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**“The fraud exception in international documentary credit transactions seen from an English and German perspective”**

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## CASE REGISTER

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*United City Merchants v Royal Bank of Canada* (1979) 2 Lloyds Rep. 498

*United City Merchants v Royal Bank of Canada* (1982) QB 208 (CA);

*United City Merchants v Royal Bank of Canada* (1983) AC 168 (HL);

*Equitable Trust Company of New York v. Dawson Partners Ltd.* (1926) 27 L.I.R. 49;

*Edward Owen v Barclays Bank* (1978) 1 Lloyds Rep. 166;

*Malass v. British Imex* (1957) 2 Lloyds Rep. 549; (1958) 2 Q. B. 127;

*Szejn v. Schroder Banking Corporation* (1941) 31 N. Y. S. 2nd. 631;

*Colony Trust v. Lawyers Title & Trust CO* (1924) 297 Fed. Rep. 152;

*Continental National Bank v. National City Bank* 69 F. 2nd. 312;

*Bank of Taiwan Ltd. v. Union National Bank of Philadelphia* (1924) 1 F (2d) 65;

*Bolivinter Oil SA v. Chase Manhattan Bank Commercial Bank of Syria and General Company of Homes Refinery* (1984) 1 Lloyd's Rep 251;

*Rafsanjan Pistachio Producers Co-operative v. Bank leumi (UK) plc* (1992) 1 Lloyd's Rep 513;

*Timber Ltd v. Barclays Bank plc* (1987) 1 Lloyd's Rep 171;

*Deutsche Rückversicherung AG v. Walbrook Insurance Co Ltd and others* (1994) 4 All ER 181;

*Themehelp Ltd v. West and others* (1995) 3 WLR 751;

German cases:

OLG Stuttgart 1979 WM 733;

RGZ 106, 304;

BGH WM 1955, 765;

BGHZ 101, 84;

BGH WM 1987, 977.

## **Topic:**

“The fraud exception in international documentary credit transactions seen from an English and German perspective“

### **I. Introduction**

This inquiry will investigate the extent to which fraudulent conduct affects the rules and principles of international documentary credit transactions particularly the issuing or confirming bank's legal position vis a vis the beneficiary. The inquiry will be taken from the perspective of English and German law, with the main focus on that very important English case, **United City Merchants v Royal Bank of Canada**<sup>1</sup>. The legal position of German law will be compared whether the German solution differs from that found by the House of Lords in *United City Merchants v Royal Bank of Canada*. Before examining this specific problem in the field of documentary credits, a short survey of the rules, principles and mechanism of documentary credits in international transaction will first be given.

### **II. What are documentary credits ?**

Documentary credits are important instruments of payment in international trade. Although the instrument is has been widely adopted in international trade and the term for the instrument varies. Documentary credits are also known as Letters of Credit, Commercial Letters of Credit or Documentary Letters of Credit. However, these terms are used interchangeably in international trade.<sup>2</sup> In this research the term Documentary Credit is favoured.

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<sup>1</sup> 1979 Lloyds Report 267 QB; 1982 QB 208 (CA); 1983 AC 168 (HL).

<sup>2</sup> Chile Trade.

Simply stated, a documentary credit is an undertaking to pay against documents specified in the credit. Documentary credits are mainly used in international transactions, e.g. in an international sale of goods. Accordingly, seller and buyer in the example of a sales contract, act from different countries and the means of delivery and payment are affected by distance. Therefore, seller and buyer have to fulfil their contractual obligation in a way which satisfies both parties.

Various ways exist in which the price of exported goods may be paid. If the seller is concerned about the creditworthiness of the buyer and is in a strong bargaining position, he may be able to stipulate payment wholly or partly in advance. In this case, the buyer faces the unpleasant situation of having paid the purchase price without having the goods, or even without a guarantee of receiving them. Another possibility, and a more pleasant one for the buyer, would be to stipulate payment upon delivery of the goods. But this puts the seller in a risky position, because he sends the goods away without having a guarantee of payment. If the buyer turns out to be insolvent and the goods are on their way, it will be either impossible or very expensive to get them back to the seller. To find a way out of this dilemma, the international trade community established the instrument of documentary credits.

In its simplest form, this involves three parties; the two parties to the underlying contract and the so-called issuing or opening bank. The starting point is when the parties to a contract agree upon payment by documentary credit. This agreement obliges the buyer to advise his bank to open a so-called letter of credit in favour of the seller. Once the letter is opened, the seller, as beneficiary of the credit, is entitled to receive the money from the bank against procurement of certain documents. The letter of credit specifies as which documents are to be procured. These documents relate to the goods and demonstrate that the goods are to be shipped according to the underlying contract. The usual and most important document is the bill of lading issued by the carrier,

which gives title to the goods.<sup>3</sup> An insurance policy, the commercial invoice, a certificate of quantity and of quality issued by an independent person may also be issued. The seller presents these documents to the issuing bank which must determine whether they are in strict conformity with the terms of the documentary credit. If they are, the seller is entitled to payment. This method of payment offers the seller the benefit of getting paid as soon as possible after the dispatch of goods. As he is paid by a bank, he is not concerned with creditworthiness of the buyer. In other words, the documentary credit offers the seller a guaranteed payment without delay.<sup>4</sup> The benefit to the buyer lies in the receipt of the documents. The bill of lading particularly offers advantages to the buyer. First, the bill of lading is a negotiable instrument which represents the documented goods and, secondly, it constitutes a title for the holder of the bill to take possession of the goods at the place of destination.<sup>5</sup> Another advantage for the buyer may arise from negotiation with his bank. A documentary credit enables the buyer to arrange financing of the payment.<sup>6</sup> For this to occur, the bank must agree to only demand compensation for the payment at a later date, given the buyer the chance to finance the purchase; for example, by reselling the goods to a second buyer. As a method of payment the documentary credit achieves a compromise between the different interests of the parties. Accordingly, it has become the most important method of payment in international trade, and there is a continuing need for documentary credits.<sup>7</sup> As a result, the international trade community saw the need for uniform international rules for documentary credits.

### **A. UCP**

Internationally accepted standards governing the law of credits had to be introduced in order to determine the responsibilities and liabilities of the buyer, seller and the banks involved. Consequently, the International Chamber of Commerce (ICC) Commission on

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<sup>3</sup> Booysen, at 234.

<sup>4</sup> Fourie, at 153.

<sup>5</sup> Van Houtte, *The Law of International Trade*, at 269.

<sup>6</sup> Chile Trade.

Banking Technique and Practice adopted the first edition of the Uniform Customs and Practice for Documentary Credits (U.C.P.) in Vienna 1933.<sup>8</sup> Since then the UCP has been renewed on several occasions, the latest being in 1993 under the ICC brochure No. 500.<sup>9</sup> Nowadays in international trade, almost all documentary credits are expressed subject to the UCP published by the International Chamber of Commerce.<sup>10</sup> Since the UCP is involved in almost every international trade transaction, and therefore also constitutes a source of law regarding the examination of the fraud exception it is necessary to briefly examine the legal status of the UCP.

### ***B. Legal Status of the UCP***

Because the UCP rules are created by an international private organisation with no formal legislative power, the legal nature of the rules is controversial and has given rise to much legal debate. They are normally not regarded as having objective legal force.<sup>11</sup> In some legal systems, such as France and Netherlands, the UCP is recognised as customary law.<sup>12</sup> In other words, the UCP applies to every contract unless the parties agreed expressly upon something different. The leading German theory, in contrast, considers the UCP as standard conditions (Allgemeine Geschäftsbedingungen) which the parties have to incorporate into the contract.<sup>13</sup> The English law also regards the UCP as a set of standard terms and definitions which apply, subject to the agreement between the parties.<sup>14</sup> The situation in the United States is slightly different as the Uniform Commercial Code (UCC) of the United States contains rules for documentary

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<sup>7</sup> Van Houtte, at 258.

<sup>8</sup> Fourie, at 153.

<sup>9</sup> In the following just UCP.

<sup>10</sup> Goode, at 962.

<sup>11</sup> Booysen, at 235.

<sup>12</sup> Van Houtte, at 267.

<sup>13</sup> Hugo, Documentary Credits, at 153.

<sup>14</sup> Van Houtte, at 267, Hugo, at 159.

credits. But the rules of UCP prevail over the UCC, if the parties to a contract have agreed to apply them.<sup>15</sup>

The main question in this discussion is therefore whether the rules of the UCP are applicable by themselves as rules of custom or trade usage or whether they have to be incorporated in a contract by agreement in order to be enforceable. Even though some provisions of the UCP are regarded as custom or trade usage, the majority of the commentators consider the whole UCP as a bundle of rules which have to be incorporated in a contract to govern the legal relation between the parties.<sup>16</sup> This opinion corresponds with the regulation in art 1 UCP which states, that the UCP applies in every documentary credit where the UCP is incorporated into the text of the Credit. In practice, there are very few disputes over the legal nature of the UCP, because the UCP rules are most often explicitly incorporated in the contract and letter of credit anyway.<sup>17</sup>

### ***C. Different forms of credit***

The documentary credit transaction discussed above is a letter of credit in its simplest form. Various forms of different documentary credit transactions are common in international trade which are also described and governed by the UCP rules. In order to give a broad survey of customary credits, it seems appropriate to give a short introduction on the main forms of common credits.

#### **1. Revocable and irrevocable credits**

A primary distinction must be made between revocable and irrevocable documentary credits. The credit must clearly indicate its nature, because in the absence of such an indication, it shall be deemed to be irrevocable.<sup>18</sup> As stated above, one reason for the introduction of documentary credit was the assurance of payment for the seller. Only an irrevocable credit offers the exporter the necessary guarantee for payment. In fact, since

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<sup>15</sup> Schmitthoff, *The Law and Practice of International Trade*, at 402.

<sup>16</sup> Booyesen, at 237; van Houtte, at 268; Hugo, at 164; Schmitthoff, at 402.

<sup>17</sup> Van Houtte, at 268.

a revocable credit may be amended or cancelled by the issuing bank at any time without prior notice to the exporting beneficiary<sup>19</sup>, it is therefore rarely used in practice. Although uncommon, revocable credits may be used in situations where the beneficiary is in a country with an unstable currency or political situation which could disturb the performance of the contract. However, an revocable credit is indicative of the buyer being in a strong bargaining position.

## **2. Involvement of other parties (especially other banks)**

The documentary transaction in its simplest form involves three parties, but transactions where more parties other than those involving the buyer, seller and issuing bank are common.

### ***a) Confirmed credit***

The credit worthiness of a letter of credit relates to the strength of the bank which opens it. A reputable international bank in a country with a stable economy may issue a letter of credit which can be trusted. In an unstable political or economic system however changes could render the credit worthless, even though the credit is issued and still valid. In such a situation, the seller may require that another bank (preferably in the country of the seller) undertakes to honour the credit by adding its confirmation. In this way, the seller is assured that, in compliance with the terms and conditions of the credit, drawings will be paid by the confirming bank if the issuing bank cannot do so. But the issuing bank also remains responsible for the credit even after another bank has confirmed it.<sup>20</sup> As stated in art 9 (b) UCP, the confirmation constitutes an additional definite undertaking by the confirming bank.

### ***b) Acting with an advising bank***

In most instances, the issuing bank is the buyer's bank and is situated in a different country from the seller. In order to organise the procurement of documents and

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<sup>18</sup> Art 6 UCP 500.

<sup>19</sup> Art 8 (a) UCP 500.

payment, the issuing bank commonly appoints another bank, preferable, in the seller's country, to examine the specified documents and to negotiate, accept or pay the beneficiary's draft. This latter appointed bank is called the advising bank and acts as the issuing bank's agent. It is not a party of the credit itself.<sup>21</sup> Accordingly, the advising differs from the confirming bank in that it does not make any undertaking to the beneficiary. Its sole obligation is to verify the authenticity of the credit.<sup>22</sup>

### 3. Way of payment

Payment under a documentary credit takes place in different ways.<sup>23</sup> The simplest form is payment at sight (cash payment) by the bank on presentation of the documents. The documentary credit can also arrange for a deferred payment. In cases of deferred payment, in exchange for the specified documents the beneficiary receives a written irrevocable undertaking from the bank to pay at a later date, in accordance with the terms of the credit.<sup>24</sup> The deferred payment favours the buyer as he has the time to resell the goods and to repay his bank from the proceeds of the resale.

Instead of accepting deferred payment, the beneficiary may also draw a bill of exchange on the advising bank, on the issuing bank, or on the buyer. By accepting the bill of exchange, the drawee confirms his commitment to pay on the maturity of the bill of exchange. The bill of exchange can then be sold by the beneficiary on the money market to third parties. Operating with a bill of exchange offers advantages to both sides. The seller (beneficiary) gets paid as soon as possible after procurement of the documents by selling the bill on the market, and the buyer's duty to repay his bank is postponed until maturity of the bill. Despite these advantages, incorporating a bill of exchange in a documentary credit is seen as controversial by commentators because it adds

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<sup>20</sup>Van Houtte, at 260.

<sup>21</sup>Pennington, Commercial Banking Law, at 319.

<sup>22</sup>Art 7 (a) UCP.

<sup>23</sup>Art 2 UCP refers to different forms of payment but does not further specify them.

<sup>24</sup>Van Houtte, at 262.

complications and thus should be avoided unless there is a good reason for its incorporation.<sup>25</sup>

#### **4. Straight and Negotiation Credits**

The letter of credit itself is not a negotiable instrument.<sup>26</sup> A purchaser of a draft drawn on the issuing bank under the credit would have no claim against the bank if it refused to honour the draft. This is because the undertaking in the letter of credit was not given to the purchaser but only to the beneficiary of the credit. A credit of this kind is called a straight credit.<sup>27</sup>

The undertaking given in the letter of credit, however, may be issued not only for the benefit of the seller but also for those negotiating the seller's draft or documents. Such a credit is known as a negotiation credit. It entitles anyone who, pursuant to the authority in the credit, negotiates the seller's draft or documents, to call upon the issuing bank to honour the draft, provided that the appropriate documents according to the credit are presented. Again this favours the beneficiary of the credit because he can receive payment before maturity of the credit, even though payment does not mean payment of the credit but of the corresponding value of the credit.<sup>28</sup> On the other hand, the seller is unlikely to receive the full amount of money stated in the tenor of the credit, because the negotiating bank will deduct a discount for interest and commission.<sup>29</sup>

Although different forms of documentary credits other than those described above, exist, these provide a general survey of the basic forms. To detail all the different forms of commercial credits used by international operating banks would go beyond the extent of this inquiry which focuses on the exception of fraud in a documentary credit transaction.

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<sup>25</sup>Hugo, at 17.

<sup>26</sup>Goode, at 981.

<sup>27</sup>Goode, at 982.

<sup>28</sup> Art 10 (b) (ii) UCP.

<sup>29</sup> Schmitthoff, at 422.

## ***D. Important rules and principles***

To understand the fraud exception, certain rules and principles which apply to every documentary credit transaction all over the world need to be explained.

### **1. Principle of compliance**

A central principle ruling documentary credit transactions (confirmed by the UCP), is the compliance of the documents.<sup>30</sup> The issuing bank is only bound to honour the credit if it has received the documents in conformity with the credit terms. Thus, the doctrine of strict compliance is important for all parties involved in the documentary credit. The buyer has to observe it when issuing the credit and determining its terms, as does the seller because he has to negotiate the terms of the credit and as the beneficiary of the credit, has to procure documents in accordance with these terms in order to get paid.

#### ***a) Examination duty***

Likewise the issuing bank as the confirming bank is obliged to examine the procured documents with reasonable care to ascertain whether they appear, on their face, to be in compliance with the terms and conditions of the credit.<sup>31</sup> As soon as the bank has observed this obligation, it ceases to have liability or responsibility for the form, sufficiency, accuracy, genuineness or legal effect of any document, or for the general or particular conditions stipulated in or imposed by the documents. Neither does the bank assume any liability for the description, quantity, weight, quality, conditions, packaging, delivery, value or existence of the goods represented by any documents.<sup>32</sup> If the bank does not observe the examination duty and pays the beneficiary (even though the presented documents did not in comply at there face with the credit) the bank is liable for this mistake in respect of the buyer (its customer) regarding the reimbursement of the payment.<sup>33</sup>

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<sup>30</sup> Art 13 UCP.

<sup>31</sup> Art 13 (a) UCP.

<sup>32</sup> Art 15 UCP.

<sup>33</sup> Schmitthoff, at 409.

*b) Reasonable care*

The bank must examine the documents with reasonable care. The bank does not need to ascertain whether the contents of the documents are in accordance with the facts, because the bank's concern is with documents, not facts.<sup>34</sup> The paying bank is only concerned with ensuring that the documents presented to it conform at face value to the terms of the letter of credit. This refers back to the basic principle stated in art 4 UCP; the parties to a documentary credit deal with documents and not with goods. This does not mean that the bank can be careless when examining the documents. Conversely, the bank is strictly bound by the mandate of the credit. If the documents deviate in any way from the terms of the credit, even if the deviation is purely in terminology and has no materiality, the bank is in fact entitled to withhold payment.<sup>35</sup> In this context, the judgement of the English House of Lords is often cited: "There is no room for documents which are almost the same or which will do just as well."<sup>36</sup> But on the other hand, avoiding unnecessary impediments to the business transactions seems desirable as these could occur just over a printing mistake which does not change the content and sense of the document at all. A provision of the UCP was therefore designed to encourage the courts not to be mechanistic in applying the doctrine of strict compliance. In art 13 (a) UCP it is stated that compliance of documents on their face with the terms and conditions of the credit shall be determined by international standard banking practice, as reflected in the articles of the UCP.<sup>37</sup> The UCP provides for a certain amount of tolerance, e. g. by providing that unless a credit stipulates that the quantity of the goods specified must not be exceeded or reduced, a tolerance of 5 per cent more or 5 per cent less is permissible under certain circumstances.<sup>38</sup>

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<sup>34</sup> Goode, at 990.

<sup>35</sup> Goode, at 991.

<sup>36</sup> *Equitable Trust Company of New York v. Dawson Partners Ltd.* (1926) 27 L.I.R. 49.

<sup>37</sup> Goode, at 993.

<sup>38</sup> Art 39 (b).

*c) Reasonable time*

Banks must examine the documents within a reasonable time. The length of the reasonable time depends on the documents. A longer period of examination may be required depending on the complexity and language in which the documents were issued, while the need for urgency could shorten the period of time. However, according to art 13 (b) UCP, the length of examination may not exceed seven banking days following the day of receipt of the documents.

The doctrine of compliance is particularly important to bankers, since in practice it is estimated that 60 per cent of tenders of documents by sellers do not meet the requirements of the terms and conditions of the credit.<sup>39</sup> The bankers, therefore, have to check the neglected tendered documents carefully, otherwise they are liable in respect of their customers.

**2. Principle of independence**

One of the primary functions of documentary credit is to secure the seller payment for dispatching the goods. For this purpose, the principle of independence is an important doctrine of documentary credits. Documentary credit creates an abstract payment obligation, which is independent of and detached from the underlying contract. Accordingly, the bank's duty to pay is to be found exclusively in the terms of the letter of credit, and the right and duty to make payment do not, in any way, depend on performance by the parties to the underlying contract.<sup>40</sup> Thus, a bank is only concerned with the terms of the credit, whether or not the documents tendered by the seller correspond to those specified in the terms of the credit.

This principle is stated in the UCP in the following terms. In Art 4 is stated that the parties to a documentary credit are dealing with documents and not with goods, services or other performances to which the documents may relate. More specifically, art 3 (a)

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<sup>39</sup> Goode, at 993.

UCP determines that credits, by their nature, are separate transaction from the sales or other contracts on which they may be based, and banks are in no way concerned with or bound by such contracts, even if any reference at all to such a contract is included in the credit. Consequently, the undertaking of a bank to pay, accept and pay draft, or to negotiate or fulfil any other obligations under the credit, is not subject to claims or defences by the applicant resulting from his relationships with the issuing bank or the beneficiary.<sup>41</sup>

The terms of the UCP describe the independence principle as an absolute, referring to it as a rule with no possible exception. According to art 3 (a) UCP, credits are by their "nature" independent and an exception from the independence principle is by any reference whatsoever not possible. But in the past, courts have had to face situations where there was a need to disregard this main principle of independence. These were cases where fraudulent conduct was involved, and disregarding the independence principle has generally become known as the so-called "fraud exception".<sup>42</sup> There is still no clarity in international law, and the circumstances under which a bank is entitled vis a vis the beneficiary, to refuse payment for reasons other than those originating in the documentary credit itself is left to the different national legal systems.

The leading English case in this regard is *United City Merchant LTD v. Royal Bank of Canada*. The decisions of the Queens Bench,<sup>43</sup> Court of Appeal<sup>44</sup> and the House of Lords<sup>45</sup> were all reported, and generated substantial academic interest. In order to examine the fraud exception in international law, it seems appropriate to analyse the three decisions the courts found in *United City Merchant LTD v. Royal Bank of Canada*.

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<sup>40</sup> Goode, at 988.

<sup>41</sup> Art 3 (a) UCP.

<sup>42</sup> Schmitthoff, at 404; van Houtte, at 273; Goode, at 988.

<sup>43</sup> 1979 1 Lloyd's Rep 267.

<sup>44</sup> 1982 QB 208 (CA).

<sup>45</sup> 1983 1 AC 168 (HL).

### **III. United City Merchants (Investment) Ltd v Royal Bank of Canada**

#### ***A. Facts of the case***

Early in 1976, the second plaintiff, Glass Fibres, entered into a contract with Vitro to manufacture equipment for installing a glass fibre plant in Peru. For payment, they agreed to open a letter of credit in favour of Glass Fibres which, was done through the defendants, the Royal Bank of Canada. The credit was irrevocable and payable against procurement of full set of clean, on board, ocean bills of lading covering the fibre glass equipment.

Shipment was to be from London to Callao, on or before October 15, 1976, while the credit was to remain open until October 30 1976, for negotiation of the shipping documents.

On July 22 1976, Glass Fibres assigned to the first plaintiff, United City Merchants, their rights, entitlements and benefits due under the letter of credit, and notice of the assignment was given to the defendants.

On November 9 1976, the defendants notified Glass Fibres that the letter of credit had been amended by the extension of the shipment date to December 15, and the date for presentation of documents to December 31. This amendment was regarded in what followed as having been accepted by the defendants, and thus presented a valid extension of original letter of credit.<sup>46</sup>

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<sup>46</sup>1979 1 Lloyd's Rep 267, at 268.

The facts relating to the fraud issue are as follows. In order to organise the transport of the glass fibre equipment, Glass Fibres informed M.C.K., their freight forwarding agent, in very explicit terms about the requirements with which the bills of lading had to comply, including indication of shipment from London to Callao. Glass Fibres emphasised that the relevant letter of credit permitted shipment up to December 15. An employee of the freight agent contacted Mr. Baker, an employee of E. H. Mundy the loading brokers for the American Prudential Lines, and gave him the necessary details for bills of lading, including "indicating shipment from London to Callao, latest shipment date 15th December".

The goods arrived at the United States Line's quay at Felixstowe on December 9, and were put on board the American Accord on December 16. The bill of lading was issued by Mr. Baker, with the date altered to December 15, and bearing a signed and dated notation that the goods were actually loaded on board the American Accord on that date. The port of loading was described as London, with Callao as the port of final destination.

The documents were presented to the defendants right in time but were rejected by the plaintiffs on the grounds that:

"information in our possession suggests that shipment was not in fact effected as it appears by the bill of lading".

The plaintiffs brought an action against the defendants. The defendants contended that the goods were put on board at, and shipped from, Felixstowe and not London and that they were loaded on board the American Accord on December 16 and not December 15. They also claimed that before the presentation both plaintiffs knew that the goods had been loaded at Felixstowe and not London, and that Mr Baker had acted fraudulently on

the plaintiffs' behalf in making out the bills of lading as he did with the intention that the defendants would act on them.<sup>47</sup>

### **B. Queens' Bench Decision<sup>48</sup>**

Accordingly, Judge Mocatta had to deal with the issue whether the defendant (Royal Bank of Canada) were entitled to refuse payment on the grounds they brought forward within their defence; i. e., whether the plaintiffs were entitled to receive payment against presenting the documents as they did.

#### **1. Clarifying the facts of the case**

In order to handle this issue, the court first had to clarify the facts brought forward by the parties. The action by the plaintiffs, United City Merchant, was against the defendants, Royal Bank of Canada, on the defendant's refusal to accept and pay for documents presented by the plaintiffs against a letter of credit. In their defence the defendants made the points:

(i) the goods were put on board at and shipped from Felixstowe and not from London, and they were loaded on board the *American Accord* on December 16 not December 15;

(ii) it was further alleged that Mr. Baker acted fraudulently on behalf of the plaintiffs in making out the bills of lading as he did with the intention that the defendants should act upon the information they contained.

(iii) it was also alleged that the plaintiffs knew, before the presentation of the documents, that the goods had been loaded at Felixstowe and not London;

Given the evidence presented, Judge Mocatta could easily find out whether the goods were shipped on December 15, according to the notification on the bills of lading, or on

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<sup>47</sup>1979 1 Lloyd's Rep 267, at 268.

<sup>48</sup>1979 1 Lloyd's Rep 267.

December 16, as alleged by the defendants. Mr. Baker himself, the issuer of the bills who gave oral evidence under subpoena, told the Judge that he had no reason to suppose the containers had been actually on board on December 15.<sup>49</sup> Other evidences confirmed this so the judge held that there was no doubt that the goods in question were put on board the American Accord on December 16.<sup>50</sup> It was also clear that the vessel in question did not leave the port of London as indicated in the bills of lading, but according to evidence left Felixstowe on December 17.<sup>51</sup>

The next allegation which Judge Mocatta had to deal with was whether Mr. Baker, the issuer of the bills of lading in question, had acted fraudulently. After examining and analysing all the evidence brought forward by the defendants, Judge Mocatta came to the conclusion that in issuing bills of lading dated December 15, with a signed on-board notation of that date, Mr. Baker was making a false representation as to the date of shipment without belief in its truth, or careless as to whether it was true or false. Judge Mocatta held that Mr. Baker did this knowing that the correct date was a matter of importance in relation to a letter of credit. Accordingly, he considered Mr. Baker's conduct as fraudulent.

The next and quite important issue the court was concerned with was whether Mr. Baker or his company acted on behalf of the plaintiffs in dating the bills of lading back to December 15. The defendants claimed that the plaintiffs procured Mr. Baker to alter the date on the bills of lading, or at least connived with him to do so. After examining the evidence and facts Judge Mocatta found that the plaintiffs neither procured nor connived with Mr. Baker to forge the bills of lading. A second point Judge Mocatta considered was how the alteration of the documents was done. He pointed out that the documents he saw were so clumsily altered that the plaintiffs could not be fraudulently

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<sup>49</sup>At 271.

<sup>50</sup>At 271.

<sup>51</sup>At 273.

mind in presenting these documents to the defendant.<sup>52</sup> However, he stated that the plaintiffs neither acted fraudulently by letting Mr. Baker act on their behalf, nor did they act fraudulently by themselves, nor did he find evidence that they knew of the forgery of the documents at the time of representation.<sup>53</sup>

In summary the facts Judge Mocatta used as a basis for his argument:

(i) the documents presented by the plaintiffs did not represent the truth. The goods were not boarded on December 15, as claimed in the documents, but on December 16;

(ii) the alteration of the documents was fraudulently done by Mr. Baker the loading broker.

(iii) neither Mr. Baker nor his company acted on behalf of the plaintiffs;

(iv) at the time of representation, the plaintiffs did not act fraudulently by themselves, nor did they even know about the fraudulent alteration of the documents.<sup>54</sup>

## 2. Legal arguments

The starting point of Judge Mocatta's consideration was whether the defendants were liable to pay against the presented documents. He emphasised that there was nothing on the face of the document to indicate that it did not comply with the letter of credit. The bill of lading bore a signed notation that the goods were actually on board the American Accord on December 15.<sup>55</sup> From that one could assume a liability to pay, since the plaintiffs presented documents which were on their face complying with the terms of the credit.

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<sup>52</sup>At 274.

<sup>53</sup>At 268.

<sup>54</sup>At 268.

<sup>55</sup>At 275.

a) *Referring to authorities*

Judge Mocatta went on to refer to authorities that established the independence principle, and significant in this case, that agreed on established exceptions to this principle. In particular, he referred to the case *Edward Owen v Barclays Bank*<sup>56</sup>, in which Lord Denning confirmed the strength of the independence principle established by earlier authorities. Of special significance was the well known statement by Lord Justice Jenkins in *Malass v. British Imex*<sup>57</sup>:

“It seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that banker’s confirmed credits are of that character, and, in my judgement, it would be wrong for the court in the present case to interfere with that established practice“.

In order to deal with what Lord Denning called an exception of the independence principle in the case of established or obvious fraud to the knowledge of the bank, Lord Denning referred to the American case *Szejn v. Schroder Banking Corporation*.<sup>58</sup> In this case, the seller sent cow hairs and other rubbish instead of the bristles he was contractually obliged to do. Although the documents presented to the buyer’s bank complied on their face with the requirements in the letter of credit, the court held:

“on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller’s fraud has been called to the bank’s attention before the drafts and documents have been presented for payment, the principle of the independence of the bank’s obligation under the letter of credit should not be extended to protect the unscrupulous seller“.

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<sup>56</sup>(1978) 1 Lloyds Rep. 166.

<sup>57</sup>(1957) 2 Lloyds Rep. 549; (1958) 2 Q. B. 127.

<sup>58</sup>(1941) 31 N. Y. S. 2nd. 631.

Accordingly, a bank is entitled to refuse payment despite procurement of documents which at face value comply with the credit if following requirements are met. The seller's conduct must have been fraudulent and the fraudulent conduct must be known by the bank which is supposed to pay out the credit. By adopting this statement, the court in *Edward Owen v. Barclays Bank* emphasised that fraud must be established or very clearly established.

In summary of the statements by the authorities Judge Mocatta referred to, the English cases suggest that where the documents tendered comply with the requirements of the letter of credit, the bank has no option but to pay, except in the case of fraud.<sup>59</sup>

**b) Defendants pleading**

After examining the authorities' view on the duty to pay and the fraud exception, Judge Mocatta dealt with the defendants' pleading. In his submission Mr. Staughton, defence counsel, sought to establish a broader opinion on the possibilities for refusing payment. He submitted that the bank might refuse to pay if it knew that any of the documents was inaccurate in a material particular. In greater detail, he argued that the obligation of a bank to the beneficiary of a letter of credit is to pay if:

(a) the draft is genuine and not forged and

(b) the documents appear on their face to comply with the credit; unless:

(i) any of the documents is inaccurate in a material particular; i. e., something which the letter of credit requires to be in the documents or which is not complied with, would enable the buyer to reject; or, alternatively,

(ii) any of the documents is thus inaccurate to the knowledge of the person who made it; or, alternatively,

(iii) any of the documents is thus inaccurate to the knowledge of the beneficiary.<sup>60</sup>

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<sup>59</sup>At 277.

Mr. Staughton himself had to admit that the recent cases required either established fraud or clear cases of fraud, but emphasised that this cases where interlocutory applications for injunctions. Accordingly, he submitted that where the proceedings were not interlocutory, a bank was justified in refusing to pay if the documents tendered, although correct at face value were inaccurate in a material respect.

To support this submission Mr. Staughton relied mainly on the American case *Old Colony Trust v. Lawyers Title & Trust CO.*<sup>61</sup> In this case the court stated that when the issuer of a letter of credit knows that a document, although correct in form, is in fact false or illegal, he cannot be called upon to recognise such a document as complying with the terms of the credit. Judge Mocatta did not adopt this statement, and quoted a later American case, *Continental National Bank v. National City Bank.*<sup>62</sup> The court in this case referred to *Old Colony Trust v. Lawyers Title & Trust Co.* and said that if the court intended to lay down a broad general principle, this would be that the issuing bank could always refuse to honour the credit, if the goods did not, in fact, comply with the description in the documents. Further on, the court stated to make it a general requirement that the goods must comply with the documents would practically undermine the general principle that the bank must honour the draft if the documents comply with the terms of the letter of credit.<sup>63</sup> Therefore, Judge Mocatta saw the case that the defendants' counsel, Mr. Staughton, relied upon as a special one, depending on its own terms and facts.<sup>64</sup> Accordingly, Judge Mocatta rejected the defendants' counsel's submission, and came to the following conclusion.

### **c) Conclusion**

Judge Mocatta stuck to the narrow exception of fraud found in the American case *Sztejn v. Schroder* which was approved by the Court of Appeal in *Edward Owen v. Barclays*

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<sup>60</sup>At 277.

<sup>61</sup>(1924) 297 Fed. Rep. 152.

<sup>62</sup>69 F. 2nd. 312.

<sup>63</sup>At 277.

*Bank*. Since he found that Mr. Baker did not act as the plaintiffs' agent in making out the bills of lading, and that there was no fraud on the part of the plaintiffs in presenting them, the case is vitally different from the *Sztejn v. Schroder* case where there was personal fraud by the seller presenting the documents.<sup>65</sup> The court consequently held that the plaintiffs were entitled to succeed.<sup>66</sup> From this one can infer the following general points:

(i) where there has been personal fraud or unscrupulous conduct by the seller presenting the documents under the letter of credit, it is right that a bank should be entitled to refuse payment against apparently conforming documents on the principle *ex turpi causa non oritur actio*;

(ii) the matter of a material inaccuracy that does not involve fraudulent conduct on the seller's side, does not entitle the bank to refuse payment.

### **C. Court of Appeal<sup>67</sup>**

The further proceedings of the case need some explanation before the arguments of the Court of Appeal can be reported. In the course of the first trial the defendants were given leave to raise by amendment, the further issue that the letter of credit was unenforceable by virtue of the Bretton Woods Agreements Order in Council 1946. Having postponed the trial on this issue, Judge Mocatta held at a second trial that the contract of sale and purchase was a disguise for exchanging currencies contrary to the exchange control regulations of Peru. He further held that therefore the contract of sale as well as the letter of credit were unenforceable by reason of article VIII, section 2 (b), of the Bretton Woods Agreements Order in Council 1946.<sup>68</sup> Since the contract as well as the letter of credit were held unenforceable the plaintiffs found themselves in a position

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<sup>64</sup>At 277.

<sup>65</sup>At 278.

<sup>66</sup>At 278.

<sup>67</sup>(1982) QB 208 (CA).

<sup>68</sup>(1979) 2 Lloyds Rep. 498.

where they were not entitled to payment. The plaintiffs appealed against this decision. In the Court of Appeal judgements were delivered by Stephenson LJ , Ackner LJ and Griffiths LJ.

### **1. Pleading by the plaintiffs**

The plaintiffs appealed on the grounds that the judge erred in law in holding the underlying contract of sale was a monetary transaction in disguise. Further more, they contended that irrespective of whether the contract of sale was unenforceable by reason of the terms of the Bretton Wood Agreements they were still entitled to receive payment under the letter of credit, since the letter of credit was a completely autonomous contract entirely independent of the underlying sale contract.<sup>69</sup> They also pleaded that the letter of credit had to be enforceable to an extent which did not infringe the exchange control regulations of Peru. In other words the letter of credit had to be divided into an invalid and a valid part and subsequent enforcement of the valid part.

Finally, in their appeal the plaintiffs insisted on the position regarding the fraud exception in documentary credits affirmed by Judge Mocatta's first decision. This is that only in cases of established fraud will legal enforcement of a letter of credit be withheld and the fraud must be that of the beneficiary and not of a third party unconnected with him.<sup>70</sup>

### **2. Pleading by the defendants**

In their submission, the defendants supported Judge Mocatta's decision regarding the unenforceability of the letter of credit by reason of the Brenton Woods Agreements. On the other hand, however, they still disagreed with Judge Mocatta's view taken in the first judgement regarding their right to refuse payment because of fraudulent conduct by Mr. Baker. They stuck to the view previously brought forward in the first trial:

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<sup>69</sup>(1982) QB 208 (CA), at 212 C.

<sup>70</sup>At 213 F-G.

“...the banks obligation to the beneficiary of the letter of credit is to pay if the draft is genuine and the documents appear on their face to comply with the terms of the credit. If any of the documents (1) inaccurate in a material particular, or (2) so inaccurate to the knowledge of the person who made it, or (3) so inaccurate to the knowledge of the beneficiary, then the bank is not obliged to pay. It is immaterial whether the person tendering the documents is a holder for value without notice of the defect.”<sup>71</sup>

### 3. Legal arguments

The first thing the court of appeal had to decide was whether the underlying contract of sale was a monetary transaction in disguise, and therefore an offence against Peruvian money exchange law. This is not of particular importance to the topic of this inquiry, but for the sake of completeness and understanding of the whole case it will very briefly be referred to.

#### *a) Monetary transaction in disguise and independence principle*

The parties of the underlying contract of sale agreed to double the price for the goods. The final purpose of this was to exchange US dollars for Peruvian soles. The court had no difficulty finding that the underlying contract was a monetary transaction in disguise, contrary to the exchange control regulations of Peru, and therefore unenforceable according to the Bretton Woods Agreements.<sup>72</sup> The main issue which the court had to consider in the following was whether or not, given the independence principle, this affected the letter of credit. Judge Stephenson then dealt comprehensively with the principle of independence and the authorities who described it, and considered it the “life-blood of international commerce“. Despite this, he also considered whether enforcing the letter of credit (payment in favour of the beneficiary) would lend weight to the enforcement of a contract declared unenforceable by the Bretton Wood Agreements.<sup>73</sup> According to his opinion, courts should do their best to prevent breaches of the Bretton Woods Agreement as this is required by international comity. In his judgements therefore, the courts of a country which is party to the Agreement, should

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<sup>71</sup>At 214 G.

<sup>72</sup>At 221 A.

do their best to promote both international comity and international trade. In order to comply with this double duty, he came to the conclusion that that part of the sale agreement which did not offend against the law of Peru (the purchase price equivalent to the value of the goods) should be enforced but not the part of it which is a disguised monetary transaction by which currencies are to be exchanged in breach of that law.<sup>74</sup> In other words, the part of the letter of credit which is equivalent to the normal value of the shipped goods is payable, while the rest of the credit, payable only for the purpose to exchange currencies, is invalid, according to the Bretton Wood Agreement. This compromise solution was affirmed by the judgements of Ackner and Griffiths L.JJ.<sup>75</sup> Without going deeper into this subject, it is interesting that the court apparently found another exception from the independence principle besides the exception of fraud with which the court had to deal afterwards. This exception is in cases where the enforcement of the letter of credit would give effect to an unenforceable and illegal transaction.

The court now came to the issue which is more important in this inquiry. This is the question as to whether the plaintiffs were entitled to payment under the letter of credit, despite the facts found by Judge Mocatta that the bill of lading presented conformed, on face value, with the terms of the credit but was false and fraudulently made by the person who issued it. Judge Mocatta had already decided, as reported above, and the Court of Appeal had to also deal with it.

*b) Refusing payment because of involved fraud*

At first Judge Stephenson dealt with the defendants' broad submission, namely inaccuracy in a material particular.<sup>76</sup> Put differently, an inaccurate statement when material in a document would entitle a bank to refuse payment. In this point, Judge Stephenson followed Mocatta J. in stating that to accept the defendants' submission

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<sup>73</sup>At 227 C.

<sup>74</sup>At 227 E.

<sup>75</sup>At 244 C; at 253 A.

<sup>76</sup>At 231 H.

would practically undermine the general principle that the bank must honour the draft if the documents comply with the terms of the letter of credit and might greatly hold up the smooth running of international trade, and might place exceptionally onerous investigations on banks.<sup>77</sup>

Afterwards, Judge Stephenson examined the main English and American authorities in regard to the fraud exception in documentary credits. He basically referred to the same judgements Mocatta J. had already referred to, and concluded that, according to the authorities, the exception of fraud is limited to the fraud of the beneficiary and nothing is said about fraudulent conduct of a third party.<sup>78</sup> Consequently, he again followed Mocatta J in saying that the limited fraud exception, as determined by the authorities, is a good reason to dismiss a beneficiary's claim under a letter of credit.

Nonetheless, Stephenson did not agree that this limited exception should be the only reason for a bank to reject payment. His reluctance to accept Judge Mocatta's view seems mainly to be this consideration:

“Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for the documents they present, it is important to all concerned that those documents should accord, not merely with the requirements of the credit but with the facts; and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer“<sup>79</sup>

To support this reflection Judge Stephenson had to admit that no authority, neither English nor American, had clearly decided that the fraud of a third party, such as the maker of false document, is or is not a good defence against payment under a letter of credit. Nevertheless, he examined more authorities to find hints to a solution in cases

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<sup>77</sup>At 232 D.

<sup>78</sup>At 234 B.

<sup>79</sup>At 234 E.

where fraudulent conduct of a third person is involved. He first referred to the case *Bank of Taiwan Ltd. v. Union National Bank of Philadelphia*,<sup>80</sup> in which the court held that the bona fide holder of a false document must at least know about it before payment can be refused. In this case, the holder of a document is not innocent anymore. But in the present case the beneficiary did not know about the misrepresentation and therefore this case is no help in supporting Judge Stephenson's reflection. After examining opinions expressed in textbooks with regard to the fraud exception, and referring to the American Uniform Commercial Code (UCC) and the UCP without marked success, his inquiries finally led him to Goode's statement written in reaction of Mocatta's judgement:

“(The beneficiary) himself has a duty to tender documents which are in order, and the fact that he acted in good faith in tendering forged documents is thus irrelevant. This fundamental point appears to have been overlooked by Judge Mocatta ... . The beneficiary under a credit ... is only entitled to be paid if the documents are in order. A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party.”<sup>81</sup>

In adopting this view, Stephenson stated that a forged document is not a genuine or valid document that entitles the presenter of it to be paid. If the banker to whom it is presented under a letter of credit knows it to be forged, he must not pay, whether or not a forged document is a nullity.<sup>82</sup> Now an important fact in the present case has to be considered. The previous ruling was that whether the bill of lading was a forgery, not having pleaded or argued before was not open to the defendants in this court.<sup>83</sup> In other words, one cannot assume that the bill of lading was a forgery itself. Therefore, the court had to decide whether a fraudulent document as this bill of lading was, was likewise not a genuine or valid document no more entitled than a forgery to require payment, and equally, to be rejected by the banker who knows it to be fraudulent.

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<sup>80</sup>(1924) 1 F (2d) 65, 66.

<sup>81</sup>At 238 D.

<sup>82</sup>At 239 A.

<sup>83</sup>At 238 G.

In reaching a decision however, Stephenson J as a starting point the premise that forgery by a third party entitles a bank to refuse payment as well as forgery by the beneficiary. He subsequently said:

“if a document false in the sense that it is forged by a person other than the beneficiary can entitle a bank to refuse payment, I see no reason why a document in any way false to the knowledge of a person other than the beneficiary should not have the same effect.”<sup>84</sup>

In consequence, Stephenson J. decided that the defendants were right to refuse to honour the plaintiffs' credit, even though the plaintiffs were the innocent party. But, according to his opinion reported above, the plaintiffs put Mr. Baker in the position in which he made the bill and thus it is their rather than the defendants who should bear the loss.<sup>85</sup>

Judge Ackner came to the same conclusion as his earlier colleague, but added some considerations and arguments which are worth mentioning. He also raised the question whether the fraud exception to the strict rule that the bank must pay if the documents are, on their face, in order, is limited to cases where the fraud is the seller's, or whether it applies in all cases of fraud known to the bank. He noticed that the cases referred to in the pleadings and the previous judgement were of little help. In these cases the seller himself acted fraudulently, whereas in the present case a third person was fraudulent. Thus, he raised the issue of the underlying justification which led the courts to establish the exception of fraud in these cases. The Latin maxim *ex turpi causa non oritur actio* (the inability of the fraudulent seller to rely upon his own wrongdoing) did not seem an exhaustive explanation to him.<sup>86</sup> In his opinion, a banker cannot be compelled to honour a credit against documents which he knows are wastepaper. To hold otherwise, would

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<sup>84</sup>At 239 C.

<sup>85</sup>At 240 A.

<sup>86</sup>At 246 F.

be to deprive the banker of that security for his advances which is a cardinal feature of the process of financing carried out by means of the credit.<sup>87</sup> Hence, a different acceptable basis for the exception had to be sought:

“In order to do so, it is necessary to go back to first principles. The buyer has arranged with the bank to provide finance for the seller, in the seller’s country, on delivery of certain documents. The banker’s authority or mandate is to pay against genuine documents and that is what the bank has undertaken to do. It is the character of the document, not its origin, that must decide whether or not it is a conforming document which complies with the terms of the credit.”<sup>88</sup>

Accordingly, if a bank knows that a bill of lading has been fraudulently completed by a third party, it must treat that as a nonconforming document in the same way as if it knew that the seller was party to the fraud. Thus, Ackner J also dismissed the appeal.

Griffith J, joining Stephenson and Ackner JJ, stressed that the bank takes documents as security for payment. It therefore cannot be obliged to take worthless documents if it knows the documents are forgeries.<sup>89</sup> He also stated that the identity of the forger is immaterial. It is the fact that the documents are worthless that matters to the bank. In such cases, the right of the bank to refuse payment does not rest upon the maxim *ex turpi causa non oritur actio*, but, as with Ackner J, he found that the bank’s obligation is to pay upon the presentation of genuine documents in accordance with the requirements of the letter of credit. If the documents presented are fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay.<sup>90</sup>

### *c) Conclusion*

Several arguments the Court of Appeal brought forward in dismissing the appeal depart from Mocatta’s J judgement and for clarity should be summarised:

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<sup>87</sup>At 246 G.

<sup>88</sup>At 247 C-D.

<sup>89</sup>At 254 B.

<sup>90</sup>At 254 D.

- (i) There are good reasons to let the beneficiary bear the loss caused by false documents, even though he may act in good faith, since he goes to others for issuing the documents;<sup>91</sup>
- (ii) the bank's obligation is to pay upon presentation of genuine documents;
- (iii) forged or fraudulently completed documents are not genuine documents and therefore have to be treated as non conforming documents;
- (iv) it is the character of the document and not its origin which renders it invalid;
- (v) compelling a bank to pay against forged documents would diminish its security;
- (vi) the fraud exception therefore does not rely only on the maxim *ex turpi causa non oritur actio* but also includes the fraudulent conduct of a third person.

**d) Additional remarks**

The inconsistent argumentation of the court is worth mentioning. The judges considered the solutions they have found in the present case to be covered by the fraud exception. Stephenson J expressed this when he distinguished the defendants' wider submission from the exception of fraud.<sup>92</sup> Following Goode's statement, it seems more appropriate to distinguish this solution from the fraud exception as established by English and American authorities and, moreover, to consider it a matter of non-compliance with the terms of the credit. Goode claims, "*a fraudulently completed bill of lading does not become a conforming document*", which implies that a forged document is not a document in compliance with the terms of the credit. So Stephenson argued, saying that a forged document is not a genuine or valid document on presentation of which the bank is not compelled to pay.<sup>93</sup> This might also indicate why Stephenson J. held that the

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<sup>91</sup>At 234 E.

<sup>92</sup>At 232 C.

<sup>93</sup>At 239 A.

defendant's right to refuse payment is rather a matter of compliance than an extension of the fraud exception, as established by the authorities and Mocatta J.'s judgement. Similarly, in their statements Ackner and Griffith JJ departed from the maxim *ex turpi non oritur actio* and relied upon the beneficiaries' obligation under the credit to present genuine documents. Consequently, they said that a document fraudulently completed by a third party must be treated as a nonconforming document. This also sounds like a matter of non compliance of the documents rather than an extension of the fraud exception found by the authorities so far. However, the argumentation the court delivered in their judgement remains important.

#### ***D. House of Lords***<sup>94</sup>

The case was brought by appeal of the plaintiffs before the House of Lords. In his speech Lord Diplock delivered the judgement.

##### **1. Dealing with the broad proposition**

Despite the fact that the Court of Appeal did not accept the defendants' submission in the whole extent,<sup>95</sup> they stuck to it. Their pleading before the House of Lords again included the opinion that a bank is not obliged to pay regardless whether the documents are on their face in order if the documents contain some statement of material fact that is not accurate.<sup>96</sup> For this reason, Lord Diplock, referring to it as the broader proposition, had to deal with it first. He considered this exception as a clear application of the maxim *ex turpi causa oratio actio*, emphasising that the fraud exception, as determined by previous authorities is the only established exception from the duty to pay in cases where the documents are in order at face value.<sup>97</sup> Since the seller in this case was not aware of the misrepresentation, this exception does not apply. This is contrary to the broader proposition that says that the bank is entitled to refuse payment if the

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<sup>94</sup>(1983) 1 AC 168 (HL).

<sup>95</sup>Stephenson J, (1982) QB 208, 232 D.

<sup>96</sup>At 175 F-G.

documents contain material inaccuracy irrespective of the knowledge of the beneficiary. Nevertheless Lord Diplock did not accept this broader proposition for the following reasons:

First, he relied on the contractual relationship between the bank and the buyer. He pointed out that the law is clear and has never been disputed that the contractual duty between the bank and the buyer is to examine the documents with reasonable care and, if they appear on their face to be in accordance with the terms of the credit, to pay the beneficiary.<sup>98</sup> According to him, the law is equally clear, and is so provided by article 9 UCP, that banks assume no liability or responsibility to the buyer "*for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents.*" He then continued that it would be strange from a commercial point of view, if the contractual duty owed by the bank to the buyer to honour the credit on presentation of apparently conforming documents, despite the fact that they contain inaccuracies or are even forged, was not matched by a corresponding contractual liability of the bank to the beneficiary.<sup>99</sup> In other words, it would be strange if the bank owed the buyer the contractual duty to pay against documents which are false, but on their face in order whereas the bank, in the same case vis a vis the seller would be entitled to refuse payment because of a material inaccuracy which was not apparent on the face of the documents.

Another reason for rejecting the broad proposition was the requirement of a "material inaccuracy." According to Lord Diplock this requirement invites the query: "material to what?". The answer suggested was: a misstatement of a fact which, if the truth had been disclosed, would have entitled the buyer to reject the goods. But this, stated Lord Diplock, would destroy the autonomy of documentary credit, which is its *raison*

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<sup>97</sup>At 184 A.

<sup>98</sup>At 184 E.

<sup>99</sup>At 185 A.

d'être.<sup>100</sup> It would make the seller's rights to payment by the confirming bank dependent upon the buyer's rights against the seller under the terms of the underlying contract. Lord Diplock therefore firmly rejected the defendants' broad proposition.

## 2. Dealing with Court of Appeal's decision

Further on Lord Diplock dealt with the proposition accepted by the Court of Appeal. Lord Diplock referred to it as the "half-way house" between the fraud exception and the broad proposition favoured by the defendants with which he had hitherto been dealing.<sup>101</sup> This is confusing as Mocatta J also called the broader proposition the half way house in his judgement.<sup>102</sup> However, "half way house" in the following discussion refers to the proposition which was accepted by the Court of Appeal.

What distinguishes the accepted proposition from the broad proposition is the fact that the misrepresentation of fact was false to the knowledge of the person who issued the document, and intended by him to *deceive* persons, including the beneficiary, into whose hands the document might come.<sup>103</sup> But according to Lord Diplock, this difference is not a reason to find another solution than rejecting this proposition on the same arguments as already stated in relation to the broad proposition. He stated:

"what rational ground can there be for drawing any distinction between apparently conforming documents that, unknown to the seller, in fact contain a statement of fact that is inaccurate where the inaccuracy was due to inadvertence by the maker of the document, and the like documents where the same inaccuracy had been inserted by the maker of the document with intent to deceive, among others, the seller himself?"

In order to find a rational ground he recalled the argumentation the Court of Appeal used. After referring to American cases and the Uniform Commercial Code, the court

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<sup>100</sup> At 185 E.

<sup>101</sup> At 186 E.

<sup>102</sup> (1979) 1 Lloyd's Rep. 267(277).

<sup>103</sup> At 187 B.

started from the premise that a bank could refuse to pay against a document it knew to be forged, even though the beneficiary had no knowledge of that fact. From this premise they reasoned that if forgery by a third party relieves the bank of liability to pay the beneficiary, fraud by a third party ought to have the same consequence.<sup>104</sup> Expressing doubts about the validity of the premises relating to forged documents, Lord Diplock rejected the Court of Appeal's conclusion even if the premise that a bank is entitled to refuse forged documents irrespective the knowledge of the beneficiary is assumed to be correct. He stated although forgery of a third party that makes a document a nullity entitles a bank to refuse payment, this does not mean that fraud by a third party which does not render the document a nullity has the same consequence. Thus, he considered the decision of the Court of Appeal to be wrong and favoured the decision found by Mocatta J in the first judgement.<sup>105</sup>

### 3. Conclusion

In summary of the judgement, the following can be said:

- (i) the exception of fraud is based on the maxim *ex turpi causa non oritur action*;
- (ii) therefore, the fraud must be fraud by the beneficiary or at least he must have knowledge of the fraudulent conduct;
- (iii) material inaccuracy in apparently correct documents without knowledge of the beneficiary is not covered by the fraud exception and does not entitle the bank to reject payment;
- (iv) assuming that forgery by a third party renders the document a nullity which entitles a bank to reject payment does not lead to the conclusion that fraudulent conduct by a third person which does not render the document a nullity gives the bank the same right;
- (v) it is expressly left open whether a forgery of a third party without the beneficiary's knowledge entitles a bank to reject payment.

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<sup>104</sup>At 187 F-G.

#### IV. Academic reaction

The final decision by Lord Diplock in the *United City Merchant* case not only received unambiguous support in academic circles but, also raised doubt about the correctness.

Goode had already criticised the first judgement found by Mocatta J (referred in the reasoning by Stephenson in the Court of Appeal). Goode blamed Mocatta for overlooking the point that a fraudulently completed bill of lading is not a conforming document, irrespective whether the document was altered by a third party or the beneficiary himself.<sup>106</sup> Goode also made a statement in regard to the final decision of Lord Diplock. He did support the Court on the grounds that the bill of lading was a genuine document in that it was issued by the party by whom it purported to have been issued, so that what was false was simply the information in it.<sup>107</sup> In other words, the altered bill of lading was not a forgery and not a nullity, and therefore the decision itself is supportable. However he firmly criticised Lord Diplock's process of reasoning. As in his first comment, he did not approve the court's opinion that a bank may not be entitled to withhold payment even if the documents presented are forged. According to Goode, this proposition conflates two distinct principles; that the documents must conform to the credit and that the bank may withhold payment in the event of fraud, but only if the fraud is that of the beneficiary or his agent. Forged documents cannot conceivably be treated as conforming documents; to say that the beneficiary has a right to payment against even forged documents, if he is not party to the forgery, finds no justification in the terms of the letter of credit or in the provisions of the UCP.<sup>108</sup>

Oelofse argued similarly in supporting the Court's decision.<sup>109</sup> He approved the Court's reasoning that the bill of lading in the present case was just a document containing a false

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<sup>105</sup>At 188 B-C.

<sup>106</sup>Goode, "Reflection on Letters of Credit", *Journal of Business Law* 1980, at 291, (294).

<sup>107</sup>Goode, "Commercial Law", at 1008.

<sup>108</sup>Goode, "Commercial Law", at 1009.

<sup>109</sup>Oelofse, "The Law of Documentary Credits in a comparative perspective", at 394.

statement and therefore remained a conforming document, against which procurement the bank had no defence but to pay. But he also pointed out that it is material to distinguish between a forged document and one that merely contains a fraudulently false statement. A forged document is not what it purports to be. It follows logically that it is not a conforming document, even though it may appear to be and the bank will have a defence against a claim by the beneficiary.<sup>110</sup>

To sum up one may say that both authors agreed with the Court's decision in the end, but they both criticised the Court's reasoning. In return, they promoted a clear distinction between the exception of fraud and the matter of non-compliance of the documents which they did not think the Court's argumentation had elaborated sufficiently. In both statements, this distinction was considered as material, since according to them, a forged document which is a nullity does not conform with the terms of the credit, and it therefore does not matter who committed the forgery or even whether the beneficiary has knowledge of it to entitle the bank to reject payment. The fraud exception based on the *ex causa non turpi oritur actio* rule entitles a bank to reject payment only if the beneficiary does not act in good faith in presenting the false documents.

Jack R. in his statement agreed with the Court's finding that the alteration of the bill of lading neither rendered it a forgery nor a nullity.<sup>111</sup> He also recognised Lord Diplock's doubt in accepting that forgery which is a nullity entitles a bank to refuse payment, regardless the knowledge of the beneficiary. Nonetheless, he took up the point that the basis on which a bank *might* reject a document as a nullity even though the party presenting it has no knowledge of any fraud, cannot be the *ex turpi causa non oritur actio* rule. If such documents can be rejected, it must be surely on the basis that these

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<sup>110</sup>Oelofse, "The Law of Documentary Credits in a comparative perspective", at 393.

<sup>111</sup>Jack, "Documentary Credits", at 217.

documents are not in conformity with the terms of the credit.<sup>112</sup> This is similar to the opinions reported above. But Jack departed from these in suggesting that a bank should not be entitled to reject documents which are a nullity unless it can bring itself within the fraud exception. In this he followed Lord Diplock and relied on the provision of the UCC in which it is stated that a bank is not entitled to reject payment even though the documents are fraudulent or forged, if the presenter of the documents is a negotiation bank in good faith. Like Lord Diplock, he saw no reason to distinguish between a negotiation bank and the beneficiary unless, and very significantly, the beneficiary is likely to be the innocent party who put the person responsible for the document into a position to do as he has done, and so the innocent beneficiary should bear the loss rather than the bank.<sup>113</sup> To support this statement he refers to Stephenson J who argued in the same way in the Court of Appeal decision. It seems odd that Jack first accepted the decision found by the House of Lords, but later supported the argumentation used by the Court of Appeal in regard to forged documents. This can only be explained by the fact that Jack considered like the Lords, also the altered bill of lading in the present case not to be a forgery. However, if a document is a forgery, Jack then adopts Stephenson's argument; that is that the bona fide holder of the document, whether a negotiation bank or the beneficiary himself, has a right of payment, unless the beneficiary put the person responsible for the forgery of the document into the position to issue it.

Other writers have also criticised the Lord's decision. Arora A., for example, stressed the point that the judgement, if followed in subsequent cases, would have the result that documents representing the truth but which are insufficient can quite properly be rejected as non conforming. On the other hand, if the bona fide beneficiary presents falsified documents, the bank can not reject the documents even if it knew of the falsity. In other words, the bank is compelled to accept documents which are known by them to be false. According to Arora, the judgement opens the gate to the seller who does not

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<sup>112</sup>Jack, "Documentary Credits", at 217.

<sup>113</sup>Jack, "Documentary Credits", at 218.

conform in fact to the terms of a letter of credit, allowing him to enforce the obligations of the bank under a letter of credit even though the seller only tenders apparently conforming documents. It also protects him by removing the burden from the seller of ensuring that the documents he tenders are not false or forged.<sup>114</sup>

Ellinger in an earlier time reaction to the Mocatta judgement, quoted a statement made by Lord Denning in the case *Etablissement Esefka International Anstalt v. Central Bank of Nigeria* that a set of forged or fraudulent documents constitutes a bad tender, which may therefore be rejected. He also stated that the fraud exception should be available even if the deceit was performed by a third party.<sup>115</sup>

Trying to find general concurrence among academics in reaction to the United City Merchant case, one may say that there is unanimity over the Lord's findings that the fraudulently altered bill of lading was just a false document without it being a forgery and a nullity. Opinions are also united over the fraud exception as confirmed by the Lords. The fraud exception applies only if the beneficiary himself acts fraudulently, whether in actually acting fraudulently or knowing about it. The issue under discussion is what would have happened if the bill of lading had been a forgery which had been a nullity. Among academic writers, one find support for the solution that this must be distinguished from the fraud exception and must be seen as a matter of non compliance with the terms of the credit. As a consequence, the bank is entitled to reject payment under the credit even if the beneficiary acts in good faith. The tendency, as seen in Lord Diplock's speech, is different. Although he expressly left this question open, by referring to the UCC he argued that he saw no reason why a beneficiary should be treated differently to a bona fide negotiation bank which is protected by the provisions of the UCC.

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<sup>114</sup>Arora, "Documentary Fraud: the United City Merchants Case", *Company Lawyer*, 1984, 131 (134).

<sup>115</sup>Ellinger, "Fraud in Documentary Transactions", *Journal of Business*, 1981, 258 (264).

This statement in particular is arguable. Indeed is a holder of documents in due course protected by the provisions of the UCC even if the presented documents are forged. But Lord Diplock's reasoning to treat a seller/beneficiary the same way does not seem very convincing since the provisions of the UCC also provide no fewer than four exceptions to the independence principle. This includes forgery, the presentation of fraudulent documents and fraud in the transaction. Thus in opposition to Lord Diplock there are indeed reasons to treat a seller / beneficiary differently to a holder of documents in due course.

## V. The case law after United City Merchants

Following the discussion on academic reaction to the United City Merchant decision, how subsequent English courts dealt with the exception of fraud in documentary credits needs explanation. The main issue in some subsequent court decisions was the burden of proof before the court if fraud is involved. In *Bolivinter Oil SA v. Chase Manhattan Bank Commercial Bank of Syria and General Company of Homes Refinery*<sup>116</sup> the court stressed that the evidence of fraud must be clear before injunction against payment can be granted. A burden of evidence required by the court is less in the newer decision of *Rafsanjan Pistachio Producers Co-operative v. Bank leumi (UK) plc*<sup>117</sup> which found that a very heavy burden of proof rests upon the defendants to establish their case to the highest level of probability.

Unfortunately, not many cases that had to deal with the question of whether a fraud by a third person entitles a bank to reject payments, the most important question in the United City Merchant case in my opinion. Interesting in this regard is the case *Tukan Timber Ltd v. Barclays Bank plc*<sup>118</sup> where the court required proof of bad faith on the part of the beneficiary, although this was a case of an alleged forgery.<sup>119</sup> From this one

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<sup>116</sup>(1984) 1 Lloyd's Rep 251.

<sup>117</sup>(1992) 1 Lloyd's Rep 513.

<sup>118</sup>(1987) 1 Lloyd's Rep 171.

<sup>119</sup>At 176.

may infer that on one hand the court still considered the bad faith of the beneficiary as a necessary prerequisite for the application of the fraud exception, but on the other, that the court took the point, against academic opinion, that a forgery by a third party does not entitle a bank to reject payment, unless the beneficiary acts in bad faith presenting the forged documents.

The United City Merchant case raised another issue regarding the fraud exception which was discussed in subsequent English cases. This is whether the fraud exception is limited to fraud in the documents only, or whether there may be other fraudulent conduct of the parties, e.g. in the transaction, which entitles the bank to reject payment. Lord Diplock in the United City Merchant case formulated the fraud exception with specific reference to fraud in the documents only,<sup>120</sup> whereas Philips J in *Deutsche Rückversicherung AG v. Walbrook Insurance Co Ltd and others*<sup>121</sup> also considered other forms of fraud or other improper conduct as sufficient for an injunction. The case of *Themehelp Ltd v. West and others*<sup>122</sup> was again concerned with this issue. The alleged fraud in the *Themehelp* case was actually limited to the underlying contract and although whether the case at hand exceeded the bounds of the narrow formulation in United City Merchants was not investigated, the majority view simply seems to have assumed that it did not.<sup>123</sup> Evans LJ argued in another direction in his minority judgement. He stressed that, for an injunction to be granted, the drawing or intended drawing under the credit must itself be fraudulent. Although there are indications in the Philips' judgement in the *Deutsche Rückversicherungs* case and in the majority judgements in the *Themehelp* case that the formulation of the fraud exception by the House of Lords should not be read quite literally, and thus seen as only applying for fraud in presenting the documents, this aspect seems to be far from settled.<sup>124</sup>

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<sup>120</sup>(1983) 1 AC 168 (HL), at 183 G.

<sup>121</sup>(1994) 4 All ER 181.

<sup>122</sup>(1995) 3 WLR 751.

<sup>123</sup>At 755 H.

<sup>124</sup>Oelofse, at 406.

In summary, one may say that although not many cases concerned the fraud exception, the subsequent courts confirmed the finding of the House of Lords in referring to its arguments and statements. It can thus hardly be doubted that the decision of the House of Lords still represents the substantive English law in this regard.<sup>125</sup>

## **VI. Fraud exception in German law**

The German law, in accordance with the UCP, English and American law, also recognises the principle of independence.

### ***A. Independence Principle***

More specifically, German law distinguishes at least three relationships in an ordinary documentary credit transaction. The first is the relationship between the beneficiary and the applicant of the letter of credit, which could be called the relationship governed by the underlying contract. The second is the relationship between the issuing bank and the applicant, its customer, and the third is that between the issuing bank and the beneficiary of the credit. In general, the principle of independence stands for validity of the relationship between bank and beneficiary, independent from the relationships between the beneficiary and the applicant or between the bank and the applicant. Put differently, the bank is not entitled to use any defences which have their origin either in the relationship to its customer or in the underlying contract between beneficiary and applicant in order to escape its duty to pay the beneficiary under the terms of the credit. Only defences which arise out of the relationship between the bank and the beneficiary are available to the bank for rejecting payment. From this general principle, German law provides certain exceptions.

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<sup>125</sup>Hugo, at 277.

## **B. Exceptions**

### **1. In general**

In German case law and literature, the possible exceptions to the principle of independence are usually based on the “good faith” provision contained in paragraph 242 of the German Civil Code. Its concept is called “abuse of right” (Rechtsmissbrauch). According to this concept, it is considered counter to the legal system if the beneficiary relies in any case on this right although, in theory, he has an indefeasible right against the bank.<sup>126</sup> Consequently, under certain circumstances the bank is entitled to use defences arising out of the underlying contract to reject payment, which certainly is against the independence principle. Due to the importance of the independence principle for documentary credit transactions, also which is recognised by German law, these circumstances must be limited and exceptional.<sup>127</sup> In general, one may say the exceptional conditions are present if the beneficiary is assured that he has no rights arising from the underlying contract but nevertheless still relies on the right of payment under the letter of credit. In this case, he seeks for an advantage he does not deserve and consequently he abuses his right.<sup>128</sup> This can be seen as a general statement in relation to the exception of “abuse of right” but one which for the reasons arising out of the underlying contract that exactly entitles a bank to refuse payment, is a much discussed issue in German law.

### **2. Particular reasons**

There are four main factors in this discussion; (i) invalidity of the underlying contract; (ii) underlying contract induced by seller’s fraud; (iii) fraudulent documents; (iv) defective or non-existent goods.

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<sup>126</sup>Canaris, HGB Staub Grosskommentar - Bankvertragsrecht, para 1015.

<sup>127</sup>Eisemann / Schütze, “Das Dokumentenakkreditiv im internationalem Handelsverkehr“, at 198.

<sup>128</sup>Canaris, para 1016.

a) *Invalidity of the underlying contract*

The underlying contract can be void for various reasons. One is the possibility that the contract did not come into existence because of defective conduct of the parties; another case might be a subsequent faulty conduct of the parties which renders the contract invalid. Why the contract does not exist anymore is not that important. Of greater significance is the claim, which had its origin in the contract, no longer exist. It would be an abuse of right, if despite the fact that his claim no longer exist, the beneficiary demanded payment under the letter of credit. On first sight, this seems to put the issuing bank in a position where it has a wide range of possible excuses to escape payment, a procedure which does not conform with the idea of documentary credits. The independence principle, in particular, demands that the right of payment under the letter of credit is completely independent from litigation of the parties about matters of the underlying contract. This is perceived similarly in German law and therefore in German cases and literature, where, in order to limit the possibility of the bank escaping payment, the matter of proof comes into play. The general view is that the mere invalidity (possible or even probable) of the underlying contract does not provide a defence against the claim in terms of the credit. The validity of the contract must be quite clear on the basis of liquid proof.<sup>129</sup> Liquid proof basically means that the bank is in possession of documents that make it perfectly clear that the right of the beneficiary out of the underlying contract no longer exist. But statements from independent expert witnesses may also be sufficient. It is, however, not necessarily limited to documentary evidence. The test of whether proof is liquid is its immediate availability and penetrating strong evidence. The judgement of a court of competent jurisdiction which states that the underlying contract is void is in any case sufficient.<sup>130</sup> An interlocutory injunction does not meet the requirement of liquid and clear proof, because it is only a contemporary and not a final decision.<sup>131</sup>

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<sup>129</sup>Canaris, para 1017; Eisemann / Schütze, at 199.

<sup>130</sup>Oelofse, at 447; Canaris, para 1018.

<sup>131</sup>Canaris, para 1018.

In summary, it may be said that German law is very liberal as far as the recognition of the defence on the basis of the invalidity of the underlying contract is concerned. At first sight, this goes far beyond the defences allowed under English and American law, but one has to consider the strict requirements for proving the defence. The defence applies only in cases where the invalidity is quite clear and where the bank has access to liquid evidence. Seen in connection with the general requirement of the concept of "abuse of right", with the reliance on the right of payment despite the fact that the beneficiary knows he does not have a claim out of the underlying contract, this brings the German law into the ambit of the Common law exception of established fraud by the beneficiary.<sup>132</sup>

***b) Underlying contract induced by seller's fraud***

German law provides the bank with the defence of "abuse of right" if the underlying contract was reached because of fraudulent, threatening or other unethical conduct by the beneficiary.<sup>133</sup> It is arguable whether in these cases, the bank still has to meet the strict requirements of liquid proof. It is claimed that in cases where the beneficiary acts in this way, one should refrain from the strict requirements of liquid proof.<sup>134</sup> Another position is that even in cases of fraud by the beneficiary in negotiating the underlying contract, if the bank uses this as a defence, it has to present liquid evidence.<sup>135</sup> However, the important fact is that the bank has a defence against payment if the beneficiary acted fraudulently in the course of the underlying contract.

***c) Fraudulent documents***

Fraudulent documents are ones that tell a lie. Put differently, they are what they purport to be, but they do not reflect the truth. Whether the lie is obvious and finds its

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<sup>132</sup>Canaris, para 1016, who considers the concept of "abuse of right" as similar to the English and American fraud exception.;

<sup>133</sup>Oelofse, at 452.

<sup>134</sup>Canaris, para 1020.

<sup>135</sup>Oelofse, at 452.

way into the documents as a result of bad faith will determine whether or not the bank is entitled to refuse payment.<sup>136</sup> This is in accordance with the concept of “abuse of right“, where it would be an abuse if the beneficiary relied on the documents knowing they had been fraudulently altered.

*d) Defective or non-existent goods*

A major issue in German law is whether the bank is entitled to reject payment if the goods are defective. In the past German courts stated that payment under the letter of credit might be refused if, despite the documents having conformed, the goods delivered under the contract were obviously completely unfit for the performance of the underlying contract.<sup>137</sup> In a more recent case, the Federal Court stressed even more clearly that the goods must have been completely unfit for performance of the underlying contract before a bank is entitled to reject. The mere presence of defects in the goods is not enough, even if the defects are serious.<sup>138</sup> This led to the distinction between delivery of defective goods and totally useless goods. The first does not constitute an “abuse of right“ whereas the latter does.

Canaris rejects this distinction as an unbearable breach of the independence principle.<sup>139</sup> The question of whether the delivered goods are useless or not is not a question which concerns the documentary credit. Moreover, in accordance with art 4 UCP, the question is clearly limited to litigation between the parties of the underlying contract, since the bank deals with documents not with goods. To act otherwise, according to Canaris, would endanger the function of documentary transactions, the guaranteed payment for the seller. Therefore, he requires there to be an element of crime on the side of the seller/beneficiary, either in intentionally sending goods that do not comply or presenting

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<sup>136</sup>OLG Stuttgart 1979 WM 733, at 735.

<sup>137</sup>RGZ 106, 304, 308; BGH WM 1955, 765, 768; BGHZ 101, 84, 92.

<sup>138</sup>BGH WM 1987, 977.

<sup>139</sup>Canaris, para 1021.

documents where no goods have been sent.<sup>140</sup> This seems to be a similar position to the one the court took in the American *Sztejn* case, seen as the case that formed the basis of fraud exception in Common law. Here it was held that sending rubbish instead of bristles was fraud in the transaction, entitling a bank to refuse payment.

However, a less strict position regarding defective or useless goods allows the bank to refuse payment in the case of totally useless goods provided that the uselessness of the goods has been established by an objective third party, regardless of any criminal conduct of the beneficiary.<sup>141</sup>

In summary, one may say that Canaris' position aside, German law found a broader approach to the matter which in English law is called fraud in the transaction. According to the concept of "abuse of right" the bank has the right to refuse payment not only where fraud of the beneficiary has been established, but also where it is established that the sent goods are useless.

## **VII. Fraud of a third party under German law**

### ***A. General considerations***

Little has been said so far about how the fraudulent conduct of a third party, independent from the beneficiary, might affect his right of payment. Examination of the general concept of "abuse of right" is helpful here. This concept states that the beneficiary abuses his right if he knows that his claim out of the underlying contract does not exist anymore.<sup>142</sup> From this the importance of the beneficiary's knowledge can be inferred. Consequently, a beneficiary in good faith who relies on the credit, despite the invalidity of the underlying contract, does not abuse the right he obtained under the letter of credit. In so far as the demanding beneficiary acts in good faith, one may assume

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<sup>140</sup>Canaris, para 1021.

<sup>141</sup>Hugo, at 261.

that fraudulent conduct by another person not connected to the beneficiary does not have any effect on the letter of credit. Similarly in English law, in the *United City Merchant* case, the House of Lords eventually concluded that the bona fide beneficiary would not lose his right of payment even if the documents were fraudulently altered. A similar solution is conceivable in the case if the approach in German law is followed. As long as the beneficiary is not party to the alteration or does not know about it, he cannot abuse his right of payment obtained under the letter of credit.

### **B. Haftung für den Erfüllungsgehilfen<sup>143</sup>**

Another concept in German law is worth mentioning here. A very important fact in the *United City Merchant* was that the fraudulent Mr. Baker neither acted as an agent for the beneficiary nor was he instructed by the beneficiary to alter the bill of lading. Consequently, the fraud was not seen as a fraud of the beneficiary. The German Civil Code not only provides liability for a principal where the agent's conduct is culpable, but it also provides liability for a party if the faulty help of another person is used to fulfil the obligations under the contract. Paragraph 278 of the German Civil Code states that the debtor is liable for the culpable conduct of persons whose service he uses to fulfil his obligation. Certain requirements have to be met for this provision to apply. The following discussion will elaborate on whether this provision is applicable and whether the application would lead to a solution different from the *United City Merchant* case and other cases where fraud of a third party is involved.

#### **1. Contractual relationship**

A contractual relationship is important for the application of the *Haftung für den Erfüllungsgehilfen*. This relationship is not connected with the helping person, but is between two other parties for whom the third person renders his services. Thus, in the case of a documentary credit transaction, there must be a relationship between the

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<sup>142</sup>Canaris, para 1016.

<sup>143</sup> The translation for "Haftung für den Erfüllungsgehilfen" is: liability for a helping person, a person who is helping to fulfil a contractual obligation.

beneficiary and the bank. In English law, this relationship is considered a contract under which the bank is obliged to make payments against procurement of the documents.<sup>144</sup> German law considers the relationship a “*Schuldversprechen*“, which can also be seen as a contract.<sup>145</sup> The requirement of a contractual relationship therefore is met.

## 2. *Erfüllungsgehilfe* (helping person)

The *Erfüllungsgehilfe* must be a person who acts with intention of one party to the contract in order to help fulfil the contractual obligations. For example, would an issuer of a bill of lading, such as Mr. Baker in *United City Merchants*, be such a person. The *Erfüllungsgehilfe* neither has to be employed by one party nor has to be in another relationship to it, the mere fact that the person helped to fulfil one party's obligation is sufficient.<sup>146</sup> Whether issuing a bill of lading or another document can be considered helping to fulfil a contractual obligation is debatable. The *Erfüllungsgehilfe* does not have to fulfil the obligation itself; all he has to do is a contribution to the fulfilment.<sup>147</sup>

The beneficiary of a letter of credit has the duty to tender documents which are in order.<sup>148</sup> Thus, issuing such a document is at least a contribution to the tender of conforming documents. Another matter requiring explanation is whether an issuer of a bill of lading does so with the intention of the beneficiary. The intention does not have to be expressively announced, like an order or instruction. The approval of the *Erfüllungsgehilfe's* action satisfies whether the approval is made explicitly or tacitly.<sup>149</sup> It seems quite obvious that a beneficiary approves the issuing of a bill of lading the tendering of which will help him to get his payment. Therefore, one can assume that the beneficiaries in the *United City Merchant* case approved the issuing of the bill of lading by Mr. Baker as well. They apparently did not approve the fraudulent issuing.

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<sup>144</sup>Stephenson J in *United City Merchants v Royal Bank of Canada* (1982) QB 208 (217).

<sup>145</sup>Canaris, para 1004.

<sup>146</sup>Hanau, “Müchener Kommentar BGB“, Band 2, 2nd ed, § 278, para 4.

<sup>147</sup>Hanau, para 17.

<sup>148</sup>Goode, “Reflections on Letters of Credit I“, *Journal of Business Law* 1980, at 294.

After considering all these requirements of application, one comes to the conclusion that the provision about liability for fraudulent conduct of a *Erfüllungsgehilfe* does apply in cases like the *United City Merchant* case. Consequently, applying German law to the case of *United City Merchant* case would have had the effect of holding the beneficiaries liable for the culpable (fraudulent) conduct by Mr. Baker. The bank would therefore have been entitled to reject payment.

### **C. Consideration about limitation of the concept**

One should not apply the concept of *Haftung für den Erfüllungsgehilfen* without consideration about its limitation. The concept does not consider every action of an involved person as contribution to the fulfilment of a contractual obligation. For example, a producer of a certain product is not the wholesaler's *Erfüllungsgehilfe* (helping person) only because he produces the product the wholesaler is selling to the consumer. In documentary credit transaction, it would endanger the concept of letter of credits if the beneficiary were liable for the conduct of a unlimited circle of people involved in the transaction. The beneficiary had to face a unpredictable risk of not getting paid because of other people having done a bad job. This cannot be in accordance with the concept of letter of credit which meaning it is to assure payment against documents.

As far as cases such as *United City Merchants* are concerned one has to ask who should bear the risk of fraudulently altered documents. Art 15 UCP states that banks assume no liability or responsibility for genuineness or falsification of any documents. Against its apparent meaning this article does not release the bank of any liability for accepting fraudulently altered documents. This article rather rules the standard of examination.<sup>150</sup> Thus, the bank is not obliged to examine the document's genuineness. But the bank, despite this limited examination standard, is forced to reject payment against documents

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<sup>149</sup>Hanau, para 15.

<sup>150</sup>Nielsen, "Neue Richtlinien für Dokumenten-Akkreditive", art 15, para 120.

which are to its knowledge fraudulently altered.<sup>151</sup> If the bank were failing to obey this obligation it could be held liable for overlooking an apparent mistake in the documents by its customer.

On the other side is the innocent beneficiary. He, acting in good faith, presents documents which are on their face in order but fraudulently altered by a third person. It is part of his obligation under the documentary credit to provide proper documents. Therefore, it seems justified if he rather than the bank bears the risk of fraudulently altered documents. In other words, it seems justified if the bank is entitled to refuse payment even though the beneficiary is innocent.

The concept of *Haftung für Erfüllungsgehilfen* provides a solution for this consideration about allocation of risk between an innocent beneficiary and a bank. This concept classifies fraudulent conduct of person who's service the beneficiary uses to tender proper documents as the beneficiary's own fault. In this case the bank is entitled to refuse payment as soon as it knows about the fraudulent alteration. It is worth to note at this stage of the discussion that the concept of *Haftung für Erfüllungsgehilfen* does not extend the range of a bank's examination duty. Naturally the concept of *Haftung für Erfüllungsgehilfen* applies only in cases where the bank has for whatever reasons knowledge of the falsification. It does not mean that the bank has to examine the documents more carefully than required in the provisions of the UCP.

This solution for cases such as *United City Merchants* is different from the solution the Lords found. They stuck to the strict rules of documentary credits. As long as the documents are on their face in order the bank is obliged to pay. From this general rule they applied as only exception the exception of fraud. Further on the exception of fraud is based on the maxim *ex turpi causa non oritur action*. Consequently, the fraud exception does not apply for fraud of a third party. This led to the in my eyes weird

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<sup>151</sup>Canaris, para 392; Nielsen, "Neue Richtlinien für Dokumenten-Akkreditive", art 15, para 120.

solution that the bank in *United City Merchants* had to pay against documents which were to its knowledge fraudulently altered documents.

In my opinion this constitutes a violation against another rule of the UCP. Art 13 (a) UCP requires from the bank to examine the document with reasonable care to ascertain whether or not they appear on their face to be in compliance with the terms of the credit. It is hard to believe that a bank knowing that it pays against fraudulently altered documents acts with reasonable care. Consequently, the Lords forced the bank against the provision of the UCP to act unreasonable. The Lords' solution also is contrary to the justified allocation of risk as it was elaborated above. The decision of the Lords put the bank in a position where the reimbursement by its customer is endangered. The customer may blame the bank for paying against improper documents and refuse reimbursement. Rather the beneficiary than the bank should bear the risk of not getting paid in cases of fraudulently altered documents.

For this reasons the strict opinion concerning fraud of a third party is not worth to follow, whereas the concept of *Haftung für Erfüllungsgehilfe* provides certainly a reasonable solution for this problem. But on the other hand one should be careful in applying this concept. It is not according to the meaning of documentary credits to extend the circle of persons for who's conduct the beneficiary could be held liable. The liability must be limited to persons such as Mr. Baker in *United City Merchants* who directly render their service for the benefit of the beneficiary. Otherwise the assured right of payment would be endangered.

## **VIII. Conclusion**

In English law, the leading case remains *United City Merchants* in which the House of Lords confirmed the existence of a fraud exception in documentary credits, but strictly limited this exception to the fraud of the beneficiary. Despite a wider approach by academics, the English courts are even reluctant to apply forgery of a third person as a reason for the bank to refuse payment. From this one might infer the importance of the

independence principle and, consequently, the beneficiary's assured right of payment which the courts consider as "the whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade".<sup>152</sup>

At first sight, the situation in German law seems to depart from this narrow application of the fraud exception in common law. According to German law, the concept of abuse of right applies as an exception to the independence principle. The cases under discussion are ones where the underlying contract is invalid or where the shipped goods are of no use. This seems to constitute a much wider disregard of the independence principle than that allowed in Common law. But the exceptions have to be seen in context with the whole concept of abuse of right and in connection with the burden of proof. Considering that the concept of abuse of right is limited to cases where the beneficiary acts in bad faith, and where the failure must be clearly established, one comes to the conclusion that the German concept is almost as limited as the fraud exception in Common law.

In regard to the particular issue of whether the fraud exception applies for fraud of a third party, German law provides the provision of *Haftung für den Erfüllungsgehilfen*. Applying this would lead to a different solution from that found in the *United City Merchant* case. This can be considered as a remarkable difference between Common and German law. In common law, the fraudulent conduct of a third person does not affect the documentary credit as long as the third person is not an agent or otherwise bound by a beneficiary's instructions, whereas German law renders the beneficiary liable for the fraudulent conduct of persons who were helping to procure proper documents.

It is interesting to note in this regard that this concept of German law is similar to the thoughts the Court of Appeal considered as a basis for their argument. Stephenson emphasised that the beneficiaries had to go to others to issue the documents they

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<sup>152</sup>Lord Diplock in *United City Merchants v Royal Bank of Canada*, (1983) 1 AC 168 (183 F).

present, and that they therefore should bear the loss despite their innocence.<sup>153</sup> This was confirmed in his conclusion where he stated that the beneficiaries put Mr. Baker in the position in which he fraudulently made the bill, and therefore even if the beneficiaries were innocent rather they should bear the loss than the bank.<sup>154</sup> The idea behind this reasoning is the same as the idea behind the concept of *Haftung für den Erfüllungshelfen* in German law. A party who uses the service of a third party to fulfil its contractual obligation should be held liable if the third party's conduct is faulty. Considering this, the differences between Common law and German law approaches do not seem as great.

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<sup>153</sup>Stephenson in *United City Merchants v Royal Bank of Canada*, (1982) QB 208 (234 E).

<sup>154</sup>Stephenson in *United City Merchants v Royal Bank of Canada*, (1982) QB 208 (240 A).