Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand

FELICITY MONTEIRO*

I INTRODUCTION

Documentary credits are vital tools for financing international trade. They allow transactions of goods and services in an international arena that may not have otherwise taken place. The utility of letters of credit is reliant upon their inherent autonomy from the underlying transaction; a bank that has issued a letter of credit cannot deny payment when conforming documents are presented to it, even if the underlying transaction has not been performed. Thus the seller has the security of guaranteed payment and the buyer can protect its interests by requiring specific documents to be provided such as the transport documents, quality certificate and insurance documents, which to some extent ensure performance. The autonomy principle is consequently vitally important to the use of letters of credit.

The only established exception to the autonomy principle is the fraud exception.[1] When the seller fraudulently presents the documents for payment, the bank is entitled to refuse payment. Alternatively, the applicant may be entitled to an injunction to prevent such payment. The law on documentary credits is highly controversial as it attempts to balance two competing principles: upholding the autonomy of documentary credits, and preventing fraud. There is no internationally agreed construction of the fraud exception; instead domestic legal systems have construed the exception differently. It is unclear how the New Zealand courts will treat this contentious issue as it has not yet arisen at an authoritative level.[2]

Part II of this article will outline what documentary credits essentially are and why the autonomy principle is important, Part III will set out the fraud exception as laid down in the foundation case of *Sztejn v J Henry*

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1 Pullen, "Recent Developments in Letters of Credit" (2001) F&CL 1, 5. A possible exception of nullity has been considered in the courts and unconscionability has also been accepted as an exception in certain foreign jurisdictions, but fraud is the only well-established and universally recognised exception.

2 The High Court has considered some claims for injunctions against payment in *Fortex Group Ltd v New Zealand Meat Producers Board* (16 June 1995) unreported, High Court, Wellington, CP 118/95; *JW Hartnell & Co Ltd v New Zealand Meat Producers Board* (21 February 1995) unreported, High Court, Christchurch, CP 20/95; *New Forest Sawmilling Co Ltd v Timberlands West Coast Ltd* (22 July 1992) unreported, High Court, Christchurch, CP 244/92.

Schroder Banking Corp,[3] and the leading English case of *United City Merchants v Royal Bank of Canada.*[4] Part IV considers the conceptual basis for the fraud exception. Part V examines the contrasting approaches to the scope and standard of the fraud exception from around the common law world, and Part VI assesses the justifications for such approaches. Part VII considers domestic banking relationship between bank and customer and relates this to the law of documentary credits. Finally, Part VIII makes recommendations on how New Zealand courts ought to approach the issue when it arises.

This article will approach the fraud exception from a conceptual basis; it will then focus on whether the fraud exception should include only fraud in the documents or also fraud in the underlying transaction, and refer to the standard of fraud required to invoke the exception. The English courts have applied a very narrow construction of the exception, applying it only to cases of fraud in the documents.[5] The United States and Canadian courts have widened the exception to include fraud in the underlying transaction.[6] The Australian and Singaporean courts have expanded the exception further, to include unconscionable conduct.[7] All jurisdictions require that a certain level of fraud must be met for the exception to be invoked.[8] As yet, no case has arisen directly on this point in New Zealand.

The essential thesis of the article is that the fraud exception to the autonomy principle should be based on an implied term in the contract between the applicant and the issuing bank. According to this conceptualization, the letter of credit is a mandate for the bank to make payment. The bank has no mandate to pay, however, when there is clear evidence of fraud on the documents. This approach to letters of credit was introduced by Rix J in *Czarnikow Rionda Sugar Co v Standard Chartered Bank London Ltd.*[9] The approach is bolstered by the domestic banking law which supports a contractual approach and a duty of care owed by the bank to withhold payment when it has clear notice of fraud. It is hoped that New Zealand will adopt this approach.

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3 (1941) 31 NYS 2d 631.

4 [1983] 1 AC 168.

5 Ibid.

6 See the Uniform Commercial Code (UCC) ss5-109; *NMC Enterprises Inc v Columbia Broadcasting Systems* 14 UCC Rep Serv 1427; *Bank of Nova-Scotia v Angelica-Whitewear Ltd* (1987) 36 DLR (4th) 161.

7 *Inflatable Toy Co v State Bank of New South Wales* (1994) 34 NSWLR 243; *Bocotra Construction Pte Ltd v Attorney General (No 2)* [1995] 2 SLR 733; *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan Bin Zayed Al Nahyan* [2000] 1 SLR 657.

8 In the United States, the UCC requires 'material' fraud. The same formulation is used in England in *United City Merchants*, supra note 4. In Canada, Australia and Singapore fraud must be clear or a strong *prima facie* case, see *CDN Research and Development v Bank of Nova Scotia* (1980) 18 CPC 62 (Ont HC); *Inflatable Toy Co*, supra note 8, and *Dauphin Offshore Engineering*, supra note 7, respectively.

9 [1999] 2 Lloyd's Rep 187.

II THE AUTONOMY OF CREDITS

Documentary Credits

Financial transactions in international trade are inherently risky because the seller and the buyer are geographically separated. It is thus more difficult for the seller to gauge the buyer's ability and willingness to pay for goods and their trustworthiness.[10] There are also other risks, such as disputes as to the quality of the goods holding up payment, conversion of currency, and political risks.[11] In international trade transactions, the seller's principal concern is to receive the purchase price, and the buyer's principal concern is to receive the goods in conformity with the contract. Documentary credits provide a solution to the conundrum that the buyer will not wish to pay for the goods until they are en route and out of the seller's hands while the seller will not wish to part with them until he is assured of payment.

A documentary credit is a means of making a domestic or international payment by substituting a bank for the buyer as the party who guarantees and makes the payment.[12] A buyer (applicant) will request their bank (issuing bank), usually in their country, to open a letter of credit in the seller's (beneficiary's) favour. The issuing bank then guarantees to the seller payment, upon presentation of certain agreed upon documents, usually including the bill of lading, insurance documents and the commercial invoice. There is usually another bank (advising bank) involved, normally located in the seller's country, which advises the seller of the credit in their favour. The advising bank can only be involved if the credit nominates the bank or it is a freely negotiable credit.[13] The seller approaches the advising bank with the required documents, and if they conform to the letter of credit the advising bank makes payment to the seller. The advising bank then presents the documents to the issuing bank for reimbursement. If the issuing bank considers that the documents conform to the credit stipulations, they are bound to reimburse the advising bank. The issuing bank can then debit the buyer's account and pass on the documents to the buyer. A properly functioning letter of credit thus ensures that neither the buyer nor the seller has both goods and cash at the same time.[14]

The overwhelming majority of documentary credits incorporate and, thus, are regulated by the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits (UCP). Article 2 of the 2006 version, known as UCP 600, defines a credit as follows: "Credit

10 Dalhuisen, *Dalhuisen on International Commercial, Financial and Trade Law* (2 ed, 2004) 456-457.

11 See Dalhuisen, supra note 10, for a fuller discussion of these risks.

12 Jack, *Documentary Credits* (3 ed, 2001) 2.

13 Under article 6(a) of UCP 600 a credit must indicate whether or not it is freely negotiable and/or whom the nominated bank is.

14 Note, "Fraud in the Transaction: Enjoining Letters of Credit During the Iranian Revolution" [1980] *Harv .L. Rev.* 993, 1000.

means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation."

The payment effected by the bank is thus against the documents, not on the transfer of the goods.[15] The documents represent the goods while they are in transit and their transfer is a symbolic delivery of the goods, provided that a bill of lading is included. The use of credits is useful for the buyer who can stipulate all the documentary requirements in the credit, thus getting the security that the goods have been shipped (bill of lading) and that they conform to the contract (quality certificate). The seller gets a high degree of security as payment does not depend on the solvency of the buyer; payment is guaranteed by the bank as long as there are complying documents. The bank has an irrevocable obligation to pay on presentation of documents that comply on their face.[16]

The Autonomy Principle

As the bank's obligation to pay arises on the presentation of conforming documents, not on delivery of the goods, the financial transaction is essentially independent from the underlying sales transaction.[17] This characteristic of documentary credits is known as the autonomy principle. That the credit transaction is separate from the sales contract is expressly set out in Articles 4 and 5 of UCP 600. Article 4 provides:

> A credit, by its nature, is separate from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract .... Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit, is not subject to claims or defences by the applicant resulting from his relationships with the issuing bank or the beneficiary.

Article 5 further illustrates this point by adding "Banks deal with documents and not with goods, services or performance to which the documents may relate."

The consequence of this principle is that the performance of the underlying transaction is irrelevant to the payment of the credit,[18] thus payment may be made on the documents even if the goods never arrive and the buyer has to seek damages from the carrier.

The autonomy of letters of credit is what gives them their appeal; they guarantee payment of the purchase price irrespective of the performance of the underlying transaction to which they relate. If the seller was not

15 Jack, supra note 12, 2.

16 UCP 600, art 15.

17 Jack, supra note 12, 21; Dalhuisen, supra note 10, 463; Pryles, Waincymer and Davies, *International Trade Law Commentary and Materials* (2 ed, 2004) 307.

18 Jack, supra note 12, 21.

guaranteed payment their utility would be undermined. The efficacy of documentary credits has been described as "the life blood of international commerce".[19] It is exactly the independence from the performance of the underlying contract that gives documentary credits their international commercial utility and efficacy.[20] The courts have traditionally been very reluctant to deviate from the strict autonomy principle.[21] They are extremely unwilling to allow an applicant to prevent a bank from making payment to a beneficiary who presents seemingly conforming documents. There is, however, an exception to this principle, which can be invoked in cases of fraud.[22]

III FRAUD EXCEPTION

The Fraud Exception Explained

Despite the bank's unconditional obligation to pay the seller upon presentation of the required documents, the issuing bank is not bound to pay under the letter of credit when there has been fraud by the seller.[23] Fraud is a significant risk to the banks and buyers involved in credit transactions, and has been described as "a cancer in international trade".[24] Thus a bank may refuse payment if they have clear evidence of fraud.

While most common law jurisdictions recognise the fraud exception to the autonomy principle, UCP 600 contains no definition of it or direct reference to it.[25] In determining the scope of the fraud exception, articles 7, 8, 14 and 34 are relevant; these govern both the liability of the issuing or confirming bank and the duty of strict compliance owed by the bank in determining whether or not to accept the documents.

The ambit of the fraud exception is a very controversial area of commercial law. However, as previously stated, rather than attempting to address all of the controversies, this article will focus upon the conceptual basis of the fraud exception. This consideration will lead to conclusions on the ambit of the exception, as well as the standard of fraud required to invoke the exception.

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19 *Intraco Ltd v Notis Shipping Corporation of Liberia: The Bhoja Trader* [1981] 2 Lloyd's Rep 256, 257; *R.D. Harbottle (Merchantile) v National Westminster Bank Ltd* [1977] 2 All ER 862.

20 *Angelica-Whitewear*, supra note 6.

21 Zohrab, "Standby Letters of Credit: Autonomy" [1996] NZLJ 417; Goode, *Commercial Law* (3 ed, 2004) 972. It is to be noted, however, that the courts may be showing a willingness to disregard the autonomy principle: see *Mahonia Ltd v JP Chase Morgan Bank* [2003] 2 Lloyd's Rep 911 and *Sirius International Insurance Co v FAI General Insurance Ltd* [2004] 1 WLR 3251.

22 Jack, supra note 12, 258; Goode, supra note 21, 972.

23 Dalhuisen, supra note 10, 472.

24 *Standard Chartered Bank v Pakistan National Shipping* [1998] 1 Lloyds Rep 684, 686.

25 Dalhuisen, supra note 10, 473. Some writers have suggested that the UCP ought to be revised to include a fraud provision, such as Davidson, "Fraud; the Prime Exception to the Autonomy Principle in Letters of Credit" (2003) 8 Int'l Trade & Bus L. Ann. 23, 45.

Fraud in the Underlying Transaction

The United States case of *Sztejn v J Henry Schroder Banking Corp*[26] is generally accepted as the foundational authority on the fraud exception.[27] The plaintiff in this case had contracted to purchase a quantity of bristles from Transea Traders Ltd. The purchase price was to be paid by letter of credit upon presentation of an invoice and bill of lading covering shipment of the goods. The documents presented described the bristles called for by the letter of credit; however, the plaintiff alleged that Transea had filled the crates with worthless material with intent to simulate genuine merchandise and defraud him as purchaser. The plaintiff thus applied for an injunction to prevent the bank from making payment on the letter of credit on the basis of the seller's fraud.

The court came to the conclusion that where a seller is fraudulent, the independence of the bank's obligation under the letter of credit should not be extended to protect that unscrupulous seller. Thus the fraudulent beneficiary was not to benefit from his own fraud and the injunction was granted. The difficulty arising from *Sztejn* is that it is unclear whether it is a case of false documents or a case of fraud in the underlying transaction. Although it is generally recognised as introducing the "fraud on the documents" exception, Sheintag J looked to the performance of the underlying transaction in making his determination of documentary fraud.[28] This created the controversy between the two concepts of the fraud exception, which are often difficult to distinguish. Since this case, there has been much academic argument about the breadth of the fraud exception; some take a narrow view that fraud is restricted to the credit transaction and others take a broad view that fraud in the underlying transaction is also included.[29]

The leading case in England is *United City Merchants v Royal Bank of Canada*.[30] In this case Lord Diplock stated that the exception referred to documents that contain, expressly or by implication, material representations of fact that to the beneficiary's knowledge are untrue. This seems to suggest that the fraud exception is limited to fraud in the documents themselves; however, whether the exception also applies to wider fraud in the underlying transaction, is an important but somewhat open question.[31]

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26 Supra note 3.

27 There are, however, earlier cases that refer to fraud in letter of credit transactions, see, for example, *Pillans v Van Mierop* (1765) 3 Burr 1663, 1666; *Old Colony Trust Co v Lawyer's Title & Trust Co* (1924) 297 F 152; *Higgins v Steinhardter* (1919) 106 Misc. 168, and *Société Metallurgique d'Aubrives & Villerupt v British Bank for Foreign Trade* (1922) 11 Lloyd's Rep 168.

28 Fellinger, "Letters of Credit: The Autonomy Principle and the Fraud Exception" (1990) 1 JBFLP 4, 10.

29 Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 101-113.

30 Supra note 4.

31 Jack, supra note 12, 266.

IV CONCEPTUAL BASIS FOR THE FRAUD EXCEPTION

The way in which the courts conceptually base the fraud exception has made a major impact on how the courts have defined and limited it. In *United City Merchants*,[32] Lord Diplock set out the maxim *ex turpi causa non oritur actio,* or fraud unravels all as the basis of the fraud exception.[33] The case essentially addressed the issue of whether fraud by a third party of which the beneficiary was unaware could be included in the exception. In holding that the only fraud sufficient to invoke the exception was that of the beneficiary himself or that to which he was a party, thus excluding the fraud of a third party, Lord Diplock supported a narrow formulation of the exception. The rationale for the exception was held to be the prevention of the proliferation of fraud. Thus framed, the exception focuses on the conduct of the beneficiary. Viewed in this way, it is easy to see why the exception is limited to fraud to the knowledge of the beneficiary or person claiming payment only and not to third party fraud.

Despite Lord Diplock's intention to limit the exception, his conceptual basis for the exception, that fraud unravels all, leads to much less certain limitations than he may have expected. If fraud unravels all i.e. the bank's irrevocable obligation to pay on seemingly conforming documents, why should this only be limited to fraud that is evident in the documents and not fraud in the underlying transaction? There appears to be no justification for making this distinction; in fact it appears a very difficult distinction to maintain as fraud in the documents can only be proved by reference to some conduct in the transaction, a point picked up in the North American Jurisprudence.[34] This distinction seems to only be maintainable if one restricts the examination to falsity in the documents alone. Thus Lord Diplock's argument is somewhat internally inconsistent as he wishes to condemn fraud, but limit the condemnation to fraud in the documents alone, with no satisfactory rationale for this limitation. This basis also makes it unclear why there is a requirement that the bank be aware of the fraud, if condemnation of beneficiary fraud is to be the justification it should not be of any legal consequence whether or not the bank is aware of this fraud, only a practical limitation. These issues can be resolved by taking an alternative view of the conceptual basis of the fraud exception.

In *Czarnikow Rionda Sugar Co v Standard Bank London Ltd*,[35] Rix J conceptualised the fraud exception as based on an implied term in the contract between the bank and the applicant. Thus it is implied into documentary credit contracts that the bank will not pay out on documents in the face of clear fraud. To do so, according to this reasoning, would

32 Supra note 4.

33 Ibid 184.

34 See for example *Angelica Whitewear Ltd*, supra note 6.

35 Supra note 9.

be beyond the bank's mandate[36] and the bank would thus be liable to the applicant for damages for breach of that mandate. These damages may extend to loss of profit or damage to reputation as appropriate under *Hadley v Baxendale*.[37] This approach adequately explains the requirement of the bank's knowledge that the fraud had taken place.

By this formulation, the bank's knowledge is relevant as a practical requirement, but the person presenting the documents need not be aware of the fraud as it is the relationship between the bank and the applicant which is relevant, not the source of the fraud. Because the bank is mandated to pay against apparently conforming documents, Rix J's formulation would probably exclude consideration of fraud that did not taint the documents in some way. As will be outlined in Part VII, the mandate approach fits well with domestic banking law relating to a bank's duty of care towards its customer when making payment.

Critics of the implied term approach have pointed to the words of Article 34 of the UCP 600 as justification of their views. Article 34 of the UCP 600 sets out that the banks assume "no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document ... or for the good faith or acts or omissions, solvency, performance or standing of ... any other person".

The Working Group for the Revision of the UCP 400 agreed that Article 34 did not attempt to regulate the relationship between the banks and the applicant when a proved fraud has been committed.[38] The fraud exception thus comes in over the top of Article 34. A bank is generally not liable for the accuracy of the documents but when the documents are clearly fraudulent, the bank has no mandate to pay in the face of fraud. The fraud exception thus becomes part of the bank's consideration of the documents for strict compliance. This shows that the implied term approach is consistent with the UCP and its intended meaning. It also provides much more certainty for all parties involved, the bank knows that it has an irrevocable obligation to pay in all circumstances except where the documents do not comply or are clearly fraudulent, the applicant and beneficiary are also sure that payment is guaranteed except for this narrow exception and can protect their respective interests accordingly. The strict wording of Article 34 actually bolsters the narrow approach to the fraud exception based on an implied term as this approach causes the least interference with the rule in that article.

The *Czarnikow* formulation of the fraud exception has unfortunately been consistently rejected by the English courts since it was handed down. Most notably in *Montrod Ltd v Grundkotter Fleischvertriebs GmbH*[39] the

36 Ibid 207.

37 (1854) 9 Exch 341.

38 De Busto (ed), *Documentary Credits UCP 500 &400 Compared* (1993) 49. Assumedly, the same will be true of article 34 of the UCP-600.

39 [2002] 1 All ER (Comm) 257.

Court of Appeal clearly set out that "the fraud exception to the autonomy principle recognised in English law ... should remain based upon, the fraud or knowledge of fraud on the part of the beneficiary or other party seeking payment".[40] This rejects the implied term conceptualisation and brings the jurisprudence back to the position taken in *United City Merchants*. *Montrod* itself, however, has been expressly rejected in Singapore so far as it relates to the nullity exception,[41] and so may only be of limited importance.

The jurisdictional basis of the fraud exception is relevant when the applicant is applying for an injunction to prevent a bank from making payment as it determines what the cause of action will be. Under the *United City Merchants* approach, the cause of action will be deceit or breach of contract by the beneficiary, whereas under the *Czarnikow* approach, the cause of action will be breach of contract by the bank.[42] This basis will also be relevant in determining where the balance of convenience lies.[43] It is noted in *Czarnikow* that the balance of convenience will always be against the granting of an injunction as the bank's obligation is so important that it will always, in the absence of exceptional circumstances, outweigh the applicant's need for protection.[44] As between the beneficiary and the bank, the cause of action for the beneficiary in a summary judgment application may also be based on a breach of contract by the bank by not honouring its obligation to pay out on presentation of conforming documents. Thus the bank has an obligation to the beneficiary to pay on conforming documents that is a mirror image of its mandate from the applicant, in that it also has an inbuilt exception that they will not be obliged to pay if the presented documents are clearly fraudulent.

This article will now critically examine approaches to the fraud exception from several common law jurisdictions, analyse the justifications for each approach and make recommendations for the New Zealand jurisprudence which tie into the duty of care owed by a bank under domestic banking law. When approaching the fraud exception from the implied term basis it is relevant to consider both what material the bank may refer to in establishing fraud and the standard of fraud required.

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40 Ibid para [56]. In *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911, the court also reverted to the *ex turpi causa* foundation of the fraud exception.

41 See *Beam Technology Pte Ltd v Standard Chartered Bank* [2003] 1 SLR 597.

42 See discussion in *Czarnikow*, supra note 9.

43 See *American Cyanamid Co v Ethicon Ltd* [1975] 1 All ER 504; *Klissers Farmhouse Bakeries Ltd v Harvest Bakeries Ltd* [1985] 2 NZLR 129.

44 Supra note 9, 208.

V FOREIGN JURISPRUDENCE

The United Kingdom

The first time the English courts considered the nature and extent of the fraud exception was in the case of *Malas and Another v British Imex Industries Ltd.*[45] In this judgment, Jenkins LJ took the opportunity to highlight that the obligation of a bank to pay in credit transactions is irrevocable irrespective of any dispute between the buyer and seller and that the courts ought not to interfere with commercial practice.[46] Thus a dispute over the quality of the goods was not sufficient to invoke the exception.[47] The issue did not arise in the courts again until the late 1970s when the Court considered the cases of *R.D. Harbottle Ltd v National Westminster Bank Ltd*[48] and *Edward Owen Engineering Ltd v Barclays Bank International Ltd.*[49] These cases consider the standard of fraud required to invoke the exception, which is relevant when looking at the exception from the implied term approach as it relates to the amount of knowledge that the bank must have in making payment in order to be beyond its mandate.

In *Harbottle*, Kerr J reiterated the importance of the independence of credit transactions and set out that the courts would only interfere in exceptional cases of established fraud. He also drew attention to the use of bank's irrevocable obligations as assignments of risk; the applicant takes the risk of the unconditional wording of a credit and the court should not be concerned with the difficulties of these applicants to enforce their claims against a fraudulent beneficiary with whom they have elected to trade.[50] This case demonstrates the strength of the autonomy principle and the unwillingness of the courts to meddle in international commerce.

A different approach to the fraud exception emerged in *Edward Owen Engineering.*[51] The judgment was delivered by Lord Denning MR who formulated the fraud exception as follows: "The bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment."[52] This characterization makes it clear that fraudulent or forged documents are not the only bases for refusal to honour, but that the exception also encompasses fraudulent demands for payment, which would be based on some kind of fraud in the underlying transaction.[53] This

45 [1958] All ER 262.
46 Ibid 263.
47 Ibid.
48 Supra note 19.
49 [1978] 1 Lloyd's Rep 166.
50 Supra note 19, 870.
51 Supra note 49.
52 Ibid 171.
53 Hooley, "Fraud and Letters of Credit, Part 1" (2003) 18 JIBFL 91, 95-96.

approach appears to base the exception on a condemnation of fraud in such transactions rather than on the relationship between the bank and the applicant.

Lord Denning's formulation of the exception also encompasses a wider range of situations due to the language "in circumstances where there is no right to payment". This wide formulation undermines the autonomy principle as it involves stipulations in the agreement between the applicant and beneficiary into the credit transaction which ought to be completely insulated from any underlying agreements, it should thus not be followed.

All of the cases in the United Kingdom have demanded that a certain degree of fraud be met in order to invoke the exception; there must be a clear case of established fraud to prevent payment under a credit. The English case law relating to the conceptualisation of the exception including the leading case of *United City Merchants*[54] is discussed above.

United States

Since the landmark *Sztejn*[55] decision, the Uniform Commercial Code (UCC) has codified the fraud exception. The fraud exception can be found at section 5-109, and the language used offers to the courts a more flexible approach to the exception. The UCC has been adopted, sometimes in a modified form, in almost every state.[56] This part of the article will follow the development of the fraud exception in the United States.

For four decades legal analysts in America have tried to reconcile *Sztejn* and the UCC with the autonomy principle. The original codification of the fraud exception in 1955 was found in section 5-114 of the UCC. That section only provided that a court of appropriate jurisdiction could enjoin honour only if there was a forgery or fraud in a required document.[57] In 1957, an amendment provided that the courts could enjoin payment when a required document is forged or fraudulent "or there is fraud in the transaction."[58] This new phrase caused confusion as to whether "transaction" meant only the credit transaction per se or also included the underlying transaction as well. This issue split both the commentators and the courts.[59]

Proponents of the fraud in the credit transaction view limit the exception to cases where the beneficiary submits false documents to the issuer or has otherwise committed fraud on the issuer.[60] Under this interpretation *Sztejn* would have been a case of fraud in the credit transaction because

54 Supra note 4.

55 Supra note 3.

56 *Angelica-Whitewear*, supra note 6, 74.

57 See UCC 5-114; *Mid-America Tire Inc v PTZ Trading Ltd* 2000 Ohio App 47 UCC Rep Serv 2d 853, [119].

58 UCC 5-114(2); *Mid-America Tire*, supra note 57, [119].

59 Ibid 121.

60 It could be argued that, even if the fraud was actually in the underlying transaction, there is always an element of fraud on the issuer as false representations are made in order to induce the issuer to make payment.

the documents presented misrepresented the underlying transaction. In contrast those who would extend the UCC 5-114 exception to encompass the underlying transaction saw *Sztejn* as such a case as fraud existed in the underlying transaction because the buyer would receive rubbish [sic] instead of the goods transacted for.

One of the first cases to arise in the American courts after *Sztejn* and the subsequent codification in UCC section 5-114 was *NMC Enterprises Inc v Columbia Broadcasting System Inc.*[61] In that case NMC sought an injunction to prevent Columbia Broadcasting System from presenting drafts for payment under a letter of credit (and against the bank) on the basis that the merchandise delivered did not conform to the contract specifications. The New York Supreme Court held that they could grant injunctive relief to prevent the bank from honouring the drafts even though the documents conformed on their face, when the documents or the underlying transaction are tainted with intentional fraud. Thus, the court took the view that the fraud exception as set out in *Sztejn* was relatively wide and encompassed fraud in the underlying transaction.

A case considered not long after by the Supreme Court of Pennsylvania was *Intraworld Industries Inc v Girard Trust Bank.*[62] This case took a narrower view of the exception. The court considered in more detail the utility of letters of credit and how this flowed from the independence of such transactions from the underlying contracts to which they referred.[63] The court held that in the light of the importance of the independence rule the only circumstances that will justify an injunction against honour are when the wrongdoing of the beneficiary has so vitiated the entire transaction that the independence of the issuer's obligation would no longer be served.[64] Thus a beneficiary seeking payment under a letter of credit must have no bona fide claim to payment for an injunction to be granted. Although this sets the bar higher than *NMC Enterprises*, it does not completely exclude fraud in the underlying transaction as long as such fraud vitiates the entire transaction.

A narrower approach was set out in *Shaffer v Brooklyn Park Garden Apartments*,[65] in which the Supreme Court of Minnesota considered the issue of granting an injunction under UCC 5-114. The court held that despite the autonomy principle and the fact that the bank is not obligated to go behind the documents, a court can grant an injunction to prevent the autonomy of credits being used to protect the unscrupulous seller.[66] An injunction was granted in this case as the court considered that there is just as much public interest in discouraging fraud as there is in encouraging

61 (1974) 14 UCC Rep Serv 1427 (SC NY).
62 (1975) 336 A (2d) 316.
63 Ibid 323.
64 Ibid 324.
65 (1977) 250 NW 2d 172.
66 Ibid 180.

the use of letters of credit.[67] This case considered that fraud amounting to justification of an injunction was limited to fraud in the documents of which the issuer has received notice, and did not extend to mere controversies between the buyer and seller concerning the merchandise.[68]

A swing back to the broader approach took place in *Rockwell International Systems Inc v Citibank*.[69] The court noted that the UCP provided no guidance on the fraud in the transaction defence, but that this defence marked the limits of the autonomy principle. It held that "fraud in the transaction" embraced more than mere forgery of documents.[70] Oakes J set out that the logic of the fraud exception entailed looking beyond the documents, thus included fraud in the underlying transaction.

This line of jurisprudence has taken a two-level approach. An issuing bank has an obligation to pay on documents conforming to the letter of credit and is protected if they pay out in good faith on such documents regardless of whether there is an alleged fraud. The courts on the other hand have a wider discretion to impose an injunction against such payment. This approach is reflected in the writings of Fellinger[71] and attempts to maintain the utility of letters of credit by preventing a bank from looking behind conforming documents to establish fraud, while allowing the courts to prevent the proliferation of fraud in such transactions through the use of injunctions. Thus the bank's mandate and the court's power to injunct are not necessarily the same. My own criticism of this approach is that it ultimately destroys the utility of credits by encouraging applicants to go to court to injunct payment, either on the advice of their banks or due to some suspicion or disagreement in the underlying transaction. This obstructs the essential speed and efficacy of credit transactions.

Following this confusion in the State courts, the Uniform Commercial Code was redrafted. The section now encapsulating the fraud exception is section 5-109. The language of that section has been amended to read that a court may enjoin payment under a letter of credit if "a required document is forged or materially fraudulent, or the honour of the presentation would facilitate a material fraud".[72] The official comment sets out that the codification was intended to make clear that the fraud must be found either in the documents or must have been committed by the beneficiary on the issuer or applicant.[73] The use of the word 'material' requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction.[74] Thus the courts must examine the underlying transaction

67 Ibid 181.
68 Ibid 180.
69 (1983) NA 719 F 2d 583.
70 Ibid 588.
71 See Fellinger, supra note 28.
72 UCC s5-109(a).
73 Official Comment on the Uniform Commercial Code, 603.
74 Ibid.

when there is an allegation of material fraud, for only by examining the transaction can they determine whether a document is fraudulent to a material extent. This recodification supports the decision from *Intraworld*[75] that fraud in the transaction is included in the exception, but must be of a certain standard ('material') to satisfy the criteria.

The fraud issue has arisen in the courts since the new UCC s5-109 came into force. In 2002, the Supreme Court of Ohio considered *Mid-America Tire In v PTZ Trading Ltd.*[76] The court examined the history of the exception and noted the need to extend the meaning of "fraud in the transaction" beyond fraudulent documentation. The rationale for this is the need to deny rewarding fraudulent behaviour by beneficiaries.[77] Another justification being that ordinarily the customer/applicant must bear the risk of loss but should not be required to assume the risk of making payment to a beneficiary who has engaged in fraudulent conduct. It is not clear why the applicant should not bear the risk of a fraudulent beneficiary as they elected to trade with them, whereas the bank has less choice. Further, they chose to use a letter of credit to finance the trade rather than some other form of finance and so contractually allocated the risk as between them in knowing the irrevocable nature of credits.

The courts in the United States have thus allowed the fraud exception to include fraud in the underlying transaction. This is mainly reliant on the focus of the courts being on the prevention of fraud rather than on the efficacy of documentary credits and the needs of trade. Although a certain standard of fraud ("material fraud") is required to satisfy the court to grant an injunction, this approach encourages applicants to take their cases to court to prevent or delay payment on the basis of the underlying contract.

Canada

The Canadian Courts have encountered issues involving the fraud exception in both *Rosen v Pullen*[78] and *CDN Research and Development Ltd v Bank of Nova Scotia.*[79] These cases were both concerned with the standard of fraud that must be established to enable a plaintiff/applicant to obtain an injunction against payment of a credit. The former case sets out that a strong prima facie case of fraud is required and the latter that there must be clear fraud.

The document/transaction controversy was first examined in *Bank of Nova Scotia v Angelica-Whitewear Ltd.*[80] In that case the letters of credit required an inspection certificate to be presented along with the drafts for payment. Upon presentation of such documents, Whitewear informed the

75 Supra note 62.
76 Supra note 57.
77 Ibid, [129].
78 (1981) 126 DLR (3d) 62.
79 (1980) 18 CPC 62 (Ont HC).
80 Supra note 6.

bank that the signature on the inspection certificate had been forged. The Court of Appeal upheld the applicant's (Angelica) claim in fraud and the bank appealed to the Supreme Court of Canada.

The Supreme Court examined the fraud exception in some detail and firmly set out its opinion as to the confines of the exception. It held that the exception to the autonomy principle should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction that is of such a character as to make the demand for payment under the credit a fraudulent one.[81] The court also noted that the exception does not extend to the fraud of a third party of which the beneficiary is innocent. It appears that it is a difficult distinction to make, as a fraudulent draw is merely an attempt to draw in circumstances where there is no entitlement to do so and the intent is to defraud. Thus the difference between being fraudulent and merely not being entitled is intent. It is inappropriate that the courts get involved in considering the intent of the beneficiary in letter of credit cases. It is also undesirable that the intent of the beneficiary dictate whether or not a bank is entitled to make payment as it negates the utility of credits by subjecting them to court investigations. A fraud exception that does not rely on the intent of the beneficiary is much more certain and easily understood and applied by all concerned parties.

In confirming that the fraud exception was part of Canadian law, Le Dain J based it on the *ex turpi causa non oritur actio* maxim, thus closely following the *United City Merchants* approach. The reasoning for including fraud in the underlying transaction is the inherent difficulty in differentiating between cases of false documents and cases of fraudulent shipping covered by documents that accurately describe the goods called for. The judge expressed the opinion that the exception ought to be extended to any situation in which the beneficiary would obtain payment as a result of fraud.[82]

On the facts the bank was held not to have been entitled to accept the documents and pay out due to discrepancies in the documents. The argument based on fraud failed, however, because it was not sufficiently obvious to the bank that there was a forgery or a fraud, and so faced with seemingly regular documents the bank had no duty to satisfy itself that there had not been fraud.[83] This case demonstrates the different standards of the fraud exception for applications for interim injunctions and those to establish improper payment after notice of alleged fraud by the beneficiary. The former being the prima facie case standard and the latter the more stringent test that the fraud must be clear and obvious to the bank.[84]

81 Ibid 83.
82 Ibid 83.
83 Ibid 88.
84 Ibid 84.

Australia

The Australian courts have struggled with defining the fraud exception, particularly with defining limits to the exception. In 1985, Young J tackled the issue in *Hortico (Australia) Pty v Energy Equipment Co (Australia) Pty Ltd.*[85] In that case the learned judge considered the need for a hands-off approach in commercial transactions[86] and stated numerous times that only actual fraud that is clearly established would justify the grant of an injunction.[87] However, his Honour clarified:[88]

> [I]t does not seem to me that anything short of actual fraud would warrant this court in intervening, though it may be in some cases (not this one), the unconscionable conduct may be so gross as to lead to exercise of the discretionary power.

This statement vastly widens the limits of the fraud exception as it is traditionally understood. To include mere unconscionable conduct which does not itself amount to fraud is to severely threaten the autonomy principle on which the letter of credit system rests. It encourages parties to a contract that underlies a letter of credit to bring contractual or tortious causes of action based upon purely contractual matters to court as grounds for an injunction against payment of a credit. This is clearly inconsistent with Articles 3 and 4 of the UCP.

Subsequent courts have seized upon this approach; it is cited in both *Inflatable Toy Co v State Bank of New South Wales*[89] and *Olex Focas Pty v Skodaexport Co Ltd.*[90] In the former case, Young J requires that there be clearly established fraud but reiterates his sentiments from *Hortico* with obiter statements that the concept of fraud should not be narrowly constrained,[91] and that it is wise to keep open the possibility that unconscionable conduct may be an exception, even musing that non-performance could be encompassed by the exception.[92] This approach makes further inroads into the autonomy principle thereby threatening their usefulness in international trade. In the latter case, Batt J held that a breach of s51AA of the Australian Trade Practices Act 1974 was sufficient to justify an injunction against payment of a letter of credit. In his own words this makes "substantial inroads into the well-established common law autonomy of letters of credit".[93]

As a result of the above case law, the grounds for obtaining an

85 (1985) 1 NSWLR 545.
86 Ibid 553.
87 Ibid 545, 551.
88 Ibid 554.
89 Supra note 7.
90 (1996) 134 FLR 331.
91 Supra note 7, 251.
92 Ibid.
93 Supra note 90, 358.

injunction to prevent payment under a letter of credit include fraud in both the underlying transaction and in the documents, unconscionable conduct by the beneficiary and a breach of s51AA of the Trade Practices Act, which relates to "conduct that is unconscionable within the meaning of the unwritten law".[94] This is a very wide exception to the autonomy principle and the use of the nebulous concept of unconscionability makes the assurance of payment much less certain. In the very least payment under credits will be delayed by litigation asserting one of the above grounds.

The Australian experience is particularly relevant to New Zealand as we have adopted our own version of the Trade Practices Act 1974 in the form of the Fair Trading Act 1986. In *Olex Focas*,[95] Batt J considered the general law relating to the fraud exception as a separate cause of action from the claim for an injunction under the Trade Practices Act. He did, however, consider that the Trade Practices Act applied to letter of credit transactions, as they involve trade between Australia and a place outside Australia. The extremely broad application of s51AA of the Trade Practices Act, which prohibits unconscionable conduct in trade and commerce, does appear to subsume the fraud exception in its entirety. Subsequent writers have argued that the section was not intended to be used in this way.[96]

Singapore

In formulating the fraud exception, the Singaporean courts have also considered unconscionability as a ground for granting an injunction against payment of a commercial letter of credit. This is, however, a very recent development in the law. In *Brody, White & Co Inc v Chemet Handel Trading Pte Ltd*[97] the court held that clear fraud in the documents alone would be sufficient to constitute an exception to the autonomy principle and that fraud in respect of the underlying transaction would not affect the credit contract between the seller and issuing bank.[98] This case thus followed the strict approach expounded in *United City Merchants*.[99]

Only a few years later, the same court handed down the judgement of *Bocotra Construction Pte Ltd v Attorney-General*.[100] The court examined the considerations that ought to be made in applications for injunctions restraining payment of bank guarantees. It concluded that the sole consideration to be made is whether there is clear fraud or unconscionability.[101] This seems to assume that a claim of unconscionable behaviour on the part of the beneficiary would be grounds for the granting

94 See s 51AA (1) of the Trade Practices Act 1974 (Australia).

95 Supra note 90.

96 Browne, "The Fraud Exception to Standby Letters of Credit in Australia: Does it embrace Statutory Unconscionability?" (1999) 11 Bond LR 98, 103.

97 [1993] 1 SLR 65.

98 Ibid 71.

99 Supra note 4.

100 Supra note 7.

101 Ibid 746.

of an injunction to prevent payment. The judgment gives no authority for this development of the law, nor any justification. As a ground enabling a bank to enjoin payment under a letter of credit, unconscionability requires the bank to look past the documents and into the underlying transaction to determine whether there has been some unconscionable conduct on the part of the beneficiary. This defeats the autonomy principle by allowing contractual issues to interfere with the credit transaction.

In 2000, the court scrutinised the issue again in *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan Bin Khalifa Bin Zayed Al Nahyan.*[102] In that case, the court examined the *Bocotra* judgment and pointed out that unconscionability was clearly a ground for an injunction and was distinct from the fraud exception. It appeared that this ground of unconscionability required the court to look at the circumstances surrounding the underlying contract in making a determination. The court declined to define what would constitute unconscionability beyond a broad indication that it would involve a lack of bona fides and would be determined on a case by case basis. It appears that this case created a separate narrow fraud exception. The court notes that "fraud as a ground was quite distinct from that where you had to examine the circumstances surrounding the underlying contract."[103] The court did not discuss what constitutes the fraud exception in Singapore as separate to the unconscionability exception, but this quotation makes it clear that it does not involve examining the surrounding circumstances, but is thus restricted to fraud in the documents alone. It does state that there must be a strong prima facie case of fraud to satisfy the exception.

In the opinion of the author, the introduction of an unconscionability exception is a major threat to the efficacy of credits in international commerce. Not only does it create a new exception to the autonomy of credits which is short of fraud, it also fails to precisely define that exception. The court seems to suggest that contractual issues as between the buyer and seller are sufficient grounds for an injunction, which is fundamentally contrary to articles 4 and 5 of the UCP.[104]

VI ANALYSIS

Before any meaningful recommendations can be made for New Zealand, it is necessary to analyse the justifications for the different constructions of the fraud exception. This analysis will be confined to the wider exception of the North American jurisdictions that includes underlying fraud, and the narrow conception as favoured by the English courts.

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102 Supra note 7.

103 Ibid 667.

104 Ibid 669 in which failure of consideration is given as an example of unconscionability.

Having already adopted the implied term approach, as set out by Rix J in *Czarnikow*,[105] as the conceptual basis for the fraud exception, this article will be arguing in favour of the narrow fraud exception under which the bank may only consider the documents and not refer to the underlying transaction and must have clear evidence of fraud to refuse payment. The same approach is also used by Brindle and Cox in *Law of Banking Payments*,[106] although they express certain reservations.[107]

The Wide Approach

The wide approach is that fraud in the underlying transaction as well as fraud in the documents is sufficient grounds for declining payment or granting an injunction under a commercial letter of credit. This approach is favoured by several academics[108] as well as the North American Courts. The main justification for this conception seems to be the prevention of the proliferation of fraud, particularly fraud in the underlying transaction.[109] It is argued that the proliferation of fraud threatens the utility of letters of credit as much as, if not more than, court injunctions. On the other hand, it is not the place of banks to act as international policemen.

If we view the fraud exception as based on the *ex turpi causa* maxim as set out in *United City Merchants*,[110] it is hard to see why only fraud in the documents should be prevented and not wider fraud. This appears to be a strong point, but when we consider this point from the contractual approach expounded in *Czarnikow*, this argument becomes irrelevant as it is not for the courts to reassign the contractual allocations of risk between the parties. If the exception is based upon the bank's mandate, the exception will be limited to the documents, as they are within the bank's knowledge and expertise. The applicant is not deprived of alternative avenues of justice which do not undermine the credit contract; they can file suit against the fraudulent beneficiary for breach of contract, deceit or conspiracy to recover any damages incurred.

Another more academic argument in favour of the wide conception is that the narrow exception is illusory.[111] It is illusory because the credit

105 Supra note 9.

106 Brindle and Cox, *Law of Banking Payments* (3 ed, 2004).

107 They argue that according to Rix J's approach although the claim against the issuing bank may be in breach of contract, there is no basis for a claim for an injunction against a confirming bank with whom the applicant has no direct contractual relationship. This can be overcome if it is recognised that the confirming bank owes the applicant a duty of care, see *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554. Whether such a duty of care exists between the confirming bank and applicant is still an open issue.

108 See Ellinger, "Fraud in Documentary Credit Transactions" [1981] JBL 258; Fellinger, supra note 28 and Gao, supra note 29.

109 Gao, supra note 29, 112.

110 Supra note 4, 184.

111 Gao, supra note 29, 112; see also the Task Force Report on the Study of UCC Article 5 "An examination of UCC Article 5 (Letters of Credit)" (1990) 45 Bus Law 1521, 1524 and Bertrans, *Bank Guarantees in International Trade* (2 ed, 1996).

transaction is so closely related to the underlying transaction that allegations that the documents are false or forged cannot be assessed merely by examining the documents, but instead one must look to the beneficiary's performance of the actual contract. At first blush this argument is hard to set aside; again, however, this argument can be dealt with by approaching it from the contractual point of view. If we look upon the fraud exception as part of the doctrine of strict compliance,[112] then only fraud that is clear from the face of the documents will justify a refusal of payment on the part of the bank. Banks after all are not expected to be experts on fraud in trade transactions; indeed it is outside of their liability and concern to examine extrinsic evidence that would indicate fraudulent statements within correct documents.[113]

Proponents of this view have also justified it by pointing out that the innocent applicant may have no other remedy against the fraudulent beneficiary; thus this cause of action ought to be wider to allow injunctions in more cases. This argument is not compelling, as when a merchant decides to trade with another merchant and to arrange finance by way of a letter of credit, they are taking on the risk that the other merchant may be fraudulent. They choose to use a credit transaction because they know that payment will be guaranteed as long as the documents are strictly compliant with the credit. As these transactions are to be treated like cash, the applicant's correct cause of action in matters concerning the beneficiary is against the beneficiary alone and should not concern the credit transaction. The parties have thus contractually allocated risk as between themselves, and the courts should not seek to interfere with this, nor be concerned with the difficulties of proper remedies.[114] This argument fits well with the *Czarnikow* approach in that the only time that the bank has contractually agreed to take on the risk is when they pay in circumstances that are beyond its mandate i.e. in the face of clear fraud in the documents or on non-conforming documents.[115]

The wider approach is not compelling because it allows purely contractual issues to defeat the letter of credit and reassigns the contractual allocation of risk as between the parties.[116] This attacks the basic premise upon which letters of credit rely — their autonomy — and defeats the intentions of the parties. A defrauded applicant has other causes of action for redress, whereas a bank would be left without such redress if upon unknowingly paying out to a fraudulent beneficiary it could neither recover from the applicant nor that beneficiary, assuming that the fraudulent beneficiary had disappeared after receiving the money. If the beneficiary was still in the picture, the bank would have a claim for unjust enrichment,

112 See Article 14 of the UCP 600.

113 Browne, supra note 96.

114 *R.D. Hartbottle (Merchantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155-156.

115 *Czarnikow*, supra note 9.

116 See Bertrans, *Bank Guarantees in International Trade* (2 ed, 1996) 59-60 for a fuller discussion on the allocation of risk as between the contracting parties.

conspiracy or deceit.[117] However, enforcing these claims ought not to fall on the bank, who is supposed to take a purely mechanical role in these transactions, dealing only in documents to ensure they are compliant.[118]

The Narrow Approach

The narrow approach favoured by the English courts is also supported by several academics.[119] The overwhelming rationalization for the narrow approach lies in an explanation of the nature of credits. It has been repeated throughout this article that documentary credits rely on their independence from the underlying contracts for their very utility. To allow a party to block payment on the basis of a breach of the underlying contract undermines the parties' expectations and the contractual allocation of risk.[120] The position ought to be the same whether restraining the bank from making payment or the beneficiary from claiming payment as the effect on the credit contract is the same.[121] It is noted, however, that in *Sirius*[122] underlying contractual matters were permitted to interrupt the credit contract.

The narrow formulation is justified practically as the bank deals exclusively with the documents alone. Therefore the only kind of fraud that a bank is entitled to consider as sufficient to justify a refusal to make payment is that which is clear on the face of the documents. The bank is capable of identifying clear fraud in the documents as part of the duty to ensure strict compliance. This is what an applicant would have intended when giving power to the bank to pay on presentation of conforming documents.

Another justification for the strict approach is that the wider application of the exception is damaging to the reputation of banks.[123] An injunction, however, should not affect a bank's reputation as they are absolutely bound to follow a court order,[124] and thus can hardly be shunned for adhering to the injunction. A better way of looking at this argument is the damage to international trade: if parties cannot rely on the fact that documentary credits are a form of guaranteed payment, then they are not likely to use them; this would mean that parties who lack confidence in one another are unlikely to trade. It is the credit instrument that allows such parties to contract and so without the essential characteristic of autonomy, these parties are left without a guarantee of performance of the other party. International trade would thus suffer.

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117 See, for example, *Standard Chartered Bank v Pakistan National Shipping Corporation*, supra note 24; *Bankgesellschaft Berlin AG v Makris* (20 January 1999), Queen's Bench Division.

118 See UCP 600, art 14.

119 See Hare, "Not so Black and White: The Limits of the Autonomy Principle" [2004] CLJ 288; Davidson, "Fraud: The Prime Exception to the Autonomy Principle in Letters of Credit" (2003) 8 Int'l Trade & Bus. L. Ann 23.

120 Zharab, "Standby Letters of Credit: Autonomy" [1996] NZLJ 417, 419; see also Bertrams, *Bank Guarantees in International Trade* (2 ed, 1996) 59.

121 *Group Josi Re v Walbrook Insurance* [1996] 1 Lloyd's Rep 345, 356 and *Czarnikow*, supra note 9, 207.

122 Supra note 21.

123 Ellinger, supra note 108, 265.

124 Ibid 266.

As discussed earlier, documentary credits are governed by the UCP which is binding as between the parties if expressly incorporated by the credit.[125] The UCP applies in the overwhelming majority of cases and is thus the best indication of the contractual arrangements between the parties. Although the UCP does not formulate the fraud exception in its terms, it does give some guidance as to what the role of the issuing or confirming bank ought to be. Article 14 states that the compliance of the documents must be determined on the basis of the face of the documents alone.[126] Article 34 is the most relevant provision for assessing the liability of a bank and it states:

> Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s) ... nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by the document(s), or for the good faith or acts and/or omissions, solvency, performance or standing of the consignors, the carriers, the forwarders, the consignees, or the insurers of the goods, or any other person whomsoever.

This makes it very clear that banks play a purely mechanical role in credit transactions; they ensure the documents are strictly compliant and are in no way liable for the content of those documents. Banks are not experts in trade transactions; they are not qualified to evaluate evidence of fraud and they do not have the resources to ensure that the contents of the documents are accurate and the parties reliable.[127] To assume such a role would make credit transactions slow and cumbersome; it ought to be the responsibility of the applicant to verify the details of the transaction. The bank merely ensures that all stipulations are met and can then be relied upon to pay out on the credit.

The fraud rule becomes an exception to the traditional role of the banks set out in the UCP only if it allows the banks to look outside of the documents and to scrutinise the underlying transaction as expounded by the wider understanding. However, if looked at as a rule that is part of the compliance of documents, it is not an exception at all. It is obvious that if a document is clearly forged or fraudulent, the bank is not mandated to accept it, as the bank is required to ensure compliance and a forged document is surely not what is required by the credit. Thus only fraud that is clear to the bank from the face of the documents that it is bound to inspect will justify a refusal of payment as gleaned from Article 15.

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125 See UCP 600, art 1.

126 See UCP 600, art 14.

127 Fellinger, supra note 28, 22.

VII DOMESTIC BANKING LAW

In formulating a fraud exception for New Zealand, one ought to pay particular attention to the domestic banking law. If both the applicant and the issuing bank are situated in New Zealand the domestic law will govern all their banking transactions; this may include documentary credits. The domestic law presents us with a ready-made approach to the relationship between the bank and its customer, which can be directly applied to letter of credit transactions to determine the rights and obligations of the parties involved.

It is trite law that the relationship between a bank and a customer is contractual in nature.[128] Further, the contract is implied rather than explicit. This implied contract is subject to specific arrangements that are in writing which form 'authorities' or 'mandates'.[129] Cheques, for example, are a particular form of such mandates.[130]

An essential duty that a bank owes to its customers is a duty to obey these mandates exactly.[131] As long as the bank acts within its mandate it is entitled to debit the customer's account. Where it acts outside this mandate, it has no authority to debit the account.[132] The relationship between a paying bank and the customer is one of principal and agent.[133] A cheque, therefore, is an order from the principal to the agent to pay the amount of the cheque to the payee out of the principal's money held by the agent.[134]

The bank also has a duty to obey its mandate with reasonable care and skill.[135] This duty is an implied term of the contract between banker and customer.[136] This duty may conflict with the fundamental duty to follow valid and proper orders.[137] Thus in some circumstances the bank has a duty to make inquiries even if all the formal preconditions have been satisfied. In *Selangor United Rubber Estates v Cradock*[138] it was held that the duty to exercise reasonable skill and care in carrying out its obligations is an objective standard, and that the relevant considerations include:[139]

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128 *Tai Hing Cotton Mill Ltd v Lin Chong Hing Bank Ltd* [1986] AC 80; Tyree et al, *Tyree's Banking Law in New Zealand* (2ed, 2003) 57-58; Weerasooria & Wallace, *Banker-Customer: Resolving Banking Disputes* (1994) 89.

129 Weerasooria, supra note 128, 89.

130 Wadsley & Penn, *The Law Relating to Domestic Banking* (2ed, 2000) 212. Cheques are considered to be mandates in both civil and common law countries, see Geva, *Bank Collections and Payment Transactions* (2001) 89.

131 Weerasooria, supra note 128, 99; Thomas and Megrah. *Banker and Customer* (5ed, 1947) 166.

132 Thomas and Megrah, supra note 131, 213.

133 *Barclays Bank plc v Quincecare Ltd* [1992] 4 All ER 363.

134 *Westminster Bank Ltd v Hilton* (1926) 43 TLR 124, 126; Weerasooria, supra note 128, 103.

135 Waldsley, supra note 130, 213; Quincecare, supra note 133, 375-376.

136 Quincecare, supra note 133, 376.

137 Ibid.

138 [1968] 2 All ER 1073.

139 Ibid 1119. See also *Karak Rubber Co Ltd v Burden and others* [1972] 1 All ER 1210.

> [t]he prima facie assumption that men are honest, the practice of bankers, the very limited time in which banks have to decide what course to take ... without risking liability for delay, and the extent to which an operation is unusual or out of the ordinary course of business.

This leads us to the position that the bank should normally act in accordance with its customer's mandate, but not if reasonable skill and care indicate a different course.[140] The bank's duty to pay on demand, therefore, is not an absolute unqualified duty to pay without enquiry.[141] Thus a bank should question the mandate or make further inquiries when a reasonable banker would consider that there is serious possibility that the customer was being defrauded.[142] The banker must therefore have reasonable grounds for believing that an order is an attempt to misappropriate funds.[143]

Basing the ability of the customer to sue the bank on the excess of mandate that has occurred, rather than the fact that some third party has committed fraud by forging a cheque, ensures certainty in this area of the law. A bank will only be liable if it goes outside of its instructions; that is when it pays or refuses to pay in circumstances in which it is not authorised to do so. This certainty allows all parties to know where they stand in relation to payment and liability.

The law of domestic banking relating to the obligations of a bank on cheque payment can be extended to apply to the law on documentary credits. If we base the bank's obligation to pay on a mandate from the customer, as in domestic banking law, the rights and obligations of the parties are more certain. A bank is absolutely bound to pay the credit according to its customer's instructions as long as apparently conforming documents are presented and it has performed its duty of reasonable skill and care. If a document is clearly fraudulent, such that the reasonable banker would be put on inquiry, it is not within the bank's mandate to make payment as the customer would not have intended it. The only problem with this direct analogy is that the domestic law cases empower the bank to consider any material in confirming their suspicions of fraud, thus they may look to an underlying transaction. In letters of credit, however, the bank's mandate is to consider the documents only and not to refer to extraneous material. This is due to the special nature of credits, which does not apply to other banking transactions such as cheques. Thus although all the same principles apply, they are restricted in performing their duty of skill and care (i.e. determining whether there has been a fraud) to looking only at the documents presented to them. If they determine there has been a fraud it is not within their mandate to make payment.

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140 See Selangor, supra note 138; Karak, supra note 139; *Verjee v CIBC Bank Trust Company (Channel Islands) Ltd* [2001] BPIR 1149.

141 See Karak, supra note 139.

142 *Lipkin Gorman v Karpnale and Lloyds Bank* [1989] 1 WLR 1340.

143 *Quincecare*, supra note 133, 376.

Using the domestic banking law leads us to the same approach as set out in the *Czarnikow*[144] case and fits with the purpose of the UCP in minimising disturbance to the autonomy principle.

VIII THE FRAUD EXCEPTION FOR NEW ZEALAND

The suggestions for New Zealand are that the fraud exception should be drawn by reference to the contractual relationship between the applicant and the issuing bank and conform as closely as possible to the intent of the UCP.

It is proposed therefore, that the implied term approach adopted in *Czarnikow* should be applied in New Zealand. The fraud exception would thus be narrowly defined so as to allow the autonomy of letters of credit to be disturbed in the least possible of instances. The court, similarly, would be interfering in commerce to a minimal degree.

According to Articles 4 and 5 of the UCP, the credit transaction must be autonomous from the underlying sales transaction, so that the bank is dealing with documents alone and not goods. Under Article 34 the bank takes no responsibility for the accuracy or falsification of any document, and under Article 14 must ensure, on the basis of the documents alone, that the presentation comply with the requirements set out in the credit. When electing to open a letter of credit, an applicant is forming a contractual relationship with a bank based on the terms of the UCP.

This contractual relationship consists of the applicant giving the bank a mandate to pay out, on their behalf, the amount of the credit when the beneficiary presents conforming documents. The bank is not entitled to refuse to pay unless the documents do not conform, and they are not permitted to look to the underlying performance in deciding whether to pay. A term implied into this relationship would be that the bank is not mandated to pay on documents that are clearly fraudulent. Thus when a bank is considering the compliance of the presented documents and discovers that a document is clearly forged or has been fraudulently altered, they are not permitted to pay. To do so would be beyond their mandate and they would be liable for a breach of contract.

This reflects the contractual allocation of risk as between the applicant and the beneficiary. Having agreed to use a letter of credit to finance their trade relationship, the parties have chosen an irrevocable instrument and all the risks involved in such a payment method. The exception to this would be that the applicant would not expect a bank to pay out on clearly fraudulent documents. The bank would not expect to bear the risk of a fraudulent beneficiary as they had no choice to deal with them, unlike

144 Supra note 9.

the applicant who did choose to trade with that party. This approach thus allocates the risk of fraud between the parties in a way that is most just.

According to this formulation, an applicant can apply for an injunction (or a bank can electively refuse payment) when there is clear fraud in the documents. If the issuing bank has already paid out in the face of such fraud, the applicant can pursue a breach of contract claim against the bank for going beyond its mandate. When the bank pays in a situation in which it is entitled to pay, however, such as when there are accurate and conforming documents but the beneficiary has committed some kind of fraud in the underlying transaction, the applicant's rightful remedy is not against the bank but a claim in fraud against the beneficiary.[145] The mandate approach addresses the issues of both what the bank is required to consider (the documents only), and the level of knowledge required of the bank (the documents must be clearly fraudulent).

This formulation will best serve the needs of international commerce as it retains and respects the autonomy of credit transactions and clearly defines when a bank or applicant can refuse or prevent payment. It does not allow courts to take a discretionary approach as to when to grant an injunction and when not to do so.

IX CONCLUSION

The fraud exception to the autonomy principle has created vast confusion throughout the common law world both as to its conceptual basis and its limits. New Zealand is in the advantageous position of having no binding authorities on the fraud exception and so is free to conceptualize and limit the exception in the best way possible. This article has aimed to show that the best way to conceptualize the exception is in terms of the contractual relationship between the applicant and issuing bank, rather than on a general condemnation of fraud.[146]

This contractual basis not only accords with domestic banking law, but also preserves the autonomy of letters of credit. Giving the exception this conceptual basis restricts the application of the exception to clear fraud in the documents and prevents it from becoming too expansive or nebulous. The fraud exception, thus understood, is easy and quick for issuing or confirming banks to apply and therefore conserves the speed and efficacy that is essential to international credit transactions. This conceptualization makes the fraud exception part and parcel of the bank's duty to ensure the strict compliance of documents. Thus only clear evidence of fraud that does not require the bank to investigate outside of those documents is

145 This is supported by the bank's right of reimbursement of moneys paid by it from the applicant as demonstrated in *Gian Singh & Co Ltd v Bank de L'Indochine* [1974] 2 All ER 754.

146 The *ex turpi* approach in *United City Merchants*, supra note 4.

sufficient to invoke the exception. This is consistent with the UCP and the expectations of the parties.

Certainty is highly valued in international trade law and is sorely needed in the particular area of the fraud exception of documentary credits. It is undesirable for countries to have different approaches, as it may lead to traders being more selective as to which nationality of traders they will deal with, or making express choices as to the proper law governing their contracts based on their interest in being able to get or prevent an injunction against payment. Although the author prefers a particular approach, it is admitted that the uncertainty in this area of the law is a great concern, and an agreed approach that is universally applied is preferable to the current state of the common law.