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Confusion and difficulties surrounding the fraud rule in letters of credit: an English perspective

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It has been established law for a long time that, in limited circumstances, fraud could provide a valid ground to withhold payment in letters of credit transactions. This article examines the fraud rule which was created to prevent unscrupulous fraudsters from benefiting from the system. Whilst it is recognised that there is a need to preserve the integrity of the system and maintain the certainty of payment, the way in which English law restricts the fraud exception is excessive to the extent of defeating the objective of the exception. In this article, some suggestions are made for the relaxation of the fraud exception.

I Introduction

In international sale transactions, the parties involved operate their businesses in different countries and the goods are transported across national borders. Immediate payment in exchange for goods is practically impossible. Various factors such as currency exchange restrictions, political risks and the physical distance between the parties create a lack of trust and uncertainty for the parties involved. Therefore, a sophisticated tool such as the letter of credit was invented to finance international trade. The letter of credit is able to address effectively both sellers' and buyers' concerns because the bank steps in, substituting itself for the buyer as the party who will make payment to the seller. The bank is a suitable intermediary because of its sufficient credit standing and the banking facilities it possesses abroad. Sellers are provided with security of payment since the bank is under a legal obligation to pay them as long as they present documents which conform to the conditions of the credit. As for buyers, they can be assured that the goods which conform to their agreement are delivered before payment is made.

The autonomy principle is regarded as the most fundamental concept in letters of credit transactions. It posits that a letter of credit is separate and independent from the underlying contract of sale between the seller and the buyer. It is also independent of the contract between the buyer and the issuing bank. The function of this principle is to preserve the main function of the letter of credit, which is to guarantee quick and reliable payment to the seller. However, the certainty of quick payment carries with it the risk of fraudsters exploiting the letter of credit system for monetary gain. There are circumstances where it is obvious that the seller's breach of contract is not one which could have occurred through mere negligence and in which a strict adherence to the autonomy principle would benefit fraudsters while

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denying justice to the other parties. Consequently, an exception to the autonomy principle, based upon the maxim *ex turpi causa non oritur actio* has been developed in order to deny payment under a letter of credit where fraud is proved. The basis of the fraud exception is that in cases of fraud the issuer of the letter of credit can refuse, or a court can restrain, payment under a letter of credit. Nevertheless, it is certainly the case that this departure from the autonomy principle remains minimal in order to maintain the commercial utility of letters of credit as an instrument for guaranteeing payment.

Despite being the most well-established exception to the autonomy principle and the only exception recognised by nearly every jurisdiction in the world, the fraud rule is complicated, riddled with many difficulties and has its own shortcomings. The overriding aim of this article is to highlight the problems involved where the fraud exception is applied to withhold payment and to provide a better understanding of some of the most difficult issues associated with the fraud rule. Some suggestions are presented in this article to allow the fraud rule to accommodate growing issues in both the banking and trading industry. The article begins with a review of the leading case in England which sets out the standard of fraud under the fraud exception. It goes on to discuss the problem of third party fraud, which sits uneasily with the current standard of fraud in English law, and explores the option of extending the fraud exception to include third party fraud. The issue of proof of fraud, an issue which intertwines with nearly all aspects of the fraud exception because evidence of any alleged fraud must be present in the circumstances in order for payment to be withheld, is then examined. Finally, the article evaluates the 'balance of convenience' test, which currently applies to injunctions related to letters of credit.

II The requirement of beneficiary's knowledge as the standard of fraud

The pivotal English case on this subject is *United City Merchants (Investments) Ltd v Royal Bank of Canada*.¹ In this case, an employee of the loading brokers to the carriers fraudulently predated the bill of lading to 15 December 1976 when shipment had been made on 16 December. On presentation of the documents, the confirming bank refused to pay because it became aware that the shipment had not been made as shown on the bill of lading. In the High Court, Mocatta J made the finding that the loading agents were not acting on behalf of the sellers, and neither the sellers nor its assignee were aware of the alteration. For this reason, he held that the bank was not entitled to reject the documents. The Court of Appeal later reversed the decision, holding that so long as the bank knew of the forged document, it would be entitled to withhold payment regardless of the fact that the seller was unaware of the fraud. On appeal to the House of Lords, Lord Diplock emphasised that a confirming bank deals with documents and not with goods but affirmed the fraud exception:

to this general statement of principle [of independence] as to the contractual obligations of the confirming bank to the seller, there is one exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue.²

Following this, the application of the fraud exception is limited to cases where the beneficiary had knowledge of the fraud. Since the sellers in this case were not aware of the fraudulent alteration, the House of Lords overruled the decision of the Court of Appeal and held that they should have been paid on presentation of the documents. The effect of the decision was a trend whereby English courts have generally avoided defining what constitutes fraud. Rather, when identifying fraud in letters of credit, the courts have always emphasised the *mens rea* – the state of mind of the beneficiary. Hence, there is uncertainty as to what constitutes 'material representation'. Jack offers one possible suggestion:

¹ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168.

² *ibid* 183.

It is suggested that this must mean material to the bank's duty to pay, so that if the document stated the truth the bank would be obliged and entitled to reject the documents. For example, if the bill of lading and the invoice in the *Sztejn* case had stated that the shipment consisted of cowhair and rubbish purporting to be bristles, they would not have conformed. And, in the *United City Merchants* case itself, if the bill of lading had had the correct date of shipment, it would have been outside the credit period.³

A similar idea was rejected by Lord Diplock in *United City Merchants*:

It is conceded that to justify refusal the misstatement must be 'material' but this invites the query: 'material to what?' The suggested answer to this query was: a misstatement of a fact which if the true fact had been disclosed would have entitled the buyer to reject the goods; date of shipment (as in the instant case) or misdescription of the goods are examples. But this is to destroy the autonomy of the documentary credit which is its *raison d'être*; it is to make the seller's right to payment by the confirming bank dependent upon the buyer's rights against the seller under the terms of the contract for the sale of goods, of which the confirming bank will have no knowledge.⁴

Although not the same, Jack's suggestion is not too different from the one rejected by Lord Diplock, since any facts which would allow the buyer to reject the goods would also allow the bank to reject the documents. However, the converse is not true. Jack's suggestion is certainly broader but it avoids Lord Diplock's argument that the autonomy principle will be destroyed because, following his suggestion, the seller's right to payment is still dependant on the right under the credit agreement with the bank and not on the seller's right under the contract with the buyer. Later on in his judgment, Lord Diplock suggested the following:

... [T]he answer to the question: 'to what must the misstatement in the documents be material?' should be: 'material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security'.⁵

It may be difficult to determine whether a misrepresentation affects a bank's security, whereas the determination of whether a document is compliant is an exercise with which banks and courts are familiar. Jack's suggestion is more viable than Lord Diplock's and offers greater certainty. It is submitted that his suggestion should be adopted by the courts. As it currently stands, there is a lack of focus on the issue of what is material. It is observed that although 'material misrepresentation' is the established standard of fraud in England, a more accurate terminology to indicate the position as it is now is 'intentional fraud'.

It should be pointed out that the courts in other jurisdictions such as Canada⁶ and Australia,⁷ have followed English courts on this matter, with a focus on inquiring into the state of mind of the beneficiary in calling the letter of credit. On the other hand, US courts adopt a different approach to finding fraud, looking at the factual circumstances of the case, in particular the effect and severity of the wrongdoing.⁸ Overall, US courts adopt the least stringent concept of fraud. In *United Trading Corporation S.A. and Murray Clayton Ltd. v Allied Arab Bank Ltd*, Ackner LJ referred to some of the cases cited in the official comment to UCC §5-109⁹ and

³ R Jack *Documentary Credits: The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees* (4th edn Tottel Haywards Heath 2009) 9.17.

⁴ Note 1 168, 185.

⁵ *ibid* 186.

⁶ *Bank of Nova Scotia v Angelica-Whitewear* [1987] 1 SCR 59.

⁷ *Contronic Distributors Pty Ltd v Bank of New South Wales* [1984] 3 NSWLR 110.

⁸ R P Buckley 'The 1993 revision of the uniform customs and practice for documentary credits' (1995) 6 *JBFLP* 77, 97.

⁹ *Dynamics Corporation of America v the Citizens and Southern National Bank*, 356 F. Supp. 991 (1973); *Harris Corporation v National Iranian Radio and Television*, 691 F.2d 1344 (1982); *Itek Corporation v First National Bank of Boston*, 566 F. Supp. 1210 (1983).

made the observation that the US concept of fraud is far wider than that of the English jurisdiction, to the extent of including ordinary breach of contract.¹⁰

One US writer argues that the English approach is better ie that for the purposes of injunctive relief, fraud should be found only where there is a dishonest intention on the part of the beneficiary.¹¹ While the focus on intention or knowledge of fraud is certainly an approach to which English courts have consistently adhered, it is submitted that English law should not limit the scope of this exception to actual knowledge. This is because any investigation into the state of mind of the beneficiary is not likely to be easy and may require extensive investigation. Proof of actual intention on the part of the beneficiary is difficult to establish in a full trial, let alone in a preliminary hearing. The relevant evidence on the issue of intention may be just the words of the alleging party. Due to these difficulties, the writer feels that if the law is to require only actual knowledge, the allocation of risk is unfairly in favour of the beneficiaries.

It is suggested here that the question the courts should be concerned with is not just 'did the beneficiary actually know?' but should also include the additional question of 'ought the beneficiary to know?' The idea is that the relevant state of mind will be found objectively, by directing the inquiry into factual circumstances of the case. This is also supported by the writings of Professors Ellinger and Jack who interpret knowledge as similar to the tort of deceit.¹² The tort of deceit contains the following elements: (1) knowing the representation to be false; (2) without belief in its truth; or (3) recklessly, careless whether it be true or false.¹³ 'It may well be that where the party presenting the documents has some serious ground for suspicion of a document so that if he gave proper consideration to it he would realise that it most likely contained a false statement but shuts his eyes to that, this would be sufficient.'¹⁴

In a recent US case, *Levin v Meagher*, Margulies J stated:

What unifies the various standards formulated in the cases cited in the official code comment is their requirement that fraud be determined by an objective examination of the circumstances, rather than by reference to the subjective beliefs of the beneficiary.¹⁵

The writer's submission appears to be the same as the position adopted in America, albeit expressed in different terms. This means that if accepted, the fraud exception in England would be much more in line with the fraud exception in America. As explained by one US judge, an objective approach fits in comfortably with the fundamental principle which forms the mechanics of the letter of credit:

The adoption of an objective standard is consistent with the contractual nature of letters of credit. Under such contracts, a beneficiary has the right to draw on the letter of credit only if certain conditions are met. If there is 'no bona fide claim' that those conditions have been met – in other words, if it is clear that the beneficiary has no right to draw on the letter of credit – the beneficiary should not be permitted to draw on the line of credit merely because the beneficiary has formed a good faith but mistaken belief that conditions permitting a draw do exist.¹⁶

¹⁰ [1985] 2 Lloyd's Rep 554, 561.

¹¹ E L Symons 'Letters of credit: fraud, good faith and the basis for injunctive relief' (1980) 54 *TLR* 338.

¹² Jack (n 3) 9.18; E P Ellinger 'Documentary Credits and Fraudulent Documents' in C M Chinkin et al (ed) *Current Problems of International Trade Financing* (Butterworths Singapore 1983) 161.

¹³ *Derry v Peek* [1884] AC 337, 374. However, Jack recognises that there is a distinction between the reckless presentation of documents and the tort of deceit in that the bank did not enter into the contract based on misrepresentation but is merely refusing to perform it.

¹⁴ Jack (n 3) 9.18.

¹⁵ 2004 Cal. App. Unpub LEXIS 7060, 18.

¹⁶ *3Com Corp. v Banco do Brasil, S.A.* (2nd Cir. 1999) 171 F.3d 739, 747 per S. Sotomayor J.

One may argue that a beneficiary could have genuinely committed a mistake or be genuinely unaware of the misrepresentation but such an approach would have the result of unfairly punishing the beneficiary. This concern is to a large extent unjustified since, as the discussion later will show, evidence has to satisfy a high evidential threshold. The evidence would need to show circumstances where it would be hard to imagine that the beneficiary seller had not been reckless and where there were strong reasons for the seller to be held responsible for his behaviour.

III Third party fraud

The following discussion explores the contentious issue of whether the scope of the fraud exception encompasses fraudulent conduct which is not perpetrated by the beneficiary. Although Lord Diplock famously stated in *United City Merchants* that 'fraud unravels all', fraud does not in fact unravel the legal position of all parties under English law. In *United City Merchants*, the House of Lords held that a bank was obliged to pay even though it had knowledge of the fraud because the beneficiary did not have knowledge of the fraud. The effect of *United City Merchants* is that the identity of the party who perpetrated the fraud is crucial – a document forged by a third party without the involvement of a beneficiary will not provide a ground to refuse payment under the fraud exception. This position is followed in other common law jurisdictions such as Canada¹⁷ and Australia.¹⁸ Section 5–109 UCC does not provide that the beneficiary's knowledge of the fraud is required in order for the fraud exception to intervene payment. So far there is no direct authority in US cases specifying that the fraud exception is limited to fraud of the beneficiary. Moreover, in demand guarantee cases, it has been expressly stated in US courts that there is no need to establish that the beneficiary acted 'deceptively or with malicious intent'.¹⁹ Therefore, US courts appear to differ in this respect from other common law jurisdictions.

There are many reasons why English law retains the requirement of beneficiary's knowledge in the fraud exception. The main justification is that it is in the interest of international trade to maintain the efficacy of the letter of credit as a system of payment. Beneficiaries choose the use of letters of credit because of the certainty of payment offered and should be able to rely on it. There is also the argument that it is rather unfair to refuse payment to an innocent beneficiary on the basis that a third party has forged a document. Moreover, forgery and fraud are certainly different kinds of wrongdoing, hence a good justification for each to be treated differently in the eyes of law. Arguably, the allocation of risk in the event of third party fraud should fall on the applicant because this is the risk that any applicant consents to by agreeing to pay by letter of credit.

III.1 The drawbacks of *United City Merchants*

The disadvantage of the judgment in *United City Merchants* is that it creates a rather absurd situation – a bank which obtains strong evidence before payment that a document is forged by a third party is still obliged to make payment, despite knowing that the documents are in fact forged. Ultimately, the burden falls on the applicant who is to reimburse the bank. Such a rule could make this payment instrument a 'breeding ground for fraudsters. One commentator referred to letters of credit as a 'crooks' charter'.²⁰ Although circumstances

¹⁷ *Bank of Nova Scotia* (n 6). Although not at issue in this case, LeDain J, for the unanimous court, agreed with *United City Merchants* and took the view that the 'fraud exception should be confined to fraud by the beneficiary of a credit and should not extend to fraud by a third party of which the beneficiary is innocent'.

¹⁸ *Contronic Distributors Pty Ltd* (n 7).

¹⁹ *Rockwell International Systems Inc. v Citibank N.A.* 719 F.2d 583 (1983); *Harris Corporation* (n 9); *Dynamics Corporation of America* (n 9).

²⁰ Ademun-Odeke 'Double invoicing in international trade; the fraud and nullity exceptions in letters of credit – are the America accord and the UCP 500 crooks' charters?' (2006) 18 *Denning LJ* 115.

where a beneficiary conspires with a third party would fall within the scope of the fraud rule, the evidential difficulties of proving the beneficiary's involvement in practice mean that beneficiaries can get away with defrauding banks. It may be argued that the act of fraud remains fraud and its effect on international trading is detrimental, regardless of who perpetrates the fraud. The effect of fraud on the right to payment should have no correlation to the identity of the perpetrator.

Many commentators advocate that the requirement of beneficiary's fraud should be abolished.²¹ The primary argument is that, despite being apparently compliant, a document forged by a third party is not genuinely conforming. As Professor Goode correctly states: 'A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party.'²² Take for example the bill of lading in *United City Merchants*. It is difficult to see how a bill of lading which has been deliberately modified to record the wrong shipping date could be conforming when even minor and truthful errors in documents could provide a ground for rejection under the principle of strict compliance. International trading often involves goods with a volatile market value. Since the price of the goods could vary significantly from one day to another, an incorrect shipping date should not be seen as trivial. Furthermore, in *M Golodetz & Co Inc v Czarnikow-Rionda Co Inc*, Donaldson J stated that: 'A tender of documents which, properly read and understood, call for further inquiry or are such as to invite litigation is clearly a bad tender.'²³

In his writings, Xiang Gao highlights the importance of maintaining a fair balance between the competing interests of the many parties involved in the letter of credit transaction:

The normal operation of the letter of credit not only provides the beneficiary with safe and rapid access to the purchase price or a sum of money when the applicant defaults, but also provides the applicant with credit and/or other commercial benefits and protects the applicant against improper calls on the credit by requiring the beneficiary to present *genuine* documents indicating that it has properly performed its obligations under the underlying transaction. If forged or fraudulent documents are allowed to trigger payment, the balance assumed in the letter of credit scheme will be undermined.²⁴

It is true that, in the event that a bank pays against documents which are forged by a third party and suffers a loss, the bank may have a cause of action in tort law against that third party under the principle established in *Hedley Byrne v Heller*.²⁵ The bank's loss would be classified as pure economic loss, a form of actionable damage which is itself surrounded by many complications. In fact, this remedy extends to the applicant, who may ultimately suffer the risk of the bank paying against the tender of documents which have been forged by third parties.²⁶ The chances of successfully recovering money from a fraudulent third party are undeniably low. First, pure economic loss is itself notoriously difficult to recover under English tort law. Secondly, fraudsters often disappear and any attempt to commence legal action against them may be futile.

The argument that it is unfair for an innocent beneficiary to be refused payment because of the fraud of a third party cannot always be sustained. Take for instance the example of a master who observes that the condition of the goods is not as it should be and inserts

²¹ *ibid*; R Goode 'Abstract Payment Undertakings' in P Cane and J Stapleton (eds) *Essays for Patrick Atiyah* (Clarendon Oxford 1991); Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (1st edn Kluwer Law International London 2003) ch 5.

²² R Goode 'Reflections on letters of credit -1' [1980] *JBL* 291, 294.

²³ [1980] 1 *WLR* 495, 510.

²⁴ Xiang Gao, Ross P Buckley 'A comparative analysis of the standard of fraud required under the fraud rule in letter of credit law' (2003) *Oxford University Comparative Law Forum* <http://ouclf.iuscomp.org/articles/gao-buckley.shtml#fn1>.

²⁵ [1964] *AC* 465.

²⁶ *Niru Battery Manufacturing Co v Milestone Trading Ltd* [2004] 1 *Lloyd's Rep* 344.

remarks into the mate's receipt. The charterer is keen to have a clean bill of lading since a claused bill of lading is no good for the shipper. Therefore, the charterer provides a letter of indemnity to cover the master in the event of cargo claims in return, for which the master issues a clean bill of lading. Meanwhile, the beneficiary of the credit (the shipper) is not aware of this. In this example, although the beneficiary was not the person perpetrating the fraud, it is hardly unfair to refuse payment to the beneficiary since the goods shipped were not in acceptable condition.

The UCP and other international regulations do not expressly deal with the issue of third party fraud. However, in China, Article 8 of the Provisions of the Supreme People's Courts on Some Issues Concerning the Trial of Cases of Disputes over Letters of Credit (which took effect on 1 January 2006) provides the following:

The letter of credit fraud shall be determined as constituted under any of the following circumstances:

- (i) The beneficiary has forged documents or presented documents containing fraudulent information;
- (ii) The beneficiary has intentionally failed to deliver goods or delivered goods with no value;
- (iii) The beneficiary has conspired with the applicant or a third party and presented fraudulent documents whereas there is no actual underlying transaction; or
- (iv) Other circumstances of letter of credit fraud.

While subsections (i)–(iii) focus on beneficiary's fraud, subsection (iv) appears to be a catch-all clause with no reference to the beneficiary's involvement at all. This means that subsection (iv) may encompass circumstances where a beneficiary is innocent but a third party is fraudulent. It is likely that subsection (iv) would include such circumstances, although Xiang Gao expresses his uncertainty as to the effect of this subsection.²⁷

Based on a review of the arguments presented for and against the extension of the fraud exception to third party fraud, it is submitted here that third party fraud should be included within the limits of the fraud rule. Nevertheless, as one commentator rightly points out, the principle in *United City Merchants* is influential and well entrenched even in other common law jurisdictions, and a consideration of whether the fraud exception should be extended to third party fraud is likely to be futile.²⁸ It is hoped that English courts will review this issue. Otherwise the autonomy principle will continue to protect unscrupulous fraudsters, allowing them to obtain monetary gains from the letter of credit system.

It would be rather dogmatic not to reveal the disadvantage which arises on the part of sellers if the fraud exception is to encompass third party fraud. For example, consider a seller in a CIF arrangement who has insured the goods, delivered the goods as agreed in the contract and supplied documents which comply strictly with the terms of the credit. Subsequently, another person such as a shipping agent changes the date of the bill of lading. In such circumstances, a seller who later presents the documents for payment without knowledge of this fraud is not at fault in any sense. The seller has been honest and responsible but in accordance with a fraud rule which extends to third party fraud, will not be paid despite having incurred costs in delivering, insuring and producing the goods. Although this example illustrates that, in certain circumstances, an outright extension of the fraud rule to third party will have the effect of exposing some sellers to hardship, this is arguably justified as the operation of the letter of credit is based on the duties of a beneficiary to present documents which comply with the conditions of the credit. If the beneficiary fails to do this, why should the law not hold the beneficiary responsible by bearing the risk of non-payment? However, the need to reduce the exposure of unfairness to the seller/beneficiary leads to my contention that

²⁷ Xiang Gao 'The fraud rule in law of letters of credit in the PRC' (2007) 41 *International Law* 1067, 1080.

²⁸ Dora Neo 'A nullity exception' [2004] *Sing JLS* 46, 69.

although there is a place for third party fraud to be included in the fraud rule, the scope of this inclusion needs to be limited in some way. This leads to another question – how does one confine the scope of third party fraud?

III.2 Limiting the inclusion of third party fraud under the fraud exception

It is challenging, both conceptually and practically, to include third party fraud in the fraud exception and yet limit the scope of this inclusion. Nevertheless, it will be shown here that there are a few ways in which the scope of a fraud rule which encompasses third party fraud can be restricted.

III.2.1 *Constructive knowledge*

It was suggested earlier in this article that beneficiary's fraud should not be a requirement for the application of the fraud rule, but rather an objective approach should be adopted whereby all the circumstances of the case are looked at in order to determine whether the beneficiary/seller ought to have known of the fraud. This idea was proposed to improve the general standard of fraud in the fraud exception but it also serves the purpose of limiting the scope of inclusion of third party fraud. If this principle is adopted, it will 'catch' certain circumstances of third party fraud, but will only allow payment to be withheld in very limited cases involving third party fraud. For example:

The conditions of the letter of credit require a quality inspection certificate to be presented by the beneficiary. The beneficiary presents a quality inspection certificate which appears to comply with the conditions of the credit. However, the paying bank obtains evidence that the goods do not in fact meet the standard of quality as agreed between the parties and that the quality inspector who signed the certificate is a close relative of the seller.

In this example, following the adoption of the principle of constructive knowledge, the fraud exception can be applied to withhold payment under a credit although it is not proven that the beneficiary has *actual* knowledge of the fraud. The fraud exception is applied to the third party fraud to withhold payment here because, based on the objective approach, a reasonable person taking into account the evidence would reach the conclusion that the seller has knowledge of the third party fraud. On the other hand, if in the example above there is no evidence which indicates that the quality inspector was a relative of the beneficiary, the fraud exception will not apply to withhold payment although third party fraud has occurred somewhere in the production of the documents. This example illustrates that the extension of the concept of actual knowledge to constructive knowledge will catch some instances of third party fraud but that it is not a sufficiently broad approach since many instances of third party fraud will not be caught.

III.2.2 *The effect of forged documents on the bank's security*

In practice, documents which are forged by a third party may be of different degrees of severity. Since withholding payment in cases of third party fraud can intrude on the commercial reliability of the letters of credit, one possible way to limit the scope of third party fraud is to assess whether the bank's security is affected by the document in question – payment will only be refused under the credit if the bank's security is affected by the document which has been forged by a third party. Some documents which are forged by third parties may be insignificant, resulting in very few practical consequences, while others may be more significant and can potentially affect the security of the bank. The position of banks may often be affected by forged documents. Although conceptually it may be that applicants will ultimately absorb the risk of paying against documents forged by third parties, in practice, the banks will sometimes bear the risk of payment.²⁹ The rationale behind this approach is

²⁹ An example of this is where an applicant is involved in a complex scheme of fraud and subsequently disappears without reimbursing the issuing bank.

that it offers some kind of protection to the financial position of banks. In *United City Merchants*, Ackner LJ in the Court of Appeal highlighted this:

A banker ... 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.³⁰

Griffiths LJ expressed the same concern: 'The bank takes the documents as its security for payment. It is not obliged to take worthless documents.'³¹

This proposition is susceptible to two arguments. First, as a prominent writer on letters of credit, J F Dolan, commented: 'It may be misleading to suggest that bank issuers are always concerned about their security interest in the goods. It is probably fair to say that they do mind having the security interest but are more concerned about the applicant's ability to reimburse the issuer when it pays the beneficiary.'³² However, it should be pointed out that additional security is frequently not asked from the applicant, and even if it is required, additional security does not usually cover the total amount of the applicant's liability. Hence the documents still represent important security to the bank.

Secondly, there may be difficulties in evaluating whether the bank's security is affected. In *United City Merchants*, Lord Diplock stated the following in relation to material misstatements:

... the answer to the question: 'to what must the misstatement in the documents be material?' should be: 'material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security.'³³

It is submitted that the above statement is good guidance, although there will inevitably be an element of commercial judgment. This would most certainly restrict the application of the fraud exception to certain circumstances of third party fraud, since payment will only be withheld where the presentation of a forged document results in a reduced price for the goods if they were to be sold for proceeds by the bank.

III.2.3 Identity of the insured party

One possible methodology to restrict the scope of the inclusion of third party fraud in the fraud exception is to examine the identity of the insured party in the insurance policy. It is arguable that if the insured party named on the insurance policy is the issuing bank, then payment under the letter of credit should not be restrained even if third party fraud is involved. This is because if a document which has been forged by a third party results in a loss, the issuing bank may have a possible claim under the insurance policy. Hence, the risk of paying against the presentation of a document which has been forged by a third party is minimised. On the other hand, if the beneficiary is the insured party on the insurance policy, the issuing bank incurs the risk of significant loss in the event of paying against presentation of a forged document. Reducing the risk of loss on the part of banks also indirectly benefits applicants, since the burden of the loss may ultimately be borne by applicants, who are under a legal obligation to reimburse their issuing banks. However, the arguments presented here are weakened when taking into consideration that not all risks are insured against. There may well be circumstances where, despite being the insured party, an issuing bank will not be covered for the losses it suffers as a result of paying against forged documents.

³⁰ [1982] QB 208, 246.

³¹ *ibid* 54.

³² J F Dolan *The Law of Letters of Credit. Commercial and Standby Credits* (revised edn Warren Gorham & Lamont Inc Boston 1996) 8–23.

³³ [1983] 1 AC 168, 186.

Comparing the three approaches, the third probably appears the most unorthodox, although it offers the most certainty, an advantage where the financing of international trading is concerned. However, it is the author's view that the first approach should be adopted as this would align with the law in America. It could be said that the US courts' approach of looking at the factual circumstances of the case and not inquiring into the state of mind of the beneficiary in calling the letter of credit is an indirect extension of the fraud exception to third party fraud. Moreover, it may be that the identity of the insured party on the insurance documents and a forged document which severely affects a bank's security are facts which can be taken into account in the assessment of constructive knowledge. It is difficult to tell which of these approaches is the most expansive, as they work in different instances to restrict the application of the fraud rule. What is clear from the discussion of these ideas is that it is possible to include third party fraud in the fraud rule while limiting the scope of this. This means the law is able to prevent the proliferation of fraud while preserving the future of the letter of credit as an important financial instrument.

IV Proof/evidence of fraud

In order to rely on the fraud exception to withhold payment, any allegation of fraud must be supported by sufficient evidence. This issue is of particular importance because the evidential threshold can be the primary device used to limit the application of the fraud rule. However, the fraud exception may be argued at different stages of proceedings and this has the practical effect of entangling the required standard of proof, making it far from clear. Consequently it is useful to discuss this issue by drawing a distinction between a pre-trial and a full trial hearing.

IV.1 Pre-trial

IV.1.1 Application for injunction

Since questions relating to the fraud exception are likely to arise primarily in applications for interim injunctions to restrain payment by the bank, where the evidence will be by affidavit or witness statement³⁴ and the decision will have to be taken without a full hearing on the merits, the approach to the standard of proof assumes particular importance.³⁵ English courts generally require a high degree of proof for proceedings on this matter. It is difficult to see how the courts did not find established fraud in some of these cases, although the facts were very much in favour of the claimants. For instance, in *Discount Records Ltd v Barclays Bank Ltd*,³⁶ not only were the goods delivered later than the date stated in the invoice, there was evidence to show that 97 per cent of the goods delivered were either not as ordered or rubbish. This evidence was in the form of the buyer's inspection of the goods in the presence of the issuing bank. In addition, at the hearing, one of the boxes was presented showing that it had been tampered with.³⁷ Nevertheless, the High Court decided that the evidence had not satisfied the required standard. Megarry J also stated that it would be difficult to resolve an issue of fraud in any hearing to which the seller was not a party.³⁸ In *R D Harbottle (Mercantile)*

³⁴ An application for an interim injunction must be supported by evidence set out in either (1) a witness statement, or (2) a statement of case provided that it is accompanied by a statement of truth, or the application provided that it is verified by a statement of truth, unless the court, an Act, a rule or a practice direction requires evidence by affidavit (CPR 25PD.3.2).

³⁵ But the effect of granting an interim injunction will merely be to delay payment to the beneficiary if at trial the beneficiary's claim for payment is found to be justified.

³⁶ [1975] 1 Lloyd's Rep 444.

³⁷ The numbers indicating the serial number of the records inside which appeared on the outside of the box had been pasted over with some semi-transparent material and different numbers put on the outside; the outside numbers corresponded with the order and the covered-up numbers did not.

³⁸ 1975] 1 Lloyd's Rep 444, 448.

*Ltd v National Westminster Bank Ltd*³⁹ and *Edward Owen Engineering Ltd v Barclays Bank International Ltd*,⁴⁰ the judges emphasised that the standard is that of 'clearly established fraud' – in both cases injunctions were refused because it was decided that fraud was alleged but not established.

Moreover, these cases do not reflect a one-off approach. In *Bolivinter Oil SA v Chase Manhattan Bank*,⁴¹ it was specifically stated that '... [T]he evidence must be clear, both as to the fact of fraud and as to the bank's knowledge'.⁴² In *United Trading Corp SA v Allied Arab Bank*,⁴³ Ackner LJ provided further explanation on this issue:

We would expect the Court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud.⁴⁴

One may question whether 'the only realistic inference' standard set out in this case is a slightly lower threshold than the test of clearly established fraud. In *Turkiye IS Bankasi AS v Bank of China*,⁴⁵ Waller J took the view that there is no material difference between the two and it is agreed here that this is correct.

English courts later appeared to have deviated from the traditional strict approach in *Themehelp Ltd v West & Others*.⁴⁶ In this case, the plaintiff contracted to buy shares in a company from the defendants. The purchase price was to be paid by instalments, the third and last being the largest secured by a performance guarantee issued by a third party. The purchase was negotiated on the assumption that the demand for the relevant product from a major customer, Sony, would continue in the future. Before the final instalment, the plaintiff started proceedings for rescission of the contract and damages. It was alleged that there was a fraudulent misrepresentation by the defendants, namely that the defendants knew that Sony was in fact sourcing its products from a competitor at the time of contracting but concealed this fact from the plaintiff. The defendants denied the misrepresentation, claiming that the plaintiff was in default and that they were therefore entitled to claim under the guarantee. The plaintiff applied for an interlocutory injunction to restrain the defendants from giving notice to the guarantor, on the grounds that there was fraudulent misrepresentation. The plaintiff had to prove that in the course of negotiating the purchase of the shares, the defendants fraudulently concealed the fact that Sony would no longer be a major customer of the company. An injunction was granted at first instance and later affirmed by the Court of Appeal. The Court of Appeal affirmed the trial judge's finding that the plaintiff had satisfied the onus of proof, which is the establishment of a seriously arguable prospect at trial that the only realistic inference to draw is that the defendants were fraudulent.⁴⁷ This appears to be the same test set out in *United Trading Corp* but the Court of Appeal in *Themehelp* was much more lenient in its approach and even accepted some of the hearsay evidence involved. In

³⁹ [1978] QB 146.

⁴⁰ [1978] QB 159.

⁴¹ [1984] 1 Lloyd's Rep 251.

⁴² *ibid* per Sir John Donaldson MR at 257.

⁴³ [1985] 2 Lloyd's Rep 554.

⁴⁴ *ibid* 561.

⁴⁵ [1996] 2 Lloyd's Rep 611, 616.

⁴⁶ *Themehelp Ltd v West & Others* [1996] QB 84.

⁴⁷ Counsel for the buyers did not seek to argue in this appeal that the judge adopted the wrong test. Therefore the Court of Appeal assumed that the correct test was adopted.

fact, the dissenting judge, Evans LJ, decided that any finding of the alleged misrepresentation was unrealistic.⁴⁸

In Canada, earlier cases took up the strict English approach of requiring clearly established fraud⁴⁹ but subsequently, in *CDN Research & Development Ltd v Bank of Nova Scotia* Galligan J established the test of a strong prima facie case of fraud.⁵⁰ This approach, which is less onerous than the English standard of proof, is also adopted by Australian courts.⁵¹ US courts have not formulated any test in relation to establishing proof of fraud. The reason behind this may be that preliminary proceedings in US fraud cases sometimes involve extensive and multiple hearings with delays.⁵² Perhaps this could also be partly due to US courts focusing more on the rules of procedural law governing the issuance of preliminary injunctive relief.

IV.1.2 Summary judgment

When a bank refuses to pay on grounds of fraud, a beneficiary will often try to obtain a summary judgment against the bank to obtain quick payment. In *Solo Industries UK v Canara Bank*,⁵³ a beneficiary made an application for summary judgment against a bank which refused to pay under a performance bond. The Court of Appeal had to consider the standard of proof which is to be applied in a summary judgment hearing where a bank is defending an application by the beneficiary for a summary judgment. Mance LJ drew a distinction between two types of cases:

Cases where it is alleged that the bond's issue had been obtained by fraud or misrepresentation

Where the validity of a bond is challenged, the Court of Appeal in *Solo Industries* held that the applicable test was the lower civil test – whether the bank had a ‘real prospect of successfully defending the claim’.⁵⁴ Mance LJ gave the following reason:

The cash principle means that (short of established fraud) any claim that a bank may acquire against a beneficiary making a fraudulent demand must be pursued separately and subsequent to payment, and cannot normally be used as a defence or set-off to avoid payment. All that is clear. But such risks all arise out of and on the basis of the instruments issued. They assume the ‘integrity’ of the instrument that the bank has issued. It does not follow that banks accept the risk that the instrument itself has been induced by conspiracy between, or misrepresentation by, their customers and the beneficiaries. The mere appearance of a valid instrument cannot commit a bank.⁵⁵

⁴⁸ *Themehelp* (n 46) 104. Evans LJ gave the following reasons:

‘The plaintiffs purchased the defendants’ shareholdings in the Shinecrest group of companies on terms negotiated over several months and set out in the share sale agreement dated 29 May 1992 . . . Both parties were represented by experienced solicitors and each had access to financial advisers (Price Waterhouse for the defendants). The plaintiffs were acting in conjunction with their two bankers, 3i and Midland Montagu, and Mr Daniel of 3i accompanied Mr Adrian Evans, of the plaintiffs, to all meetings with the defendants except apparently a visit which Mr Evans made to the defendants on 27 April 1992 at which the allegedly fraudulent misrepresentation was made. Moreover, in January the plaintiffs . . . received Price Waterhouse’s update which included trading and financial forecasts on the express assumption that the Sony UK business would decline almost to zero. I find it difficult to accept that the plaintiffs, their bankers and advisers relied ultimately, even in part, on an oral assurance given by the second defendant to Mr Evans alone on 1 April, or that Mr Evans and Mr Daniel, of 3i, who visited Sony’s offices at Staines in order to establish the company’s trading prospects with Sony, failed to discover either what the prospects were or that Mr Rose, the senior executive to whom they spoke, was not the appropriate person within the Sony organisation for them to see (if such was the case), without realising that they had not done so.’

⁴⁹ *Lumcorp Ltd v Canadian Imperial Bank of Commerce* [1977] Que SC 993; and *Aspen Planners Ltd v Commerce Masonry & Forming Ltd et al* (1979), 100 D.L.R. (3d) 546, 25 O.R. (2d) 167, 7 B.L.R. 102 (H.C.).

⁵⁰ (1980) 18 CPC 62.

⁵¹ *Hortico (Aust) Pty Ltd v Energy’ Equipment Co (Aust) Pty Ltd* (1985) 1 NSWLR 545; *Inflatable Toy Co v State Bank of New South Wales* (1994) 34 NSWLR 243, 251; Unreported, Supreme Court of Western Australia, 13 February 1997, 2221/1996.

⁵² Roeland Bertrams *Bank Guarantees in International Trade* (3rd edn ICC Publication Paris New York 2004) 359.

⁵³ *Solo Industries UK v Canara Bank* [2001] 2 Lloyd’s Rep 578.

⁵⁴ Civil Procedure Rules 1998/3132, 24.2(a).

⁵⁵ *Solo Industries* (n 53) 578, 587.

Solo Industries fell within this category. Based on the evidence, the Court of Appeal held that the bank passed the test and refused summary judgment to the beneficiary.

Cases where it is alleged that a fraudulent demand was made on the bond

In such circumstances, it was held that the applicable standard is that of established fraud, or establishing 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 performance bonds. The Civil Procedure Rules Part 24 test for summary judgment was rejected:

If instruments such as letters of credit and performance bonds are to be treated as cash, they must be paid as cash by banks to beneficiaries. The courts in the *Harbottle* and *Edward Owen* cases emphasised this, and, in my view, set a higher standard than 'a real prospect of success' in relation to all these situations.⁵⁶

In a later case, *Banque Saudi Fransi v Lear Siegler Services Inc*,⁵⁷ the Court of Appeal followed *Solo Industries* and held that the test of standard of proof at summary judgment on this matter was higher than that laid down by Civil Procedure Rules Part 24.⁵⁸

Recently, in *Enka Insaat Ve Sanayi AS v Banca Popolare Dell'alto Adige SPA*,⁵⁹ banks which issued guarantees sought to resist summary judgment on the basis that there was a fraudulent demand for payment. These cases were reviewed in the High Court and Teare J took the view that the test on a summary judgment application 'is not entirely clear'.⁶⁰ Rather than following *Solo Industries* and *Banque Saudi Fransi*, Teare J established that the test to be applied is 'whether there is a real prospect that the banks will establish at trial that the only realistic inference is that the fraud exception applies'.⁶¹ He distinguished *Solo Industries* and *Banque Saudi Fransi* on the basis that the courts in both cases were not considering a claim against a bank where the defence was that there was a fraudulent demand under a guarantee – the comment in *Solo Industries* is *obiter dicta* while *Banque Saudi Fransi* concerned a claim against a person who had given a bank a counter indemnity under a performance bond. Although the test which was applied in *Enka* without doubt set a lower standard than that established in *Solo Industries* and *Banque Saudi Fransi*, it remains the case that this standard is still fairly high, as evidenced by the banks' failure to meet it in *Enka*. It is agreed here that Teare J's approach is correct as the Civil Procedure Rules Part 24 should be applied whenever the court is considering an application for summary judgment.

IV.2 Full trial

In civil cases, the standard of proof required to convince the court that a proposition is true is to prove it 'on the balance of probabilities'. Professor Goode writes that this is the standard to be applied even at the trial of letters of credit cases, while emphasising, however, that 'in fraud cases, this is at the high end of the scale'.⁶² This may be correct, since in *Themehelp Ltd v West*, Waite LJ referred to the balance of probabilities standard as 'weighing the evidence with due regard to the gravity of the particular allegation'.⁶³ Xiang Gao, however, submits that, due to the very small number of cases, it is too early to conclude that the balance of

⁵⁶ *ibid* 586.

⁵⁷ [2007] 2 Lloyd's Rep 47.

⁵⁸ *ibid* [16]. Interestingly, it was stated that the applicable test is different in a case which involved a claim against a person who had given a counter-indemnity. It was held that the test applied in such circumstances is that set out in CPR 24.2, which is whether the defendant had shown that there was a real prospect that it would be able to prove the fraud exception at trial.

⁵⁹ [2009] EWHC 2410 (Comm).

⁶⁰ *ibid* [19].

⁶¹ *ibid* [24].

⁶² R Goode *Commercial Law* (3rd edn Lexis Nexis London 2004) 993.

⁶³ [1996] QB 84, 99.

probabilities is to be applied in trials considering the fraud exception.⁶⁴ He points out that such a distinction is not drawn in the United States.⁶⁵ One English case which considered the fraud exception in a full trial is *Turkiye IS Bankasi AS v Bank of China*,⁶⁶ where the Court of Appeal applied the 'only realistic inference is that of fraud' test, the same standard of proof which is applied in an application for interlocutory injunction to restrain payment on grounds of fraud.

Interestingly, in the Canadian case *Bank of Nova Scotia v Angelica-Whitewear*,⁶⁷ Le Dain J adjusted the test from *CDN Research* by distinguishing the proof of fraud required in an application for an interlocutory injunction to restrain payment on the ground of fraud from that of a case determining whether a draft was improperly paid by the issuing bank after notice of alleged fraud by the beneficiary:

A strong prima facie case of fraud would appear to be a sufficient test on an application for an interlocutory injunction. Where, however, no such application was made and the issuing bank has had to exercise its own judgment as to whether or not to honour a draft, the test in my opinion should be the one laid down in *Edward Owen Engineering*, 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.⁶⁸

He justifies this distinction by explaining the difficulty faced by the issuing bank at that point in comparison with that of a court in an application for an interlocutory injunction:

In view of the strict obligation of the issuing bank to honour a draft that is accompanied by apparently conforming documents, the fact that the decision as to whether or not to pay must as a general rule be made fairly promptly, and the difficulty in many cases of forming an opinion, on which one would hazard a lawsuit, as to whether there has been fraud by the beneficiary of the credit, it would in my view be unfair and unreasonable to require anything less of the customer in the way of demonstration of an alleged fraud.⁶⁹

This approach of adopting a higher standard of proof of fraud at full trials has also been adopted in Australia.⁷⁰

The analysis so far reveals that there are four possible conclusions in relation to the issue of standard of proof in a full trial:

- the standard at full trial is as high as that at pre-trial (the US position)
- a lower standard is applied in a full trial (Professor Goode's account)
- a higher standard is applied in a full trial (the Canadian and Australian position).
- the standard at full trial is as high as that at pre-trial where an injunction is sought; the standard at full trial is higher than that at pre-trial where a summary judgment is sought (the English position).

It is submitted here that there is no reason for a lower standard of proof to apply at trial. At trial, when considering the fraud exception, the courts will be looking retrospectively to the time when payment was made or should have been made. In view of the difficulties faced by banks in making a quick decision at that point, the writer agrees with the reasoning of Le Dain

⁶⁴ Xiang Gao (n 21) 51.

⁶⁵ He cites as support Official Comment 5 on UCC §5-109 which provides the following:

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

⁶⁶ *Turkiye* (n 45).

⁶⁷ (1987) 36 DLR 4th 161.

⁶⁸ *ibid* 177.

⁶⁹ *ibid* 178.

⁷⁰ *Hortico* (n 51) (SC).

J that a higher standard of proof at a full trial is needed. There is support for this in the judgment of Rix J in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* where the learned judge stated that 'the claimant gets the benefit of a lower standard of proof for the purposes of a pre-trial hearing'.⁷¹ Nevertheless, English judges are close to being too rigid in the application of the high standard of proof in pre-trial hearings where injunctions are sought and should be cautious in this regard. Otherwise, the fraud exception may not be able to serve its purpose, which is to prevent fraudulent parties from receiving payment.

V Additional hurdles for injunctions

The circumstances where the fraud exception may arise include the following:

- (a) an applicant seeking an injunction against the beneficiary from calling the credit on grounds of fraud
- (b) an applicant seeking an injunction against the paying bank from making payment on grounds of fraud
- (c) where payment has been made and recovery is sought but either the beneficiary or the issuing bank disputes their obligation to reimburse on the grounds of fraud.

In relation to a) and b), there is a further hurdle which an applicant has to overcome – the balance of convenience test propounded in *American Cyanamid v Ethicon Ltd*,⁷² according to which the court has to determine whether one party risks being prejudiced should an injunction be granted. In this case, Lord Diplock said that:

It would be unwise to attempt even to list all the various matters which may need to be taken into consideration in deciding where the balance lies, let alone to suggest the relative weight to be attached to them. These will vary from case to case.⁷³

If there is no imbalance, the courts should preserve the *status quo*, which is the state of affairs before the defendant embarked on the conduct sought to be restrained, provided the plaintiff did not delay the application for relief.

The *American Cyanamid* principles are also firmly adhered to in other common law jurisdictions. In relation to applications for injunctions involving letters of credit, it is often said that the test provides an extra benefit to banks because the balance of convenience is usually weighted against the applicant; only in exceptional cases would the test be overcome. The test requires a consideration of whether damages would be an adequate remedy for the applicant. If the bank pays and there is no breach of contract by the bank, there is no basis for an injunction; where the threatened payment is a breach of contract, the applicant will have a good claim for damages against the bank and an injunction would be inappropriate.⁷⁴ For these reasons, in *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*, Kerr J expressed the view that an applicant seeking an injunction would face an 'insuperable difficulty' and that the balance of convenience is 'hopelessly weighted against the plaintiffs'.⁷⁵

Moreover, it seems that in determining the balance of convenience in the context of letters of credit, the courts will always have to consider the position of the bank if payment was restrained. Most of the time, an injunction would expose the bank to multiple suits and the consequential costs involved in defending them. In *Czarnikow v Standard Bank London Ltd*,⁷⁶

⁷¹ [1999] 2 Lloyd's Rep 187, 202.

⁷² [1975] AC 396.

⁷³ *ibid.*

⁷⁴ [1978] QB 146, 155.

⁷⁵ *ibid.* Similar sentiments were expressed by the Ackner LJ in *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 565.

⁷⁶ [1999] 2 Lloyd's Rep 187.

Rix J asserted that if a claimant could obtain a Mareva injunction against a beneficiary, the overriding interest to protect a bank's reputation and the autonomy of banking commitments would always tip the balance against granting an injunction:

Ex hypothesi, the bank would be entitled, in the absence of an injunction, to pay the beneficiary and would not be in breach of contract to the claimant in doing so. Why, therefore, should the interests of the claimant overtop the public and general interests in the maintenance of banking commitments and in the autonomy of such commitments? The preference of concern about the private loss of the defrauded claimant to the general weal might arguably in a particular case fall in favour of the former, if the claimant could be in no other way protected. But it seems to me that the presence of the Mareva injunction or freezing order, which the Courts can grant in a case of fraud even on a worldwide basis and even as merely ancillary relief to litigation abroad, militates very strongly against that argument.⁷⁷

He noted that there were only two cases where an injunction had been upheld on an *inter partes* basis and there were problems with both.⁷⁸ It might be questioned whether consideration of the bank's reputation is relevant where the injunction sought is one against the beneficiary. Rix J emphasised in this case that there was no difference between seeking an injunction against a bank and a beneficiary, approving the words of Staughton LJ in *Group Josi Re Co SA v Walbrook Insurance Co Ltd* that: 'the effect on the life blood of commerce will be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment'.⁷⁹

In the US, equitable rules require an applicant seeking a preliminary injunction to show:

- (1) irreparable injury and either
- (2) (a) probable success on the merits or
 - (b) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the preliminary relief.⁸⁰

Following §5-109 (b)(3) UCC,⁸¹ these requirements also apply to the fraud exception. Generally, financial losses will not be regarded by the court as irreparable harm since this loss can be compensated if the applicant brings an action against the beneficiary under the underlying contract.⁸² In 1979, the Iranian revolution resulted in the non-performance of many contracts by US parties in Iran, most of which were secured by standby letters of credit. Fearing and anticipating that the Iranian government would make calls on the standby credits, some US applicants sought injunctions to restrain the US banks from paying. The applicants based their claim on the argument that the financial loss they would suffer would be irreparable since there would be no real remedy for them in the Iranian courts.

In *KMW International v Chase Manhattan Bank*⁸³ and *American Bell v Islamic Republic*,⁸⁴ the US courts rejected this argument on the basis that the plaintiffs had assumed the business

⁷⁷ [1978] QB 146, 155, 190.

⁷⁸ One of these two case is *Themehelp* (n 46) where there was a concession that a claim against a beneficiary, as distinct from a claim against a bank, was not covered by prior authority. The other case is *Kvaerner John Brown Ltd v Midland Bank plc* [1998] CLC 446 where the balance of convenience test was not applied at all.

⁷⁹ [1999] 2 Lloyd's Rep 187, 190.

⁸⁰ *Caulfield v Board of Education* 583 F.2d 605, 610 (2nd Cir. 1978); *Jackson Dairy, Inc. v H. P. Hood & Sons, Inc.*, 596 F.2d 70, 72 (2d Cir. 1979).

⁸¹ Sections 5-109 (b)(3) UCC provides that 'all of the conditions to entitle a person to the relief under the law of this State have been met'.

⁸² See *Jackson Dairy* (n 80) (per curiam); *Hudson Tire Mart, Inc. v Aetna Casualty & Surety Co.*, 518 F.2d 671, 675 (2d Cir. 1975); *Robert W. Stark Jr., Inc. v New York Stock Exchange, Inc.*, 346 F. Supp. 217, 231 (S.D.N.Y.), Aff'd, 466 F.2d 743, 744 (2d Cir. 1972); *Shelley v The Maccabees*, 183 F. Supp. 681, 684 (E.D.N.Y. 1960).

⁸³ 606 F.2d 10 (2d Cir. 1979).

⁸⁴ 474 F. Supp. 420 (S.D.N.Y. 1979).

risks of international transactions which included the possibility that, if a dispute arose and international litigation ensued, their funds would be paid out under the irrevocable letter of credit and held in foreign hands. In *American Bell*, the district judge even admitted that resorting to Iranian courts would be futile but decided that the plaintiff would be able to receive an adequate remedy in US courts. In both cases, it was held that the balance of hardship did not tip in favour of the plaintiffs because the defendant banks would suffer loss of credibility in the international banking community, a factor also taken into great account by English courts in the balance of convenience test. However, in many cases with similar circumstances heard after the Iran hostage crisis,⁸⁵ the courts held that Iranian courts were an unsuitable forum for obtaining any appropriate remedy because of Iran's hostility towards Americans.⁸⁶ Therefore, in these cases, the risk of foreign litigation was enough to show irreparable harm. The inconsistency between decisions in earlier and later cases may be justified by the differing circumstances before and after the hostages were taken.

It seems that US and English courts take into account very similar considerations when deciding whether to grant an injunction to stop payment. The extreme difficulties in seeking an interim (interlocutory) injunction, caused by the application of these conventional requirements, leads one to question whether it is appropriate for English courts to apply the *American Cyanamid* test in the context of the fraud exception. In *Brody, White & Co Inc v Chemet*,⁸⁷ the Singaporean Court of Appeal held that the balance of convenience test should be displaced in cases involving irrevocable letters of credit. In *Bocatra Construction Pte Ltd v Attorney General (No 2)*,⁸⁸ the application of this test was also rejected in relation to performance bonds:

... If the appellants' arguments are accepted,⁸⁹ this would mean that the court has to deal with both the equitable principle as well as the balance of convenience. To require such a 'double-barrelled' test would be dichotomous and illogical. In our opinion, whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be granted. Once this can be established, there is no necessity to expend energies in addressing the superfluous question of 'balance of convenience'. It does not lie in the mouth of the defendant to claim that damages would still somehow be an adequate remedy.⁹⁰

This study has already highlighted the high standard of proof of fraud required in proceedings for interlocutory injunctions to interrupt payment in England. Given that this high standard is in place to curb the potential injustice caused to other parties in a letter of credit transaction, it is contended that the application of the *American Cyanamid* test is unnecessary. The stringency of this standard was clearly recognised by Karthigesu JA in *Bocatra (No 2)*:

... [D]ispensing with consideration of the balance of convenience does not make an injunction any easier to obtain. Indeed, a higher degree of strictness applies, as the applicant will be required to establish a clear case of fraud or unconscionability in interlocutory proceedings. It is clear that mere allegations are insufficient.⁹¹

⁸⁵ This was a diplomatic crisis where 53 Americans were held hostage by Islamist students and militants following the seizure of the US Embassy in Tehran on 4 November 1979.

⁸⁶ *Harris Corporation* (n 9) 1344, 1356–57 (11th Cir. 1982); *Itek Corporation v First National Bank of Boston*, 511 F. Supp. 1341, 1349 (D.Mass. 1981), vacated and remanded on other grounds, 704 F.2d 1 (1st Cir. 1983); *American International Group, Inc. v Islamic Republic of Iran*, 493 F. Supp. 522, 525 (D.D.C. 1980); *Stromberg-Carlson Corp. v Bank Melli Iran*, 467 F. Supp. 530, 532 n 3 (S.D.N.Y. 1979).

⁸⁷ [1993] 1 SLR 65, 70.

⁸⁸ [1995] 2 SLR 733.

⁸⁹ The appellants argued that, on the balance of convenience, declaratory relief should have been granted since the appellants might suffer irreparable damage to their reputation as a consequence of a call for payment under the guarantee.

⁹⁰ *Bocatra* (n 88) [44–45].

⁹¹ *ibid* [47].

It is argued here that the Singaporean courts were right to reject the *American Cyanamid* test. In fact, the disposal of the *American Cyanamid* test should not be limited to cases involving irrevocable credits and performance bonds. The consideration of the bank's reputation in the balance of convenience test has the unfair effect of resulting in the dismissal of applications involving all types of credit. The focus of the test is the balancing of the applicant's interests against the interests of the other parties involved. Consistent with the *ex turpi causa non oritur actio* maxim, if an applicant is able to prove a clear case of fraud to a high standard in these proceedings, surely this overrides the potential inconvenience caused to any of the parties involved. If an injunction is not to be granted even in the event of the applicant proving a clear case of fraud, this defeats the purpose of the existence of the fraud exception. To impose the *American Cyanamid* requirements is to make the fraud exception practically defunct. Arguably, if an applicant is able to show a clear case of fraud, then the balance of convenience is tipped in the applicant's favour. Ironically, the balance of convenience test is commonly referred to as the 'balance of risk of injustice';⁹² but surely there is a greater risk of injustice if, upon proving a clear case of fraud, the injunction is still refused because of failure to satisfy this test? Also, there is greater uncertainty as a result of the application of the *American Cyanamid* principles, since judges have unfettered discretion in determining the relevant factors used to decide the balance of convenience. English law has already established that there are exceptions to the *American Cyanamid* principles in certain circumstances where there are other overriding interests.⁹³ In view of these arguments, the balance of convenience test should be abandoned in any application for an injunction to restrain payment on grounds of fraud.

VI Conclusion

The international trading and letter of credit systems are plagued with problems of fraud. Where the requirements of the fraud exception are met, a bank can refuse to make payment or an applicant (or another bank) can seek an injunction to restrain the paying bank from making payment. It must be said that the fraud exception has played a part in the advancement of the letter of credit as one of the most sophisticated forms of payment. However, despite being the most established ground to refuse payment, the analysis of the law related to the fraud exception clearly shows that only in very few instances would the fraud exception be invoked.

It has also been shown that the restriction on the identity of the fraudulent party in *United City Merchants* is not without its problems and can put banks in a very difficult position. Opinion is divided as to whether payment should be refused when a bank is presented with a document which has clearly been forged by a third party. It is recognised that there is a need not to intervene with payment arrangements entered into in international trading, but this should also be balanced against the importance of effectively deterring fraud. The writer urges English courts to review *United City Merchants* so that the fraud exception encompasses third party fraud. However, because an applicant/seller might be disadvantaged by this extension of the fraud rule, it has been emphasised in this article that the inclusion of third party fraud must be restricted. The many ways in which this can be achieved have been discussed, but this article inclines towards the adoption of the concept of constructive knowledge, which would serve the dual purpose of including and confining the parameters of third party fraud in the fraud exception.

⁹² *Cayne v Global Natural Resources plc* [1984] 1 All ER 225, 237; *Films Rover International Ltd v Cannon Film Sales Ltd* [1987] 1 WLR 672, 680.

⁹³ For example, defamation, covenants in restraint of trade, passing off cases etc. See Craig Osborne *Civil Litigation* (Oxford University Press Oxford 2006).

From analysis of the relevant case law it is clear that the standard of proof in applications for injunctions in English law is very high, although other jurisdictions adopt a different approach. The position in England is not ideal and should be changed so that a slightly lower standard of proof is applied at pre-trials where injunctions are sought. In relation to the standard of proof at full trials, almost all jurisdictions require a very high level of proof of fraud. Nevertheless, a bank's knowledge of any solid evidence must be timely.

It has also been argued that the balance of convenience test from *American Cyanamid* is unnecessary in the context of the fraud exception, since there are other mechanisms in place which considerably restrict the scope of the fraud exception. This test lacks certainty and imposes an unnecessary hurdle as the applicants are already burdened with the requirement to prove fraud to an extremely high standard. Further, this argument is consistent with the *ex turpi causa non oritur action* maxim, which forms the conceptual basis of the fraud exception. Hence it is proposed that the balance of convenience test should not be applied by judges when considering whether to grant an injunction under the fraud exception.