

**THE EXCEPTIONS TO THE PRINCIPLE OF AUTONOMY OF  
DOCUMENTARY CREDITS**

By

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## **Abstract**

This thesis critically appraises the exceptions to the principle of autonomy in documentary credits. In appraising the exceptions, the central theme pursued is to address the question whether the application of the exceptions to the principle of autonomy is satisfactory. In addressing this general question, the study pays special attention to English law on documentary credits. However, the thesis also looks at the comparable position in other common law jurisdictions, such as United States, Canada, Australia, Singapore, and Malaysia.

Recently, in the different jurisdictions, opinion has not been consistent on what constitutes exceptions to the principle of autonomy in letters of credit. Apart from the traditional exception of fraud, recent English decisions to some extent have recognised illegality and express contractual restrictions on a beneficiary's right to draw on a credit as compelling grounds on which the autonomy doctrine would be ignored. In other jurisdictions, other exceptions such as nullity and unconscionability have emerged. This dissertation assesses all these exceptions to the principle of autonomy with the aim of answering the question whether these exceptions facilitate documentary credits' practice or as argued in some quarters, undermine the assurance of payment promised the seller/beneficiary.

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*McConnell v Common Wealth Pictures Corporation* 7 NY 2d 465, 166 NE 2d 494, 199 NYS 2d 483 (1960).

*Mid-America Tire Inc v PTZ Trading Ltd.* 95 Ohio St 3d 367, 768 N.E.2d 619 (2002).

*Old Colony Trust Co v Lawyers Title & Trust Co* 297 F152.

*Paris Savings & Loan Association v Walden* 730 SW 2d 355 (1987).

*Ross Bicycle Inc v Citibank NA* 178 AD 2d 388, 577 NYS 2d 826 (1991).

*Semetex Corporation v UBAF Arab American Bank* [1995] 2Bank LR 73.

*Sztejn v Henry Schroder banking Corporation* 31 NYS 2d 631 (1941).

*Tranarg CA v Banca Commerciale Italiana* 90 Misc 2d 829 (1977).

## **Table of Statutes**

Bretton Woods Agreement Order in Council 1946

Civil Procedure Rules 1998

Contracts (Right of Third Parties) Act 1999

Factors Act 1889

Financial Services Act 1986

Sale of Goods Act 1979

Insurance Companies Act 1982

Finance Act 1933

Sales of Reversion Act 1867

Unfair Contract Terms Act 1977

Unfair Terms in Consumer Contracts Regulations 1999

## **Table of Figure**

Figure 1: Illustration of the Five Parties to Documentary Credits

## Chapter One

### 1.0. General Introduction

The documentary credit<sup>1</sup>-characterized sometimes as ‘the life blood of commerce’<sup>2</sup>-retains its role as an instrument for financing international trade. Its development as a financing tool in international trade is a creation of modern commerce that involves parties trading long distances with at times neither previous commercial relationship nor being properly aware of parties’ financial position. In this kind of situation where parties sometimes are unaware of the other parties’ financial position, what the seller/beneficiary needs when dealing with a buyer/applicant with whom no previous commercial relationship exists is an assurance that before he makes shipping arrangements or parts with the goods that he will be paid after shipping the goods. These concerns of the seller/beneficiary<sup>3</sup> with respect to his right to payment upon shipment of the goods remain a primary concern which documentary credits<sup>4</sup> are designed to satisfy in international sales.

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<sup>1</sup> A payment instrument that ought to be differentiated from “open” or “travellers” letter of credit which is a letter furnished by a banker or by a merchant of reputation to a person travelling overseas, addressed to the issuers’ correspondents, who were promised with reimbursement for amounts advanced to the beneficiary. It has to be noted that the popularity of travellers’ letters of credit diminished after the development of travellers cheques in 1909 by American Express Co. and has gradually become obsolete. See Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2009); Michael Bridge (ed), *Benjamin’s Sale of Goods* (8<sup>th</sup> edn, Sweet and Maxwell 2010) para 23-001. For detailed discussion on the origin of Documentary credits, see FR Sanborn, *Origin of the Early English Maritime and Commercial Law* (New York Press 1930) 347.

<sup>2</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155 (Kerr LJ); *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 2 Lloyd’s Rep 394,400 (Griffiths LJ); *Intraco Ltd v Notis Shipping Corporation of Liberia*; *The Bhoja Trader* [1981] 2 Lloyd’s Rep 256, 257 (Donaldson LJ); *Hong Kong and Shanghai Banking Corporation v Kloecker & Co AG* [1989] 2 Lloyd’s Rep 323, 330 (Hirst J).

<sup>3</sup> Note also that there is equally a concern for the buyer/applicant who for the purposes of hedging his own position does not want to pay the price for the goods until the goods are no longer at the disposal of the seller.

<sup>4</sup> It has to be noted that documentary credits are also used to cover payment obligations which do not arise from the shipment or supply of goods and hence does not require the presentation of shipping documents.

The documentary credit contract, despite being a creature of the seller's and the buyer's interest in the underlying transaction<sup>5</sup> that gave rise to it, once issued has the fundamental characteristics of being independent of the underlying contract/transaction that brought it into being. This situation where the documentary credit contract is detached from the underlying contract is aptly captured by the autonomy doctrine. To emphasize this autonomy, a documentary credit is stated to be documentary in character. In this circumstance, the paying bank is prepared to pay the seller/beneficiary because it holds the documents as collateral security and would be prepared to make payment once the documents are conforming regardless of issues in the underlying transaction. Put differently, it is irrelevant to the bank whether the underlying contract involves the purchase of corn, machinery or oil.<sup>6</sup> The only exception traditionally recognized where the bank should refuse to pay under the credit occurs if it is proved to the appropriate standard that the documents, though apparently conforming on their face, are in fact fraudulent and the seller/beneficiary or his agent was involved in such fraud.<sup>7</sup>

The emergence of fraud as an exception to the principle of autonomy has had its own legal implications. One of such implications is that the scope of the fraud rule varies from one common law jurisdiction to the other. Jurisdictions like Australia and Canada, in terms of enforcement of the principle, have developed a more robust and

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<sup>5</sup> The point here is that the documentary credit contract is established because there is an underlying contract on the basis of which the documentary credit contract was established. This underlying contract sometimes relates to goods which are being exchanged between the buyer and the seller in an international business transaction. However, despite the credit contract taking its life from the underlying transaction, it is assumed to operate independently of the underlying contract that gives its life.

<sup>6</sup> But the irrelevance of the underlying contract as to the right of a beneficiary to payment under the credit contract does not mean that where the exceptions operate, a beneficiary's right to payment under the credit is unaffected.

<sup>7</sup> This is known as the fraud exception to the principle of autonomy.

wider ground of interference. Jurisdictions like Singapore, while insisting on the restrictive approach of English law to the fraud rule, have developed some further exceptions like nullity and unconscionability. The primary implication of the fraud rule is that the perceived impregnability of documentary credits is no longer absolute with some circumstances justifying interference with the autonomy doctrine. These circumstances which could displace an otherwise absolute principle by way of being exceptions to this autonomy principle are central to the analysis undertaken in this thesis.

### **1. 1. Overview of the Research**

As its main goal, the thesis examines critically the exceptions to the principle of autonomy in documentary credit transactions. The analysis, as reflected in the title of the thesis, centres fundamentally on documentary credits. However, bearing in mind that documentary credits and demand guarantees are both abstract payment instruments<sup>8</sup> that share similar characteristics,<sup>9</sup> the thesis, for the purposes of sustaining its arguments, at times analyses case law and secondary data<sup>10</sup> dealing with both documentary credits and demand guarantees. The approach adopted in this thesis of treating documentary credits and demand guarantees as payment instruments sharing similar characteristics has the support of not only English jurisdiction but other common law jurisdictions like Canada, Singapore and Malaysia that have

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<sup>8</sup> The position that documentary credits and demand guarantees are abstract payment instruments is properly reflected in case law. Its abstract nature arises because the credit contracted is said to be autonomous to the underlying contract or transaction upon which it is based. See *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 QB 127; *Howe Richardson Scale Co. Ltd v Polimex-Cekop* [1978] 1 Lloyd's Rep 161; *R D Harbottle (Mercantile) Ltd. v National Westminster Bank Ltd* [1978] QB 146.

<sup>9</sup> See *Howe Richardson Scale Co. Ltd v Polimex-Cekop* [1978] 1 Lloyd's Rep 161 and *Bolivinter Oil S A v Chase Manhattan Bank N.A.* [1984] 1 WLR 392, 393.

<sup>10</sup> In this case, I refer to opinion expressed in books, articles and other published materials that are different from case law and statutes.

regularly maintained that the relevant legal principles applicable are the same in both types of case and judicial authorities have sustained this assumption by using authorities interchangeably.<sup>11</sup>

To facilitate the discussion necessary to deal with the topic, the thesis analyses:

- (a) Documentary credits, the autonomy doctrine and the rationale behind it,
- (b) The established fraud exception to the principle of autonomy in documentary credit;
- (c) The rationale and scope of the exception;
- (d) The reason why it established itself as a defence capable of breaching the autonomy doctrine;
- (e) The other exceptions to the principle of autonomy in documentary credits;
- (f) Arguments in support of and against their recognition and whether their recognition in any way affects documentary credit practice.

In addressing the above issues, the thesis aims to answer some crucial research questions viz:

- (a) How satisfactory is the present approach of English law with respect to the scope of the fraud exception and to what extent does it defeat or facilitate the letter of credit instrument?

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<sup>11</sup>*Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; *Howe Richardson Scale Co Ltd v Polimex- Cekop* [1978] 1Lloyd's Rep161.

- (b) To what extent is illegality a defence to the principle of autonomy in documentary credits and to what extent is the scope of the exception properly defined?
- (c) Apart from fraud and illegality, are there convincing reason(s) for the judicial recognition of some other exceptions to the principle of autonomy in documentary credits? In addressing this question, the thesis investigates such other exceptions as nullity, beneficiary's recklessness, unconscionability, and finally discusses contractual restrictions on a beneficiary's right to draw on a credit.
- (d) Taking into consideration that documentary credit law represents an area of law that is constantly changing and embracing wisdom that did not previously exist, the thesis, as part of its conclusion, suggests approaches to the exceptions that the author deems preferable. Put differently, the thesis explores whether a change of attitude from the current predominant approach that emphasizes the supremacy of the autonomy doctrine even in the face of strong countervailing consideration(s) ought to be revisited. The recommendation offered is based on the information gathered from the detailed and critical analysis of issues under consideration.

## **1. 2. Methodology of the Research**

The thesis adopts an approach that is analytical and not simply descriptive of the issues discussed. It critically examines the research topic and the issues raised there in,

by principally analysing case laws, statutes and other legal instruments related to the issues under consideration. It also makes an extensive use of other secondary literature related to the topic.

The thesis, for the purposes of ensuring that the issues analysed are clear, adopts a method that analyses the exceptions in the order that simplifies the understanding of the exceptions. In this regard, fraud as a primary exception to the principle of independence is analysed first. After examining fraud, exceptions, which though not based on fraud but are perceived to be an extension of the fraud exception, are examined. Here the thesis investigates the extent to which it is appropriate to say that issues that are detached from the fraud of the beneficiary or his agent could in fact provide a good defence that could displace the autonomy principle. Specific issues, emerging as separate exceptions, which seem to have evolved or are still evolving in the course of judicial pronouncement on the fraud exception are nullity, unconscionability or bad faith and beneficiary's recklessness. Other exceptions whose operations are predicated on some other legal considerations that are different from fraud are considered. The exceptions considered here include illegality and express contractual restrictions on beneficiary's right to draw on the credit.

Finally, the thesis addresses the research questions by comparatively analysing the legal positions (but not in all circumstances) in other common law jurisdictions namely Canada, United States, Australia, Singapore and Malaysia. The objective is to analyse the legal practices in other common law jurisdictions with respect to the exceptions and use it as a yardstick for judging the merits or satisfactoriness of the

arguments that have been advanced mostly in English law against the widening of the exceptions.

### **1. 3. The Thesis Outline**

The thesis chapter structure reflects a sequential presentation of arguments that address the key research questions. It is divided into nine chapters. Overall, the thesis begins with a general introduction and ends with a general conclusion.

Chapter One is the introductory chapter. The chapter highlights the general overview of the thesis, the research methodology adopted and overall structure of the thesis.

Chapter Two deals with the nature of documentary credits and analyses the relevance of the principle of autonomy. The chapter looks at the general components of documentary credits. It introduces the various contracts involved in a documentary credits transaction and also outlines the basic features of each layer of contract. It highlights the cardinal principle evident in documentary credits known as the autonomy principle and the role it plays in documentary credits. This chapter also examines the nature and relevance of this doctrine. It explains how the strict adherence to the doctrine of autonomy has shaped the practice and perception of documentary credits in the different legal jurisdictions. It also analyses the extent to which the strict interpretation of the autonomy doctrine is well founded. Finally, the chapter closes with a discussion of the functions of documentary credit and the different ways in which it can be utilized.

Chapter Three analyses the issues relating to the fraud exception to the principle of autonomy in documentary credits. It is divided into two parts. Part One analyses the general issues relating to fraud. In this respect, it notes that the autonomy principle is central to documentary credit. However, the autonomy principle admits of an important exception if the beneficiary of the undertaking fraudulently seeks payment when he has no right to payment. Courts of different legal jurisdictions have in a long line of cases acknowledged fraud as an exception to the principle of autonomy in documentary credits. But the parameters or scope of the fraud exception to the autonomy principle remain largely imprecise. The reason for this lies in the way that the different national courts have defined the scope of fraud that is capable of constituting an exception to the principle of autonomy in documentary credits. Also the standard of proof required to establish such fraud has been a subject of different treatment from the various jurisdictions. The chapter takes a comparative approach to the issue of fraud with the objective of establishing if the English approach to the fraud rule is in the main satisfactory. It ends with a question as to whether there is room for some other exceptions to the principle of autonomy. The second part of the analysis relating to the fraud rule concentrates on fraud in deferred payment and the effect of the current UCP 600 in relation to such fraud. It seeks to address the question whether the problems created by the *Banco Santander Case* has been resolved by this latest edition of the UCP 600.

Chapter Four assesses the nullity exception in documentary credits which is an extension of the fraud rule. Nullity as an exception that is distinct from fraud has been recognised by the Singapore courts. But in England it has been held that the nullity exception is not part of the English law. The chapter considers the Singapore

approach to the exception and the extent to which its recognition is founded on sound legal principle bearing in mind the autonomy rule. It also considers the scope and rationale for the exception. Finally the chapter concludes with an examination of the arguments for or against the nullity exception with the objective of assessing whether it should be recognised in other jurisdictions.

Chapter Five considers whether recklessness of the beneficiary in tendering a document forged by a third party is an exception to the autonomy principle and capable of excusing payment where his dishonesty could not be established. Beneficiary's recklessness traces its origin from the dictum of the court in the Singapore case of *Lambias* and has been favourably commented on by the English Court of Appeal in *Montrod's case*. The chapter considers to what extent the enthusiasm generated by the dicta of the courts in the case of *Lambias* and *Montrod* regarding beneficiary's recklessness as a possible exception to the autonomy principle should be welcomed or whether its recognition runs contrary to accepted documentary credit practice. In addressing the question relating to beneficiary's recklessness, consideration is given to the question whether the beneficiary owes a duty to act carefully so as to safeguard the issuing bank and/or the applicant against being defrauded by a third party who may be involved in the preparation of the documents stipulated in the credit.

Chapter Six deals with the unconscionability exception and the focus of this chapter is a consideration of whether unconscionability can constitute a separate ground upon which the independent undertaking in documentary credits can be breached. It then explores the question whether unconscionability should be recognised in English law.

Chapter Seven examines the illegality exception to the principle of autonomy in documentary credits. Under English law, the illegality exception is gradually gaining ground as an exception to the autonomy rule in letters of credit. This is evident from prevailing judicial pronouncements. The chapter looks at the nature of the illegality exception. It analyzes the authorities that are a pointer in the direction of its recognition as well as decisions that have acknowledged it. It aims to define and analyse the scope of the exception and the standard for establishing it. It also weighs the exception by analysing the arguments for or against it. The chapter concludes by addressing in a comparative manner illegality issues in letter of credit from other jurisdictions with the view to understanding the law and practice in place in other jurisdictions.

Chapter Eight deals with contractual restrictions on the beneficiary's right to draw on the credit. It discusses the exception to ascertain to what extent it is accurate to argue that the principle of autonomy is undermined in a case where the beneficiary had expressly agreed with the applicant for the credit not to draw down the credit unless certain conditions are fulfilled and a draw down is sought to be prevented on the grounds of non-fulfilment.

Chapter Nine summarizes the issues and conclusions arrived at. It aims to take a position based on the issues raised and discussed in the preceding chapters. It endeavours to point out issues that probe the current thinking (accepted practice of documentary credits law exceptions) with a view to assessing the satisfactoriness of the current position of the law.

## Chapter Two

### 2.0. Nature of Documentary Credit and Principle of Autonomy

#### 2. 1. Introduction

Amidst the various ways in which the price of exported goods may be paid, documentary credit<sup>12</sup> plays a vital role in international sales. Its origin is traceable to the activities of merchants concerned with the ways of resolving the conflicting interests between the parties to a contract of sale. On the one hand, the seller does not want to give up the control of the goods before he has received the purchase price. On the other hand, the buyer of goods, for the purposes of hedging his own position, does not want to pay the price for the goods until the goods are no longer at the disposal of the seller. It is to resolve this conflict between the buyer and the seller arising from their interest in the goods that the documentary credit was developed.<sup>13</sup>

The primary concern of this chapter is to spell out the fundamental issues relating to documentary credits, whose understandings are necessary for a proper appreciation of the issues subsequently discussed in later chapters. The chapter is divided into sections and generally deals with the meaning of documentary credit, the mechanism

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<sup>12</sup> Documentary credit has already occasioned one of the greatest outpourings of legal writings. Notable textbook in the area include: Richard King, *Gutteridge and Megrah's Law of Bankers Commercial Credits* (Europa Publication 2001); Peter Ellinger, *Benjamin's Sale of Goods* (10<sup>th</sup> edn, Sweet & Maxwell 2002); Michael Brindle & Ray Cox *Law of Bank Payment* (Sweet & Maxwell 2004) Ch 8; Mark Hapgood, *Paget's Law of Banking* (Lexis Nexis 2007) ch. 34; Ewan McKendrick, *Goode on Commercial Law* (Penguin 2009) Ch. 35; Ali Malek and David Quest *Documentary Credits* (4<sup>th</sup> edn, Tottel Publishing 2009); Raymond Jacks, *Documentary Credit* (Trottel 2009); Peter Ellinger & Dora Neo, *The Law and Practice of Documentary Credit* (Hart Publishing 2010).

<sup>13</sup> Michael Bridge (ed), *Benjamin's Sale of Goods* (8<sup>th</sup> edn, Sweet and Maxwell 2010) para 23- 001.

of operations and the parties to it. It discusses the principle of autonomy which together with the doctrine of strict compliance form the cardinal rules that underpin the law and practice of documentary credits. Some aspect of the sections, deal with the different legal instruments that regulate and govern documentary credit practice.

## 2. 2. The Concept of Documentary Credits

The documentary credit was once described by Professor Kozolchyk<sup>14</sup> as a type of mercantile currency embodying an abstract promise of payment, which possesses a high, though not total, immunity from attack on the ground of breach of duty of the seller to the buyer. This apt definition of documentary credits raises a further question inherent in the definition itself as to the circumstance(s) contemplated in the definition under which the high immunity evident in the abstract promise to pay will not be total.<sup>15</sup> Another eminent academic,<sup>16</sup> referred to a documentary credit as ‘a money promise which is independent of the transaction that gives it birth and which is considered binding when received by the beneficiary without acceptance, consideration, reliance, or execution in solemn form.’<sup>17</sup>

In similar vein, the Uniform Customs and Practice for Documentary Credits (UCP 600) defines documentary credit as an arrangement, however named or described, that

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<sup>14</sup> See Kozolchyk, ‘Letters of credit’, (1973) in IX *International Encyclopaedia of Comparative Law* (ed K zweigert and Ulrich Drobniig, 1973) Chapter 5 at pp138-143; Roy Goode ‘Abstract Payment Undertakings’ in Peter Cane and Jane Stapleton (ed), *Essays for Patrick Atiyah* (OUP 1991) 1079, 1098. See also the definition offered by Professor Ellinger, where he argued that documentary credits should be treated as a sui generis instrument embodying a promise which by mercantile usage is enforceable without consideration. E P Ellinger, *Documentary Credit* (1970) ch.IV cited in Ewan McKendric *Goode on Commercial Law* ( Penguin 2009) 1078.

<sup>15</sup> It has to be noted that these circumstances albeit restricted to those situation where they displace the autonomy principle remain the major interest pursued in this thesis.

<sup>16</sup> See Roy Goode ‘Abstract Payment Undertakings’ in Peter Cane and Jane Stapleton (eds), *Essays for Patrick Atiyah* (OUP 1991).

<sup>17</sup> *ibid* at 209.

is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.<sup>18</sup> In this regard, a complying presentation is also defined in the UCP 600 as ‘a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of this rule and international standard banking practice.’<sup>19</sup>

From the foregoing definition of documentary credits, some issues are worth pointing out. The first is that the contracts of documentary credits though having a binding force<sup>20</sup> does not follow the normal rules of contract. It still remains binding in the absence of the normal contract law rules of consideration and acceptance.<sup>21</sup> The explanation logically given for its binding force in the absence of such ingredients like consideration (being ingredients required to make a contractual obligation binding) is that its application is based on mercantile usage.<sup>22</sup> Secondly and more importantly, is that the undertaking is independent. The nature of the independence of the undertaking is captured by the Professor Kozolchik<sup>23</sup> who described its independence in terms that reflect documentary credits as possessing a high, though not total immunity from attack on the ground of breach of duty of the seller to the buyer. As will be reflected later in the subsequent chapters, the thesis analyses the circumstances

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<sup>18</sup> Article 2, UCP 600, note also that only irrevocable credit is described as credit and is different from the UCP 500 that describes both revocable and irrevocable credit.

<sup>19</sup> *ibid.*

<sup>20</sup> Article 7 (b) where the UCP 600 stated that an issuing bank is irrevocably bound to honour as of the time it issues the credit.

<sup>21</sup> Consideration and acceptance are essential ingredients that make a contract binding in ordinary rules of contract.

<sup>22</sup> EP Ellinger, *Documentary Letters of Credit- A Comparative Study* (University of Singapore Press 1970); Roy Goode, ‘Abstract Payment Undertakings’ in Peter Cane and Jane Stapleton (eds), *Essays for Patrick Atiyah* (OUP 1991) 225.

<sup>23</sup> See Kozolchik ‘Letters of Credit’ (1973) in K Zweigert and K Drobniig (eds), *IX International Encyclopaedia of Comparative Law* (Mohr Siebeck and Martinus Nijhoff Publishers 1973) 138-143.

under which the high immunity<sup>24</sup> on the ground of breach of duty of the seller to the buyer could be displaced.

### **2. 3. Parties to Documentary Credit**

In line with the current definition of documentary credits,<sup>25</sup> five contractual relationships<sup>26</sup> arise in a transaction in which an irrevocable documentary credit is issued.<sup>27</sup> These basic contractual relationships exclude the addition of parties through negotiation of drafts or the transfer of credit.<sup>28</sup> The five contractual relationships which arise in a typical transaction involving an irrevocable credit are: (1) a contract of sale between the buyer (the applicant for the credit) and the seller (the beneficiary), (2) a contract between the buyer and the issuing bank containing the terms on which the letter of credit is opened, (3) a contract between the issuing bank and the bank which confirms or advises the credit (the confirming or advising bank) embodying the advising or confirming bank's mandate to advise and/or confirm the credit, collection of documents and payment on acceptance or negotiation, (4) a contract between the issuing bank and the seller containing the issuing bank's undertaking to the seller to pay him or accept or negotiate his draft(s) provided that the seller has presented the stipulated documents in accordance with the terms of the credit and (5) a contract between the confirming bank and the seller containing the confirming bank's additional undertaking to the seller to pay him or accept or negotiate his draft(s)

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<sup>24</sup> High immunity in this case referring to the impregnability of documentary credits as reflected in the doctrine of autonomy of the credit.

<sup>25</sup> See the definition of the UCP 600 in article 2.

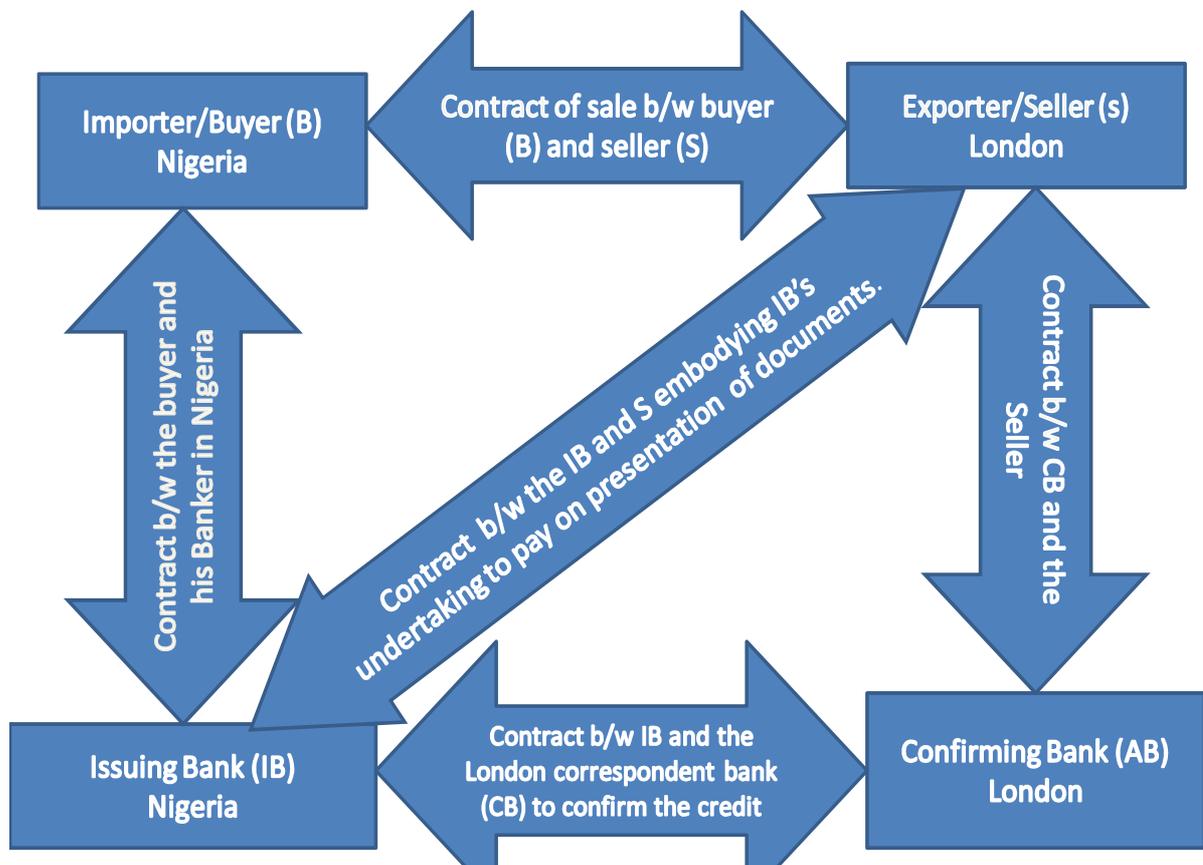
<sup>26</sup> For more detailed analysis of the parties to a documentary credit, see Ewan McKendrick (ed), *Goode on Commercial Law* (4<sup>th</sup> edn, Penguin 2009) 1087.

<sup>27</sup> Note that in *United City Merchant (Investment) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 182, Lord Diplock identified only four autonomous but interconnected contract in a documentary credit sales. Lord Diplock here excluded the contract between the issuing bank and the seller/beneficiary embodying the issuing bank's undertaking to pay upon presentation of complying documents.

<sup>28</sup> Roy Goode, *Commercial Law* (Penguin 2004) 978.

provided that the seller has presented the stipulated documents in accordance with the terms of the credit.<sup>29</sup>

Figure 2: The Diagram below illustrates the five parties to documentary credits. (Own Illustration)



The above diagram represents (barring the addition of other parties in the contract through negotiation of draft or transfer of credit) the five main parties to a

<sup>29</sup> See *Standard Chartered Bank v Pakistan National shipping corporation* (No 2) [1998] 1 Lloyd's Rep 218 and [2001] 1QB 167; *Bank of Credit & Commerce Hong Kong Ltd (in Liquidation) v Sonali Bank* [1995] 1Lloyd's Rep 227.

documentary credit in a hypothetical case of a Nigerian importer/buyer and an English Exporter/seller in London. Note the double-arrowed lines showing the two-way relationship between the parties to documentary credits –leading to the five contractual relationships that arise in a typical transaction in which an irrevocable documentary credit is issued.

### **2. 3.1. The Underlying Contract of Sale**

Basically, the contract between the buyer and seller is the root contract from which all contracts stem. The seller's right to demand a letter of credit, and the nature of the credit to which he is entitled, depends on the terms of the contract of sale. On the other hand, the buyer must ensure that the letter of credit issued to the seller is that prescribed by the contract. Fulfilment of this obligation is a condition precedent to the seller's duty to perform his delivery obligations.<sup>30</sup> For example if the letter of credit stipulates a bill of lading as one of the shipping documents when the contract permits seller to tender a delivery order, the letter of credit will be defective and can be rejected by the seller.<sup>31</sup> If a nonconforming letter of credit is tendered and rejected, the buyer may cure the defect by procuring the issue of a new and conforming letter of credit if still within the time limit.<sup>32</sup> However, if he fails to do so or is out of time, he commits a repudiatory breach, which entitles the seller to treat the contract as discharged<sup>33</sup> and to recover damages from him. It may also be noted that if the seller

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<sup>30</sup> *Garcia v Page & Co Ltd* (1936) 55 LI L Rep 391; *Etablissements Chinbaux SARL v Harbourmaster Ltd* [1955] 1 Lloyd's Rep 303.

<sup>31</sup> See Roy Goode *Commercial Law* (3<sup>rd</sup> edn, Penguin 2004) 979, (4<sup>th</sup> edn, Penguin 2009) 1087.

<sup>32</sup> *Forbes, Forbes, Campbell & Co v Stanley & Co* (1921) 9 LI L Rep 202.

<sup>33</sup> *Trans Trust SPRL v Danubian Trading Co Ltd* [1952] 1 Lloyd's Rep 348.

elects to waive the breach and accept a nonconforming letter of credit, he loses his right to complain of breach<sup>34</sup>

It should be noted that a term in the contract of sale providing for payment by letters of credit is for the interest of both parties. Hence, the seller is not ordinarily entitled to demand payment in any other way nor to sue for the price during the pendency of the credit or complain of non-payment by the buyer during this period.<sup>35</sup> The letter of credit, like the bill of exchange, is considered to be taken as conditional payment unless otherwise agreed, and during the lifetime of the credit, the seller's right to sue for the price is suspended. If the credit is honoured, that constitutes payment under the contract of sale. If it is dishonoured, the seller's right to sue the buyer for the price or for damages revives.<sup>36</sup>

In the same vein, the buyer is generally not entitled to call for the tender of documents in a manner inconsistent with the letter of credit arrangements prescribed by the contract of sale. So, if pursuant to that contract (or a later arrangement or understanding by the parties) the letter of credit issued to the seller calls for the tender of document to the advising bank, the seller is not obliged to tender the documents directly to the buyer or to the issuing bank or to anyone other than the advising bank.<sup>37</sup>

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<sup>34</sup> In this regard, no question of damages as for breach of warranty arises; by waiving the breach, the seller assents to the letter of credit in the form in which it is issued.

<sup>35</sup> See exception as expressed in *Mann (E D and F) Ltd v Nigerian Sweets and Confectionery Co Ltd* [1977] 2 Lloyd's Rep 50, in situation where the letter of credit has failed due to the issuing bank going into administration. In this case, the claimant/ beneficiary could proceed against the buyer directly for the price agreed in the contract of sale or sue for damages for breach of their contractual promise to pay by letter of credit. See also *WJ Alan & Co v L Nasr Export* [1972] 1 Lloyd's Rep 313.

<sup>36</sup> See EP Ellinger, 'Does an Irrevocable Credit Constitute Payment' (1977) 40 MLR 91.

<sup>37</sup> Roy Goode, *Commercial Law* (3<sup>rd</sup> edn, Penguin 2004) 980.

As to the time of the opening of the credit, subject to any express provisions in the contract which gives the parties the liberty to contract according to their own terms, the letter of credit has to be opened within reasonable time<sup>38</sup> This means a reasonable time calculated back from the date of the shipment, not calculated forward from the date of conclusion of the contract.<sup>39</sup> Taking the first date of shipment as the starting point, the buyer has, it is thought, to open the credit a sufficient time in advance of that event to enable the seller to know before he sends the goods to the docks that his payment will be secured by the credit for which it is stipulated.<sup>40</sup>

The duration of credit or the date of expiration is a very vital statement in the letter of credit. In the absence of such a statement, the implication is merely that the credit endures for a reasonable time, a somewhat vague concept that leaves the seller in a state of uncertainty as to whether he is covered for the full shipment period and as to the latest date by which a tender of document is acceptable.

The UCP 600 re-emphasized the crucial nature of this statement in letter of credit. Article 6(d)(i)<sup>41</sup> provides:

‘A credit must state an expiry date for presentation. An expiry date stated for honour or negotiation will be deemed to be an expiry date for presentation’

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<sup>39</sup> This is an implied term of the contract. See *Diamond Cutting Works Federation v Triefus & Co Ltd* [1956] 1 Lloyd's Rep 216, 225.

<sup>40</sup> *Sinaison-Teicher Inter-American Grain Corporation v Oilcakes and Oilseeds Trading Co Ltd* [1954] 1WLR 935.

<sup>41</sup> UCP 500 Art. 42(a).

The UCP further contains detailed provisions for the ascertainment of the expiry date and its extension should it fall on a day when the bank is closed<sup>42</sup> or in case of interruption of the bank's business.<sup>43</sup>

Finally, in terms of rejection of the goods, the acceptance of documents under a letter of credit does not preclude the buyer from subsequently rejecting the goods themselves if on arrival they are found not to conform to the contract of sale.<sup>44</sup>

### **2.3.2. The Contract between the Buyer and the Issuing Bank**

Here, pursuant to the contract of sale, the buyer requests his own bankers to open a documentary credit in favour of the seller. The relationship between the issuing bank and the buyer is that of a banker and customer. The buyer completes an application form provided by the banker. The terms of the contract are set out in details in the Issuing Bank's standard form of application, which normally incorporates the UCP. In English practice, the contract is usually a unilateral contract in which the buyer's submission of the application constitutes an offer which the issuing bank accepts by conduct in issuing the letter of credit.<sup>45</sup> The issuing bank owes the usual duties of a banker strictly to observe the terms of the mandate,<sup>46</sup> and to act in other respects with reasonable care and skill in relation to the credit, except so far as these duties are

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<sup>42</sup> See Art.29 (a) and (b), UCP 500 Art.44.

<sup>43</sup> UCP 600, Art.36, UCP 500 Art. 17.

<sup>44</sup> Here, the buyer's right to reject defective or nonconforming goods is not affected by the fact that the defect or nonconformity was apparent on the face of the documents accepted by the issuing bank. One rational explanation for this is that in accepting the documents, the paying or confirming bank acts as principal, not as the buyer's agent. Hence, it would seem that the buyer is entitled to reject even for defect apparent on the face of the documents, which he would not be entitled to do if the documents had been accepted by him or his agent.

<sup>45</sup> Ewan McKendrick (ed), *Goode on Commercial Law* (4<sup>th</sup> edn, Penguin 2009) 1089.

<sup>46</sup> *ibid* 1089.

effectively qualified by the contract. In particular, the issuing bank is responsible for ensuring that the letter of credit issued to the seller complies strictly with the instructions contained in the application for the credit and that payment, acceptance or negotiation is effected only on presentation of documents which fully accord with the terms of the credit.

It need not be over-emphasized that the letters of credit issued by the issuing bank to the seller constitutes an autonomous engagement in which the issuing bank acts as principal, not as the agent of the buyer.<sup>47</sup> It simply follows from the above that the buyer is not entitled to give instructions to the issuing bank to withhold payment or to deviate from the terms of the credit. The issuing bank is both entitled and obliged to ignore any such instructions so long as the documents are presented within the period of the credit and duly comply with its provisions.

Also, if the credit is not honoured, the issuing bank is obliged to indemnify the buyer against any liability he may incur from the seller.<sup>48</sup> On the contrary, where the issuing bank makes payment without authority against non-complying presentation,<sup>49</sup> the buyer, though not entitled to reject conforming goods from the seller, may as between himself and the issuing bank decline to adopt the transaction, on account of breach of mandate.<sup>50</sup> In this case, the issuing bank cannot debit the buyer with the price paid or with remuneration for its services, while the buyer for his part is taken to have

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<sup>47</sup>RM Goode, *Commercial law* (3<sup>rd</sup> edn, Penguin 2004) 982. Note also that in some authorities like *Bank Melli Iran v Barclays Bank* [1951] 2 Lloyd's Rep 267, a relationship between the issuing bank and the instructing bank which is similar to the relationship between an issuing bank and applicant was referred to as that of agency. Note also the dictum of Devling J. in *Midland Bank v Seymour* [1955] 2 Lloyd's Rep 147, 153.

<sup>48</sup> Ewan McKendrick (ed), *Goode on Commercial Law* (Penguin 2009) 1090.

<sup>49</sup> If he acts promptly, the buyer may be able to obtain an injunction to restrain such payment.

<sup>50</sup> Ewan McKendrick (ed), *Goode on Commercial Law* (Penguin 2009)1090.

rejected (abandoned) the goods to the issuing bank, in whom they will then vest<sup>51</sup> In addition, the buyer may claim damages for any loss reasonably foreseeable by the issuing bank as likely to flow from the breach.<sup>52</sup>

The buyer as an alternative to rejecting the documents may waive the breach or accept the documents without prejudice to his right to damage for any resulting loss. Here the buyer will be deemed to have waived any nonconformity if he obtains delivery of the goods from the carrier without production of the bill of lading<sup>53</sup> in circumstances where this needs to be tendered under the credit. Where this is the case, it may be noted that the buyer has no right to take the goods from the carrier and it would be fraud on the seller from the buyer, having wrongfully procured the goods, to prevent payment under the credit. At the moment, there seems not to be any English case law on the subject of acceptance of documents under reservation of the right to damages<sup>54</sup> and thus no adequate guide to the measure of damages.

### **2. 3.3. The Contract between the Issuing Bank and the Advising Bank**

The issuing bank begins the inter-bank contractual relationships when it asks another bank, usually in the seller's country, to advise the seller (beneficiary) of the credit or to confirm the credit. The contract is made between the issuing bank and the advising

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<sup>51</sup> R Goode, *Commercial Law* (Penguin 2004) 980.

<sup>52</sup> Here damages are recoverable under the rule in *Hadley v Baxendale* (1854) 9Exch341.

<sup>53</sup> It may be noted that at present, carriers sometimes agree to release goods without the bill of lading against guarantees and warranties. This takes care of situations where the preparation and delivery of the bill of lading is delayed with the result that goods arrive before it. See generally RM Goode, *Proprietary Rights and Insolvency in Sales Transactions* (2<sup>nd</sup> edn 1989); For latest edition, see Roy Goode and Simon Mills, *Proprietary Rights and Insolvency in Sales Transactions* (3<sup>rd</sup> edn, Sweet and Maxwell 2009).

<sup>54</sup> This may be due to allegation of wrongful honour of credit being resolved mainly through out of court settlement.

bank when the later signifies its acceptance of the terms to the issuing bank.<sup>55</sup> Once acceptance has taken place, then, the banks are bound to carry out the terms of their obligation. The advising bank must comply strictly with the instructions in the letter of credit, failing which it cannot claim reimbursement or remuneration from the issuing bank.<sup>56</sup>

In terms of the duty or role of the advising bank, it is principally to advise the beneficiary about the opening of the credit on his behalf by the issuing bank. In doing so, the advising bank is acting on the mandate of the issuing bank and is commonly perceived as the agent of the issuing bank.<sup>57</sup> In the capacity of the advising bank as the issuing bank's correspondent, no contract exists between the advising bank and the beneficiary and in relation to the credit, it does not promise to honour the credit. Also, the advising bank does not have a contractual relationship with the applicant. The reason for this is that the issuing bank, although opening the credit at the request of the applicant and using the advising bank to notify the beneficiary of the opening of the credit, it (issuing bank) deals with the advising bank in its own capacity and not as an agent of the applicant.<sup>58</sup>

So far as communications between the banks are concerned, the UCP now provide for "teletransmissions",<sup>59</sup> a term that appears to cover cable, telegram and telex, as well as telefax and telephone.

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<sup>55</sup> The confirming bank acts as the agent of the issuing bank: *Credit Agricole Indosuez v Muslim Commercial Bank Ltd* [2002] 1 All ER (Com) 172.

<sup>56</sup> However, the advising bank's wrongful acceptance of the documents will probably bind the issuing bank and the seller if within the scope of the advising bank's apparent authority.

<sup>57</sup> See Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* ( Hart Publishing 2010) 177.

<sup>58</sup> *ibid* 178.

<sup>59</sup> Article 11, UCP 500.

Where the issuing bank instructs an advising bank ‘by any teletransmission’ to advise a credit, and intends the mail confirmation to be the ‘operative credit instrument’, the teletransmission must state ‘full details to follow’ or some similar expression. The “operative credit instrument” must then follow without delay.<sup>60</sup>

If the advising bank receives instructions that are not clear, they have a choice either to give the beneficiary a preliminary notification for information only, and, of course, without responsibility; or not saying anything.<sup>61</sup> Much, however, will depend on the circumstances, but usually the advising bank is expected to verify the facts contained in the issuing bank’s instruction before making any notification.

#### **2.3.4. The Contract Between the Issuing Bank and the seller**

At this level in the chain of relationships, the issuing bank undertakes that payment will be made on due presentation of documents.<sup>62</sup> The issuing bank’s undertaking to make payment, though given in response to the buyer’s request, is given by the issuing bank as principal and not as an agent. It follows that if the issuing banker accepts inadvertently a tender of nonconforming documents, then, while this may be a breach of his duty to the buyer under the agreement between them, the buyer, as a stranger to the separate contract generated by the letter of credit, has no *locus standi* to complain that the issuing bank’s acceptance of the tender was not valid and binding

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<sup>60</sup> Article 11C, UCP 500.

<sup>61</sup> UCP, Art. 12.

<sup>62</sup> For some exceptional cases in which payment may be refused despite the conformity of the documents, - see *Group Josi Re v Walbrook Insurance Co Ltd* [1966] 1 Lloyd’s Rep 345; *Mahonia Ltd v J P Morgan Chase* [2003] 2 Lloyd’s Rep 911; *Solo Industries Ltd v Canara Bank* [2001] 1 WLR 1800.

for the purpose of the contract.<sup>63</sup> The buyer must base any claim he wishes to make on breach of his contract with the issuing bank, and/ or breach of the underlying contract of sale with the seller.<sup>64</sup>

If the documents do not conform to the credit, the issuing bank has various options open to it. It may consult its customer, the buyer,<sup>65</sup> to see whether he is willing to waive the discrepancy, which in most cases he will as the commercial motive of the buyer is to obtain the goods and not to rely on technical points to reject the documents. However, the issuing bank may reject the documents<sup>66</sup> or pay under reserve. The effect of paying under reserve is to safeguard itself in circumstances where the buyer fails to ratify its action. In this case, it may be entitled to recover the payment.<sup>67</sup> Where the issuing bank decides to reject the documents, as not in conformity with a credit, it must inform the party from whom it received the documents within a reasonable time, not exceeding seven banking days following the receipt of the documents.<sup>68</sup> The notice must state all the discrepancies in respect of which the bank refuses the documents.<sup>69</sup> The bank must also state whether it is holding the documents at the disposal of or is returning them to the presenter and if the bank fails in this duty,

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<sup>63</sup> See the legal perception of the relationship between the issuing bank and buyer as it relates to the seller from the dictum of Sir Christopher Staughton in *Credit Agricole Indosuez v Muslim Commercial Bank* [2000] 1 Lloyd's Rep 87 where the learned judge stated that the undertaking given by the issuing bank, though given in response to the buyer's request, is given by the issuing bank as principal or at best a commission agent.

<sup>64</sup> As it is on the terms of those contracts that any remedy which it pursues against the issuing bank can legally be predicated

<sup>65</sup> Note that where the documents are presented to the advising bank as the confirming bank, the advising bank's consultation (if any) will be with the issuing bank who, in turn, may consult the buyer.

<sup>66</sup> See *Bankers Trust Co v State Bank of India* [1991] 2 Lloyd's Rep 443 where Lloyd LJ expressed the view that the issuing bank cannot rely on any consultation with the buyer as extending its time of rejection. Note that the UCP 600 in Article 16 (b) has endorsed the position adopted by Lloyd LJ.

<sup>67</sup> *Banque de l'Indochine et de Suez SA v J.H Rayner (Mincing Lane) Ltd* [1982] 2 Lloyd's Rep 476.

<sup>68</sup> Note that UCP 600 has jettisoned the use of "reasonable time", see also Article 13(b), 14(d)(ii)

<sup>69</sup> UCP 500. Art.14 (d) (ii). UCP 600 Art. 16

it is precluded from claiming that the documents do not constitute a complying presentation.<sup>70</sup>

### **2. 3.5. The contract Between the Advising Bank and the Seller**

It may be noted that English law does not recognize any privity of contract between the advising bank and the buyer.<sup>71</sup> It then follows that if the advising bank advises the letter of credit in erroneous terms or pays the credit against non-complying presentation, the buyer's remedy is against the issuing bank.

The advising bank, by adding its own confirmation is undertaking that the credit will be honoured on due presentation. This is a separate undertaking from that given by the issuing bank and is given by the advising bank as principal, not as the issuing bank's agent. Here the promise of the issuing bank and that of the advising bank are separate and distinct. It follows that if the terms of the confirmation are more restricted than those of the credit as issued by the issuing bank, the advising bank's liability to the seller is limited accordingly.<sup>72</sup>

### **2. 4. The Principle of Autonomy**

The autonomy doctrine is central to the operation of documentary credits. Its primary function in a documentary credit transaction is to create an abstract payment obligation that is independent of and detached from the underlying contract of sale

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<sup>70</sup> UCP 600 Art. 16 (f)

<sup>71</sup> *GKN Contractors Ltd v Lloyds Bank PLC* (1985) 30 BLR 48.

<sup>72</sup> A careful look at the sentence, will raise the question whether, the advising bank, by giving a restricted mandate, will not be in breach of its mandate from the issuing bank.

between the seller/beneficiary and the buyer/applicant and the separate contract between the buyer/applicant and the issuing bank. It then follows as a cardinal rule of documentary credits that the conditions of the bank's duty to pay are to be found subject to the defences on only the terms of the documentary credits. The implication is that the right and responsibility of the bank to make payment to the beneficiary does not depend on the seller/beneficiary's obligations under the contract of sale. It follows in particular that a breach of those obligations by the seller/beneficiary by shipping goods which fail to correspond in a material respect to the contract description or are of unsatisfactory quality does not entitle the bank under instruction by the applicant to refuse payment under the credit.

It needs to be stated that the perception accorded the autonomy doctrine, mostly in English documentary credit law which states that the letter of credit contract is detached from the underlying contract that gave rise to it, is at the root of so many practices which as noted in decided cases<sup>73</sup> have made this area of law wholly unsatisfactory.<sup>74</sup> The practice which inflexibly seeks to detach the documentary credits contract from the underlying contract that gave rise to it, if pursued to its extreme, may even call into question the basis of recognising any exceptions in the first place. It is submitted that the basis of the autonomy principle is to provide an assurance of payment to the seller/beneficiary on the implicit understanding that the

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<sup>73</sup> Because the letter of credit contract is perceived to be completely detached from the underlying contract that gave rise to it, the standard of proof required to prove the exception(s) is set very high as to make it somewhat unattainable. The difficulty of proof of the exceptions (principally the fraud exception) which remotely lay in the way the exception to the autonomy principle is perceived has led to an approach that is not uniform. Relying on the exception as the basis of an injunction, Staughton L.J noted the differences of opinion that have arisen with respect to whether the beneficiary or the bank itself is being enjoined. While the Lord Justice noted that there is no difference whether the bank or the beneficiary is enjoined, the court agreed with the Balcombe LJ in *Themehelp v West & Others* [1996] QB 84. that the law in this area is wholly unsatisfactory. See generally, Staughton L.J in *Group Josi Re v Walbrook Insurance Co. Ltd. and Others* [1996] 1 Lloyd's Rep 345, 361.

<sup>74</sup> Balcombe LJ in *Themehelp v West & Others* [1996] QB 84.

seller/beneficiary will comply with the agreed terms of the underlying transaction that gave rise to the credit contract.<sup>75</sup> It is not to provide an assurance of payment where no underlying contract exists at all.

Having noted the above, it may be pertinent to look at the common law position as well as some instruments that have emphasized the autonomy doctrine.

#### **2. 4.1. Common Law Position**

Many common law cases<sup>76</sup> have enunciated the autonomy doctrine. Prominent in the list is the English case of *United City Merchant (Investment) Ltd v Royal Bank of Canada* where Lord Diplock noted that the fundamental principle that underlies the autonomy doctrine when his Lordship stated thus

‘The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment’.<sup>77</sup> The importance of this assurance of payment lies principally in the fact that that the buyer who has contracted with the seller is usually from a different country thereby making

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<sup>75</sup> This position has been adopted by D Horowitz in criticism of the pronouncement of Lord Diplock that the sole purpose of the autonomy principle in documentary credits is to provide the seller with an assurance of payment. Horowitz added in support of the position adopted above that the purpose of the autonomy principle does not exclude assuring the buyer that the goods which are the reason for the opening of the credit would be delivered. Hence, the autonomy doctrine does not exclude considerations involving the buyer’s interest. See Deborah Horowitz, *Letters of Credits and Demand Guarantees Defences to Payment* (Oxford University Press 2010) 20.

<sup>76</sup> *Hamzeh Malas & Sons v. British Imex Industries Ltd* [1958] 2 QB 127; [1958] 2 WLR 100; [1958] 1 All ER 262, C.A.

<sup>77</sup> *United City Merchants (Investments) Ltd v Royal Bank Of Canada* [1983] 1AC 168,183.

legal action to recover the price inconvenient. Also, in *Trans Trust SPRL v Danubian Co Ltd*,<sup>78</sup> Denning LJ hinted at the reason for the autonomy doctrine by referring to situations where the seller obtains goods or components of the goods from a third party and hence is relying on the letters of credit given by the buyer to finance the purchase either directly or through his own bank.

More recently, in the United States of America, the autonomy doctrine was again illustrated in the American case of *Semetex Corporation v UBAF Arab American Bank*.<sup>79</sup> Here Semetex contracted to supply an ion implanter to a factory in Baghdad. Payment was arranged to be made by an irrevocable letter of credit. The conditions of payment were that Semetex present to UBAF (a) commercial invoices and a certificate of origin and (b) freight prepaid air waybill from the United States to Baghdad via Iraqi Airways or carrier authorised by Iraqi Airways (c) a telex cable to the buyer advising him of the flight number and date of arrival at Baghdad airport. The letter of credit did not require an on board bill of lading or other evidence that the ion implanter had actually been received by the designated carrier. On July 31, 1990 the ion implanter began its journey by truck from Austin Texas, to JFK airport in New York where it was to be flown to Iraq. On August, 1 1990, while the truck was in transit, the freight forwarder hired by Semetex presented the documents called for by the credit to UBAF. On the night of August 1, Iraq invaded Kuwait. Early on August 2, 1990, President Bush issued an Executive Order blocking all Iraqi assets in the United States. To comply with the Executive Order, the manufacturers whom Semetex had engaged to build the ion implanter, instructed the carriers to divert the truck to a warehouse in Massachusetts.

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<sup>78</sup> [1952] 2QB 297 at 304.

<sup>79</sup> [1995] 2Bank LR 73.

On application for summary judgment by Semetex, the US District court relied on the autonomy doctrine and granted Semetex's motion for summary judgment against UBAF for payment under the letter of credit on the ground that they had complied with the terms of the letter of credit. The court, however observed that the buyer would have been protected if he had stipulated in the credit for a document evidencing shipment on board the designated carrier. The court further held that since such a document was not required, it did not matter that the goods, the subject of the underlying contract, were still lying in a warehouse in Massachusetts.

The above case exemplifies the autonomy doctrine. Owing to the autonomy doctrine, the case did not consider the rights of the buyer/applicant against the seller/beneficiary under the underlying contract. It was also held in *Power Curber International Ltd v. National Bank of Kuwait SAK*<sup>80</sup> that the concept of autonomy in documentary credits is the basis for the general rule which prevents the issuing bank or the buyer/applicant from resisting the seller's claim for breach of the underlying sale contract. This position enunciated in many decided cases has also been giving statutory effect by some instruments that deal with documentary credits. One of such instruments is the Uniform Customs and Practice for Documentary Credits.

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<sup>80</sup> [1981]2 Lloyd's Rep 394.

#### 2. 4.2. UCP 600

Accepted banking practice relating to documentary credit is standardised by the Uniform Customs and Practice for Documentary Credits (UCP),<sup>81</sup> which are a set of rules issued by the International Chamber of Commerce (ICC). The UCP was first published in 1933 and have seen many revisions of which the most current is the UCP 600 that came into force on the July 1, 2007.<sup>82</sup>

The principle of autonomy that remains one of the cardinal principles of documentary credits' practice was precisely articulated in Arts 4 and 5 of the UCP 600 in these terms:

A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary.<sup>83</sup>

It further states that

A beneficiary can in no case avail itself of the contractual relationships existing between the banks or between the applicant and the issuing bank. An

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<sup>81</sup> The latest edition is the UCP 600.

<sup>82</sup> Documentary credits opened before the July 1, 2007 date will continue to be governed by the previous edition of the UCP known as the UCP 500.

<sup>83</sup> UCP 600 art 4.

issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like. Finally, banks deals with documents and not with the goods, services or performance to which the document relate.<sup>84</sup>

These respective articles cited above provide the UCP 600 provisions with respect to the autonomy principle.

#### **2. 4.3. Uniform Commercial Code (USA)**

The above position reflected in the UCP 600 regarding the autonomy principle is replicated in the American Uniform Commercial Code of the United States. It states precisely in Section 5- 103(d) that ‘the rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of the contract or arrangement out of which the letter of credit arises or which underlie it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary’. Section 5-108(f)(1) underlies the importance of the doctrine of independence by further stating that ‘an issuer is not responsible for the performance or non-performance of the underlying contract, arrangement, or transaction’.

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<sup>84</sup> UCP 600 art 5.

## 2. 5. Does the Autonomy Doctrine Operate without Exceptions?

The autonomy doctrine operates on the established premise that between parties to documentary credit transactions, issues related to the underlying transaction have to be pursued by the buyer bringing a separate action for breach of the underlying contract and not by withholding all or part of the credit. Put differently, the autonomy doctrine operates on the principle of ‘pay now, sue later’. The effects of this approach to the autonomy doctrine have been overwhelming and have at times being interpreted in a manner that appears literalistic.<sup>85</sup> The approach to the autonomy doctrine has led Professor Goode to argue that ‘English courts have become beguiled by the autonomy doctrine that they decline to allow refusal of payment in favour of a beneficiary acting in good faith even where the documents are forged or otherwise fraudulent, on the supposed principle that the beneficiary’s duty is to tender documents which appear to conform to the credit even if they are in fact fraudulent and worthless’.<sup>86</sup> This argument of Professor Goode, a testament to his disagreement to how the exceptions have been applied in English law, partly foreruns the issues discussed in this research. The research further investigates whether it can be persuasively argued that in all

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<sup>85</sup> Literalism as an interpretative tool is being discouraged because in most cases it does not capture the commercial expectation of the parties. There is a shift from literal methods of interpretation towards an approach that captures the real intention of the parties. See *Antaios Compania Naviera SA v Salen Rederierna AB* [1985] AC 191, 201, per Lord Diplock. By literalism, such example given in the moral philosophy of *Paley* comes to mind. In that work which has influenced thinking on contract since the 19th century, “the tyrant Temures promised the garrison of Sebastia that no blood would be shed if they surrendered to him. They surrendered. He shed no blood. He buried them all alive.” This is literalism at work as the tyrant, Temures live up to his promise not to shed any blood by burying his captives alive. But the question must be asked if such treatment from the tyrant represented the mutual expectation of the parties when they struck an agreement to surrender? Borrowing from this approach, autonomy doctrine ought not to be understood in a manner that makes it too literalistic.

<sup>86</sup> Roy Goode, *Commercial Law* (Penguin 2004) 972.

cases, issues related to the underlying transaction have no part to play as to whether the beneficiary is entitled to payment?

It has to be noted that despite the force of authority which the principle of autonomy commands in documentary credits, it operates with recognised exceptions. Put differently, its application in documentary credit is not absolute. Fraud of the beneficiary or his agent whether in relation to obtaining of the credit or presentation of the documents, entitles the bank if on notice of it to withhold payment.<sup>87</sup>

On the other hand, it is the position of the English courts<sup>88</sup> that the autonomy principle is not undermined in a case where the beneficiary has expressly and contractually agreed with the other party to the transaction not to draw down on the credit unless certain conditions are fulfilled and the draw-down is sought to be prevented on the ground of non-fulfilment of such express contractual terms.

An exception to the autonomy doctrine exists where the honouring of the credit would be illegal according to the law of the place where the bank's performance is due.<sup>89</sup> Moreover, it has been demonstrated in a series of Singaporean<sup>90</sup> and Australian cases, that an independent ground forming a basis for an exception to the autonomy doctrine exists where in the particular circumstances of the case, the beneficiary would be guilty of unconscionable conduct in presenting the documents and collecting payment on the instrument.

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<sup>87</sup> This exception applies only where the fraud is that of the beneficiary or his agent. The bank is not obliged to investigate a mere suspicion of fraud.

<sup>88</sup> *Sirius Insurance International Ltd v FAI General Insurance* [2003] 1 WLR 87.

<sup>89</sup> *Mahonia v Chase Manhattan Bank* (No. 1) [2003] EWHC 1927 (Comm.) [2003] 2 Lloyd's Rep 911.

<sup>90</sup> *Bocotra Construction Pte Ltd v Unitrack Building Construction Pte Ltd* [1995] 2 SLR 733; *GHE Pte Ltd v Unitrack Building Construction Pte Ltd* [1994] 4 SLR 904.

Finally, there is another exception, which has been dismissed in English law but recognised in Singapore<sup>91</sup> in the form of a nullity exception. In support of this exception, Professor Goode has argued that it is a distortion of the autonomy principle to allow a beneficiary so far as he acts in good faith, to tender documents which purport to be what they are not and collect payment against worthless pieces of paper.<sup>92</sup> This thesis will seek to examine these exceptions to the principle of autonomy in detail. The thesis would endeavour to answer the research question whether the application of the exception(s) is satisfactory.

## **2. 6. Conclusion**

The chapter examines the basic issues relating to documentary credit and its importance in international trade. In analysing the nature of the instrument (documentary credit), the cardinal role of the autonomy doctrine was highlighted as well some of the instruments that govern documentary credits practice. The current perception with respect to the role the autonomy doctrine plays in documentary credits has led to so many different and at times conflicting interpretations of the circumstances under which autonomy principle could be displaced by way of an exception. In English law, the circumstances under which the autonomy doctrine could be displaced have primarily been in the case of fraud of the beneficiary or his agent and its scope remains very restrictive.<sup>93</sup> But case law and academic

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<sup>91</sup> See *Beam Technology Pte Ltd v Standard Chartered Bank* [2003]1 SLR 597.

<sup>92</sup> See Roy Goode, *Commercial Law* (Penguin 2004) 996. For current edition see E. Mckendrick *Goode on commercial Law* (4<sup>th</sup> edn, Penguin 2009).

<sup>93</sup> Though some case laws in the current English documentary credit practice may question to what extent this traditional restrictive approach remains the law. For the preceding comment, see *Themehelp*

commentaries continue to highlight the existence of some other exceptions. The object of the thesis is to critically examine these exceptions to the principle of autonomy. In the course of this intellectual enterprise, (analysing the exceptions to the autonomy principle) the research pursues the primary and specific research goal of addressing the question as to how satisfactory the application of these exceptions are, and pays special attention to English documentary credits law.

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*v West & Others* [1996] QB 84, where there is an arguable case that the fraud exception might not be so limited based on the principle enunciated in the case.

## Chapter Three

### 3.0 The Fraud Rule

#### 3.1. Introduction

Having examined in the preceding chapter the juridical basis of the autonomy doctrine, which represents a fundamental principle in documentary credits, this chapter analyses the first recognised exception to the autonomy doctrine known as the fraud rule, its nature, application and the basis for its recognition. It need not be over-emphasized that the phenomenon of fraud presently applied in documentary credits<sup>94</sup> is 'timeless and universal'.<sup>95</sup> So are human efforts for the control of fraud. However, despite being regularly seen in legal contexts, there seems to be no universally accepted definition of fraud.<sup>96</sup> The reason for this lies mostly in the inherent difficulty associated with attempting a catchall definition of fraud.<sup>97</sup> In documentary credits, the phenomenon of fraud is also a vexed issue. The enormity of its effect obliged a learned judge<sup>98</sup> to characterize it as a cancer in international trade.

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<sup>94</sup> Has its origin in general law and has for centuries represented a very slippery and sometimes difficult legal concept to deal with.

<sup>95</sup> See L.H Leigh *The Control of Commercial Fraud* (Gower Pub Co1982) 3.

<sup>96</sup> J. Ulph *Commercial Fraud* (University Press 2006) 6.

<sup>97</sup> See *R v Metropolitan Police Commissioner* [1975] AC 819, 834, per Viscount Dilhorne, where he said that 'there has always been a great reluctance among lawyers to attempt to define fraud, and this is not unnatural when we consider the number of different kinds of conduct to which the word is applied in connection with different branches of law, and especially in connection with the equitable branch of it. I shall not attempt to construct a definition which will meet every case which might be suggested, but there is little danger in saying that whenever the words 'fraud' or 'intent to defraud' or 'fraudulently' occur in the definition of a crime two elements at least are essential to the commission of the crime: namely, first, deceit or an intention to deceive or in some cases mere secrecy; and, secondly, either actual injury or possible injury or an intent to expose some person either to actual injury or to a risk of possible injury by means of that deceit or secrecy'.

<sup>98</sup> See Cresswell J in *Standard Chartered Bank v Pakistan National Shipping Corporation and Others* [1998] 1 Lloyd's Rep 684, 687.

It is to deal with this problem that the fraud rule was developed. Ordinarily, the obligation to pay under a documentary credit is independent of the underlying transaction in respect of which the credit is issued. However, as an exception to the principle of independence, fraud may be raised as a ground for non-payment.

This chapter is concerned principally with the principles relating to the application of the fraud exception in documentary credits. It critically examines some aspects of the fraud rule by discussing its meaning and scope. It looks at the rationale and standard of proof. It also considers the question whether the English approach to the exception is satisfactory having regard to the approach that is obtainable in other jurisdictions.

The chapter is divided into eight main sections with each section dealing with a specific aspect of the fraud rule. Apart from section 3.1 which is the general introduction, section 3.2 outlines the rationale for the fraud rule as a guide to understanding the different approaches to its scope. Section 3.3 examines the scope of the exception. Section 3.4 discusses the standard of proof required to trigger the exception in English law. Sections 3.5 undertakes a comparative analysis of the fraud rule in Canada, Singapore and Malaysia respectively with the view to understanding how the exception has been understood and applied in those jurisdictions. Section 3.6, draws a conclusion based on the above examined issues.

### 3. 2. Rationale

This section discusses the rationale for the fraud rule in documentary credits. It contends that based on case law<sup>99</sup> and academic commentaries,<sup>100</sup> the rationale for the fraud rule has attracted divergent opinions. It highlights the pitfalls associated with the main views and concludes by aligning with the view that is based on strong public policy requirement of the law for the prevention of fraud.

The basis of the fraud rule in the law of documentary credit seems to have been captured by Lord Diplock when he stated that ‘the exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or if plain English is to be preferred, “fraud unravel all”. The court will not allow its process to be used by a dishonest person to carry out a fraud’<sup>101</sup> However, if the rationale for the fraud rule is that ‘fraud unravels all,’ one would have thought that a fraud of a loading broker in the *United City Merchants* which affected the conformity of the credit would have been capable of enjoining payment. The decision of the court was that fraud of a loading broker of which the beneficiary was innocent would be incapable of stopping the beneficiary from getting paid. If the decision is correct, would it not be more appropriate to say that on the basis of the exception propounded in *United City Merchants* it would be

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<sup>99</sup> See specifically the rationale in these two cases: *American Accord* [1983] 1 AC 168,184 and *Czarnikow-Rionda Sugar Trading Inc v Standard Bank of London Ltd* [1999] 2 Lloyd’s Rep 187.

<sup>100</sup> X Gao, *The Fraud in Letters of Credit; A Comparative study* (1999, Kluwer Law international, New York) See also Boris Kozolchyk, “The immunization of Fraudulently Procured Letter of Credit acceptances: *All Services Exportacao, Importacao Comercio S A v Banco Bamerindus do Brazil S.A and First Commercial v. Gotham Originals*”, 58 Brook. L. Rev, 369,370. See also K. Donnelly, ‘Nullity for Nothing: a Nullity Exception in Letters of Credit’ (2008) JBL 316.

<sup>101</sup> See *United City Merchant v Royal Bank of Canada* [1983] 1 AC 168, 184.

more accurate to say that only some fraud unravels all, namely fraud perpetrated by the active dishonesty of the beneficiary.<sup>102</sup>

The rationale for the fraud rule evident in the *American Accord* has been considered more recently by Rix J in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank of London Ltd*<sup>103</sup> where he disagreed with the rationale propounded by Lord Diplock.<sup>104</sup>

Rix J stated that the basis of the fraud exception is premised on an implied contractual term. He reasoned that the claim for an injunction (between the applicant and the issuing bank) is based on a breach of contract by the bank and not as contended by the claimant that the power to grant an injunction arises from the court's unwillingness to avoid its process being used by a dishonest person to commit fraud. According to Rix J,<sup>105</sup> the basis for the exception is that there is an implied term in the contract between the paying bank and the beneficiary that documents presented do not, to the presenter's knowledge, make any statements of fact which are false, and that the documents are not being presented as part of a fraud against the bank or the buyer. According to Rix J '... if the source of the power to injunct were purely the law's interest in preventing the beneficiary from benefitting from his own fraud, I do not see why there should be the added requirement that the fraud be patent to the bank'.

Commentators<sup>106</sup> have premised the rationale for the fraud rule on so many grounds ranging from the desire to close the loophole in the law,<sup>107</sup> the law's public policy for

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<sup>102</sup> Indeed if fraud unravels all, does it matter who perpetrated the fraud? See also K. Donnelly, 'Nullity for Nothing: a Nullity Exception in Letters of Credit' (2008) JBL 316, 321.

<sup>103</sup> [1999] 2 Lloyd's Rep 187.

<sup>104</sup> See *Czarnikow-Rionda Sugar Trading* [1999] 2 Lloyd's Rep. 187, 203; See also K Donnelly, 'Nullity for Nothing: a Nullity Exception in Letters of Credit' [2008] JBL 316, 322.

<sup>105</sup> See *Czarnikow- Rionda Sugar trading Inc v Standard Bank of London Ltd* [1999] 2 Lloyd's Rep 187 199-203.

<sup>106</sup> See X Gao, *The Fraud in Letters of Credit; A Comparative study* (New York, Kluwer Law international, 1999) See also Boris Kozolchyk, 'The immunization of Fraudulently Procured Letter of

the control of fraud,<sup>108</sup> maintaining the commercial utility of letter of credit and that based on an implied contract term between the beneficiary and the paying bank. All these mentioned rationales closely examined would most likely expose their strengths and weaknesses. However, it is argued that the fraud exception is based on the strong policy ground of providing an ‘extra- contractual defence’<sup>109</sup> in cases of fraud to the contractually unqualified payment obligation. It constitutes the most convincing rationale for the fraud exception in letters of credit law. The reason for this may not be farfetched. First, as noted by Cresswell J, fraud and fraudulent documents constitute what he termed a ‘cancer’ in international trade and should be discouraged in the strongest terms possible. Secondly, the rationale based on an implied contract term between the beneficiary and the paying bank adopted in *Czarnikow- Rionda Sugar Trading Inc v Standard Bank of London Ltd*<sup>110</sup> raises unanswered questions.<sup>111</sup> Thirdly, the contention that the fraud exception is founded on the rationale that fraud unravels all cannot be true in all circumstances.<sup>112</sup> Although, the above mentioned public policy stance of the law in controlling fraud remains the basic rationale, the application of the exceptions has attracted divergent opinions with respect to its scope. Hence the scope of the exception is considered to ascertain the approach adopted in English law.

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Credit acceptances: *All Services Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus do Brazil S.A and First Commercial v. Gotham Originals*’ 58 Brook L Rev 369,370.

<sup>107</sup> See X Gao, *The Fraud in Letters of Credit; A Comparative Study* (Kluwer Law international 1999). 56.

<sup>108</sup> See NE Enonchong, ‘The Autonomy Principle of Letter of Credit: An Illegality Exception?’ (2006) LMCLQ 404-405.

<sup>109</sup> See *Deutsche Ruckversicherung Aktiengesellschaft v Walbrook Insurance Co ltd* [1995] IWLR 1017, 1029.

<sup>110</sup> [1999] 2 Lloyd’s Rep. 187.

<sup>111</sup> It could be argued that it belies the purpose of the fraud rule introduced by the first American case of *Stejn v Henry Schroeder Banking Corporation* (1941) 31NYS 2d 631.

<sup>112</sup> If it is, the fraud of a third party should displace the autonomy principle.

### 3. 3. The Scope of the Fraud Exception in English Law

The treatment of the ambit of the fraud exception in letters of credit could touch on a multiplicity of issues. However, in this section, an aspect of the scope specifically dealing with the nature of fraud that would justify breach of the autonomy doctrine is examined. It answers the question whether in English law the letter of credit fraud is the equivalent of the common law tort of deceit?<sup>113</sup> It is in this light that the section considers the extent to which letter of credit fraud is equivalent to the tort of deceit and whether such comparison is in any way helpful. Secondly, it considers whether fraud in the transaction is an aspect of the fraud rule; and if so, whether it is capable of leading to an enjoinder of credit under the fraud rule. It finally assesses the scope of fraud in the context of a deferred payment credit and whether the UCP 600 has effectively addressed the problem generated by the *Banco Santander Case*<sup>114</sup>

#### 3. 3.1. Letters of Credit Fraud and Tort of Deceit

Fraud may justify a breach of the autonomy principle. However, the scope of the fraud that will warrant such a departure from the principle has in some respects differed in the different jurisdictions. In England,<sup>115</sup> the position is that letter of credit fraud is akin to the common law tort of deceit.<sup>116</sup> This perception is evident in Lord

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<sup>113</sup> This comparison was made by Professor Goode in *Goode Commercial Law* (Penguin 2004). see latest edition by E. Mckendrick, *Goode on Commercial Law* (Penguin 2009) 1100.

<sup>114</sup> See *Banco Santander SA v Bayfern Ltd & Ors* [1999] CLC 1321, *Banco Santander SA v Banque Paribas* [2000] CLC 906.

<sup>115</sup> See *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank Of Canada* [1983] 1 AC 168.

<sup>116</sup> See Goode, *Commercial Law* (Penguin Press 2004) 991; See also R. Jack, *et al Documentary Credits* (3<sup>rd</sup> edn, 2001) 266; Ali Malek and David Guest *Jacks Documentary Credits* (4<sup>th</sup> edn, Tottel 2009) 254 where it was stated that Lord Diplock's formulation is very close to a statement of the element of fraudulent misrepresentation that constitute the tort of deceit.

Diplock's formulation of the exception<sup>117</sup> from the standpoint of fraudulent misrepresentation by referring to 'documents that contain, expressly or by implication, material representations of facts that to his knowledge are untrue.' If the fraud rule capable of displacing the autonomy doctrine is akin to common law tort of deceit, does it presuppose that for a party to be capable of pleading the fraud rule successfully, it must prove the common law tort of deceit (fraud)?

Addressing the above issue, David Steel J in *Uzinterimpex JSC v. Standard Bank Plc*<sup>118</sup> identified the elements of the tort of deceit otherwise known as fraud as (a) the defendant must have made a representation, which can be clearly identified; (b) It has to be a representation of facts; (c) the representation has to be false; (d) it must have been made dishonestly in the sense that the representor had no real belief in the truth of what he stated, so that there was conscious knowledge of the falsity of the statement; (e) the statement must have been intended to be relied upon; (f) it must have in fact been relied upon leading to a loss.<sup>119</sup>

One issue that arises in the context of perceiving letter of credit fraud as akin to the common law tort of deceit<sup>120</sup> is whether it is possible to prove all its ingredients. Is it possible to prove the legal ingredients of 'reliance and damage' associated with the tort of deceit in all cases of letters of credit fraud? This becomes necessary in view of

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<sup>117</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168-183.

<sup>118</sup> [2007] 2 Lloyd's Rep.187,188.

<sup>119</sup> See *Hornal v Neuberger Products Ltd* [1954] 1 QB 247.

<sup>120</sup> See the comment of Roy Goode where he defined the fraud required in documentary credits by stating that "fraud does not necessarily mean that the maker of the statement should be dishonest in the sense used in criminal law. It suffices that it constitutes the tort of deceit in that it is made knowingly and with intent that it should be acted upon by the person to whom it is addressed". For this see Roy Goode *Commercial Law*, (3<sup>rd</sup> edn, Penguin 2004) 991, Ewan McKendrick *Goode on Commercial Law* (4<sup>th</sup> edn, Penguin 2009) 1100.

the dictum of Croke J in *Baily v. Merrell*<sup>121</sup> which was restated by Buller J in *Pasley v. Freeman*.<sup>122</sup> Buller J while considering whether an action based on deceit can be sustained without damage noted as follows ‘Fraud without damage, or damage without fraud, gives no cause of action; but where these two concur, an action lies’.<sup>123</sup> In similar vein, Lord Tucker noted in *Briess v Woolley*<sup>124</sup> that ‘the tort of fraudulent misrepresentation (fraud) is not complete when the representation is made. It becomes complete when the misrepresentation is acted upon by the representee’.

It is against this backdrop that the propriety of the assertion that letter of credit fraud is equivalent to the common law tort of deceit<sup>125</sup> is considered, as there are cases in which letter of credit fraud can be established without some of the ingredients that need to be present to make the tort of deceit complete. Some of these cases where the ingredients of tort of deceit need not be present could be seen in letter of credit fraud cases. It is not necessary to prove reliance and damage which are key ingredients of the tort of deceit in some instances where letter of credit fraud has been successfully pleaded. However, for an action in the tort of deceit to succeed, all the legal ingredients need to be proved to the required standard. This position of the law was generally articulated in *Re: H and others (minors)*<sup>126</sup> where it was held that all ingredients of the tort of deceit need to be proved only to the required balance of probabilities for an action to succeed.

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<sup>121</sup> 3 Bulst. 95.

<sup>122</sup> (1789) 3 Term Reports 51.

<sup>123</sup> (1789) 3 Term Reports 51,56.

<sup>124</sup> [1954] AC 333, 353.

<sup>125</sup> See Roy Goode *Commercial Law*, (3<sup>rd</sup> edn, Penguin 2004) 991; see also Ewan McKendrick *Goode on Commercial Law* (4<sup>th</sup> edn, Penguin 2009) 1100.

<sup>126</sup> [1996] AC 563 at 586, compare with the earlier case of *Hornal v Newberger Products Ltd* [1957] 1 QB 247.

Having noted the above, it is necessary at this point to consider some instances of letters of credit fraud to ascertain whether all the ingredients of the tort of deceit could be established in all cases. In *Banco Santander SA v Banque Paribas*,<sup>127</sup> a decision which is primarily on letter of credit fraud, an issuing bank refused payment to a confirming bank which had discounted a beneficiary's presentation prior to its due date under a deferred payment undertaking. What was assumed to be a letter of credit fraud, upon which the confirming bank's reimbursement was denied, was information from the applicant to the issuing bank that the certificates of quality and quantity relating to the cargo were false. In this instance of letter of credit fraud, there was no reliance on the confirming bank's presentation by the issuing bank nor did the issuing bank suffer any damage before a finding of fraud was made. More so in the *American Accord*,<sup>128</sup> what was held to be the fraud of the shipping broker by the House of Lords was nothing but an intentional and dishonest misrepresentation in a document by a shipping broker. Any analysis of the circumstances that led to the fraud would not reveal any kind of reliance or damage before it was dubbed fraud.

In similar vein, Hirst J<sup>129</sup> in *Rafsanjan Pistachio Producer's Cooperative v Bank Leumi UK Plc* recognised the difficulty of proving all the ingredients of the tort of deceit in letters of credit fraud. Against the contention of the plaintiff's counsel that there was no reliance since the bank did not rely on the misrepresentation having rejected the documents, the learned judge held that what is needed in letter of credit fraud is the proof of potential reliance by the bank as no interlocutory injunction for

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<sup>127</sup> [2000] CLC 906.

<sup>128</sup> [1983] 1AC 168.

<sup>129</sup> See *Rafsanjan Pistachio Producers Cooperative v Bank Leumi UK Plc* [1992] 1 Lloyd's Rep 513, 542; See also *Solo Industries v Canara Bank* [2001] 2 Lloyd's Rep 578 where the bank successfully resisted the application for summary judgment by the beneficiary of a bond on the ground of fraud. The bank did not prove reliance or its loss resulting from the misrepresentation.

fraudulent presentation could ever be obtained if there is an insistence on the proof of reliance by the bank. It is submitted that a careful analysis of the instances of letters of credit fraud reveals a crucial distinction. It reveals that a bank that refuses to pay on the ground of letters of credit fraud in some situation has not relied on any misrepresentation or suffered any loss as a result of the beneficiary's presentation. Its refusal to perform the contract which it has with the beneficiary is because there is fraud and not because the bank has relied on or has been duped by any fraud<sup>130</sup>. Put differently, the power to grant an injunction or resist summary application by a bank on grounds of fraud<sup>131</sup> arises from the perceived fraudulent conduct of the presenter of the documents and not on any reliance on the deceit of the alleged fraudster. In *Themehelp v West*,<sup>132</sup> what was held to be fraud in the words of Waite LJ consisted of nothing but 'deliberate or reckless failure on the part of the sellers (*West and Ors*) to inform the buyers (*Themehelp Ltd*) of the full extent of the falling-off of future demand from Sony (a major customer) of which they were aware by the date of the contract and of which, to their knowledge, the buyers were not aware'.<sup>133</sup> Hence an arguable case of fraud was established and interlocutory injunction granted against the seller/beneficiary from making a demand for payment under an unconditional guarantee.

In *Solo Industries v Canara Bank*<sup>134</sup> the Court of Appeal refused an application for summary judgment by the beneficiary for payment on the ground that the letter of credit was issued as a result of fraudulent misrepresentation between the beneficiary

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<sup>130</sup> See *Rafsanjan Pistachio Producers Cooperative v Bank Leumi UK Plc* [1992] 1 Lloyd's Rep 513,542.

<sup>131</sup> *Solo Industries v Canara Bank* [2001] 2 Lloyd's Rep 578.

<sup>132</sup> [1996] QB 84.

<sup>133</sup> *ibid* 96.

<sup>134</sup> [2001] 2 Lloyd's Rep 578.

and the applicant for the credit. For the issuing bank to resist summary judgment on the grounds of fraud, it was not possible to establish damage on the part of the issuing bank since the beneficiary in the circumstance has not yet being paid.

It is submitted that the proof of reliance and damage suffered by the representee can be dispensed with in some instances of letters of credit fraud. This is particularly so if fraud is alleged for the purposes of injunctive relief and contesting of a summary judgment application. The bank's refusal to pay the fraudulent beneficiary either as a result of injunction from the applicant or by contesting a summary judgment application by the beneficiary for payment is at the heart of documentary credit fraud rule. Does it not raise doubt as to the propriety of the assertion that letter of credit fraud is equivalent to common law tort of deceit if fraud can be established without proof of all the ingredients of tort of deceit? The justification for this arises from the fact that the proof of the tort of deceit cannot be complete without the proof of all its ingredients without fail.

An aspect of letter of credit fraud that compares favourably with the tort of deceit can be seen in a situation where payment has already been made and the paying bank is coming to court to recover payment because payment is alleged to have been fraudulently obtained by the beneficiary. This situation particularly arises where there is a claim for damages by the paying bank on the ground that the beneficiary in presenting the documents and obtaining payment committed fraud.<sup>135</sup> It is in this situation that the tort of deceit and its ingredient can be complete. However, when the

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<sup>135</sup> See *KBC Bank v Industrial Steels (UK) Ltd* [2001] 1All ER (Comm) 409; *Komerčni Banka AS v Stone and Rolls Ltd* [2003] 1 Lloyd's Rep 383; *Niru Battery Manufacturing Company v Milestone Trading Ltd* [2002] 2All ER (Comm) 705; See also the Singapore case of *DBS Bank Ltd v. Carrier Singapore (Pte) Ltd* [2008] 3 SLR 261.

fraud exception is invoked in practice, what usually happen is that the fraudulent beneficiary is restrained from obtaining payment. The beneficiary is prevented from taking advantage of his own wrong doing at the expense of the paying bank or the applicant. Hence the core of letter of credit fraud is to restrain the fraudulent beneficiary from obtaining payment and not the recovery of damages occasioned by the payment of a fraudulent beneficiary. For it cannot be said that the autonomy principle has been breached on the grounds of fraud in claims for damages arising from payment resulting from the beneficiary's fraudulent presentation of documents.

It has to be finally stated that judging from case law, the ingredients needed to prove fraud within the context of injunctive relief consist of two key elements. First the document must contain expressly or by implication a material representation that is untrue.<sup>136</sup> Secondly the seller must fraudulently present the document for the purpose of drawing on the credit with the knowledge of the untruth.<sup>137</sup> With respect to the first requirement, what does the document containing expressly or by implication a material misrepresentation mean? Can such material misrepresentation be gleaned only from the documents themselves or both the documents and the underlying transaction that gave rise to the credit?

### **3.3.2. Ambit of Fraud-Fraud in the Transaction**

Relying on the *American Accord*, it can be argued that the approach of the English court is to restrict the fraud exception to misrepresentation in the document alone.<sup>138</sup>

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<sup>136</sup> [1983] 1 AC 168 at 184.

<sup>137</sup> Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Credit* ( Hart Publishing 2010) 141.

<sup>138</sup> Lord Diplock refers to material misrepresentations that are untrue

Hence there is no English authority<sup>139</sup> which discusses specifically whether the exception extends to a situation where the documents presented are truthful but there is fraud in the underlying transaction.<sup>140</sup> However, recent cases suggest a trend towards extending the exception to fraud in the underlying transaction.<sup>141</sup> In *Solo Industries Ltd v Canara Bank*,<sup>142</sup> the Court of Appeal refused to grant a summary judgment in favour of a beneficiary of a performance bond against the bank seeking to avoid payment on the ground that its issue (the bond) was induced by a fraudulent conspiracy and/ or misrepresentation to which the beneficiary was a party. Analysing the *Solo Industries cases*, the fraud that necessitated the issuance of the performance bond was such fraud that took place in the underlying transaction. Also, in *Themehelp v West & Others*,<sup>143</sup> a case on performance bonds, fraud in the underlying transaction sustained the fraud exception.<sup>144</sup>

Looking at these cases and the grounds for decision, they suggest an approach which supports an extension of the fraud rule to a situation where the documents show an apparent conformity but the underlying transaction is tainted with fraud. But the extent to which these decisions can alter the pronouncement of the House of Lords is still not yet very clear. Many<sup>145</sup> have suggested that in the light of the current trend

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<sup>139</sup> Some authorities that have dealt with the issue like *Themehelp v West & Others* [1996] QB 84. received some scathing criticism by the dissenting judge. Other authorities like *Czarnikow-Rionda Sugar Trading Inc. v Standard Bank of London Ltd and Others* [1999] 2 Lloyd's Rep. 187 did not expressly deal with the issue but however did not raise any objection in granting an injunction to the buyer on the fact there was no fraud in relation to the documents.

<sup>140</sup> The question in Scotland is regarded as open in the case of *Royal Bank of Scotland v Holmes* [1999] SLT 563.

<sup>141</sup> See *Themehelp v West* [1996] QB 84; see also *Czarnikow- Rionda v Standard Bank* [1999] 2 Lloyd's Rep 187.

<sup>142</sup> [2001] 1 WLR 1800, [2001] EWCA Civ 1059.

<sup>143</sup> [1996] QB 84.

<sup>144</sup> But this authority has always been questioned as not sustaining the argument that fraud rule in English law relates to the document as well.

<sup>145</sup> Discussion with Professor N E Enonchong and other researchers in the area tend to suggest that in the light of current trend of complicity between the account party and the beneficiaries in the

evidencing fraud in the procurement of letters of credit, it is doubtful whether Lord Diplock's formulation of the rule in the *American Accord* by restricting the fraud rule to only fraud in the documents is still sustainable.<sup>146</sup> It is submitted that until there is an express decision to the effect that English letter of credit's fraud exception encompasses fraud in the documents as well as fraud in the underlying transaction, the traditional position is that it restricts its enquiry to fraud in the documents. It is however submitted that if the fraud exception is such that seeks to prevent an unscrupulous seller/beneficiary from benefitting from his own wrong, an approach that extends the fraud rule to fraud arising from the underlying transaction rather than restricting it to fraud arising from the presentation of documents should be welcomed.<sup>147</sup> However, even if the fraud rule is restricted to fraudulent misrepresentation in the documents in English law, another class of problem with respect to the scope of documentary credit fraud has been generated by the decision of the English court in the *Banco Santander case* which for the purposes of this study ought to be examined.

### **3. 3.3. Ambit-Fraud in Deferred Payment Obligation**

Where a credit provides for deferred payment, the obligation of a nominated bank<sup>148</sup> is to pay on maturity date(s) ascertainable in accordance with the terms of the credit. Since payment is not immediate, cash may not be available to the seller of goods till

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procurement of the letter of credit, letter of credit fraud cannot be restricted to fraud in the documents alone.

<sup>146</sup> See Ali Malek and David Quest, *Jacks:Documentary Credit* (4<sup>th</sup> edn, Trottell 2009) 259.

<sup>147</sup> Here, it needs to be noted that the degree of connection with the underlying contract fraud is relevant and is consistent with authorities in other common law jurisdictions of United States and Canada. For cases in the USA, see the Ohio Supreme Court case of *Mid- America Tire, Inc v PTZ Trading Ltd* 95 Ohio St. 3D 367, 768 N.E. 2d 619, For Canada, see *Bank Of Nova Scotia V. Angelica-Whitewear Ltd* (1987) 36 DLR 161.

<sup>148</sup> A nominated bank is defined in the Article 2, UCP 600 as the bank with which the credit is available or any or any bank in the case of a credit available with any bank.

the maturity date for payment.<sup>149</sup> In this kind of situation, it becomes the responsibility of the seller to ship the goods and wait for the maturity period for payment.

The financial burden of shipping the goods and waiting for the maturity period is huge on the seller and in consequence a practice known as forfaiting developed whereby a nominated bank may be willing to pay the beneficiary and take up the documents by way of discounting arrangement and expecting reimbursement at the maturity date of payment. Under the UCP 500, as the facts and the decision in *Banco Santander SA v. Banque Paribas*<sup>150</sup> revealed, this forfaiting or discounting arrangement posed a serious problem to the discounting bank where fraud, perpetrated by the beneficiary, is uncovered just after the nominated bank has discounted the credit, taken up discounted documents and paid the beneficiary,<sup>151</sup> but before the maturity date as stipulated in the deferred payment credit.

In *Banco Santander v Banque Paribas*, a decision under the UCP 500 where documentary credit fraud was tested in a deferred payment obligation, it was held that a nominated bank that has discounted a fraudulent beneficiary's documents or right to payment could only be seen as an assignee of the fraudulent beneficiary's right and stood in no better position than the assignor of such right. The facts of the case could be summarized as follows: Under a deferred payment credit, Napa Petroleum Trade Inc (Napa) was the applicant for a credit that was issued by Banque Paribas (Paribas) in favour of the beneficiary, Bayfern Ltd (Bayfern). Paribas requested Banco

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<sup>149</sup> Take for example, where the seller does not negotiate the documents to his banker for presentation upon maturity.

<sup>150</sup> [2000] CLC 906.

<sup>151</sup> Such discounted documents remain his security for payment and it is on the strength of these documents that he waits for the maturity period to be paid the sum agreed under the credit.

Santander (Santander) as the nominated bank to advise the credit and add its confirmation. The deferred payment was due 180 days from the date of the bill of lading. Santander's advice of the credit to Bayfern offered, in addition to the deferred payment, the possibility of discounting the full value of the credit at Santander's offered rate of discount.

On 15 June 1998, the beneficiary presented documents to Santander. The presentation was found to be conforming, and the obligation of Paribas (issuer) and Santander (confirmer) to pay Bayfern (beneficiary) the amount of the credit after 180 days in accordance with the deferred payment credit thereupon crystallised on the 27 November 1998. But before the maturity date for the deferred payment credit, Santander informed Bayfern's bank that it had discounted the documents and had paid the sum of money less the discounting fee into Bayfern's bank account. In return, Bayfern irrevocably and unconditionally assigned its right under the deferred payment credit to Santander. However, before the maturity date of the credit, Paribas as the issuer of the credit, informed Santander that the documents that it (Santander) had presented included forged documents. On the maturity date, Paribas refused to pay Santander, on the ground of fraud on the part of Bayfern prior to the maturity date of the credit. Accordingly, the central issue before the court was whether such refusal on account of fraud of Bayfern was justified.

The Court of Appeal affirmed the trial judge's finding that Bayfern had assigned its right under the credit to Santander. In consequence, Santander as an assignee of Bayfern's right, took subject to equities of the assignor and could not be in a better position than the assignor (Bayfern). It was a matter of common understanding by the

parties that if the beneficiary as the assignor had sought payment at maturity, it would have failed because Paribas as the issuer of the credit would have had a good defence based on the fraud exception. In the alternative, an argument was made that Santander was entitled to reimbursement as a confirming bank when the confirming bank paid under the deferred payment credit under the UCP 500. This alternative argument was equally rejected by the Court of Appeal on the ground that the issuing bank was only required to reimburse the confirming bank when the confirming bank paid the money due at the maturity date rather than before it is due. This position of law defined the scope of the fraud rule under English law<sup>152</sup> in a case of deferred payment undertaking prior to the introduction of UCP 600 and actually became an unwelcome development to a banking community who for commercial reasons<sup>153</sup> were making the discounting of payment a common practice.

However, with the coming into effect of the UCP 600, the UCP 600<sup>154</sup> has resolved the dilemma created by the decision in *Banco Santander* and fraud could no longer be used as a ground to refuse payment to a nominated bank that has discounted payment prior to maturity even if fraud is discovered before the due date of the credit. This position of the UCP 600 undoubtedly has further implications for documentary credit practice in England. It applies where the credit has adopted the UCP 600. The question may then arise as to what happens in a deferred payment credit where the parties have opted out of the UCP 600. Which position applies- the position recognised in *Banco Santander* or the recent provision of the UCP 600 which has

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<sup>152</sup> This position was different from the practice prevalent in the United States under the Uniform Commercial Code (UCC) where a bank acting as an assignee who has discounted payment in good faith was entitled to payment.

<sup>153</sup> The practice of discounting payment was preferred to acceptance credit because most often in some jurisdiction, acceptance credit attracted stamp duty because of the draft used.

<sup>154</sup> For parties expressly subject to its provision

been expressly excluded? Moreover, what happens where a bank that seeks to discount payment before maturity is not a nominated bank within the definition of UCP 600? Lastly, what does art.12 (b) of the UCP 600 imply when it states ‘that once a bank is nominated to incur a deferred payment credit, the bank is authorised to prepay’? Has the provision in the UCP 600 rendered redundant the literal meaning of a deferred payment credit as payment due after a certain period of time on the presentation of complying documents?

The above presented situations create legal difficulties with respect to the scope of the fraud rule in deferred payment credit in English law. However, it is submitted that the position reflected in UCP 600 art 12 (b) which states that ‘by nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorises that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank’ is preferred to the position adopted in *Banco Santander* as it protects the interest of banks involved in the forfait market.

Having assessed the scope of the fraud exception in English law, another issue that has troubled the court is the standard of proof required to establish fraud. For the purpose of succinctly analysing the standard of proof, the subject will be treated under three broad heading viz: application for interim or interlocutory injunction, standard of proof at full trial and finally summary judgment application.

### 3. 4. Standard of Proof

This section explores the standard required to justify the proof of fraud in English law.

This section deals with the standard of proof required in documentary credit fraud in three separate headings viz (i) application for interim/ interlocutory injunctions (ii) summary judgment application and (iii) proof required at full trial.

#### 3. 4.1. Injunctive Relief

In documentary credits, whether the action is instituted by the applicant on its own accord or on the instruction of the paying bank that is unwilling to make payment, it is at times the case that the applicant for the credit seeks a remedy where he considers that the beneficiary is likely or has made a presentation under the credit which the beneficiary should not make and which the applicant feels ought not to be met with payment by the paying bank. Where the above situation arises, the applicant may seek to prevent the presentation or payment or both by applying for an injunctive relief<sup>155</sup> against either the bank to stop it from making payment or against the beneficiary to stop the beneficiary's presentation.

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<sup>155</sup> This application is sometimes made ex parte (without notice) and upon affidavit evidence. It has to be noted that the leading English authority on injunctions is the House of Lord's decision in *American Cyanamid Co v Ethicon* [1975] AC 396, but care must be taken as letters of credit cases are perceived to be special cases which ought to be viewed somewhat differently from the *American Cyanamid* guidelines. See Staughton L.J in *Group Josi Re v Walbrook Insurance Company* [1996] 1 WLR 1152 at 1160 quoting with approval the view of Lloyd LJ in *Dong Jin Metal Co Ltd v Rayment Ltd* Unreported, 13 July 1993 Court of Appeal (Civil Division) transcript No 945 of 1993.

If the above situation arises, the standard of proof required in England in documentary credit fraud cases with respect to injunctions<sup>156</sup> has been considered in some cases.<sup>157</sup>

The cases emphasize that for fraud to be capable of restraining payment under the fraud rule, it must be clearly established both as to the fact of fraud and the bank's knowledge. In *Edward Owen*<sup>158</sup> the position was re-emphasized by Lord Denning MR when he held that 'the only exception is where there is clear fraud of which the bank has notice'<sup>159</sup> Geoffrey Lane LJ restated the opinion of Lord Denning MR when he said 'If it has been clear and obvious to the bank that the buyer has been guilty of fraud',<sup>160</sup>

The standard of proof required to establish fraud in letter of credit transaction was also considered in the *United City Merchants (Investment) Ltd v Royal Bank of Canada*,<sup>161</sup> where the court adopted a rigid approach towards the application of the fraud rule by setting a high standard of proof which requires 'clear,' 'obvious,' or 'established' fraud known to the issuer or confirmer of the letter of credit. Accordingly, fraud has been very difficult to establish in English courts.

The restrictive standard of proof required in fraud cases in the *American Accord* has been followed by subsequent cases. In *Themehelp Ltd v West and Others*,<sup>162</sup> one of the few English cases (though on demand guarantees) where an injunction was granted, the Court of Appeal followed the approach in *American Accord* with respect

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<sup>156</sup> *Discount Record Ltd v Barclays Bank Ltd* [1975] 1WLR 315; *RD Harbottle (Mercantile) v National Westminster Bank* [1978] QB 146; *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; *Bolivinter Oil SA v Chase Manhattan Bank* [1984] Lloyd's Rep 251; *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152.

<sup>157</sup> *Ibid.*

<sup>158</sup> [1978] QB 159.

<sup>159</sup> *ibid* at 171.

<sup>160</sup> *ibid* at 175.

<sup>161</sup> [1979] 1 Lloyd's Rep 267.

<sup>162</sup> [1996] QB 84.

to the standard of proof (in relation to injunctioning an issuing bank) and affirmed the trial court's decision. Balcombe, Evans and Waite LJJ, in the Court of Appeal citing the dictum of Ackner LJ in *United Trading Corp. SA v Allied Arab Bank Ltd*,<sup>163</sup> noted that the standard of proof required of an applicant seeking to bring itself within the fraud rule was stated in the *United Trading Case*.<sup>164</sup> The court pronounced that:

...The evidence of fraud must be clear, both as to the fact of the fraud and as to the [guarantor's] knowledge. The mere assertion or allegation of fraud would not be sufficient...We would expect the court to require a strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer.<sup>165</sup>

The court further stated that in general, for the evidence of fraud to be clear, it would be expected that the buyer was given the necessary opportunity to answer the allegation against him and he (buyer) fails to provide any, or any adequate answer in circumstances where one could properly be expected. If the court considers that on the material before it the only realistic inference<sup>166</sup> to draw is that of fraud, then the seller would have made out a sufficient case.

Also in *Banco Santander SA v. Bayfern Ltd*<sup>167</sup> the confirmer discounted the obligation of a deferred payment letter of credit before its maturity. Shortly after the discounting, some of the documents presented were found to be fraudulent. Subsequently, the issuer refused to pay the confirmer. The confirmer brought the action against the

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<sup>163</sup> [1985] 2 Lloyds Rep 554, 561.

<sup>164</sup> Ibid.

<sup>165</sup> [1985] 2 Lloyds Rep 554, 561.

<sup>166</sup> In this case still referring to the high standard of clear fraud

<sup>167</sup> [2000] 1 All ER (Comm) 776.

issuer for reimbursement and sought summary judgment, claiming it should be immune from the fraud rule despite fraud. At the trial of preliminary issues, fraud was assumed to have been established in the case. The trial court ruled for the issuer on the basis of established fraud. On appeal, the decision was upheld by the Court of Appeal. Both courts cited with approval, Lord Diplock's above passage relating to the standard of proof.

Another aspect, which is not much different from the above position with which the English law looks at the standard of proof, was evident in *Solo Industries UK Ltd v. Canara Bank*.<sup>168</sup> In the Court of Appeal, Mance LJ in responding to the contention of the respondent bank as to the standard of proof, which must preclude 'any possibility of innocent explanation,' drew from the earlier case of *United Trading Corp. SA v Allied Arab Bank Ltd*<sup>169</sup> and stated a position that directly confirms the position as postulated in the case of *United Trading Corp. SA*.

Mance LJ recognized that the letter of credit is an essential machinery of international trade and to delay payment strikes not only at the proper working of international commerce but also at the reputation of the international banking community. He however, cited the observation of Mr. Justice Neill<sup>170</sup> that it cannot be in the interest of the banking community as a whole if, having established an important exception to what had been previously been thought an absolute rule, the courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves

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<sup>168</sup> [2001] EWCA Civ 1041.

<sup>169</sup> [1985] 2 Lloyds Rep 554, 561.

<sup>170</sup> Court of first instance in *United Trading Corp. SA v. Allied Arab Bank Ltd* [1985] 2 Lloyds Rep 554,561.

from intervening. He also noted that if this was to be the case, then impressive and high sounding phrases such as ‘fraud unravels all’ would become meaningless.

One notable academic<sup>171</sup> commented as follows

Material misrepresentation’ thus appears to have been settled as the standard of fraud in the law governing letters of credit in the United Kingdom. In language the English position is close to that of the United States in Revised U.C.C. Article 5, Section 109: “material fraud.” As both of them have not been sufficiently tested, it is too early to make a reasonable comparison. If a comparison has to be made, however, the difference between the two appears to be that the U.S. position is enshrined in a statute, but the U.K. position is embodied in the common law.

From the above, what does suffice as the standard of proof has been formulated in different ways by the courts in England. Part of the reason being the court’s attempt to balance between setting a standard high enough to safeguard the autonomy principle but not so high as to be unattainable. This has led to differences of emphasis, ranging from ‘established or obvious’ fraud<sup>172</sup> to ‘a good arguable case that on the material available the only realistic inference’ is that the beneficiary/seller was fraudulent<sup>173</sup> or simply a ‘real prospect’ of establishing fraud.<sup>174</sup>

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<sup>171</sup> Ross Buckley, ‘The Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 6 *Banking and Fin L & Prac* 77, 97.

<sup>172</sup> *Edward Owen Engineering Ltd v. Barclays Bank international* [1978] QB159, per Lord Denning MR at 169. Note that this a decision on a performance bond but the principle is the same.

<sup>173</sup> *United Trading Corporation SA v. Allied Arab Bank* at FN 27 per Ackner LJ at 561., also a decision on performance guarantee meaning that it is the seller in this case who has to show fraud

<sup>174</sup> *Solo Industries UK Ltd v Canara Bank* [2001] 1 WLR 1800, [2001]EWCA Civ 1059

Another important issue that has been given consideration in ascertaining the standard of proof is the stage of proceeding at which the matter comes for consideration before the court. The above position applies if the proceeding is at the interlocutory stage. More so, even if the interlocutory injunction's standard of proof is satisfied, the balance of convenience must favour the grant of injunction, and otherwise it will be refused.<sup>175</sup>

### 3.4.2 Summary Judgment- Standard of Proof

A bank may refuse to pay the beneficiary on grounds of what it perceives to be fraud affecting the letter of credit.<sup>176</sup> Where the bank has refused payment, an aggrieved beneficiary<sup>177</sup> may seek a remedy in a court of law through an application for summary judgment against a bank that has refused payment upon the presentation of apparently conforming documents. Where the above position is the case, what is the level of proof required for this application to either fail or succeed?

In England, summary judgment applications are governed by the English Civil Procedure Rules (CPR). Part 24.2 of the CPR states that 'the court may give summary judgment against a claimant or defendant on the whole of a claim or on a particular issue if –

(a) it considers that –

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<sup>175</sup> See *Czarnikow-Rionda Sugar Trading Inc. v Standard Bank of London Ltd. and Others* [1999] 2 Lloyd's Rep 187.

<sup>176</sup> The fraud may be in the document themselves or from the underlying transaction that gave rise to the credit.

<sup>177</sup> Aggrieved because payment has been refused in a manner that is inconsistent with a right which the beneficiary believes he legitimately has to be paid upon the presentation of conforming documents.

- (i) that claimant has no real prospect of succeeding on the claim or issue; or
  - (ii) that defendant has no real prospect of successfully defending the claim or issue; and
- (b) there is no other compelling reason why the case or issue should be disposed of at a trial'.<sup>178</sup>

In a letter of credit, the recent case of *Enka Insaat Ve Sanayi AS v Banca Popolare dell'Alto Adige SpA*<sup>179</sup> ascertained the required standard of proof where an application for summary judgment is made by a claimant against a bank. The court noted that the proof required in a summary judgment by a beneficiary has previously been considered in three<sup>180</sup> decided cases. However the court expressed the view that the standard of proof required with respect to how Part 24(2) of the (CPR) should be applied in a letter of credit where a summary judgment application is brought against a bank is not entirely clear.

The court in *Enka Insaat* noted that in two previous authorities (*Solo Industries v Canara Bank*<sup>181</sup> and *Banque Saudi Fransi v Lear Siegler Services Inc*) the standard of proof required by a defendant to refute a summary judgment application by a claimant was held to be higher than that required under CPR part 24.2. The standard of proof required was a heightened standard of proof as the courts considered the realistic

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<sup>178</sup> Part 24.2 of the Civil Procedure Rules accessed online at <http://www.hrothgar.co.uk/YAWS/rules/part24.htm#IDAZBHOB> on 28/03/2011. Note also Ord. 14 of the Rules of the Supreme Court which is the previous provision that was replaced by this current CPR.

<sup>179</sup> [2009] EWHC 2410 (Comm) (2009 )WL 2958787.

<sup>180</sup> *Safa Ltd v Banque du Caire* [2000] 2 Lloyd's Rep.600; *Solo Industries UK Ltd v Canara Bank* [2001] 1 WLR 1800; *Banque Saudi Fransi v Lear Siegler Services Inc.* [2007] 2 Lloyd's Rep 47

<sup>181</sup> [2001] 1 WLR 1800.

prospect of success to be a low test to satisfy.<sup>182</sup> After reviewing the above authorities,<sup>183</sup> the court held that “the test to be applied must be that of a “real prospect” because that is the test set out in CPR Part 24. The court noted that it is bound to apply a “heightened test”.<sup>184</sup> In arriving at this decision the court noted that it was mindful that in applying the test reflected in CPR Part 24 (2), the Court ought to be wary of the principle that banks, when sued on a letter of credit or performance bond or guarantee, need particularly cogent evidence to establish the fraud exception.<sup>185</sup>

### 3.4.3 Full Trial

At the trial stage, the bank has to prove fraud only on a civil standard requiring proof on a balance of probabilities.<sup>186</sup> However, Lord Nicholls clarified the necessary ingredients of this standard of proof in *Re: H and others (minors)*<sup>187</sup> when he noted that ‘the balance of probability standard means that a court is satisfied an event occurred if the court considers that, on the evidence, the occurrence of the event was

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<sup>182</sup> *Enka Insaat Ve Sanayi AS v Banca Popolare dell'Alto Adige SpA* [2009] EWHC 2410 (Comm) para.20-23.

<sup>183</sup> *Solo Industries v Canara Bank* [2001] 1 WLR 1800 and *Banque Saudi Fransi v Lear Siegler Services Inc* [2007] 2 Lloyd's Rep 47.

<sup>184</sup> See also *Safa Ltd. v Banque du Caire* [2000] 2 Lloyd's Rep 600, 608 per Waller J.

<sup>185</sup> For similar warning which the court noted ought to be taken into consideration, see *Czarnikow-Rionda v Standard Bank* [1999] 2 Lloyd's Rep 187, 202 where Rix J. said: ‘However, the fact that the claimant gets the benefit of a lower standard of proof for the purposes of a pre-trial hearing, places on the Court, as I believe the cases demonstrate, an additional requirement to be careful in its discretion not to upset what is in effect a strong presumption in favour of the fulfilment of the independent banking commitments.’

<sup>186</sup> See *Re: H and Others (minors)* [1996] AC 563, Goode, *Commercial Law* (Penguin 2004) 992.

<sup>187</sup> [1996] AC 563,586.

more likely than not'.<sup>188</sup> Lord Nicholls went further to give clarity to this standard required in civil cases by asserting that the court

when assessing the probabilities the court will have in mind as a factor, to whatever extent is appropriate in the particular case, that the more serious the allegation the less likely it is that the event occurred and, hence, the stronger should be the evidence before the court concludes that the allegation is established on the balance of probability. Fraud is usually less likely than negligence. Deliberate physical injury is usually less likely than accidental physical injury. A step-father is usually less likely to have repeatedly raped and had non-consensual oral sex with his under age stepdaughter than on some occasion to have lost his temper and slapped her. Built into the preponderance of probability standard is a generous degree of flexibility in respect of the seriousness of the allegation.<sup>189</sup>

By stating the above criteria, the court noted that it does not mean that where a serious allegation is in issue the standard of proof required is higher. It means only that the inherent probability or improbability of an event is itself a matter to be taken into account when weighing the probabilities and deciding whether, on balance, the event occurred.<sup>190</sup>

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<sup>188</sup> *Noble v Owens* [2011] EWHC 534 (QB) 2011 WL 722313 at para.24 restating the position expressed by the House of Lords *Re: H and others (minors)* [1996] AC 563.

<sup>189</sup> *Re: H and Others (minors)* [1996] AC 563, 586.

<sup>190</sup> See also *Ungoed-Thomas J.* where the court noted in *In re Dellow's Will Trusts* [1964] 1 WLR 451,455 that 'the more serious the allegation the more cogent is the evidence required to overcome the unlikelihood of what is alleged and thus to prove it.'

### **3.5. Fraud Rule in Some Common Law Jurisdictions**

Section 3.5 takes a comparative analysis of the fraud rule in Canada, Singapore and Malaysia. The examination of the scope and standard of proof in these jurisdictions is the main thrust of the analysis. The objective is to ascertain the extent to which the practice in these jurisdictions is similar to or different from the English approach.

#### **3.5.1. Canadian Approach to Fraud Rule**

The Canadian courts have recognised the fraud exception to the principle of autonomy of documentary credit. The recognition of the fraud rule in Canada is traceable to the US case of *Sztejn v Henry Schroeder Banking Corporation*.<sup>191</sup> In *Sztejn*, an applicant for a credit claimed an injunction against the issuing bank to prevent the issuing bank paying on the documents which had been presented. The credit had been advised to the seller in India by the issuing bank's correspondent in India. The correspondent bank had not confirmed the credit. The applicant alleged that what had been shipped was rubbish rather than bristle that was contracted for. The bank applied to dismiss the claim for an injunction on the ground that there was no cause of action.

For the purpose of hearing the motion, Shientag J of the Supreme Court of New York, assumed that all the allegations of the complainants were true, namely, that the Indian seller was engaged in a scheme to defraud the plaintiff. Hence the buyer did not face the difficulty of establishing the fraud which he alleged with sufficient certainty to

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<sup>191</sup> (1941) 31 NYS 2d 631.

satisfy the court. Based on the assumed facts that fraud had been committed in the transaction, the court rejected the bank's motion to dismiss the plaintiff's complaint and decided in favour of the plaintiff. The court held that 'in 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.' Following the *Sztejn* case, the Supreme Court of Canada in *Bank of Nova Scotia v Angelica-Whitewear*<sup>192</sup> unanimously recognized the fraud exception to the independent nature of the bank's obligation to the beneficiary. However, the application of the exception in terms of its scope has differed in some respect in different jurisdiction.<sup>193</sup>

## I. Scope of Fraud

Arguably, the Canadian courts' application of the fraud exception in documentary credit is wider than that of the English courts. The central issue is whether fraud should be restricted to documents or extended to the underlying transaction? For some time in England, the conventional view<sup>194</sup> was that the fraud exception confines its enquiry to documents presented by the beneficiary for payment.<sup>195</sup> This has been the position adopted by the English House of Lords in *United City Merchant v Royal*

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<sup>192</sup>(1987) CarswellQue 24.

<sup>193</sup> It was worthy to note that English approach to the fraud rule has been very restrictive as emphasis is placed much on preserving the commercial utility of the letter of credit.

<sup>194</sup> See the minority view as epitomised by the majority decision of the Court of Appeal in *Themehelp v West* [1996] QB 84. It has to be noted that this decision is in bank guarantee but with similar application to documentary credit.

<sup>195</sup> See House of Lords in *United City Merchants (Investment) Ltd v Royal Bank of Canada* [1983] 1 AC 168.

*Bank of Canada*<sup>196</sup>

However, the Canadian Courts have departed from the above position. In stating its fraud rule, it adopted a broad view that does not restrict the fraud to the tendered documents alone but will include fraud as evidenced in the underlying transaction. The exception broadly stated, was invoked in the Canadian case of *Rossen v Pullen*.<sup>197</sup> A woman who lived in Houston Texas agreed to live with and subsequently marry a man who resided in Toronto after about eleven months of cohabitation. Subject to the understanding that she would reside with him for the agreed period, an unconditional performance bond was opened in her favour. In flagrant abuse of the underlying agreement,<sup>198</sup> she presented a demand for payment within just a few days of the date when the performance bond had been arranged. Craig J relying on fraud in the underlying transaction held that the action of the defendant in calling on the bond within two business days of its receipt when prima facie she knew she was not entitled to the proceeds of the letter of credit before the agreed period of cohabitation had expired, constituted fraud.

In *Henderson v Canadian Imperial Bank of Commerce; Bruchet v Canadian Imperial Bank of Commerce*<sup>199</sup> the broad view of the fraud exception was also adopted. This case concerned an application for an interlocutory injunction brought by the plaintiff on ground of fraud. The plaintiff arranged an irrevocable letter of credit to fulfill his obligation relating to the purchase price of a unit entitlement in 20 episodes of two television shows from a production company. Although the shows were never

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<sup>196</sup> *ibid* at 168.

<sup>197</sup> (1981) 16 BCLR 28.

<sup>198</sup> An agreement that she will live with the applicant of the letter of credit for a continuous period of at least eleven months before she can call on the letter of credit.

<sup>199</sup> (1982), 40 BCLR 318.

produced before the production company went into bankruptcy, the receiver made demand on the bank for payment under the letter of credit. Berger J in granting the injunction and deprecating the approach of the English court held

Lord Diplock has rendered the exception in language that would limit it to cases where there is material misrepresentation of fact in the call documents. If the exception is to be understood in this way it means that the exception will be narrowed to the point of virtual insignificance... If Lord Diplock's statement of the exception to the rule is adopted, the exception becomes illusory. This court is not bound by the judgments of the courts in England, even those proceeding from highest authority.

Hence the position of the court is that the fraud exception applies to what amounts, in the particular circumstances of a case, to a fraudulent demand for payment, and it has been said that the exception should not be confined, as possibly suggested in *United City Merchants*, to fraud in the tendered document<sup>200</sup>

In the Canadian case of *Bank of Nova Scotia v Angelica Whitewear Ltd*,<sup>201</sup> Le Dain J also noted, 'In my opinion the fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but

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<sup>200</sup> See *Henderson v. Canadian Imperial Bank of Commerce* (1982) 40 BCLR 318 [4] where the court made reference to a demand for payment utterly without justification. See also *Bank of Nova Scotia v Angelica-Whitewear Ltd* (1987) 36 DLR 4<sup>th</sup> 161.

<sup>201</sup> (1987) 36 DLR 4<sup>th</sup> 161,182.

should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one . . . .<sup>202</sup>

It is submitted that if the rationale for the fraud exception is the law's public policy stance on the control of fraud, an approach which includes fraudulent misrepresentation in the presented document as well as material fraud in the underlying transaction is a better approach.

## II. Standard of Proof

As to the standard of proof of fraud required to establish the fraud exception, the Canadian courts initially started off adopting the English position as decided in *Edward Owen Engineering Ltd v Barclays Bank Ltd*,<sup>203</sup> namely that of clear and established fraud. In *Aspen Planners Ltd v Commerce Masonry and Farming Ltd*,<sup>204</sup> Henry J of the Ontario Supreme Court cited the *Edward Owen* standard of obvious fraud known to the bank and dismissed an application for an interim injunction to restrain the contractor from drawing down the final payments of the contract price under the letters of credit and an interim injunction to restrain the bank from paying under the letters of credit. The reason of the court was that there was no established fraud of which the bank had knowledge. In *Lumcorp Ltd v Canadian Imperial Bank of Commerce*<sup>205</sup> the court<sup>206</sup> shared the same position when reference was made to the

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<sup>202</sup> See Justice Blair affirming the position in *Angelica Whitewear in Cineplex Odeon Corp v 100 Bloor West General Partner Inc.* (1993) OJ No. 112 (O.C.J. Gen Div), See also *Bombardier Inc v Hermes Aero LLC* [2004] CarswellQue 2865.

<sup>203</sup> [1978] QB 159.

<sup>204</sup> [1979] 7 BLR 102.

<sup>205</sup> (1977) CarswellQue 77 [27].

<sup>206</sup> See *Lumcorp Ltd v Canadian Imperial Bank of Commerce* (1977) CarswellQue 77, [27].

case of *Discount Record Ltd v Barclays Bank Ltd*<sup>207</sup> as to the standard of obvious fraud.

However, more recent cases, have adopted a less onerous test of a ‘strong prima facie case’ of fraud on applications for interlocutory injunction, as exemplified by Galligan J in *CDN Research and Development Ltd v Bank of Nova Scotia*.<sup>208</sup> The case involved a contract for the delivery to the Iranian government of five fire-fighting vehicles. Performance was secured via a standby letter of credit arranged by the Canadian sellers, which could be called upon in the event of their failure to deliver. A demand was made, but evidence indicated that it was long after delivery. The sellers applied to have the bank enjoined from paying out and the injunction was granted.<sup>209</sup> The court reasoned that the potential harm of the plaintiff being defrauded without any realistic hope of redress weighed greater than the defendant bank’s potential harm of reputational damage in international banking circles.<sup>210</sup> Based on the foregoing reasoning of the court, it found a prima-facie proof of fraud sufficient to warrant an interlocutory injunction. This is contrary to the test of clearly established fraud advocated by the case of *Edward Owen Engineering Ltd v Barclays Bank Ltd*.<sup>211</sup>

In the leading Canadian case of *Bank of Nova Scotia v Angelica Whitewear*,<sup>212</sup> Le Dain J. drew a distinction as to the standard of proof required based on the stage and/or type of injunction being sought. On the issues of what the account party must

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<sup>207</sup> [1975] 1 Lloyd's Rep 444.

<sup>208</sup> [1981] 32 O.R. (2d) 578.

<sup>209</sup> The judge granted the injunction reasoning that given the political uncertainty in Iran, it was unlikely that the beneficiary would respond to the process of a Canadian court.

<sup>210</sup> See *C.D.N. Research and development Ltd v Bank of Nova Scotia* (1980) 32 O.R. (2d) 578; See also GA Fellingner, ‘Letter of Credit: The Autonomy Principle and Fraud Exception’ [1990] JBFLP 4, 20.

<sup>211</sup> [1978] QB 159.

<sup>212</sup> (1987) CarswellQue 24.

show to justify the conclusion that the issuer was not obliged to pay out under the letter of credit because of prior knowledge of fraud by the beneficiary, the court found a prima-facie proof of fraud as sufficient. In a unanimous decision of the Supreme Court of Canada, it was held that a strong prima facie case of fraud is sufficient on an interlocutory injunction.<sup>213</sup> However, on the application before the court, concerning whether the bank was entitled to reimbursement from the applicant when it has paid the beneficiary, it was held that the standard of fraud is that of established fraud. The reason is that since the bank had to exercise its own judgment as to whether or not to honour the draft, the test should be the stricter one as laid down in *Edward Owen*, namely: ‘whether fraud was so established to the knowledge of the issuing bank before payment of the draft as to make the fraud clear or obvious to the bank’.<sup>214</sup>

On the facts of this case, it was held that the inflation of the prices in the invoice by some 17 dollars per dozen above those agreed to in the underlying sales contract did constitute sufficient fraud. However, the evidence had not been clearly brought to the bank’s attention prior to payment and it had no duty to undertake its own investigation on such matters.<sup>215</sup>

### **3. 5.2. Singapore**

The Singapore court’s approach to the fraud rule has been consistent with the approach of the English Courts as there has been a serious effort to streamline its letter of credit fraud practice with the approach in *United City Merchants*. To this extent, *Brody White & Co Inc v Chemet Handel Trading (S) Pte Ltd*<sup>216</sup> confirmed the

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<sup>213</sup> *Bank of Nova Scotia v Angelica Whitewear* (1987) CarswellQue 24 at para. [17]

<sup>214</sup> *Bank of Nova Scotia v Angelica Whitewear* (1983) 40 BCLR 318.

<sup>215</sup> *ibid* 184.

<sup>216</sup> [1993] 1 SLR 65.

trend of restricting letter of credit fraud to fraudulent misrepresentation in the documents as the applicable position of the law in Singapore. However, the general approach of the Singapore jurisdiction to the exceptions to the principle of autonomy in documentary credit appears to have ignored one of the core reasons for English restrictive approach to fraud rule.<sup>217</sup>

## I. Scope of Fraud

As to the kind of fraud that will constitute an exception to the autonomy principle, the Singapore Court of Appeal in the case of *Brody, White & Co Inc v Chemet Handel Trading (S) Pte Ltd*<sup>218</sup> followed the position in the *United City Merchant*. The court held that the kind of fraud sufficient to constitute an exception to the autonomy of irrevocable credits is fraud in the presentation of the required documents to the bank, that is, where the beneficiary, for the purpose of drawing on the credit, fraudulently presents to the bank documents that contain material representations of fact that to his knowledge are untrue. Hence the court categorically held that fraud in respect of the underlying contract of sale would not affect the contract of documentary credit between the seller and the issuing/ confirming bank.<sup>219</sup>

The facts arose from a commercial relationship between Chemet Ltd (a Singapore Company) and Brody, White and Co (a US commodity trading company) in which a

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<sup>217</sup> One of the core reasons for the restrictive approach of the English court to fraud rule lies in the preservation of the integrity of banking contracts under which letter of credit contracts are independent of the underlying contract upon which they are based. Singapore jurisdiction, has adopted the approach of English courts as to the fraud rule but have recognized further exceptions like nullity. The recognition of the nullity exception appears contrary to the core reason why the courts in England restricted the fraud rule.

<sup>218</sup> [1993] 1 SLR 65.

<sup>219</sup> *ibid* 66.

letter of credit was utilized to finance a transaction between the parties. The appellants were commodity traders appointed by the respondents as their commodity brokers to trade in the New York Commodities Exchange and in the London Metal Exchange. Disagreements between the parties led to the appellant closing the market position of the respondent resulting in losses. The respondents commenced proceedings against the appellants for the loss suffered. The respondents also applied for an interim injunction to restrain the appellants from collecting or receiving any moneys under the letters of credit opened in their favour. The appellants filed a defence and counterclaim. The appellants also applied to discharge the interim injunction. However, Goh Joon Seng J ordered that the injunction was to be continued. The appellants appealed against the decision. The central ground of appeal was that the learned judge had failed to realize that a finding of fraud was the only ground for enjoining encashment of a letter of credit.

The Singapore Court of Appeal, allowing the appeal, held that the kind of fraud sufficient to constitute an exception to the autonomy of irrevocable credits is fraud in the presentation of the required documents to the bank. Fraud in respect of the underlying contract of sale would not affect the contract of documentary credit between the seller and the issuing/confirming bank.

On the facts of the case, the decision of the court should be applauded as it held that there was no letter of credit fraud. However, to hold that fraud in the underlying transaction does not form part of the fraud rule is with respect a judgment that could justifiably be argued to be flawed. It represents a misunderstanding of the fraud rule and its public policy stand for the prevention of fraud. Despite the Singapore courts

adopting the position in England that seeks to restrict fraud in the documents alone, recent case law<sup>220</sup> in England suggest that fraud in the underlying transaction is part of the fraud rule.

On a proper analysis of the grounds for judgment, it seems the reason for the decision solely lies in the House of Lords pronouncement in *United City Merchants v Royal Bank of Canada*.<sup>221</sup> The Singapore Court of Appeal relying on the *United City Merchants* held, ‘It would seem that fraud as perpetrated by the seller on the buyer in respect of the underlying contract of sale between them would not affect the contract of documentary credit between the seller and the issuing/ confirming bank.’<sup>222</sup> The pronouncement of the court, with respect appears to lack conviction, as it seems the court is not sure if the pronouncement of Lord Diplock meant that fraud in the underlying transaction is not part of the fraud rule.<sup>223</sup> It also seems to be out of position with modern documentary credit practice in other jurisdictions.<sup>224</sup> Also, persuasive in this regard is the Scottish case of *Royal Bank of Scotland v Homes*<sup>225</sup> where Lord Macfadyen in answering the question as to whether fraud inducing the underlying contract will “infect” the claim for payment, enabling the customer to resist the bank’s claim for reimbursement on the ground that fraud brought to the knowledge of the bank was furnished with adequate material evidencing that fraud before it met the beneficiary’s demand, made this insightful comment. ‘my initial

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<sup>220</sup> *Solo Industries Ltd v Canara Bank* [2001] 1 WLR 1800, [2001] EWCA Civ 1059.

<sup>221</sup> [1983] 1 AC 168.

<sup>222</sup> *Brody, White & Co Inc v Chemet Handel Trading (S) Pte Ltd* [1993] 1 SLR 66, 71.

<sup>223</sup> Compare this with the statement of the Canadian court in *Henderson v Canadian Imperial Bank of Commerce; Bruchet v Canadian Imperial Bank of Commerce* (1982), 40 BCLR 318.

<sup>224</sup> The US and Canadian courts appreciate that fraud in the underlying transaction of such a nature as to make mockery of the beneficiary right to payment is sufficient fraud that can entitle the beneficiary from getting payment under the documentary credit. Also recent English decision is suggesting recognition of fraud in the underlying transaction. See *Themehelp v West* [1996] QB 84, see also *Solo Industries UK ltd v Canara Bank* [2001] 1 WLR 1800, [2001]EWCA Civ. 1059.

<sup>225</sup> [1999] Scot Law Times 563.

impression was that fraud at that earlier stage would not support the fraud exception, but on reflection it seems to me that it might do so'<sup>226</sup> His lordship went on to reason that if fraud induced a party to enter into an underlying contract upon which a demand guarantee was issued, then the beneficiary's subsequent demand on the guarantee was in a derivative sense also fraudulent.<sup>227</sup>

However, if the approach of the Singapore court was to restrict the fraud rule in the same manner as in England, one would have thought that the reason why the English court adopted a restrictive approach to the scope of fraud would have been taken into consideration. The English approach tends to emphasize the autonomous nature of documentary credits and the importance of international trade. But the recognition in Singapore of another exception<sup>228</sup> to the autonomy of documentary credit calls for a re-thinking as to whether its jurisdiction actually favours the restrictive approach of the fraud rule as adopted by English Court. It is submitted that the recognition of another exception in Singapore is an indication that the court is not comfortable with the restrictive approach of the English fraud rule as a grounds for withholding the beneficiary from payment even though the decision of *Brody, White & Co* is to that effect. It suggests that its approach favours conditions that are not so restrictive as to encourage abusive drawing, bad faith and generally ignore what the credit calls for as well as the competing interest of the parties in the transaction.

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<sup>226</sup> *Royal Bank of Scotland v Homes* [1999] Scot Law Times 563,569.

<sup>227</sup> However, despite his insightful comment, he went to reserve his opinion as to whether fraud exception can be founded on fraud which induced the customer to enter into the underlying contract with the beneficiary.

<sup>228</sup> Note that the English court in keeping faith with its tradition of emphasizing the utility of documentary credit in international trade held that nullity exception was not part of English law. However, the Singapore court has recognised another exception to the autonomy principle. The recognition of the nullity exception is an attempt by the court to widen the scope upon which the autonomy principle can be set aside.

## II. Standard of Proof

The standard of proof needed to withhold payment under a documentary credit appears somewhat different from that of demand guarantees. As a result the position adopted in Singapore may call for a serious reflection as it has been far from being harmonious.<sup>229</sup> In line with its common law background, the courts seek to adopt the position in England. Hence, the Singapore Court of Appeal in *Korea Industry Co Ltd v Andoll Ltd*<sup>230</sup> held that for fraud to be adduced as a ground for withholding payment, it must be clear fraud. The court held that ‘where fraud was alleged at an interlocutory stage, there had to be clear evidence to support the allegation, with strong corroborative evidence in the form of contemporary documents; the buyer also had to be given an opportunity to answer the allegations and to have failed to answer adequately’.<sup>231</sup>

It is the position of the law that letters of credit stand on the same footing with performance bonds. However, in the case of *Chartered Electronics Industries Pte Ltd v Development Bank of Singapore*,<sup>232</sup> the Singapore High Court had the opportunity to consider the standard of proof required in fraud cases so as to enjoin the beneficiary from receiving payment. It held, choosing to adopt the position applicable in Canada,

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<sup>229</sup> For this purpose, two Singapore cases will be critically examined. One is the Court of Appeal case of *Korea Industry Co Ltd v Andoll Ltd*. [1989] SLR 134 and the other is *Chartered Electronics Industries Pte Ltd v Development Bank of Singapore*. [1992] SLR 655.

<sup>230</sup> [1989] SLR 134.

<sup>231</sup> *Korea Industry Co Ltd v Andoll Ltd* [1989] SLR 134, 135.

<sup>232</sup> [1992] SLR 655.

that the required standard of proof is not that of obvious or clear fraud but the less onerous ‘strong prima-facie case of fraud.’ The case relates to an application made by the plaintiff to continue two separate interlocutory injunctions, which, were obtained ex-parte restraining the defendant from paying any money under a performance guarantee and an indemnity issued by them on the grounds of the beneficiary fraud.

Keong J, of the Singapore High Court compared the test evident in the Canadian case of *CDN Research and Development Ltd v Bank of Nova Scotia*<sup>233</sup> of ‘strong prima-facie case of fraud’ with the standard of proof articulated by Lord Denning in *Edward Owen Engineering Ltd v Barclays Bank International Ltd. And Another*<sup>234</sup> (Standard of clear or obvious fraud) and held that ‘there is no reason why the less onerous test of a “strong prima case” should not suffice for instruments given purely to secure the performance of contracts.’<sup>235</sup> The learned Justice reasoned that a performance guarantee could be an oppressive instrument if abused. Such abuse is given encouragement if the court, by laying down a standard of proof at the threshold, which a plaintiff can seldom (if ever) cross, is often unable to grant relief.

He went further to state that in *Edward Owen Engineering*,<sup>236</sup> Lord Denning MR realized the dilemma of his own decision<sup>237</sup> as he was moved to observe that abuse was such a real possibility that ‘the English supplier, if he is wise, will take it [the 10% or 5% performance guarantee] into account when quoting his price for the

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<sup>233</sup> (1980) 18 CPC 62 (Ont.HC).

<sup>234</sup> [1978] QB 159.

<sup>235</sup> Ibid 668,[40].

<sup>236</sup> [1978] QB 159.

<sup>237</sup> See Geoffrey Lane LJ in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159, 175-176.

contract’.<sup>238</sup> In justification of his decision, he cited Smith J in *CDN Research and Development Ltd v Bank of Nova Scotia*<sup>239</sup> to the effect that ‘it may well be that the test of ‘clear fraud’ is too high for it takes us beyond the interlocutory into the realm of final determination. And more importantly, it purports to facilitate international transactions without sufficient regard for the clear signal that a refusal to enjoin may send to those who would engage in unscrupulous and fraudulent activities’.<sup>240</sup>

He concluded that the injunction would be extended on the grounds that the demand for payment under the performance guarantee by the buyers (defendant) was not made bona fide. As to the applicable standard of proof, the learned judge noted that ‘the test applied by Galligan J of a strong prima facie case appears to be more apt and is less onerous than that of Lord Denning in *Edward Owen Engineering Ltd v Barclays Bank International Ltd*,<sup>241</sup> of clear or established fraud.’

On proper reflection on the issues raised in the case and the decision reached, it appears inconsistent with the earlier Court of Appeal decision in *Korea Industry Co Ltd v Andoll Ltd*<sup>242</sup> that set the standard of clear and obvious fraud. As performance guarantees stand on the same footing with letter of credit in terms of applicable principles,<sup>243</sup> one would have thought that under the doctrine of precedent, the High Court in *Chartered Electronics Industries Pte Ltd v Development Bank of Singapore*<sup>244</sup> would have adopted the earlier position as enunciated in *Korea*

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<sup>238</sup> *ibid* 176.

<sup>239</sup> (1980) 18 CPC 62 (Ont.H.C.).

<sup>240</sup> [1992] SLR 655,669.

<sup>241</sup> [1978] QB 159.

<sup>242</sup> [1989] SLR 134.

<sup>243</sup> See *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159, which decision has been affirmed Singapore Courts.

<sup>244</sup> [1992] SLR 655.

*Industry's* case, which reflects the position of the Court of Appeal. However, it did not. The apparent inconsistency in decisions appears to be linked with the imprecise and unsatisfactory manner in which the issues of fraud and fraud rule in letters of credit have been handled in England.<sup>245</sup> But the inevitable consequence of the above scenario is that the position of the law as to the standard of proof in Singapore is far from being clear as conflicting decisions make legal clarity an illusion.

### 3. 5.3. Malaysia

Documentary credit fraud has not been a subject of detailed decisions in Malaysian Law.<sup>246</sup> Due to the want of detailed decisions on documentary credits, an effort will be made to use decisions on performance bond, which have been held<sup>247</sup> to stand on a similar footing with documentary credit to analyze the Malaysian position. To this extent, the Malaysian courts have recognized the existence of the fraud exception to the principle of autonomy in documentary credit. In *Nafas Abadi Holdings Sdn Bhd V Putrajaya Holdings Sdn Bhd &Anor*,<sup>248</sup> it was held that 'the performance guarantee stands on the similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the

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<sup>245</sup> The formulation of the standard of proof at least at the interlocutory stage has seen the use of phrases like "clear fraud", the "only realistic inference" good arguable case etc. The approach to fraud rule from the stand point of common law fraud, seems from the facts and decision in *United City Merchants case* to arguably restrict the fraud in letters of credit to fraudulent misrepresentation in the documents alone. The approach lays much emphasis on the principle of autonomy and the commercial utility of letters of credit and down plays the strong public policy requirement of the law in the prevention of fraud.

<sup>246</sup> There has not so far been case law discussing the proper scope and availability of the fraud exception in documentary credit law in Malaysia. In a few cases the courts in deciding cases of performance guarantee/performance bond/banker's guarantee have to a limited extent referred and discussed the autonomy principle and the fraud exception of documentary credit

<sup>247</sup> See *Edward Owen v Barclays Bank International* [1978] 1 Lloyd's Rep 166, 171 per Lord Denning MR where he said that performance guarantee stands on similar footing to a letter of credit.

<sup>248</sup> [2004] MLJU 148.

least with the relations between the parties to the transaction. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is where there is clear fraud of which the bank has notice'<sup>249</sup>

However, the understanding of the fraud rule in Malaysia has not been free from controversy. Judicial decisions in the area, with respect, seem inconsistent and irreconcilable. In some cases, authorities seem to favour the high standard of proof adopted in England. In others, there is the trend of following what is considered to be capable of doing justice in the particular circumstances<sup>250</sup> of each case, thereby lowering the standard of proof of fraud. An effort will made to discuss these issues under the heading of the scope of fraud and the standard of proof required in Malaysia.

## I. Scope of Fraud

No attempt has been made by Malaysian courts to set the scope of fraud capable of withholding payment under the fraud rule.<sup>251</sup> Will fraud only be evident in the document or will it include fraud in the underlying transaction? Secondly, what kind of fraud is capable of enjoining payment? For the purposes of the fraud rule in Malaysia, is fraud that is capable of enjoining payment akin to the common law tort of deceit,<sup>252</sup> as contended in England by some writers, or will it include the concept of

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<sup>249</sup> *ibid* 148, 151.

<sup>250</sup> The trend of making reference to unconscionability and what will do justice to each individual case when dealing with fraud exception to the autonomy principle may be an indication that Malaysian courts do not have a strict view that aptly defines the scope of the fraud rule.

<sup>251</sup> In most of the cases fraud is emphasized to be common law fraud and in some of the cases it is treated as if lack of good faith or no honest belief.

<sup>252</sup> See Roy Goode *Commercial Law* (Penguin, 2004) .

abusive drawing as some writers have posited? Many cases<sup>253</sup> have given an insight<sup>254</sup> into the way the fraud rule is construed in Malaysia. The trend in the line of decided cases in Malaysia suggests that the fraud that will entitle the issuing bank or the confirming bank to refuse payment to the beneficiary will not only relate to fraud as evident in the documents but will include fraud in the underlying transaction. The attitude of the courts has been that what will constitute fraud as to warrant an injunction has to be arrived at taking the whole circumstances of the matter into consideration.<sup>255</sup>

In *The Radio and General Trading Co Sdn Bhd v Wayss & Freytag*<sup>256</sup> the Malaysian High Court upheld the existence of the fraud exception and took the position that while an injunction could not be granted against a bondsman- in this case the bank-, it was available against the beneficiary to restrain him from calling on the bond in circumstance where he had no right to payment.

However, the position adopted in *Radio and General Trading* is contrary to the earlier position adopted by the Malaysian court in *Bains Harding (Malaysia) Sdn Bhd v Arab Malaysian Merchant Bank Bhd*<sup>257</sup> where the court readily granted an interlocutory injunction in favour of an account party to restrain the beneficiary of the bond from receiving payment under the performance bond on the basis that the defendants

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<sup>253</sup> See *Bains Harding (Malaysia) Sdn Bhd v Arab Malaysian Merchant Bank Bhd* [1996] 1 MLJ 425; *The Radio and General Trading Co Sdn Bhd v Wayss & Freytag* [1998] 1 MLJ 346, and also *LEC Contractors (M) Sdn Bhd v Castle Inn Sdn Bhd* [2000] 3MLJ 339.

<sup>254</sup> Understanding most Malaysian judgment is sometimes difficult as some of the cases have their decision in a local language. Their translations at times lack the coherence that is needed to understand some of the issues.

<sup>255</sup> *Nafas Abadi Holdings Sdn Bhd v Putrajaya Holdings Sdn Bhd & Anor* [2004] MLJU 148.

<sup>256</sup> [1998] 1 MLJ 346.

<sup>257</sup> [1996] 1 MLJ 425.

(beneficiary) were guilty of fraud and had acted in bad faith.<sup>258</sup> The facts were that the plaintiff contracted to carry out certain insulation and painting work as sub-contractors to the defendants in respect of the defendants' contract with the main contractor. The services were highly specialized which meant that only the plaintiff and very few others including a company called Meisei Corporation of Japan was capable of doing the work. Two performance bonds were provided by the plaintiff and issued by the first defendant (Malaysian Merchant Bank) in the form of guarantee.

The defendants subsequently terminated the contract, relying on a clause which provided that the contractor had a right at any time, for any reason and at its absolute discretion to terminate the contract by notice in writing. There was no allegation by the defendants that the plaintiff was in default in the performance of its work. After the termination of the contract, Meisei Corporation took over the plaintiff's work, and the defendants demanded that the plaintiff pay its creditors (the lower-tier subcontractors), failing which the defendants would seek payments under the bank guarantees. The plaintiff contended that the defendants were not entitled to make such claims. The plaintiff further argued that the defendants had conveniently terminated the contract, and gave it to Meisei Corporation with which the defendants had a financial connection, and that the defendants called on the bank guarantees to pay off the lower tier subcontractors so that Meisei Corporation could continue to utilize the lower tier subcontractors' services to complete its work, at the expense of the plaintiff.

Based on the above ground and pending trial of the issues in question, the plaintiff applied to the court for an interlocutory injunction restraining the defendants from

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<sup>258</sup> *ibid* 443.

accepting any money from the bank under the guarantees. The Malaysian High Court granted the injunction on grounds of the defendants' fraud and bad faith. On the facts of the case, the court's ruling has many implications. One, fraud cannot be restricted in the documents alone. Secondly, the approach to the fraud capable of enjoining payment is not common law fraud as there is a continuous reference to what is equitable. Also the readiness with which Malaysian courts are willing to grant injunction on grounds of perceived fraud of the beneficiary at the interlocutory stage raises doubt as to its appreciation and understanding of the English position of 'clear and established fraud' which, in most cases, the courts seek to adopt in many decided cases.<sup>259</sup> More so, granting an interlocutory injunction against the bank seems to have neglected many of the core reasons of the restrictive approach of the English Courts. It downplays some of the pertinent issues that have been raised in the English Court in line with the 'Siskina'<sup>260</sup> doctrine and balance of convenience test. In the granting of an interlocutory injunction against the bank, are the necessary questions being asked as to whether the account party has a cause of action against the bank which has a mandate to pay once a call has been made or complying documents has been presented?

As there is no Malaysian decision that has categorically ruled on the scope of fraud, an insight into the scope of fraud can only be inferred from the decisions so far held on fraud rule. Judging from the courts' penchant to use fraud and bad faith<sup>261</sup> sometimes interchangeably, and the consideration of whether a call or documentary

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<sup>259</sup> See *Nafas Abadi Holdings Sdn Bhd v Putrajaya Holdings Sdn Bhd* [2004] MLJU 148.

<sup>260</sup> See *Ibrahim Shanker Co. and Others v Distos Compania Naviera S.A. ("Siskina")* [1978] 1 Lloyd's Rep 1., where the issue of cause of action being a ground which a claimant must establish to merit an interim injunction was brought to light.

<sup>261</sup> *Bains Harding (Malaysia) Sdn Bhd v Arab Malaysian Merchant Bank Bhd* [1996] 1MLJ 425, 443.

presentation is inequitable<sup>262</sup> or not, it may not be unreasonable to contend that the scope of the Malaysian fraud rule extends to bad faith or equitable fraud. This in effect means that the Malaysian fraud rule may not be as restrictive as some of its decided cases suggest but will include a consideration of issues in the underlying contract to determine whether fraud exist.<sup>263</sup>

## II. Standard of Proof

The standard of proof of fraud is not very clear. In *Nafas Abadi Holdings Sdn Bhd v Putrajaya Holdings Sdn Bhd*<sup>264</sup> the court in answering the question of the required standard of proof for the grant of an injunction stated that the answer lies in the judgment of Ackner LJ in *United Trading*,<sup>265</sup> which is ‘have the plaintiffs established that it is seriously arguable, that on the material available, the only realistic inference is that the beneficiary could not honestly have believed in the validity of its demands on the letter of credit’.<sup>266</sup> However, the court after considering the standard approved by the dictum of Ackner LJ that it cited, went on to state its view in the following terms; ‘on the contrary, I consider the correct contractual inference that should normally be drawn is that the beneficiary will be entitled to draw on the letter of credit provided that he has a bona fide claim to payment under the underlying contract.’<sup>267</sup>

Though this statement does not properly reflect the actual standard of proof adopted

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<sup>262</sup> See *The Radio General Trading Co Sdn Bhd v Wayss & Freytag* [1998] 1 MLJ 346.

<sup>263</sup> See Suriyadi J in *Nafas Abadi Holdings Sdn Bhd v Putrajaya Holdings Sdn Bhd & Anor* [2004] MLJU 148. to the effect that the beneficiary will be entitled to draw on the letter of credit provided that he has a bona fide claim to payment under the underlying contract

<sup>264</sup> [2004] MLJU 148.

<sup>265</sup> [1985] 2 Lloyd's Rep 554, 561.

<sup>266</sup> *United Trading Corp SA v Allied Arab Bank* [1985] 2 Lloyd's Rep 554.

<sup>267</sup> [2004] MLJU 148 at 9.

by the court, the overall stance of the court in the case suggested an approach that did not favour the high standard of proof adopted by Ackner LJ in *United Trading*.

From the foregoing position of the court, it seems the standard of proof adopted by Ackner LJ is at variance with the inference drawn by the Malaysian High Court.<sup>268</sup> While the test of Ackner LJ promotes a high standard based on the common law proof of fraud; the reference made to 'bona fide claims' suggests an adoption of the equitable standard to the proof of fraud. The position thus adopted on the standard of proof seems to have departed from the earlier stand taken by the Malaysian courts<sup>269</sup> on the fraud exception. Hence, in *Kirames Sdn Bhd v Federal Land Development Authority*,<sup>270</sup> the court consistently referred to the test propounded by Ackner LJ in *United Trading Corp*<sup>271</sup> and Lord Denning *Edward Owen*<sup>272</sup> which points to clearly established fraud as the only requirement for a restraint on payment.

### 3. 6. Conclusion

The fraud exception to the principle of autonomy in documentary credits remains largely controversial in terms of definition and application. In English law, the perception that the fraud rule is akin to the tort of deceit is not established because letter of credit fraud can be established without the proof of the ingredients of reliance

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<sup>268</sup> Note the reference to the beneficiary being unable to draw on the letter of credit where there is no bona fide claim to it. Ackner's reference to established fraud is a mile away from the proof of the beneficiary's bona fide.

<sup>269</sup> See *Kirames Sdn Bhd v Federal Land Development Authority* [1991] 2 MLJ 198, *LEC Contractors Sdn Bhd v Castle Inn Sdn Bhd* [2000] 3MLJ 339.

<sup>270</sup> [1991] 2 MLJ 198.

<sup>271</sup> [1978] 1 All ER 976.

<sup>272</sup> [1985] 2 Lloyd's Rep 554.

and damages required to prove the tort of deceit. Hence a bank that has refused to pay the beneficiary as a result of fraud has not relied on any misrepresentation on the part of the beneficiary but is refusing payment because the representation is fraudulent. So, if there is a summary judgment application against the bank, to establish fraud, the bank need not show its reliance on the misrepresentation or that it has been damaged by it. Hence this may be an invitation to check the propriety of the assertion that letter of credit fraud is akin to the tort of deceit. It is submitted that, what is necessary to establish letter of credit fraud is to prove the dishonesty of the beneficiary in tendering the false documents.

The question of whether the fraud exception includes fraud in the underlying transaction is still open in England despite recent cases pointing towards recognizing fraud in the transaction as part of the fraud rule. However, the Singapore Court of Appeal<sup>273</sup> relying on the House of Lords decision in *American Accord* held that fraud in the transaction is not part of the fraud rule. If regard is had to recent trends in documentary credits practice in England, the Singapore Court of Appeal position on the fraud rule, despite its restatement of the English position as the position in Singapore may not represent the current state of the law in England.

In England, the task of establishing letters of credit fraud at the interlocutory stage becomes even more arduous by the usual insistence, on the requirement of clear fraud. Plausible as this requirement might be as it promotes the mercantile objective of the assurance of payment to the beneficiary without unnecessary recourse to minor underlying contractual disputes, it leaves one wondering whether such a requirement

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<sup>273</sup> See *Brody, White & Co Inc v Chemet Handel Trading (S) Pte Ltd* [1993] 1 SLR 66 at 68.

has not raised the level of proof to a point where its practical utility becomes illusory. In England, the fraud rule is part of the common law and to establish fraud, an enquiry into the mind of a suspected fraudster as to determine his intent, knowledge and dishonesty poses tremendous difficulty in terms of proof. As a result, a disturbing feature is that fraud is very difficult to prove even in the absence of good faith on the part of the defendant. However, in Malaysia, fraud is most often confused with bad faith and has encouraged what seems like a lower standard of proof.

Finally, the fraud rule in documentary credit will continue to be a source of conflicting application until there is uniformity of perception as to the two competing considerations. The differences of view with respect to fraud issues, particularly the kind of fraud and proof required, reflect the tension between the two principal policy considerations: the importance to international commerce of maintaining the principle of the autonomy of documentary credits and the limited role of an issuing bank in the application of that principle; and the importance of discouraging or suppressing fraud in letter of credit transactions. Until there is a clear signal as to which policy consideration is superior to the other, the era of conflicting decisions<sup>274</sup> and apparent irreconcilable treatment of the fraud rule is still far from being over. However, it is respectfully submitted that between the competing considerations, the public policy stand of the law in discouraging fraud should be encouraged. Hence Galligan J<sup>275</sup> posited: 'I do not think a Court can live in a vacuum and close its eyes completely to

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<sup>274</sup> Despite the current trend in England shifting toward the recognition of fraud in the transaction as being part of the fraud rule- (see Ali Malek and David Quest *Jack: Documentary credit* (4<sup>th</sup> Ed, Tottel 2009) at p.259 and *Solo Industries v Canara Bank* [2001] 1 WLR 1800) the Singapore Court of Appeal in *Brody, White* relied on the English decision in *United City Merchant case* to hold that fraud in the transaction is not part of the fraud rule. Compare *United City Merchant Case*, where fraud was restricted to documentary fraud with *Themehelp v West & Others* [1996] QB 84, where there was a consideration of the underlying transaction to grant an injunction against the beneficiary.

<sup>275</sup> *CDN Research and Development Ltd v Bank of Nova Scotia* (1980) 18 CPC 62.

world events;’ commercial fraud is on the increase and assuming boundless and unpredictable level of sophistry. If the trend is left unchecked by the rigid application of the fraud rule, the inevitable outcome might as well pose a more potent danger to the commercial utility of letter of credit.

## Chapter Four

### 4.0. Nullity

#### 4.1. Introduction

This chapter examines the nullity exception in documentary credits. It analyses the exception, having the primary objective to establish whether the nullity exception is or should be an exception to the principle of autonomy in documentary credit and whether it merits the recognition which a common law jurisdiction<sup>276</sup> and some commentators<sup>277</sup> have accorded it. In order to accomplish this task and further our understanding of the exception, it may be helpful to remind ourselves of a point raised in the introductory chapter in respect of the definition of documentary credit offered by Professor Kozolchik.<sup>278</sup> Documentary credit was once described by Professor Kozolchik<sup>279</sup> as a new type of mercantile currency embodying an abstract promise of payment, which possesses a high, though not total, immunity from attack on the ground of breach of duty of the seller to the buyer. This apt definition of documentary credits, for the curious mind, raises a further question inherent in the definition itself as to the circumstance(s) contemplated in the definition under which the high immunity evident in the

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<sup>276</sup> The exception has attracted judicial recognition in Singapore

<sup>277</sup> Scholars like Richard Hooley, Roy Goode and to some extent EP Ellinger have either voiced support for the exception or expressed in writing opinion which does not deny the existence of the exception. See RM Goode, *Commercial Law* (Penguin 2004) 996, R Hooley 'Fraud and Letters of Credit: Is there a Nullity Exception' (2004) CLJ 279, P Ellinger 'Documentary Credits' in A Guest (ed) *Benjamin Sale of Goods* (Sweet & Maxwell 2004).

<sup>278</sup> Kozolchik 'Letters of credit', Chapter 5 at pp138-143

<sup>279</sup> See Kozolchik 'Letters of credit', Chapter 5 at pp138-143, See also Goode 'Abstract Payment Undertakings' in P Cane and J Stapleton (eds), *Essays for Patrick Atiyah* (Clarendon 1991) pp 972, 989.

abstract promise to pay will be not total.<sup>280</sup> Established circumstances exist in documentary credits that are capable of breaching the autonomy (immunity of abstract promise) rule and it is undisputed in English law that fraud of the beneficiary displaces the abstract promise to pay the beneficiary or the impregnability of documentary credit.

Put differently, the abstract promise to pay is not immune from the fraud of the beneficiary in England. Despite the traditional English position (that it is only in the case of fraud of which the beneficiary is culpable that the impregnability of documentary credit could be broken), other issues (regarding the circumstances under which the impregnability of documentary credit could be displaced) continue to generate much judicial attention and debate within the courts and academic circles. One of those issues is whether a null document, presented by the beneficiary and or a third party is an independent ground, different from fraud, upon which the autonomy doctrine could be displaced. It is against this background that nullity (considered in Singapore as a separate exception to the principle of autonomy, but currently, at least in practice, rejected in England for constituting no separate exception) will be analyzed in this chapter.

The cases and judicial dicta generating the debate whether nullity is an exception to the principle of autonomy in documentary credit are demonstrably articulated mainly in two English decisions- *United City Merchant Ltd v Royal Bank of Canada*<sup>281</sup> and *Montrod Ltd v Grundkottner*.<sup>282</sup> The established view is that nullity

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<sup>280</sup> The word 'total' in this respect refers to the absoluteness of the abstract promise as seen in the autonomy doctrine and circumstances under which it could be displaced

<sup>281</sup> [1982] 2 WLR 1039, [1983] 1 AC 168.

<sup>282</sup> [2001] EWCA Civ 1954.

is not part of English documentary credit law. This view, reflected in judicial decisions in England represents the current position of English documentary credit law.

However, a thorough analysis of nullity as reflected in judicial dicta in English documentary credit law may point to some issues of nullity (as an exception to the principle of autonomy) still unresolved. This unresolved issue<sup>283</sup> regarding nullity together with the difficulty<sup>284</sup> inherent in utterly rejecting a separate nullity exception, necessitated a Singapore court to authoritatively hold that null document presented by the beneficiary in seeking payment under documentary credits are an exception to the principle of autonomy, and may lead an issuing bank/confirming bank presented with null documents to refuse payment to a good faith beneficiary in circumstances where his moral blameworthiness could not be established. This decision is apparently in conflict with established English authorities. However, despite its conflict with established English authorities, it raises crucial issues on the question of nullity in documentary credits that are the object of this chapter. What reason/rationale underpins the conflicting decisions reached by two common law jurisdictions on the same legal issue? Which position represents a better approach considering the nature of documentary credit and principles that govern its application in financial transactions? Is it possible to ascertain with identifiable clarity, the scope of a general nullity exception? What are the arguments, if any, in favour of a nullity exception in documentary credits and how they compare with

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<sup>283</sup> Whether there is room for judicial recognition of a separate nullity exception in documentary credits law. Also because Lord Diplock did leave the issue of nullity open in the *United City Merchants v Royal bank of Canada* [1983] 1 AC 168.

<sup>284</sup> Difficulty in the sense that null document does not generally become conforming document primarily because the presenter of the document is not implicated in any way in the document being a nullity.

the counter-arguments against its recognition? The above issues will be considered in detail in this chapter.

For the sake of structural clarity, the chapter is divided into five sections. Section 4.1, introduces the topic and highlights the structure and basis of the entire argument undertaken in the entire chapter. Section 4.2, discusses the nature of nullity exception. In discussing the nature of nullity exception, the analysis will draw from the perception of nullity in general law. The objective is to assess the extent to which the understanding of nullity in general law assists in giving clarity to the proper understanding of the concept as the basis of the exception to the principle of autonomy in documentary credits. . In Section 4.3, the crux of the analysis is to critically examine the merits and demerits of nullity as an exception to the principle of autonomy in documentary credit. Section 4.4, examines the sometimes difficult question of the applicable scope of the nullity exception in documentary credit. Here, the study will examine in detail some of the grounds that need to be met before a nullity exception would apply. In analyzing the scope, it considers to what extent, if any, the contention that a general nullity exception would be incapable of definition defeats the essence of the exception in documentary credit. Section 4.5, presents a conclusion based on the foregoing analysis.

## **4. 2. Nature of Nullity Exception**

This section discusses the meaning of nullity in two contexts. It examines the meaning and effect of nullity in general law. The analysis of nullity in general law

provides an introduction to the analysis of nullity in documentary credits. In the course of the chapter, the cases that have addressed the nullity exception will be used as a yardstick for analysing the merits of the contention (in subsequent sections) whether a general nullity exception has any future in the law of documentary credits.

#### **4. 2.1. Nullity in General Law**

Nullity in general law provides a seemingly difficult and complex legal puzzle<sup>285</sup> in terms of articulating precisely its meaning. To this extent, its use in law has been seen in different spheres with varied and at times conflicting meaning.<sup>286</sup> In general law, the use of the term nullity, in reference to many legal situations is not novel and it is accepted that there are different types of nullities, judging from the different ways in which the term has been used in legal situations. Take for example, the use of the term absolute and relative nullities are known in law to have varying legal consequences.<sup>287</sup> Apart from the consequences arising from distinguishing types of nullities, nullity is perceived to arise in law through a variety of ways. It could arise through mistake, lack of consent or incapacity. It also could arise through fraud, forgery or even illegality.<sup>288</sup> Despite the ways through which nullity could arise, ascertaining what a nullity is in general law remains a difficult question.<sup>289</sup> Looking at its literal meaning, it has been defined

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<sup>285</sup> Puzzle in the sense that nullity in the law could arise from many legal situations.

<sup>286</sup> At times, the difficulty of appreciating what it means stems from the varied and sometimes conflicting circumstances under which a document or a process has been described as a nullity.

<sup>287</sup> Absolute nullity referring to being completely void without remedy while the nullity that is relative could be seen as a defect in law that could be remedied

<sup>288</sup> C.Lefter and O.I. Dumitru “Theoretical and Practical Aspects Regarding the Nullity of Commercial Companies” in <http://www.ectap.ro/articole/422.pdf> accessed at 25/10/2010

<sup>289</sup> Most often what could be termed a nullity depends on the factual matrix of each individual case

differently though in many respect, the definitions share similar characteristics. Nullity is defined as ‘nothing, ... an act or proceeding in a cause which the opposite party may treat as though it had not taken place or which has absolutely no legal force or effect.’<sup>290</sup> It has also been seen as ‘want of force- efficacy, an error ... which is incurable, and this differs from an irregularity, which is amenable’<sup>291</sup> The meaning of nullity is perceived in a similar light to the legal phrase null and void. These words when used in a statute or legal document indicate that the usual expected legal consequences will not follow upon the act or thing in connection with which they are used. They are the exact contrary of the words ‘full force and effect.’

The central message that derives from these definitions is that nullity once established has the effect of invalidating the legal obligation and expectation of the parties. However, since ascertaining what a nullity is depends largely on the factual matrix of each individual case, opinion has been divided as to whether its use in law is helpful.

#### **4. 2.2. Nullity in Documentary Credits**

The issue of nullity in documentary credit<sup>292</sup> usually manifests itself in the form of documents that are perceived to be forged, valueless or false so as to destroy the essence of the document. Determining the extent of falsity in a document as to

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<sup>290</sup> Bryan Garner, *Black’s Law dictionary* [9<sup>th</sup> edn, Thomson Reuters 2009] 1179.

<sup>291</sup> *Wharton’s Law Lexicon*, 13<sup>th</sup> Ed. 1925.

<sup>292</sup> It is conceded that nullity in documentary credit is grossly undeveloped as there remains uncertainty as to what is or makes a document a nullity. See L. Chin and Y. Wong, ‘Autonomy A Nullity Exception at Last?’ (2004) LMCLQ 14, 17.

classify it as a nullity has been uncertain. Take for example, Devlin J. in *Kwei Tek Chao v British Traders and Shippers*<sup>293</sup> who described a misdated bill of lading as being 'valueless but not a complete nullity'.<sup>294</sup> Conversely Leggatt J. in *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies (The Raffaella)*<sup>295</sup> was of the opinion that a misdated bill of lading which additionally included a misstatement of the vessel's name as a 'sham piece of paper'.<sup>296</sup> The uncertainty with respect to what actually is a nullity appear to be at the root of the criticism levelled against recognising this exception.

However, the nullity exception (as well as other exceptions like fraud and illegality) in documentary credit is invoked to challenge the underlying reason for the autonomy principle- that the letter of credit is independent of the underlying contract in respect of which it is issued. It is this cardinal principle evident in the autonomy principle that forms the bedrock of the documentary credit. The principle as captured by Lord Diplock is to 'give the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract being used as a ground for non payment or reduction or deferment of payment'.<sup>297</sup> This autonomy principle ensured the smooth and speedy utilization of letter of credit with issues in the underlying transaction being no bar to immediate payment. However, to ensure that the principle of autonomy operates without problem in documentary credit, it is equally complimented by another crucial principle, that is the principle or doctrine of strict compliance. The compliance by the beneficiary strictly with the presentation requirements as stipulated in the strict compliance

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<sup>293</sup> [1954] 2 QB 459.

<sup>294</sup> *Kwei Tek Chao* [1954] 2 QB 459, 476.

<sup>295</sup> [1984] 1 Lloyd's Rep 102.

<sup>296</sup> *The Raffaella* [1984] 1 Lloyd's Rep 102 at 116.

<sup>297</sup> [1983] 1AC 168,183.

doctrine ensures that there is no recourse to the underlying sale contract with respect to payment for the goods.

These two doctrines (autonomy and strict compliance) have been neatly captured by stating that the letter of credit is independent from the underlying sale contract and that the beneficiary will be paid by the issuing/confirming bank provided that he presents documents that conform strictly to the requirement of credits. This principle operates regardless of any dispute that the seller may have with the buyer, for example in respect of the quality of the goods. Once the above principle is complied with, the beneficiary must be paid and the buyer/ applicant must seek his remedies against the beneficiary separately. A point that needs to be emphasized is that the principle of independence is intrinsically interwoven with the doctrine of strict compliance in order to be effective and produce the required certainty in documentary credits. Where this is so, is it correct to argue that the autonomy principle trounces all countervailing arguments<sup>298</sup> even where it could be established that a document has failed the compliance test by reason of being a nullity. To this effect, one of the key questions that will be pursued subsequently in this chapter is whether the principle of autonomy actually trounces all countervailing arguments where a presentation is a nullity. Put differently, whether the presentation of a document, which by the circumstances of that document is agreed to be a null document could be said to represent a conforming document stipulated by the credit. If it is not a conforming document by reason of failing the strict compliance test which is intrinsically interwoven with the autonomy doctrine as to make it effective, does the nullity exception not survive the autonomy doctrine?

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<sup>298</sup> This conclusion that the autonomy principle trounces all countervailing argument, including that of nullity has been emphasized recently by Professor Paul Todd. See P Todd 'Non-genuine shipping documents and nullities' (2009) LMCQ 547, 572.

It is in the above context that nullity is discussed as an exception to the principle of autonomy. It is an exception that is separate from fraud that arises as a result of fraud of the beneficiary of the credit in a situation where for example, he (beneficiary) has falsified the documents. Hence, the nullity exception arises where the document tendered is a nullity but the beneficiary is free from any fraud on his part. What is crucial in the nullity exception is that a tendered document is a nullity that has arisen through various ways. It could arise due to a mistake,<sup>299</sup> incapacity or lack of consent;<sup>300</sup> it could even arise through fraud,<sup>301</sup> forgery or illegality rendering a required document a nullity. Where this is the position, what then is the effect of the null document in documentary credit? Will the beneficiary still be paid regardless of the null document since it could not be established that he is guilty of any fraud on his part?

One of the strongest criticisms of the nullity exception is that it is imprecise in terms of definition. Part of the reason for the imprecision is that the concept of nullity is not developed in documentary credit law. However, this has not deterred the finding of nullity in documentary credit cases.<sup>302</sup> As early as 1993, Goh Phai Cheng<sup>303</sup> of the Singapore High Court has precisely identified the problem of nullity occasioned by the forgery of a document caused by an imposter. The court relied on the grounds that the documents were discrepant, but however observed that the nullity of the document

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<sup>299</sup> See *Heskell v. Continental Express Ltd* [1950] 83 LI L Rep 438, 455 (Col 2) where the loading brokers were mistaken as to the presence of the cargo and issued a bill of lading

<sup>300</sup> See *Montrod Ltd v Grundkötter Fleischvertriebs GmbH* [2001] All E.R. (Comm) 368 at 381, [2002] 3 All E.R. All ER 697 at 712.

<sup>301</sup> See *American Accord* [1983] 1 AC 168, albeit the fraud here is that of a third party.

<sup>302</sup> The case of *Beam Technology v Standard Chartered Bank* [2003] 1 SLR 597 was a trail blazer in this regard. Such view found in *Beam Technology* case still has the support of dicta from other legal decisions.

<sup>303</sup> See *Lambias (Importers & Exporters) Co v Hongkong & Shanghai Banking Corporation* [1993] 2 SLR 751.

would be a serious ground upon which payment could be denied to the beneficiary in circumstances where his moral turpitude could not be impeached.

The court noted in *Lambias Co v HSBC*<sup>304</sup> as follows, ‘In the present case, the QWI certificate cannot be said to be anything but a nullity. First, it was issued by the beneficiary instead of the applicant as required by the letter of credit. Secondly, it failed to state the necessary particulars to relate it to the goods which were the subject of the letter of credit. Thirdly, it failed to contain the necessary statement as to the quality or weight of the goods ostensibly inspected, and most important of all, it had been counter-signed by an imposter and not by the party appointed to sign it. All these elements taken together made the QWI certificate a nullity ab initio. There was no question of the certificate having been accepted by any party as a valid document’.<sup>305</sup>

The decision in *Lambias (Importers & Exporters) Co v Hongkong & Shanghai Banking Corporation*<sup>306</sup> indicates that the court considers some issues in determining whether a document is a nullity. The extent and nature of the falsity in a document are factors that the courts are likely to consider in determining if a document is an utter nullity.<sup>307</sup> It has been suggested that, if the falsity in the document destroys the ‘whole or essence of the instrument,’ it will be considered a nullity.<sup>308</sup>

Also in the *American Accord*, Lord Diplock remarked that it may be that the *American Accord* does not apply to a document which is a nullity, a document ‘so worthless to the confirming bank as a security for its advances to the buyer.’ Hence Lord Diplock described a null document as such document whose fault deprived it of

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<sup>304</sup> [1993] 2 SLR 751.

<sup>305</sup> Ibid at 762-763 (Emphasis added).

<sup>306</sup> [1993] 2 SLR 751.

<sup>307</sup> Chin and Wong, ‘Autonomy- A Nullity Exception At Last’ (2004) LMCLQ 14, 17.

<sup>308</sup> A. Guest *Benjamin's Sale of Goods*, (6th edn , Sweet & Maxwell 2002) para.19-034.

all legal effects.<sup>309</sup> Regarding the document tendered, Lord Diplock opined as follows, ‘the bill of lading with the wrong date of loading placed on it by a carrier’s agent was far from being a nullity. It was a valid transferable receipt for the goods giving the holder a right to claim them at their destination... and was evidence of the terms of the contract under which they were carried.’ It was evident from the above passage of Lord Diplock that since the incorrect date of loading did not prevent the document tendered from performing the essential function of a bill of lading, it could not have been said to be a nullity.

The lesson supposedly derived from Lord Diplock’s statement is that what constitutes a nullity in that circumstance depends to a large extent on the legal right conferred on the holder of the bill against the carrier. If it still properly confers on the holder of the bill, the right to claim the cargo on arrival, it could, by implication not be said to be a nullity because of the incorrect date of shipment. The justification for this is that the incorrect date on the bill of lading in the circumstance (the right to claim the cargo on presentation of the bill of lading was still available to the holder of the bill) does not deprive the document of all its legal effects.

On the above parameters set by Lord Diplock, a bill of lading for an invented ship and cargo would be a classical example of nullity, since it would clearly not perform any of the functions identified by Lord Diplock in the above passage.<sup>310</sup> Based on the same reasoning of Lord Diplock, a document would be a nullity if a bill of lading incorrectly identifies a ship or bears a forged master’s signature. It could also be a nullity if it was entirely forged for a non existing cargo on an existing ship since the

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<sup>309</sup> [1983] 1 AC 168.

<sup>310</sup> For more clarity to this, See P Todd ‘Non-genuine shipping documents and nullities’ (2009) LMCLQ 547, 561.

document could not bind the carrier or perform any of the functions identified above. The analysis of what amounts to a nullity as seen above depends on the factual matrix of each individual case and goes to prove that there are situations when what amounts to a nullity is not difficult to define as contended by some authorities.<sup>311</sup>

#### **4. 2.3. Different Jurisdictions- Issues and Legal Positions**

To enhance a proper understanding of the nullity exception and the issues raised, the position of the different jurisdiction will be set out below.

##### **4. 2.3.1. English Position**

In English law, the nullity question that went beyond the fraud exception was deliberately left open by Lord Diplock in the House of Lords in the case of *United City Merchant Ltd v Royal Bank of Canada*.<sup>312</sup> However, the most current pronouncement on this issue was made by Potter LJ in 2001 in the case of *Montrod Ltd v Grundkotter Fleischvertriebs GmbH*,<sup>313</sup> where his Lordship held that there is no general nullity exception in English law whether as a separate ground or as an extension of the fraud exception. The facts involved a document presented under a letter of credit, which had been signed by the beneficiary believing that it was authorized to do so by the applicant. Here, the applicant (Montrod) in the letter of credit was an English finance company that financed the purchase of frozen pork meat by a Russian buyer. One of the documents required under the credit was an inspection

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<sup>311</sup> The difficulty of definition has been put forward as one of the strong reasons against the nullity defence.

<sup>312</sup> [1983] 1AC 168.

<sup>313</sup> [2001]EWCA Civ. 1954, [2002]I ALL ER (Comm) 257.

certificate signed by the applicant. This was a device to ensure that the applicant (*Montrod*) was put in funds by the beneficiary to cover its liability when the credit was operated. The Russian buyer informed the seller that one of its employees should sign the inspection certificates on behalf of *Montrod*. The seller honestly believing that it had the applicant's authority to sign the credit, presented certificate so signed. The frozen pork meat was delivered to the buyer in Moscow. However, between the date of presentation and the date of payment, it became clear that the applicant had not given its authority for the seller to sign the certificates. The issuing banker decided to pay the beneficiary, but the applicant disputed its right to reimbursement. The applicant's (*Montrod*) nullity arguments were that the inspection certificates were a nullity despite the absence of fraud on the part of the beneficiary and that, since the bank was aware of the nullity before payment, it was not entitled or bound to make payment to the seller.

Both the court of first instance and the Court of Appeal rejected the argument on the ground that the 'nullity exception' which was argued to operate even in the absence of fraud on the part of the beneficiary, formed no part of English law.

The first instance judge, HHJ Raymond Jack QC, was of the view that the applicant's position was neither supported by authority nor the UCP 500, the terms of which were imported into the credit, and held that the seller was entitled to payment under the credit and the issuing banker was entitled to reimbursement from the applicant.<sup>314</sup> The Judge observed that the proposition 'provides a further complication where simplicity

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<sup>314</sup> See *Montrod Ltd v Grundkottler Fleischvertriebs GmbH* [2001] 1 ALL ER (comm.) 368.

and clarity are needed. There are problems in defining when a document is a nullity. The exception has unfortunate consequences in relation to the right of third parties.’<sup>315</sup>

In the Court of Appeal Potter LJ, who gave the only judgment, and with whom the other members of the court concurred, stressed that there were ‘sound policy reasons’ for rejecting a general nullity exception. He opined that in the law relating to letters of credit, precision and certainty were paramount, and ‘the creation of a general nullity exception, the formulation of which does not seem...susceptible to precision, involves making undesirable inroads into the principle of autonomy and negotiability universally recognised in relation to letters of credit transaction’. He also noted that if a general nullity exception were to be introduced, ‘it would place banks in a further dilemma as to the necessity to investigate facts, which they are not competent to do and from which the UCP 500 is plainly concerned to exempt them’. Further, a nullity exception ‘would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question,’ and such development would ‘undermine the system of financing international trade by means of documentary credits’.<sup>316</sup>

#### **4. 2.3.2. The Position in Singapore**

The basis of the decision<sup>317</sup> in the *Montrod’s case* presented itself in another jurisdiction in the Singapore Court of Appeal case of *Beam Technologies v Standard*

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<sup>315</sup> [2001] All ER (Comm.) 368, 381.

<sup>316</sup> See *Montrod Ltd v Grundkötter Fleischvertriebs GmbH* [2002]3 All ER 697, 712 para58.

<sup>317</sup> That is whether nullity of the document presented by beneficiary in circumstance where he is not implicated in any fraud could be an independent ground upon which payment could be refused that is separate from fraud.

*Chartered Bank*.<sup>318</sup> Here the court took a contrary position to that adopted in England. In a very bold and novel manner, the court upheld the nullity exception and held that there is a nullity exception, separate and distinct from the established fraud exception. The situation in which the Court of Appeal was prepared to recognise the nullity exception is best stated thus:

It is our opinion that the negotiating/ confirming bank is not obliged to pay if it has established within the seven- day period that a material document required under the credit is forged and null and void and notice of it is given within that period<sup>319</sup>

Hence, the issuing/ confirming bank is entitled to reject payment, apart from fraud on the part of the beneficiary, on the basis that the documents presented are forged and therefore an utter nullity.

### **The Facts**

In the case of *Beam Technologies*, a letter of credit was opened by an Indonesian buyer, PT Mulia Persada Permai (“the buyers”) in favour of Beam Technologies (Mfg) Pte Ltd (“sellers”); a Singapore company. The letter of credit was to facilitate the sale of electronic components. The buyers obtained the issue by PT Bank Universal HO Jakarta (“PT bank”) of a letter of credit for the sum of US \$277, 500 in favour of the sellers. This was subject to the terms of the UCP 500. Standard Chartered Bank confirmed the credit. One of the documents required under the credit was a ‘full set of clean air waybills’. The buyers notified the sellers that the air waybill would be issued

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<sup>318</sup> [2003] 1 SLR 597, See also *Beam Technologies v Standard Chartered Bank* [2002] 2 SLR 155 (Sing HC).

<sup>319</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597 at [36].

by their freight forwarders, 'Link Express Pte Ltd.' When the seller presented the documents, the confirming bank rejected them on the ground that the air waybill was a forgery because Link Express Pte Ltd., the freight forwarders who purportedly issued the air waybill, was a nonexistent entity. The seller brought an action against the confirming bank to claim payment under the letter of credit. The question for the determination of the court as recast by the Court of Appeal could be summarized as follows: can a confirming bank, in a case where there is no discrepancy in the document tendered, nevertheless refuse payment because they have reliably established that a material document is forged even where the seller/ beneficiary was innocent of the forgery, having obtained and tendered the document in good faith?<sup>320</sup>

The Singapore Court of Appeal took a robust approach in addressing this issue. The court observed that only two English cases had expressly dealt with the issue before them- the *United City Merchants* and the case of *Montrod*. However, the court was of the view that neither of these cases was a direct authority on the question. The House of Lords in *United City Merchants* deliberately left the existence of the nullity exception open. Though the Court of Appeal's decision in *Montrod* seems to be an authority in the negative, the Court of Appeal in *Beam Technologies* distinguished the Court of Appeal decision in *Montrod* on the ground that it concerned a bank's obligation to pay against an unauthorized document, that is, a certificate issued by the seller in honest belief that he had the authority to so act, as opposed to a null document, that is, a document that is forged and of no legal effect. Secondly, Chao Hick Tin JA also noted that, while the autonomy principle and the commercial requirement of international trade financing necessitate the issuing/confirming bank to

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<sup>320</sup> See *Beam Technologies*[2003]1 SLR 597.

pay against apparently compliant documents, such that the banks are entitled to reimbursement even if those documents subsequently turn out to be false,<sup>321</sup> it does not follow that the issuing/conforming bank is obliged to pay against documents which the bank can establish conclusively at the time of presentation to be false.

The court's most visible justification for the finding that there existed a nullity exception that is distinct from fraud in *Beam Technologies v Standard Chartered Bank*<sup>322</sup> is evident in this compelling statement of the Singapore Court of Appeal where Chao JA opined that:

To say that a bank, in the face of a forged, null and void document (even though the beneficiary is not privy to that forgery), must still pay on the credit, defies reason and good sense. It amounts to saying that the scheme of things under the U.C.P 500 is only concerned with commas and full stops or some misdescriptions, and that the question as to the genuineness or otherwise of a material document, which was the cause of the issue of the letter of credit is of no consequence.<sup>323</sup>

The Court further emphasized that implicit in the requirement of a conforming document is the assumption that the document is true and genuine.<sup>324</sup> As noted by Teck JC, in the court of first instance, a forged document is not a "document" at all and is indistinguishable from a 'blank piece of paper'.<sup>325</sup>

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<sup>321</sup> See *Gian Singh & Co Ltd v Banque De L'Indo chine* [1974] 2 Lloyd's Rep 1.

<sup>322</sup> [2003] 1 SLR 597.

<sup>323</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597 para. 33

<sup>324</sup> *ibid.* at para. 33.

<sup>325</sup> [2002] 2 SLR 155 [12].

#### 4.2.3.3. United States of America

On the basis of the Revised Article 5-109, of Uniform Commercial Code (UCC) the United States jurisdiction recognises that the forgery resulting in nullity of document is a ground upon which the autonomy principle could be displaced. Art. 5 -109 (b) which supports the nullity exception states as follows: 'If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons ...'.<sup>326</sup> It is evident from the above wording of Uniform Commercial Code (UCC) that a required document that is forged is a ground for enjoining payment regardless of whether the forgery is that of a third party or the beneficiary. The emphasis is on the required document being a forgery. Hence, art.5-109 of UCC in defining the context in which payment may be withheld recognises the nullity exception.

However, decided cases in America are yet to acknowledge the above provision of the UCC by expressly holding that nullity exception is part of United States Law.

#### 4.3. The Nullity Arguments

Since the English case of *Montrod v Grundkottter*<sup>327</sup> has arguably discountenanced the nullity exception, despite its recognition by the Singapore court in *Beam*

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<sup>326</sup> Art. 5- 109 (b).

<sup>327</sup> 257 [2002] CLC 499, [2001] EWCA Civ 1954, [2002] 1 WLR 1975, [2002]3 All ER 697 [2002] 1 All ER (Comm) 257.

*Technology*,<sup>328</sup> the apparent basis for these parallel decisions have generated an argument either for or against the nullity exception. This section explores these arguments with the aim of determining to what extent, if any, a compelling case can be made for the nullity exception in documentary credit. It is observed that the arguments supporting the nullity exception may well be primarily justified on the wider basis of non-conformity of documents. This approach has the merit of keeping distinct the exception arising from beneficiary fraud and the obligation and right to refuse payment on ground of non-conformity of the documents.

#### **4.3.1. Arguments against the Nullity Exception**

The arguments against the nullity exception will be considered first. The issues analysed, which constitute the reasons for the rejection of the nullity exception would form a springboard to explore the arguments in favour of the nullity exception.

##### **4.3.1.1. Want of Certainty**

The most enduring reason for rejecting the nullity exception in England has been the lack of certainty argument. This reason was evident in the Court of Appeal decision of *Montrod Ltd v Grundkötter Fleischvertriebs GmbH*,<sup>329</sup> where Potter LJ noted that in the law relating to documentary credit, precision and certainty were paramount; the creation of a general nullity exception, the formulation of which does not seem susceptible to precision, involves making undesirable inroads into

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<sup>328</sup> [2003] 1 SLR 597.

<sup>329</sup> [2002] 1 WLR 1975.

the principle of autonomy and negotiability universally recognized in relation to letter of credit transactions.<sup>330</sup>

Some reasons account for the want of certainty argument. One of such reasons is the problem of defining with precision when a document is a nullity. Rejecting the exception for want of certainty could arise from the problem of defining when a document is a nullity. The apparent difficulty in this area could be seen in the different definitions that already exist as to what a null document is. Lord Diplock described a null document as ‘such a document whose fault deprived it of all legal effect’.<sup>331</sup> The basis for the formulation of this definition of nullity is that the bill of lading in the *American Accord*, though apparently altered to reflect an incorrect date of shipment, was however a valid receipt which entitled the consignee to the goods at the port of discharge. Hence, the fraudulent alteration of the bill of lading by the loading broker of the date of shipment did not completely deprive the document of all legal effects. The difficulty with this definition is the criteria for ascertaining when the document would be said to be deprived of all its effects. Does it relate to the procedure for obtaining the document or does it pertain generally to the substance of the document?

The above difficulty was apparent in *Heskell v Continental Express Ltd*,<sup>332</sup> where Devlin J, described an issued bill of lading as a nullity in the absence of any apparent fraud<sup>333</sup> but on the ground that, though the ship and cargo existed, the cargo had been left behind. The bill of lading covering the cargo where the cargo

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<sup>330</sup> [2002] 1WLR 1975 at 58.

<sup>331</sup> [1983] 1 AC 168 at 187.

<sup>332</sup> (1950) 83 LI 1 Rep 438 at 455.

<sup>333</sup> It appeared from the facts of the case that the loading brokers were simply mistaken

has been mistakenly<sup>334</sup> left behind was described as a nullity. The position in *Heskell* was described as a nullity despite the apparent lack of fraud. A contrasting situation was evident in *Kreditbank Cassel GMBH v Schenkers Limited*<sup>335</sup> where Bankes LJ described a bill of lading as a nullity just because the signature was proved to be obtained through fraud of the company denying liability.<sup>336</sup> In the case of fraud, it has to be noted that the nature of fraud is also crucial as it relates to whether it makes the documents a nullity. In *Kwei Tek Chao v British Traders and Shippers Ltd*,<sup>337</sup> Devlin J held a bill of lading that had been fraudulently backdated, though not by the CIF seller, not to be a nullity. The rationale for this decision was that the alteration did not go the whole essence of the document.

A thorough investigation into some of the cases dealing with whether a document is a nullity reveals the difficulty associated with attempting such legal analysis. Crucially, if there is difficulty in ascertaining when a document is a nullity, it may be reasonable to infer that such attempts (whether failed or successful) would introduce some degree of uncertainty in the law. However, compelling as this assertion might seem, it neglects what is crucially part of the legal process. Many legal processes are in fact not certain and some of the uncertainty and illusoriness of the legal process are understood based on the facts of each particular case. As posited by the Court of Appeal judgment in the *Beam Technologies* case, questions of nullity are not that much more difficult to answer than the question whether something is reasonable, an assessment that courts are used to making.<sup>338</sup> Here the ‘thrombosis of international

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<sup>334</sup> It is not evident in the facts of the case that the loading brokers were guilty of fraud.

<sup>335</sup> [1927] 1 KB 826.

<sup>336</sup> The company argued that the forgery was the unauthorized act of one of its branch managers

<sup>337</sup> [1954] 2 QB 459.

<sup>338</sup> [2003]1 SLR 597 at [36].

trade',<sup>339</sup> resulting from want of certainty, caused by more cumbersome and less efficient banking verification procedures seems to have been exaggerated. The bank would not be in any worse a situation than that already faced by it in a situation when there might be fraud on the part of the beneficiary under the fraud exception. Looking at Potter LJ's judgment in *Montrod* case, part of the solution to the problem is contained in that decision. The Court of Appeal made the point that in the context of the fraud exception, a bank was not expected to make its own enquiries about allegations of fraud brought to its notice. The court opined that if a party wished to establish that a demand was fraudulent, it had to place before the bank evidence of clear and obvious fraud.<sup>340</sup> There is nothing that stops the same rule being applied to a nullity exception. It may be noted that even in *Beam Technologies* where the court recognised the 'nullity exception,' it was stated that that the bank would not be expected to make any investigations other than to examine the documents and see that they conform to the credit.<sup>341</sup> *Dora Neo*<sup>342</sup> considered the bank's duty as regards the nullity exception and noted that:

The nullity exception would merely mean that when a bank is satisfied (because it has come to its notice by whatever means) that a required material document is clearly a nullity, it need not pay even if the documents on their face conform to the credit. In any case, the idea of protecting banks from the dilemma of whether to investigate facts or to pay is not relevant in cases where the bank is not in any dilemma because it is sure that a material document is

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<sup>339</sup> See Donaldson J. *The Bhoja Trader* [1981] 2 Lloyd's Rep 256, 257.

<sup>340</sup> [2002]3 ALL ER 697, 712 [58].

<sup>341</sup> [2003] 1 SLR 597 at para. 34. This is the same as the position under the fraud rule exception. See *Turkiye Is Bankasi A.S v Bank of China* [1996] Lloyd's Rep 611, affirmed [1998] 1 Lloyd's Rep 251

<sup>342</sup> See *Dora Neo*, 'Nullity exception in Letters of Credit' (2004) SING LS 46, 7.

forged and a nullity and wishes to withhold payment. The lack of nullity exception in such cases is a hindrance rather than a help.<sup>343</sup>

Another variant of the certainty argument is the contention that there will be great difficulty in defining what constitutes nullity in the first place. Opponents of the nullity exception have posited that whether a document is a nullity or not is a real issue a bank often faces and the difficulty in determination may be compounded where the documents presented are of varying degrees of nullities, e.g., where only certain alleged facts on the document are false as opposed to the whole document being forged.<sup>344</sup>

Take for an example, how false must a bill of lading be in order that it constitutes a serious nullity to justify a bank's rejection? Devlin J. in *Kwei Tek Chao v British Traders and Shippers*<sup>345</sup> was of the opinion that a misdated bill of lading is 'valueless but not a complete nullity'.<sup>346</sup> This could be contrasted with the position taken by Leggatt J in *The Raffaella*<sup>347</sup> who described a misdated bill of lading which additionally includes a misstatement of the vessel's name as a 'sham piece of paper'.<sup>348</sup> The approach adopted by the *Beam Technologies* case was that the question of what document is a nullity is one that ought to be answered based on the factual context of the underlying transaction.<sup>349</sup> However, there are situations where a document sought to be presented could be established within the time available to the bank to be a null document with the bank having little or no dilemma as to its duty.

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<sup>343</sup> *ibid* 7.

<sup>344</sup> See generally, LY Chin and YK Wong 'Autonomy- A Nullity Exception At Last' (2004) LMCLQ 14.

<sup>345</sup> [1954] 2 QB 459.

<sup>346</sup> *ibid* 476.

<sup>347</sup> See *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies (The Raffaella)* [1984] 1 Lloyd's Rep 102.

<sup>348</sup> [1984] 1 Lloyd's Rep 116.

<sup>349</sup> [2003] 1 SLR 597, at para.36.

#### 4. 3.1.2. That the Principle of Autonomy should generally prevail

This point against the nullity exception has been recently made by Professor Todd,<sup>350</sup> who, relying on the *American Accord*, argued in a recent article that the logic of the autonomy principle trounces all countervailing arguments regarding the application of the nullity defence.<sup>351</sup> He reasoned that the autonomy principle works on the assumption that parties to a documentary credit contract on the basis that the bank would neither wish nor be able to concern itself with disputes under the underlying transaction, and the seller's assured right to payment should be independent of the underlying contract. Proceeding on this basis of the independence of the contracts, he reasoned that the rationale of the autonomy principle is inconsistent with the application of the nullity exception.<sup>352</sup> But inherent in the requirement for the exceptions in documentary credit is the incontestable notion that in certain condition the otherwise impregnability of documentary credit could in certain circumstances be displaced. This point was noted as far back as 1941 in *Sztejn v Henry Schroder Banking Corporation* where the court restated the autonomy principle but stated that 'Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, ...when the issuer of a letter of credit knows that a document, although correct in form, is, in point of

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<sup>350</sup> See P Todd 'Non-genuine shipping documents and nullities' (2009) LMCQ 547,572.

<sup>351</sup> *ibid* 572.

<sup>352</sup> See P Todd 'Non-genuine shipping documents and nullities' (2009) LMCQ 547, 554. This point was restated by JC Chuah in *Law of International Trade, Cross Border Commercial Transaction* (4<sup>th</sup> edn, Sweet & Maxwell 2009) 537.

fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit',<sup>353</sup>

In similar vein, Lord Diplock in the *American Accord*, after restating the autonomy principle, recognised that certain grounds could displace it. The exception of fraud was founded on the principle that fraud unravels all. In the same case, Lord Diplock left open the issue of whether nullity of document should be a separate ground on the basis of which the impregnability of documentary credit could be displaced. That a certain kind of nullity was capable of breaching the autonomy principle was remotely evident in Lord Diplock's dictum when his Lordship stated 'But even assuming the correctness of the Court of Appeal's premise as respects forgery by a third party of a kind that makes a document a nullity for which at least a rational case can be made out, to say that this leads to the conclusion that fraud by a third party which does not render the document a nullity has the same consequence appears to me, with respect, to be a non sequitur.' It is evident from this statement that Lord Diplock accepted that a rational case could be made out of certain kind of forgery by a third party that rendered the document a nullity. This implicit admission was regardless of Lord Diplock's restatement of the autonomy rule. It then, becomes really difficult to see from the foregoing how the autonomy principle should trounce all arguments regarding the nullity exception in documentary credit. The autonomy principle, while designed to protect the seller from defences based on the underlying sale contract, does not mean that the seller should also be protected from defences that are related to the documents themselves.<sup>354</sup> Accordingly, it is suggested that a third party fraud in

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<sup>353</sup> See also, *Old Colony Trust Co v Lawyers' Title & Trust Co.*, 2 Cir. 297 F. 152, 158, certiorari denied 265 U.S. 585, 44 S.Ct. 459, 68 L.Ed. 1192.

<sup>354</sup> Dora Neo, 'A Nullity Exception' (2004) SJLS46, 67. See also K Donnelly 'Nothing for Nothing: a Nullity Exception in Letters of Credit?' (2008) JBL 316.

relation to a document that renders it a nullity must surely be linked to the document itself rather than a matter confined to the underlying contract.<sup>355</sup>

#### **4.3.1.3. The Absence of the Logic of *Ex Turpi Causa* Doctrine in Nullity Exception**

One of the arguments put forth recently against the nullity exception by Professor Todd is that in the fraud exception, the logic of the *ex turpi causa* doctrine demands that the bank should only take the risk of refusing payment where fraud is involved.<sup>356</sup> His reasoning is that the fraud exception operates as an application of the principle of public policy, rightly intended to prevent proven fraudsters from claiming payment. He further argues that no such public policy applies in the case of a nullity where a non-fraudulent beneficiary tenders an apparently conforming document which happens to be a nullity. There are many reasons why this argument with respect might not be tenable. If the logic of the *ex turpi causa* rule justify the fraud exception, why will a null document which results from the fraud of a third party not have the same effect? It may not be relevant to distinguish whether the fraud is that of the beneficiary or not. Since, in some instances of nullity, fraud or forgery may be involved, this *ex turpi causa* argument does not survive those instances of nullity where the null document results from the fraud or forgery of some sort. It is likely that cases where the nullity of document results from a non- fraudulent act may be

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<sup>355</sup> Dora Neo, 'A Nullity Exception' (2004) SJLS 46, 67.

<sup>356</sup> P Todd, 'Non Genuine Shipping Documents and Nullities' (2009) LMCQ 547.

difficult to justify with respect to the *ex turpi causa* rule.<sup>357</sup> It is submitted that though this kind of situation is likely to exist, its existence should not deter the finding of nullity where it involves a fraudulent act.

#### **4.3.1.4. Seller/ Beneficiary being in a Worse Position than a Holder in Due Course**

The point more prominent among the reason for anti-nullity sentiments is the contention by the opponents of the nullity exception that allowing the exception would result in the seller/ beneficiary being in a worse position than a holder in due course. In the *United City Merchant v Royal Bank of Canada*,<sup>358</sup> Lord Diplock expressed the view in the House of Lords that even where the documents under a credit were a forgery, the American Uniform Commercial Code protects a person who has taken a draft drawn upon the credit in circumstances that would make him a holder in due course. His Lordship added that there was nothing in the Uniform Commercial Code to suggest that a seller/beneficiary who was ignorant of the fraud should be in any worse position because he had not negotiated the draft before presentation.<sup>359</sup> In the case of *Montrod v Grundkottter*,<sup>360</sup> Potter LJ in reference to Lord Diplock's views noted as follows:

As I understand it, Lord Diplock was of the view that a seller/ beneficiary who was ignorant of forgery by a third party of one of the documents presented, or of the fact that the document contained a representation false to the knowledge

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<sup>357</sup> It may, from a different stand point be reasonably justified from the stand point of strict compliance in the sense that a null document is not a complying document.

<sup>358</sup> [1983] 1 AC 168.

<sup>359</sup> [1983] 1 AC 168, 187.

<sup>360</sup> [2002]3 All E.R. 697.

of the person who created it, should not be in a worse position than someone who has taken a draft drawn under a letter of credit in circumstances which rendered him a holder in due course.<sup>361</sup>

The summary of the argument of Lord Diplock which was adopted by the Court of Appeal in the *Montrod case* is that a holder in due course would have been entitled to payment where fraud is perpetrated by a third party without his knowledge. To that extent, the seller/beneficiary should also be so entitled.

The above argument, commendable as it might seem, has been criticized by Professor RM Goode who commented as follows:

It is trite law... that a holder in due course is in a favoured position and is insulated from defences not available to holders of the bill, let alone to a seller whose documents and draft have been rejected. Moreover, the Uniform Commercial Code, far from protecting the seller in this situation, provides no fewer than four exceptions to the autonomy principle, including forgery, the presentation of fraudulent documents and fraud in the transaction<sup>362</sup>

The learned Professor, in strong criticism of Lord Diplock's view, further stated,

Unhappily, Lord Diplock's influence manifested itself in a subsequent decision of the Court of Appeal in *Montrod Ltd v Grundkotter Fleischvertriebs GmbH*,<sup>363</sup> where it was held that the nullity of the document was not an

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<sup>361</sup> [2002] supra at 697,712 [56]

<sup>362</sup> See RM Goode, *Commercial Law* (3<sup>rd</sup> edn, Penguin 2004) 996; See also American Commercial Code, Section 5-109 of the Revised Article 5 and Section 5-114(2) of the first Promulgation,

<sup>363</sup> [2002]1 WLR 1975.

independent ground for refusal of payment and that a beneficiary who tendered documents in good faith was entitled to payment even if the documents were fraudulent or otherwise devoid of commercial value.<sup>364</sup>

It may also be noted that dissenting views have also been expressed by the courts. A case in point is the Singaporean High Court case of *Lambias (Importers & Exporters) v Hong Kong and Shanghai Banking Corporation*, where Goh CJ in reference to Lord Diplock's view stated as follows

With respect, I do not think that it is right to say that the seller/beneficiary who has not negotiated the draft before presentation should be in the same position as a bona fide holder in due course. I think the short answer to this is that as a party to the underlying contract, he has an additional recourse against the buyer which is not open to a holder in due course.<sup>365</sup>

Also, in the Court of Appeal case of *Beam Technologies*, Chao J.A. affirming Professor Goode's view, noted that 'the beneficiary under a letter of credit is not like a holder in due course of a bill of exchange; he is only entitled to be paid if the documents are correct'.<sup>366</sup>

The above passages suggest that the view of Lord Diplock for rejecting the nullity exception which had a 'spill over' effect on the Court of Appeal may respectfully have been misconceived.

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<sup>364</sup> See R. M Goode, *Commercial Law* (Penguin 2004) 996.

<sup>365</sup> [1993] 2 SLR 751,763.

<sup>366</sup> [2003] 1 SLR 597, 35.

#### 4.3.1.5. Unfortunate Consequences to the Right of Third Parties

Potter LJ, noted in his judgment in *Montrod Ltd v Grundkottner*<sup>367</sup> that the recognition of a general nullity exception would cause prejudice to innocent beneficiaries participating in a chain of contracts in situations where their good faith is not in question. This point was summarily made by Potter LJ. One possible situation might be where a seller/beneficiary is in possession of apparently conforming documents which were passed to him by another seller further up the chain which without his knowledge are forged and null documents. As a result of the document that is a nullity, the seller/beneficiary fails to be paid because the nullity exception entitles the confirming/ issuing bank to withhold payment on such documents. It may be argued that there is no question of prejudice to the beneficiary if the beneficiary had been aware of the nullity, as he might have withheld his own payment to his sellers in the string sale thereby minimizing his losses. Even where the seller/beneficiary's actions can be seen to be blame-worthy; for instance, he has acted recklessly by not vetting his source of supply, there appears to be no prejudice to him if the documents are rejected for it being a nullity.

However, where the beneficiary does not know about the nullity before paying his own seller, this could lead to the prejudice or unfairness referred to by Lord Justice Potter where the beneficiary is precluded from claiming under the letter of credit even though his 'good faith is not in doubt'. One salient point needs to be made to the effect that, even though the Court of Appeal in the *Montrod* case singled out beneficiaries in string sales as likely to be prejudiced if a nullity exception is

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<sup>367</sup> [2001] EWCA Civ 1954 [2002] CLC 499.

recognized because they are innocent, the same situation applies for a beneficiary in a single sale transaction. This is so because the context in which the nullity exception is discussed includes a situation where the beneficiary is innocent of the forgery but the document presented is a nullity whether in a chain or otherwise, and the argument of 'unfairness or prejudice' can be applied to any innocent beneficiary who fails to get payment through no fault of his own.

Prejudice or unfairness to the seller/ beneficiary whose good faith is not in doubt is an important consideration and a justification for those against the nullity exception. However, there are no easy answers to the question of who should bear the loss caused by the nullity of the document. If the seller/beneficiary is allowed to claim on the credit, it will ultimately be the buyer/applicant who has to bear the loss by taking up documents which may be worthless and in no way guarantee the security needed in documentary sales. As between innocent parties, the question of who has to bear the loss can only be reasonably decided after balancing the interests of all the parties to the transaction. It may be reasonably contended that there is no reason in justice to allow the buyer/applicant to bear the loss occasioned by the tender of forged documents. It is more appropriate in balancing the interest of the parties to the transaction to require the seller/beneficiary, though innocent, to bear the loss where a document required under the credit is forged and a nullity. This is so if recourse is had to the fact that what is required is a conforming document and a forged document cannot be said to be it.

#### 4.3.1.6. Matching the Bank's Duty to the Applicant with that of the Seller/ Beneficiary

In *United City Merchants v Royal Bank of Canada*,<sup>368</sup> one of the arguments put forward by Lord Diplock was that the bank's duty to the buyer/applicant to honour the credit upon apparently conforming documents (even where they in fact contained inaccuracies or were forged) should, from a commercial point of view, be matched by a corresponding liability to the seller/beneficiary to pay the sum due on the credit upon presentation of apparently conforming documents.<sup>369</sup> This appears to be one of the reasons why the court felt the seller/beneficiary in the *United City Merchants case* should be paid by the bank despite the fraud in the documents. However, Dora Neo, affirming the argument of RM Goode, has contended that the first part of the House of Lords equation is problematic. She reasons as follows: neither the UCP nor the common law imposes any duty on the bank towards the applicant to pay upon apparently conforming documents. The rules are directed at the duty of the applicant (or the issuing bank) to reimburse the issuing bank (nominated bank) if the bank has, despite having exercised all due care, mistakenly paid the beneficiary upon apparently conforming documents which were inaccurate or forged.<sup>370</sup> The concern of UCP 500 is the bank's entitlement to be reimbursed by the applicant, not its duty to the applicant to honour a facially conforming credit. Indeed, it is hard to conceive that the bank would have a duty to the applicant to honour apparently conforming documents even if it knows that these are in fact false or fraudulent, and thereby allow the

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<sup>368</sup> [1983] 1AC 168.

<sup>369</sup> [1983] 1 AC 168 at 184-5.

<sup>370</sup> See U.C.P 500, Art. 15.

applicant to be defrauded.<sup>371</sup> Even if the first part of the proposition were correct, the second part (corresponding liability to the seller/beneficiary to pay the amount due on the credit upon the presentation of apparently conforming documents) would be suspect. Under Article 9 of the UCP 500, the issuing bank undertakes to pay on the credit provided that the stipulated documents are presented and the terms and conditions of the credit are complied with. It does not state that conformity on the face of the document is sufficient. This point has been made by Professor RM Goode when he opined that:

...but the notion that the bank owes a buyer, its own customer, a duty to pay against forged or fraudulent documents, thus allowing the buyer to be defrauded, is surely bizarre!.....But documents which are forged cannot conceivably be treated as conforming documents; the bank may be safe in paying them if it has examined them with reasonable care and they appear to be in order, but to say that the beneficiary has a right to payment against even forged documents if he is not a party to the forgery finds no justification in the terms of the letter of credit or in the provision of the UCP and has the effect of extending to the beneficiaries the benefit of a rule designed exclusively to safeguard the bank<sup>372</sup>

The learned academic has argued that the proposition of Lord Diplock in the House of Lords is misconceived.

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<sup>371</sup> There is now authority stating that a bank has a duty not to pay in such circumstances. See *Czarnikow-Rionda .v. Standard Bank* [1999] 2 Lloyd's Rep 187.

<sup>372</sup> See Roy Goode, *Commercial Law* (Penguin 2004) 996.

#### 4.3.1.7. Lack of Authority for the Nullity Exception

Finally, another point that was made in *Montrod Ltd v Grundkottner*<sup>373</sup> as a reason for not recognizing the nullity exception is the issue of lack of judicial authority or decision. Raymond Jack QC commenting on the statement of Lord Diplock where he left the issue of nullity exception open in the case of the *United City Merchant* stated thus:

This is very slender support for the submission that there exists in parallel with the fraud exception a second exception covering documents which are nullities to the knowledge of the bank at the time of payment though the beneficiary is innocent of any deception. There is, in my view, no other support that has been found in the reported cases. I think that it is wishful to seek to find such support in one sentence...

The point sought to be made by the learned judge is that at the time the case of *Montrod*, and by extension the *Beam Technology* case came before the court, a nullity exception was neither supported by judicial decision nor the UCP 500. However, it may be noted that the lack of authority under the UCP or in any decided case should not be a constraint for the recognition of a nullity exception. This is so because it is generally accepted that the UCP 500 was to be supplemented by domestic rules where appropriate. Also, the fraud rule which is an established exception to the principle of autonomy, is a common law exception that was not governed by the UCP 500. It similarly follows that a nullity exception could as well exist independently of the UCP

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<sup>373</sup> [2001] 1 All ER 368.

500. Moreover, the absence of a judicial authority for a nullity exception should not lead the court to conclude that such an exception should not be recognized. There seem to be no legal justification for this as such situations where legal issues are novel lead to the growth and better development of the law. The simple reason for the lack of judicial authority supporting the nullity exception at the time was that the issue had not directly come before the court for a determination. The absence of authority far from being an obstacle presents a clear opportunity for the law to be developed.

#### 4.3.2. Pro- Nullity Argument

In the light of the reasons advanced for not recognizing the nullity exception, is there still a room for a separate nullity exception? It may be recalled that the fraud exception is justified by the application of the maxim *ex turpi causa non oritur action*. The basic rationale for the recognition of the fraud exception being that the court will not allow their processes to be used by a dishonest person to carry out fraud.<sup>374</sup> The prime justification for the fraud exception may not be applicable for the nullity exception. To that extent, the protagonists of the nullity exception like Hooley<sup>375</sup> and Professor RM Goode<sup>376</sup> have sought to justify the nullity exception on some other considerations which will be considered below.

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<sup>374</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168.

<sup>375</sup> See Hooley, R 'Fraud and Letters of Credit: Is there a Nullity Exception' (2002) CLJ 279.

<sup>376</sup> See 'Abstract Payment Undertakings' in Cane and Stapleton (eds), *Essays For Patrick Atiyah* (Oxford University Press 1991).

#### **4.3.2.1. Banks Deal in Documents and not in Goods**

One of the arguments that support the nullity exception, contrary to some legal opinion<sup>377</sup> that has used the same argument against it, is the contention that seeks to emphasize the autonomy principle by stating that in credit transaction bank deals in documents not in goods. If a bank deals in documents alone, it presupposes that what is important, to ascertain whether the demanding party gets payment is on the basis of the document alone. Where such document which entitles the beneficiary to payment is a mere forgery and thus a nullity, is it necessary to go into the circumstances that made the document a forgery and thus a nullity. Put differently, does a bank that ought to make payment on the basis of the document alone need to investigate whether the beneficiary's good faith has been impeached by his dishonesty in presenting the document? Investigating whether the beneficiary was dishonest in presenting the forged document would amount to, as Potter LJ pointed out, albeit in another context, creating uncertainty in an area of law where the need for precision and certainty are paramount.

#### **4.3.2.2. Duty to Tender Conforming Documents**

One of the strongest arguments in support of nullity remains the duty placed on the seller/beneficiary in documentary credit to tender conforming documents. This calls into question, what is meant by a conforming document. It may be stated that the concept of what amounts to a conforming document has elicited different opinions

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<sup>377</sup> Most legal opinion both judicial and academic largely contend that because in credit bank deals in documents not in goods, any contention that a nullity exception should be allowed in documentary credit law goes against the trend of authority. The reason for this contention, though debatable, is largely that the investigation of when a document is a nullity will involve investigating the underlying transaction.

both from the academics and the courts. One of the strongest voices among the academics remains Professor RM Goode. The learned Professor has argued that

documents which are forged cannot conceivably be treated as conforming documents; the bank may be safe in paying on them if it has examined them with reasonable care and they appear to be in order, but to say that the beneficiary has a right to payment against even forged documents if he is not a party to the forgery finds no justification in the terms of the letter of credit or in the provisions of the UCP and has the effect of extending to the beneficiaries the benefit of the rule designed exclusively to safeguard the banks.<sup>378</sup>

In the same vein, Professor Ellinger commenting on Lord Diplock's view in the *United City Merchants case* states as follows; 'the beneficiary is promised payment against a set of documents described in the documentary credit. Can it be seriously argued that the promise is meant to cover false documents?' he comments further as follows;

It is disturbing that whilst a document stating the true loading date could have been rejected by the bank in the light of the doctrine of strict compliance, a document in which the loading date was fraudulently misrepresented by its maker constituted a valid tender in the beneficiary's hands.<sup>379</sup>

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<sup>378</sup> See RM Goode *Commercial Law* (Penguin 2004) 996.

<sup>379</sup> See P Ellinger 'Documentary Credits' in Guest (ed), *Benjamin Sale of Goods* (Sweet & Maxwell 2004) Chap 23.

In the *Beam Technology case*, the Court of Appeal noted that implicit in the requirement of a conforming document was the assumption that the documents were true and genuine. Hence, Chao Tin J.A. (who delivered the judgment of the two member court, which comprised Tan Lee Meng J.) predicated his reason for finding a nullity exception thus;

To say that a bank, in the face of a forged, null and void document (even though the beneficiary is not privy to that forgery), must still pay on the credit, defies reason and good sense. It amounts to saying that the scheme of things under the U.C.P 500 is only concerned with commas and the full stops or some misdescriptions, and the question as to genuineness or otherwise of a material document, which was the cause for the issue of the letter of credit, is of no consequence.<sup>380</sup>

The same position was adopted by the Court of Appeal in the *United City Merchant case*<sup>381</sup> which was referred to by the court in the *Beam Technology case*. Ackner LJ, appreciating the importance of documents as security for the bank, was of the view that a banker need not be under an obligation to pay against documents which he knows to be a waste paper as to 'hold otherwise would 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>382</sup>

In similar vein with Ackner LJ, Griffiths L.J was of the opinion that where the documents were forgeries, the right to of the bank to refuse payment rests upon the

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<sup>380</sup> [2003] 1 SLR 597 at para 33.

<sup>381</sup> [1983] 1AC 168.

<sup>382</sup> *ibid.* at para 19.

fact that the bank's obligation is to pay upon the presentation of genuine documents in accordance with the requirement of the credit. He further noted that 'if the documents were fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay',<sup>383</sup>

A Hong Kong barrister at law, Peter Ho, has voiced support for nullity exception. He submitted:

a fortiori and in bearing in mind the wording of the UCP 500, 1993, whilst a bank which pays against apparently conforming documents including null documents after reasonable examination is entitled to reimbursement, the beneficiary however, does not have a right to such payment and a bank is entitled to refuse to pay. It is evident that null documents are the very antithesis of the stipulated documents required under the UCP 500. Accordingly, it is submitted that an issuing bank is under no duty, contrary to Lord Diplock's view, to pay against such null documents.<sup>384</sup>

The issue of conforming documents might have been expressed in different ways; however, the point sought to be made above is that what is required under the letter of credit are genuine documents and a forged document does not meet this requirement despite the apparent conformity. As a result, the seller/ beneficiary should not be paid. This argument becomes more forceful in the context of a forged document that is a nullity. Hence, as posited by Peter Ho,<sup>385</sup> an issuing bank is not under any duty to pay

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<sup>383</sup> *ibid.* at para 21.

<sup>384</sup> See Peter Ho, "Documentary credit: Null Documents" available at <http://www.ashffords.co.uk/publications/Banking>.

<sup>385</sup> *ibid.* 2.

against such null document on the ground that such null documents could in no sense be called the stipulated documents under article 10 of the UCP 500.

#### **4.3.2.3. Discouraging Forgery**

Another reason for the recognition of the nullity exception has been the argument that in international trade, falsification or forgery of documents should not be tolerated. Maritime fraud involving false and antedated bills of lading is a problem in international trade.<sup>386</sup> This has caused the victims to lose huge amount of money.<sup>387</sup> A judge, in the United Kingdom has referred to this a ‘cancer in international trade’.<sup>388</sup> With this background in mind, it would seem to be a disservice to the interests of letters of credit that a beneficiary who presents a document that is forged and a nullity should be allowed to claim on the credit. Indeed, it has been argued that the failure to recognize a nullity exception would seem to tolerate the circulation of forged documents in the international trade, and that this is undesirable as the proliferation of fraudulent and null documents will undermine the trust that forms the foundation of international trade.<sup>389</sup>

The fraud exception already addresses the problem of beneficiaries who commit fraud. A fraudulent beneficiary is not entitled to be paid even if the documents conform to the credit. A fraudulent beneficiary is not entitled to payment even if the documents conform to the requirement of the credit .If the bank knows about such fraud before it

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<sup>386</sup> See generally, Demiz- Araz, ‘International Trade, Maritime Fraud and Documentary Credits’ Int. TLR 8(4).

<sup>387</sup> *ibid* at 128.

<sup>388</sup> See *Standard Chartered Bank .v. Pakistan National Shipping Corp.* No 2 [1998] 1 Lloyd’s Rep. 684, 686.

<sup>389</sup> R Hooley, ‘Fraud and Letters of Credit: Is there a Nullity Exception’ (2002) CLJ 279.

has paid on the credit, it can withhold payment. However, where the fraud is that of a third party, the lack of a nullity exception obviously leaves a gap. While the application of the nullity exception would disadvantage the innocent beneficiary without punishing the third party wrongdoer, it would be an important development that signals that the law takes the problem of fraud seriously and will not give effect to fraudulent documents.<sup>390</sup> The court and the bank should not be bound by the doctrine of autonomy so as always to bow to the demands of an innocent beneficiary presenting clearly forged documents, simply because the forgery was committed by someone other than the presenting beneficiary.<sup>391</sup> Furthermore, by placing the burden onto the sellers/beneficiaries who procure such documents to police those with whom they deal, something that sellers should be in a better position to do than the banks or applicants, the law might be able to help slow down the spread of fraud and forgery in international trade.

#### **4.3.2.4. Documents as Bank's Security**

One of the compelling arguments that favour the recognition of the nullity exception is that the documents which the beneficiary tenders to the issuing or confirming bank in exchange for payment serves as the bank's security. In as much as the applicant's creditworthiness is important to the issuing bank, who must look to the applicant for reimbursement after paying on the credit, a bank will strengthen its position by taking security from the applicant for protection in case the applicant is unable to pay. Bills of lading play an important role as documents of title and have primarily formed an ideal security for the bank. Although the development of other forms of transport

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<sup>390</sup> See generally, Smith, 'Irrevocable Credit and Third Party Fraud: The American Accord' [1983] 24 *Virginia J Int' L* 55.

<sup>391</sup> See LY Chin and YK Wong, 'Autonomy- A nullity Exception At Last' [2004] *LMCLQ* 18.

documents that are not documents of title might have weakened the primary security function of the documents under a credit,<sup>392</sup> bills of lading remains widely used as a the bank's security. Since the bank may be relying on the documents under the credit as collateral for any advances that it gives to the applicant (primarily the payment of the beneficiary when conforming documents are tendered), it is hard to justify a rule that requires the bank to pay the beneficiary when presented with documents that it knows are worthless. This would appear unreasonable as worthless documents will provide the bank with no security.<sup>393</sup> The contention that the bank should not be concerned with the worth of the documents should not deprive the bank of the needed security for their advances.<sup>394</sup> As noted by a Hong Kong attorney at law,

The issuing bank is not under any duty to pay against such null documents on the ground that such null documents could in no sense be called the stipulated documents under article 10 UCP 1993. To hold otherwise is to compel the issuing bank to become the underwriter against the risk of null documents with respect to the seller/beneficiary and to deprive the issuing bank, where the bill of lading is void, of the security to which it would have been entitled. It is submitted that this could not be the intention of the parties to the documentary credit transaction or the true effect of the UCP 500.<sup>395</sup>

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<sup>392</sup> See R Jack, *Documentary Credits* (3<sup>rd</sup> edn, Butterworth 2001) 91, 325, The same point was re-emphasized by the latest edition. See Ali, M & Quest D Jack: *Documentary Credits* [4<sup>th</sup> edn, Tottel 2009] 101-104

<sup>393</sup> See generally, Dora Neo, "Nullity Exception in Letters of Credit Transactions" (2004) Sing JLS 46.

<sup>394</sup> See R Jack, *Documentary Credits* (3<sup>rd</sup> edn, Butterworth 2001) 270, see also Ali Malek & David Quest, *Jack: Documentary Credits* (4<sup>th</sup> edn, Tottel 2009) 101 -104.

<sup>395</sup> See Peter Ho, "Documentary Credits: Null Documents" available at <http://www.ashffords.co.uk/publications/Banking> at p.2.

The point sought to be made is that preservation of the bank security remains a relevant factor. This was given recognition even in the seminal case of *Sztejn v J Henry Schroeder Banking Corporation*<sup>396</sup> where Shientag J said ‘while the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account.....the bank ... is vitally interested in assuring itself that there are some goods represented by the documents’.<sup>397</sup>

In Singapore, the importance of the documents as security for the bank was recognised long before the *Beam Technology case* in the case of *Mees Pierson NV v Bay Pacific Pte. Ltd.*<sup>398</sup> Here Rajendran J. stated that, ‘to require the bank to make payment when the bank knows that the bills of lading are a nullity is to require the bank to knowingly forgo its security. That will be tantamount to requiring the bank to honour the credit on terms less favourable to the bank than envisaged under the credit arrangement’.<sup>399</sup>

#### **4.3.2.5. Bank’s Agreed Mandate to the Applicant**

It is not in dispute that in letter of credit transactions, the bank has a contract with the applicant whereby the bank agrees to issue the letter of credit in favour of the beneficiary and to pay the seller/beneficiary the amount of the credit upon presentment of conforming documents. The contract provides that the bank is entitled to claim reimbursement from the applicant when it has paid upon reasonable

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<sup>396</sup> (1941) 31 N.Y.S. 2d. 631.

<sup>397</sup> *ibid* at 631, See also *United City Merchant’s case* (Supra)247 (per Ackner L.J) 254 (per Griffiths L.J)

<sup>398</sup> [2000] 4 SLR 393.

<sup>399</sup> *ibid* 408.

examination of the document within the required period. As Ackner LJ stated in the Court of Appeal in *United City Merchant* case:<sup>400</sup>

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 that is a document which complies with the terms of the credit.<sup>401</sup>

Based on the above view, a bank that breaches its mandate and knowingly pays upon apparently conforming documents that are not genuine does so at its peril as it would not be able to claim reimbursement from the instructing party. The view that the bank has a limited mandate is an attractive one. It would be inexplicable that an applicant should be willing to authorize a bank to pay the beneficiary upon documents that the banks knows are forged and null, thereby allowing itself to be left bearing the losses. The bank should be allowed to withhold payment to the beneficiary so as to stay within the terms of its mandate from the applicant, and recognizing the nullity exception would easily achieve this result.

#### **4.3.2.6. Prejudice to Beneficiaries/Sellers in a Chain**

Another point which supports the nullity exception is derived from one of the arguments of those against the nullity exception which is to the effect that recognizing the nullity exception will prejudice seller/beneficiaries in string situations where their good faith is not in doubt. It may be noted that in consideration of fairness and

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<sup>400</sup> [1983]1 AC 168.

<sup>401</sup> [1982] QB 208, 247.

allocation of risk, it is by no means clear that it would be fairer to place the loss on the buyer/ applicant. The pertinent question is which of the two innocent parties should suffer. No doubt, this question may not be easy to answer. In the *United City Merchants* case, Stephenson LJ made the following pronouncement in the Court of Appeal:

Banks trust beneficiaries to present honest documents; if the 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 requirement of the credit but with 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.

The above passage seems very much persuasive. It represents a rational and more realistic judicial opinion on the proper allocation of loss between the beneficiary and the applicant. This view seem to have received very little judicial attention but the rationale behind it is anchored on the fact that if it is the beneficiary who has the obligation to present conforming documents which are genuine and valid, it seems fair that he, and not the applicant, should bear the risk that a document presented might be a nullity.

#### 4.3.2.7. Understanding the Letter of Credit Contract

Finally, mention needs to be made of the support that a nullity exception gathers from proper appreciation of the letter of credit contract. A letter of credit transaction normally involves more than three contracts. For the purposes of the current enquiry, three core contracts that consist of a contract between the buyer/applicant and the issuing bank, between the issuing bank and the seller/beneficiary, and between the buyer and the seller should be borne in mind. Because a letter of credit is governed by well established and generally applicable rules, it is easy to forget that as in all contracts, the intention of the parties and the agreement between them should not be ignored,<sup>402</sup> otherwise, the resultant danger could be that the court might develop the law in a way that is completely divorced from the expectation of the parties when they entered into the contracts.<sup>403</sup> To evaluate the rights and obligations of each party in the letter of credit transaction, courts have to construe the contracts made by the parties. Express terms must be interpreted, and where necessary implied terms read into it. Take for example, if a letter of credit issued by the bank in favour of the beneficiary provides that the sale price of the goods is payable against a 'full set of clean on board ocean bill of lading' drawn to the order of the issuing bank covering the goods sold, the court ought to interpret these terms to see if a bill of lading that is forged and a nullity falls within the requirements.<sup>404</sup> In understanding the letter of credits contracts,

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<sup>402</sup> It may be noted that there are standard contracts where terms are implied by law based on considerations other than the intention of the parties, but it is not clear that the contracts in a letter of credit transaction belong to this category. One indicator that the intentions of the parties do actually matter in letters of credit is that the UCP takes effect between parties only if it has been expressly incorporated into the contract.

<sup>403</sup> Construction being basically a matter of law; however, where there is a lacuna, a construction that will meet the justice of the case ought to be adopted. See Lewison, *Interpretation of Contract* (2<sup>nd</sup> edn, Sweet & Maxwell 1997) at para. 3.05. For the current edition see K Lewison, *The Interpretation of Contract* (4<sup>th</sup> edn, Sweet and Maxwell 2007) [3.07]

<sup>404</sup> Recourse should be had to the argument of RM Goode and Court of Appeal decision in *Beam Technologies* that conforming document means genuine documents.

the totality of the transaction ought to be borne in mind and a construction of the contracts which seeks to detach the credit completely from the underlying contract that gave life to it ought not to be favoured. Such construction treats null document which provide no security to the applicant as complying documents.

It may also be worthy of note that the reasonableness of a result may be one of the factors to be taken into consideration in choosing between different constructions of a contract.<sup>405</sup> In the word of Lord Reid: ‘The fact that a particular construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result, the more unlikely it is that the parties have intended it...’<sup>406</sup>

The pertinent question that emanates from the foregoing regarding the construction of contracts of documentary credit is whether it is reasonable that a bank which is aware that a material document is forged and a nullity should nevertheless be bound to make payment to the beneficiary and be entitled to claim a reimbursement from the applicant. It is hard to see how a reasonable answer to this will be in the positive. Any answer in the affirmative will seek to make mockery of the contractual obligation of the bank if the seller/beneficiary can satisfy the obligation to present a particular document by tendering forged ones. If the beneficiary has not fulfilled the obligation to produce genuine documents, it is unreasonable to expect the bank to make payment without any security in the documents, or the applicant to later reimburse the bank for worthless documents. Dora Neo<sup>407</sup> has argued that it might be imaginable that a buyer could agree, in the interest of the smooth functioning of the letter of credit payment

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<sup>405</sup> See generally Lewison, *The Interpretation of Contract* (2<sup>nd</sup> edn, Sweet & Maxwell, 1997) para. 6.13. For the current edition see K Lewison, *The Interpretation of Contract* (4<sup>th</sup> edn, Sweet and Maxwell 2007) [6.17]

<sup>406</sup> See *Schuler (L.) A G v Wickman Machine Tool Sales Ltd.* [1974] AC 235 at 251.

<sup>407</sup> Dora Neo, ‘Nullity Exception in Letters of Credit Transactions’ (2004) Sing J LS 46.

system, to bear the risk of third party fraud where this does not render the documents a nullity, and sue the seller for any breach of contract afterwards. But it seems most unlikely that the buyer would extend this agreement to a situation where a material document is a nullity and definitely completely worthless. She further argues that the principle of autonomy and the fraud exception is one that is anchored on reasonableness. However, the principle of autonomy is more prejudicial to the buyer than to the other parties; this is so as it could operate to deprive the buyer of the self-help option of withholding payment in cases where the goods are defective. It is more reasonable to recognize a nullity exception where documents are forged regardless of the identity of the forger.

#### **4.4. The Scope of the Nullity Exception**

Having identified, the strengths and weaknesses of the nullity exception in the preceding section, this section addresses the often difficult question of what the likely boundaries of the nullity exception should be in practice and the standard of proof required to reach the threshold. In dealing with this thorny question of setting clear guidelines for the working scope of the nullity exception, instances will be borrowed from documentary credit practice as well as practices in general law.

##### **4.4.1. Formulating Nullity in Documentary Credit**

The first question to be addressed is what kind of nullity should be capable of triggering the exception. In answering this question, two issues should be considered.

First, is the question whether the circumstance leading to the nullity is an important factor. Secondly, what is the nature or extent of the falsity in the document that could be categorized as a nullity? The answer to this question undoubtedly has either been partly answered by some of the cases dealing with the nullity exception or could be gleaned by critical analysis of the issues in the cases.

In answering the first question, must the nullity in the document always arise as a result of forgery or fraud or could it arise, for example by virtue of innocent mistake? It ought to be noted that a great deal of the discussion in respect to a possible nullity exception in documentary credit arises in the context of forgery of a third party other than the beneficiary to the exclusion of other circumstances in the absence of fraud that could give rise to a nullity. However, circumstances leading to a document being a nullity might not always arise through forgery or fraud. The *Montrod case*<sup>408</sup> exemplifies a situation where a document could be argued to be a nullity albeit without fraud or forgery.<sup>409</sup> In this situation, the question that cries for an answer is whether a possible nullity exception should only include those circumstances where the nullity results from fraud or forgery or should include those situations where a nullity results from other circumstances like innocent mistake or documents arising from a non-existent entity.

In this regard, Dora Neo explores two strands of argument. She opines that 'where a required document is a nullity without being forged, it is important to look at the requirement of the credit. If the document that is presented is exactly what is required

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<sup>408</sup> [2001] EWCA Civ 1954 [2002] CLC 499.

<sup>409</sup> In this case, a document sought to be presented and argued to be a nullity was signed in an honest and mistaken belief that the maker had the authority to sign it.

under the credit, it is arguable that the beneficiary is entitled to payment even if the document is a nullity and without legal effect'.<sup>410</sup> It is respectfully submitted that it is difficult to see how a document can be what is exactly required by the credit if it is a nullity and without any legal effect. In the second strand of her argument, she posits that where the beneficiary presents a conforming document that is not a genuinely conforming document despite the absence of a dishonest intent on the part of the maker of the document, it is arguable that the nullity exception should apply. Her reason is that the arguments that favour the nullity exception are equally persuasive in the absence of fraud or forgery. This position explored in this second strand of her argument seems very attractive. In setting the boundary or scope of the nullity with regard to its meaning, is it necessary to limit nullity to those arising from fraud or forgery? As evident in her analysis, if a document is a nullity and does not conform to the requirement of the credit, it should not matter whether it was caused by mistake or through a fraudulent act.<sup>411</sup>

The second question relates to materiality with regard to nullity. Here the argument as it concerns 'destroying the whole essence of the document' is explored. Let's take for example that one of the required document in a documentary credit transaction is a bill of lading,- are there circumstances where what appears to be a bill of lading would be so defective that it cannot be regarded as a bill of lading in real sense so as to be capable of being described as a nullity. Lord Diplock, in the *American Accord* addressed this question and viewed a fraudulently backdated bill of lading by a shipping broker as not amounting to a nullity. The apparent legal basis for this reasoning in the *American Accord* was that a document could not be said to be a

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<sup>410</sup> Dora Neo, 'Nullity Exception in Letters of Credit Transactions' (2004) Sing J L S.46.

<sup>411</sup> Dora Neo 'A Nullity Exception in Letter of Credit Transaction' (2004) Sing J LS 46, 68.

nullity unless its fault deprived it completely of all its legal effects. To drive home this perception of nullity from the point of an instrument ‘without any legal effect’ Lord Diplock in the *American Accord* held that ‘the bill of lading with the wrong date of loading placed on it by the carrier’s agent was far from being a nullity. It is a valid transferable receipt for the goods giving the holder a right to claim them at their destination... and was evidence of the terms of the contract under which they were being carried’. Hence central to Lord Diplock’s analysis is that the incorrect date of loading did not prevent the bill of lading from performing its essential function of conferring on the holder of the bill the right to claim the goods at their destination. Hence, the insertion of the wrong shipping date by the loading broker, though obtained through the fraud of the broker, did not completely destroy the whole essence of the bill of lading as to make it a nullity. It is submitted that this approach to establishing when a document is a nullity by ascertaining whether the whole essence of the document has been destroyed is fundamentally helpful in defining the nature of nullity required to trigger the exception. The approach would simplify judicial decisions once the legal facts are known.

Another variant of materiality relates to how essential the document argued to be a nullity in relation to the letter of credit should be as to make its nullity displace the autonomy principle. Put differently, should nullity of any document required for presentation be capable of enjoining payment or does it have to be only the very essential documents like the bill of lading? Chao JA, in *Beam Technology*, did not disregard the question as to how essential a document<sup>412</sup> would be and in response used the word ‘essential’ as being synonymous with the word ‘material’. Reflecting

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<sup>412</sup> As to make the document a nullity

on this approach of the court; Dora Neo<sup>413</sup> posed the question as to what the materiality should relate to. As rightly pointed by the academic, one possible answer may be that the materiality is in relation to the credit. If this is the position, it means that any document stipulated in the credit is material. But this seems to run against the position adopted by Chao JA in distinguishing *Montrod* from *Beam Technology* case. In *Beam Technology* the court, in reference to the *Montrod* case, saw the required certificate of inspection as non-material but made reference to a document which is the cause of the issue of the letter of credit as the material document. Hence, from the tone of the court, it seems that the court determined materiality on the basis of the document that provided security for the bank's advances. This approach to limiting materiality to documents that 'caused the issue of letter of credit', while it has the potential of setting a high standard of materiality, since not all document required under the credit would have the potential of satisfying the requirement of being the 'cause of the issue of letter of credit', it would undermine precision and certainty. It is submitted that the approach that treats every document stipulated under the credit as material documents whose nullity would displace the autonomy doctrine is preferable. The basis for this contention is that parties to a documentary credit, in stipulating the documents required for presentation, consider those documents to be material and any derogation from the stipulated documents by way of any of the documents being established as a nullity should displace the autonomy principle.

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<sup>413</sup> Dora Neo 'A Nullity Exception in Letter of Credit Transaction' (2004) Sing J LS 46, 68.

#### **4.4.2. Standard of Proof**

Having set out above the working principles relating to the nature of nullity that could bring the nullity exception into place, other primary issues like the standard of proof need to be properly defined in order to understand the scope of the exception. In this regard, the age-long standard of proof established in decided cases with respect to the fraud exception would be helpful to the nullity exception. With respect to proof and the standard which a claimant needs to reach to cross the threshold needed to establish the nullity exception, three broad areas of interest come to mind.

(A) Where the bank has refused payment on the ground that a presented document is a nullity and the beneficiary applies to court for summary judgment

(B) Where the bank has paid the beneficiary despite information from the applicant that a tendered document is a nullity, what is the level of proof required for the applicant to resist reimbursing the paying bank?

(C) Lastly, where the applicant for the credit seeks an injunction against the paying bank seeking to prevent it from paying the beneficiary on the ground that the document sought to be tendered by the beneficiary to obtain payment is a nullity.

##### **4.4.2.1. Summary Judgment**

If the beneficiary applies for summary judgment against the bank that has refused payment on the grounds of nullity of the document(s), the law is that the standard of proof required is that which governs the application for summary judgment. In

England, summary judgment application is governed by the Civil Procedure Rules (CPR) part 24.2.<sup>414</sup>

A subsidiary question that has arisen in the context of the fraud exception, which would be relevant to the nullity exception, is what the position would be where the bank, though having no clear evidence of nullity at the time of presentation of the documents and therefore having a choice to pay, nevertheless declines to pay because it suspects that the presented document(s) is a nullity. Can it resist an application for summary judgment if, by the time the application is heard, it has obtained evidence that the presented document is a clear nullity? Waller LJ, in *Safa Ltd v Banque du Caire*,<sup>415</sup> in the case of fraud, answered the above question in the positive noting that it would be absurd for the court to give summary judgment to the beneficiary in the face of clear evidence of fraud merely because the evidence was not available at the time of the demand. The basis of this decision is persuasive and compelling. It is submitted that its application to a nullity exception will ensure that the standard required with respect to the exceptions remain uniform.

#### **4.4.2.2. Resisting Bank's Entitlement to Reimbursement**

Where the bank has paid the beneficiary despite information from the applicant that a tendered document is a nullity, what is the level of proof required for the applicant to resist reimbursing the paying bank? In this case, the standard required would be

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<sup>414</sup> The provision of (CPR) part 24.2 was stated in the fraud rule. *Solo Industries Ltd v Canara Bank* [2001] EWCA Civ 1059. [2001] 2 Lloyd's Rep. 578 at 595, *Safa Ltd v Banque Du Caire* [2000] 1 Lloyd's Rep. 600, and *Banque Saudi Fransi v Lear Siegler Services Inc* [2007] 2 Lloyd's Rep 47.

<sup>415</sup> [2000] 2 Lloyd's Rep 600 at 606, Waller LJ was restating the earlier court's position in *Balfour Beatty Civil Engineering Ltd v Technical & General Guarantee Co. Ltd* (1999) 68 Con. LR 180, CA

whether it can be proven that the bank had clear knowledge that the document in question was a nullity. To succeed, the applicant needs to show that the evidence of nullity was clear at the time the bank made the payment.<sup>416</sup>

Finally, where the applicant for the credit seeks an injunction against the issuing bank intending to enjoin payment, the position should not be any different from the fraud exception. The prevailing view in England is that there can be no intervention by way of injunction unless it is 'to prevent the alleged breach of a legal duty owed by the defendant to the plaintiff or by way of ancillary relief required by a party to proceedings who asserts a cause of action'.<sup>417</sup> This presupposes that there must be an existing cause of action to which the grant of an injunction is merely ancillary.

#### **4.4.2.3. Injunction against Payment**

As the facts of commercial life sometimes reveal, there are situations where the applicant for the credit considers that the beneficiary for the credit is likely to make or has made a demand for payment which ought not to be met with payment. In this circumstance, that applicant may proceed to injunct the beneficiary from presenting the document or the bank from making payment. In *Group Josi Re v Walbrook Insurance Company*,<sup>418</sup> Staughton L.J. noted that there is no difference with respect to the standard of proof where either the beneficiary is injuncted from presenting the document or the bank from paying under the credit.<sup>419</sup>

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<sup>416</sup> See Dora Neo 'A Nullity Exception in Letter of Credit Transaction' (2004) Sing. J LS 46, 72.

<sup>417</sup> *Ibrahim Shanker & Co v Distos Compania Naviera S.A.* [1978] 1 Lloyd's Rep. 1, per Lord Diplock albeit in an application for Mareva Injunction., See also *Chief Constable of Kent v V.* [1983] 1QB 34 per Slade L.J at 49 and Donaldson L.J. at 45 in the case of interlocutory injunction.

<sup>418</sup> [1996] 1 WLR 1152.

<sup>419</sup> [1996] 1 WLR 1152, 1161.

Despite *American Cyanamid Co. v Ethicon*<sup>420</sup> being a leading case with respect to the criteria for the grant of interlocutory injunction,<sup>421</sup> letter of credit cases have somehow deviated from this landmark decision. A reason for such deviation could be gleaned from the comment of Staughton LJ<sup>422</sup> when he noted that that letter of credit cases are special cases within the *American Cyanamid* guidelines. With regard to letters of credit, most decided cases<sup>423</sup> in England support the view that the standard of proof required for the purposes of interlocutory injunction is a clear case of fraud of which the bank must have notice.<sup>424</sup> This position was further validated by Donaldson MR in the Court of Appeal case of *Bolivinter Oil SA v Chase Manhattan Bank*.<sup>425</sup> Here the Court of Appeal noted that ‘the wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear both as to the fact of fraud and as to the bank’s knowledge’.<sup>426</sup> It is submitted that this approach that is evident in English documentary credits fraud injunction cases should ordinarily be the position where nullity to be recognised in English law. However, despite the high standard of proof required for interlocutory injunctions, a claimant is still faced with some other difficulties which ought to be

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<sup>420</sup> [1975] AC 396.

<sup>421</sup> The summary of this case with respect to interlocutory injunction is that the grant interlocutory injunction has to be taken at the time when the claimant right or the violation of it, or both, was uncertain and would remain uncertain till final judgment. Hence the court noted that for an interlocutory injunction to be granted, the court only need to be satisfied that there is a serious issue to be tried. Serious issue to be tried in the sense that the court is not interested in prejudging the issue before it goes to trial but merely had to be satisfied that that the claimant action is not frivolous or vexatious.

<sup>422</sup> In approving the comment of Lloyd LJ, in *Dong Jin Metal Co Ltd v Raymet Ltd* Unreported, 13 July 1993, (Court of Appeal Division) Transcript No. 945 of 1993.

<sup>423</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, *Edward Owen Engineering v Barclays Bank International Ltd* [1978] QB 159, *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd’s Rep 251.

<sup>424</sup> See *Edward Owen Engineering v Barclays Bank International Bank Ltd* [1979] QB 159, 171. per Lord Denning MR.

<sup>425</sup> [1984] 1 Lloyd’s Rep 251.

<sup>426</sup> [1984] 1 Lloyd’s Rep 251, 254.

satisfied before an injunction would be granted. Such legal consideration will be considered briefly below.

#### **4.4.2.4. Injunction- Other Legal Considerations**

Therefore, under the nullity exception, an injunction to restrain payment under the credit will be issued by way of ancillary relief to a cause of action which the applicant for the credit has against the issuer.<sup>427</sup> Under the fraud exception, it was considered in *United Trading Corporation S.A v Allied Bank Ltd*,<sup>428</sup> that the cause of action which the applicant for the credit can rely on lies in the duty of care<sup>429</sup> which the issuer owes the applicant. This duty of care arises because the issuer of the credit owes the applicant a duty of care not pay out on the credit if it is clear on the evidence that the beneficiary demand is fraudulent. The same applies to a nullity exception. Hence, in so far as there is a clear case of nullity, through the presentation of evidence that is clear as to the nullity,<sup>430</sup> an injunction should be granted to the applicant for the credit provided that other conditions for the grant of injunction like the balance of convenience test has been satisfied.

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<sup>427</sup> Though the authority of *Czarnikow-Rionda Sugar Trading Inc. v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 200 highlighted the difficulty with respect to establishing this cause of action by the applicant for the purposes of pre-trial injunction.

<sup>428</sup> [1985] 2 Lloyd's Rep. 554 at 559 -560.

<sup>429</sup> *Anns v Merton London Borough Council* [1978] AC 728.

<sup>430</sup> There will be clear evidence if it can be shown that the only realistic inference on the evidence available is that the presented document is a nullity.

#### 4.5. Conclusion

The development of the nullity exception to the principle of autonomy in documentary credits partly highlights a tension based on fairness as between the parties and the commercial requirement that the parties' obligation be absolutely certain. It has been suggested that allowing a broad judicial discretion which recognises the nullity exception would introduce a high level of uncertainty into important areas of letters of credit where precision and reliability should not be compromised. It is also unlikely that the judgment of the Singapore court in *Beam Technology* has in any way dispelled this myth<sup>431</sup> of uncertainty<sup>432</sup> which relentlessly, has been used against the nullity exception.

There is no doubt, that documentary credit is rule-orientated and the assurance of payment promised to the seller/beneficiary would be interfered with if the nullity exception is recognised without identifiable limits. Equally, an important consideration is that the popularity of the letter of credit is based on the faith of its users. If the possibility of abuse of the letter of credit system is not curtailed, and tender of null documents flourishes, faith in the letters of credit system will fade, as will the commercial utility of letters of credit.

Having noted the above, some issues regarding nullity ought to be pointed out. The controversy whether nullity in documentary credits should be an exception to the

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<sup>431</sup> Myth in the sense that the contention that recognizing the nullity exception will cause uncertainty while looking like a credible reason for not recognizing the exception, might if critically examined, be seen to be misplaced. This issue of certainty was addressed by the Court of Appeal in the case of *Beam Technology* where the fear of uncertainty was allayed.

<sup>432</sup> Certainty in the law is an elusive term that can only be aspired to but difficult to realize. Its realization remains elusive because human action (including commercial action), the basis of which law operates is by no means definite.

principle of autonomy in English law remains both interesting and complex. It is interesting, for two principal reasons. The first is that nullity, once established in general law, has the effect of fundamentally altering the legal position of the parties and in most circumstances, has been used as a ground for avoiding what would, save for the nullity, be a legally binding obligation. Despite, letters of credit being a specialty contract, it remains curious why a document established to be a nullity should not have the same effect as fraud in displacing the autonomy principle.

Secondly, the controversy surrounding the recognition of the nullity exception indirectly highlights the difficulty posed by the inflexible nature of the fraud rule in English law, particularly the delineation of ‘innocent’ and ‘non-innocent’ beneficiaries. An approach that insists on the requirement of beneficiary knowledge for the fraud rule to displace the impregnability of documentary credit has far-reaching implications. This undoubtedly, has led to debate over whether there should be a further exception to the autonomy principle to provide for the situation where an issuing bank is presented with documents which are nullities.

It may be noted that that the whole thesis of the nullity exception stems from a forgery of a document, albeit by a third party, or a non-genuine document that renders the document a nullity and thus non-conforming. This third party forgery of documents could be subsumed in the fraud rule. However, it has been excluded due to the restrictive nature of the English fraud rule, which, in the main excludes third party fraud. But, it has to be pointed out that a beneficiary’s duty in a credit transaction that entitles him to payment is to tender documents that are in order and strictly conform

to the requirements of the credit. This important requirement complements the autonomy rule.

It is submitted that while the requirements of certainty and autonomy are essential to the letter of credit system, they are not absolute and may be sacrificed where appropriate considerations arise. It may be to the interest of letters of credit that the principle of autonomy is further restricted by recognising a limited scope of nullity exception so that the cancer of fraudulent document may be drastically reduced.

For now, there may be problems with regard to the scope of the exception. This is primarily a difficulty which the dynamic nature of law thrusts upon us. While the chapter has endeavoured to analyse and set the benchmark for the scope of the nullity exception by borrowing from decided cases, the formulation provided by the Singapore Court of Appeal in *Beam Technology* still remains a relevant guiding light. It is a decision that should be welcomed for its stance on forged documents and its relevance in restoring trust and sanctity that is the cornerstone of the letters of credit system.

## Chapter Five

### 5.0. Recklessness of the Beneficiary

#### 5.1. Introduction

In chapter three, we noted that it is only the fraud of the beneficiary or his agent in presenting the forged or fraudulent documents that comes within the scope of the English fraud rule and is capable of displacing the autonomy principle. Chapter Four examined the rejection in English law of the nullity exception, which in the main concerns fraud of a third party that leads to a stipulated document that is a nullity being presented under the credit. This chapter deals with an issue that was highlighted by the decision of the Court of Appeal in *Montrod Ltd v Grundkottner*<sup>433</sup> with respect to the nullity exception. Potter LJ, while dismissing the nullity exception in *Montrod*, raised an issue that has currently been interpreted to suggest a separate exception<sup>434</sup> to the principle of autonomy in documentary credits. The Court of Appeal observed that it is possible that the beneficiary, though not actively implicated in the fraud of a third party,<sup>435</sup> but may be culpable for the fraud because he acted recklessly, in haste or somehow was at fault.<sup>436</sup> In this kind of situation pointed out by Potter LJ,<sup>437</sup> where

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<sup>433</sup> [2001] EWCA Civ 1954, [2002] CLC 499. This case dealt extensively with the issue of nullity which was left open by Lord Diplock in the *United City Merchants* case and in the main summarizes the English position on the issue of nullity

<sup>434</sup> See Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing, (2010) 169.

<sup>435</sup> In this case referring to third party fraud which formed the basis of the discussion under the nullity exception

<sup>436</sup> The circumstance mentioned in the introduction that constitutes the recklessness exception was articulated by Potter LJ as having some kind of attraction in the English case of *Montrod v Grundkottner Fleischvertriebs GmbH*, [2001] EWCA Civ 1954, [2002] CLC 499. In this case, the Court

the fraud of the beneficiary is not present but he is deemed to be reckless as to the presentation of required documents, will such recklessness leading to the fraud prevent the beneficiary from claiming on the credit? The above situation constitutes the circumstance under which the recklessness of the beneficiary<sup>438</sup> is discussed as an exception to the principle of autonomy. It has to be noted that judicial dicta point to recklessness of the beneficiary, either in assisting the tender or actually tendering of forged/ fraudulent documents, as a possible exception to the principle of autonomy in documentary credits.<sup>439</sup> This chapter assesses the merit of this contention to determine whether the favourable comment it has received as a possible exception to the principle of autonomy is deserved.

The Chapter is divided into four sections. Apart from the introductory Section 5.1, Section 5.2 deals with the possible nature of the exception. Section 5.3 examines certain considerations that are required for the recklessness of the beneficiary exception to apply. It considers issues that are necessary for the recklessness exception to be proved, and to achieve this, the section analyses such issues as whether the beneficiary owes a duty of care either to the issuing bank or the applicant with respect to the documents which it presents for payment. If no such a duty exists, can recklessness of the beneficiary be established against him and on what basis will such proof be made. If such duty exists, what will be the standard of proof and are

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of Appeal in rejecting the Nullity exception commented favourably towards the possibility of the beneficiary's recklessness being an exception to the principle of autonomy.

<sup>437</sup> Note that Potter LJ expressed the view that denying payment to the beneficiary in such circumstance articulated above holds some kind of attraction to him.

<sup>438</sup> For general reading on the exception see Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 169.

<sup>439</sup> See the obiter comment of Potter LJ in *Montrod v Grundkötter Fleischvertriebs GmbH* [2002] 1 WLR 1975, see also the Singapore case of *Lambias Importers & Exporters Co Pte Ltd v Hong Kong & Shanghai Banking Corporation* [1993] 2 SLR 751.

there arguments that work against the recognition of the exception? Section 5.4 concludes the chapter.

## 5.2. Possible Nature of the Exception

Before moving on to ascertain the specific nature of the beneficiary's recklessness as an exception to the principle of autonomy, it may be useful to look at the nature of recklessness in general law.

### 5.2.1. Recklessness in General Law

There seems to be great difficulty<sup>440</sup> in analysing the meaning of recklessness in law as the term has been given several shades of interpretation by the courts over the years. *Black's Law Dictionary* defines recklessness as 'conduct whereby the actor does not desire harmful consequences but nonetheless foresees the possibility and consciously takes the risk', or alternatively as a state of mind in which a person does not care about the consequences of his or her actions.<sup>441</sup> It further states that 'recklessness

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<sup>440</sup> As Andrew Ashworth noted in his book *Principle of Criminal Law* (Clarendon Press Ltd 1991). 'An abiding difficulty in discussing the legal meaning of recklessness is that the term has been given several different shades of meaning by the courts over the years. In the law of manslaughter, 'reckless' was long regarded as the most appropriate adjective to express the degree of negligence needed for a conviction: in this sense, it meant a high degree of carelessness. In the late 1950s the courts adopted a different meaning of recklessness in the context of *mens rea*, referring to D's actual awareness of the risk of the prohibited consequence occurring: we shall call this "common-law recklessness." Controversy was introduced into this area in the early 1980s, when the House of Lords purported to broaden the meaning of recklessness so as to include those who failed to give thought to an obvious risk that the consequence would occur....' More so, it ought to be noted that the courts have hovered between objective and subjective definition of recklessness and recently there is a shift by the court from objective assessment of recklessness to one that has a subjective test or criteria.

<sup>441</sup> Bryan Garner (ed), *Black's Law Dictionary* (8<sup>th</sup> edn, West Publishing Company 2005).

involves a greater degree of fault than negligence but a lesser degree of fault than intentional wrongdoing'.<sup>442</sup>

In English law, though the discussion of recklessness has sometimes been seen in the form of obiter dicta, Lord Diplock attempted an objective analysis of recklessness in *R v Caldwell*<sup>443</sup> when his Lordship stated that a defendant is reckless if: (a) he commits an act that creates an obvious risk.... , and (b) when he does the act, he either has not given any thought to the possibility of there being any such risk or has recognized that there was some risk involved and nonetheless gone on to do it. However, reliance on this *Caldwell* recklessness (an objective test) has declined considerably after the House of Lords decision in *R v G and Anor*.<sup>444</sup> The decision based on its facts seems to have adopted a subjective test. In reference to its subjective meaning, Lord Bingham, noted that a person acts recklessly with respect to (a) a circumstance when he is aware of a risk that it exists or will exist; (b) a result when he is aware of a risk that it will occur; and it is, in the circumstance known to him, unreasonable to take the risk. This recent position emphasizes a subjective test that judges recklessness on the basis of identifiable subjective criteria like the age, experience and understanding of the person in question rather than on the standard of a hypothetical reasonable person who might have better knowledge and understanding. Despite, this recent emergence of the subjective test, the test applied in practice remains nonetheless a hybrid one, as the credibility of the defendant's denial of

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<sup>442</sup> See further Bryan Garner (ed), *Black's Law Dictionary* (Thomson Reuters 2009) 1385.

<sup>443</sup> [1982] AC 341, See also the English Law Commission's definition which states that a person should be regarded as being reckless as to a particular result of his conduct if, but only if,- a. he foresees at the time of that conduct that it might have that result, and b. on the assumption that any judgment by him of the degree of that risk is correct, it is unreasonable for him to take the risk of that result occurring. Cited in D.W. Morkel On the 'Distinction between Recklessness and Conscious Negligence' assessed on 21/03/2011 <http://www.jstor.org/stable/839632>.

<sup>444</sup> [2003] UKHL 50.

knowledge and understanding will always be judged by an objective standard of what you would expect a person of the same general age, experience and abilities as the defendant to have known.<sup>445</sup>

The analysis of recklessness above despite involving the use of subjective criteria, also involves the consideration of some objective element like reasonableness. In its subjective assessment, such issues like understanding the mindset of the defendant and whether such conduct deemed to be reckless was foreseen<sup>446</sup> are relevant considerations.

### **5.2.2. Beneficiary's Recklessness in Documentary Credits**

The emergence of the beneficiary's recklessness as a possible exception to the principle of autonomy is traceable to the dicta of the courts in two common law jurisdictions namely England and Singapore. In the Singapore case of *Lambias (Importers & Exporters) Co Pte Ltd v Hong Kong & Shanghai Banking Corporation*,<sup>447</sup> the beneficiary unknowingly allowed a quality and inspection certificate which it issued to be countersigned by an impostor by bringing the impostor to the bank without checking his identity. Cheng JC, despite not relying on the alleged beneficiary's recklessness as a ground for rejecting the beneficiary's claim for payment, noted that 'the present case is not concerned with the beneficiary's fraud for which the common law exception applies, rather it is one where, ... the relationship between the bank and the beneficiary depends on whether and to what

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<sup>445</sup> See generally G Williams, 'Recklessness Redefined' (1981) 40 CLJ 252, *see also* L H Leigh, 'Recklessness after Reid' (1993) 56 MLR 208.

<sup>446</sup> See generally A R White 'Carelessness, Indifference and Recklessness' (1961) MLR 592-595.

<sup>447</sup> [1993] SLR 751.

extent the beneficiary is responsible for the defects in the documents tendered'.<sup>448</sup> The court further stated that 'the law cannot condone actions which, although not amounting to fraud per se, are of such recklessness and haste that the documents produced as a result are clearly not in conformity with the requirements of the credit. The plaintiffs (beneficiary) in the present case are not guilty of fraud, but they were unknowingly responsible for having aided in the perpetration of the fraud. In such a case where the fraud was discovered even before all other documents were tendered, I think it is right and proper that the plaintiffs should not be permitted to claim under the letter of credit'.<sup>449</sup>

In the English Court of Appeal decision of *Montrod Ltd v Grundkötter Fleischvertriebs*,<sup>450</sup> Potter LJ despite rejecting a general nullity exception based on the concept of a document being fraudulent in itself or devoid of commercial value without the beneficiary being implicated in the fraud, however noted that 'I would not seek to exclude the possibility that, in an individual case, the conduct of a beneficiary in connection with the creation and/or presentation of a document forged by a third party might, though itself not amounting to fraud, be of such character as not to deserve the protection available to a holder in due course'.<sup>451</sup> These dicta of both the Singapore court in *Lambias* and the English Court of Appeal in *Montrod* have been interpreted as arguably justifying the proposition that the recklessness of the beneficiary in presenting a fraudulent document from a third party fraudster could be a ground for displacing the autonomy principle and stopping the beneficiary from receiving payment when his dishonesty could not be established. The dicta expressed

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<sup>448</sup> *ibid* at 765.

<sup>449</sup> [1993] SLR 751, 765-766.

<sup>450</sup> [2001] EWCA Civ 1954 [2002] CLC 499.

<sup>451</sup> *Montrod Ltd v Grundkötter Fleischvertriebs GmbH & Anor* [2002] CLC 499, 512-513.

in these cases raise the question as to whether the beneficiary recklessness could in fact provide a defence to the right of the beneficiary to get payment upon the tender of apparently complying documents.

### **5.3. Applying Beneficiary's Recklessness: Legal Considerations**

If the beneficiary's recklessness is to be recognized as an exception to the autonomy principle, the beneficiary's recklessness exception needs to be precisely identified and defined. To resolve what amounts to beneficiary's recklessness, some legal considerations need to be investigated. Such issues might include whether the beneficiary whose recklessness is argued to be a ground justifying non-payment, owes a duty of care to the applicant in relation to the documents which it presents. Where the dishonesty of the beneficiary could not be established, what is the basis for asserting that he was reckless as to the tender of document? Finally, are there some justifiable objections to the beneficiary's recklessness being a ground for non-payment of the beneficiary?

#### **5.3.1. Does the Beneficiary owe a duty to be careful?**

The relevance of the above investigation to the question of whether a reckless beneficiary can justifiably be denied payment in documentary credits on the basis of his recklessness in tendering a forged or fraudulently altered document by a third

party is necessary.<sup>452</sup> It is true that carelessness may not in itself be sufficient to constitute recklessness, although it is one of the factors that ought to be taken into account in ascertaining whether someone is reckless. Clearly, a presentation by a beneficiary cannot be both careful and reckless. Hence, carelessness is an important ingredient to prove recklessness. If this is so, the question whether the beneficiary owes a duty to be careful with respect to the documents which he presents becomes relevant. Where the duty to be careful does not exist, on what ground will the beneficiary be characterized as reckless, albeit grossly careless, with respect to the document which he presents leading to a refusal of payment?

In *Montrod v Grundkötter*<sup>453</sup> the court held that ‘it cannot be argued that the beneficiary to a credit owes a duty to the applicant with regard to the documents which he presents’.<sup>454</sup>

A point is sought to be made in the forgoing analysis. That point is that the beneficiary of a credit owes neither a duty of care to the applicant nor the paying bank with respect to the documents which he presents under the documentary credits contract for the purpose of getting payment under the credit. The ground for this contention was noted by Potter LJ when the Court of Appeal held that the beneficiary, in seeking to ensure that documents presented to the issuing bank comply with the terms of the letters of credit, is pursuing its own commercial interests. The beneficiary

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<sup>452</sup> The necessity of this question arises because it can be persuasively argued that the starting point of ascertaining whether a person is reckless will be to consider whether he owes a duty to be careful. The ground for such persuasion is that most definition of recklessness has seen it from the point of aggravated or gross carelessness or negligence. As noted by Alan White in ‘Carelessness, Indifference and Recklessness’ (1961) MLR 592,595 a person could not be accused of being reckless if he cannot be adjudged to be a person who did not care whether he caused damage or not.

<sup>453</sup> *Montrod Ltd v Grundkötter Fleischvertriebs-GmbH & Ors* [2001] CLC 466.

<sup>454</sup> *Montrod Ltd v Grundkötter Fleischvertriebs-GmbH & Ors* [2001] CLC 466 at 479-480.

seeks to present documents in order to be paid in a transaction in which the commercial interests of the issuing bank and other parties involved with the letter of credit are dealt with in the manner provided for under UCP 500.<sup>455</sup>

In a more recent Singapore case of *DBS Bank Ltd v Carrier Singapore*,<sup>456</sup> the question whether there exists a duty of care on the part of the beneficiary seeking payment regarding the documents it presents was answered in the negative. The court justified its conclusion that there exists no duty of care on the basis that it is consistent with the narrowness of the fraud exception as posited by Lord Diplock in *United City Merchants v Royal Bank of Canada*.<sup>457</sup> Hence the decision in *Carrier Singapore* is that a duty of care would only exist if the beneficiary had assumed an express responsibility to the issuing bank/ the confirming bank or the buyer to ensure that the documents were accurate, failing which no duty of care would ordinarily be presumed to exist. The above analysis reflects the position of case law with respect to whether there exists a duty of care owed by the beneficiary to the issuing bank / confirming bank or the applicant with regard to the document(s) which he presents under a documentary credits contract.

Thus judging from the above position, (the difficulty of establishing a mere duty of care owed to the applicant or the paying bank by the beneficiary with respect to the document it presents) it would be difficult to see how the beneficiary's recklessness, which could be compared to a duty of care owed in gross negligence<sup>458</sup> can arise. The

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<sup>455</sup> Note that the current edition is UCP 600 which came into effect on July 2007

<sup>456</sup> [2008] 3 SLR 261.

<sup>457</sup> [1983] 1 AC 168.

<sup>458</sup> As in some cases, recklessness is used in relation to the degree of carelessness required to find a person guilty of an offence. More so, of decisive importance is that an act or omission could not be treated as careless, reckless or negligent unless three things are established by the claimant. These are

reason for the above assertion is that where such a duty (duty of care) could not be established, it is difficult to find a legal basis to judge the beneficiary's recklessness if he has presented the required document(s) (as a commercial party pursuing his own commercial interest) which entitles him to payment. Secondly, if the *Montrod* case rejected the third party (nullity) defence, it is curious how a document that is presented by the beneficiary which was forged by a third party could provide a convincing ground for displacing the beneficiary's right to payment.

**5.3.2. Where the dishonesty of the beneficiary cannot be established, is there any justifiable basis for asserting his recklessness as a ground for non payment?**

The above legal question was given judicial attention in *BDS Bank Ltd v Carrier Singapore*,<sup>459</sup> where the court observed that if a bank may rely on negligent misrepresentation (which in this case includes reckless conduct) by a beneficiary as a ground to recover any money it has paid out to the beneficiary, then the law would have to accept that the banks, and by extension the applicant, are entitled to invoke negligent misrepresentation (which includes reckless conduct) by the beneficiary as a ground for not paying the beneficiary in the first place.

The court further noted that the overall implication of the above would be to unravel the narrow fraud exception which the English House of Lords<sup>460</sup> took pains to limit. It

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(a) that the defendant owes to the claimant a duty to take reasonable care not to act the way he did; (b) that the defendant breached the duty; and (c) and that the claimant suffered damage as a result of the breach. See Sally 'Cunningham Recklessness: Being Reckless and Acting Recklessly' (2010) 21 K LJ 445, 447.

<sup>459</sup> [2008] 3 SLR 261.

<sup>460</sup> *United City Merchants Ltd v Royal Bank of Canada* [1983] 1 AC 168.

means that banks and the applicant could insist on not paying the beneficiary once there was any inaccurate statement of material facts by simply alleging that the beneficiary was grossly negligent or reckless in his conduct.<sup>461</sup> This position has received the earlier judicial support of Lord Diplock in *United City Merchant (Investment) Ltd v Royal Bank of Canada*<sup>462</sup> where it was made clear that nothing but the fraud of the beneficiary or his agent will relieve the issuing or confirming bank of its duty to pay upon the tender of facially conforming documents.

### **5.3.3. Objections to Allowing Beneficiary’s Recklessness as a Ground for Denying payment**

The strongest argument (in this case probably well justified) against adopting beneficiary recklessness in presenting a third party fraudulent document as a ground for displacing the autonomy doctrine is that its application would lead to much uncertainty and unjustified erosion of the principle of independence. This point was well made in *DBS Bank Ltd v Carrier Singapore*<sup>463</sup> where the Singapore High Court per Andrew Ang. J, noted<sup>464</sup> that ‘one has to bear in mind that the underlying foundation of the system of documentary credits is to give sellers, as far as possible, an “assured right” to payment notwithstanding disputes in the underlying sale contract’.<sup>465</sup> The court further noted that developing the law to allow for a negligent

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<sup>461</sup> *DBS Bank Ltd v Carrier Singapore* [2008] 3 SLR 261 [99] [100].

<sup>462</sup> [1983] 1 AC 168.

<sup>463</sup> [2008] 3 SLR 261 [100].

<sup>464</sup> The court in giving its dictum highlighted the point that was made by Lord Diplock in *United City Merchant v Royal Bank of Canada* [1983]1 AC 168,183; *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155–156 regarding the point that trust in international trade will be greatly affected if such unjustified erosion of the principle of autonomy is allowed.

<sup>465</sup> [2008] 3 SLR 261 [100].

misrepresentation exception (reckless conduct) as a ground upon which autonomy doctrine could be displaced would be an unjustified erosion of this very premise.

Another variant of the certainty argument that could be made regarding adopting beneficiary's recklessness as a ground for non-payment of the beneficiary was evident in the judgment of HHJ Raymond Jack in *Montrod v Grundkotter*,<sup>466</sup> where he pointed out some of the inherent difficulties with respect to establishing when conduct is reckless or proving that a duty of care exists. For such legal analysis as to beneficiary's recklessness to succeed, it needs to justify its existence by proving further issues like remoteness and foresight.<sup>467</sup> These (remoteness and foresight) are not issues which are easily within the competence of the bank to ascertain before it determines whether to pay the beneficiary or not. Having noted the above objections to beneficiary's recklessness, it may be apposite to consider whether any advantage exists in having beneficiary recklessness as a ground to displace the autonomy principle.

#### **5.3.4. Arguments for Allowing Beneficiary's Recklessness as a ground for denying Payment.**

The most striking argument that could be advanced for beneficiary's recklessness in documentary credits is that its recognition as an exception to the principle of autonomy would lead to the beneficiary being more diligent with respect to the document which he tenders for payment. Diligence of the beneficiary with respect to

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<sup>466</sup> [2001] CLC 466.

<sup>467</sup> *ibid* 479. Note that this point was made by the court with respect to proving the duty of care but such analysis could be extended to proving when a person's conduct could be adjudged to be reckless

the documents he tenders would warrant the beneficiary carefully inspecting the documents stipulated in the credit which emanates from a third party so as to exonerate himself (beneficiary) from any charge of recklessness which could be brought<sup>468</sup> as a ground for non-payment of the beneficiary upon the tender of conforming documents. However, the diligence of the beneficiary with respect to the documents raises a further question as to what extent would the beneficiary be diligent with respect to the documents as not to be dubbed reckless? This question arises because the documents<sup>469</sup> which the beneficiary relies on for payment may come from third parties whose commercial activities may have no direct relationship with the beneficiary. Consequently, another problem may arise as to the criteria for judging when and which beneficiary conduct is reckless. It will involve analysing the thorny issues with respect to foresight, remoteness and meeting the subjective test required to adjudge the beneficiary reckless with respect to the documents. These ingredients required to establish whether the beneficiary has been reckless, it is submitted compound paying banks' duties in documentary credits. To this extent, whatever benefit that is achieved by making the beneficiary more diligent<sup>470</sup> in handling third party documents is extinguished by the dilemma which the investigation of whether the beneficiary has been reckless would cause the bank for payment to be made.

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<sup>468</sup> Most often by the applicant for the credit with respect to the presentation made by the beneficiary

<sup>469</sup> Such documents like the bill of lading are issued most often by the ship master who may have no direct relationship with the beneficiary.

<sup>470</sup> In any case an assessment of whether he is not diligent will be a subjective and troubling legal assessment to make and should not be encouraged for the sake of the independent banking commitment assumed by banks.

#### 5. 4. Conclusion

The chapter has sought to answer the question whether the beneficiary is entitled to payment in a situation where his reckless conduct, albeit not amounting to fraud in itself, enabled a third party to present fraudulent documents under a credit. In Singapore, this view which possibly could be perceived as an exception to the principle of autonomy found favour with Goh Phai Cheng JC in *Lambias Co Ptd Ltd v. Hong Kong & Shanghai Banking Corpn.* This dictum of the court in *Lambias case* has been argued to have the support<sup>471</sup> of the English Court of Appeal in *Montrod*. The dicta of the courts with respect to beneficiary's recklessness seem to ignore some crucial aspects of *Montrod's* decision. HHJ Raymond Jack, with whom Potter LJ agreed, emphatically held in the *Montrod* case that the beneficiary owes no duty of care to the issuing [or nominated] bank or the applicant with respect to the documents it presents to get payment under the credit. The reason given for the above submission was captured by the Court of Appeal in *Montrod* when it stated that in the absence of any express assumption of responsibility the beneficiary in seeking to ensure that documents presented to the issuing bank comply with the terms of the letters of credit, is pursuing his own commercial interests. He (beneficiary) seeks to present compliant documents in order to be paid in the context of a transaction in which the commercial interests of the issuing bank and other parties involved in connection with the letters of credit are dealt with in the manner provided for under UCP 500,<sup>472</sup> subject to the provisions of which they are aware that the transactions will be conducted and the commercial risk distributed. If based on the documentary credits contracts no such duty of care exists on the part of the beneficiary, it may be difficult to justify an

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<sup>471</sup> See Peter Ellinger and Dora Neo *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 170.

<sup>472</sup> See the recent version called UCP 600 which came into effect on July 2007

attempt to rely on his reckless<sup>473</sup> conduct as ground for denying payment to the beneficiary under the credit.

More so, relying on the beneficiary's recklessness as a ground for withholding payment will, as the cases have highlighted, introduce an unnecessary level of uncertainty with respect to payment under the documentary credits contract. This could easily be gleaned from the issues that will ordinarily need to be considered before a beneficiary is adjudged to be reckless, issues like whether the beneficiary had foreseen the third party fraud, and if he has, to what extent the harm caused is not too remote from the beneficiary's point.

The enthusiasm generated by the comments of the courts with respect to beneficiary's recklessness being an exception to the principle of autonomy runs contrary to established authority. While it can be argued to provide opportunity for greater diligence on the part of the beneficiary, it should be dismissed as wishful thinking and runs contrary to established principles primarily accepted in this area of law. The inquiry into the recklessness of the beneficiary in presenting the forged documents where he is not proven to be dishonest will introduce a high level of uncertainty<sup>474</sup> in an area where precision is paramount. Its subjective nature will arise because the bank in deciding whether or not to pay the beneficiary upon the tender of apparently conforming document will have to decide on the degree of fault required to adjudge a beneficiary reckless in order to curtail the beneficiary right to payment. This

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<sup>473</sup> In any case bank need a clear test to apply as to what amounts to being reckless as what amounts to recklessness, without much definition is too vague.

<sup>474</sup> The uncertainty that will result by inquiring into whether the beneficiary's action is reckless could be seen in the *Montrod* case itself. The issues decided bordered on reckless conduct - that is failure to take reasonable care - was not mutually agreed by the courts. If such issues could generate disagreements between lawyers and judges who are versed in law, it may not be an issue that ought to be considered by a bank before it decides whether it ought to pay the beneficiary or not.

undoubtedly is no little task as the bank will have to consider the extent of the beneficiary's knowledge in presenting the forged document. The knowledge of the beneficiary will have to be judged by tests of foresight and proximity as to whether the fraud in question was foreseen by the beneficiary before being adjudged reckless or unscrupulous.

## Chapter Six

### 6.0. Unconscionability

#### 6.1. Introduction

This chapter considers whether unconscionability is a justifiable ground upon which the autonomy principle could be displaced. Unconscionability<sup>475</sup> as an exception to the principle of autonomy envisages a situation where a beneficiary's conduct though not fraudulent in the sense of being dishonest, could be so tainted with bad faith that a court would be amenable to restraining either the beneficiary from claiming or the bank from paying.<sup>476</sup> The circumstances that could lead to the above have attracted a less than satisfactory development in different common law jurisdictions originating principally from the amorphous<sup>477</sup> nature of the term. Unconscionability is a subject that has attracted many descriptions<sup>478</sup> both from case law and commentators alike. The reason for the many unfavourable descriptions of the term may not be unconnected with the difficulty associated with articulating its concise definition and the circumstances under which it could apply as a defence. It has been criticized as

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<sup>475</sup>N Enonchong, *Duress, Undue Influence and Unconscionable Dealing* (Sweet & Maxwell 2006). It has to be noted that unconscionability here, is treated from the standpoint of its effect as an exception to the principle of autonomy in documentary credit law but the analysis borrows from the perception of the term in general law.

<sup>476</sup> See EP Ellinger and Dora Neo, *The Law and Practice of Documentary Credit* (Hart Publishing, Portland 2010) 169.

<sup>477</sup> Criticism has arisen by the failure of the law to articulate in precise details what the term unconscionability actually means.

<sup>478</sup> Santow J in *Woodson (Sales) Pty v Woodson (Australia) Pty Ltd*, Unreported, Supreme Court of New South Wales, 12 July 1996 described it in the following terms. 'Unconscionability and its variant 'Unconscionable conduct'' have rapidly become prominent but largely incoherent features of the legal landscape. And they creep across all contexts in which private law is applied. The terms are sometimes used, I suspect, by both practitioners and judges in these days of smorgasbord pleadings to describe an all embracing claim when a more specific and legitimate ground fails to present itself. A commentator referring to the above described it as "the last refuge of the desperate' or 'the first refuge of the analytically lazy' For the immediate preceding comments, see C Rickett 'Unconscionability and Commercial Law' in John Lowry *Commercial Law : Perspective and Practice* (Lexis Nexis 2006) 175.

defying predictability or serving any purpose in terms of being a normative guide<sup>479</sup> for application by an exercise of judgment to the facts of the case.<sup>480</sup> Generally, its proponents however, argue that unconscionability gives the courts some flexibility<sup>481</sup> and allows them to 'police agreement directly'<sup>482</sup> by denying contractual right/liability where it appears that the element of free choice is absent.<sup>483</sup>

In the context of documentary credits law, the general law perception of unconscionability as an unruly horse<sup>484</sup> is visible in the manner in which its application as an exception to the principle of autonomy has been received in some jurisdiction.<sup>485</sup> However, there is a trend developing in some jurisdictions that unconscionability is a ground upon which the independent undertaking of documentary credits could be displaced. The main thrust of this chapter is to critically examine this emerging trend and to answer the question as to what extent, if any, unconscionability could be a valid defence to the impregnability of documentary credits and whether this development would be a credit or setback to the law of documentary credits.

It will be contended that despite the inherent difficulty associated with articulating a comprehensive and exhaustive definition of unconscionability, it is not completely

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<sup>479</sup> It needs to be noted that having a normative guide is a fundamental observation about the nature of law and the adjudicative process that a system of law offers. Hence the term "normative" is simply used to describe the way something ought to be done according to a value position

<sup>480</sup> C Rickett 'Unconscionability and Commercial Law' in John Lowry *Commercial Law: Perspective and Practice* (Lexis Nexis 2006) 179 para 9.28.

<sup>481</sup> Richard Epstein 'Unconscionability: A Critical Reappraisal' (1975) 18 J LEcon. 293, 304.

<sup>482</sup> Robert Hilman 'Debunking some Myth About Unconscionability: A New Framework for UCC Section 2-302' 67 Cornell L Rev 1, 15 (1981).

<sup>483</sup> Hawkland UCC SERIES, S.2-302 (Art. 2) (1997-1999) 1.

<sup>484</sup> Unruly horse in the sense that once you mount it, you never know where it is going to land you. It in effect, emphasizes the degree of unpredictability associated with the term.

<sup>485</sup> In England, save for occasional receptive attitudes evident in some judicial dicta, the courts have been opposed to unconscionability as an exception to the autonomy principle. This is despite dicta in some English cases that tend to favour its recognition.

without its merits as an exception to the autonomy principle. Its most substantial critics argue that unconscionability is nothing but ‘an emotionally satisfying incantation acting as a refuge for the desperate and analytically lazy’,<sup>486</sup> which in substance means nothing. However, as will be seen in the course of this chapter, the use of unconscionability as a ground upon which the independent undertaking evident in the autonomy principle could be disregarded has proved workable in some jurisdictions.<sup>487</sup> This is a pointer to the fact that in some exceptional circumstances when unconscionability has been used as a ground for refusal of payment, minimal clarity is sometimes achievable without straying unnecessarily into the realm of unrestrained speculation.<sup>488</sup> More so, as pointed out by Professor Mugasha,<sup>489</sup> this is an area of law (exceptions to the autonomy principle) that is gradually changing and embracing wisdom that did not previously exist. To this effect, it is my submission that too much emphasis on the illusory and shadowy nature of unconscionability may mean that issues that are not beyond the range of discovery are left either uninvestigated or under-investigated.<sup>490</sup> Lastly, it may be the case that the ritualistic incantation<sup>491</sup> of promoting certainty<sup>492</sup> in international trade is served by rejecting the

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<sup>486</sup> See Rickett ‘Unconscionability and Commercial Law’ in John Lowry *Commercial Law: Perspective and Practice* (Lexis Nexis 2006)179.

<sup>487</sup> Most notably in Singapore, Australia and Malaysia, unconscionability has been used as a ground in numerous cases to restrain payment in demand guarantees. However, as a result of this development, a disruption in international commerce, which has been feared by the critic of the unconscionability doctrine, is yet to be seen.

<sup>488</sup> Such speculation is unnecessary because, the same could even apply even to the fraud enquiry because the ingredients of knowledge, dishonesty etc as the cases show can be relative and stretched to unacceptable limit. For this compare the decision reached as to proof of dishonesty in *Standard Chartered Bank v Pakistan National Shipping Corp (No.2)* [2000] 1 Lloyd's Rep. 218, with the Singapore case of *DBS Bank Ltd v. Carrier Singapore (Pte) Ltd* [2008] 3 SLR 261.

<sup>489</sup> Agasha Mugasha, ‘Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee’ (2004) JBL 515 at 538

<sup>490</sup> Unconscionability as a ground for restraint of the irrevocable undertaken assumed by banks has proved workable in jurisdiction like Singapore and Australia. One of the arguments is that too much derogation from the autonomy principle will lead to the commercial world shunning the instrument. However, this much chanted situation has not been witnessed so far in the jurisdiction which has adopted a broader approach to the exceptions.

<sup>491</sup> It is perceived as ritualistic incantation because, in most instances the arguments which are repulsive to unconscionability as an equitable doctrine, which is rooted fundamentally in certainty and predictability at times is formalistic and the element of certainty if properly investigated might be

unconscionability doctrine. Nevertheless, while such overemphasis in promoting certainty might seem to be achieving its declared objectives, it may be undermining the inherent powers of the court (using the equitable doctrine of unconscionability) from discharging the reasoned and creative function which the dynamic nature of the current law of documentary credits should require of them.

For the sake of structural clarity, the chapter is set out in seven main sections. Apart from the introduction which is discussed in Section 6.1, section 6.2 examines the nature of unconscionability. Here attempt will be made to discuss unconscionability by borrowing from the meaning associated with the term in general law with the aim of applying same to documentary credit. Section 6.3 undertakes a comparative examination of unconscionability in some jurisdictions with the aim of ascertaining how the term has influenced the law of documentary credit in these jurisdictions. In section 6.4, the limit of the unconscionability exception is explored. Section 6.5 attempts an analysis of the relevance of this term as a justifiable ground upon which the impregnability of documentary credit could be displaced. In examining Section 6.5, the factors that favour and/or work against the unconscionability exception would be explored. Finally, a conclusion would be drawn based on the above issues.

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illusory. For more on this see the analysis of AF Mason, 'Contract, Good Faith and Equitable Standard in Fair Dealing' (2000) 116 LQR 66,70.

<sup>492</sup> In commercial transactions, it could be persuasively argued that it is difficult to realize certainty in all the cases as well as dispense justice that meets the commercial expectations of the parties.

## 6.2. Nature of Unconscionability

Attempting the examination of the nature of unconscionability would inescapably lead to an encounter with its amorphous<sup>493</sup> and slippery nature. However, Edmonds J<sup>494</sup> in reference to the provision of S. 51AA<sup>495</sup> of the Australian Trade Practices Act 1974 defined unconscionability or unconscionable conduct as follows: It (Unconscionability) ‘includes conduct in respect of which a judge in equity would have been prepared to grant relief’. This attempt at proffering a definition of unconscionability was corroborated by the approach adopted by the Section 2-302 of the Uniform Commercial Code (UCC) which in its official statement referred to unconscionability as a principle with the primary objective ‘of the prevention of oppression and unfair surprise and not of the disturbance of the allocation of risks because of superior bargaining power’.<sup>496</sup>

Put differently, unconscionability has been analyzed from two standpoints: procedural unconscionability and substantive unconscionability. In this regard, Arthur A Leff<sup>497</sup> of Washington Law School, noted that unconscionability is different from the defences of fraud, duress, mistake, impossibility or illegality because unlike these

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<sup>493</sup> See the Editors Note on ‘Unconscionability: an attempt at definition’ (1969-1970) 31 U Pitt L Rev 333.

<sup>494</sup> *Optus Networks Pty Limited v Telstra Corporation Limited* [2009] WL 1998981 (FCA), [2009] FCA 728.

<sup>495</sup> The Section recognizes unconscionability and states: *A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.*

<sup>496</sup> Comment 1 to Section 2-302 provides:

This section is intended to make it possible for the courts to police explicitly against contracts or clauses which they find to be unconscionable. In the past, such policing has been accomplished by adverse construction of language,... by determination that a clause is against public policy of the dominant purpose of the contract. This section is intended to allow the court to pass directly on the unconscionability of the contract or particular clause therein and to make a conclusion of the law as to its conscionability. See generally, UCC Section 2, 302 Cmt 1(1995) and (1996) See also, JJ White and RS Summers, *Uniform Commercial Code 206* (4<sup>th</sup> edn, West Group 1995) 213.

<sup>497</sup> See generally, AA Leff ‘Unconscionability and the Code-The Emperors New Clause’ (1967) 115 U PA L Rev 485.

defences, which look at either the process of contracting or the resulting contract, but not both, unconscionability looks at both the process and the result. He described procedural unconscionability as ‘bargaining naughtiness’.<sup>498</sup> Hence, it represents some defects in the bargaining process that causes oppression and surprise to an unsuspecting party.<sup>499</sup> The evils in the resulting contract are classified as substantive unconscionability and represent another variant of the unconscionability doctrine.<sup>500</sup>

Generally, the rise of unconscionability as a judicial tool has been felt in many jurisdictions<sup>501</sup>. In the United States, section 2-302 of the Uniform Commercial Code UCC in no uncertain terms captured the relevance of unconscionability when it stated: ‘If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result’. This provision in no uncertain terms emphasizes the important role of unconscionability in the American commercial scene. One of its primary objectives is to mitigate the harshness and inflexibility that might arise as a result of the insistence on the age long doctrine that a party that signs a contract manifests intent to be bound by all of its terms. Hence, unconscionability as a judicial tool aims to fill the gap created by the difficulty of establishing common law fraud by assisting

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<sup>498</sup> Ibid.

<sup>499</sup> See Craig Horowitz, Comment ‘Reviving the Law of Substantive Unconscionability: Applying the implied Covenant of Good Faith and Fair Dealing to Excessively Priced Consumer Credit Contracts’, (1986) 33 UNCLA L Rev 940.

<sup>500</sup> See A Leff ‘Unconscionability and the Code- Emperors New Clause’ 115 U Pa L Rev (1967-1968) 492.

<sup>501</sup> See the Provision of S.2 302 of UCC of the United States and Section 51AA Trade Practices Act of Australia, See also a striking example of unconscionable provision in *Section 36 of the Nordic Contracts Act*, which in its original Finnish version provides: ‘If a contract or a term thereof is unfair, or its application would be unfair, it may be adjusted or left unapplied. When considering the unfairness the whole content of the contract, the position of the parties, the circumstances when the contract was made and thereafter and other circumstances shall be taken into account’

in rescinding contracts that are ‘not quite fraudulent’<sup>502</sup> but produced ‘clearly oppressive and unfair results’.<sup>503</sup>

Applying this general law concept of unconscionability to documentary credits, it has been observed in a recent Singapore Court of Appeal case, *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan*,<sup>504</sup> that it is not possible to define ‘unconscionability’ other than to give some broad indications such as lack of good faith. In *GHL Pte Ltd v Unitrack Building Construction Pte Ltd*,<sup>505</sup> the Court of Appeal attempted to clarify the position of unconscionability and referred to the High Court case of *Raymond Construction Pte Ltd. v Low Yang Tong and AGF Insurance (Singapore) Pte Ltd*<sup>506</sup> Chiu J stated: ‘Unconscionability to me involves unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. Mere breaches of contract by the party in question ... would not by themselves be unconscionable’.

It is submitted that the nature of unconscionability is such that any detailed enquiry would raise the difficulty associated with its definition. However, such difficulty should be expected because of the nature of the term and should not detract from the basic function; unconscionability seeks to perform as a vitiating tool. The point needs to be made that unconscionability is an equitable creation and some of the primary

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<sup>502</sup> See D Price ‘The conscience of Judge and Jury: Statutory Unconscionability as a Mixed Question of Fact and Law’ 54 Temp L Q 743,746.

<sup>503</sup> *ibid* 746.

<sup>504</sup> [2000] 1 SLR 657.

<sup>505</sup> [1999] 4 SLR 604.

<sup>506</sup> (1998) 14 Const LJ136.

considerations in its determination is what is commercially reasonable, devoid of mala fides and meets the commercial and contractual expectation of the parties.<sup>507</sup>

### **6.3. Unconscionability in Selected Common Law Jurisdictions**

The Section seeks to analyse the legal position of unconscionability in four selected common law jurisdictions. The findings made in this section would be significant in the analysis made subsequently whether English law should welcome the recognition of unconscionability exception. The examination starts off with the analysis of the position in England before delving into other jurisdictions.

#### **6.3.1. English Law**

In general law, as early as 1697, English law has formulated a rule against the enforcement of unconscionable contracts.<sup>508</sup> In the case of *Earl of Chesterfield v Janssen*,<sup>509</sup> a grandson borrowed 5000 pounds and agreed to pay 2000 pounds more as interest, upon the death of his grandmother, who was already 70 years old at the time the debt was incurred. The Chancellor, Lord Hardwicke, in setting aside the contract used the term “unconscientious” to explain the presence of presumptive fraud. In his words:

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<sup>507</sup> See generally, the Editors, ‘Unconscionability: An attempt at Definition’ 31 U Pitt L Rev 333 (1969-1970).

<sup>508</sup> See *Earl of Chesterfield v Janssen* 2 Ves Sr 125 at 128 Eng. Reprint 821 Atk 30126 Eng Rep 191. 18 Eng Rul Cas 289 (1750) See also LJ Vener ‘Unconscionable Terms and Penalty Clauses: A Review of Cases Under Article 2 of the Uniform Commercial Code’ (1984) 89 Com. LJ 403,404

<sup>509</sup> *ibid*

It may be apparent from the intrinsic nature and subject of the bargain itself; such as no man in his senses and not under a delusion would make on the one hand, and as no honest man and fair man would accept on the other; which are unequitable and unconscientious bargains; and of such even the common law has taken notice...<sup>510</sup>

It is contended that this source of unconscionability which is related to unconscionable bargains in circumstances where there was equity's special protection of heirs<sup>511</sup> has been curtailed by statute.<sup>512</sup> However, the second source of unconscionable bargain, despite the statutory modification of the earlier source was not affected by the influence of the statute.<sup>513</sup> The second source relates to circumstances where there was an intervention of the doctrine of equity in a situations where a claimant was under some disadvantages which meant he could not be expected to fend for himself in dealing with others.<sup>514</sup> A lesson from this early development of unconscionability (for example in the *Earl of Chesterfield's* case) is that a finding of unconscionability was made in the absence of actual fraud, duress or illegality.

However, in documentary credits law, the concept of unconscionability has been muted in English law as a possible exception to the principle of autonomy. The

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<sup>510</sup> *ibid* 155.

<sup>511</sup> See further *Earl of Aylesford v Morris* (1873) 8 Ch App 484.

<sup>512</sup> See Rickett 'Unconscionability and Commercial Law' in John Lowry *Commercial Law: Perspective and Practice* (Lexis Nexis 2006) [9.5] see also the *UK Sales of Reversion Act 1867*.

<sup>513</sup> *ibid* [9.5].

<sup>514</sup> For an insight into the modern doctrine of unconscionable bargain, see *Moffat v Moffat* [1984] 1NZLR 600, 604-605 where it was explained by the Court of Appeal of New Zealand took the doctrine beyond the Heir and expectant situation and included all cases in which the court of equity intervened on the ground that the parties did not meet on equal terms.

pronouncements of the courts, most often obiter, have not neglected the unconscionability development in other common law jurisdictions. The general position is that in English law, the recognized exception to the principle of autonomy is only fraud. However, the English court, in reference to both domestic and foreign case laws stated unequivocally in *TTI Team Telecom International Limited v Hutchison 3G UK Limited*<sup>515</sup> that lack of good faith that is comparable to the unconscionability doctrine in Singapore was a ground upon which the independent undertaking evident in a performance bond could be displaced. Applying this principle to documentary credits, it has long been held that documentary credits and demand guarantees stand on the same footing with respect to applicable principle. The English High Court in holding that bad faith was a separate ground upon which the impregnability of a guarantee could be displaced referred to the English case of *Elian and Rabbath v Matsas and Matsas*,<sup>516</sup> where the three justices of the Court of Appeal were in agreement that there are circumstances in which breach of faith could be a ground upon which the autonomy principle could be disregarded. The rationale for this decision, well justified in reported cases on unconscionability and which was echoed by the court is that there are situations based on the circumstances of the case where as a result of bad faith on the part of a party to a transaction (performance bond) an injunction could be granted in order to prevent an irretrievable injustice. The ratio for the above was captured by the statement of the Lord Denning, M.R.<sup>517</sup> when he said:

Now I quite agree that a bank guarantee is very much like a letter of credit.

The Courts will do their utmost to enforce it according to its terms. They will

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<sup>515</sup> [2003] 1 All ER 914.

<sup>516</sup> [1966] 2 Lloyd's Rep 495.

<sup>517</sup> [1966] 2 Lloyd's Rep 495.

not, in the ordinary course of things, interfere by way of injunction to prevent its due implementation. But that is not an absolute rule. Circumstances may arise such as to warrant interference by injunction.... Although the shippers were not parties to the bank guarantee, nevertheless they have a most important interest in it. If the bank pays under this guarantee, they will claim against the Lebanese bank who in turn will claim against the shippers. The shippers will certainly be debited with the account. On being so debited, they will have to sue the ship-owners for breach of their promise, express or implied, to release the goods. Are the shippers to be forced to take that course? Or can they short-circuit the dispute by suing the ship-owners at once for an injunction? <sup>518</sup>

Lord Denning MR concluded that this was the kind of case where it was imperative, to prevent an irretrievable injustice to grant an injunction based on its facts.

The facts of this case are that shippers in Beirut shipped barley on a Greek ship which was chartered by Lebanese charterers. She was bound for Rijeka in Yugoslavia. The goods were consigned to buyers in Hungary. When the ship got to Rijeka there was delay in unloading, and the ship-owners claimed a lien on the goods for demurrage. This lien was good under the charter-party. The shippers were not liable to pay demurrage. But they wanted the goods released to their buyers, because otherwise their good commercial relations with the buyers would be prejudiced. In order to get the goods released, there were negotiations between the shippers in Beirut with the owners and their agents, J D McLaren & Co Ltd., in London. The shippers said: 'We

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<sup>518</sup> [1966] 2 Lloyd's Rep 495.

will give a bank guarantee if you will release the lien and instruct the Captain not to exercise a lien on the cargo'. That offer was contained in telex messages. In the result a bank guarantee was given. The Lebanese shippers instructed their bankers in Lebanon, who in turn instructed the Midland Bank, Ltd., in London, who in turn gave a bank guarantee to the ship owners' agents in London. The terms of the guarantee stated as follows;

IN CONSIDERATION of the Ship-owners refraining from exercising a lien on the cargo, or raising it immediately if it has already been exercised, we, MIDLAND BANK LTD. . . . hereby undertake to pay on demand in external sterling in London to J. D. McLaren & Co., Ltd. . . . such amount as may be agreed between the Ship-owners and the Charterers, Pan Asiatic Shipping Co. of Beirut, to be due to the Ship-owners in respect of demurrage at Rijeka under the above named Charter Party and in default of agreement to pay such amount of demurrage together with interests and costs as may be found to be due by an arbitration award in accordance with Clause 28 of the Charter Party. Further, on behalf of the Charterers, we hereby waive the provisions of Clauses 8 and 27 of the Charter Party.<sup>519</sup>

The guarantee was payable against presentation of a debit note certifying that the amount claimed is properly due and given on the understanding as evident in the terms of the guarantee that the lien would be lifted and no further lien imposed. The Master of the ship upon instruction by the ship-owners after the guarantee was issued, lifted the lien but immediately exercised another lien in respect of some other liability

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<sup>519</sup> [1966] 2 Lloyds Rep 495.

of the cargo owners. This was arguably against the terms of the guarantee as captured by Lord Denning MR, who noted that ‘the guarantee was given on the understanding that the lien was raised and no further lien imposed: and that when the ship-owners, in breach of that understanding, imposed a further lien, they were disabled from acting on the guarantee’.<sup>520</sup> This by implication meant that the actions of the ship-owners, though short of fraud, should be seen as lacking in good faith so as to demand a restraint by the way of injunction. This was the same basis of a concurring decision by Danckwerts LJ, with whom Winn LJ agreed and found it unnecessary to add further opinion on the issue.

In similar vein, Eveleigh LJ in the Court of Appeal case of *Potton Homes Ltd v Coleman Contractors (Oversea) Ltd*<sup>521</sup> added to this trend that has been utilized in the ratio of the decisions in *TTI Telecom International Ltd*<sup>522</sup> and the case of *Elian and Rabbat*.<sup>523</sup> In an obiter dictum, he categorically stated that:

In principle I do not think it possible to say that in no circumstances whatsoever, apart from fraud will the court restrain the buyer. The facts of each case must be considered. If the contract is avoided or if there is a failure of consideration between the buyer and the seller for which the seller undertook to procure the issue of a performance bond, I do not see why, as between seller and buyer, the seller should not be unable to prevent a call on the bond by the mere assertion that the bond is to be treated as cash in hand.

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<sup>520</sup> (1984) 28 Build LR 19, 20-21.

<sup>521</sup> (1984) 28 Build LR 19.

<sup>522</sup> [2003] 1 All ER 914.

<sup>523</sup> [1966] 2 Lloyds Rep 495.

Again, Eveleigh LJ's statement touches on some of those cardinal issues that underpin the unconscionability doctrine. First, it considers the facts of each case to determine whether a restraint is necessary. Secondly, Eveleigh LJ notes that compelling circumstances absent fraud may displace the impregnability of documentary credit.

One of the strongest criticisms of the approach in the above cases discussed is that it runs contrary to established authority which in the main recognizes only one established exception to the principle of autonomy in England which is fraud. Eveleigh L.J statement in *Potton Homes Ltd v Coleman Contractors (Overseas) Ltd*<sup>524</sup> cited above as to the possibility of other exceptions different from fraud has been dismissed by Professor Enonchong<sup>525</sup> as being uncertain, made ex tempore, obiter and running contrary to established English authority. As it is, his comment captures the predominant thinking as reflected in English documentary credit cases.

However, the development in other jurisdictions of other grounds different from fraud reinforces the dictum of Eveleigh LJ which refers to the possibility, based on the facts and circumstances of the case, of other grounds of restraining payment. Also the dictum of Thornton QC in *TTI Team Telecom International Limited v Hutchison 3G UK Limited*<sup>526</sup> as to the presence of a bad faith exception, which is comparable to the unconscionability exception in Singapore, has been judicially noticed in several jurisdictions. Adding to the sympathy expressed by the court in *TTI Team Telecom Case*, it may be instructive to note that reliance on fraud and its associated difficulty in terms of proof as the only ground upon which the impregnability of documentary

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<sup>524</sup> (1984) 28 Build LR 19.

<sup>525</sup> See Nelson Enonchong 'The Problem of Abusive Calls on Demand Guarantees' (2007) LMCLQ 83, 102.

<sup>526</sup> [2003] 1 All ER 914. This case is discussed in details below.

credits could be displaced is reminiscent of the opening passage of Lord Roskill's published report regarding fraud in criminal cases:

The public no longer believes that the legal system in England and Wales is capable of bringing the perpetrators of serious fraud expeditiously and effectively to book. The overwhelming weight of the evidence laid before us suggest that the public is right. In relation to such fraud, and the skilful and determined criminals who commit them, the present legal system is archaic, cumbersome and unreliable. At every stage,... the present arrangements offer an invitation to blatant delay and abuse.<sup>527</sup>

If the above view refers to the public mistrust of any investigation or trial based on fraud because of the miscarriage of justice associated with rigid application of fraud and its proof, it will not be out of place for English law to recognize in documentary credits a more flexible ground like unconscionability. Unconscionability in this case, seeks to maintain a more commercial balance based on fairness and legitimate expectation of parties devoid of unnecessary insistence of right where none exist in equity. The unconscionability exception ensures that there is no abuse in the call or manner in which documents are tendered in documentary credit. It prevents the beneficiary from taking advantage of the gaps left by the contractual provisions or inflexibility associated with the fraud rule. The flexibility of the exception means that the concept has no strict guidelines and can be tailored to suit each new case. An attempt will be made to ascertain the approach that has been adopted in other common law jurisdictions regarding an unconscionability exception to the principle of

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<sup>527</sup> Fraud Trials Committee Report, London, 1986, page 1, See also Michael Levi, 'Reforming Criminal Fraud Trial' (1986) *Journal of Law and Society*, Vol 13. 1.

autonomy.

### 6.3.2. Singapore

Courts in Singapore blazed the trail with respect to the application of unconscionability as an exception to the principle of autonomy in an abstract payment undertaking. After a period of sitting uncomfortably with the traditional English position that only fraud could displace the impregnability of documentary credit, the Singapore courts recognized that unconscionability, if successfully proved, does constitute a ground separate from fraud upon which a court will grant an injunction restraining the beneficiary from receiving payment or preventing the issuer from making payment.

In 2003, in the case of *Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd*<sup>528</sup> Lai Siu Chiu J, relied on the leading Singapore unconscionability case of *GHL Pte v Unitrack Construction Ltd*<sup>529</sup> to hold the action of the defendant (Hola) unconscionable, where the defendant had called on the original amount in the performance bond in circumstances where the original price of the contract had been revised downward, which consequently affected the amount of the bond posted. In the course of the decision, the court upheld unconscionability as a ground for restraining a call of a performance bond notwithstanding its similarity to a documentary credit. Relying on the earlier case of *Dauphin Offshore Engineering & Trading Pte Ltd v The*

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<sup>528</sup> [2003] 1 SLR 667.

<sup>529</sup> [1999] 4 SLR 604.

*Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan*,<sup>530</sup> it emphasized that it was unnecessary to define with precision the meaning of unconscionability as ‘...what kind of situation would constitute unconscionability would have to depend on the facts of each case...There is no pre-determined categorization’.<sup>531</sup>

However, Lai Kew Chai J, has perceptively suggested in *Raymond Construction Pte Ltd v Low Yang Tong*,<sup>532</sup> that the concept of unconscionability ‘involves unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensive or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. Mere breaches of contract by the party in question would not by themselves be unconscionable’. This definition was further clarified in *McConnell Dowell Constructors (Aust) Pty Ltd v Sembcorp Engineers and Constructors Pte Ltd*,<sup>533</sup> when the court noted that all unconscionability cases must involve an element of unfairness.

In conclusion, four points need be made regarding the position of unconscionability in Singapore. Firstly, unconscionability is a separate exception to fraud in Singapore. Secondly, despite the difficulty of defining unconscionability, it has not deterred the finding of unconscionability. Thirdly, the documentary credit law of Singapore (as far as the exception is concerned) cannot be said to be uncertain as the equitable doctrine of unconscionability has been applied within the terms of a recognized legal principle, at least in relation to performance bond. And finally, it has not been reported

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<sup>530</sup> [2000] 1 SLR 657.

<sup>531</sup> *Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd* [2003] 1 SLR 667 [63].

<sup>532</sup> (Suit 1715/95, 11 July 1996, unreported).

<sup>533</sup> [2002] 1 SLR 199.

anywhere, contrary to the contention of critics of unconscionability, that its subjective nature will adversely affect international trade.

### **6.3.3. Position in Malaysia**

In Malaysia, the issue of whether unconscionability is a ground for restraint of payment again resurfaced recently in the High Court case of *Mitsubishi Corp & Ors v Sepangar Bay Power Corp Sdn Bhd*<sup>534</sup> The argument of the claimant's counsel in asking for a restraint on payment was that a call on the bond was unconscionable, in bad faith and fraudulent. Kang Gee J, relying on the earlier case *LEC Contractors Sdn Bhd v. Castle Inn Sdn Bhd*<sup>535</sup> dismissed without hesitation the contention that unconscionable conduct was a ground upon which a restraint on payment could be sought. In the *LEC Contractors case*, Siddin JCA of the Malaysian Court of Appeal in reference to English authorities, opined that: '... authorities we have referred to clearly indicate that in order to justify any injunction to stop payment there must be clear evidence of fraud on the part of the first defendant which comes to the knowledge of the second defendant. Bad faith or unconscionable conduct by itself is not fraud'.<sup>536</sup> Relying on the appellate court pronouncement on the current state of the law in Malaysia, the court held that only in cases of established fraud will a restraint order be granted.

The above position seems to represent the position of the law in Malaysia. However, what is worrying about the Malaysian court decisions adopting the English orthodox position is that there are still cases where the unconscionability exception seems to

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<sup>534</sup> [2009] 9 MLJ 121.

<sup>535</sup> [2000] 3 MLJ 339.

<sup>536</sup> *ibid* at 361.

have been lauded as being of sound principle or completely adopted. In the recent case of *Pasukhas Construction Sdn Bhd v MTM Millennium Holdings Sdn Bhd*<sup>537</sup> Hishamudin J, though apparently bound by the principle expounded in *LEC Contractors* (that fraud is the only ground upon which a restraint on payment could be made) described the principle of unconscionability that was enunciated in the Singapore Court of Appeal case of *Bocotra Construction*<sup>538</sup> as being sound.<sup>539</sup> His Lordship however, expressed regret that that under the doctrine of binding precedent, he was bound to follow the Malaysian Court of Appeal decision in *LEC Contractors*.

In the unreported Malaysian case of *Nafas Abadi Holdings Sdn Bhd v Putrajaya Holdings Sdn Bhd & Anor*<sup>540</sup> the doctrine of unconscionability was recognized by the court. Suriyadi, J while recognizing that letters of credit stand on the same footing as performance bonds and that fraud constituted a ground upon which payment could be restrained noted as follows: ‘I do not think it is possible to say that in no circumstances whatsoever, apart from fraud, will the court restrain the buyer. The facts of each case must be considered. In our opinion,... fraud and unconscionability are considerations in application for injunction restraining payment or calls on bonds’.<sup>541</sup> Similarly, in *Perkasa Duta Sdn. Bhd. v Perbadanan Kemajuan Negeri Selangor*<sup>542</sup> it was also held that unconscionable conduct could also be regarded as an exceptional circumstances upon which the courts will interfere with the machinery of irrevocable obligations assumed by banks.

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<sup>537</sup> [2009] 8 MLJU 0025.

<sup>538</sup> [1995] 2 SLR 733.

<sup>539</sup> [2009] 8 MLJU 0025 [21].

<sup>540</sup> [2004] MLJU 148.

<sup>541</sup> [2004] MLJU 148 [3-6]. Emphasis added

<sup>542</sup> [2002] 2 CLJ 307, see also *Siemens Integra Transportation System Sdn Bhd & Anor v EKD Construction Sdn Bhd & Anor* [2003] MLJU 475 [5].

It is concluded that while the position of the Court of Appeal in Malaysia is that fraud is the recognized exception to the principle of autonomy, the numerous instances in which the lower courts have either expressed sympathy for, or adopted, the principle of unconscionability enunciated in Singapore leaves the rationale for the higher court pronouncement that fraud is the only established exception subject to doubt. It shows how opinion is divided in most Malaysian courts as to the current position of the law regarding what constitutes an exception to the impregnability of the independent undertaking. While the Court of Appeal in *LEC Contractors* has held that fraud is the only recognized exception, numerous High Court decisions in Malaysia<sup>543</sup> both old and current<sup>544</sup> continue to show either support or outright adoption of the unconscionability exception enunciated in Singapore. However, until an appellate court decides otherwise,<sup>545</sup> it remains the position that in Malaysia, the only exception to the impregnability of the independent undertaking is an established fraud.

#### **6.3.4. Australia**

Unconscionability as a legal doctrine became prominent in Australia with the introduction of *Part IVA* of the *Trade Practices Act 1974* (TPA). The Act, contains three sections that prohibit corporations from engaging in unconscionable conduct: SS 51AA, 51AB and 51AC. Section 51AC was added to the *TPA* in 1998 following

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<sup>543</sup> As early as 1996, in *Bains Harding (Malaysia) Sdn Bhd v Arab-Malaysian Merchant Bank Bhd* [1996] 1 MLJ 425, an injunction was granted in circumstances where a demand was held to be in 'bad faith or in an unconscionable manner'. See also *Radio & General Trading Co Sdn v Wayss & Freytag (Malaysia) Sdn Bhd* [1997] MLJU 462, where an injunction was granted on the ground that the demand was 'plainly inequitable'

<sup>544</sup> See the 2009 case of *Pasukhas Construction Sdn Bhd & Anor v MTM Millennium Holdings Sdn Bhd & Anor* [2009] 8 MLJ [21] where Hishamudin J described the unconscionability doctrine enunciated in Singapore as being of sound principle

<sup>545</sup> Those courts of first instance decisions that continue to applaud or out rightly adopt the unconscionability doctrine enunciated in Singapore.

concerns that existing statutory and common law causes of action did not adequately protect small businesses against unfair or exploitative conduct. To achieve this protection, s 51AC proscribes ‘conduct that is, in all the circumstances, unconscionable’<sup>546</sup> in connection with dealings with small businesses. The doctrine of unconscionability as evidenced in *Part IVA* of the *Trade Practices Act* forms part of a modern trend in the law towards legal evaluation of the normative conduct of commercial dealings, and attempts to free such transactions from morally reprehensible conduct.<sup>547</sup> In this respect, it may be recalled that at common law, bargains made in unfair circumstances were ameliorated to some degree by the development in equity of the doctrine of unconscionable bargains. Hence, statutory unconscionability in the *TPA* is a descendant of this equitable doctrine<sup>548</sup> and its influence has been widely felt in Australian commercial life.

In documentary credit law, it was held in the Victoria Supreme Court case of *Olex Focas Pty Ltd v Skodaexport Co Ltd*<sup>549</sup> that letter of credit stands on the same footing with demand guarantee. If this is the accepted position, what then is the Australian position as to whether unconscionability is a separate exception to the principle of autonomy in documentary credit? In *Olex Focas Pty Ltd* case, an application by the first plaintiff for an injunction restraining the first defendant from calling on a performance bond as well as a call on a mobilization advance guarantee on the ground that such call was fraudulent and unconscionable both in Australian general law and

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<sup>546</sup> *TPA* s 51AC (1), (2).

<sup>547</sup> See Paul Finn, ‘Commerce, the Common Law and Morality’ (1989) 17 *Melb. U L Rev* 87; Vivien Goldwasser and Tony Ciro, ‘Standards of Behaviour in Commercial Contracting’ (2002) 30 *Aust B L Rev* 369.

<sup>548</sup> See L. Brown ‘The Impact of Section 51AC of the Trade Practices Act 1974 (Cth) on Commercial Certainty’ (2004)28 *Melb U L Rev* 589,595.

<sup>549</sup> 1996 *VIC LEXIS* 1245 [27].

under the Trade Practices Act of 1974<sup>550</sup> attracted an approach that is with respect subject to doubt. Batt J, relying principally on the authority of *Wood Hall Ltd v Pipeline Authority*<sup>551</sup> held that unconscionability in general Australian law is not an exception<sup>552</sup> to the principle of autonomy and cited a host of English authorities to the effect that the only recognized exception to the irrevocable undertakings assumed by banks is established fraud. Turning to the argument put forward by the first plaintiff that unconscionability was a ground for restraint on payment under the *Trade Practices Act 1974* and the action of the plaintiff in calling on the performance bond was unconscionable, Batt J, considered the transaction in two parts, the performance bond in respect of the underlying contract, and the advance mobilization and procurement guarantee. In respect of the performance bond he reasoned that, considering its importance, the conduct of the first defendant was not unconscionable. The pronouncement of Batt J is captured succinctly as follows:<sup>553</sup>

I consider separately the performance bonds and the mobilization/procurement guarantees. Despite the extension by the High Court in recent years of the use of the concept of unconscionable conduct as a criterion of liability, ...I am not persuaded that the conduct of the first defendant in seeking to call up and procuring the call up of the performance bonds for their full amount is unconscionable or that there is a serious question to be tried about that...

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<sup>550</sup> See *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1996] VIC LEXIS 1245 [31] where the plaintiff contended that the first defendant by threatening to call up the bank guarantees, has engaged in unconscionable conduct under the general law and that it has in trade and commerce engaged in conduct that is unconscionable within the meaning of the unwritten law of the States and Territories of Australia and thus in contravention of s51AA of the Trade Practices Act 1974 (Commonwealth), or, alternatively of that section as given extended application by s6(2)(a)(i) of that Act.

<sup>551</sup> (1979) 141 CLR 443.

<sup>552</sup> *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1996] VIC LEXIS 1245 at [48]

<sup>553</sup> *ibid.*

However, in the case of the mobilisation and procurement guarantees I consider the position to be different.

Batt J then held that under the advance/ mobilization guarantee, the conduct of the first defendant in calling on the guarantee was unconscionable, the reasoning being that a mobilization/ procurement guarantee served a purpose different from a performance bond and the call on it was affected by unconscionable conduct within the meaning of the *Trade Practices Act*. His Honour's reason for issuing an injunction under the *Trade Practices Act* in respect of the advance/mobilization guarantee was that unconscionability was construed in a general *Trade Practices Act* sense to require parties to behave reasonably and in accordance with ordinary human standards. It includes a principle that a person should not, by an appeal to strict legal rights, cause hardship to others by violating their reasonable expectations. The court further stated that insistence on rights in circumstances which make that insistence harsh or oppressive will amount to unconscionable conduct. One can engage in unconscionable conduct even if one believes, wrongly, that one is acting within one's rights.

It is submitted that in answering the question whether unconscionability is a ground for restraint of payment in Australian documentary credits' law, an approach which separates unconscionability under the Act and that in general law, is with respect, likely to be misleading. The reason for the above submission firstly, is that the provision of the *Trade Practices Act*, though a statute, is still part of the general law of Australia and its provisions, which for restraint of payment on grounds of unconscionable conduct remain the law. The provision affirms that unconscionability is an exception to the principle of autonomy in Australia. Secondly, and more

specifically, the provision of *S51 AA* which states in its subsection (1) that ‘a corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories’ has been considered by the court in *Australian Competition and Consumer Commission v Samton Holdings Pty Ltd & Ors.*<sup>554</sup> Gray J<sup>555</sup> citing *Lange v Australian Broadcasting Corporation*<sup>556</sup> noted that ‘it is beyond controversy that the unwritten law of the States and Territories is one body of law for the whole of Australia and that Section 51AA, in referring to the unwritten law from time to time of the States and Territories, refers to the common law of Australia’.

Many Australian decisions have held that unconscionability under the Act is a ground for restraint of the irrevocable undertaking assumed by banks and one of the most recent in those line of authorities is *Clough Engineering Limited v Oil and Natural Gas Corporation & Ors*<sup>557</sup> where it was held that unconscionability under the *Trade Practices Act* is a ground for restraint of payment in respect of demand guarantees. In *Clough Engineering Limited v Oil and Natural Gas Corporation Ltd*,<sup>558</sup> Gilmour J was concerned with an application for leave pursuant to an order made under the Federal Court Rules to serve an application out of the jurisdiction and for orders to restrain Oil and Natural Gas Corporation Ltd ("ONGC") from taking further steps to demand or obtain payment or renewing or claiming to renew such demand in respect of certain performance guarantees granted by the three respondent banks to ONGC. The applicant, Clough Engineering Limited, sought a declaration that ONGC by demanding and threatening to make a demand on the performance guarantees granted

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<sup>554</sup> [2002] 117 FCR 301.

<sup>555</sup> French and Stone JJ concurred in the decision

<sup>556</sup> [1997] 189 CLR 520,563; see also *Lipohar v The Queen* [1999] 200 CLR 485,505.

<sup>557</sup> [2007] FCA 881 [2007] WL 1667145.

<sup>558</sup> [2007] FCA 881.

by the banks had engaged in, or proposed to engage in, unconscionable conduct in contravention of S. 51AA of the TPA. Gilmour J granted leave to serve and he made an order restraining ONGC from taking any further step to demand or obtain payment or renewing or claiming to renew a demand for payment from the banks under the performance guarantees. Gilmour J said that there was authority which clearly supported the proposition that an inappropriate threat to call or a call on performance guarantees can be unconscionable conduct within s 51AA of the *Trade Practices Act*. His Honour considered that it was appropriate to grant an injunction restraining ONGC from making a call on the performance guarantees and he appears to have relied on the fact that there was a serious question to be tried as to whether ONGC's conduct was unconscionable within S. 51AA of the TPA.

Shortly after his Honour made these orders, the banks applied to have them set aside in the case of *Clough Engineering Ltd v Oil and Natural Gas Corporation Limited (No 2)*<sup>559</sup> Gilmour J refused to set aside the orders: His Honour said: 'I remain satisfied that there is a serious question to be tried as to whether ONGC has acted unconscionably in contravention of S.51AA of the Act in calling on or threatening to call on the performance guarantees despite there being no legal right on its part to do so'.<sup>560</sup> To further drive home his conviction on the issue, Gilmour J cited the pronouncement of Austin J in *Boral Formwork v Action Makers*<sup>561</sup> and noted that when referring to s 51AA of the Act: 'the principle of autonomy applicable to a standby letter of credit, cannot override the statute'. His Honour finally concluded based on the decision in *Boral Formwork* he was satisfied that upon the same factual matrix, there is a serious issue to be tried.

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<sup>559</sup> [2007] FCA 927.

<sup>560</sup> *ibid* [43].

<sup>561</sup> [2003] ATPR 41-953[14].

Similarly, in respect of documentary credits, Besanko J, in *Orrcon Operations Pty Ltd v Capital Steel & Pipe Pty Ltd*<sup>562</sup> accepted the contention that apart from fraud, unconscionability was a separate exception to the principle of autonomy in documentary credits.<sup>563</sup>

#### **6.4. Scope of the Unconscionability Exception**

In answering the question as to what the limit of the unconscionability exception that would warrant a departure from the independent principle is, effort should be made to borrow from the different jurisdictions that have adopted the exception. References should also be made to the legal development in the jurisdictions that have not adopted unconscionability exception but points to the law of the jurisdiction having not neglected unconscionable conduct, as serious issue upon which the law would consider granting relief. Hence, in this section, an attempt will be made to consider the standard of proof required to establish unconscionability as well as some necessary ingredients that need to be present before a finding of unconscionability is made.

##### **6.4.1. Standard of Proof**

The issue of whether unconscionability is established as to act as a restraint on the irrevocable undertaken assumed by banks would undoubtedly warrant a discussion of

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<sup>562</sup> [2007] FCA 1319.

<sup>563</sup> *ibid* at paras [45] [70].

two phases on the issue of proof required. On one side, is an application for an injunction to restrain the beneficiary from presenting documents for payment on the grounds that it would be unconscionable to present the documents or the bank from making payment on the grounds that it would be unconscionable for the bank to pay a beneficiary whose conduct is deemed unconscionable. Related to the above is the further question as to the standard of proof required to avoid an application for summary judgment on the grounds that the beneficiary by tendering document for payment if not restrained would be acting in an unconscionable manner. And finally the question as to the standard of proof required for unconscionability cases at full trial. The above issues raised would be addressed by comparatively looking at the positions in some common law jurisdictions.

#### **6.4.1.1. Singapore**

Considering an aspect of the first question, that is, the required standard of proof in an application for interim or interlocutory injunction, the authorities with respect are not very clear on the issue. In the Singapore case of *Samwoh Asphalt Premix v Sum Cheong Piling Pte Ltd*<sup>564</sup> the Court, was of the view that depending on the circumstances of the case, the Court would grant an injunction if the applicant could make out a case of unconscionability. Unfortunately, this pronouncement of the court does not assist greatly in understanding the standard of proof required. The basic difficulty with this is that it is not clear whether a high or low standard is required. However, in the earlier case of *Bocotra*,<sup>565</sup> Karthigesu J.A opined that ‘a higher degree of strictness applies’. It was his contention that to establish unconscionability,

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<sup>564</sup> [2002] SLR 459 (CA).

<sup>565</sup> [1995] 2 SLR 733, 744.

the principal must ‘establish a clear case in interlocutory proceedings. It is clear that mere allegation is not enough’. This pronouncement seems to have been influenced by the pronouncement of English cases as to the standard of proof required to establish the fraud in an irrevocable undertaking.<sup>566</sup> In similar vein, the High Court in *Raymond Construction Pte Ltd v Low Yang Tong*<sup>567</sup> made it clear that mere allegations of unconscionability would not suffice for the grant of an injunction on the grounds of unconscionability but that a contractor seeking to restrain the employer from calling on the performance bond must establish a strong prima facie case of unconscionability.

However, this trend that seems to have been set by earlier cases of setting a high standard for the proof of unconscionability appeared to have stalled in the 1999 case of *GHL v Unitrack*.<sup>568</sup> Here the Court of Appeal of Singapore held that ‘where there is a prima facie evidence of fraud or unconscionability, the court should step in to intervene at the interlocutory stage until the whole of the circumstances of the case has been investigated’.<sup>569</sup> This approach represents a lower standard of proof to the ones adopted by earlier cases.

#### **6.4.1.2. Australia**

In Australia, where the *Trade Practices Act 1974* has recognized unconscionability as a ground upon which the irrevocable undertaking assumed by banks could be disregarded; a different standard of proof (a threshold that is lower than that required by a majority of Singapore cases) is required for the grant of interim or interlocutory

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<sup>566</sup> It must be noted that in the case, *Karthigesu JA* made reference to fraud or unconscionability.

<sup>567</sup> [1993] 3 SLR 350.

<sup>568</sup> [1999] 4 SLR 604.

<sup>569</sup> *ibid* at 614-616.

injunction. In *Western Australia v Vetter Trittler*<sup>570</sup> French J, in reference to a prima facie standard of proof, expressed an opinion in the case that ‘that a prima facie case is made out, if, on the material before the Court, inferences are open which if translated into findings of fact would support the relief claimed’. In reliance on the same principle, Gilmour J in *Clough Engineering Ltd v Oil and Natural Gas Corporation Limited*<sup>571</sup> held in an application for an interlocutory injunction to restrain the defendant oil company from making a call on the a demand guarantee opened by the plaintiff in its favour that the plaintiff (Clough) had established a prima facie case for the relief variously claimed in that the defendant’s threatened call or call on the performance bonds were unconscionable within the meaning of the *Trade Practices Act*.

This pronouncement is in line with the approach of the Australian courts that have held in a long line of cases that the standard of proof for granting an interlocutory injunction is the claimant’s legal duty to establish that there is a prima facie case for the grant of the injunction sought. The court in *Australian Broadcasting Corporation Ltd v O’Neill*<sup>572</sup> citing the decision of *Beecham Group Ltd v Bristol Laboratories Pty Ltd*<sup>573</sup> explained the meaning of prima facie as follows:

By using the phrase ‘prima facie case’, their Honours<sup>574</sup> did not mean that the plaintiff must show that it is more probable than not that at trial the plaintiff will succeed; it is sufficient that the plaintiff show a sufficient likelihood of success to justify in the circumstances the preservation of the status quo

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<sup>570</sup> (1991) 30 FCR 102, 110.

<sup>571</sup> [2007] FCA 927.

<sup>572</sup> [2006] 80 ALJR 1672 [65].

<sup>573</sup> [1968] 118 CLR 618.

<sup>574</sup> Here reference is made to the decision of the court in *Beecham Group Ltd v Bristol Laboratories Pty Ltd* [1968] 118 CLR 618 (Kitto, Taylor, Menzies and Owen JJ)

pending the trial. This was the sense in which the Court was referring to the notion of a prima facie case.<sup>575</sup>

It needs to be pointed out that in some Australian decisions,<sup>576</sup> a different wording has been used in describing the standard of proof required in interlocutory injunctions. Most courts prefer to state that the plaintiff needs to prove that there is a serious issue to be tried. However, the court in *Australian Broadcasting Corporation Ltd v O'Neill*<sup>577</sup> noted that there is no objection to the use of the word “serious question” to be tried if it is understood as conveying the notion that the seriousness of the question, like the strength of the probability, still falls under the consideration as enunciated in *Beecham Group Ltd v Bristol Laboratories Pty Ltd*<sup>578</sup> that is the requirement that the claimant must establish a prima facie case<sup>579</sup>

Another aspect of the standard of proof is the threshold required to establish unconscionability during trial. Put differently, assuming the required standard of proof is established for the grant of an interlocutory injunction and the status quo is maintained pending trial, what would be the standard required for the finding of unconscionability at the main trial? The answer to this question is not different from the answer to the appropriate standard of proof required for an allegation of fraud in civil proceedings to be established. Unconscionability exception being a concept in civil law, the standard is not different from that required in all civil proceedings. In this regard, authorities in the different jurisdictions are in harmony that the standard

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<sup>575</sup> *Australian Broadcasting Corporation v O'Neill* [2006] 80 ALJR 1672 at para.[65].

<sup>576</sup> See *Orrcon Operations Pty Ltd v Capital Steel & Pipe Pty Ltd* [2007] FCA 1319 [40-49].

<sup>577</sup> [2006] 80 ALJR 1672.

<sup>578</sup> [1968] 118 CLR 618.

<sup>579</sup> See *Australian Broadcasting Corporation v O'Neill* [2006] 80 ALJR 1672 [70].

required is proof on a balance of probabilities.<sup>580</sup> The authoritative judgment of the House of Lords in *Re B*<sup>581</sup> has cleared the confusion associated with some cases<sup>582</sup> that in certain civil cases a heightened standard of proof that is higher than the required proof on a balance of probabilities is required.

Closely related to the issue of the standard of proof in Australian jurisdictions is the enquiry as to where the balance of convenience<sup>583</sup> lies. This inquiry is undertaken after a consideration of whether the plaintiff has made out a prima facie case. The inquiry as to where the balance of convenience lies as well as proving unconscionability to the requisite standard must be resolved in the plaintiff's favour before an interlocutory injunction is granted.<sup>584</sup>

#### **6.4.2. Proving Unconscionability- Legal Ingredients**

Having set out the standard of proof required for the finding of unconscionability, it is important to note that establishing unconscionability to the required level of proof depends fundamentally on proper appreciation of the crucial elements that characterizes the unconscionability doctrine in documentary credit. Having said that,

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<sup>580</sup> In England, Singapore, Australia and Malaysia, the accepted standard of proof in civil proceeding is proof on a balance of probabilities.

<sup>581</sup> [2008] UKHL 35 [13] (Lord Hoffmann). This decision followed the earlier decision of Lord Nicholls in *In re H (Minors)* [1996] AC 563. See also the clarifying comment of Dame Elizabeth Butler-Sloss P in support of the above authorities in *In re U (A Child)* [2005] Fam 134, 143–144

<sup>582</sup> *Hornal v Neuberger Products Ltd* [1957] 1 QB 247, See also Lord Steyn in *R (McCann) v Crown Court at Manchester* [2003] 1 AC 787.

<sup>583</sup> It need to be noted that in Singapore and Malaysia, the courts have held that a consideration of the issue of balance of convenience is not necessary in determining whether to exercise a discretionary right to grant interlocutory injunction against the independent undertaken assumed by banks provided that strong prima facie case has been established..

<sup>584</sup> *ibid* at [65-66]

it would be very significant to consider some of these important elements upon which the finding of unconscionability rest in documentary credits law.

**6.4.2.1. Reprehensible Conduct of such a manner that a court of conscience will deprive the party involved or refuse to assist him**

What amounts to reprehensible conduct in documentary credit based upon which a court of conscience would intervene at times is a factual situation which varies depending on the circumstances of each particular case. In most of the cases, the answer to what amounts to unconscionable conduct could be deduced from the terms of the transaction. In this regard, Mason J,<sup>585</sup> in reference to unconscionability and reprehensible conduct noted that such conduct would include several distinct vitiating factors like undue influence, misrepresentation whether actual or constructive.<sup>586</sup> In this case, reprehensible conduct represents a kind of descriptive label for the kind of conducts with several distinct vitiating elements where the mala fides of a party is not in doubt. It is suggested that in the proof of what amount to reprehensible conduct as to prove unconscionability, establishing variants of other distinct vitiating elements to a standard required in a civil proceeding suffices. In achieving this, the opinion of the court in *Baynes Clarke v Corless*<sup>587</sup> is instructive. The court noted that ‘Questions of unconscionability were matters for the court to be decided on an objective basis having regard to the terms agreed or the representations made and the effect that they had’.<sup>588</sup> Applying this to documentary credit, it is submitted that the question of

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<sup>585</sup> *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

<sup>586</sup> See *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447,461.

<sup>587</sup> [2010] EWCA Civ 338.

<sup>588</sup> *ibid* at para.3.

whether unconscionability exist is matter to be achieved with a consideration of the whole circumstances of the contract and the reasonable expectation of the parties.

**6.4.2.2. Insistence on the strict application of legal rights in circumstances where to do so is regarded, on the facts of the particular case, to be harsh or oppressive.**

Let's take for example this hypothetical situation, AB Ltd is in a supply agreement with CD Ltd for the supply of 15 containers of aluminium profile. The agreement specifies that the aluminium profile must be of certain quality strength. Based on this, a documentary letter of credit was opened by AB Ltd in favour of CD Ltd. Out of the 15 containers contracted for, CD Ltd delivered only 5. Upon taking delivery, AB Ltd discovered that the aluminium profile was below the quality strength and wrote to CD Ltd about it. CD Ltd conceded to the quality level of the aluminium and advised AB Ltd to take necessary action to upgrade the aluminium product to the required strength and deduct their expenses from the contract price. Subsequently, after this CD Ltd went into administration and receivers appointed on behalf of CD Ltd decided to call on the letter of credit supporting the underlying transaction for the full amount despite the agreement earlier had with AB Ltd.

From the above hypothetical case, the receivers' action in calling on the full amount of the letter of credit by insisting on the separate legal right which arose from the credit would be unconscionable having regard to the circumstances of the case.

Judging for this hypothetical case, a call on the documentary credit by insisting on the right inherent in it as a separate transaction would amount to insisting on strict application of right in circumstances where to do so should be regarded, on the facts of the particular case, to be harsh or oppressive. This is so because such insistence by the beneficiary of the credit on the right inherent in the credit is done in total disregard of all the circumstances and such insistence makes the beneficiary oppressive in his demands. Where it could be established on a balance of probabilities that a demand for payment only amounts to insistence on rights in an oppressive and harsh manner, it could suffice to prove unconscionability.

## **6.5. Should English Law Recognize Unconscionability?**

This section analyses the arguments for and against unconscionability exception with the view to assessing the possibility of its recognition in English law.

### **6.5.1. Arguments in Support of Unconscionability**

Unconscionability as a ground for displacing the autonomy doctrine in documentary credit law apparently derives its support from the following grounds.

#### **6.5.1.1. Long entrenched in English legal History**

The doctrine of unconscionability as a ground for vitiating an otherwise valid contract is not novel in English law. As early as 1697, Lord Hardwicke has made reference to

the concept of unconscionability in *Earl of Chesterfield v Janssen*<sup>589</sup> by describing circumstances ‘where no man in his right senses and not under a delusion nor an honest and fair man would accept on the other hand that which is inequitable and unconscientious...’<sup>590</sup> The only criticism levelled against the *Earl of Chesterfield case* and other authorities in its class is that it is related to a particular group of cases dealing with improvident bargains with particular vulnerable group of people.

However, a wider application of the doctrine of unconscionability in a sense that depicts that it could be used in any type of transaction was evident in two English decisions of *Multiservice Bookbinding v Marden*<sup>591</sup> and *Alec Lobb v Total Oil*.<sup>592</sup> It was contended by Anthony Siopis<sup>593</sup> that these two cases suggest that English law recognizes ‘a general principle entitling a court to intervene on the grounds of unconscionability’. The principles in these cases are regarded as having a general application in any type of transaction because contrary to the approach adopted in the *Earl of Chesterfield case*, they are not confined to specific type of bargain with particular group of vulnerable class. Hence, if these cases<sup>594</sup> recognize a general application of unconscionability in English law,<sup>595</sup> there then is a strong force to the argument that its application in documentary credit as a ground for displacing the autonomy principle should, as a matter of its long entrenchment in English general law not be without support.

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<sup>589</sup> 28 Eng. Rep. 82 (Ch. 1751)

<sup>590</sup> *ibid* Emphasis added

<sup>591</sup> [1979] Ch 84.

<sup>592</sup> [1983] 1WLR 87 (at first instance), [1985] 1WLR 173 (CA) See also the modern use of unconscionability in *Ruddick v Ormston* [2005] EWHC 2547, where it was held that a transaction could only stand if it could be shown to be objectively fair, just and reasonable.

<sup>593</sup> See A. Siopis, ‘Unconscionable Bargains and General Principle’ (1984) 100 LQR 523, 525.

<sup>594</sup> *Multiservice Bookbinding v Marden* [1979] Ch. 84, *Alec Lobb v Total Oil* [1983] 1WLR 87 (at first instance), [1985] 1WLR 173 (CA).

<sup>595</sup> The use of unconscionability in English law even in modern day as a vitiating tool has not only persisted but has gone uncontested. Its use in English law is widely appreciated.

In documentary credit law, case law is replete with judicial dicta that have not completely overlooked the idea of unconscionability as a ground for displacing the autonomy rule.<sup>596</sup> In *Elian and Rabbath v Matsas*,<sup>597</sup> the Court, was prepared to intervene to prevent an irretrievable injustice in circumstance that fell short of fraud. The facts of the case hinged on a guarantee that was issued to secure the release of cargo. The claimant applied for an injunction when another lien was imposed in contravention of the agreement to release the goods on the posting of a guarantee for the first lien. Lord Denning MR granted the injunction on the grounds of irretrievable injustice. In *TTI Team International v Hutchinson 3G UK Ltd*<sup>598</sup> Judge Anthony Thornton QC referring to *Samwoh*<sup>599</sup> and *MC Connell*<sup>600</sup> noted that lack of good faith that is comparable to the unconscionability doctrine was a ground upon which the autonomy doctrine could be displaced. Hence judicial dicta as evident in the above cases are direct pointer to the fact that the concept of unconscionability is long engrained in English law and its presence offers credibility to the call for unconscionability exception in documentary credit.

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<sup>596</sup> Though some of the cases deal with performance bond, Judge Anthony Thornton QC noted in *TTI Team Telecom International v Hutchinson 3G UK Ltd* [2003] 1 All ER 914 [20-30] that 'Although this case is concerned with a contract describing itself as a performance bond, the principles governing the court's supervisory jurisdiction in relation to a beneficiary's threatened call are not limited to bonds... These credits are used to finance, secure or assist an underlying commercial transaction whether of sale, services or the provision of work and materials and to give comfort to one party to that transaction that the other party will honour or discharge a payment obligation to which that underlying transaction subjects it to'.

<sup>597</sup> [1966] 2 Lloyds Rep 495.

<sup>598</sup> [2003] 1 All ER 914.

<sup>599</sup> *Samwoh Asphalt Premix v Sum Cheong Pilling Pte Ltd.* [2002] BLR 450.

<sup>600</sup> *Mc Connell Dowell Constructors (Aus) Pty Ltd v Sembcorp Engineering and Constructors Pte. Ltd.* [2002] BLR 450.

### 6.5.1.2. Complements the Fraud Rule

In documentary credit, the recognition of an unconscionability exception would assist to fill the protection gap left by the other exceptions like fraud which by virtue of its common law origin is applied strictly and very difficult to prove. In order to prove the existence of fraud, the courts require that the alleged fraud of the beneficiary of the credit must be clearly and strictly established to the knowledge of the bank to justify a refusal by the issuing bank to honour a draft under the credit. Adding to the difficulty in the use of only fraud as a protection mechanism, is that the ingredients of common law fraud like knowledge, intention, dishonesty etc are notoriously difficult to prove. In *Discount Records Ltd v Barclays Bank Ltd*,<sup>601</sup> the restrictive approach of the fraud rule was dramatically exemplified. In this case, Megarry J, despite a substantial number of goods ordered for not being compliant with the order by either being below standard or were outright rejects, held that it was not a case of clearly established fraud and the court would 'be slow to interfere with bankers' irrevocable credits unless a sufficiently grave cause is shown. It is in this kind of protection gap, where it becomes manifest that the failure of the law to aid the claimant does not lie in his failure to prove the wrong doing or mala fides of the defendant in demanding payment on the credit but in his difficulty in proving fraud and its technicalities to the satisfaction of the court that unconscionability fills. Where this is so, the unconscionability exception becomes a 'blanket' ground coming to the aid of the claimant as its proof is less onerous than the fraud rule and lies primarily on establishing the lack of good faith of the beneficiary.

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<sup>601</sup> [1975] 1 WLR 315.

Professor Nelson Enonchong<sup>602</sup> has argued that in the absence of the unconscionability exception, the courts sometimes strain to fit facts which would lead to intervention on some other grounds within the concept of fraud.<sup>603</sup> This attempt to stretch the boundaries of fraud beyond its normal boundaries sometimes becomes difficult to justify the finding of fraud based on legal principle.<sup>604</sup> However, recognition of an unconscionability exception would readily make it possible to justify displacing the autonomy principle on the ground that the call on a credit is unconscionable in the absence of the proof of actual fraud.

#### **6.5.1.3. Flexible nature of Unconscionability**

Equity's jurisdiction of unconscionability exception ensures to a large extent that there is no unfair and/or abusive drawing in documentary credit by the beneficiary who may take advantage of the inherent difficulties associated with proving fraud and its ingredients.<sup>605</sup> The flexibility of the exception means that the concept has no strict guidelines and can be tailor-made to suit each new facts and circumstances. It thus, provide a safety net for preventing abusive drawing in documentary credits by capturing situations which fall short of actual fraud but warrants making a call on a

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<sup>602</sup> NE Enonchong 'The Problem of Abusive Calls on Demand Guarantees' (2007) LMCLQ 97,104.

<sup>603</sup> In the US, the concept of fraud is wide enough to accommodate circumstances where the defendant has not strictly acted deceitfully. See *United Bank v Cambridge Sporting Goods Corp* (1976) 41 NY 2d 254, 260; 360 NE 2d 94,949, *Harris Corp v National Iranian Radio and Television* (1982) 691 F 2d 1344, 1356.

<sup>604</sup> See *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 Lloyd's Rep. 251 where the English court seem to have stretched the concept of fraud beyond its normal boundaries and condemned a call on demand guarantee as fraudulent. However, from the facts of the case, it is difficult to justify the finding of fraud.

<sup>605</sup> See *Eltraco International Pte Ltd v CGH Development Pte Ltd* [2000] 4 SLR 290 though made in relation to demand guarantees

credit in circumstances that is abusive, oppressive and unfair.<sup>606</sup> There are situations where actual fraud could not be established but unconscionability could be used as an effective weapon against abusive demand in documentary credit. It could also be used to stop abusive demand on the credit in circumstances where a presentation is made for an already earlier amount in disregard of agreement that has reduced the amount that is otherwise due under the credit.

#### **6.5.1.4. Has Support from Common Law**

Though unconscionability, as an element in the enforcement of contracts, is equitable in origin, there is evidence to sustain the conclusion that the common-law courts as well were moved by the doctrine to invalidate contracts under certain circumstances.<sup>607</sup> In the American case of *Industra-lease Automated & Scientific Equip. Corp v RME Enters Inc.*<sup>608</sup> it was held that the disclaimers of express and implied warranties in the lease of industrial equipment were unconscionable under the circumstances where the equipment never operated. In reaching this conclusion, Hopkins JP of New York Supreme Court, Appellate Division re-inforced the submission<sup>609</sup> that unconscionability, though being of equitable origin, were in certain circumstances applied by the common law courts to invalidate a contract. This statement of the court goes to show that the common law courts in certain circumstances recognized the use of unconscionability as a ground for vitiating a

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<sup>606</sup> The following Singapore cases though mostly on demand guarantees have prevented abusive drawing by utilizing the unconscionability exception. *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd & Anor* [1999] 2 SLR 368; *GHL Pte Ltd v Unitrack Building Construction Pte Ltd v Anor* [1999] 4 SLR 604; *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd & Anor* [2002] 1 SLR 1; *Bocotra Construction Pte Ltd & Ors v Attorney General* (No 2) [1995] 2 SLR 733.

<sup>607</sup> 1 *Corbin on Contracts*, s 128, 551).

<sup>608</sup> 396 NYS2d 427,431 (NY App Div 1977).

<sup>609</sup> Already expressly noted in 1 *Corbin on Contracts* (West Pub Co1993) s 128, 551).

contract<sup>610</sup> and in appropriate circumstances its use as a ground for displacing the autonomy principle in documentary credit may borrow from the support shown to the doctrine by common law.

#### **6.5.1.5. Progress of the Unconscionability Exception in other Jurisdictions**

Courts in other jurisdictions<sup>611</sup> have advanced the cause of the unconscionability exception as a ground for displacing the impregnability of documentary credits.<sup>612</sup> In Singapore, unconscionability is an established exception to the principle of independence, at least in relation to performance bonds. In Australia, the *Trade Practices Act*<sup>613</sup> has in no uncertain terms made unconscionability a ground for restraint on payment as the provision of the Act applies to the common law of Australia which includes transactions relating to international sale of goods.<sup>614</sup>

#### **6.5.2. Arguments Against**

Having considered the arguments in favour of unconscionability exception, what are the objections against judicial intervention based on this ground? It is the contention of this section that some of the objections are well founded. However, some of the

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<sup>610</sup> Compare with the contrary view by Sam Rickett that the use and recognition of the unconscionability belies in his view a complete lack of appreciation of the entire endeavour of the common law. See further, C Rickett 'Unconscionability and Commercial Law' in John Lowry *Commercial Law: Perspective and Practice* (Lexis Nexis 2006) 179 para. 9.28.

<sup>611</sup> See for example Canada, Australia, Singapore and New Zealand where progress have made using the unconscionability.

<sup>612</sup> This assumes, as reported in many cases cited above that the applicable law is the same for both demand guarantee and letter of credit.

<sup>613</sup> See mostly S. 51AA.

<sup>614</sup> *Orrcon Operations Pty Ltd v Capital Steel & Pipe Pty Ltd* [2007] FCA 1319 [70].

reasons advanced for the rejection of the exception are based on some assumptions that in the main account for the unsatisfactory nature of the law in this branch of law. Some of these arguments would be considered forthwith.

#### **6.5.2.1. Too Vague and Uncertain**

The strongest argument against the unconscionability exception lies in the difficulty in articulating with precision what unconscionability entails. Consequently, it has led to numerous suggestions that it will lead to much uncertainty. The underlying logic behind this contention is that in each case where unconscionability is raised, the court will have to determine to what extent it limits the unqualified<sup>615</sup> right of the beneficiary to make presentation for payment under the credit. This will involve making a determination as to the meaning of unconscionability and the standard of proof. As pointed out by Alexia Ganotaki,<sup>616</sup> the Singapore cases<sup>617</sup> are illustrative of the fact that there will be ‘an unacceptable level of uncertainty’<sup>618</sup> both as to the meaning of the words and the standard of proof required.

However, it is submitted that the argument of uncertainty though in some instances, well founded, should not be elevated to a point where it becomes counter-productive. The uncertainty arising from unconscionability’s vague nature should not be over-emphasized so as to becloud its relevance. Cases are littered with legal terms that tend towards imprecision but have not affected the understanding of their meaning and the

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<sup>615</sup> It is contended by many commentators as unqualified though this is strongly arguable

<sup>616</sup> See A Ganotaki ‘Unconscionability and Bank Guarantees’ [2004] LMCLQ 148.

<sup>617</sup> See mostly, *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd & Anor* [2002] 1 SLR 1 and *McConnel v Sembcorp* [2002] BLR 450 (Sing.HC).

<sup>618</sup> Alexia Ganotaki, ‘Unconscionability and Bank Guarantees’ [2004]LMCLQ 148,153. See further on the uncertainty argument, NE Enonchong ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] LMCLQ 97,104.

courts' willingness to adjudicate on those issues. The fraud exception is also very problematic and the ingredient of dishonesty- an actual fraud requirement- tends towards imprecision and uncertainty but has not affected its acceptance as a ground upon which impregnability of documentary credit can be displaced. Similarly, the doctrine of unconscionability should not be rejected outright because of uncertainty.

Uncertainty is part of the realities of commercial activities and judicial process and should not be perceived in all circumstances to be counter-productive. Since unconscionability issues in most instances involve a consideration of the different factual situations, it should be a less telling point that seemingly uncertain decisions could be reached. This point could be gleaned from the insightful and well known comment of B Cardozo<sup>619</sup> on the nature of the judicial process when he opined that:

I sought for certainty. I was oppressed and disheartened when I found that the quest for it was futile.... As the years have gone by, and as I have reflected more and more on the nature of judicial process, I have become reconciled to uncertainty, because I have grown to see it as inevitable. I have grown to see the process in its highest reaches, is not discovery but creation: and that the doubts and misgiving, the hopes and fears, are part of the mind, the pangs of death and the pangs of birth, in which principle that have served their day expire, and new principles are born.<sup>620</sup>

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<sup>619</sup> B Cardozo, *The Nature of Judicial Process* (Yale University Press 1921)166. Daniel Klau 'What Price Certainty, Corbin, Williston, and Restatement of Contract' (1990) 70 BUL Rev 511, 1.

<sup>620</sup> *ibid* at 166,167.

Applying this to unconscionability in documentary credit, the point sought to be made is that uncertainty is part and parcel of commercial life. The argument of uncertainty should not distract from the remedies which unconscionability seeks to achieve.

Apart from the above observation, that uncertainty is inherently or at best a part of commercial life and judicial process is evident in the actions and decisions of the protagonist of certainty in documentary credits law. Consequently, the argument of certainty should not be used as a ground to completely discountenance the gain sought to be achieved by the recognition of unconscionability exception in documentary credit. In documentary credit, the law is littered with cases and legal dicta that remotely support this conclusion. In most documentary credit cases, judges have resorted to the use of unhelpful phrases like ‘this is an unusual case with extra-ordinary facts’, ‘to avoid irretrievable injustice’ etc as a ground for deviating from a patterned and certain line of thought which the call for certainty should have entrusted upon them. The hidden lesson from these phrases that has been adopted where it becomes difficult to follow the certain pattern of rules without handing out unjust decisions, is that human actions or the activities of commercial men are not certain and any attempt to systematize and subject it to a certain pattern is likely to achieve undesirable result.

Another point that considerably reduces the significance of the ‘certainty argument’ is evident in the dictum of Toohey J,<sup>621</sup> in reference to unconscionability when he stated that ‘although the concept of unconscionability has been expressed in fairly wide terms, the courts are exercising an equitable jurisdiction according to recognized principles. They are not armed with a general power to set aside contractual bargains simply

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<sup>621</sup> See *Louth v Diprose* (1992) 175 CLR 621.

because in the eyes of the judges, they appear to be unfair, harsh or unconscionable'.<sup>622</sup> Applying this to documentary credits, it means that in the application of the doctrine of unconscionability, the courts are not in reality, acting in a wholly discretionary fashion where unconscionability is invoked but exercising equitable jurisdiction according to recognized principle.<sup>623</sup>

#### **6.5.2.2. Unconscionability would lead to easy grant of injunctions, thereby destroying the purpose of the autonomy principle**

It has been contended that the recognition of an unconscionability exception would lead to easy availability of injunctions restraining a demand on a credit. Part of the reason that supports this argument is that it is easier to prove unconscionability than fraud.<sup>624</sup> While this is a fair point, it has to be submitted that the contention seems to underestimate the inherent difficulty associated with satisfying the required standard of proof which is that unconscionability 'must be significant and clearly established'.<sup>625</sup> More so, that unconscionability is easier to prove than fraud should be of less telling point as what is important is whether the unconscionability in question has been established to the required standard of proof.

Another vital point which, the contention that the recognition of an unconscionability exception in documentary credit would lead to easy grant of injunction misses is the point made by Rix J, in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London*

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<sup>622</sup> *ibid* at 654.

<sup>623</sup> The principle in the case of documentary credit being one that is based on the reasonable expectation of the parties or based on commercial reasonableness

<sup>624</sup> NE Enonchong 'The Problem of Abusive Calls on Demand Guarantees' [2007] LMCLQ 97, 104.

<sup>625</sup> *TTI Team Telecom International V Hutchinson 3G* [2003] 1 All ER 914 [37].

*Ltd*<sup>626</sup> regarding the criteria for the grant of injunctions. The case is an authority to the effect that for an injunction to be granted in documentary credit, the claimant need to establish that not only does he have a cause of action but also that the balance of convenience is in his favour. The satisfaction of these criteria before an injunction could be granted in documentary credit, in no small measure curtails the availability of injunctions.

### **6.5.2.3. Involvement with Dispute in the Underlying Contract**

An objection to recognizing the unconscionability exception is that it would lead banks and courts getting involved with disputes in relation to the underlying contract. The difficulty with this argument is that if it is true in respect of the unconscionability exception, the same would also apply to the fraud exception. The point sought to be made here is that if fraud is recognized as an exception to the principle of autonomy if it would lead to investigation of the underlying dispute, it becomes less convincing to use it against the unconscionability exception. More-over, the issue of when a call on a credit is unconscionable should be easier for the bank to determine without much involvement in the underlying dispute than when fraud is involved.<sup>627</sup>

## **6.6. Conclusion**

The chapter has sought to establish that the concept of unconscionability is not novel in English law. However, its recognition in English documentary credits law has attracted an approach that is uncertain. While the cases are littered with judicial dicta that are

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<sup>626</sup> [1999] 2 Lloyd's Rep 187

<sup>627</sup> This is possible with information from the applicant as to the circumstances which make the beneficiary insistence on strict legal right as amounting to an abuse of right and hence abusive demand.

receptive to the unconscionability exception, it remains the accepted position that in English law, that it is only in cases of established fraud that, the impregnability of documentary credits can be displaced. In other common law jurisdictions, like Singapore and Australia, an attempt to disregard the autonomy doctrine where a beneficiary's demand<sup>628</sup> is established to be unconscionable has proved successful and remains a separate exception from fraud based upon which the independent undertaking implicit in the autonomy principle could be displaced.

Whether English law, should recognize the unconscionability exception is particularly not an easy question to answer. While the court struggles and commentators indulge in a seemingly endless wrangle on what the right position is, this chapter has endeavoured to demonstrate that unconscionability as a ground upon which the principle of autonomy could be displaced remains an attractive proposition. The strongest objection to this submission is that admitting the unconscionability exception as a ground for displacing the autonomy doctrine in documentary credits would necessitate an undesirable degree of uncertainty. This argument, it has to be acknowledged, is not devoid of substance. However, what is evident, as most cases and judicial dicta reveal is a degree of uncertainty in the law because of the pursuit of certainty in documentary credits law<sup>629</sup> by the English courts.<sup>630</sup> Regrettably, this uncertainty has been hidden by adopting phrases which apparently seem to distract from the main problem. As early as 1966, Lord Denning, relied on the phrase 'this was a special case.... to prevent what might be irretrievable injustice'<sup>631</sup> to hold, contrary to accepted principle,<sup>632</sup> that an

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<sup>628</sup> This is on the assumption that a demand guarantees and letters of credit are on the same footing.

<sup>629</sup> Especially, on the issue of what should be the recognized exception and/or exceptions to the principle of autonomy in documentary credit

<sup>630</sup> The many dicta in English law that is contrary to the established position are pointer to this uncertainty.

<sup>631</sup> *Elian and Rabbath v Matsas* [1966] 2 Lloyds Rep 495, 497.

injunction should be granted. In the recent case of *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd*,<sup>633</sup> Anthony Thornton QC, citing Singapore authorities which he said were in accord with the decision in *Elian and Rabbath* and that of Morrisson J in the *Cargill International case*,<sup>634</sup> as to a demand ‘utterly lacking in bona fides’<sup>635</sup> said that ‘If a similarly clear-cut case came before an English court, it would, in the light of these cases, grant restraining relief’. It is submitted that these cases show that unconscionability is not altogether without support in English law and the pursuit of certainty, by insisting that it is only in cases of established fraud that impregnability of documentary credits can be displaced, has yielded nothing but uncertainty. If there are special cases with extra-ordinary facts that appear to defy the systematized and certain order of things and situations when the need to avoid irretrievable injustice is such that following the certain order of things will occasion injustice, the lesson partly derivable is: it may be the right time to jettison dogma<sup>636</sup> by allowing some degree of flexibility though the recognition of limited unconscionability exception so that the insulated method of payment is shielded from abuse.

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<sup>632</sup> There was no actual or clear fraud proved

<sup>633</sup> [2003] 1 All ER 914.

<sup>634</sup> See *Cargill International SA v Bangladesh Sugar & Foods Corp* [1996] 4All ER 563.

<sup>635</sup> As a ground that is different from the established actual fraud based upon which the impregnability of documentary credit could be disregarded.

<sup>636</sup> Dogma in the sense that the belief that every legal facts would conform to set or established pattern remain an illusion

## Chapter Seven

### 7.0. Illegality

#### 7.1. Introduction

Recent English cases have adopted the view that there exists an illegality exception to the principle of autonomy in documentary credit. This is evident from obiter dicta in some recent English documentary credit cases. This Chapter explores the illegality exception to the principle of autonomy in documentary credits. The primary object of the chapter is to determine the circumstances under which illegality may constitute a separate ground from fraud based upon which the independent undertaking of the issuing bank to make payment to the beneficiary upon the tender of apparently conforming documents could be displaced. With the above objective in mind, the chapter's focus is not a consideration of the question whether the exception should be recognized in English Law<sup>637</sup> but to explore the vexing issue of the manner (scope) in which illegality operates and should be applied in practice.

To achieve this purpose, the chapter is divided into six main sections. Apart from the introduction, sections 7.2 and 7.3 deal with the nature and rationale of the illegality defence. Sections 7.4 and 7.5 examine the current state of the authorities in some jurisdictions regarding illegality in documentary credits and the issue of proof.

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<sup>637</sup> As long ago as 1995 in the *Group Josi case* [1996] 1 Lloyd's Rep. 345, Staughton L.J. though obiter, emphatically stated that 'illegality is a separate ground for non-payment under a letter of credit.' This has been followed with a similar judicial pronouncement and detailed academic commentary. For this, see generally *The Mahonia* (1) & (2) [2003] 2 Lloyd's Rep 911, [2004] EWHC 1938 (Comm), N Enonchong, 'The Autonomy Principle of Letters of Credit: an Illegality Exception?' (2006) LMCLQ 404

Section 7.6 explores the ambit of the illegality defence by examining some of the criteria that would assist in limiting the exception.

It finally submits that, in appropriate circumstance, recognition of a limited illegality exception to the principle of autonomy in documentary credits, rather than harm the instrument will ensure trust in the use of the instrument by setting a standard in which parties realize that the impregnability of documentary credits may in certain limited situations be ignored where an obvious illegality in the underlying transaction is established.

## **7.2. Illegality Defence in General**

Generally, illegality arises in two broad situations.<sup>638</sup> Illegality which arises by virtue of unlawfulness arising from a breach of a legal statute otherwise known as statutory illegality and illegality which arises in relation to common law.<sup>639</sup> However, there are rare situations where the court may have to consider both questions. For example, where the contract involves the commission of a statutory illegality, the first question the court must consider is whether the legislature has provided that a claim by the relevant party to enforce the contract must be denied. If it has not, there remains a separate question of whether the claim under the contract is unenforceable at common law.<sup>640</sup> Another way of understanding illegality in general law is that a transaction is

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<sup>638</sup>Commission Consultation Paper No 189, 2009.available at <http://www.lawcom.gov.uk/docs/cp189.pdf>. at para. 3.2

<sup>639</sup> For the a detailed discussion on this, See generally, N Enonchong *Illegal Transactions* (LLP 1998)

<sup>640</sup> The above distinction is clearly explained in R A Buckley, *Illegality and Public Policy* (Sweet and Maxwell 2002) p 10; See also the second edition, RA Buckley, *Illegality and Public Policy* (Sweet & Maxwell, 2009) p.11. M P Furmston, 'The Analysis of Illegal Contracts' (1966) 16 *University of*

illegal, or at least affected by illegality, if the transaction or some aspect of it is prohibited (expressly or impliedly) by the law. This is usually the case, where the transaction involves the commission of a legal wrong or involves conduct which is contrary to public policy even though it is not otherwise prohibited by law.<sup>641</sup>

More so, the defence of illegality may also partly relate to the circumstances under which the law applies the doctrine of illegality as a ground for limiting or avoiding a contractual liability based on the alleged illegality. Opinions are divided as to the consequence of illegality in general law.<sup>642</sup> However, one common feature of the consequence of illegality in contract is that an agreement proved to be illegal or tainted with illegality is unenforceable as a result of the illegality either at law or in equity.<sup>643</sup> A contract which is unenforceable is presumed to be one in respect of which a court will not compel compliance by its order or judgment.<sup>644</sup> So far, the analysis relates to illegality and its effects in general law.

### 7.3. Illegality in Documentary Credit

Illegality in documentary credits relates to the emerging trend of documentary credits law in borrowing from the wider aspect of the general law on illegality (a vitiating

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*Toronto Law Journal* 267 and the Law Commission Consultation Paper No 189, 2009, available at <http://www.lawcom.gov.uk/docs/cp189.pdf>. at para. 3.2.

<sup>641</sup> See NE Enonchong, *Illegal Transaction* (Lloyds of London Press 1998) 2.

<sup>642</sup> There is some kind of controversy as to whether the effect of illegality is to make an agreement void or merely unenforceable. See *Mackender v Feldia Ag* [1967] 2QB 590.

<sup>643</sup> This is a settled proposition of English Law. *Cleaver v Mutual Reserve Fund* [1892] 1QB 147, at 151, see also NE Enonchong *Illegal Transaction* (Lloyds of London Press 1998) 31. However, this proposition seems to have ignored later development where some illegal conduct has not led to denial of enforcement especially where the claimant is not relying on the illegality.

<sup>644</sup> However, a court can make an order to prevent the performance of the illegal agreement. E.g. the court can grant an injunction preventing the enforcement of letters of credit if the letters of credit is issued as part of illegal transaction. On this point, see *Group Josi Re v Walbrook Insurance Co. Ltd* [1996] 1WLR 1152 where the court, however, held that there was no illegality as to warrant an injunction.

factor to a contractual liability) as a ground for displacing the autonomy principle. In displacing the autonomy principle, the contractual right and/or liability that is inherent in the separate documentary credit contract is sought to be avoided as a result of the alleged illegality. In this regard, the illegality exception would be pleaded by a litigant as a ground for rescinding an otherwise binding obligation created by the separate letter of credit contract save for the illegality. Hence the illegality exception serves to protect the letter of credit from the legal flaw that would have arisen if a credit that is illegal or tainted with illegality is allowed to be enforced. Therefore the illegality exception in documentary credits, if definitively recognized in documentary credit defies the logic held in some quarters<sup>645</sup> that the unique nature of the instrument (documentary credits) extricates it completely from the rules governing general laws.<sup>646</sup> Hence some of the crucial questions pertinent to the understanding of illegality in documentary credit are: (1) whether the illegality defence is a separate exception to the principle of autonomy in documentary credit. (2) In what circumstances can a bank rely on illegality affecting the letter of credit as an excuse to avoid payment? (3) Whether and in what circumstances is an applicant for a credit entitled to an injunction restraining payment on grounds of illegality in documentary credits?

Before, delving into the above questions, it is appropriate to understand the nature of illegality in documentary credits. To ascertain the nature of the illegality defence in documentary credits with a view to addressing the implications of illegality, three key

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<sup>645</sup> In most cases, there is always a debate in favour of protecting the integrity of documentary credit by allowing no derogation on the one hand and the contention that public policy reasons inherent in the fraud rule and illegality doctrine should defeat the otherwise impregnability of documentary credit.

<sup>646</sup> It has been noted in many cases and by commentators that letter of credit is a specialty contract that is different and not amenable to rules governing general contract law. For general understanding of the law regarding illegality and its effects on contract, see generally N Enonchong *Illegal Transaction* (Lloyds of London Press 1998) particularly at chapter 2. p. 29

questions call for consideration. One is where payment under a documentary credit is being enjoined on the ground that the letter of credit is illegal in itself. Secondly, is where a letter of credit is enjoined on the grounds that the illegality arises both from the credit and from the underlying transaction. Lastly, and a more fundamental question, is the consideration of the question whether a letter of credit is affected by the illegality in the underlying transaction in respect of which the credit is issued.

### **7.3.1. Where the Letter of Credit is in itself Illegal**

The illegality of the letter of credit itself in this case arises mostly through an express or implied statutory prohibition.<sup>647</sup> In this case, a provision in the law may for some reasons make the use of a credit illegal, for instance, where there is a government prohibition on the use of letters of credit,<sup>648</sup> it becomes immaterial that the parties did not intend to break the law and generally even an innocent party may not enforce such a credit.<sup>649</sup> The illegality of the credit itself also could arise where there is a supervening prohibition on the use of letters of credit after it has been advised by a beneficiary as a means of payment for goods or services arising from a contract for the sale of goods. The situation contemplated in this case is where a letter of credit has been lawfully issued but before payment or reimbursement obligation falls due under the credit, its use is prohibited by reason of a governmental or judicial order.<sup>650</sup> Also,

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<sup>647</sup> It has to be noted that in some situations, the distinction between express or implied prohibition may be blurred. So when such a situation arises, the statute by virtue of its apparent inconclusive nature should be probably classified as implied prohibition. For this analysis, see M Furmston, *The Law of Contract* (3<sup>rd</sup> edn, Lexis Nexis 2007) 1005 [5.20].

<sup>648</sup> *International Dairy Queen Inc v Bank of Wadley* (1976) 407 F Supp 1270 (MD Ala).

<sup>649</sup> See *St John Shipping Corp v Joseph Bank Ltd* [1957] 1QB 267, 283. However, where there is a legal prohibition by a statute, it may not be enough to lead to a denial of right if the intention evident in the statute is to the contrary.

<sup>650</sup> See *Chudian v Philippine National Bank* (1992) 734 F Supp 415.

another example is a situation where an issuing bank issues a letter of credit but before its payment or reimbursement obligation arises, its ability to carry out banking business is proscribed by reason of illegal trading like being involved in money laundering. Also there are situations where it may be discovered that a bank is set up in violation of some required statutory licences as to make illegal its carrying of business as a trading entity. Circumstances such as the above make the issuance and payment of a letter of credit in itself illegal.

Where the letters of credit is illegal as a result of the situation described above, its illegality does not arise as a result of a breach of the autonomy principle but because the credit is illegal in itself. Therefore, the issue of the circumstances under which illegality will constitute an exception to the principle of autonomy does not arise.

### **7.3.2. Illegality Affecting the Credit and Underlying Transaction**

It may happen that in some instances, the letter of credit is affected by illegality arising from the credit as well as the underlying transaction that gave rise to the letters of credit. If this is the position, a question may arise as to whether the principle of autonomy is engaged. For example, in an underlying contract for the export of publishing equipment on CIF terms to Nigeria which is supported by a letter of credit in favour of the UK exporter (seller of goods), the contract provides for the seller to procure the export licence on behalf of the Nigerian buyer and for the Nigerian buyer to procure a letter of credit in favour of the UK seller redeemable upon the presentation of an invoice, insurance and document evidencing shipment. It is

provided that the seller furnishes an export licence for payment under the credit. It happened that the UK seller inadvertently failed to procure the export licence despite having shipped the goods but prior to the arrival of the goods, a subsequent government of Nigeria legislation unconnected with the underlying transaction prohibits the importation of publishing equipment without an export and import licence and the licence has not been obtained prior to the government action. In this case, there is a provision in the underlying transaction requiring an export licence which but for the Nigerian legislation would not have invalidated the credit.

Assuming the seller having shipped the goods, presented the required documents under the credit which did not include a licence as directed in the credit, the bank refuses to pay on the grounds that it has valid information from the applicant for the credit (buyer) that the export licence was not obtained. It is apparent from this scenario that the failure to obtain an export licence would not have invalidated the credit save for the express statutory prohibition by the Nigerian government legislation. In this kind of situation where the illegality arises from a combination of an underlying contract provision and a national legislation that make it impossible to fulfill the credit requirement, is the principle of autonomy not engaged? Professor Enonchong<sup>651</sup> has argued that where illegality affects the letters of credit and the underlying transaction, the principle of autonomy is not engaged because the letter of credit is illegal in itself rather than through the underlying transaction.<sup>652</sup> The rational explanation for the submission may be that once the letter of credit is illegal, the consideration of the illegality of the underlying transaction become of lesser

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<sup>651</sup> NE Enonchong, 'The Autonomy Principle of Letters of Credit: an Illegality Exception?' (2006) LMCLQ 404.

<sup>652</sup> NE Enonchong, 'The Autonomy Principle of Letters of Credit: an Illegality Exception' (2006) LMCLQ 404, 407.

importance. However, in the present hypothetical case, the letters of credit though illegal cannot be said to be so without an analysis of the underlying contract to uncover its illegality with the result that the documents presented by the beneficiary though apparently complying is rendered illegal by failure to obtain the licence. The point sought to be made in this case is that there are situations where the circumstances that make the letter of credit illegal are a combination of the issues from the underlying transaction as well as an express prohibition unrelated to the underlying transaction. In this kind of situation where the underlying contract facts and the express provision external to the underlying contract become inextricably linked so as to make the credit illegal, is the principle of autonomy not engaged? It is submitted, that in this kind of situation, where an aspect of the underlying contract contributes to make the letter of credit illegal, the autonomy principle is engaged despite the credit being apparently seen to be illegal by an express prohibition unrelated to the underlying contract.

In *United City Merchants Ltd v. Royal Bank of Canada*,<sup>653</sup> the situation where the credit itself and the underlying transaction were illegal was exemplified. It was held that under Art. VIII (2)(b) of the Bretton Wood Agreements<sup>654</sup> as implemented in the United Kingdom, the whole transaction, that is, the credit itself and the underlying transaction was in breach of the exchange control regulation of Peru and was therefore unenforceable in England. It is contended by Professor Enonchong, that where the letters of credit is illegal in itself, whether as a result of illegality in the issuance of the credit or through a combination of illegality in the credit and that of the underlying transaction, that the principle of autonomy is not engaged because the credit is illegal

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<sup>653</sup> [1983] 1 AC 168.

<sup>654</sup> See Bretton Woods Agreement Act 1945 and the Bretton Woods Agreements Order in Council 1946

in itself rather than through the underlying transaction and therefore no difficulty arises as a result of that principle.<sup>655</sup> This proposition, it is submitted, is correct where there is no difficulty in separating the illegality in the credit as well as in the underlying transaction. But at times difficulty may arise with respect to understanding of the multiplicity of ways in which illegality can be raised.<sup>656</sup>

### **7.3.3. Illegality in the Underlying transaction**

In letters of credit transactions, the underlying transaction represents a different contract that is distinct from the letter of credit itself. However, under what circumstance will an illegality in the underlying transaction affect the letters of credit in order to restrain payment? In *Group Josi Re v Walbrook Insurance Co. Ltd. and Others*,<sup>657</sup> *Group Josi* contended that payment should be restrained on the grounds that the reinsurance contract which formed the underlying contract was illegal. It was the submission of the defendant that considering the irrevocability of letters of credit and its distinct nature from the underlying agreement which brings it into being, the credit is not illegal, void or unenforceable even if it is assumed that the contracts of reinsurance are.<sup>658</sup> On the other hand, the claimant (*Group Josi*) submits that it has an arguable case that the letter of credit is illegal, void and unenforceable on several grounds. The claimant submits that they are themselves void, either directly because they were entered into for the purposes of carrying out illegal reinsurance contracts, or

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<sup>655</sup> See NE Enonchong 'The Autonomy Principle of Letter of Credit: an Illegality Exception' (2006) LMCQ 404, 406. See also G.T McLaughlin 'Letters of Credit and Illegal Contracts: The Limits of the Independence Principle' (1988-1989) 49 Ohio St LJ 1197, 1217.

<sup>656</sup> See generally MP Furmston 'The Analysis of Illegal Contracts' (1965) 16 U Toronto LJ 267.

<sup>657</sup> [1996] 1 Lloyd's Rep 345.

<sup>658</sup> *ibid* 349.

indirectly because they are tainted with the illegality of the underlying contracts.<sup>659</sup> To support its case, it further submits that the issuing and confirming of the letters of credit in the instant case were acts of performance of prohibited business, as payment under them would be. The payment of a claim is equally illegal whether it is done by placing cash in the hands of the defendants or by placing cash in the hands of an intermediary such as a bank who pays the defendant or by any other mechanism set up by the plaintiffs including a letter of credit. Hence the letters of credit are in any event tainted with illegality and are therefore unenforceable. In all of the above, the difficult question is ascertaining when the credit is or is tainted with illegality in the underlying transaction as to be capable of breaching the absolute impregnability of documentary credits.

Regarding illegality in the underlying transaction, Staughton LJ<sup>660</sup> noted that illegality in the underlying transaction could constitute a separate ground upon which the autonomy principle in letters of credit could be breached. The Lord Justice demonstrated his conviction by giving instances where illegality could affect a letter of credit as to constitute a ground for restraining payment by a bank. These include a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract providing for the opening of a letter of credit, to operate on presentation of a bill of lading for 1000 Kalashnikov rifles to be carried to the port of Basra. He maintained that in his view, a Court would not give judgment for the beneficiary against the bank in such a case. The above example given by Staughton LJ is strong indication that the underlying contract illegality can in some circumstances affect the letter of credit as to make it illegal whether directly or by way of taint.

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<sup>659</sup> [1996] 1 Lloyd's Rep 345, 349.

<sup>660</sup> *Group Josi Re v Walbrook Insurance Co. Ltd. and Others* [1996] 1 Lloyd's Rep 345,362.

#### 7.4. The Rationale for the exception

This section addresses the policy rationale behind the illegality exception. It answers the question as to what the rationale for the illegality defence is and whether the illegality defence is based only on the 'ex turpi causa' rule. If based on the rationale of 'ex turpi causa', what is its meaning and effect in law and if not, what are the other policy rationales that underpin the illegality defence in documentary credits?

In primary terms, a rationale for the illegality defence in documentary credit would be to complement the crucial role played by fraud in breaching the autonomy doctrine in some special circumstances.<sup>661</sup> It need not be over-emphasized that the autonomy doctrine states that the letter of credit is separate from and independent of the underlying contract in respect of which it is issued and remains a cardinal principle in the law of letters of credit. However, some policy considerations<sup>662</sup> demand that the absolute impregnability of the autonomy doctrine may be set aside in cases of fraud. It is in this context that illegality exception in documentary credits is perceived to play a complementary role to the fraud rule.

More so, as expressed in a long line of cases,<sup>663</sup> the rationale for the illegality defence has been captured in well-known phrases and maxims which ultimately are intended

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<sup>661</sup> See *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168.

<sup>662</sup> Such as the need to combat fraud and avoid the abuse of the letter of credit instrument

<sup>663</sup> See for example, *Beresford v Royal Insurance Company Ltd* [1938] AC 586, 599, See also *Euro-Diam Ltd v Bathurst* [1990] QB 1. where Kerr L.J stated the basis of the "ex turpi causa" defence as rooted on the general principle that '... rests on a principle of public policy that the courts will not assist a plaintiff who has been guilty of illegal (or immoral) conduct of which the courts should take notice. It applies if in all the circumstances it would be an affront to public conscience to grant the

to portray the public policy dimension of the illegality defence. Hence maxims deployed to capture the rationale of the illegality such as ‘no person may benefit from his own wrong’, or ‘no cause of action may be founded on an illegal act’ (*ex turpi causa non oritur actio*; and *in pari delicto potior est conditio defendentis*) remain established principles. As Professor Enonchong<sup>664</sup> observed with regard to the general illegality defence, it ‘... seeks to protect the integrity of the judicial system from the disrepute which would attach to it if the courts were seen to be encouraging conduct which they ought to denounce’.<sup>665</sup> This position is not only legally persuasive but sensible if regard is had to most of the cases where illegality has been invoked.

However, the approach of explaining the rationale of illegality defence from the point of this established maxim have been criticized as being inherently vague and even question begging with the overall effect therefore likely to be one of confusion rather than illumination.<sup>666</sup> The difficulty of rationalizing the illegality defence primarily from the point of the *ex turpi* rule did not escape the insightful adverse criticism of Balcombe LJ in *Pitt v Hunt*<sup>667</sup> when he said ‘I find the ritual incantation of the maxim *ex turpi causa non oritur actio* more likely to confuse than to illuminate’. So therefore, in the midst of these competing judicial and academic opinions as to the inadequacy of explaining the rationale for the illegality defence on grounds of *ex turpi causa*, what then is the rationale upon which the illegality defence is based?

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plaintiff the relief which he seeks because the court would thereby appear to assist or encourage the plaintiff in his illegal conduct or to encourage others in similar acts’.

<sup>664</sup> See N Enonchong *Illegal Transaction* (Lloyd’s of London Press, 1998) 16.

<sup>665</sup> See N Enonchong *Illegal Transaction* (Lloyd’s of London Press, 1998) 16.

<sup>666</sup> R A Buckley *Illegality and Public Policy*. (2<sup>nd</sup> edn London, Sweet & Maxwell 2009) 1.

<sup>667</sup> [1991] 1 QB 24, 49.

The rationale for the illegality defence has been explained from the standpoint of different policy arguments. One of the rationales which underpins the illegality defence according to the Law Commission<sup>668</sup> is said to be that disallowing the claim may further the purpose of the rule which the claimant has infringed. If, for example, the law makes the sale of hand guns illegal, it furthers the purpose of gun control to prevent a seller from suing for the contract price. This is a rationale which is frequently considered in contract cases where the claimant has breached a statutory provision either in making or performing a contract. An early example is given in *Cope v Rowlands*<sup>669</sup> where the court held that an otherwise valid brokerage contract made by a person who had failed to comply with a statutory requirement to obtain a licence from the City of London was unenforceable. Closely related to this rationale is the requirement that the law should be internally consistent. If a law for whatever reason makes the selling of a gun illegal, it will amount to an ‘absurdity’ in law for it to be seen to be encouraging its sale by protecting the interest of the seller. Applied to a letter of credit, if the law makes the trafficking of heroin illegal, would the enforcement of a letter of credit furnished in respect of such transaction not be furthering the purpose of the rule which the beneficiary has infringed?

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<sup>668</sup> See The Illegality Defence (LC CP No189) [2.6]

<sup>669</sup> (1836) 2 M & W 149, 150 ER 707 per Parke B at 710-711 ‘The question for us now to determine is, whether the enactment of the statute is ... meant to secure a revenue to the city, and for that purpose to render the person acting as a broker liable to a penalty if he does not pay it? Or whether one of its objects be the protection of the public, and the prevention of improper persons acting as brokers? ... [T]he legislature had in view, as one object, the benefit and security of the public in those important transactions which are negotiated by brokers. The clause, therefore, which imposes a penalty, must be taken ... to imply a prohibition of all unadmitted persons to act as brokers, and consequently to prohibit, by necessary inference, all contracts which such persons make for compensation to themselves for so acting’.

Another contested<sup>670</sup> rationale for the illegality defence is that by upholding it, it seeks to deter the commission of crime and illegal conduct. In *Taylor v Bhail*<sup>671</sup> an agreement to defraud an insurer of an amount of money which formed part of the overall cost for the repair of a building was held to be illegal, not severable and thus not recoverable. The contention of the respondent's counsel that the agreement which contained an estimate slightly above what was the actual building cost could be severed as to enable the respondent recover what was his actual cost of repairing the building was rejected by the Court of Appeal. The court held that an illegal contract to defraud a third party insurer was not capable of severance and hence unenforceable. However, this was against the finding of the trial judge that the contract was nevertheless fully enforceable, having regard to the quality of the illegality. The trial court reasoned that the 'quality of the illegality in all the circumstances was not such that the plaintiff should not be permitted to succeed on his claim against the defendant to be paid for the work which in fact he did. If it were otherwise the defendant would have all these works done free and, what is more, keep the money from the insurers. That seems to me to be the right and just attitude to take'.<sup>672</sup> The Court of Appeal thought otherwise and held that the contract being illegal was not severable and therefore not unenforceable. It seems that the rationale for the decision of the Court of Appeal in not allowing recovery for the actual cost of the building work was because the illegality arising from the conspiracy to defraud the insurer was to deter insurance fraud by sending 'a clear message' to builders that they will not be entitled to enforce

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<sup>670</sup> It needs to be pointed out that some judges have doubted how effectively the illegality defence can uphold any deterrent effect. This is largely for two reasons. First, many of those entering into transactions involving illegality are unaware of the law. Secondly, even if they are, it could be argued that a rule which acts as a deterrent for one party to a transaction may act as an inducement to the other, should he or she be aware that the illegality defence may result in an unmerited windfall. See *Tribe v Tribe* [1996] Ch 107, 133-134 per Millett LJ and *Tinsley v Milligan* [1992] Ch 310, 334 per Ralph Gibson LJ, See also Lord Lowry in *Tinsley v Milligan* [1994] 1 Ch 340, 368

<sup>671</sup> [1996] CLC 377.

<sup>672</sup> [1996] CLC 377, 384.

payment if they provide false estimates of work. As can be inferred from the trial Judge's rationale for the decision, it will be difficult (if the sole rationale underpinning the illegality defence is to protect the integrity of the legal system and/or to prevent a party from benefitting from his/her illegal conduct) to justify the Court of Appeal's decision. In allowing a party who took part in an illegal act of defrauding an insurer by initiating and actively participating in the illegal conduct to retain the insurance money and further assisted by the court in evading the payment of the actual cost of renovation work carried out by a builder, the Court of Appeal has not justified the rationale of preventing a party from benefitting from his illegal conduct. Such an approach, it can be argued does not protect the integrity of any rational legal system. Also, it flies in the face of the assertion that the rationale for the illegality defence is to stop a party benefitting from his illegal conduct.

Judging from the above analysis, the rationale for the illegality rather than being only to stop a party benefitting from his illegal conduct, could be said to be varied and depends on the circumstance of each case.<sup>673</sup> It need not be overstated that illegality is a very serious consideration in law and once implicated in a contract or transaction, its effect is usually to make the contract unenforceable. In documentary credit, the rationale for the adoption of an illegality defence, should not only be to complement the role played by fraud but to protect the integrity of the letter of credit by making illegal credit or credit tainted with illegality to be unenforceable.

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<sup>673</sup> It has to be noted that in some instances, though a statute makes a contract illegal, what determines whether the enforceability or otherwise of such contract is only ascertainable from the intention of the statute

## **7.5. The Current State of Authorities on Illegality Exception**

This section undertakes a comparative analysis of the position of the illegality defence in documentary credits in the US, Singapore and the United Kingdom. The aim is to explore how the illegality defence has been applied in these jurisdictions and how the application in those jurisdictions may benefit the position adopted in English law with respect to illegality defence in documentary credit law.

### **7.5.1. United States of America**

The authorities in the United States seem to adopt a position that fraud is the only recognized exception to the independent principle in letters of credit. This position is explicitly supported by Art. 5-109 of the Uniform Commercial code (UCC) which expressly recognizes fraud as the only ground upon which payment may be withheld upon a complying presentation. Art. 5-109 states that ‘If a presentation is made that appears on its face strictly to comply with the terms and condition of the letter of credit, but a required document is forged or materially fraudulent, or honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant..., the issuer, acting in good faith, may honour or dishonour the presentation...or a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation that is fraudulent’

It is the traditional view<sup>674</sup> that the illegality exception is not part of the US letter of credit law as it is not expressly provided for by Art.5-109 of the Uniform Commercial Code (UCC). This view is supported by some authorities<sup>675</sup> which denounce the existence of illegality as an exception upon which the independent undertaking in documentary credits could be breached. Does it then mean that, if a credit is illegal or tainted with illegality in the United States, its courts will fail to assist the aggrieved party seeking to be relieved of the contract by virtue of the illegality? The foregoing analysis will be undertaken taking into consideration the provision of Art. 5- 103 of the Uniform commercial Code (UCC) dealing with the scope of the letter of credit provision. Art. 5-103 (b) in which it is stated that ‘the statement of a rule in this article does not by itself require, imply, or negate application of the same or a different rule to a situation not provided for, or to a person not specified, in this article’ does not exclude the illegality exception. Subsection (c) continues to the effect that with the exception of certain provision of Art. 5, the effect of the article may be varied by agreement or by a provision stated or incorporated by reference to an undertaking. Bearing this provision in mind, it is arguable whether a credit either illegal or tainted with illegality in a domestic sphere<sup>676</sup> is enforceable in the United States. Can the position be different if the illegality in a letter credit arises from a conflict of law situation.<sup>677</sup> This analysis is undertaken having regard to the facts that UCC expressly provides for only fraud and forgery as being the only ground upon which the autonomy principle may be breached.

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<sup>674</sup> See *J Zeevi & Sons Ltd v Grindlays Bank (Uganda) Ltd* (NY Ct of App 1975) 333 NE2d 168.

<sup>675</sup> *ibid*, see also Art. 5-109 of the UCC which expressly provide for the fraud exception as the ground for withholding payment.

<sup>676</sup> As separate from illegality in documentary credit arising from a conflict of law situation.

<sup>677</sup> For example where the governing law is that of a foreign law which makes a letter of credit payment in America illegal.

In the domestic context, as early as 1960, a New York court noted that ‘It is the settled law of this State (and probably of every other State) that a party to an illegal contract cannot ask a court of law to help him carry out his illegal object, nor can such a person plead or prove in any court a case in which he, as a basis for his claim, must show forth his illegal purpose’.<sup>678</sup> The court, referring to the illegality defence, further stated that no court should be required to serve as paymaster of the wages of crime. It makes no difference that the defendant has no title to the money since the court's concern ‘is not with the position of the defendant’ but with the question of whether ‘a recovery by the plaintiff should be denied for the sake of public interests’, a question which is one ‘of public policy in the administration of the law. The court in reference to public policy noted that ‘No one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime. These maxims are dictated by public policy, have their foundation in universal law administered in all civilized countries, and have nowhere been superseded by statutes.’<sup>679</sup> Judging from this, it is still arguable whether the courts in the US would still enforce a letter of credit that originates from an illegal transaction just because the provision of Art.5-109 of the Uniform Commercial Code (UCC) provides only for fraud and forgery as ground for displacing the autonomy principle.

In conflict of law situations, the Court of Appeals of New York in *J Zeevi & Sons Ltd. v Grindlays Bank (Uganda) Ltd.*,<sup>680</sup> held that the issuer's obligation under the letter of credit was not excused based on illegality abroad. The facts of this case are that

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<sup>678</sup> *Stone v Freeman*, 298 NY 268, 271, 82 N.E.2d 571, 572, 8 A.L.R.2d 304.

<sup>679</sup> *Riggs v Palmer*, 115 N.Y. 506, 511-512, 22 NE 188, 190, 5 L.R.A. 340: See also, *Carr v Hoy* 2 N.Y.2d 185, 187, 158 NYS2d 572, 574-575).

<sup>680</sup> (NY Ct of App 1975) 333 NE2d 168.

Grindlays Bank of Uganda issued a letter of credit to an Israeli beneficiary. Grindlays Bank authorized Citibank in New York to debit Grindlays Bank's account if the beneficiary's drafts complied with the terms of the credit. The Ugandan government, however, subsequently ordered the cancellation of all foreign exchange transactions with Israeli companies and nationals. Grindlays Bank then cancelled its letter of credit. Citibank, in its turn, refused to honour J Zeevi & Son's drafts presented to it through Chemical Bank. J Zeevi & Sons proceeded to sue Grindlays Bank in New York State court. The New York Court of Appeals ruled that New York law, not Ugandan law, should be applied in the case because New York had 'an overriding and paramount interest' in the lawsuit. The New York Court of Appeal found that despite the illegality arising from the cancellation of all foreign exchange controls with Israeli nationals by the then General Amin; the mere fact that payment was to be made in New York gave New York the greatest interest in the litigation and thus the law of New York, not Uganda, applied.

Hence, despite the illegality of operating the letter of credit under the Ugandan law, the credit could not be enjoined. A proper reading of this case reveals that some policy issues<sup>681</sup> were instrumental in the New York Court of Appeal not respecting the illegality resulting from the executive order of the Ugandan Government. They were policy concerns relevant to the resolution of a problem<sup>682</sup> as opposed to whether illegality was actually a ground upon which to enjoin payment such as (1) New York

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<sup>681</sup> That is 'enforcement of irrevocable letters of credit is vital to international commerce' than respecting the order of Ugandan government made in the circumstance in which it was made and that the Ugandan order represented a policy which was offensive to the citizens of New York as an international financial centre interested in the smooth operation of letters of credit.

<sup>682</sup> J A Reinhart, 'Reallocating Letter of Credit risks: Chuidian v Philippine National Bank' (1993)18 NCJ Intl. L & Comm Reg 725, See also *J Zeevi and Sons Ltd v Grindlays Bank (Uganda) Ltd* 333 NE 2d 168 (NY1975).

was the designated place of payment in the letter of credit;<sup>683</sup> (2) New York, as a financial center, had a significant interest in the smooth and consistent enforcement of letters of credit obligations;<sup>684</sup> and (3) the Ugandan order represented a policy which was offensive to the citizens of New York.<sup>685</sup>

It must be noted that despite the UCC not making an express provision recognizing the illegality defence, nothing in article 5 of the UCC dealing with letters of credit expressly excludes the exception. In the United States, if payment on the letter of credit is illegal, certainly the issuer's dishonour will be excused.<sup>686</sup> This is provided by the American Restatement of Laws published by the American Law Institute. American Restatement is essentially a codification of case law, common law judge-made doctrines that develop gradually over time because of the principle of stare decisis. Although Restatements are not binding authority in and of themselves, they are highly persuasive because they are formulated over several years with extensive input from law professors, practising attorneys, and judges.<sup>687</sup> Hence Section 202 of the American Restatement of Laws states that the effect of illegality upon a contract is determined by the law selected by application of the rules of [sections] 187-188, which deals with law of the state chosen by the parties and the law governing in absence of effective choice by the parties respectively. To ascertain the law governing a transaction, in the absence of effective choice by the parties, demands a consideration of a quite good number of issues

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<sup>683</sup> *ibid* at 171.

<sup>684</sup> *ibid* at 172.

<sup>685</sup> *ibid* at 173.

<sup>686</sup> Restatement (Second) Of Conflict Of Laws § 202(2) (1971).

<sup>687</sup> See the explanation offered by Wikipedia assessed on 25 July 2009.[http://en.wikipedia.org/wiki/Restatements\\_of\\_the\\_Law](http://en.wikipedia.org/wiki/Restatements_of_the_Law)

Also inherent in the potential application of foreign law under a conflict of laws analysis is the notion of comity. Comity is defined as ‘the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation . . . [as an] expression of understanding which demonstrates due regard both to international duty and convenience and to the rights of its own citizens or of other persons who are under the protection of its laws’.<sup>688</sup> Recognition of a foreign law thus involves a policy decision grounded in a host of concerns which a court must balance and in most of the circumstances pay due regard to consideration of illegality.

Hence, in *Chuidian v Philippine National Bank*,<sup>689</sup> the US Ninth Circuit Court of Appeal had the opportunity to address the effect of illegality in a letter of credit transaction which demanded the application of the law of a foreign nation so as to excuse liability in a letter of credit transaction on grounds of illegality. To understand this case and its implications, a discussion of its facts is necessary. In 1980, Asian Reliability Company, Inc. (ARCI), a Philippine corporation, received a loan guarantee of \$25 million from the Philippine Export and Foreign Loan Guarantee Corporation (PG).<sup>690</sup> Vincent Chuidian, a Philippine citizen living in the United States, was a 98% shareholder in ARCI. After ARCI defaulted on the loan, and caused PG to become liable through the guarantee, PG brought suit in Santa Clara County Superior Court alleging that Chuidian had misappropriated the funds for his own use and for investment in concerns outside of the scope of the loan guarantee.<sup>691</sup> The parties

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<sup>688</sup> *Somportex Ltd v Philadelphia Chewing Gum Corp.*, 453 F.2d 435 (3d Cir. 1971), *cert. denied*, 405 U.S. 1017 (1972).

<sup>689</sup> 734 F. Supp. 415.

<sup>690</sup> *Chuidian v Philippine National Bank*, 734 F. Supp. 415.

<sup>691</sup> The proceeds of the loan were supposed to be used for investment in industrial projects in the Philippines. PG alleged that the funds were instead used for Chuidian's personal benefit and to invest in two *Silicon Valley corporations*, *Dynetics, Inc. and Interlek Semiconductor, Inc.*, in violation of the

entered into a settlement carried out through a stipulated judgment under which (1) Chuidian surrendered to PG shares of stock in ARCI, Dynetics, Inc., and Interlek Semiconductors, Inc., and (2) PG agreed to pay Chuidian \$5.3 million 'to be paid by means of an irrevocable letter of credit from a United States Bank'. The letter of credit, although issued by the bank in Manila, was payable at the counters of the bank's Los Angeles branch

After the government of President Ferdinand Marcos fell in 1986, the new government in the Philippines established a Presidential Commission on Good Governance charged with the task of recovering any 'ill-gotten wealth' of President Marcos. As part of this effort, the commission ordered the bank not to pay the letter of credit that had been issued in favour of Chuidian. The commission suspected that the settlement of Guarantee Corp.'s lawsuit against Chuidian might have been fraudulent in that its purpose was to pay off Chuidian for his remaining silent about President Marcos's participation in Chuidian's businesses. Stopping payment of the letter of credit would obviously give the Commission time to analyze the legitimacy of the settlement.

Chuidian proceeded to sue the bank in a California state court in Los Angeles for refusing to pay its letter of credit. The bank remanded the case to the U.S. federal district court. After a trial, the Federal court excused the bank from paying its letter of credit on the ground that since the place of performance of the letter of credit was Manila, the order of the commission had rendered payment of the credit illegal.<sup>692</sup>

The district court considered two defences that would excuse PNB from liability

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terms of the loan. *Philippine Export and Foreign Loan Guar. Corp. v Chuidian*, 267 Cal Rptr 457, 460 (Cal. Ct. App. 1990).

<sup>692</sup> 734 F. Supp. 415 (C D Cal. 1990).

under the letter of credit. The first was fraud and duress in the underlying settlement agreement. The court rejected this defence. A different line of defence, however, was recognized by the court, which offered alternative holdings that PNB's performance was excused because (1) it was illegal or (2) the doctrines of comity and act of state meant that the Philippine executive order should be observed by a U.S. court.<sup>693</sup> The district court therefore held that the settlement agreement between PG and Chuidian was valid, but that performance of the letter of credit arising under that settlement agreement was excused because it was illegal or, in the alternative, because the doctrines of comity and act of state gave the Philippine executive order validity in the United States.<sup>694</sup> Chuidian's trustee in bankruptcy appealed this decision to the Ninth Circuit. The Ninth Circuit affirmed the decision but focused solely on the illegality of performance in the Philippines as the ground for excusing the Philippine National Bank from dishonour.

A proper analysis of this case reveals that illegality affecting the credit arose from the acts in the underlying transaction thus making the credit illegal as well as the underlying transaction. The case evidences the application of the rules of comity and conflict of laws. It largely justifies the contention that, despite the express provision of Art.5 making fraud and forgery the only ground for dishonour of a letter of credit in the United States, a letter of credit that is illegal, by the application of the rules of comity arising from the illegality, has been held to be unenforceable.

It is finally submitted that despite the UCC not making an express provision recognizing the illegality defence, nothing in article 5 of the UCC dealing with letters

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<sup>693</sup> *ibid* 420.

<sup>694</sup> *ibid* 425.

of credit expressly excludes the exception. This could be deduced by a combined effect of Article 5-103 dealing with the scope of the provision as well as other United States laws whose combined effects seem not to exclude the illegality defence in documentary credit.

### **7.5.2. Position in Singapore**

Case law and judges in Singapore have maintained a robust disposition regarding the exceptions to the principle of autonomy in documentary credit. This has been expressly felt in the recognition of a separate exception on the ground of nullity of the tendered documents in a documentary credits transaction that is distinct from the fraud rule.<sup>695</sup> It has also maintained that there is a separate exception known as the unconscionability exception.<sup>696</sup> However, on the issue of illegality as an exception to the principle of autonomy, there is currently no express judicial authority on the point. However, considering the trend of the decisions so far in Singapore on the exceptions to the principle of autonomy, it may not be totally wrong to conclude that considering the policy issues<sup>697</sup> that underpin the recognition of the illegality defence, its recognition as an exception in Singapore is only a matter of time. But till that time, the current position in Singapore is that there is no illegality exception.

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<sup>695</sup> This issue would be giving a detailed consideration in subsequent chapters under the heading the nullity exception.

<sup>696</sup> See generally, *GHL Pte v Unitrack Construction Ltd and Another* [1999]4 SLR 604, See also the decision of the Singapore court in *Kvaerner Singapore Plc Ltd v UDL Shipbuilding (Singapore) Ltd* [1993] 3 SLR 350. where an injunction restrained a beneficiary who failed to perform the underlying condition precedent before calling on a guarantee.

<sup>697</sup> Such policy issues gave way to the recognition of the other exceptions as nullity and unconscionability in Singapore

### 7.5.3. English law

The first major legal pronouncement on the issue of illegality as it affects documentary credit was in the *American Accord*.<sup>698</sup> Lord Diplock commented on illegality and its implications when it affects a documentary credit transaction. However, despite *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada*,<sup>699</sup> touching on illegality, the first English decision to have expressly raised the issue as to whether illegality in the underlying transaction should form a separate exception that is distinct from fraud is *Group Josi Re v Walbrook Insurance Co Ltd and Others*.<sup>700</sup> Here, the Court of Appeal had the opportunity to consider the issue as to whether illegality in the underlying transaction could form the basis of a separate exception that is different from fraud. Staughton LJ in resolving one of the arguments of the appellant as to why the defendant was not entitled to the encashment of the letters of credit noted as follows,

... in my judgment illegality is a separate ground for non-payment under a letter of credit. That may seem a bold assertion, when Lord Diplock in the *United City Merchants* case said that there was 'one established exception'. But in that very case the House of Lords declined to enforce a letter of credit contract in part for another reason, that is to say the exchange control regulations of Peru as applied by the Bretton Woods Agreements Order in Council 1946. I agree that the Bretton Woods point may well have been of a kind of its own, and not an indication that illegality generally is a defence

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<sup>698</sup> [1983] 1 AC 168.

<sup>699</sup> [1983] 1 AC 168.

<sup>700</sup> [1996] 1 Lloyd's Rep 345.

under a letter of credit. But it does perhaps show that established fraud is not necessarily the only exception.<sup>701</sup>

The confidence in the opinion of Staughton LJ as to the existence of a separate exception from fraud led to the citing of many instances in which he was convinced that illegality in the underlying transaction could constitute a separate exception from fraud. He cited a convincing hypothetical example where illegality could operate as a bar to payment on a letter of credit ‘a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1000 Kalashnikov rifles to be carried to the port of Basra. I do not suppose that a Court would give judgment for the beneficiary against the bank in such a case’.

In *Mahonia Ltd v JP Morgan Chase Bank and West LB*,<sup>702</sup> the issue of illegality in the underlying transaction constituting a separate exception to the principle of autonomy once again received judicial attention. In this case, a claim was brought by the claimant, Mahonia for payment of US \$165 million under a letter of credit issued by the defendant bank, West LB. The backdrop to this action was the collapse of the US energy giant, Enron. Mahonia was a special purpose vehicle utilized to enter into a series of swap transactions with Enron and JP Morgan Chase, as a result of which the letter of credit issued by West LB at Enron’s request acted as a security required in relation to one of the swaps. Upon presentation to it of conforming documents, West LB refused to make payment under the credit, contending that it had a valid defence for refusing payment, as the letter of credit was unenforceable for illegality either

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<sup>701</sup> *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345, 362.

<sup>702</sup> [2003] EWHC 1927 (Comm) [2003] 2 Lloyd's Rep 911.(Summary Judgment Application); [2004] EWHC 1938 (Comm) (trial).

directly or by way of taint from the underlying transaction.<sup>703</sup> It need not be forgotten that at the time of refusal to make payment, Enron had already filed for Chapter 11 bankruptcy proceeding in the US and West LB would have been unable to recover the value of the credit from Enron. West LB in justifying the illegality argued that the swaps transaction has been entered into as a means of Enron obtaining a ‘disguised’ loan that need not be reflected on its published accounts. The purpose it further argued was contrary to US accounting standards and in breach of US securities law.

Mahonia applied for summary judgment on the basis that West LB had no defence to the action. However, its application was refused by Colman J, on the ground that there was an arguable defence of illegality sufficient to go to trial. In considering the issues, Colman J allied his position with the pronouncement made obiter by Staughton LJ in *Group Josi Re v Walbrook Insurance Co Ltd*<sup>704</sup> when he said ‘I find it almost incredible that a party to an unlawful arms transaction would be permitted to enforce a letter of credit which was an integral part of that transaction even if the relevant legislation did not on its proper construction render ancillary contracts illegal. To take an even more extreme example, I cannot believe that any Court would enforce a letter of credit to secure payment for the sale and purchase of heroin between foreign locations in which such underlying contracts were illegal’.<sup>705</sup>

At the full trial of the action,<sup>706</sup> Cooke J found that there was no illegality in the underlying transaction as there was no breach of the US accounting standard and hence no breach of US securities law. In the words of the Cooke J, ‘It follows from

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<sup>703</sup> See [2003] 2 Lloyds Rep 911, 913-914, (Colman J).

<sup>704</sup> [1996] 1 Lloyd's Rep 345.

<sup>705</sup> See [2003] 2 Lloyds Rep 911,927.

<sup>706</sup> *Mahonia Limited v JP Morgan Chase Bank, West LB AG* (No.2) [2004] EWHC 1938 (Comm).

my finding that Enron's accounting for the prepays was not in breach of US accounting rules, that its accounting for these transactions did not constitute a breach of US Securities law. It inevitably follows that West cannot show that there was any conspiracy between Enron, Mahonia and Chase to devise, arrange and implement transactions in order to enable Enron to account wrongfully. It equally follows that there was no unlawful purpose behind the Three Swaps or the letter of credit'.<sup>707</sup> As a result of this finding, the question of the effect of illegality in a letter of credit law was not subject of an authoritative legal pronouncement in Cooke J's judgment. However, the hypothetical case based on the argument canvassed by West LB was considered. It in effect tried to resolve the hypothetical question as to what will be the effect of West LB establishing that there was an unlawful underlying purpose for the swap transactions in respect of which the letter of credit was issued. Cooke J primarily allied his view with that of Colman J at the summary application stage as to the operation of law of illegality. His conclusion was that the impregnability of the letters of credit by virtue of the autonomy principle does not prevent it from being tainted with illegality in the underlying transaction.<sup>708</sup>

It must be noted that Cooke J's opinion, which is in accord with earlier judicial views<sup>709</sup> on the issue (availability of illegality defence in documentary credit law), reflects the direction that the English law is going. However, as already pointed out by Professor Nelson Enonchong,<sup>710</sup> the views expressed so far in the cases are merely obiter as there is yet no English case where a complying presentation has been

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<sup>707</sup> 2004] EWHC 1938 (Comm) [236].

<sup>708</sup> 2004] EWHC 1938 (Comm) 429, 432-433.

<sup>709</sup> See Staughton LJ in *Group Josi Case* [1996] 1 Lloyd's Rep.345, Also Colman J at the Summary Judgment stage of Mahonia case [2003] 2 Lloyds Rep 911.

<sup>710</sup> Enonchong, N. 'The autonomy Principle of letters of credit: an illegality exception?' (2006) LM CLQ 404, 410.

dishonoured on the grounds of illegality of the underlying transaction. Hence, it may be appropriate to consider some of the legal issues that are necessary for the application of the illegality exception.

## **7.6. Legal Considerations for the Application of Illegality Defence**

Having considered the present state of English law on the availability of the illegality defence as an exception to the principle of autonomy in documentary credits; this section examines some legal issues which the existence of an illegality defence will undoubtedly bring to the fore. It attempts to define the boundaries of the exception by examining the scope of the illegality defence that will warrant a departure from the principle of autonomy. In doing the above, certain legal issues are considered and analysed. They include the evidentiary requirement for the application of the illegality defence, the intent of the beneficiary and the extent to which it remains a primary consideration to the application of the illegality defence, an analysis of whether there should be a connection between the letter of credit and the alleged illegality for it to warrant a departure from the principle of autonomy. Finally, a consideration whether the distinction between serious and trivial illegality is actually necessary in the application of the exception in documentary credits' law will be undertaken.

### **7.6.1. Evidentiary Requirement of Illegality Defence**

The evidence required for the proof of illegality is still subject to conflicting interpretation by the courts in England. This is evident not only from decided cases

but also from the opinion of experts. The uncertainties surrounding the application of the law in the area prompted Staughton LJ<sup>711</sup> to share the view expressed by Balcombe LJ in *Themehelp Ltd. v West and Others*<sup>712</sup> that ‘the law on this topic is not wholly satisfactory’.<sup>713</sup> However to understand the nature of the evidence required in illegality cases, two main issues call for consideration, the standard of proof and the time at which the bank should have the evidence upon which to establish illegality.

Staughton LJ in the *Group Josi’s* dealt with the issue of what level of evidence is required to establish illegality in documentary credit. In this regard, Staughton LJ questioned whether illegality, like fraud, has to be clearly established and known to the bank before it could operate as a defence for restraining payment by the bank. In his answer he noted the difficulty associated with this question but was of the view that it would. He continued that if illegality is merely doubtful, it may be that the bank will not be restrained. Hence, Staughton, LJ reinforced the high standard of proof already well known in documentary credits in the case of fraud. The statement of Staughton LJ raises further questions. What amounts to a situation where an illegality has been clearly established? To analyze this question, one will ignore in this part of the discourse, a question that seems to be neglected<sup>714</sup> but poses a primary difficulty in understanding of when illegality is clearly established. The question touches on the complexity surrounding the understanding of when a given contract can be said to be illegal<sup>715</sup> or when a transaction is illegal. It has to be pointed out that the extremely

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<sup>711</sup> *Group Josi Re v Walbrook Insurance Co. Ltd. and Others* [1996] 1 Lloyd’s Rep 345

<sup>712</sup> [1996] QB 84.

<sup>713</sup> Though this statement was made in the course of analysing the standard of proof of fraud

<sup>714</sup> M P Furmston, ‘The Analysis of Illegal Contracts’ (1965) 16 U Toronto LJ 267.

<sup>715</sup> This issue resurfaced in the famous trial involving the collapse of the US energy giant Enron Corporation in *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)* [2004] EWHC 1938 (Comm), 2004 WL 1808816. where against the contention of the a German bank West LB that the substance of three swaps between Mahonia and the other parties was to extend a loan to Enron without it being recorded as such in its accounting report and hence contrary to US securities law. However, it

fluid nature of the notion of ‘illegality’ and the absence of any simple agreed definition of what constitutes an ‘illegal transaction’<sup>716</sup> poses a tremendous difficulty in ascertaining when an illegality is clearly established.

If the standard of proof required in illegality cases is that the illegality must be clear, then another consideration that may arise in this circumstance is the question whether illegality would be ‘clear as to what’? Or put differently, is it supposed to be clear with respect to all the components that make up the proof of illegality? This question is raised because the overall approach of the courts as to the issues of proof of illegality have not been consistent and tend most often to be ultimately pragmatic and very much dependent on the facts of the particular case in question.<sup>717</sup> It may also be noted that the standard of proof of clear illegality which is also used in cases of fraud has been perceived to be a high standard that has so limited the exception as to have prompted Ackner LJ to warn of the inherent dangers of too high a standard of proof.

### **7.6.2. Timing**

The question of when knowledge of illegality, just like fraud, must be apparent arises in two major situations: first, if the bank has not paid and is resisting proceedings by the beneficiary for payment under the letter of credit; and secondly if the bank has already paid on the credit and the applicant is resisting reimbursement.

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was held that the transaction which involved the three swap transactions was not illegal but merely a “price risk management activities”

<sup>716</sup> See N Enonchong, *Illegal Transactions* (Lloyd’s Press 1998) 1-2. Also see, Hugh Beale, *Chitty on Contracts* (30th edn, Sweet & Maxwell 2006) para 16-001, See generally ‘Illegal Transactions: The Effect of Illegality On Contracts And Trusts’ (*Law Com. Consultation Paper No. 154*, 1999).

<sup>717</sup> M Brazier, *Clerk & Lindsell on Torts* (17th edn, Sweet & Maxwell 1995) 67. For the latest edition, see MA Jones and AM Dugdale, *Clerk & Lindsell on Torts* (20th edn, Sweet & Maxwell 2010) 69.

In the first instance, if the bank decides not to pay it has a responsibility to establish the illegality at the trial if it is sued by the beneficiary. However, for the bank to have the right of refusal, actual illegality must be demonstrated, as it is not sufficient for the bank merely to prove that there is material which would lead a reasonable banker to infer the illegality by the beneficiary.<sup>718</sup> Hence if illegality is apparent at the time payment is due, then the bank must not make payment and has a defence to a claim by the beneficiary. An issue that arises in this context is: suppose that the bank rejects documents based on an alleged illegality but that decision is subsequently conceded to be wrong based on the material available at the time payment was due. Can the bank defend proceedings relying on new evidence of illegality which came to light after the date of payment but before trial?

Drawing from the approach adopted in the fraud rule in *Balfour Beatty Civil Engineering v Technical and General Guarantee Co Ltd*,<sup>719</sup> Waller LJ, recognized the submission that if at the hearing stage the bank can produce clear evidence of fraud, it would be unreasonable to think that the bank can have judgment entered against it because evidence of the fraud was not available to the bank at the time when payment was due. However, the above submission did not deter the court from taking the view held in the *Edward Owen Case*<sup>720</sup> to the effect that the bank is only entitled to refuse payment 'where it has clear evidence of fraud'. In other words, the liability of the bank cannot alter depending on what stage the litigation has reached and it would be unreasonable to require the court to give judgment because it concluded that, although fraud was now sufficiently established, it had not been established and known to the bank at the time when the demand was made.

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<sup>718</sup> See *Society of Lloyd's v Canadian Imperial Bank of Commerce* [1993] 2 Lloyd's Rep 579.

<sup>719</sup> (1999) 68 Con LR 180.

<sup>720</sup> *Edward Owen (Engineering) Ltd v Barclays Bank International Ltd* [1978] QB 159,169.

In *Solo Industries UK Ltd v Canara Bank*<sup>721</sup> Mance LJ identified a way of removing the ‘contradiction’ that would result from insisting that the bank must have clear evidence at the time of payment. After considering Waller LJ’s analysis in the *Balfour Beatty* case, Mance LJ held that:

Another way of reaching the same conclusion... may be by applying Lord Diplock’s underlying principle that the court should not lend its process to assist fraud and that “fraud unravels all”. Not question arises in this context of the grant of injunctive relief or any requirement for that purpose to have a course of action. It would affront good sense ... if courts were obliged to give judgment in favour of a beneficiary now shown to be acting fraudulently

Also in *Mahonia Ltd v JP Morgan Chase Bank*,<sup>722</sup> Colman J expressed a view that supports Mance LJ’s approach. It is also the submission of Professor Enonchong<sup>723</sup> that Mance LJ’s approach is preferable as it has the merit of allowing the bank to use clear evidence of fraud in all cases where such evidence is available rather than in cases where it has a counterclaim. This approach, it is submitted, is not only legally persuasive but sensible if regard is had at the policy reasons behind the recognition of the fraud rule.

The second situation relates to where the bank has paid in accordance with the terms and condition of the credit and is seeking reimbursement from the applicant. In *Credit*

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<sup>721</sup> [2001] EWCA Civ 1059; [2001] 1WLR 1800 at [21].

<sup>722</sup> [2003] 2 Lloyd’s Rep11.

<sup>723</sup> See NE Enonchong, ‘The Autonomy of Letters of Credit: an Illegality Exception?’ (2006) LMCQ 404, 415.

*Agricole Indosuez v General Bank*<sup>724</sup> it was held that a bank that has paid according to its mandate is entitled to reimbursement unless there is clear evidence of fraud at the time of payment, as it is not open to the applicant objecting to the bank's decision to rely on evidence not made available to the bank at the time of payment. The above position confirmed the earlier position in *United Trading Corpn SA v Allied Arab Bank Ltd*<sup>725</sup> where the court held that the relevant date for establishing fraud in cases where the bank has made payment based on the representation of the beneficiary must be such fraud that was clear prior to the actual payment. Accordingly, 'if all that the plaintiff (account party) can establish is such knowledge after payment, then it has failed to establish his cause of action. The bank would not have been in breach of any duty in making payment without the requisite knowledge',<sup>726</sup>

### **7.6.3. The Reliance Doctrine and Proof of Illegality**

As explained above, the proof of illegality is fraught with some difficulties. One difficulty is whether the plaintiff's reliance on the illegality needs to be established so as to prove the illegality and ultimately defeat his claim. This question is raised bearing in mind that the operation of the reliance principle exists mainly in cases of trust and determination of proprietary rights.<sup>727</sup> The case of *Tinsley v Milligan*<sup>728</sup> made the reliance principle in illegality popular. The facts are that the parties were cohabitees who had both contributed to the purchase price of a house. The house had, however, been solely registered in Miss Tinsley's name in order to enable Miss Milligan to make false claims to the Department of Social Security. The proceeds of

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<sup>724</sup> [1999] 2 All ER (Comm.) 1009, 1015.

<sup>725</sup> [1985] 2 Lloyd's Rep 554.

<sup>726</sup> *ibid* at 560.

<sup>727</sup> See generally *Tinsley v Milligan* [1994] 1 AC 340.

<sup>728</sup> [1962] AC 304.

the fraud were used by both parties, but they did not amount to a substantial part of their joint income. The parties subsequently quarrelled and Miss Tinsley moved out. She brought a claim against Miss Milligan for possession of the house, asserting her legal title to it. Miss Milligan counterclaimed for an order for sale and a declaration that the house was held by Miss Tinsley in trust for them both in equal shares. Miss Tinsley contended that because of the illegal scheme, Miss Milligan could not establish any equitable interest in the house under a trust. It was held by a bare majority of the House of Lords, who upheld a majority decision of the Court of Appeal which had confirmed the finding of the trial judge, that Miss Milligan was entitled to her equitable share in the property provided that she did not need to lead evidence of the illegality in order to prove her equitable interest in the property.

The use of this doctrine in illegality cases as earlier pointed out has not been consistent. In *Chai Sau Yin v Liew Kwee Sam*,<sup>729</sup> the defendant bought a quantity of rubber from the plaintiff in breach of a Malayan statutory provision which required a purchaser of rubber to be licensed. After accepting delivery of the rubber, the defendant refused to pay the price. The Privy Council held that the sale contract entered into in breach of the licensing condition was impliedly prohibited by the statute and the defendant was able to rely on his own unlawful actions to defeat a claim by the plaintiff for the sale price. It has to be noted that the plaintiff in this case had not been in breach of any statutory prohibition and the proof of his reliance on the said illegality as to defeat the plaintiff's action for the price was not established. However, despite the failure to establish that the plaintiff, in claiming for the purchase price of goods sold was not relying on any illegality, his action for the price failed.

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<sup>729</sup> [1962] AC 304

The question may then arise as to whether the application of the illegality exception in documentary credit would require a proof of the beneficiary reliance on her illegality as to deny payment? It is submitted that the insistence on the proof of the beneficiary's reliance on the illegality would lead to an unsatisfactory result. To this effect, some academic commentators have criticized the reliance principle as being arbitrary and not based on any convincing policy reasoning.<sup>730</sup> It is submitted that in documentary credit, insisting on the proof of the beneficiary's reliance on his illegality as a ground for knowing when payment would be denied would prove problematic. This is because, in most of the cases, the beneficiary would be insisting on the separation between the documentary credit contract and whatever illegality arises in relation to the underlying contract.

In conclusion, the reliance principle, viewed from the many angles upon which illegality can affect a contract or trust has generated an approach that is unsatisfactory, arbitrary, uncertain and is not based on any convincing policy rationale.<sup>731</sup> In documentary credits, if the proof of reliance is insisted on for illegality to be a ground for withholding payment, the consequence may be that the exception of illegality may never be applied, at least with regard to the beneficiary asking for payment in documentary credits. Take for example, in situations where the beneficiary has applied for summary judgment for payment in cases of the bank's refusal to pay,

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<sup>730</sup> See N Enonchong, *Illegality: The Fading Flame of Public Policy* (1994) 14 OJLS 295, 299, See also H Stowe, 'The "Unruly Horse" has Bolted' (1994) 57 MLR 441, 446,

<sup>731</sup> See generally *Illegal Transactions: The Effects of Illegality on Contracts and Trusts*, Law Commission Consultation Paper 154 (1999). at Para. 8.8, N Enonchong, 'Illegality: The Fading Flame of Public Policy' (1994) 14 OJLS 295; H Stowe 'The "Unruly Horse" has Bolted: *Tinsley v Milligan*' (1994) 57 MLR 441.

chances are that most often than not, the beneficiary's claim would succeed, as the beneficiary does not need to rely on the illegality in the underlying transaction in order to make out his claim for payment under the letters of credit transaction.

Having noted the difficulty associated with the reliance doctrine and the standard of proof of illegality, questions may arise as to whether there are other ways of setting clear parameters upon which illegality could be founded. This in itself is an uncertain<sup>732</sup> question but considering the recommendation of the *Law Commission* that this is an area of law that requires the courts to use certain discretion in its consideration as to when illegality is proved and should constitute ground for the denial of a claim, attempt will be made to consider some of the limiting factors that the court should take into consideration in coming to a conclusion as to when illegality is established.

### **7.7. Illegality: Defining its Boundaries**

This section analyzes the ambit of an illegality exception that would warrant a departure from the autonomy rule in documentary credits. The task is undertaken bearing in mind that the complex matrix<sup>733</sup> of judicial interpretation surrounding the understanding of illegality poses a great difficulty. It needs to be emphasized that despite the difficulty of articulating all the issues that will govern the application of illegality defence in documentary credits, there are strong cases by academics<sup>734</sup> and

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<sup>732</sup> Uncertain in the sense that a discretionary method of arriving to a conclusion of what is illegal may include factors which at the present situation, facts and legal problems have not yet thrown up.

<sup>733</sup> Take for instance the different rationale that has been identified for ascertaining when illegality does or does not exist which in essence makes the this area of

<sup>734</sup> NE Enonchong, 'The autonomy Principle of Letters of Credit: an Illegality Exception?' (2006) LMCLQ 404, 416.

judges<sup>735</sup> that in certain situation, illegality could be a defence to the principle of autonomy. This section analyses some of the criteria and ingredients that need to be present for illegality to be a ground upon which the independent undertaking of documentary credits could be set aside. Such ingredients include questions as to (a) how serious the illegality is, (b) the knowledge and intention of the of the party involved in illegal conduct, (c) whether denying relief would act as a deterrent, the requirement of a close connection between the illegality and the letter of credit and finally (d) whether denying relief would further the purpose of the rule which renders the claimant's conduct illegal.<sup>736</sup>

#### **7.7.1. Seriousness of Illegality**

The seriousness of the illegality that will justify a departure from the principle of autonomy is a good parameter for limiting the illegality exception as well as a strong factor to be taking into account in the proof of illegality arising from the underlying transaction. In *Standard Chartered Bank v Pakistan National Shipping Corporation and others (No 2)*<sup>737</sup> Cresswell J<sup>738</sup> hinted at this requirement of the seriousness of the illegal conduct by noting that it is likely that even a claim which is linked to an illegal act will not fail unless the illegality is of a serious nature. Cresswell J, also noted that 'whatever theory founds a defence of *ex turpi*, the defendant must establish (a) that the plaintiff's conduct is so clearly reprehensible so as to justify its condemnation by the Court and (b) that the conduct is so much part of the claim against the

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<sup>735</sup> *Group Josi Re v Walbrook Insurance Co. Ltd. and Others* [1996] 1 Lloyd's Rep. 345. Per Staughton LJ 363.

<sup>736</sup> See the discretionary criteria recommended by the Law commission upon which illegality defence would operate in law. *The Illegality Defence: The Law Commission Consultation Paper No 189*

<sup>737</sup> [1998] 1 Lloyd's Rep 684.

<sup>738</sup> This case was primarily decided on the principle of fraud and forgery but some of the issues are relevant for our analysis of illegality.

defendant...as to justify refusing any remedy to the plaintiff'.<sup>739</sup> Also the case of *Lane v Holloway*<sup>740</sup> provides example of where the claimant's illegality was held to be trivial as to not defeat his claim.

One question that arises in deciding the seriousness of illegality is where to draw the line between an illegality which is sufficiently serious and that which is not.<sup>741</sup> Some instances of illegality that are serious were captured in *Group Josi Re v Walbrook Insurance Co. Ltd*<sup>742</sup> when Staughton LJ gave as an example, an underlying contract for the sale of arms to Iraq at a time when such sale is illegal. In the same vein, Colman J<sup>743</sup> referred to an underlying contract for the sale and purchase of heroin. The difficulty with the above approach is that it does not establish any verifiable criteria for knowing when illegality is sufficiently serious apart from the mentioning of extreme examples of illegal conduct which are rare in real commercial life.

However, Cooke J in *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)*<sup>744</sup> devised criteria for categorizing illegality that is serious enough to displace the autonomy principle. Based on these criteria, illegality was analyzed in two main categories. Illegality that involved intentional wrong doing (in which case the illegality defence applies) and illegality that arises through mere inadvertence (in

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<sup>739</sup> Ibid, 705-706.

<sup>740</sup> [1968] 1 QB 379 where the Court of Appeal rejected the argument that no action lay in damages because part of what gave rise to the claim is an unlawful fight.

<sup>741</sup> See N Enonchong, 'The autonomy Principle of letters of credit: an illegality exception?' (2006) LMCLQ 404, 416; see also *The Illegality Defence in Tort: The Law Commission Consultation Paper No 160* at 33.

<sup>742</sup> [1996] 1 Lloyd's Rep 345.

<sup>743</sup> See *Mahonia Ltd v JP Morgan Chase Bank and West LB (No. 1)* [2003] EWHC 1927 (Comm) [2003] 2 Lloyd's Rep 911.

<sup>744</sup> [2004] EWHC 1938 (Comm) [2004] WL 1808816.

which case it does not) were differentiated.<sup>745</sup> This criterion for assessing the seriousness of illegality, though commendable, appears not to provide a complete answer as to when an illegality should be seen as being serious. Case law is replete with instances where a plaintiff's claim has been defeated by illegality even though there was no intentional breach of law.<sup>746</sup> However, despite the inherent difficulty associated with ascertaining when an illegality is sufficiently serious, it does not affect the limiting role played by this test as an effective mechanism for drawing out the scope of the underlying contract illegality that will affect the letter of credit.

### **7.7.2. The Knowledge and Intention of the Claimant/ Beneficiary**

This is a very crucial criterion for narrowing the scope of the illegality defence. The claimant in this context refers to the person who is seeking to rely on what would, save for the illegality, be his or her normal legal rights and remedies.<sup>747</sup> Though this criterion for limiting the illegality defence has not received unanimous support,<sup>748</sup> there is strong force to the submission that the principle that a claimant/beneficiary should not be allowed to profit from his own wrongdoing should not be applied where the claimant does not know that the act is unlawful or is not in any way morally

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<sup>745</sup> See N Enonchong, 'The Autonomy Principle of Letters of Credit: an Illegality Exception?' (2006) LMCLQ 404, 416. See also *Beresford v Royal Insurance Co Ltd* [1937] 2KB 197; *Marles v Philip Trant & Son Ltd* [1954] 1 QB 29 at 39; *Geismar v Sun Alliance and London Insurance Ltd* [1978] QB 383.

<sup>746</sup> See for example *Chai Sau Yin v Liew Kwee Sam* [1962] AC 304 where the plaintiff's claim for the purchase price of goods was defeated by the defendant's argument that the contract was illegal for being in breach of Malaysian law even when the it was not established that the plaintiff knowingly contracted in breach of Malaysian law. See also *Re Mahmoud and Ispahani* [1921] 2KB 717.

<sup>747</sup> See *Illegal Transactions: The Effects of Illegality on Contracts and Trusts*, Law Commission Consultation Paper 154 (1999)103.

<sup>748</sup> Case law seems not to pay attention to whether the claimant was morally blame-worthy especially where a statute expressly prohibits an act as unlawful and secondly, though more doubtfully, where the contract cannot be performed in accordance with its terms without the commission of a legal wrong or conduct otherwise contrary to public policy. For this see generally *Re Mahmoud and Ispahani* [1921] 2KB 717 and also *M Allan (Merchandising) Ltd v Cloke* [1963] 2 QB 340.

culpable.<sup>749</sup> Under general law, barring some exceptions,<sup>750</sup> where an agreement is illegal as a result of being entered into for an illegal purpose, a claimant who has no knowledge of the illegal purpose is not barred by the defence of illegality.<sup>751</sup> In the Canadian case of *Bosse v Mastercraft*,<sup>752</sup> It was held that in so far as a lender did not have knowledge of a borrower's illegal purpose, an action for the borrowed money under the loan agreement is not defeated by the illegality arising from the borrower using the fund for illegal transactions. Following from the above, if applied in the context of documentary credits, it follows that illegality in the underlying transaction will not defeat the beneficiary's claim if the beneficiary was not aware of that illegality.<sup>753</sup> Take for example, an international transaction that is financed by documentary credits between an English seller and an overseas buyer, and the overseas buyer intended to commit or in fact did commit an illegal conduct by importing the goods to his country in breach of some local ports regulations without the knowledge of the seller. Will such illegality defeat the English seller's presentation of document for payment under the documentary credit? It is submitted that to protect the integrity of documentary credits, such illegality without the knowledge of the beneficiary should not defeat his claim for payment.

This criterion was impliedly adopted in part by Cooke J in *Mahonia (2)*<sup>754</sup> in deciding whether the actions of Enron in accounting for the prepay transactions in the way it did was contrary to US accounting principles and hence illegal. In determining

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<sup>749</sup> See *Strongman (1945) Ltd v Sincock* [1955] 2 QB 525, 535, Denning LJ.

<sup>750</sup> For example where the agreement is statutorily prohibited expressly

<sup>751</sup> See generally NE Enonchong, *Illegal Transaction* (Lloyd's of London Press, 1998) Ch 15.

<sup>752</sup> (1995) 123 DLR (4<sup>th</sup>) 161 (Ont. CA), See also *Canadian Imperial Bank of Commerce v Drutz* (1996) ACWS (3d) 258.

<sup>753</sup> See NE Enonchong, 'The Autonomy Principle of Letters of Credit: an Illegality Exception?' (2006) LMCLQ 404, 418 where he explained as being an application of the principle that applies in respect to other legal areas of law.

<sup>754</sup> [2004] EWHC 1938 (Comm), [2004] WL 1808816 [278-283].

whether the action of Enron in accounting for the swap transactions in the manner it did, was illegal, such factors as the knowledge of Enron as to the accounting procedures based on the advice it took from its auditor were considered. It was established, based on the advice of its auditors (Arthur Anderson), that Enron was right to account for the swap transactions as a 'price risk' management obligation and not as a loan and by so doing was not in breach of US securities law.

### **7.7.3. A Close Connection**

Another important factor that will limit the ambit of the illegality exception is the requirement of establishing a close link between the documentary credits and the underlying illegal transaction. In *Fidelity & Deposit Co of Maryland v Grand Nat. Bank*<sup>755</sup> the difficulty of identifying the criteria with which a court would determine whether, in a particular situation, there is a sufficiently close connection between a claim and an alleged illegal conduct was recognized. The court noted that 'the question of how close illegality must be woven into a transaction in order to taint it is often difficult to determine'.<sup>756</sup> It went on to state that 'the principle to be applied is one of general public policy, and the inquiry is not alone as to the effect of a particular transaction, but whether its tendency is in the direction of public detriment'.<sup>757</sup> It simply follows that the test advocated here is that to determine whether an illegal conduct is related to a claim as to taint it, consideration should not be restricted to only the relationship between the illegal conduct and claim but extended to whether barring or allowing the claim will have a public detrimental effect. Adopting this approach, it is submitted, would lead to uncertain result as in most cases the public

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<sup>755</sup> 2 F Supp 666,668 (E D Mo 1933).

<sup>756</sup> *ibid* 668.

<sup>757</sup> *ibid* 668.

detriment rule will lead to every claim having a close connection with the illegality as issues unconnected with a direct relationship between the illegality and a particular transaction will be put in perspective in determining whether there is a close connection.

In the context of documentary credits, ascertaining when illegality in the underlying transaction will have a close connection with the credit so as to taint it is also not an easy question.<sup>758</sup> Many tests have been formulated and some adapted from general law on illegality in an attempt to resolve this vexed issue. The test ranges from the one developed by the Court of Appeal in *Bowmakers Ltd v Barnet Instruments Ltd*<sup>759</sup> and confirmed by the English House of Lords in *Tinsley v Milligan* otherwise known as the ‘reliance doctrine’, to the test formulated in *Mahonia’s* case.<sup>760</sup> The central theme of the reliance doctrine was prominently illustrated in *Tinsley v Milligan*.

In *Tinsley’s Case*, the House of Lords<sup>761</sup> majority upheld a majority decision of the Court of Appeal<sup>762</sup> which had confirmed the finding of the trial judge in favour of Miss Milligan. Lord Browne-Wilkinson, in the lead speech noted that a plaintiff can at law enforce property rights so acquired provided that he does not need to rely on the illegal contract for any purpose other than providing the basis of his claim to a property right. The inference to be drawn from the above is that despite illegality affecting the underlying contract, illegality could not bar a recovery provided the claimant does not rely on the illegality to establish his claim.

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<sup>758</sup> See Enonchong, ‘The Autonomy Principle of Letters of Credit: an Illegality Exception?’ (2006) LMCLQ 404, 418.

<sup>759</sup> [1945] KB 65.

<sup>760</sup> Cooke J in *Mahonia (2)* tried to formulate a test for ascertaining when an illegality has a close link with the documentary credit as to breach the impregnability of the credit.

<sup>761</sup> See Lords Jauncey, Lowry and Browne-Wilkinson; Lords Keith and Goff dissenting.

<sup>762</sup> [1992] Ch 310 (Lloyd and Nicholls LJJ, Ralph Gibson LJ dissenting).

In *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)*<sup>763</sup> Cooke J, did not lay down any convincing approach for ascertaining the “closeness test” between the illegality in the underlying transaction and the documentary credits which is issued in respect of it. As to the contention of West LB in the above case that the letters of credit were an integral part of the three Swaps,<sup>764</sup> and suffered from the same unlawful underlying purpose, or alternatively that it was so connected with those transactions that it was tainted by the illegality which affected them, Cooke J accepted that if the illegality in the underlying transaction were to be established, he would not have hesitated to accept the contention that the documentary credit ‘was directly tied to the illegal purpose since it was an important part of the scheme which was to give rise to the unlawful accounting albeit that it was not directly connected to the accounting itself, in the manner of the Three Swaps’.<sup>765</sup> On which criteria was the conclusion reached that the underlying illegality was connected to the letter of credit? It is, with respect, subject to doubt how this conclusion was arrived at. The only rational explanation for the approach of Cooke J could be gleaned from the judgment of Kerr and Bingham LJ in *Saunders v Edwards*<sup>766</sup> where the Lord Justices adopted a discretionary and pragmatic approach in establishing a close link and stated as follows:

Where issues of illegality are raised, the courts have...to steer a middle course between two unacceptable positions. On the one hand it is unacceptable that any court of law should aid or lend its authority to a party seeking to pursue or

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<sup>763</sup> [2004] EWHC 1938 (Comm), 2004 WL 1808816. *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)* [2004] EWHC 1938 (Comm), 2004 WL 1808816.

<sup>764</sup> The swaps were part of the underlying contract that gave rise to the issuance of the letters of credit. It is the contention of the West LB (the bank that issued the letters of credit is support of the three swap) that the swap was nothing but a disguised loan in breach of US securities Law.

<sup>765</sup> [2004] EWHC 1938 (Comm), 2004 WL 1808816 at para.427.

<sup>766</sup> [1987] 1 WLR 1116.

enforce an object or agreement which the law prohibits. On the other hand, it is unacceptable that the court should, on the first indication of unlawfulness affecting any aspect of a transaction, draw up its skirts and refuse all assistance to the plaintiff, no matter how serious his loss nor how disproportionate his loss to the unlawfulness of his conduct... . [O]n the whole the courts have tended to adopt a pragmatic approach to these problems, seeking where possible to see that genuine wrongs are righted so long as the court does not thereby promote or countenance a nefarious object or bargain which it is bound to condemn. Where the plaintiff's action in truth arises directly *ex turpi causa*, he is likely to fail... [w]here the plaintiff has suffered a genuine wrong, to which the allegedly unlawful conduct is incidental, he is likely to succeed....<sup>767</sup>

Commentators have not shied way from proffering a criterion for identifying the closeness between the letters of credit and the underlying illegal transaction. For example, Professor Enonchong suggested that the 'sole criteria that should be used to determine whether the letter of credit is sufficiently connected to the illegality in the underlying transaction should be the beneficiary's complicity in it'.<sup>768</sup> It is strongly contended that once the beneficiary is aware of the illegal purpose in the underlying transaction, it should be enough to establish a close connection between the illegality in the underlying transaction and the letter of credit in respect of which it is issued.<sup>769</sup> This approach, it is submitted is in legal terms persuasive and should be commended.

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<sup>767</sup> *ibid* 1134.

<sup>768</sup> NE Enonchong, 'The autonomy Principle of letters of Credit: an Illegality Exception?' (2006) LMCLQ 404, 421.

<sup>769</sup> *ibid* 421.

#### **7.7.4. Whether Denying Relief will further the Purpose of the Rule which Renders the Contract Illegal**

This should be a very strong limiting factor to the illegality that would cause a departure from the autonomy principle. The limiting role of this criterion was recognized by McHugh J<sup>770</sup> when he said that ‘the courts should not refuse to enforce legal or equitable rights simply because they arose out of or were associated with an unlawful purpose’ unless, *inter alia*, ‘the imposition of the sanction is necessary, having regard to the terms of the statute, to protect its objects or policies’<sup>771</sup> Sir Günter Treitel has added his voice in this direction by suggesting that the question, whether success or failure of the civil claim would be more likely to promote the purpose of the invalidating rule, should be the decisive issue in all cases.<sup>772</sup>

In the context of documentary credits, the efficiency of this criterion as a test for limiting the applicability or effects of illegality was captured in the case of *Group Josi Re v Walbrook Insurance Co Ltd and Others*<sup>773</sup> where the Court of Appeal was called upon to decide whether the prohibition by a statute on overseas insurance companies from carrying out the business of insurance in England amounted to illegality that affected payment under a letter of credit. In order to resolve the problem whether there was illegality of the reinsurance contracts in the above case, Staughton LJ, though conceding that in certain cases illegality in the underlying contract would be a

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<sup>770</sup> See *Nelson v Nelson* (1995) 184 CLR 538.

<sup>771</sup> *Ibid* (1995) 184 CLR 538, 613.

<sup>772</sup> G H Treitel, ‘Contract and Crime’ in *Crime, Proof and Punishment: Essays in Memory of Sir Rupert Cross* (1981) 81.

<sup>773</sup> [1996] 1 Lloyd's Rep. 345.

valid ground for withholding payment in a documentary credit, resorted to an understanding of the purpose of the rule which was argued to make the carrying on of reinsurance business illegal. By a combined reading of Section 132 of the Financial Services Act 1986 in relation to the Section 2 Insurance Companies Act, 1982, it was held that performance of the reinsurance contracts by the reinsurers was not illegal.<sup>774</sup> The reason for so holding was that the purpose of a combined reading of the sections was to prevent insurers or reinsurers from refusing to pay claims merely because they were carrying on unauthorized insurance business.<sup>775</sup>

#### **7.7.5. Deterrent Effect of Illegality**

The ambit of the illegality defence could be further limited by addressing the question whether the application of the defence would have any deterrent effect. As noted earlier, apart from the public policy reasons, deterrence is one rationale that lies behind the illegality rules. Hence restricting the scope of the illegality defence by considering in some circumstances whether denial of relief or claim will have a major deterrent effect will further curtail the availability of the illegality defence. The general principle is that refusing to award a claimant relief will deter others from entering into or performing under similar illegal contracts. However, some

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<sup>774</sup> *Group Josi Re v Walbrook Insurance Co. Ltd. and Others* [1996] 1 Lloyd's Rep 345,364.

<sup>775</sup> *ibid* 364.

commentators<sup>776</sup> have noted that refusing relief will not act as an appropriate deterrent in all circumstances.<sup>777</sup>

In the documentary credits, using the deterrent criterion as a limiting factor will serve a very useful purpose especially where the illegality involved is sufficiently serious. Take for instance the example giving by Staughton LJ<sup>778</sup> as to situations where the court regards illegality in the underlying transaction to be capable of displacing the autonomy principle, like a contract for the sale of arms to Iraq that is financed by letters of credit, at a time when such a sale is illegal.<sup>779</sup> A bank or court of law could refuse the beneficiary payment under the documentary credits supporting such transaction on the ground that refusing payment would deter others from using documentary credits to finance such illegal transaction.

## 7.8. Conclusion

As in general law, illegality remains a central issue in documentary credit's law. As early as 1995, Staughton LJ in the *Group Josi*<sup>780</sup> case recognized the importance of illegality in relation to the principle of autonomy and stated that 'in my judgment

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<sup>776</sup> See G H Treitel, 'Contract and Crime' in *Crime, Proof and Punishment: Essays in Memory of Sir Rupert Cross* (1981) p 81 at p 100; G Virgo, 'The Effect of Illegality on Claims for Restitution in English Law' in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) p 141 at pp 183-184.

<sup>777</sup> Where it was noted that the policy of deterrence is just as likely to be achieved by allowing a remedy as by denying it, for if one party to an illegal transaction knew that the other party would be able to obtain restitution of benefits conferred, it would stop him or her entering into the illegal transaction in the first place.

<sup>778</sup> *Group Josi Re v Walbrook Insurance Co. Ltd. and Others* [1996] 1 Lloyd's Rep 345, 362.

<sup>779</sup> See also the example giving by Colman J in *Mahonia Ltd. v JP Morgan Chase Bank and West LB (No. 1)*[2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep. 911 [68].

<sup>780</sup> See *Group Josi Re v Walbrook Insurance Co. Ltd. and Others* [1996] 1 Lloyd's Rep 345

illegality is a separate ground for non-payment under a letter of credit,<sup>781</sup> Following from the pronouncement of Staughton LJ and the more recent authorities,<sup>782</sup> the vexing issue for parties involved in credit operations is not whether the exception is or should be recognized, but the manner in which it operates and should be applied in practice. Following from the above, it has to be submitted that the subject of illegality is one that presents tremendous difficulty both in terms of analysis and effectively carving out the ambit within which it operates. The complexity of analysis however should not deter from the importance of having the illegality defence because of the public policy role its recognition plays in documentary credit law by making sure that illegal underlying transaction in certain limited circumstances penetrates the otherwise impregnability of documentary credits.

However, carving out the ambit of the illegality defence based on the analysis of case law presents considerable difficulty. Part of the problem stems from the fact that the rationale for the illegality defence based upon the analysis of cases on illegality cannot be articulated from the standpoint of public policy alone. Hence, drawing the boundaries of the illegality defence invites the use of discretion and a pragmatic approach by the court by considering a multiplicity of issues like the seriousness of the illegality, the knowledge of the claimant, how close the illegality is connected to the claim under the letters of credit etc.

The question that inevitably arises is whether these considerations (the use of discretion) in the determination of when illegality exists, if viewed from the perceived

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<sup>781</sup> *ibid* at 362.

<sup>782</sup> See *Mahonia Ltd. v JP Morgan Chase Bank and West LB (No. 1)* [2003] EWHC 1927 (Comm) [2003] 2 Lloyd's Rep 911; *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)* [2004] EWHC 1938 (Comm), 2004 WL 1808816.

mercantile function of documentary credits, (to provide an assurance of payment) will not introduce uncertainty in an area of law where certainty is paramount. The answer to this question depends on how literally the concept of the autonomy of documentary credits is to be taken. For the advocates of total autonomy and irrevocability of documentary credits, illegality in the underlying contract of sale, and the attempt to reconcile conflicting public policies associated with illegality, may well give rise to uncertain consequences. However, some judges would take the view that it would be wrong in principle to invest letters of credit with a rigid inflexibility in the face of a strong countervailing public policy issue like illegality. The reason for this may not be far-fetched. If a beneficiary should as a matter of public policy be precluded from utilizing a letter of credit to benefit from his own fraud, it is hard to see, considering the seriousness of illegality in law why he should be permitted to use the court to enforce part of an underlying transaction which would have been unenforceable on grounds of its illegality if no letter of credit had been involved, however serious the material illegality involved. To prevent him doing so in an appropriately serious cases could hardly be seen as a threat to the lifeblood of international commerce.

## Chapter Eight

### 8.0. Contractual Restrictions on a Beneficiary's Right to Draw on a Credit

#### 8.1. Introduction

As the analysis in Chapters Three reveals, in English law, a fraud by the beneficiary or his agent displaces the right of the beneficiary to draw down on the letters of credit even though he presented apparently conforming documents. The above exception operates regardless of the assurance of payment promised the seller/beneficiary upon the tender of conforming documents that forms the essence of the autonomy doctrine. However, there are circumstances where the beneficiary, aware of such right which he has under the autonomy doctrine,<sup>783</sup> decides (either as a result of the strong bargaining power of the applicant for the credit or to assure the applicant of his reliability in fulfilling the underlying contract) to restrict such assurance of payment by agreeing that certain conditions should be present before he draws on the credit. Such conditions which mostly manifest in the form of contractual restrictions on a beneficiary's right under the credit raise at least two legal issues.

One is whether such restriction could be implied in the contract.<sup>784</sup> The other is whether the position could be different if there is an express contractual (as opposed to implied) restriction on the beneficiary's right to draw on the credit either in the underlying contract or a separate contract which affects the beneficiary's right to draw

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<sup>783</sup> To be paid upon the tender of conforming documents without unnecessary recourse to issues in the underlying contract upon which the credit was issued.

<sup>784</sup> In this case, the underlying contract or a related contract

on the credit. Some dicta<sup>785</sup> seem to be against implying a contractual restriction that seeks to restrict the beneficiary's right to draw on the credit. With respect to express contractual restriction, case law in different jurisdictions<sup>786</sup> and academic opinion are in its support. The positive response of the court and academic opinion<sup>787</sup> towards express contractual restriction either in the underlying contract or a separate agreement raises the question whether such express contractual restriction is an established exception<sup>788</sup> capable of displacing the autonomy principle if the beneficiary wishes to draw in breach of such express agreement. Recent decisions<sup>789</sup> and academic commentary<sup>790</sup> have demonstrated the possibility (as opposed to being established like the fraud rule) of a separate exception in the nature of this express contractual restriction on the beneficiary's right to draw on the credit.

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<sup>785</sup> See the dictum of Phillips J in *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd* [1995] 1 WLR 1017, 1030 where his Lordship rejected implying a term into the underlying contract that the beneficiary will not draw on the letter of credit unless payment under the underlying contract is due. See May LJ affirming Phillip J in *Sirius International Insurance Co v FAI General Insurance Ltd and others* [2003] EWCA Civ 470 [2003] 1 WLR 2214 at para. 30. See also the Australian case of *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812 at 826, where Callaway J A highlighted the difficulty of implying such restriction in the underlying contract. His view was affirmed by Brooking JA in *Anaconda Operations Pty Ltd v Fluor Daniel Pty Ltd* (1999 Victorian Unreported Judgement).

<sup>786</sup> *Sirius International Insurance Co v FAI General Insurance Ltd and others* [2003] EWCA Civ 470, [2003] 1 WLR 2214. See also the Australian cases of *Pearson Bridge NSW Pty Ltd v State Rail Authority (NSW)* (1982) 1 Aust. Construction LR 36; *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451; *Selvas Pty Ltd v Hansen & Yuncken (S.A.) Pty Ltd.* (1987) 6 Aust. Construction L R 36, (1987) 6 ACLR 36.

<sup>787</sup> See Nelson Enonchong, 'The Problem of Abusive Drawing on Demand Guarantees' (2007) LMCLQ 83, 89. See also Steven Gee, *Commercial Injunctions* (sweet and Maxwell, 2004) 447.

<sup>788</sup> This question is posed because case law abounds with pronouncements suggesting that the only recognised exception to the principle of autonomy in documentary credits is fraud; but this proposition is no longer tenable as this thesis seeks to demonstrate.

<sup>789</sup> See in England, *Sirius International Insurance Corp v FAI General Insurance Co Ltd* [2003] EWCA Civ 470, 1 WLR 2214. Australia, see *Pearson Bridge NSW Pty Ltd v State Rail Authority (NSW)* (1982) 1 Aust. Construction LR 36, *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451 *Selvas Pty. Ltd. v. Hansen & Yuncken (SA) Pty Ltd* (1987) 6 Aust. Construction L.R 36, (1987) 6 ACLR 36, *J. H. Evans Industries (N.T.) Pty Ltd v Diano Nominees Pty Ltd (unreported, N.T. Supreme Court, 30 January 1989)* *Mitsui Kensetsu Corporation Australia Pty Ltd v State of South Australia (unreported, Qld. Supreme Court, 9 August 1990)*, In Malaysia, see *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur* [2004] 7 MLJ 136.

<sup>790</sup> Prof. Nelson Enonchong described the circumstance contemplated in this chapter as the underlying contract exception in a recent article on abusive drawing in demand guarantees' See NE Enonchong, 'The Problem of Abusive Drawing on Demand Guarantees' (2007) LMCLQ 83,89.

This restriction on the beneficiary's right to draw on the credit is sometimes referred to as the underlying contract exception<sup>791</sup> to the principle of autonomy in documentary credit. By restricting the beneficiary's right to draw on the credit, it is not intended to contradict the age long principle, reflected in the principle of autonomy that states that letters of credit is separate from the underlying transaction in respect of which it is issued. However, it (contractual restriction on a beneficiary right to draw down the credit) seeks to answer the question whether there is a separate exception other than fraud in circumstances where a demand by a beneficiary is made in breach of an express stipulation in the underlying transaction or a separate contract, of such a nature as not to be categorized as fraudulent representation. Put differently, where a beneficiary aware of the nature of a credit which separates the credit from any underlying contract, agrees expressly with an applicant to restrict his right to draw down on the credit, by stipulating some conditions which need to be present before his entitlement to draw down on the credit arises; can the beneficiary be allowed to rely on the autonomy principle as a ground for renegeing on his express contractual undertaking? The above forms the basis of the analysis in this chapter.

For structural clarity, the chapter is divided into five sections. Section 8.1 examines the nature of the exception. Section 8.2, undertakes an evaluation of the rationale for the exception. Section 8.3 analyses the current state of the authorities in three common law jurisdiction- viz Australia, Malaysia, and England, Section 8.4 examines to what extent, the exception survives the autonomy principle. In the section, arguments that support and/or contradict the exception will be examined. Section 8.5

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<sup>791</sup> See NE Enonchong, 'The Problem of Abusive Drawing on Demand Guarantees' (2007) LMCLQ 83, where underlying contract exception was argued as being capable of displacing the autonomy principle in a demand guarantee.

defines and assesses the working boundaries of this emerging exception in documentary credit law. Section 8.6 draws a conclusion based on the issues analyzed.

## **8.2. Nature of the Exception**

In opening a letter of credit, it is assumed that the special nature of the contract relies primarily on the principle of autonomy. The autonomy principle draws a sharp distinction between the credit and the underlying contract with respect to which it is issued, and provides a beneficiary an assured right to payment<sup>792</sup> once conforming documents have been presented. The applicant for the letter of credit, perhaps anxious about the nature of his undertaking (giving an assured right to the beneficiary once conforming document has been presented) may seek to have better control over the beneficiary's draw-down on the credit, or restrict such unconditional right of the beneficiary. Also, the beneficiary may wish to instil confidence in the applicant as to his ability to perform the underlying contract by suggesting or agreeing that his right to draw down the credit be restricted. This happens in a variety of ways but fundamentally, the applicant for the credit, may stipulate that the beneficiary's right to draw down on the credit should be effective only when certain conditions related to the underlying contract or a separate agreement have been fulfilled. Take, for example, where the beneficiary agrees with the applicant for the credit that a draw down should not take effect except with a written consent of the applicant.

The above position was highlighted by the English case of *Sirius International*

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<sup>792</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168, 183.

*Insurance Co v FAI General Insurance Ltd and others*<sup>793</sup> and provides the factual background and detail that exemplify the nature of the exception under consideration. The facts of *Sirius International Insurance* may be summarized as follows. Agnew, a member of a Lloyd's syndicate wished to reinsure its liabilities and FAI General insurance (FAI) was proposed as the reinsurer. Agnew was not happy with the choice of FAI as the reinsurer as there were issues as to the solvency of FAI. This led Agnew to demand a stronger and more solid reinsurer. Sirius became that reinsurer. Under the arrangement, Sirius agreed to reinsure the liabilities of Agnew and then retrocede such liabilities to FAI. Under the agreement, in the event of any claim under the reinsurances, Sirius would be liable to the syndicate and FAI would be correspondingly liable to Sirius. It was a term of the agreement that FAI provide the *Sirius* with a letter of credit for US\$5m.

The letter of credit provided on the basis of the underlying agreement between Sirius and FAI was subject to an express restriction or negative covenant that Sirius, being the reinsurer, would neither pay a claim by the syndicate nor draw down without FAI's consent in writing. It is this contractual restriction on the beneficiary's right to draw on the credit that forms the crux of the analysis in this chapter and highlights the nature of the problem under consideration. Hence, it raises the question whether Sirius's right to draw on the credit could be defeated by the express restriction contained in a separate contract related to the underlying agreement between the beneficiary and the applicant for the credit. The Court of Appeal that decided on whether the right to draw on the credit could be defeated by an express restriction on the credit held as follows: 'There is no authority extending this autonomy for the

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<sup>793</sup> [2003] EWCA Civ 470 [2003] 1 WLR 2214.

benefit of the beneficiary of a letter of credit so as to entitle him as against the applicant to draw the letter of credit when he is expressly not entitled to do so'.<sup>794</sup> Hence, the Court of Appeal decided that an express restriction on a beneficiary's right to draw on a credit was capable of enjoining the beneficiary's right to draw on the credit.

If the above position of the Court of Appeal is correct, there must be a rationale for the Court of Appeal so holding. This leads us to a consideration of whether there is/are a justifiable reason(s) for the Court of Appeal's decision.

### **8.3. Rationale for the Exception**

When the English Court of Appeal in *Sirius International Insurance Ltd v FAI General Insurance*,<sup>795</sup> rejected the claimant's (beneficiary) contention that the letter of credit being an autonomous obligation, it was entitled to draw down on the credit once conforming documents has been tendered. It put its decision on the ground that express conditions in the letter of credit detailing the circumstances under which draw-down could be made has not been met. Despite the rationale for the decision not being apparent on the face of the decision, this section explores the likely rationale for the court's conclusion.

An insight into the reason for the court's decision could be gleaned from the House of Lords decision in *Doherty v Allman*<sup>796</sup> which was cited by the Court of Appeal in *Sirius International*. In *Sirius International*, the Court of Appeal treated a contractual

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<sup>794</sup> [2003] EWCA Civ 470 [2003] 1 WLR 2214, 2224- 2225 (CA).

<sup>795</sup> [2003] EWCA Civ 470 [2003] 1 WLR 2214.

<sup>796</sup> (1877-78) LR 3 App Cas 709.

restriction on a beneficiary's right to draw on a credit as equivalent to an express negative covenant. This being the case, the court applied the law as if the beneficiary's restriction was an express negative covenant with an implication that is well known in law. The Court's justification for the reasoning with respect to an express negative covenant was evident in the House of Lords decision in *Doherty v Allman*.<sup>797</sup> Lord Cairns, with respect to a negative covenant and the basis of which it could be used to grant an injunction, justified its rationale by stating thus:<sup>798</sup>

if there had been a negative covenant, I apprehend, according to well-settled practice, a Court would have had no discretion to exercise. If parties, for valuable consideration, with their eyes open, contract that a particular thing shall not be done, all that a Court has to do is to say, by way of injunction, that which the parties have already said by way of covenant, that the thing shall not be done; and in such case the injunction does nothing more than give the sanction of the process of the Court to that which already is the contract between the parties. It is not then a question of the balance of convenience or inconvenience, or of the amount of damage or of injury— it is the specific performance, by the Court, of that negative bargain which the parties have made, with their eyes open, between themselves.

With respect to documentary credit, it is evident from the pronouncement of May LJ that the court looked to the above passage when it held that 'there is no authority extending this autonomy of documentary credit for the benefit of the beneficiary of a letter of credit so as to entitle him as against the applicant to draw the letter of credit when he is expressly not entitled to do so'.<sup>799</sup> The justifying principle in these kinds of cases is that the beneficiary, despite being armed with the autonomy principle, is

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<sup>797</sup> *ibid.*

<sup>798</sup> *Doherty v Allman* (1877-78) LR 3 App Cas 709,719-720.

<sup>799</sup> *Sirius International Insurance Corp v FAI General Insurance Co Ltd* [2003] EWCA Civ 470 [2003] 1 WLR 2214, 2224-25.

assumed to have subjugated such right by an express agreement that restricts his right to draw on the credit. Provided such agreement was mutually entered into by the parties under no controlling influence, there are justifying and strong reasons why its terms should be given effect by the court.

The underlying policy reason which justifies the above pronouncement, though not apparent in the Court of Appeal judgment in *Sirius Insurance International*, can be gleaned from the forceful pronouncement of Jessel MR with regard to a public policy need to enforce contractual obligations freely entered into by the parties. His Lordship, in reference to public policy inherent in the keeping of contractual promise openly and mutually agreed, said that:

It must not be forgotten that ...if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice. Therefore, you have this paramount public policy to consider— that you are not lightly to interfere with this freedom of contract.<sup>800</sup>

Put differently, this policy rationale emphasizes the supremacy of contractual undertakings fully and openly entered into among parties. Where such undertaking is threatened, it is the position that a court of competent jurisdiction is entitled and indeed obliged to grant a restraining order in line with contractual expectations of the parties.<sup>801</sup>

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<sup>800</sup> Per Jessel M.R, in *Printing and Numerical Registering Company v Sampson* [1873] 177, (1874-75) L R 19 Eq. 462, re-affirmed by the House of Lords in *Fender v St. John-Mildmay* [1938] AC 1.

<sup>801</sup> It is the same kind of policy reason that inspired the recognition of the fraud exception.

Professor Enonchong<sup>802</sup> has justified the recognition of this exception albeit in a different context,<sup>803</sup> on the policy ground that it is a useful tool in curtailing abusive and unjustified draw-down by the beneficiary of the credit in apparent violation of his contractual undertaking regarding the condition under which presentation and drawdown could be made. This argument seeks to emphasize the need to hold the beneficiary accountable to his/her contractual undertaking by insisting that the contract with the applicant be respected. It disentitles the beneficiary from using the assured promise of payment reflected in the autonomy principle as a ground for breaking a promise mutually and openly made with respect to conditions for a draw down. But the question as to what the real rationale behind this kind of contractual undertaking is cannot be perceived in detail without evaluating the ways that contractual stipulation stating the conditions of draw on a credit have been applied in the different jurisdictions. The analysis of the jurisdictional approaches would provide us with more details as to whether the factual matrix leading to such contractual stipulations operates as an exception to the principle of autonomy in documentary credit.

#### **8.4. Current State of Authorities**

Having fundamentally relied on general law position and the position of the law in the English case of *Sirius Insurance International* to establish the rationale for the application of this exception in documentary credits, this section explores the different

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<sup>802</sup> See generally Nelson Enonchong, 'The Problem Of Abusive Calls in Demand Guarantees'(2007) LMCLQ 83, 94.

<sup>803</sup> This exception has been endorsed by Prof. NE Enonchong with respect to demand guarantees. See Nelson Enonchong, 'The Problem Of Abusive Calls in Demand Guarantees' (2007) LMCLQ 83,94.

jurisdictionals' approach with respect to contractual restriction on the beneficiary's right to draw on the credit.

#### **8.4.1. Jurisdictional approaches**

Here an attempt to explore the approaches adopted in the different jurisdictions will be undertaken.

##### **8.4.1.1. Australia**

In addressing the question whether a contractual restriction on a beneficiary's right to draw on the credit constitutes an exception to the principle of autonomy, some cases, mostly relating to bank guarantees in Australia, have sought to deal definitively with this legal issue. Prominent in this direction is *Pearson Bridge (NSW) Pty Ltd v State Railway Authority of New South Wales*.<sup>804</sup> In *Pearson Bridge (NSW) Pty Ltd v State Railway Authority of New South Wales*,<sup>805</sup> Yeldham J., in continuing the order of an injunction granted by Ash J., which was already in force pending the hearing of the action, held that a clause in a contract which restricted a call in demand guarantees was a negative stipulation the breach of which entitled the claimant to an injunction.<sup>806</sup> In reaching this conclusion, the court relied on a host of Australian legal authorities<sup>807</sup> and in the main relied on a stipulation in the underlying contract which restricted the circumstances under which the performance guarantee could be called. A certain clause in the underlying contract on its proper construction required a

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<sup>804</sup> (1982) 1 Aust Construction LR 81.

<sup>805</sup> (1982) 1 Aust Construction LR 81.

<sup>806</sup> (1982) 1 Aust. Construction LR 81 at p.86.

<sup>807</sup> *Ampol Petroleum Limited v Mutton* (1952) 53 S.R.1; *Williamson Limited v Lukey and Mulholland* (1931)45 CLR 282, 299.

beneficiary of a demand guarantee to ask for payment under the guarantee if and only if the beneficiary became entitled to exercise all or any of his rights under the contract in respect of the security. Yeldham J., in holding that this particular clause amounted to a contractual restriction which governed and restricted the circumstances in which, as a matter of contract between the beneficiary and the applicant, the latter could call on the guarantee, distinguished it from the Australian High Court case of *Wood Hall Ltd v The Pipeline Authority*.<sup>808</sup> In the *Wood Hall Limited case*, the court noted that such a restriction never existed because there was no restriction on the performance bond which amounted to an equivalent of cash in hand liable to be called upon by the principal.

The court in *Pearson Bridge*, in arriving at the above conclusion, noted that some Australian cases are in support of this conclusion. Notable in this respect are the cases of *Ampol Petroleum Limited v Mutton*<sup>809</sup> and *Williamson Limited v Lukey and Mulholland*.<sup>810</sup> The facts and decisions support the principle that a negative stipulation as evident in the case of *Pearson Bridge* was such as to entitle a claimant to an injunction. Relying on the principle enunciated in these cases, the court accepted that a contractual restriction on the beneficiary's right, which in most cases is a negative stipulation, was such that displaced the autonomy principle and continued the injunction already granted by Ash J.

In a similar vein, the Supreme Court of New South Wales, adopted the position espoused in *Pearson Bridge* in *Selvas Pty Limited v Hansen Yuncken (SA) Pty Ltd*,

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<sup>808</sup> 141 CLR 443.

<sup>809</sup> (1952) 53 SR1.

<sup>810</sup> (1931) 45 CLR 282, 299.

*State Bank of South Australia*<sup>811</sup> and distinguished the case from the legal position adopted in *Hortico (Australia) Pty Ltd v Energy Equipment Company (Pty) Ltd*<sup>812</sup> and *Wood hall Limited v The Pipeline Authority*.<sup>813</sup> The court argued that to the extent that the facts of the case (*Hortico Australia*) was authority for the same proposition enunciated in *Woodhall* case, the court had no other choice but to depart from it as they court deemed it inapplicable. The facts that gave rise to the application for an injunction were that around August 1984, the claimant entered into a subcontract with the first defendant to whom the plaintiff agreed to supply and installs certain dry wall partitions in a building to be constructed by the first defendant as the main contractor. A provision in the sub-contract required that the claimant as the sub-contractor provide security for due and proper performance of its obligation under the sub-contract. In accordance with this requirement, the claimant caused its bank - the second defendant - to issue two bank guarantees to the first defendant. Also, a certain provision in the sub-contract restricted the circumstances under which the first defendant, as the main contractor, could call on the bankers' guarantee. The issue before the court, when the claimant applied for an injunction attempting to restrain the first defendant from seeking payment from the second defendant that issued the bankers guarantees, was whether the conditions restricting the circumstances under which the demand could be made on the guarantee had been complied with.

The court in dealing with this issue of whether a contractual provision in a demand guarantee was such as to enable the court to depart from the autonomy principle had this say

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<sup>811</sup> (1987) 6 Aust. Construction LR 36.

<sup>812</sup> (1985) 4 NSWLR 545, (1986) BCL 366.

<sup>813</sup> 141 CLR 443.

In my view, neither the *Wood Hall case* nor the *Hortico Case* applies to this matter. Because, like Yeldham J in *Pearson Bridge case*, I am of the view that such a line of authority is to be distinguished on the basis that the sub-contract in this case contains a provision which can be interpreted as defining the circumstances under which the first defendant was to have recourse to the banker's guarantees<sup>814</sup>

The court relying on the above passage felt justified in granting the injunction sought on the ground that there was a real issue to be tried. This approach of the court where the autonomy principle is being displaced because of a contractual stipulation has also been adopted in a more recent decision by Rolfe J in the Australian case of *Barclays Mowlem Construction Limited v Simon Engineering (Australia) Pty Ltd.*<sup>815</sup>

Despite the fact that this line of authorities holding that a contractual restriction on the beneficiary's right to draw on the credit is an exception to the principle of autonomy, these decisions have not been endorsed by the decisions in the higher courts in Australia. However, the cases so far demonstrate in no uncertain terms that Australian courts are ready to intervene and displace the autonomy principle where there is a contractual stipulations the terms of which stipulate the condition of recourse to an independent undertaking.

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<sup>814</sup> *Selvas Pty Limited v Hansen Yuncken (SA) Pty Ltd, State bank of South Australia* (1987) 6 Aust. Construction LR 36 at p.40.

<sup>815</sup> (1991) 23 NSWLR 451.

#### 8.4.1.2. Malaysia

The approach of the Malaysian courts with respect to contractual restrictions affecting the beneficiary's right to draw on the credit in commercial letters of credit is not settled. However, a reported case on bank guarantees seems to be similar to the position adopted in Australia. The similarity of the approach of the two jurisdictions is evident in the case of *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur*.<sup>816</sup> In this case, a guarantee was opened by the claimant in favour of the defendant as a condition for the defendant consenting to the installation of ground anchors on the defendant's land. Part of the agreement for opening the bank guarantee contained an express condition which stipulated the circumstance under which the defendant could have recourse to the guarantee and it was expressly stated among other things that before the defendant could demand payment under the guarantee, it 'must inform Daewoo Corporation by written notice of your intention to claim against the guarantee not later than 14 (fourteen) days before the date of the aforesaid demand'. At the expiration of the initial guarantee, the defendant wanted to vary the terms of the guarantee to exclude the express agreement but the plaintiff objected to it. Because the plaintiff failed to renew the guarantee due to the plaintiff insisting that the express term of the agreement be removed or varied, the defendant called on the guarantee arguing that a letter of guarantee was an unconditional guarantee payable without any requirement on the side of the defendant.<sup>817</sup>

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<sup>816</sup> [2004] 7 MLJ 136.

<sup>817</sup> See *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur* [2004] 7 MLJ 136 [18].

In an action by the plaintiff for declaratory relief on the ground that the call or threatened call on the bank guarantee was wrongful and in breach of the written agreement, the Court granted an injunction to the plaintiff on the ground that there were serious triable issues which were neither frivolous or vexatious and which needed to be properly dealt with at trial.<sup>818</sup> In other words, the condition(s) stipulated in the credit detailing the condition of draw-down had not been met.

It could be submitted that the legal implication of this case (*Daewoo Engineering*) in Malaysia is that where there is an express contractual agreement, whether in a separate contract or in the underlying contract, which forms the basis of the issue of an independent undertaking, the court in dealing with the question whether the beneficiary has a right to claim under the credit or guarantee, will not ignore the contractual agreement openly entered into by the parties.

#### **8.4.1.3. England**

In England, the question whether there is a contractual restriction capable of displacing the autonomy principle has been answered in the case of *Sirius International Insurance*. The legal implication of the decision in *Sirius International Insurance Corp v FAI General Insurance Co Ltd*<sup>819</sup> is that English court is minded to displace the autonomy principle and grant an injunction to a claimant where the beneficiary for the purposes of drawing on the credit breaches an express contractual restriction affecting the credit. Justifying the above position, the Court of Appeal in

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<sup>818</sup> *ibid* at para. [25].

<sup>819</sup> [2003] EWCA Civ 470 [2003] 1 WLR 2214

*Sirius International Insurance case*<sup>820</sup> held that the principle of autonomy does not go so far as to entitle the beneficiary of a letter of credit, as against the account party, to draw on the letter of credit when the beneficiary contractually has an express agreement which does not entitle him to draw down in a separate agreement.

Jacob J at first instance decided the same issue of whether an express contractual restriction on the beneficiary's right to draw on the credit was in breach of the autonomy principle. He held that whilst the principle of autonomy which applied to letters of credit was of vital importance, it could neither be undermined nor was there any justifiable reason why the law should not give effect to an express agreement that a party would not draw down a letter of credit unless certain (express) conditions were met.<sup>821</sup> The basis of the court's decision was the defendant's submission that the full implication of the express agreement not to draw on the credit was that it constituted an express negative covenant, and that 'the court always enforces a negative covenant on the well known principle that it is only making a man refrain from doing that which he has agreed not to do',<sup>822</sup>

The Court of Appeal agreed in its judgment with the trial court that an express contractual restriction was such as to displace the autonomy principle. At the level of the House of Lords, the issue of whether the autonomy principle in letter of credit was such as to allow the beneficiary to draw on the credit in breach of an express contractual stipulation relating to the condition of draw down was not considered. The House of Lords instead focused on the correct contextual interpretation of documents

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<sup>820</sup> Ibid at 476

<sup>821</sup> See *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd and others* [2002] EWHC 1611 (Ch), [2003] 1 WLR 87 [20]

<sup>822</sup> *ibid* at [10]

relating to the conditions of draw down on the letter of credit. The omission by the House of Lords to make any definitive pronouncement on the issue (autonomy principle and the effect of an express contractual restriction on a beneficiary right to draw down on the credit) is a missed opportunity. It is a missed opportunity because a decision by the House of Lords would have authoritatively confirmed the position taken by the Court of Appeal. It follows that the English Court of Appeal's pronouncement which affirmed the court of first instance's decision on the issue remains the position of English law with respect to express contractual restrictions on a beneficiary right to draw down on the credit. The inescapable question that arises from the trail blazing judgment of the English Court of Appeal that an express contractual restriction displaces the autonomy doctrine is whether the decision remains a good law. This inevitably leads us to consider the arguments for or against the exception.

## 8.5. Arguments

The novelty of this decision that an express restriction on a beneficiary right to draw on the credit was capable of displacing the autonomy principle has led to some objections.<sup>823</sup> In this section the arguments in support of or against the exception will be placed in perspective. The objective is to assess to what extent the decision of the court in *Sirius Insurance international* is well founded. The argument in support of the exception will be considered first before going into the argument against it.

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<sup>823</sup> Part of the objection could be gleaned from the argument of the claimant counsel at the court of first instance where he strenuously argued that such limitation was contrary to the independence principle. See *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd and others* [2002] EWHC 1611 (Ch) [2003] 1 WLR 87 [13, 14, 15,19] and 20, see also Hare C, 'Not so black and white: the limits of the autonomy principle' (2004) CLJ 63(2) 288-291.

### **8.5.1. Argument in support of the Exception**

Having considered some of the arguments against the exception, the arguments that support the exception would be considered below.

#### **8.5.1.1. Novelty and Variant of the more Typical Case**

The idea of novelty which provides one of the strongest supports for the exception comes from the nature of the letter of credit under consideration. In this respect, the court captured the novelty of these kind of cases in the Australian case of *Bachmann Pty Ltd v B.H.P Power New Zealand Ltd*<sup>824</sup> regarding express restriction on a standby letter of credit when it stated that

...so far as I am aware, of the cases which have come before the courts in this country the present may be said to be novel in one respect and unusual in another. It is novel in the sense that the present case raises for the first time the effect of an express, albeit qualified, contractual prohibition (in the underlying contract) on the conversion of a security into cash. The novelty resides in the circumstance that the present contract contains an express, but qualified, prohibition on conversion of a security into cash -- express in the sense that it is in form a negative stipulation ('a party shall not convert . . . until the party becomes entitled').

The above statement of the Australian court demonstrates that these cases are novel and represent a special class of case. The willingness of the court to enforce this kind of express provision is based on its novelty and special nature. Its special nature does

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<sup>824</sup> (1999) 1 VR 420.

not affect what is generally accepted as an independent and abstract undertaking.<sup>825</sup> Being an abstract undertaking, the obligation of the bank to pay on the credit once conforming documents are tendered is not based on the rights existing between the beneficiary and applicant in the underlying contract. Stephen J realised the force of this submission in the *Pearson Bridge* case when he cited the case of *Wood Hall Limited v The Pipeline Authority & Another* as authority for the proposition that a letter of credit is an equivalent of cash in hand. However, Stephen J noted that the equivalent of cash principle would as well be defeated if the underlying contract contained some qualification on the beneficiary's power to make a demand under the performance guarantee. Rolfe J in *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* restated the novelty of this type of case when he stated: 'In my opinion neither *Wood Hall* nor *Hortico*, nor the various cases to which I was referred stating that there was an obligation on the party giving an unconditional performance bond to pay that bond on demand are determinative of the present case. Indeed in *Wood Hall*, Stephen J expressly leaves open, so it seems to me, this question for determination'.<sup>826</sup>

To clarify this point, Rolfe J, directed his analysis to the statement of Stephen J in *Wood hall* case. He noted that in that case the court pointed out in the following words: '... Had the construction contract itself contained some qualification upon the Authority's power to make a demand under a performance guarantee, the position might well have been different.

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<sup>825</sup> As the beneficiary is deemed to be aware of the right which he has in the abstract payment before agreeing to expressly restrict such right.

<sup>826</sup> *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451,457.

In fact the contract is silent on the matter'.<sup>827</sup>

In similar vein, in *Sirius Insurance International v FAI General Insurance*, Jacob J, realised the novelty and special nature of the cases dealing with express contractual restrictions on a beneficiary's right to draw on the credit when he stated that 'Whilst I accept the submission that the principle of autonomy is of vital importance, I cannot see that it is undermined in the very special case where a party expressly agrees not to draw down unless certain conditions are met. Suppose instead of a letter of credit an account had been opened in the name of *Sirius* with *Westpac* and credited with the US\$5m. Suppose *Sirius* had agreed with FAI not to touch the account unless the conditions were satisfied. I can see no reason why a contract to that effect should not be enforced. Cash, like a letter of credit, is autonomous, perhaps even more so, but people can agree not to touch identified pots of it, if that is what they want to do. If such an agreement is made, there is no reason why the law should not enforce it'.<sup>828</sup> The message derived from the cases is that where the beneficiary unreservedly consents to an express restriction stipulating the condition for draw down on the credit, it creates a novel and special case, where the 'cash principle' becomes conditional on the fulfilment of the express restrictions.

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<sup>827</sup> *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443,459 restated in *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451,457.

<sup>828</sup> See *Sirius International Insurance Co v FAI General Insurance Ltd and others* [2002] EWHC 1611 (Ch) [2003] 1 WLR 87, 92-93. The same position was also restated in the in the same case at the Appellate Court.

### **8.5.1.2. Legitimate Expectations of the Parties to the Underlying Contract**

The primary concern of the court, at least in contract, is to enforce legitimate expectation of the parties. In England and other common law jurisdictions, the court has consistently made it clear that in determining a dispute arising from a contract, the solution depends largely on what the parties themselves have agreed. That solution is to be gathered from the terms and conditions of the contract in the light of the surrounding circumstances. Thus, where a credit gives a right to draw on a credit upon presentation of specified documents, in determining whether the bank should pay and/or the beneficiary is entitled to payment, the court will look at the credit in view of the material surrounding circumstances. One such circumstance is a contract under which a beneficiary has agreed to demand or obtain payment upon the fulfilment of certain conditions. In England, the leading case in this regard is *Sirius Insurance International*, where May LJ impliedly gave effect to the legitimate expectation of the parties, when he rejected the contention of the appellant in the *Sirius Insurance International* case that the autonomous nature of letter of credit entitled him to draw on the credit in breach of a negative covenant stipulating the conditions of a draw-down on the credit.

### **8.5.1.3. Contractual Restriction as an Express Negative Covenant**

A Restriction in a beneficiary's right stipulating the condition under which a draw-down could be made most often comes in the form express negative covenant.<sup>829</sup> As pointed out by the House of Lords in *Doherty v Allman*, the courts have little or no

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<sup>829</sup> The term was used in the court of first instance as well as the Court of Appeal in the *Sirius International* case.

discretion in giving effect to an express negative covenant openly and mutually entered into by the parties. The underlying reason justifying it being that the court is merely using its instruments to give effect to that which the parties have expressly and contractually agreed should not happen.

#### **8.5.1.4. Lack of Authority Specifically against the Exception**

This argument was accepted by both the High Court and Court of Appeal in *Sirius Insurance International v FAI General insurance*. Against the contention<sup>830</sup> that it is only in the situation of established fraud that the autonomy of letter of credit can be displaced, the court accepted the reasoning of the claimant that there is no authority specifically against this exception. The court stressed that none of the cases which the court had been referred to is specifically against the exception. It continued that in the circumstances of this particular case, there is an 'express provision in the underlying contract saying that the beneficiary will not draw down unless conditions have been fulfilled. In those circumstances, you do not have the normal case of 'pay now argue later', which is the main point of providing letters of credit in normal circumstances'.<sup>831</sup> In other words, the court was minded to recognise that an express contractual restriction in a credit is capable of displacing the autonomy principle on the ground that there was no direct authority specifically against the exception.

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<sup>830</sup> The contrary contention was supported with the case of the *United City Merchants* that it is only in cases of established fraud can the impregnability of documentary credit be displaced.

<sup>831</sup> *Sirius International Insurance Co v FAI General Insurance Ltd and others* [2002] EWHC 1611 (Ch) [2003] 1 WLR 87,92 [18]

## 8.5.2. Arguments against the Exception

Having looked at the arguments in favour of the exception, this sub-section analyses the arguments against the exception.

### 8.5.2.1. Contrary to the Independence Principle

One of the leading arguments against the exception is that the recognition of the express contractual restriction on the credit is contrary to the independence principle. This argument was strenuously pursued by the claimant (Sirius) at the court of first instance where it<sup>832</sup> contended that the letter of credit was an autonomous contract not affected by the conditions as to its draw-down agreed between themselves, Sirius and FAI. They were entitled to draw the letter of credit according to its terms. Even if Sirius resorted to it in breach of those conditions, the remedy would be a claim for damages and an injunction would not be granted. The answer to the above contention was empathically delivered by Jacob J in the *Sirius* case. His Lordship reasoned that while he accepted that the principle of autonomy is of vital importance, he could not see that it is undermined where a party expressly agrees not to draw down unless certain conditions are met.<sup>833</sup>

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<sup>832</sup> *Sirius International Insurance Co v FAI General Insurance Ltd and others* [2002] EWHC 1611 (Ch) [2003] 1 WLR 87,91.

<sup>833</sup> *ibid* [19].

### 8.5.2.2. Want of Certainty

The argument that the recognition of this exception will create uncertainty has been in substance raised by a number of Australian authorities.<sup>834</sup> Part of the issue of uncertainty has originated from the issue of construction with respect to the express agreement restricting the condition of draw down on the credit. Here the construction question most often relates to the meaning of the express terms and in some cases doubt has been raised regarding the uncertainty that would arise as to the proper meaning of the terms and whether the circumstances referred to in the term have or have not arisen. It is evident that in some Australian cases, some contractual provisions with similar clauses, have been construed differently<sup>835</sup> leading to the conclusion that the recognition of the exception will lead to uncertainty. This argument of uncertainty was approved by Callaway JA when he expressed doubt with the line of cases beginning with *Person Bridge*. Callaway JA's submission, as plausible as it might seem<sup>836</sup> raises the same question which has been highlighted with regard to broadening the exceptions to the principle of autonomy. That question is that the uncertainty arising from the recognition of the exception would undermine the

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<sup>834</sup> See *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 V R 420, *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812.

<sup>835</sup> See also the criticism of the interpretation of the contractual clauses restricting the beneficiary right to draw on the credit by Brooking JA with whom Tadgell and Ormiston JJA agreed. Here the Court noted and analysed the flaws and uncertainty regarding the treatment of the contractual clauses with respect to the uncertainty surrounding its meaning and construction. See *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 V R 420.

<sup>836</sup> The contention is not without its merit in the sense that in Australia where the exception has been recognised, there has been numerous cases where the parties have come to court to stop a beneficiary from getting payment on this ground even when the basis of the action can at best be said to be spurious. See *Anaconda Operations Pty Ltd v Flour Daniels Pty Ltd* (1999 Unreported) where Brooking JA reinforced the argument of uncertainty for seeing no apparent express contractual restriction upon which the claimant is relying to ask for an injunction stopping the beneficiary from asking for payment.

policy considerations<sup>837</sup> which underlie the nature of letters of credit. However, as pointed out by Professor Enonchong,<sup>838</sup> the issue of uncertainty generated by the recognition of the exception could be ameliorated by insisting that the exception should only apply where the alleged contractual restriction is an express term of the contract openly and mutually entered into by the parties. Such express term restricting the beneficiary's right to draw on the credit should be clear that the parties contemplated that the otherwise unqualified right of the beneficiary to draw on the credit is limited by the express term in the restricting clause.<sup>839</sup>

There is no easy approach to looking at certainty in letters of credit. More than anything else, there has been much uncertainty with the insistence that it is only in the case of established fraud that the beneficiary's right to payment could be set aside. This has resulted, as some of the cases<sup>840</sup> reveal, in a losing battle to fit all cases into fraud or nothing. The result of this attempt to fit all the cases into the fraud rule<sup>841</sup> is that letter of credit cases are littered with instances where the court resorts to stating that this is a special case that permits the court to intervene on some other ground. A critical analysis of the cases most often shows that there is nothing special about the cases but a point that has been strenuously canvassed in some cases<sup>842</sup> is that there are

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<sup>837</sup> Policy consideration like certainty and prompt payment

<sup>838</sup> See Nelson Enonchong, 'The Problem of Abusive Calls on Demand Guarantees' (2007) LMCLQ 96.

<sup>839</sup> As pointed out in passing by Brooking JA in passing in *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 V R 420, such express contractual restriction drafted alongside the unconditional undertaking or after the credit has been issued would provide evidence that the parties intend that beneficiary unqualified right to draw down on the credit be qualified by the express contractual restriction on the credit.

<sup>840</sup> See *Kvaerner John Brown Ltd v Midland Bank PLC* [1998] CLC 446 where an injunction was granted on the grounds of fraud whereas, the reason is that the beneficiary was adjudged not to have given a written notice before drawing down on a letters of credit. If the case is analyzed critically, it falls under failure to comply with an express restriction rather than fraud.

<sup>841</sup> Which in most cases is not possible as the ground for intervention cannot be properly predicated on fraud.

<sup>842</sup> Special circumstances include illegality, unconscionability, express contractual restriction in the form of a negative covenant affecting the beneficiary's right to draw on the credit. Where they are

some other instances where the court could intervene to displace the principle of autonomy, for example where the beneficiary, as a hard headed commercial man, with his eyes open expressly contracts that his right to payment should be only arise on the fulfilment of certain conditions. It is unlikely that uncertainty will arise because the court has intervened to give effect to an express contractual restriction agreed by the parties.

## **8.6. The Working Principles of the Exception**

Having analyzed the position of the law with respect to contractual restrictions on beneficiary's right to draw down on the credit in the above mentioned three jurisdictions, it may be proper to examine the working principles of the exception as evident both from general law and the cases already analyzed. It must be mentioned that some of the working principles of the exception are found in *Sirius Insurance International*. However, it is possible to devise some other formulation based on a proper appreciation of the issues and borrowing from well founded legal principles in general law. This more than anything else will assist in the later adjudication of cases where the scope of this exception is correctly defined.

### **8.6.1 What kind of Contractual Restriction is Required?**

The restriction required must be express, unequivocal and negative in nature.

*Sirius Insurance International*, the pivotal English authority that affirmatively holds that a beneficiary should not be allowed to draw on a credit in breach of a contractual

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recognized, it promotes certainty by not allowing technical rules to defeat the commercial expectation of the parties.

restriction in a separate agreement talks about the restriction being an express negative covenant. It follows that where there is a restriction on the right of the beneficiary to draw down on the credit, the restriction must be express and unequivocal<sup>843</sup> because the autonomy doctrine is strongly in favour of the beneficiary. That this express provision in the underlying contract or a separate agreement, regulating the condition of draw-down is required for the autonomy principle to be displaced can be seen in Philip J's warning in the *Deutsche Ruckversicherung* case.<sup>844</sup> His Lordship in defence of the autonomy principle noted that 'where a letter of credit is issued by way of conditional payment under an underlying contract, I do not consider that it is correct to imply a term into the underlying contract that the beneficiary will not draw on the letter of credit unless payment under the underlying contract is due'.<sup>845</sup> The significance of this statement was pointed out by May LJ in the *Sirius International* case when he held that an express contractual restriction in the form of an express negative covenant displaced the autonomy principle. May LJ concluded that the court's decision was in accord with Phillips J's pronouncement by drawing a distinction between the situation contemplated by Phillip J, which deprecated implying a condition or restriction on the beneficiary's right to draw on the credit in the underlying contract, with a situation where there is an express condition in an underlying contract or a separate agreement restricting or stipulating the conditions of draw down.

## **8.6.2 Beneficiary's Unconditional Assent to the Express Contractual Stipulation**

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<sup>843</sup> This may lead to a plausible argument that if the restriction is ambiguous or equivocal but on the ground of construction the court finds that it actually prevents the beneficiary from drawing on the credit, the right to collect the sum named in the credit does not arise.

<sup>844</sup> [1995] 1 Lloyd's Rep 153,162-163.

<sup>845</sup> *ibid* at 162 col. 2.

One of the limiting criteria for this exception is where the beneficiary unconditionally accepts the inclusion of the express contractual restriction without raising any objection to it. Take for example, the facts of *Sirius Insurance International*. The express contractual restriction contained in a separate agreement clause(s) saying that the beneficiary will not draw down unless certain conditions have been fulfilled. It would be assumed that the parties have unconditionally assented to it if the express term is drafted in such a way that it is absolutely clear that both parties contemplated that the entitlement of the beneficiary to draw on the credit is restricted or qualified by such limitation in the underlying contract.

The force of the above submission has been recognised in the Australian case of *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd*.<sup>846</sup> In this case, even though the court was not persuaded by the submission that the absolute right of the beneficiary under a demand guarantee was restricted by a provision in the underlying contract, Callaway JA was minded to express the view that the court should rely on this ground as a basis of restraint only where there is an express clause in the underlying contract qualifying the unconditional undertaking in the guarantee. Such express clauses restricting the beneficiary's right, inserted without challenge by the beneficiary, points to the beneficiary assenting to such terms. The court in *Fletcher Construction Australia Ltd*<sup>847</sup> added that no implication should be made that is inconsistent with the commercial purpose of an independent undertaking. This statement of the court allies with the need to make sure that the court does not imply from the underlying contract terms to which the beneficiary has not given his assent.

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<sup>846</sup> [1998] 3 VR 812.

<sup>847</sup> *ibid*

It is submitted that if the terms of the express restriction are clear and the beneficiary with his eyes open unconditionally assents to them, the scope of this ground will be restricted and not cause any uncertainty or undermine any policy consideration that underpins the use of letters of credit.

### **8.6.3 Standard of Proof of the Express Restriction on the Beneficiary Right to Draw on the Credit**

As in the cases of fraud, another criterion that will help to limit the scope of this exception is the standard of proof required to trigger the exception. In this situation, the standard required to prove the exception just like in the case of the traditional fraud rule, ought to be of a higher standard than the normal standard for civil cases.

However, with respect to the standard of proof for the grant of interim and interlocutory injunctions, most Australian cases, mostly in demand guarantee cases, have followed the benchmark set by the decision of the English House of Lords in *American Cyanamid Co v Ethicon Ltd*.<sup>848</sup> This has led to the courts granting injunctions against the beneficiary on the basis that a contractual restriction on the beneficiary's right to draw on a credit has been breached in cases where the facts of some of the cases raised only a serious issue to be tried.<sup>849</sup> Granting injunctions on the basis that there is only a serious issue to be tried contrasts remarkably with approach

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<sup>848</sup> [1975] 2 WLR 316, [1975] AC 396.

<sup>849</sup> *Pearson Bridge (N.S.W.) Pty. Ltd. v. State Rail Authority of New South Wales* (1982) 1 Aust. Construction LR 81, *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty. Ltd* (1991) 23 NSWLR 451, *Selvas Pty Ltd v Hansen & Yuncken (SA) Pty Ltd* (1987) 6 Aust. Construction L.R 36, (1987) 6 ACLR 36, *J. H. Evans Industries (N.T.) Pty. Ltd v Diano Nominees Pty. Ltd.* (unreported, N.T. Supreme Court, 30 January 1989) *Mitsui Kensetsu Corporation Australia Pty Ltd v State of South Australia* (unreported, Qld. Supreme Court, 9 August 1990).

adopted in the cases of the fraud exception where established clear fraud is required. The approach has led to suggestions that the standard is too low and that an exception designed to make the beneficiary stick to his contractual undertaking could thus end up providing a loophole for the applicant to renege easily from the independent undertaking evident in the autonomous nature of credits.<sup>850</sup>

To alleviate the above difficulty, Prof. Nelson Enonchong<sup>851</sup> has argued -albeit in the context of demand guarantee- that the scope of the exception could be further restricted by insisting that the applicant for the credit, to be entitled to an injunction, needs to prove to a higher standard the express restriction on the beneficiary's right. He further submitted that it should not be enough for the applicant for the credit to show that there is a serious issue to be tried as to whether the express restriction in the credit has been satisfied, but that the applicant to be entitled to an injunction should demonstrate that he has a real prospect of proving at trial that the express restriction has not been satisfied.<sup>852</sup> This point, to the extent that it helps to keep the scope of this emerging exception within narrow limits by making sure that injunctions are not readily available, is commendable and ought to be adopted.

However, for the purposes of injunctions, the difficulty with insisting that the applicant prove that he has or would have a realistic prospect of success at the trial that the express restriction has not been complied with before an injunction could be granted was pointed out by the House of Lords in *American Cyanamid Co. v Ethicon*

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<sup>850</sup> See N.E Enonchong, 'The Problem of Abusive Call on Demand Guarantees' (2006) LMCLQ 83, where this opinion is expressed in no uncertain terms

<sup>851</sup> Nelson Eonchong, 'The Problem of Abusive Call on Demand Guarantees' (2006) LMCLQ 83,97.

<sup>852</sup> See Nelson Enonchong, 'The Problem of Abusive Call on Demand Guarantees' (2007) LMCLQ 83, 97.

*Ltd*,<sup>853</sup> Lord Diplock, pointed out the difficulty, albeit in the context of interlocutory injunctions that ‘in those cases where the legal rights of the parties depend upon facts that are in dispute between them, the evidence available to the court at the hearing of the application for an interlocutory injunction is incomplete. It is given on affidavit and has not been tested by oral cross-examination. The purpose sought to be achieved by giving to the court discretion to grant such injunctions would be stultified if the discretion were clogged by a technical rule forbidding its exercise if upon that incomplete untested evidence the court evaluated the chances of the plaintiff’s ultimate success in the action at 50 per cent or less, but permitting its exercise if the court evaluated his chances at more than 50 per cent’.<sup>854</sup>

The point sought to be made in the immediate preceding paragraph is that the need to raise the standard of proof is welcome as a way of limiting the scope of this exception, but insisting on a particular standard like realistic prospect of success would as, Lord Diplock warned,<sup>855</sup> be likely to create room for error. The primary reason for this contention is that at the stage of injunction, the evidence available is in the nature of an affidavit, yet to be tested by any form of oral cross-examination. Hence, apart from providing a discretionary remedy in injunctions, it may be premature to judge based on the affidavit evidence whether the claimant has a realistic prospect of success. A somewhat different approach is to insist on a standard that is high enough to safeguard the autonomy principle but not so high as to be unattainable.<sup>856</sup> As the benchmark for knowing when an express contractual restriction is proved, it is suggested that

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<sup>853</sup> [1975] 2 WLR 316, [1975] AC 396,406.

<sup>854</sup> [1975] 2 WLR 316, [1975] AC 396,406.

<sup>855</sup> *American Cyanamid Co v Ethicon Ltd* [1975] 2 WLR 316, [1975] AC 396, 406-407.

<sup>856</sup> In this respect, the court in letter of credit fraud cases has formulated in different ways the standard required, ranging from ‘established or obvious fraud’- see *Edward Owen Engineering Ltd v Barclay Bank International Ltd* [1978] QB 159, Per Lord Denning MR, ‘a real prospect of establishing fraud’- see *Solo Industries Uk Ltd v Canara Bank* [2001] 1 WLR 1800, Mance LJ [1815- 1816].

adopting the same high standard of proof evident in letters of credit fraud cases - where the applicant to succeed in an application for an injunction ought to show that evidence of fraud is compelling<sup>857</sup> should be considered. This high standard, in addition to the assessment of where the balance of convenience lies, should assist in keeping this exception within very narrow confines. This will not only protect the autonomy principle but would encourage uniformity with other exceptions, as well as achieve the discretionary goal for the grant of injunction which demands that the court should be satisfied that the claim that an express contractual restriction has not been complied with is not frivolous or vexatious. In assessing the frivolity of the claim, the court ought to pay regard to the autonomous nature of letters of credit by setting a higher standard that require clear proof of the express restriction by the claimant.

## 8.7. Conclusion

The recognition of the exception examined in this chapter does not appear to be in doubt but what seems to pose difficulties, on the facts of some of the cases<sup>858</sup> analysed is defining the scope of the exception. In relation to the scope, *Sirius International Insurance* has demonstrated the point made by Phillip J<sup>859</sup> that implying such a restriction into a documentary credit would not be permitted by the courts but where express agreement has been made; there can be no reason not to give effect to it by way of displacing the autonomy principle. Also with respect to the scope, its application as reflected in the Australian cases albeit in the context of demand

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<sup>857</sup> This by implication is the result of all the decisions which has formulated the standard of proof differently.

<sup>858</sup> Mostly the Australian cases where the distinction is not drawn between express restrictions and that implied from the contract.

<sup>859</sup> See *Deutsche Rückversicherung AG v Walbrook* [1995] 1WLR 1017.

guarantees suffers from want of certainty in the sense that the Australian cases have not drawn a line between express restriction and implied restriction.

More so, *Sirius Insurance International* can be argued implicitly to highlight the unsatisfactory nature of the law in England with respect to the exception(s) to the principle of autonomy. On examining the cases dealing with contractual restrictions, the unsatisfactory nature of the law with respect to the exception(s) becomes evident. While the courts continue to emphasize, even in the face of compelling decisions and dicta to the contrary, that the traditional position is that fraud is the only recognized exception to the principle of autonomy, some judicial pronouncements- the rationale for which it is difficult to fault, continue to undermine and lead to a contrary position. One of these contrary positions was clearly demonstrated both at first instance and in the Court of Appeal in *Sirius Insurance International* case. The decisions of both courts clearly appreciated and held that, apart from fraud, there are other special circumstances in which the autonomy principle may be displaced.

One of those special circumstances, the courts held, is where the beneficiary in drawing on the credit, is acting in breach of a contractual clause or condition expressly restricting or defining his right to payment on the credit. The court held that the principle of autonomy is not undermined where the beneficiary had expressly agreed with the applicant for the credit not to draw down the credit unless certain conditions are fulfilled, and draw down is sought to be prevented on the grounds of non-fulfilment. The legal position enunciated in *Sirius Insurance International* has the support of both Australian and Malaysian authorities.

If emphasis is placed on the argument that the autonomy doctrine in the absence of fraud of the beneficiary, trounces all countervailing consideration, then the High Court and the Court of Appeal in *Sirius Insurance International* would be criticized for departing from the traditional position that emphasizes the supremacy of the autonomy doctrine. However, considering the nature of these cases, the courts should be applauded for courageously holding the beneficiary accountable to his contractual bargain and not to use the principle of autonomy as a ground for reneging from an express contractual restriction openly and mutually agreed to. To hold otherwise, would, as highlighted in the chapter, defeat the commercial and legitimate expectation of the parties.

It is also a persuasive argument that letter of credit is an equivalent of cash in hand whose realization, is not dependent on issues in the underlying contract or any other contract. This position could be argued to be correct where the unconditional nature of the instrument has not been qualified by a contractual restriction on the beneficiary's right. The beneficiary, by accepting the express contractual restriction, and not affected by any form of legally recognised factors vitiating the contract, should held to have made his right to payment conditional on fulfilling that negative stipulation in a contract which he has agreed to. To hold otherwise, is to give the beneficiary the unrestricted freedom to agree to whatever terms (including terms which may be primary reason why the applicant agreed to the issue of the letter of credit in the first place) whether in the underlying contract or in a separate contract as binding upon him, only to later hide under the autonomy principle to renege on those promises.

## Chapter Nine

### 9.0. General Conclusions

Documentary credits are financial instruments used to finance international business transactions. A primary object of documentary credits (as highlighted at the beginning of the thesis) is to cater for the interest of both parties in securing the performance of the underlying contract that gives rise to a documentary credit. On the part of the seller, if he parts with the possession and property in the goods or ships them solely based on the buyer's promise in the contract of sale, the seller may have no effective security against the buyer's default in payment. On the other hand, if the buyer pays the price before the shipment of the goods, he may not have adequate protection against default in performance by the seller or against his bankruptcy. This primary object which protects both parties' interests in a documentary credit transaction remains pivotal to the utility of documentary credits.

To realize the above object and enable the proper utilisation of documentary credits, it (documentary credit) operates on two cardinal principles viz: the autonomy doctrine and the doctrine of strict compliance.<sup>860</sup> The autonomy doctrine presupposes that it is a cardinal rule of documentary credits that the bank's duty to pay is to founded on the credit itself and the right and duty to make payment do not in any way depend on the performance of the seller/beneficiary's obligations under the contract of sale.

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<sup>860</sup> The doctrine of strict compliance despite being a cardinal principle in documentary credit is not specifically relevant in the issues pursued in this thesis.

It has been argued in chapter two that the current practice evident in the autonomy principle in documentary credits that seeks inflexibly to detach the credit from the underlying transaction that gave rise to it is at the root of some of the problems with regard to the exceptions in documentary credit. While it is correct to define the autonomy doctrine as a principle that seeks to separate the credit contract from the underlying contract, such definition ought to be understood in line with the function which the autonomy doctrine, in conjunction with the doctrine of strict compliance, performs in documentary credit operations. That function is primarily to make sure that the seller who has shipped goods is paid expeditiously with the underlying contract not used as a ground for non-payment. The autonomy doctrine, it has been argued, is not designed to assure payment in circumstances where the underlying contract does not even exist but its non existence is not the result of the beneficiary's fraud. Such treatment of the autonomy doctrine, it has been argued, is unnecessarily literalistic and at times leads to a conclusion that flouts business common sense.

Having noted the problem with the perception of the autonomy doctrine, it is to be stressed that the obligation of an issuing bank or a confirming bank to honour a beneficiary's complying presentation under documentary credits admits of certain exceptions which have either been recognised or received favourable comments in common law jurisdictions such as England, Singapore, Australia, Canada and Malaysia. Such exceptions, which this thesis has sought to analyse, include fraud, nullity, beneficiary's recklessness in presenting document(s) forged by a third party, unconscionability, illegality, and express contractual restriction on the beneficiary's right to draw on the credit.

With regard to fraud, it has been argued in part of chapter three that one of the fallouts of the perception accorded the autonomy doctrine in English law is that the fraud rule is very restrictively applied. To restrict the scope of the exception, proof of clear fraud is required even at the interlocutory stage. The insistence on the proof of clear fraud at the interlocutory stage raises the standard of proof to a point where it becomes difficult to invoke the exception in practice for the purposes of injuncting the beneficiary whose presentation is alleged to be fraudulent by the applicant. A cursory look at the very few cases where the exception has been applied tends to show that the courts were more motivated by the demands of justice rather than living up to the legal technicalities that satisfy the proof of clear fraud in English documentary credits practice. It has been argued that an approach which sets a very high standard of clear fraud on the grounds that too much derogation will affect the commercial vitality of documentary credits ought to be balanced against some other considerations like the commercial and legitimate expectation of the parties. This suggestion has been offered because, in some of the cases analysed, the high standard of proof required to establish fraud allows the beneficiary's claims to be based upon legal technicalities (which the standard of proof required put upon the applicant for an injunction) rather than on whether the actual presentation is fraudulent. If this suggestion is received, the result would be an approach which in most instances defeats the technical issues, the insistence upon which hinders the invoking of the fraud rule in documentary credits' practice. The current practice tends to put the beneficiary in an overly strong position with respect to obtaining payment. The result is that fraud which ought to have been stopped before payment is made to the beneficiary is allowed to succeed and the beneficiary running off with a colossal sum of money fraudulently obtained.<sup>861</sup>

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<sup>861</sup> See the enormous letters of credit fraud perpetrated by Mahdev Patel with his Solo Group Industries

Also, in England with respect to deferred payment, a nominated bank that honours or negotiates apparently conforming documents in good faith is entitled to reimbursement from the issuing bank regardless of any fraud affecting the document. In contrast, in the United States under the revised UCC Revised Article 5-109 the concept of fraud with respect to the beneficiary is conceived broadly. In particular, if at the time of a presentation the issuing bank or confirming bank knows that one or more of the document is materially fraudulent, it is within its rights to refuse payment regardless of whether or not the presenting beneficiary is innocent. Admittedly, as this study has sought to demonstrate, the courts are still to have the opportunity to test the validity of the wide language used especially in relation to the immateriality of the beneficiary's innocence. Remarkably the Revised Article 5 of the UCC differs markedly from the English position on the question of the right of a forfaiter who has innocently taken up apparently conforming but actually fraudulent documents from a beneficiary under a deferred payment credit. While in England, prior to the UCP 600, such a party is not protected because he is regarded as a party who takes subject to equities existing against the assignor/beneficiary- in the United States he is fully protected. Despite the UCP 600 apparent alignment of the English position with that of America, an uncertainty still remains with respect to an English documentary credit that is not subject to UCP 600. In such a case the position is still uncertain as to whether to adopt the *Banco Santander* position or that provided by the UCP 600. While from a legal point of view, it is difficult to fault the position adopted in the *Banco Santander* case, as assignees take subject to the equities of the assignor. It is however submitted that the American approach which currently has been endorsed in

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for which he is still currently wanted. See also the letter of credit frauds perpetrated by Zvonko Stojevic as the directing mind and will of the company Stone & Rolls Ltd and the difficulty of recovering the huge sum involved owing to the beneficiary company being insolvent.

the UCP 600 is to be preferred because it is commercially more sensible and protects the interest of banks involved in the forfait market.

In other jurisdictions like Singapore, the courts still adopt the restrictive approach of the fraud rule as practiced in England. However, in Singapore, the *Beam Technology* case<sup>862</sup> departs from the English position by recognising a separate nullity exception. The court in *Beam Technology*<sup>863</sup> held that forged documents which amount to a nullity should not be treated as conforming documents for the purposes of the UCP and should in fact displace the autonomy doctrine. The thesis has endeavoured to argue in Chapter Four, after analysing the argument in support and against the nullity exception, that a limited nullity exception seems appropriate for two principal reasons: first, its stance against the circulation of forged documents that nullities and secondly, null documents do not represent conforming documents required under the UCP.

Despite the restrictive approach of fraud and the general rejection of the nullity exception in England, the *Montrod* case<sup>864</sup> in England suggested that if the beneficiary has acted recklessly in presenting the documents forged by a third party, then this might give rise to a defence to a refusal to honour a presentation. While this exception may encourage the beneficiary to be more diligent with respect to the document presented for payment, the thesis contends in chapter five that the juridical basis for penalising the beneficiary without establishing any form of dishonesty on his part is somewhat questionable. As noted by Steven Gee,<sup>865</sup> commercial men often act

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<sup>862</sup> [2003] 1 SLR 597.

<sup>863</sup> [2003] 1 SLR 597.

<sup>864</sup> [2001] EWCA Civ 1954 [2002] CLC 499, 512-513.

<sup>865</sup> Steven Gee, *Commercial Injunctions* (Sweet and Maxwell 2006) para.15.007.

carelessly and selfishly but this should not be a good defence to refusing their contractual bargain.

In the absence of clear guidelines on what amounts to commercial recklessness, such a rule would be too vague and uncertain. Issues like whether the beneficiary had knowledge of the third party fraud will have to be determined. In the absence of clear knowledge, it has to be determined whether the beneficiary has foreseen the third party fraud and if he has, then to what extent the harm that will be caused is not remote from the beneficiary's point of view. All these issues put together will introduce some level of subjectivity and may fall outside the competence of the bank called upon to make payment on the tender of apparently conforming documents.

In other common law jurisdictions, unconscionability has been held to be an exception to the principle of autonomy in documentary credits. The scope of unconscionability, considering its equitable origin, is perceived to be uncertain and would introduce some level of uncertainty in an area of law where it is argued that certainty and precision is paramount. However, it is argued that where it could be proven, and the beneficiary is insisting on enforcing his rights in circumstances where such a right does not exist, nothing should as a matter of principle stop the autonomy principle being displaced. Chapter six has endeavoured to argue that to insist on the autonomy principle as justifying ground for paying the beneficiary in circumstances where to do so will be unconscionable ignores the legitimate and reasonable expectation of the parties to a documentary credits' transaction and in reality goes contrary to the object which documentary credits was designed to satisfy. This reasonable expectation of the

parties played a role in displacing the autonomy doctrine in the case of fraud and ought to be taken into account where insistence on the separate nature of the contracts will amount to a technical insistence on strict rights where the beneficiary, putting the whole issues in perspective, has no right to it. This approach has been followed in jurisdictions like Australia and Singapore.

The principal argument against recognizing such exception like unconscionability in documentary credits is that its application will be uncertain and generally will affect the commercial utility of documentary credits. The thesis has endeavoured to make a case for unconscionability on the main ground that the argument of its uncertainty is exaggerated. As demonstrated in chapter six of the thesis, most legal terms tend towards imprecision but have not affected their acceptance as recognised legal terms having full effects in law. More so, it has been submitted that the pursuit of certainty has created its own problems. One such problem is that the pursuit of certainty has resulted in many cases dealing with the exception(s) being categorised as special. A lesson could be learnt from these special cases. If there are special cases that defy the certain order of things, and situations when the need to avoid irretrievable injustice is such that following the certain order of things will occasion injustice, the lesson is that it may be the right time to jettison dogma<sup>866</sup> through the recognition of limited unconscionability exception so that the insulated method of payment is shielded from abuse.

More so, the argument of uncertainty and destroying the efficacy of documentary credits if the exception to the autonomy principle is widened to accommodate

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<sup>866</sup> Dogma in the sense that the belief that every legal facts would conform to established pattern remains an illusion and flexibility is required in some circumstances.

unconscionability, neglects developments in some other common law jurisdictions. Jurisdictions like Singapore and Australia have adopted a wider ground of displacing the autonomy of documentary credits by recognizing unconscionability. Specific example includes Section 51AC of the Trade Practices Act 1974 introduced in Australia to protect business from unconscionable conduct with a scope that embraces documentary credit transactions. It is still to be seen that the banking activities of these jurisdictions with respect to documentary credits have collapsed due to the uncertainty arising from the recognition of these exceptions. More than anything else, it reminds commercial parties in documentary credits in those jurisdictions of the need for fair dealing and lack of protection where the request for payment would be unconscionable. It is suggested that a robust approach that takes into consideration the commercial and legitimate expectation of both parties to documentary credits as seen in some jurisdictions should be considered in English law with a view on adopting it. It accords with the evolving trend to commercial activities, a trend that considers and promotes the commercial object, commercial morality, reasonable expectation, and fair dealing on the part of commercial actors.

The thesis also sought to analyse the illegality defence in documentary credits. While the defence of illegality as a ground upon which the autonomy principle could be displaced is not in doubt, the distinction as to when the credit itself is illegal and when the illegality results from the underlying contract was highlighted in the analysis. As demonstrated in chapter seven of the thesis, the thorny issue in relation to illegality in documentary credits lies where the illegality in question results from the underlying contract. Despite the variety of ways through which illegality may result, it is

contended in chapter seven of the thesis that whether illegality in the underlying contract will be such as to taint the credit contract in a manner that bars the beneficiary from requesting payment against a tender of documents depends on the nature of illegality and the circumstances of the case. In this regard, the seriousness of the illegality, the knowledge of the beneficiary and a close connection between the underlying illegal transaction and the credit are considerations which ought to be taken into account before the beneficiary could be barred from payment.

With respect to the exception dealing with contractual restrictions on the beneficiary's right to draw on the credit, the thesis notes in chapter eight that in *Sirius Insurance International*, an express contractual restriction on the beneficiary's right to draw on the credit was held to be a basis for an injunctive relief and could displace the autonomy doctrine. The decision reached by both the High Court and Court of Appeal in *Sirius International*<sup>867</sup> that an express contractual stipulations, restricting the conditions of draw down is such that displaces the autonomy doctrine is commendable as it represents the mutual expectation of the parties upon the opening of the credit. The House of Lords in the same case failed to express an opinion on whether an express restriction on the beneficiary's right to draw on the credit was in fact a basis of an injunctive relief. The House of Lords stated in their decision that 'it was unnecessary for the House to resolve any issue regarding the so-called autonomy principle applicable to letters of credit issued by banks, and the appeal turned on the basis of the correct contextual interpretation of non-standard documents.'<sup>868</sup>

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<sup>867</sup> [2003] 1 WLR 87, [2003] 1 WLR 2214 (CA).

<sup>868</sup> *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd and others* [2004] UKHL 54 [2004] 1 WLR 3251 at 3253 (Lord Steyn).

Qualifying the autonomy doctrine with the phrase “so called” may be an indication that the court, may not have disagreed with the Court of Appeal if the same issues which were considered by the Court of Appeal were considered by the House of Lords.

Finally, the pursuit of certainty, while a legitimate and crucial aspect of documentary credits law, need not completely disregard the consideration of fairness which is implicit in the cases categorised as special cases. The thesis has sought to argue that there is nothing special about the cases that have displaced the autonomy doctrine on grounds other than fraud and illegality which have been referred to as special. But implicit in these decisions are responses of the courts motivated by fairness and avoiding irretrievable injustice but constrained by the current position of the law which fails to acknowledge such grounds as exceptions to refer to the cases as special. These decisions, which seek to preserve and promote the legitimate expectation of commercial parties, most often run contrary to established authorities. They also remind us that a flexible approach to the autonomy doctrine and its exceptions meets the expectation of parties. The thesis argues that, apart from fraud, exceptions like unconscionability, illegality, and beneficiary’s express contractual restriction, should be capable of displacing the autonomy doctrine. Viewing the autonomy doctrine as an assurance of payment inflexibly detached from the underlying contract upon which it is based would sometimes present situations where the approach does not live up to commercial realities. Unless such perception of the autonomy principle is discontinued, we would not cease to see cases relying on such legal ratio like “this is a

special case or to avoid irretrievable injustice” as the grounds for justifying their departure from the recognised exception(s).

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