

## THE IDENTITY OF THE FRAUDULENT PARTY UNDER THE FRAUD RULE IN THE LAW OF LETTERS OF CREDIT

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### I INTRODUCTION

The fraud rule in the law governing letters of credit plays a vital role in situations where the documents presented by the party demanding payment under a letter of credit strictly comply on their face with the terms and conditions of the letter of credit, but are in fact forged or fraudulent. According to the rule, payment under the letter of credit may be dishonoured by the issuer or enjoined by a court if fraud is found in the transaction, provided that the party seeking payment does not belong to a specified class of protected persons.

In most cases, fraud in a letter of credit transaction is practiced by the beneficiary, in which case the fraud rule clearly applies. Even if the fraud is not perpetrated by the beneficiary itself, the fraud rule will still apply if the beneficiary knows of, or has participated in, the fraud.<sup>1</sup> However, fraud in a letter of credit transaction can occasionally be perpetrated by somebody other than the beneficiary and without the knowledge of the beneficiary. The perpetrator may be the applicant or a third party. This article addresses the question of whether the fraud rule can or should be applied in such situations so that payment under the letter of credit is interrupted.

To facilitate the discussion, the article commences with a brief review of the mechanism of the letter of credit and the rationale for the fraud rule. This is followed in Part III by an examination of the relevant provisions of the rules and statutes governing letters of credit. Part IV discusses situations of fraud by applicants and third parties, primarily through the use of case studies. In

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1 See, eg, *Contronic Distributors Pty Ltd v Bank of New South Wales* [1984] 3 NSWLR 110, in which the beneficiary and applicant colluded in fraudulently obtaining a letter of credit and the fraud rule was applied.

particular, Part IV analyses in detail the decision of the House of Lords in *United City Merchants v Royal Bank of Canada* ('*United City Merchants*').<sup>2</sup> In Part VI, a critique of the House of Lords' conclusion regarding the application of the fraud rule to third party fraud is offered and an alternate approach is proposed.

## II THE MECHANISM OF THE LETTER OF CREDIT AND THE ROLE OF THE FRAUD RULE

The letter of credit is an extremely useful device for facilitating various complex commercial transactions. It is a written instrument, issued to a beneficiary, normally by a bank of good reputation, for the account of the applicant. The issuer promises that it will honour a draft or a demand for payment made by the beneficiary, provided that the terms and conditions specified in the letter of credit are strictly complied with.

A simple example illustrates the operation of the mechanism. Assume a seller in Shanghai wishes to sell some goods to a buyer in Sydney. The seller and the buyer are strangers and the seller is worried that after going to the expense of loading and shipping the goods, the buyer may become insolvent or refuse to pay upon arrival of the goods in Sydney. If the buyer does not pay, the seller will have to go to great expense to sue the buyer in a foreign jurisdiction, and will also incur the costs of disposing of the goods in an unfamiliar territory. In turn, the buyer is worried that it may not in fact receive the goods if it pays the seller in advance. To assuage the parties' legitimate fears, they contract to conduct the transaction through a letter of credit arrangement.

Under this arrangement, the buyer procures an irrevocable letter of credit from a bank of good reputation, which commits the bank to pay the draft drawn by the seller upon proper presentment of the draft accompanied by the documents specified in the letter of credit, which usually includes a commercial invoice and a bill of lading – a document of title signifying the seller's ownership of the goods. Thus the seller retains ownership of the goods until it presents the documents to the bank, at which time the seller is paid (in the case of a sight draft) or the draft is accepted (in the case of a time draft). The buyer knows that its money will not be paid to the seller unless the seller produces documents describing the goods and indicating that the goods have been shipped. The bank pays the seller for the buyer by taking security (a pledge) over the documents to secure the advance made to finance the transaction.

As this example illustrates, a typical letter of credit transaction involves three parties and three transactions. The three parties are:

- (1) the buyer, known as the applicant;
- (2) the seller, known as the beneficiary; and
- (3) the bank, known as the issuer.

The three transactions are:

- (1) the underlying transaction between the buyer and the seller;

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2 [1983] 1 AC 168.

- (2) the transaction or the application agreement between the buyer and the bank; and
- (3) the transaction between the bank and the seller, that is, the letter of credit itself.<sup>3</sup>

There are two fundamental principles in the law of letters of credit: the principle of independence and the principle of strict compliance. Under the principle of independence, the transactions under a letter of credit arrangement are independent from each other. The obligation of the issuer to pay the beneficiary is direct, primary and independent. The issuer is therefore required to pay the beneficiary, irrespective of any disputes or claims relating to the underlying transaction between the beneficiary and the applicant. However, the issuer is entitled to make the payment with full recourse against the applicant, even if the seller's documents turn out to be forgeries or to include fraudulent statement, provided that the forgery or fraudulent statement does not appear on the face of the documents. The issuer's only concern therefore is whether the documents tendered conform *on their face* to the terms and conditions of the letter of credit.<sup>4</sup>

According to the principle of strict compliance, the party to a letter of credit transaction who wishes to receive payment must tender complying documents. If the documents tendered are on their face in strict compliance with the terms and conditions of the credit, the party who is bound to honour the obligation under the letter of credit must do so when it receives the documents. It may not add further conditions or look beyond the face of the documents in order to avoid its obligation under law. However, if the documents tendered are not in strict compliance with the terms and conditions of the letter of credit, the party tendering the documents may not get paid even though it has fully performed the

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3 Letters of credits are divided into commercial letters of credit and standby letters of credit. Commercial letters of credit are used as payment devices in the financing of international sales of goods. Standby letters of credit operate as guarantees and can be used in various transactions to which they are adapted. These two types of credits are of the same legal nature although basic differences in usage do exist between them. Commercial letters of credit are more typical than standby letters of credit, and therefore the hypothetical example given here employs a commercial letter of credit. However, the discussion in the rest of the article will make reference to both commercial and standby letters of credit. For some leading works on letters of credit see John F Dolan, *The Law Of Letters Of Credit: Commercial And Standby Credits* (1996); E P Ellinger, *Documentary Letters of Credit – A Comparative Study* (1970); H C Gutteridge and Maurice Megrah, *The Law of Bankers' Commercial Credits* (7<sup>th</sup> ed, 1984); Henry Harfield, *Bank Credits And Acceptances* (5<sup>th</sup> ed, 1974); B Kozolchyk, 'Letters of Credit', in Jacob S Ziegel (ed), *International Encyclopaedia of Comparative Law* (1979) vol 9, ch 5; Lazar Sarna, *Letters Of Credit: The Law and Current Practice* (2<sup>nd</sup> ed, 1986); and Brooke Wunnicke *et al*, *Standby and Commercial Letters of Credit* (2<sup>nd</sup> ed, 1996).

4 The principle of independence is expressed in Articles 3 and 4 of the International Chamber of Commerce ('ICC'), *Uniform Customs and Practice for Documentary Credits* (1993). The *Uniform Customs and Practice for Documentary Credits* ('UCP') was first published by the ICC in 1933, and has been revised a number of times since. The current version was published in 1993 and is known as 'UCP 500'. (It is this version that is referred to in the following discussion unless indicated otherwise.) Article 3 emphasises the separateness of the letter of credit from the other transactions and provides that '[c]redits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s)'. Article 4 emphasises that the parties to the letter of credit deal in documents and not in goods.

underlying contract. The presentation of a commercial equivalent, even if of equal or greater value, does not suffice, and the tender must be made strictly in the manner and within the time prescribed in the letter of credit.<sup>5</sup>

Because of the operation of the principle of independence, the beneficiary requiring payment does not have to show the issuer that it has properly performed its contractual duties under the underlying transaction. It need only produce documents that conform to the requirements of the letter of credit. Yet this leaves an obvious loophole for unscrupulous beneficiaries to abuse the system and defraud the other parties involved. An extreme example would be a situation in which the seller is paid by the issuer after presenting documents which comply (in their form) with all the requirements set out in the letter of credit, but the buyer does not receive the goods it has ordered because the documents are, in fact, forged. In such a case, an action by the applicant on the underlying contract would normally be ineffectual. Thus strictly applying the principle of independence could produce harsh and unfair results by operating to unjustly enrich an unscrupulous beneficiary.<sup>6</sup> To prevent such unfairness, the fraud rule has been developed to balance the 'commercial utility of letters of credit against the desire to prevent the inequitable results which flow from fraudulent misrepresentations in individual cases'.<sup>7</sup>

### III RELEVANT PROVISIONS

There are a number of documents governing letters of credit generally. Among them the *Uniform Customs and Practice for Documentary Credits* ('UCP')<sup>8</sup> is the most used and most important. However, specific provisions on fraud in letter of credit transactions can only be found in Article 5 of the *Uniform Commercial Code* ('UCC')<sup>9</sup> in the United States ('US') and in the *Convention on Independent Guarantees and Stand-by Letters of Credit* ('UNCITRAL Convention'),<sup>10</sup> promulgated by the United Nations Commission on International Trade Law ('UNCITRAL'), in the international context.

#### A Article 5 of the UCC

The *UCC* is a collection of model statutes drafted and recommended by the National Conference of Commissioners on Uniform State Laws and the American Law Institute. The *UCC* (or a version of it) is intended to be enacted

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5 Ellinger, above n 3, 277.

6 'Note: Letters of Credit: Injunction As a Remedy for Fraud in UCC Section 5-114' (1979) 63 *Minnesota Law Review* 487, 490.

7 Greg A Fellinger, 'Letters of Credit: the Autonomy Principle and the Fraud Exception' (1990) 1 *Journal of Banking and Finance Law and Practice* 4, 6.

8 International Chamber of Commerce, above n 4.

9 The National Conference of Commissioners on Uniform State Laws and the American Law Institute, *Uniform Commercial Code Article 5 – Letters of Credit* (1995).

10 Opened for signature 11 December 1995, UN Doc A/Res/50/48 (1995) (entered into force 1 January 2000).

by the legislatures of the various States of the US.<sup>11</sup> The *UCC* consists of 11 different Articles, each covering a different aspect of commercial law.<sup>12</sup>

Article 5 of the *UCC* is a uniform statutory scheme governing letters of credit. It was first drafted in the 1950s ('Prior *UCC* Article 5') and thoroughly revised in 1995 ('Revised *UCC* Article 5'). The fraud rule was originally provided for in Prior *UCC* Article 5, s 5-114(2), and is now embodied in Revised *UCC* Article 5, s 5-109. Prior *UCC* Article 5, s 5-114(2) read as follows:

Unless otherwise agreed when documents appear on their face to comply with the terms of the credit but a *required document* ... is forged or fraudulent or there is fraud in the transaction ... an issuer acting in good faith may honour the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honour.<sup>13</sup>

The original wording did not mention the identity of the fraudulent party, and it has been suggested that the section was ambiguous on this issue.<sup>14</sup> However, a careful study of the section permits a different interpretation. Section 5-114(2) was concerned merely with the nature of the documents tendered, and utterly neglected the identity of the fraudulent party. As such, the fraud rule was applicable whenever 'documents' or 'a required document' were forged or fraudulent. Put another way, under Prior *UCC* Article 5, s 5-114(2), the nature of the documents tendered was the sole concern in a case of fraud.

Revised *UCC* Article 5, s 5-109 now provides that:

(a) If a *presentation* is made that appears on its face strictly to comply with the terms and conditions 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...

(b) If an applicant claims that a *required document* is forged or materially fraudulent or that *honour of the presentation would facilitate a material fraud by the beneficiary* on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons.<sup>15</sup>

Section 5-109 specifically uses the term 'beneficiary' when stating that the fraud rule will be invoked 'if a required document is forged or ... fraudulent or honour of the presentation would facilitate a ... fraud by the beneficiary'.<sup>16</sup> This has led some commentators to argue that 'the section requires either forgery or material fraud "by the beneficiary"'. If the fraud is perpetrated by someone else, an injunction is not authorised'.<sup>17</sup>

11 Paul S Turner, 'Revised UCC Article 5: The New US Uniform Law on Letters of Credit' (1996) 11 *Banking and Finance Law Review* 205, 206. For a brief history of the advent of the *UCC*, see Charles Bunn, Harry Snead and Richard Speidel, *An Introduction to the Uniform Commercial Code* (1964) 1-5.

12 See generally Turner, above n 11.

13 Emphasis added.

14 Wunnicke *et al*, above n 3, 163.

15 Emphasis added.

16 Emphasis added.

17 James J White and Robert S Summers, *Uniform Commercial Code* (4<sup>th</sup> ed, 1995) vol 3, 185.

However, it is submitted that an examination of the section leads to a different conclusion. Under s 5-109, the fraud rule applies in only two situations:

- (1) where 'a required document' that is presented is forged or materially fraudulent; or
- (2) where 'honour of the presentation' for payment would facilitate fraud by the beneficiary.<sup>18</sup>

Although the perpetrator will always be the beneficiary in the latter case, this will not necessarily be so in the former,<sup>19</sup> as it is possible for someone other than the beneficiary to produce a forged or fraudulent document.

Thus Revised *UCC* Article 5 has not entirely ruled out the application of the fraud rule when somebody other than the beneficiary perpetrates the fraud. As was the case with its predecessor, Revised *UCC* Article 5, s 5-109 is ultimately concerned with the *nature of the documents tendered*, rather than the identity of the fraudulent party.

### B The *UNCITRAL Convention*

The *UNCITRAL Convention* was opened for signature by the General Assembly of the United Nations on 11 December 1995.<sup>20</sup> The Convention came into effect on 1 January 2000 after having been adopted by the requisite five nations.<sup>21</sup>

The *UNCITRAL Convention* applies to 'an international undertaking'<sup>22</sup> such as an independent guarantee or a standby letter of credit.<sup>23</sup> It can also apply to commercial letters of credit if the parties expressly state that their letter of credit is subject to it.<sup>24</sup> Article 19 of the *UNCITRAL Convention*, entitled 'Exception to Payment Obligation', provides that the fraud rule can be invoked if one of the following is 'manifest and clear':

- (a) where *any document* is not genuine or has been falsified;
- (b) where no payment is due on the basis asserted in the demand and the supporting documents; or
- (c) where, judging by the type and purpose of the undertaking, the demand has no conceivable basis.

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18 Henry Gabriel, 'The Revision of the Uniform Commercial Code in the United States and Its Implications for Australia' (1998) 24 *Monash University Law Review* 291, 316. This is also indicated in The National Conference of Commissioners on Uniform State Laws and the American Law Institute, *Official Comment on s 5-109*: 'This codification makes clear that fraud must be found *either in the documents or must have been committed by the beneficiary on the issuer or the applicant*': [1] (emphasis added).

19 Turner, above n 11, 229; Wunnicke *et al.*, above n 3, 177.

20 GA Res 50/48, 50 UN GAOR (Supp No 49), Un Doc A/Res/50/48 (1995).

21 As of 15 April 2001, the *UNCITRAL Convention* has been adopted by Ecuador, El Salvador, Kuwait, Panama and Tunisia, and signed by Belarus and the United States.

22 Article 1(1).

23 Article 2(1).

24 Article 1(2). See Lars Gorton, 'Draft *UNCITRAL Convention on Independent Guarantees*' [1997] *Journal of Business Law* 240, 244, n 11: 'Some voices were raised to expand the Convention to also cover documentary credits generally, but they were in a very clear minority'.

With respect to the application of the fraud rule, the *UNCITRAL Convention* – like the *UCC* – is mainly concerned with the nature of the documents. It does not mention the identity of the fraudulent party. Under art 19, the fraud rule applies if ‘any document is not genuine or has been falsified’, regardless of the identity of the party perpetrating the fraud.

#### IV FRAUD ON THE PART OF THE APPLICANT

Fraud by the applicant (‘applicant fraud’) may be perpetrated either by the applicant itself, or by the applicant in concert with another party or the beneficiary. However, if fraud is perpetrated by the applicant and the beneficiary together or, even where the beneficiary does not participate, with the knowledge of the beneficiary, it will in law be regarded as fraud on the part of the beneficiary and the fraud rule will be held to apply.<sup>25</sup> Accordingly, the following discussion of applicant fraud will only address cases of fraud perpetrated by the applicant without the knowledge of the beneficiary.

The American case of *Comdata Network Inc v First Interstate Bank* (‘*Comdata*’)<sup>26</sup> provides a primary example. In that case, Comdata Network (‘Comdata’), the plaintiff, was a corporation engaged in money transfer services (by providing money to truck drivers while they were ‘on the road’). Whenever Comdata entered into a business relationship with a trucking company, it required a letter of credit, or some other type of security. C & K Transport (‘C & K’) was Comdata’s client, and had a letter of credit issued on its account by First Interstate Bank (‘FIB’), the defendant, in favour of Comdata as security for Comdata’s services. C & K also took out a loan from FIB, secured by liens on C & K’s tractors and trailers. C & K’s owners allegedly defrauded FIB (in respect of the loan) by transferring C & K’s assets to a different corporation, Eagle Express, and then halting repayment of the loan. C & K eventually went into bankruptcy. When C & K defaulted, FIB cancelled its letter of credit. Comdata demanded payment from FIB prior to the cancellation of the letter of credit, but was refused. Comdata therefore brought an action against FIB for wrongful dishonour and succeeded at trial.

On appeal, the Supreme Court of Iowa affirmed the decision of the lower court. After citing a number of authorities emphasising the principle of independence, the court stated:

C & K’s misconduct, in other words, *is not relevant to this dispute which is between Comdata and the bank*. The rule is settled that ‘the claim of a beneficiary of a letter of credit is not subject to [defences normally applicable to third-party contracts]. The issuer must honour his drafts even if the *issuer’s customer* has failed to pay agreed fees, *has defrauded the issuer*, has unequivocally repudiated, and so on.’<sup>27</sup>

In *Comdata*, the applicant (C & K) was the only fraudulent party. The Court ruled that applicant fraud was outside the scope of the fraud rule, basing its

25 See, eg, *Contronic Distributors Pty Ltd v Bank of New South Wales* [1984] 3 NSWLR 110.

26 497 NW2d 807 (1993).

27 *Ibid* 809 (emphasis added).

judgment chiefly upon the principle of independence. In the view of the Court, the letter of credit was a transaction which was separate and independent from other transactions and C & K, the applicant, was not a party to the letter of credit. As such, fraud perpetrated by C & K against the issuer could not serve as grounds for the application of the fraud rule to the letter of credit between Comdata and FIB.<sup>28</sup>

*Aetna Life & Casualty Co v Huntington National Bank* ('Aetna')<sup>29</sup> provides another example of applicant fraud. In that case, Huntington National Bank ('HNB'), the defendant, was the primary lender to Kyova Corporation ('Kyova') and its subsidiary Tri-State. Kyova was 90 per cent owned by a Mr Tyler. When the financial situation of Kyova and Tri-State deteriorated, Tyler offered to provide HNB with a letter of credit that would protect HNB from loss exposure, to which HNB agreed.

Tyler applied for an irrevocable letter of credit in favour of HNB from Algemene Bank Nederland NV ('ABN'), an international banking institution with its principal office in Amsterdam and a branch office in Pittsburgh. The branch manager at the ABN Pittsburgh office, Mr Soels, had authority to lend and extend letters of credit up to US\$300 000 without the approval of ABN's main office. On 28 October 1981, HNB received from ABN's Pittsburgh office a telex confirmation, signed by Soels and the assistant manager of the office, Mr Hammar, stating that ABN had issued an irrevocable standby letter of credit in the amount of US\$2 million. HNB followed its customary verification procedures to confirm the authenticity of the letter of credit and the signatures, and was unable to detect any irregularities.

HNB used the letter of credit as security for loans made to Kyova and Tri-State. The loans totalled approximately US\$2 million by January 1992, at which time ABN informed HNB that there appeared to be irregularities in the issuance of the letter of credit. On 15 January 1992, HNB demanded payment by ABN of approximately US\$2 million on the letter of credit. ABN paid the draft to HNB but reserved its rights and filed a claim in the paid amount on its fidelity bond with the plaintiff, Aetna Life & Casualty Co ('Aetna'), which provided fidelity bond coverage to ABN against the misdeeds of its employees.

Aetna settled the bond claim with ABN, took an assignment of the rights and commenced a lawsuit against HNB in the US District Court for the Southern District of Ohio, seeking recovery of its payment to ABN under the fidelity bond. The grounds of Aetna's claim were that HNB knew or should have known of the precarious financial difficulties of all corporations closely related to Tyler, and had therefore conspired with Tyler to procure the letter of credit despite the fact that it knew or should have known that the letter of credit was fraudulent. The claim was rejected and Aetna appealed.

The Sixth Circuit Court confirmed the judgment of the trial court, stating that 'the legislative history of [s] 5-114(2) indicates that "fraud in the transaction"

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28 White and Summers, above n 17, 180. See also Philip W Thayer, 'Irrevocable Credits in International Commerce: Their Legal Effects' (1936) 36 *Columbia Law Review* 1326, 1330, n 21.

29 934 F2d 695 (6<sup>th</sup> Cir, 1991).



was meant to embody *an exception to the independence principle ... based solely on the beneficiary's misperformance of the underlying contract*'.<sup>30</sup> As for the agreement by HNB to accept the letter of credit, the Court observed that

[o]bviously, HNB knew that its Tyler-related customers were in precarious financial straits. That was HNB's reason for demanding that Tyler furnish it with additional security. When Tyler produced a letter of credit from another bank ... HNB made the customary checks to determine that the letter was in proper form and the signatures were authentic. There was no concealment of the purpose for which HNB wanted and would use the letter of credit.<sup>31</sup>

The Court concluded that

ABN failed to produce evidence of fraud in the transaction within the meaning of s 1305.13 [Prior UCC Article 5, s 5-114] and, thus, it had no defence to HNB's demand for payment under the irrevocable letter of credit. Aetna, as assignee of ABN's rights, stands in no better position.<sup>32</sup>

The facts in *Aetna* are slightly different from those in *Comdata*. The issuer's employees may have conspired with the applicant in issuing the letter of credit in *Aetna*. However, the decision in *Aetna* also supports the view that applicant fraud is outside the scope of the fraud rule (although the Court based its judgment on different grounds). The Court ruled that the application of the fraud rule required the beneficiary to be the wrongdoer.<sup>33</sup> In the view of the Court in *Aetna*, the fraud rule should only be applied in cases where fraud has been perpetrated by the beneficiary, and not in cases in which fraud has been committed by the applicant, or the applicant together with other parties, without the knowledge of the beneficiary.

Although the grounds for each decision were different, both *Comdata* and *Aetna* are consistent with the statutory provisions discussed above. In both cases, the applicants' fraud occurred in the application agreement or otherwise in the process of procuring the letter of credit. The applicants might have induced the issuers or even conspired with the issuers' officers into issuing the letters of credit, but the fraud had nothing to do with the letters of credit themselves or the presentation of documents. If the judgments had expressed this connection explicitly, that is, that the applicants' fraud had nothing to do with the *documents tendered* (ie, with whether or not the tendered documents were genuine), this point would perhaps have been more obvious.

It can also be seen from both cases that the fraud rule will not be applied to applicant fraud even if an innocent beneficiary has learned about the fraud involved before presentation of the documents or demand for payment. However, it is not clear whether applicant fraud will continue to remain beyond the scope

30 Ibid 700 (emphasis added), citing 'Note: Fraud in the Transaction: Enjoining Letters of Credit during the Iranian Revolution' (1980) 93 *Harvard Law Review* 992, 1004.

31 *Aetna*, 934 F2d 695, 701-2 (6<sup>th</sup> Cir, 1991).

32 Ibid 703.

33 The view of the court in *Aetna* mirrors that of the court in *InterFirst Bank Greenspoint v First Federal Savings & Loan Association* 747 P2d 129 (1987), where the defendant, the issuer, refused to pay the letter of credit, alleging that its president did not have the authority to issue the credit and that the plaintiff, the beneficiary, should have discovered the situation. The Court rejected this argument and ruled that "fraud in the transaction"... must stem from the conduct of the beneficiary against the customer, not the customer against the issuer of the letter of credit': 134.

of the fraud rule if the beneficiary *continues* to take advantage of the letter of credit and maintains its business relationship after learning about the applicant's fraud. For example, in *Aetna*, when HNB was notified that there appeared to be irregularities in the issuance of the letter of credit, HNB immediately presented a draft and demand for payment. What if it had continued making loans to Tyler's companies after knowing of the fraud? In such a case, it is submitted, the fraud should fall within the scope of the fraud rule and should be treated as beneficiary fraud. Thus the time at which the beneficiary acquired knowledge of the applicant's fraud is crucial to the application of the fraud rule.

## V THIRD PARTY FRAUD: THE CASE OF *UNITED CITY MERCHANTS*

As discussed above, a typical letter of credit arrangement involves three parties: the applicant, the beneficiary and the issuer. However, in most letter of credit cases further parties are involved; they can be classified into two groups. The first comprises those parties who are directly involved in the letter of credit payment process, for example, banks, such as the negotiating bank, the confirming bank or the advising bank. The second group comprises those parties who are not directly involved in the letter of credit transaction, but participate in other transactions or activities related to it. So, in a commercial letter of credit transaction, parties such as insurers, carriers and loading brokers are not directly involved, but may participate in preparing documents for the presentation or demand for payment on the letter of credit. In the following discussion the parties in the second group will be treated as third parties, and fraud perpetrated by them will be regarded as 'third party fraud'.

As third party fraud in letter of credit transactions occurs only in a minority of cases '[t]here is a remarkable dearth of authority on this question'.<sup>34</sup> In 1981, Stephenson LJ noted that:

There is ... no authority, English or American, directly deciding that the fraud of a third party such as the maker of a false document is or is not a good defence to a claim to be paid in accordance with the terms of a letter of credit. Most of the cases of fraud are ... cases of fraud by a seller hoping to be paid for rubbish or, at the least, defective goods before the true state of affairs was known which his own misdescription had concealed.<sup>35</sup>

34 Roy M Goode, 'Reflections on Letters of Credit' (Pt 1) [1980] *Journal of Banking Law* 291, 294.

35 *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd's Rep 604, 620 (Stephenson LJ, Court of Appeal). In *United City Merchants* [1983] 1 AC 168, 182, Lord Diplock in the House of Lords made a similar statement:

[T]here is no direct authority to be found either in English or Privy Council cases or among the numerous decisions of courts in the United States of America ... So the point falls to be decided by reference to first principles as to the legal nature of the contractual obligations assumed by the various parties to a transaction consisting of an international sale of goods to be financed by means of a confirmed irrevocable documentary credit.

However, the issue was raised and tested in the English case of *United City Merchants*. Because of its significance, *United City Merchants* warrants detailed treatment.

### A The Facts of the Case

The facts relevant to the issue of third party fraud in *United City Merchants* are as follows.<sup>36</sup> In October 1975, Glass Fibres and Equipment Ltd ('GFE'), an English company, entered into a contract to sell glass fibre making equipment to a Peruvian company named Vitrorefuerzos SA ('Vitro'). Payment was to be made by an irrevocable letter of credit issued by the Banco Continental SA of Peru and confirmed by the Royal Bank of Canada ('RBC'). GFE assigned their rights, entitlements and benefits under the letter of credit to United City Merchants ('UCM'), and notice of the assignment was given to the banks. Shipment, after some amendments, was to be from London to Callao on or before 15 December 1976.

Once the pieces of equipment were complete, GFE sent them for temporary storage to their forwarding agents. GFE told the forwarding agents, who in turn told a Mr Baker, an employee of E H Mundy & Co (Freight Agencies) Ltd, the details of the requirements for the bills of lading, including the latest shipment date. However, the goods were not shipped until 16 December (not 15 December, as required in the contract). But Baker, not acting for, and without the knowledge of the sellers or the consignees of the letter of credit, fraudulently entered 15 December as the date of shipment on a notation stamped on the bill of lading.

When documents were presented for payment by UCM, RBC refused to pay on the basis that it had information suggesting that shipment had not in fact been

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36 This case involves another important issue regarding the law of letters of credit: whether payment of a letter of credit should be enforced if the underlying contract is illegal. In *United City Merchants*, Vitro (the buyers) requested, and GFE (the sellers) agreed, to double the purchase price of their contract in the related documents and transfer the excess amount to a draw-down account in favour of an American company in Miami closely associated with Vitro. This was in order to avoid the Peruvian foreign exchange control regulations, under which it was prohibited to withdraw money from Peru for transfer to the US. It was therefore argued that the underlying contract between GFE and Vitro was illegal and/or unenforceable, as its enforcement would be in violation of Peru's exchange control regulations and the *Bretton Woods Agreement Order 1946*. This argument was successful in the first instance, and partly successful on appeal, in the sense that part of the letter of credit was allowed to be paid, and part was enjoined. The trial court found that the sales contract between GFE and Vitro was an exchange contract because it was a monetary transaction in disguise, and payment made under the letter of credit would give effect to an exchange contract in violation of Peruvian law and the *Bretton Woods Agreement Order 1946*. Therefore the court held that the letter of credit transaction was unenforceable. The Court of Appeal agreed that the sales contract was a 'monetary transaction in disguise' and held that the letter of credit was 'part and parcel' of the scheme to evade the Peruvian foreign exchange regulations. However, the Court decided that it would enforce the part of the sales contract which was not contrary to Peruvian law by allowing the plaintiff to recover the sales price of the equipment. The House of Lords upheld the decision of the Court of Appeal on this point. As this issue is outside the scope of this article, for detailed discussion see, eg, Linda C Cansler, 'International Letters Of Credit: The American Accord Case: Fraud Exception Limited' (1982) 17 *Texas International Law Journal* 229, 241; Gerald T McLaughlin, 'Letters Of Credit and Illegal Contracts: The Limits of the Independence Principle' (1989) 49 *Ohio State Law Journal* 1197.

effected as indicated in the bill of lading. The plaintiffs then brought the action against the defendants for wrongful dishonour. In its defence, RBC contended, *inter alia*, that the presentation was fraudulent in that the goods were loaded on board the *American Accord*<sup>37</sup> on 16 December and not on 15 December as agreed.

## B The Judgments

Justice Mocatta of the Queen's Bench Division, after citing a series of authorities including *Sztejn v J Henry Schroder Banking Corp* ('*Sztejn*'),<sup>38</sup> accepted that, although the issuing of a letter of credit constitutes a bargain between the issuer and the beneficiary which imposes an absolute obligation on the issuer to pay the amount of the letter of credit upon the presentation of conforming documents irrespective of any dispute between the parties about the underlying transaction, there was 'an exception to the strict rule: the bank ought not to pay under the credit if it knows that *the documents* are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment'.<sup>39</sup>

But because Mocatta J found that 'Mr Baker was not the plaintiffs' agent for making out the bills of lading and that there was no fraud on the part of the plaintiffs in presenting them',<sup>40</sup> relying on the principle of *ex turpi causa non oritur actio*, his Honour held that the case was vitally different from the situation in *Sztejn*, and therefore rejected the defendants' arguments, concluding:

Where there has been personal fraud or unscrupulous conduct by the seller presenting documents under the letter of credit, it is right that a bank should be entitled to refuse payment against apparently conforming documents on the principle *ex turpi causa non oritur actio*. But here I have held that there was no fraud on the part of the plaintiffs, nor can I, as a matter of fact, find that they knew the date on the bills of lading to be false when they presented the documents. ... Accordingly, I take the view ... that the plaintiffs are ... entitled to succeed.<sup>41</sup>

Justice Mocatta's decision was reversed by the Court of Appeal, which construed the applicant's mandate to the bank as only to pay against the presentation of genuine documents; therefore the bank was justified in refusing to pay against forged documents. The Court held that the fact that the fraud had been committed by a third party could not prevent the bank from raising the defence of fraud against the beneficiary. Lord Ackner stated:

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37 This case is often cited as *The American Accord* because of the name of the ship involved.

38 31 NYS2d 631 (1941). *Sztejn* is the landmark case in the course of the development of the fraud rule in the law of letters of credit. It has not only been codified in the *UCC* in the US, but has also been followed or considered in numerous letter of credit fraud cases throughout the world.

39 *United City Merchants v Royal Bank of Canada* [1979] 1 Lloyd's Rep 267, 276 (emphasis added), quoting Lord Denning in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976, 982.

40 *Ibid* 278.

41 *Ibid*.

[T]he buyer, unless otherwise agreed, cannot be deemed to have authorised the banker to pay against documents which are known to be forged. If the documents are forged, then obviously they are not valid ... 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...

[I]f I am correct ... then it must follow that if the bank knows that a bill of lading has been fraudulently completed by a third party, it must treat that as a nonconforming document in the same way as if it knew the seller was party to the fraud.<sup>42</sup>

The Court of Appeal also considered the issue of risk allocation between innocent parties. In relation to that issue Stephenson LJ observed:

Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for documents they present, it is important to all concerned that those documents should accord, not merely with the requirements of the credit but with the facts, and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer.<sup>43</sup>

Stephenson LJ went on to say that

[e]ven though the Judge was not able to find that Baker was the plaintiffs' agent in making the bill of lading for presentation to the defendants, the plaintiffs were the innocent party who put him in the position in which he made the bill, and made it fraudulently, and in my judgment it is they rather than the defendants, already impoverished by the dollars remitted to the United States of America, who should bear the loss.<sup>44</sup>

The Court also considered the bank's security interest resulting from the fraud by a third party under a letter of credit, in relation to which Ackner LJ stated:

A banker cannot be compelled to honour a credit unless all the conditions precedent have been performed, and he ought not to be under an obligation to accept or pay against documents which he knows to be waste paper. 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>45</sup>

Lord Justice Griffiths concurred with Lord Justice Ackner's assessment of the relevance of the bank's security interest, and went on to consider the issue of the identity of the fraudulent party.

The bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the documents are forgeries it must refuse to accept them. It may be that the party presenting the documents has himself been duped by the forger and believes the documents to be genuine but that surely cannot affect the bank's right to refuse to accept the forgeries. *The identity of the forger is immaterial. It is the fact that the documents are worthless that matters to the bank.* In such a case the right of the bank to refuse payment does not rest upon

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42 *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd's Rep 604, 628-9. Lord Stephenson approached the point as follows: 'whether or not a forged document is a nullity, it is not a genuine or valid document entitling the presenter of it to be paid and if the banker to which it is presented under a letter of credit knows it to be forged he must not pay': 623.

43 Ibid 620.

44 Ibid 623.

45 Ibid 628 (citations omitted).

the application of the maxim *ex turpi causa non oritur actio*, but upon the presentation of genuine documents in accordance with the requirements of the letter of credit. If the documents presented are fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay.<sup>46</sup>

The Court of Appeal concluded that the decision of Mocatta J had put the bank in a curious position:

The latest date for shipment of the machinery was [December] 15, 1976. The machinery was in fact shipped on [December] 16, 1976, and if the bill of lading had shown that date the bank would have refused to pay upon presentation of the documents because of the strict rule that the documents must comply in every respect with the terms of the letter of credit ... [I]t would be a strange rule that required a bank to refuse payment if the document correctly showed the date of shipment as [December] 16, yet obliged the bank to make payment if it knew that the document falsely showed the date of shipment as [December] 15 and that the true date was [December] 16.<sup>47</sup>

However, on appeal, the House of Lords unanimously overruled the decision of the Court of Appeal and restored that of Mocatta J on this issue. Lord Diplock, delivering the opinion of the Court,<sup>48</sup> began by reiterating the principle of independence through an emphasis on the autonomous and 'paper-driven' nature of the letter of credit arrangement, saying:

It is trite law that there are four autonomous though interconnected contractual relationships involved. (1) The underlying contract for the sale of goods ... (2) the contract between the buyer and the issuing bank ... (3) if payment is to be made through a confirming bank, the contract between the issuing and confirming bank ... and (4) the contract between the confirming bank and the seller. ... Again, it is trite law that in contract (4), with which alone the instant appeal is directly concerned, the parties to it, the seller and the confirming bank, 'deal in documents and not in goods', as article 8 of the Uniform Customs [and Practice for Documentary Credits (1974)] puts it.<sup>49</sup>

His Lordship went on to observe that

[t]o this general statement of principle ... there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material misrepresentations of fact that to his knowledge are untrue.<sup>50</sup>

The House of Lords held that '[t]he exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio*'.<sup>51</sup> As 'the sellers [were] unaware of the inaccuracy of Mr Baker's notation of the date at which the goods were actually on board *American Accord*' and as they in fact 'believed that it was true and the goods had actually been loaded on or before December 15, 1976, as required by the documentary credit', the beneficiaries in the case were innocent.<sup>52</sup>

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46 Ibid 632.

47 Ibid (Griffiths LJ), (citations omitted).

48 Lords Fraser, Russell, Scarman and Bridge concurred.

49 *United City Merchants* [1983] 1 AC 168, 183.

50 Ibid.

51 Ibid 184.

52 Ibid.

Accordingly, their Lordships held that '[t]he instant case ... does not fall within the fraud exception'.<sup>53</sup>

RBC had argued that a confirming bank was not under any obligation to pay to the beneficiary the sum stipulated in the credit against the presentation of documents 'if the *documents* presented, although conforming on their face with the terms of the credit, nevertheless *contain some statement of material fact that is not accurate*'.<sup>54</sup> This argument was rejected by Lord Diplock, who stated:

It has, so far as I know, never been disputed that as between confirming bank and issuing bank and as between issuing bank and the buyer the contractual duty of each bank under a confirmed irrevocable credit is to examine with reasonable care all documents presented in order to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit, and if they do so appear, to pay to the seller/beneficiary by whom the documents have been presented the sum stipulated by the credit ...

It would be strange from the commercial point of view, although not theoretically impossible in law, if the contractual duty owed by confirming and issuing banks to the buyer to honour the credit on the presentation of apparently conforming documents despite the fact that they contain inaccuracies or even are forged, were not matched by a corresponding contractual liability of the confirming bank to the seller/beneficiary (in the absence, of course, of any fraud on his part) to pay the sum stipulated in the credit upon presentation of apparently conforming documents.<sup>55</sup>

His Lordship also rejected RBC's amended argument, which was narrower and claimed that if any of the documents presented by the beneficiary contained a material misrepresentation of fact, known to be false by the issuer of the document and intended to deceive persons into whose hands the document might come, the confirming bank was under no liability to honour the credit, even though the persons whom the issuer of the document intended to, and did, deceive included the beneficiary itself. In rejecting this narrower argument, Lord Diplock stated:

[I]f the broad proposition for which the confirming bank has argued is unacceptable for the reasons ... discussed, what rational ground can there be for drawing any distinction between apparently conforming documents that, unknown to the seller, in fact contain a statement of fact that is inaccurate where the inaccuracy was due to inadvertence by the maker of the document, and the like documents where the same inaccuracy had been inserted by the maker of the document with intent to deceive, among others, the seller/beneficiary himself?<sup>56</sup>

Finally, the House of Lords held that the legal effect of the forgery in the bill of lading was not such as to make the bill a 'nullity';<sup>57</sup> therefore neither its validity nor the bank's security interest would be affected by the forgery. Although the issuing date on the bill of lading was false, the goods had been

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<sup>53</sup> Ibid.

<sup>54</sup> Ibid (emphasis added).

<sup>55</sup> Ibid 186-7.

<sup>56</sup> Ibid 187.

<sup>57</sup> In Lord Diplock's view, a forged document would be a 'nullity' if it were so forged as to deprive it of all legal effect: *ibid*. His Lordship also stated that he 'would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case': *ibid* 188.

shipped and the bill of lading gave the right of possession to the holder. According to Lord Diplock:

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 was a valid transferable receipt for the goods giving the holder a right to claim them at their destination, Callao, and was evidence of the terms of the contract under which they were being carried.<sup>58</sup>

[T]he realisable value on arrival at Callao of a glass fibre manufacturing plant made to the specification of the buyers could not be in any way affected by its having been loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976.<sup>59</sup>

## VI A CRITICAL VIEW

Each of the courts that dealt with the case of *United City Merchants* approached the issue of third party fraud differently and reached a different conclusion. The trial court, relying on the principle of *ex turpi causa non oritur actio*, concluded that only fraud by the beneficiary could invoke the fraud rule. Justice Mocatta therefore did not apply the fraud rule in the case at hand because a third party had perpetrated the fraud.

The Court of Appeal addressed the issue by analysing the nature of the tendered documents, holding that it was the nature of the documents, not their origin, which mattered. If the documents were not genuine, or were in some respects forged, the fraud rule should be applied regardless of who had perpetrated the fraud.

Adopting a similar approach to Mocatta J, and relying on the doctrine of *ex turpi causa non oritur actio*, the House of Lords held that the case was outside the scope of the fraud rule and therefore the confirming bank was not entitled to refuse payment.

It has been said that, as a result of the House of Lords' decision,

English law ... appears to protect shrewd sellers who utilise the services of third parties discreet enough to keep their fraudulent practices to themselves. The law in effect encourages sellers not to inquire into the details of the activities of third parties involved in their transactions so long as the bills of lading appear valid, for any knowledge of wrongdoing would jeopardise the sellers' chances of being paid. A bank which receives firm evidence external to the documents of fraud by a third party does not even have the option of refusing to honour a credit governed by English law as stated in the *American Accord*.<sup>60</sup>

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58 Ibid 188.

59 Ibid 186. It has been unfortunately suggested that '[t]o the shipping industry, this case, by contrast with *Sztejn*, might be analogous to an inconsequential "white lie" specifically designed to rectify the unduly burdensome formalities inherent in maritime venture financing': Joseph A Walsh II, 'Documentary Maritime Fraud: Redefining the Standard' (1989) 6 *Arizona Journal of International and Comparative Law* 223, 250.

60 Guy G Smith, 'Irrevocable Letters of Credit and Third Party Fraud: The American Accord' (1983) 24 *Virginia Journal of International Law* 55, 70-1.



This is clearly not an ideal result.<sup>61</sup> Considering all three decisions, it is, with respect, submitted that the judgment of the Court of Appeal is more convincing<sup>62</sup> than those of the House of Lords and Mocatta J for the following reasons.

### A The Centrality of Documents

Article 4 of the *UCP* states that in credit transactions 'all parties concerned deal with documents, and not with goods, services or performances to which the documents may relate'. As documents play such a vital role in letter of credit transactions, the standard and requirements of the documents must be high and strictly maintained. Documents must not only meet the terms and conditions of the credit but must also be genuine and valid, and reflect the real facts of the transaction involved. The genuineness of the documents is the foundation of the success of letters of credit.<sup>63</sup>

The historical development of the fraud rule shows that it is the nature of the documents which matters, not the identity of the perpetrator. In an early American case of letter of credit fraud, *Old Colony Trust Co v Lawyers' Title and Bank Trust Co*,<sup>64</sup> a bank's refusal to honour a fraudulent warehouse receipt was upheld on the basis that 'when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognise such a document as complying with the terms of a letter of credit'.<sup>65</sup> In another American case, *Maurice O'Meara Co v National Park Bank*,<sup>66</sup> the New York Court of Appeals stated that '[t]he bank's obligation was to pay sight drafts when prescribed if accompanied by genuine documents specified in the letter of credit'.<sup>67</sup> In *Sztejn*, the court stated that 'the application of this doctrine [the principle of independence] presupposes that the documents

61 Unfortunately, this position has been adopted in the leading Canadian case *Bank of Nova Scotia v Angelica-Whitewear Ltd* (1987) 36 DLR (4th) 161. For a comment on the case see John F Dolan, 'Commentary on Legislative Developments in Letters of Credit Law: An Interim Report' (1992) 8 *Banking and Finance Law Review* 53.

62 See also Clive M Schmitthoff, 'Export Trade' [1981] *Journal of Banking Law* 381, 383: 'The decision of the Court of Appeal represents sound commercial sense. In particular, its decision that a bank should not honour a letter of credit if, to its knowledge, a fraudulent bill of lading is tendered, is correct, and it is immaterial in this connection whether the seller was a party to the fraud or the fraud was committed by a third party without the knowledge of the seller. Banking business could not be carried on with the necessary expedition if the bank were compelled to make detailed inquiries into the nature of the fraud'.

63 *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd's Rep 604, 620. See A G Davis, *The Law Relating to Commercial Letters of Credit* (3<sup>rd</sup> ed, 1963) 149: 'If the documents are forged, then obviously they are not valid. The buyers' instructions to the banker must be construed as requiring the acceptance of valid documents only, and the bankers' promise to the seller must be similarly construed. Any other construction would defeat the whole intention behind letter of credit transactions'. See also Maurice Megrah, 'Risk Aspects of the Irrevocable Documentary Credit' (1982) 24 *Arizona Law Review* 255, 257: 'The implicit obligation of the banker is to pay against "genuine" conforming documents; otherwise credits would be a sham and open to all sorts of chicanery'.

64 297 F2d 152 (1924).

65 *Ibid* 158 (emphasis added).

66 146 NE 636 (NY Ct App, 1925).

67 *Ibid* 639 (emphasis added).

accompanying the draft are genuine and conform in terms to the requirements of the letter of credit'.<sup>68</sup>

This is also the view expressed in United Kingdom cases. In *Edward Owen Engineering Ltd v Barclays Bank Int Ltd*,<sup>69</sup> Lord Denning MR held that 'the bank ought not to pay under the credit if it knows the *documents are forged* or that the request for payment is made fraudulently in circumstances when there is no right to payment'.<sup>70</sup> In *Etablissement Esefka International Anstalt v Central Bank of Nigeria*,<sup>71</sup> it was stated that:

*The documents ought to be correct and valid* in respect of each parcel. If that condition is broken by forged or fraudulent documents being presented — in respect of any parcel — the defendants [the bank] have a defence in point of law against being liable in respect of that parcel.<sup>72</sup>

Under both the *UCC* and the *UNCITRAL Convention*, it is the nature of the documents, not the identity of the fraudulent party, which matters: the fraud rule applies if the documents tendered are forged or fraudulent.

This view makes commercial sense. The letter of credit is, after all, an instrument of payment. It is designed to facilitate the underlying transaction between the applicant and the beneficiary. The documents required under the letter of credit perform particular functions. Under a commercial letter of credit transaction, normally a commercial invoice and a set of bills of lading are required. The commercial invoice is the statement by the beneficiary of the merchandise shipped under the sales contract. The bill of lading represents the carrier's receipt for what has been received for shipment and also serves as the document of title to the shipment. When the applicant asks the bank to issue the letter of credit and pay the beneficiary in exchange for documents, it expects that the documents will be those evidencing the performance by the beneficiary of its obligation in the underlying contract. The bank, although it may also take other property as security, normally takes the documents as security when the letter of credit is issued and paid.

In order for the letter of credit mechanism to perform these functions, the first and foremost requirement is that the relevant documents be genuine, evidencing the truth of the fact. Only genuine documents can satisfy the bargain entered into by the parties and can be accepted by issuers and applicants, whose interests otherwise will not properly be protected. Trusting that genuine documents will be tendered, the applicant authorises the issuer to pay the beneficiary, and the issuer agrees to pay the beneficiary when documents conforming on their face to the requirements of the letter of credit are received. So, if documents cannot be taken to mean what they say, the commercial foundation of letters of credit will vanish. Although it is not explicitly stated in every letter of credit that the documents should be genuine, it is logically and generally recognised that there

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68 31 NYS2d 631, 634 (1941) (emphasis added).

69 [1978] 1 All ER 976.

70 Ibid 982 (emphasis added).

71 [1979] 1 Lloyd's Rep 445.

72 Ibid 447 (Lord Denning MR), (emphasis added).

is an implied warranty by the beneficiary that the documents tendered are genuine.<sup>73</sup>

In *United City Merchants*, the House of Lords took the view that the issuer (and the confirmer) owed a contractual duty to the applicant to honour the credit when documents that conformed on their face to the letter of credit were presented, despite the fact that the documents contained inaccuracies or even forgeries. The House of Lords further held that the bank owed a corresponding contractual duty to the beneficiary to pay the sum stipulated in the letter of credit upon presentation of apparently conforming documents if there was no fraud on the part of the beneficiary. According to the House of Lords then, because the issuer is entitled to make payment against documents that conform on their face with full recourse against the applicant if the documents turn out to be forgeries or to include fraudulent statements, so long as the forgery or fraudulent statement does not appear on the face of the documents, the beneficiary is entitled to payment from the issuer when it presents documents that conform on their face (despite the fact that they contain forgeries or fraudulent statements) *provided that* the beneficiary is not the fraudulent party.

It is submitted, with respect, that this view is not a cogent interpretation of the law of letters of credit. It is incorrect to say that because '[b]anks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s)',<sup>74</sup> the beneficiary also assumes no liability for the genuineness and validity of the documents for two reasons. First, the presentation of genuine and valid documents is, as just mentioned, part of the bargain that the applicant and the issuer agree to with the beneficiary. Second, the rule that 'all parties concerned deal with documents' should apply only to transactions directly involved in the payment process, not to the transactions that generate documents. It is difficult to see how the letter of credit system could remain viable if the beneficiary is not responsible for the genuineness of the documents presented. When a bank knows that the documents tendered are forged or fraudulent it should be entitled to refuse to honour the presentation,<sup>75</sup> regardless of the identity of the fraudulent party.

The House of Lords in *United City Merchants* found that the realisable value of the subject of the underlying sales contract 'could not be in any way affected by its having been loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976'.<sup>76</sup> The Court therefore dismissed the bank's argument that a forged document would harm its security interest. These conclusions are, with respect, less than cogent: it cannot be said that the rule is that fraud or forgery is to be allowed provided that the consequence is not so serious as to

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73 See, eg, J P Benjamin, *Benjamin's Sale of Goods* (5<sup>th</sup> ed, 1997) 1715; Harfield, above n 3, 80; Reade H Ryan, 'Who Should Be Immune from the "Fraud in the Transaction" Defense in a Letter of Credit Transaction' (1990) 56 *Brooklyn Law Review* 119, 126.

74 Article 15 of the UCP.

75 See Anu Arora, 'False and Forged Documents under a Letter of Credit' (1981) 2 *Company Lawyer* 66, 66-7.

76 [1983] 1 AC 168, 186.

affect the value of the underlying contract.<sup>77</sup> This reasoning, which links the performance of the letter of credit with that of the underlying transaction, is also against the principle of independence.

### B Risk Allocation between Innocent Parties

It is widely acknowledged that letters of credit are instruments employed by contractual parties to reduce and allocate their risks through negotiation. The widespread use of letters of credit over a long period of time has created clear expectations among parties as to their operation and requirements.<sup>78</sup> Although under a letter of credit transaction applicants and issuers agree to take various risks in the normal course of business, they should not legally be required to take the risk of accepting falsified documents; they bargain on the basis of genuine and valid documents. The beneficiary 'has a duty to tender documents which are in order, and the fact that he acted in good faith in tendering forged documents is thus irrelevant'.<sup>79</sup> The state of mind of the beneficiary should not affect the issue.<sup>80</sup> However,

[t]his fundamental point appears to have been overlooked by Mocatta J [and later by the House of Lords] in *The American Accord* when he held that the beneficiary was entitled to collect payment despite the insertion of a fraudulent shipping date on the bill of lading, since the fraud had been committed by the loading broker who was the agent of the carrier, not the seller/beneficiary.<sup>81</sup>

Considerations of commercial policy also justify placing the risk of loss as a result of third party fraudulent activity on the beneficiary.<sup>82</sup> The rationale for the final decision in *United City Merchants* was that the fraud had been committed by a third party without the beneficiary's knowledge. However, the facts of the case show that all the parties directly involved in the letter of credit transaction — the applicants, the beneficiaries and the banks — were innocent. Only Baker, a third party, was guilty of fraud. Under such circumstances, who should suffer any resulting loss? What if Baker had stolen the goods, replaced them with worthless rubbish and issued bills of lading that seemed to conform on their face with the terms of the letter of credit? Although the contractual relationship with the loading agents was not specifically discussed in the case, the facts indicate that the beneficiaries had a closer relationship with them than the banks or the applicants, who were much more remote in relation to Baker and his employer. In such circumstances, it is the beneficiaries 'who put [the loading broker] in the position in which he made the bill, and made it fraudulently, and ... it is they ... who should pay'.<sup>83</sup>

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77 'That case suggests that English courts are not exceedingly concerned with the issuer's security. Although the fraud in *United City Merchants* related to a date, the rule of the case apparently would apply if the bills misrepresented the goods': Dolan, above n 3, 8-23, n 111.

78 Smith, above n 60, 72.

79 Goode, above n 34, 294. See also *ibid* 62.

80 See generally Smith, above n 60.

81 Goode, above n 34, 294 (citations omitted).

82 Smith, above n 60, 82.

83 *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd's Rep 604, 623 (Stephenson LJ).

From a public policy perspective also, third party fraud ought to come within the scope of the fraud rule and the beneficiary ought to be the party bearing any loss resulting from such fraud. A rule of this kind would provide an incentive for the beneficiary, who normally receives documents from third parties and then submits them for payment, to exercise more care in reviewing them. As in *United City Merchants*, the beneficiary is normally in a closer position to the third party than the applicant or the issuer, and therefore has the advantage in investigating suspicious conditions. The rule established in *United City Merchants*, on the other hand, has the potential to result in making fraud by the beneficiary easier to conceal, as the beneficiary may well try to claim that the fraud was perpetrated by a third party.

### C The Principle of Strict Compliance

It seems that there was no dispute over the quality or quantity of the goods involved in *United City Merchants*; the fraud related only to the dating of the bill of lading, and the fact that the goods were shipped a day late would seem to have made little difference in practical terms. With the documents tendered in the case, the applicant could obtain the goods for which it had contracted. Therefore, the fraud involved in the case was merely of a technical nature. For this reason, the decision of the House of Lords may be regarded with some sympathy.<sup>84</sup>

However, viewed in terms of legal principle, the decision of the House of Lords and the trial court is arguably hard to accept. According to the principle of strict compliance, documents tendered for payment under a letter of credit must comply with the terms and conditions of the credit. If the letter of credit specifies, for example, that the bill of lading must evidence shipment on or before 15 December, but the bill of lading tendered shows that the goods are shipped on 16 December, the bank is bound to refuse to honour the letter of credit unless the discrepancy is waived. If the bank pays the beneficiary nonetheless, the beneficiary will not be obliged by a court to reimburse a bank that has not strictly obeyed its instructions. In *United City Merchants*, if the bill of lading had not been fraudulently antedated (ie, if the beneficiaries had tendered one bearing the true date of loading), the bank could have relied on the principle of strict compliance and simply refused to honour the presentation. In such a situation, the beneficiaries would not have had a case.<sup>85</sup>

Yet, according to the House of Lords, once the documents had been fraudulently antedated, the beneficiaries were entitled to come before a court and to succeed. This result has prompted one commentator to observe that

[i]t 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>86</sup>

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84 See Benjamin, above n 73, 1715.

85 Cf Griffiths LJ in *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd's Rep 604, 632; see above n 47 and accompanying text.

86 Benjamin, above n 73, 1715.

And has led another commentator to argue that

[t]he House of Lords' decision leaves banks in an anomalous position. Under a documentary credit, a confirming bank has a duty to honour conforming documents. After *American Accord*, banks must honour a credit and accept fraudulently completed documents, unless they were fraudulently completed by the beneficiary.<sup>87</sup>

## VII CONCLUSION

The rules and standards regarding the fraud rule in the law of letters of credit are neither direct nor clear in addressing the issue of the identity of fraudulent parties, being more concerned with the nature of documents presented. It might be argued that some of the rules have simply neglected the issue of the identity of the fraudulent party. But if the rules are read closely with this issue in mind, a reasonable interpretation is that the fraud rule will be applied if documents are forged or fraudulent *no matter who* is responsible for the fraud.

However, the cases discussed in this article have taken a different line. They demonstrate that the identity of the fraudulent party raises a real issue in cases where the beneficiary is not the perpetrator of the fraud. The decisions analysed indicate that the courts (with the exception of the English Court of Appeal) have accepted the argument put forward by the beneficiaries in each case and have held that the fraud rule should not apply when the fraudulent party is the applicant or a third party other than the beneficiary.

This trend in the case law is comprehensible given that the fraud rule was developed to prevent beneficiary fraud and that cases in which the fraud is perpetrated by parties other than the beneficiary are very rare. As most letter of credit fraud cases involve beneficiary fraud, it is common to find in them expressions or paragraphs which indicate that the fraud rule should be applied because of the fraud by the beneficiary. However, it is at the very least arguable that when courts apply the fraud rule in cases of beneficiary fraud, they are not necessarily excluding the application of the rule in cases where the fraud is not perpetrated by the beneficiary. They are simply stating the principles relevant to the facts of the particular case before them.

However, these expressions or paragraphs have been understandably relied upon and emphasised by those representing innocent beneficiaries or presenters in cases where the fraud is perpetrated by someone other than the beneficiary, to argue that the fraud rule is not applicable. Unfortunately, most judges are unlikely to be letter of credit specialists, and may accept these arguments. However, it is submitted that such acceptance is to the detriment of the fundamental principle governing the application of the fraud rule – that '[i]t is the character of the document, not its origin',<sup>88</sup> which matters.

The cases discussed in this article have been argued and adjudicated on the basis that the fraudulent party was either the applicant or a third party other than

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87 Cansler, above n 36, 240.

88 *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd's Rep 604, 628.

the beneficiary. In such cases (with the notable exception of the decision of the English Court of Appeal in *United City Merchants*), it has been held that the fraud rule does not apply. It is submitted that, while the outcome in the cases of fraud by the applicant may be acceptable, with respect, the decision of the leading case on third party fraud is not.<sup>89</sup>

Applicant fraud does not come within the scope of the fraud rule at all: it occurs under the application agreement and will therefore never involve the presentation of documents required by the letter of credit. However, in cases of third party fraud, the whole case turns on the relevant documents.

In conclusion then, it is the nature of the documents which should be the relevant and determining factor in the application of the fraud rule, not the identity of the fraudulent party. No matter who perpetrates fraud, the fraud rule should apply if (and only if) the documents or demand for payment are forged or fraudulent.

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89 Dolan has argued that *United City Merchants* is 'a remarkable English case', which is 'not consistent with the language of the Code and probably not good authority in the United States': Dolan, above n 3, 7-61. See also Alan A Tyree, *Banking Law in Australia* (2<sup>nd</sup> ed, 1995) 500. But cf Turner, above n 11, 229: 'There are no comparable cases under the US law, but there is a great deal of dicta that states that relief from fraud is not available unless the perpetrator is the beneficiary'.