South Africa. Like Revised UCC Article 5, the Convention demonstrates a more flexible approach, requiring evidence of clear and manifest fraud as the basis to withhold payment and does not mention that the wrongdoer's intention must be proven. Thus the Convention's approach is heavily centred on the nature of the misconduct rather than the intention of the fraudulent party.<sup>12</sup> With regard to provisional court measures, the Convention is strict enough with the applicants while still being flexible enough to permit the granting of such legal remedies only in exceptional circumstances.

In examining the implementation of the fraud rule under South African law, there is a need to be mindful that certain scopes of the fraud exception have gradually changed overtime in selected common law jurisdictions as well at international level in keeping with the commercial trends of that time as determined by the judiciary of the day. This trend is evident from, for example, the way the United States have and the UNCITRAL Convention have reassessed the implementation of the fraud rule in light of the international business community's expectations. The South African law on the other hand, is lagging behind some way. However, if such laudable scopes are

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<sup>10</sup> HY Low 'Confusion and difficulties surrounding the fraud rule in letters of credit: an English perspective' (2011) 17 *JIML* 462 at 471.

<sup>11</sup> Gao op cit (n3) 130.

<sup>12</sup> Ibid 97.

embraced by the South African courts and allow a step forward beyond the traditional scopes of the fraud rule, then there is no reason why the South African courts ought not to close this gap by way of adopting a flexible approach. However, the momentum to do so, lies upon the South African courts and the concerned national legislators to consider the fact that the certain scopes of the strict approach that were for a long time unchallengeable, ought to yield to the commercial trends of the day.

## **II Recommendations**

This dissertation has shown from the comparative perspective that the South African courts have adopted a narrow and strict approach to the application of the fraud rule, which is more weighted on the autonomy arguments than preventing the proliferation of fraud. In the light of limited case law, it is suggested that the South African courts should also consider adoption of a preferable approach in the following four key areas:

### *(a) Standard of fraud*

The South African courts, like the English Courts, seem to have settled that the beneficiary's knowledge as the standard of fraud. The problem associated with the standard of intentional fraud is that proof of the beneficiary's actual intention or knowledge is difficult to establish whether at trial or in an interim interdict. Due to these hurdles imposed on the applicant by this standard, the allocation of risk is unfairly in favour of the beneficiary. Another potential loophole presented with this standard is that in a case of fraud involving a third party, the beneficiary may easily get away with it, if the applicant fails to show proof the beneficiary's knowledge when in actual fact the beneficiary was involved in conspiracy with a third party.<sup>13</sup> In this regard, it is suggested that the South African courts should consider adopting an objective standard as seen from the United States and the UNCITRAL Convention. As observed by one expert in letters of credit fraud, a proper approach to the fraud exception that can to a large extent enhance the predictability of the fraud rule, is one that takes a combination of material fraud as a general standard, which is encapsulated in revised UCC Article 5, s 5-109 and the provisions of Article 19 the UNCITRAL Convention as detailed examples.<sup>14</sup>

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<sup>13</sup> Ibid 133.

<sup>14</sup> Ibid 99.

*(b) Fraud in the underlying transaction*

So far, a handful of South African cases have shown that the courts have not yet dealt with the question whether the fraud exception extends to fraud in the underlying transaction. In the absence of case law, it is suggested that the South African courts should consider following a wide approach in line with that adopted by the United States and the UNCITRAL Convention. The main justification for adopting a wider view of the fraud exception stems from the policy considerations that it serves no commercial purpose to accept the fraud exception, yet on the other end disregard the fraud committed by the beneficiary in the underlying transaction. Fraud jeopardises the integrity of the letters of credit system, and the effect is the same whether be it fraud in the documents or in the underlying transaction.

*(c) Standard of proof in interim interdicts*

Analysis of the South African position shows that there is gap in the degree of evidence required and the issue still remain unsettled under South African law. Some lesson from the English jurisprudence is that the English courts have generally accepted that the appropriate test to determine whether there is clear evidence of fraud is that it is 'seriously arguable that on the material, the only realistic inference to draw is that of fraud'. It is suggested that the South African courts should follow the English courts' approach in this regard.

*(d) Flexibility in issuing of interdicts as a means to prevent fraud*

Similarly to the English courts, the South African courts have strictly applied the fraud exception to an extent making the granting of an injunction almost unattainable. It creates unsatisfactory position to accept the general condemnation of fraud, yet on the other hand, making it nearly impossible for the parties to have access to legal remedies necessary for prevention of fraud. In contrast, the United States, like the UNCITRAL Convention, has adopted a flexible approach that allows the courts to issue an interim injunction on the basis of suspicion of fraud. It is suggested that the South African courts should follow an approach that falls between the strict approach favoured by the English and the more relaxed approach espoused by the United States.

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