

LETTERS OF CREDIT AND FRAUD: A REVISIONIST VIEW

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*The letter of credit has been used for many years in international trade, but its legal nature and impact are not yet fully understood. This article analyses the specific problem of the effect of fraud on the generally accepted principle of the autonomy of documents that comply with the terms of the credit. The "gross" or "egregious" fraud standard, adopted in the United States in *Sztejn v. J. Henry Schroder Banking Corp.* and in England in *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, is not well founded in precedent, is inconsistent with the contractual nature of the letter of credit, and, in the United States, with modern legislation.*

A more liberal approach to the effect of fraud on letters of credit would be more compatible with equitable principles available in contract law generally, would more correctly reflect the increasing knowledge and consequent responsibilities of businessmen and their bankers, and would permit the law to respond flexibly to varying circumstances in particular cases. Existing rules applicable to charges of fraud would prevent a flood of litigation. The result of such a shift would not constitute a death-blow to the letter of credit, but permit it to continue as a vital, useful device in international trade.

*La lettre de crédit s'utilise depuis de nombreuses années pour le commerce international mais sa nature en droit et son importance sont encore mal connues. L'auteur analyse, dans cet article, les problèmes créés par les effets de la fraude dans le cadre de l'autonomie des documents qui satisfont aux conditions des lettres de crédit, principe généralement bien établi. L'étalon de la fraude grossière que les États-Unis ont adopté dans l'affaire *Sztejn v. J. Henry Schroder Banking Corp.* et l'Angleterre dans l'affaire *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, n'a pas de base solide en jurisprudence. Il est aussi en conflit avec l'aspect contractuel de la lettre de crédit et, aux États-Unis, avec la législation moderne.*

Un traitement plus libéral des effets de la fraude sur les lettres de crédit s'accorderait mieux avec les principes d'équité qu'offre le droit des contrats en général, refléterait plus précisément les connaissances toujours accrues des hommes d'affaires et de leurs banquiers et permettrait à la loi de s'appliquer de

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façon plus flexible aux différentes circonstances que présentent les cas. Les règles actuelles pour les mises en accusation pour fraude empêcheraient la multiplication des litiges. Cette modification ne sonnerait pas le glas de la lettre de crédit; elle lui permettrait au contraire d'être l'outil essentiel du commerce international.

Introduction

As the level of international trade has risen in recent years, businessmen have developed increasingly sophisticated and imaginative mechanisms for payment and financing. The device which has enjoyed their greatest favour is the documentary letter of credit. The rapid increase in its use in the wide variety of transactions now carried on in international trade is a tribute to its success in performing the vital function of a funnel or conduit through which flow documents representing goods and services sold and the money paid for them.

The letter of credit has been known and used for many years, but its nature and the major legal issues which arise in connection with its use remain little understood and only now are being studied systematically. As Taylor J. wryly observed in the recent case of *Michael Doyle Associates Ltd. v. Bank of Montreal*,¹ "[t]he actual letter of credit appears to be an instrument which has achieved a status so legendary in the world of international credit transactions as to render it wholly mythical. . . ." This imperfect understanding of the nature of the letter of credit has often made it difficult to deal with a number of legal and practical problems, expected and unexpected, which can and do interfere with the parallel flow of goods and documents which the parties anticipate. Some of these include: fraud by the beneficiary, freight forwarder or vessel master; bank failure; non-cooperation by consulates or chambers of commerce; technically or substantively deficient documentation; and changes in exchange regulations or other governmental requirements.

This article will re-evaluate two interrelated aspects of the operation of the letter of credit, the need for documentary compliance and the effect of fraud. Awareness of the significance of these subjects in Anglo-Canadian law has been considerably heightened in the wake of the House of Lords' judgment in *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*.² However, it is suggested that the decision neither makes practical sense nor springs as the logical or natural consequence of the nature of the letter of credit. To illustrate this, it will be useful before dealing with documentary compliance and fraud, to discuss the fundamental nature of the letter of credit in terms of its relationship to the mainstream of contract law.

¹ *Michael Doyle & Associates Ltd. v. Bank of Montreal* (1982), 140 D.L.R. (3d) 596, at p. 600 (B.C.S.C.).

² [1983] 1 A.C. 168. [1982] 2 All E.R. 720 (H.L.).

1. *The Nature of The Letter of Credit*

The Uniform Customs and Practice for Documentary Credits ("UCP") published by the International Chamber of Commerce defines a letter of credit as follows:³

... any arrangement, however named or described, whereby a bank (the issuing bank), acting at the request and in accordance with the instructions of a customer (the applicant for credit),

i. is to make payment to or to the order of a third party (the beneficiary), or is to pay, accept or negotiate bills of exchange (drafts) drawn by the beneficiary, or

ii. authorizes such payments to be made or such drafts to be paid, accepted or negotiated by another bank,

against stipulated documents, provided that the terms and conditions of the credit are complied with.

The parallel provision in the Uniform Commercial Code in the United States ("UCC") provides:⁴

(a) "Credit" or "letter of credit" means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor.

The genius of the letter of credit is that documents are used to represent the goods which are the subject of the underlying commercial transaction. This separation of documents and goods has been considered essential to the continued utility of the instrument, and the basis upon which banks enter into these transactions. Typically, the letter of credit itself is one of three sets of relationships which operate in conjunction with one another. The first relationship is the contract between the customer (buyer of goods or services and applicant for the credit) and the beneficiary (seller of goods or services and the person to whom the credit is issued). This contract will include the customer's promise to make payment for the goods or services by means of the letter of credit, and should set out the provisions of the credit in terms acceptable to the customer, the beneficiary, and their respective banks. The second relationship is formed between the customer and the issuing bank. The customer makes application for the credit on the issuing bank's standard form, specifying its terms and conditions, and also providing for reimbursement of amounts paid by duly honouring the beneficiary's draft, together with interest and other charges. The third relationship is that between the issuing bank and the beneficiary. This relationship may be direct, but more often there are interposed between these parties additional persons such as confirming, advising or negotiating banks. This relationship is constituted in the letter of credit

³ International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits (1974).

⁴ Uniform Commercial Code, art. 5-103(1)(a).

itself, by which the issuing bank engages to make payment upon presentation of the documents specified in the credit.

This deceptively simple sequence of events gives rise to a number of important legal questions. Two are fundamental to the letter of credit; first, how far does the opening of a credit constitute payment by the customer to the seller, and second, what is the nature of legal relationship between the various banks and the beneficiary.

On one view, a letter of credit can be considered a conduit for payment, or even payment itself, although the latter view has been generally discredited in the United Kingdom. Numerous authorities have established that the opening of a credit operates as a mere conditional discharge, so that if the issuing bank fails to perform its undertaking, the customer's duty to pay the price is revived.⁵ In *Maran Road Saw Mill v. Austin Taylor & Co. Ltd.*,⁶ Ackner J. decided that the buyer had not performed its entire duty under a sales/agency contract by furnishing a letter of credit and putting the issuing bank in funds, and on the issuer's insolvency, was obliged to pay the price over again. Ackner J. relied on a dictum of Stephenson L.J. in *W.J. Alan and Co. Ltd. v. El Nasr Export and Import Co.*,⁷ where the latter said that the buyers had "promised to pay by letter of credit, not to provide by a letter of credit a source of payment which did not pay".⁸ Ackner J. added that "a letter of credit operates as conditional payment of the price and not as absolute payment . . . based on the analogy . . . a cheque. . ."⁹

The American position is somewhat different. In *Vivacqua Irmaos, S.A. v. Hickerson*,¹⁰ and in *Ornstein v. Hickerson*,¹¹ the buyer received the goods and documents and paid the price to the bank, which failed before maturity of the draft it had accepted. Contrary to Ackner J.'s view, the court in *Ornstein* concluded that the customer had performed its contractual obligations by furnishing the letter of credit, arranging for acceptance of the beneficiary's draft and paying the issuer before maturity. This view suggests that a letter of credit may indeed constitute payment.

The UCC offers one practical solution to this conflict by giving the beneficiary of a letter of credit a priority over unsecured creditors in the

⁵ E.P. Ellinger, Does an Irrevocable Credit Constitute Payment? (1977), 40 Modern L. Rev. 91, at p. 92.

⁶ [1975] 1 Lloyd's Rep. 156 (Q.B.D.).

⁷ [1972] 2 Q.B. 189, [1972] 2 All E.R. 127 (C.A.).

⁸ *Ibid.*, at pp. 220 (Q.B.), 146 (All E.R.).

⁹ See *Maran Road Saw Mill*, *supra*, footnote 6, at p. 159.

¹⁰ 190 So. 657 (S.C. La.; 1939).

¹¹ 40 F. Supp. 304 (5th Cir. Dist. Ct.; 1941).

event of the bank's insolvency.¹² One commentator has assessed this approach in the following way:

... the Uniform Commercial Code focuses on the segregation, not the source, of the funds as being the key factor in creating a trust-type relationship between the bank that has been paid by its customer, the buyer, and the beneficiary of the credit or other holder of the accepted draft. When insolvency occurs before the letter of credit transaction has been completed, the security interest held by the bank, the funds from the bank's customer to pay the seller's drafts, and the related drafts and documents are to be considered separately from the deposit liabilities and the general assets of the bank.¹³

If one accepts the English position, and assumes that the letter of credit does not constitute payment, the second question, the nature of the relationship between the beneficiary and the issuing and advising banks takes on an added significance. The legal nature of this relationship has never been understood fully and continues to be uncertain. For example, in the UCP it is stated that an irrevocable credit constitutes a "definite undertaking".¹⁴ The UCC refers to it merely as an "engagement".¹⁵ These formulations seem deliberately vague. Is the advising bank's "engagement" a promise, and is the bank/beneficiary relationship contractual in nature? The matter is of practical as well as academic significance. Among other things, the resolution of this issue can determine the applicability of legislation governing boycotts.¹⁶

¹² Uniform Commercial Code, art. 5-117(1):

Where an issuer or an advising or confirming bank or a bank which has for a customer procured issuance of a credit by another bank becomes insolvent before a final payment under the credit: ... the receipt or allocation of funds or collateral to secure or meet obligations under the credit shall have the following results:

- (a) to the extent of any funds or collateral turned over after or before the insolvency as indemnity against or specifically for the purpose of payment of drafts or demands for payment drawn under the designated credit, the drafts or demands are entitled to payment in preference over depositors or other general creditors of the issuer or bank; and
- (b) on expiration of the credit or surrender of the beneficiary's rights under it unused any person who has given such funds or collateral is similarly entitled to return thereof; and
- (c) a change to a general or current account with a bank if specifically consented to for the purpose of indemnity against or payment of drafts or demands for payment drawn under the designated credit falls under the same rules as if the funds had been drawn out in cash and then turned over with specific instructions.

¹³ Steven R. Berger, *The Effects of Issuing Bank Insolvency on Letters of Credit* (1980), 21 *Harvard Int. Law J.* 161, at p. 174.

¹⁴ Uniform Customs and Practice for Documentary Credits, art. 3(a).

¹⁵ Uniform Commercial Code, art. 5-103(1)(a).

¹⁶ This point may be illustrated by reference to Ontario's Discriminatory Business Practices Act, R.S.O. 1980, c. 119. If one accepts that the relationship between a confirming or advising bank and a beneficiary is contractual in nature, then section 10(2) has very serious implications. If the credit calls for presentation of a negative certificate of origin or other offensive document, and if either the bank or the beneficiary is located in Ontario and

In *Data General Corp. Inc. v. Citizens National Bank of Fairfield*,¹⁷ it was accepted that this relationship is fundamentally contractual, and alternative analyses were reviewed under which the letter of credit can be characterized as a bilateral contract, a unilateral contract, or a contract for the benefit of a third party. A contractual characterization can be used to justify the recent trend toward greater flexibility in the interpretation of the issuing bank's obligation to pay, and the application of doctrines generally applicable to contracts, such as substantial performance, or breach of warranty, as well as the importation of other equitable considerations. In letter of credit transactions, substantial performance has been equated in some quarters with substantial documentary compliance. The UCC and UCP terms "undertaking" and "engagement" lend support to a contractual characterization as well.

II. *Autonomy, Documentary Compliance and Fraud*

As indicated above, the central feature of the letter of credit is its substitution of documents to represent the goods or services which are the subject of the underlying commercial transaction. Megrah has stated that, "banks are not concerned with the sales contract or the goods; if it were otherwise credit business would be impossible. In law, the credit contract stands by itself. . ."¹⁸ General Provision (c) of the UCP provides that, "credits, by

could be considered a person in Ontario, then the clause in the credit calling for the document in question would be deemed a nullity, and severable from the contract. In such an event, the beneficiary could ignore the clause, decline to present the document in question, and yet claim payment from the bank on the basis that the valid and subsisting clauses of the credit contract have been complied with. This could provide a positive opportunity for a non-Ontario beneficiary faced with consular insistence on boycott compliance, to obtain payment at the expense of an "Ontario person" bank. The bank in turn, would be left with an incomplete set of documents against which to claim reimbursement.

The scheme of the Act does leave the bank with some contrary arguments, but they are of questionable force. Banking is a head of legislative power reserved to the federal government by the Constitution. The Act's prohibition against, for example, negative certificates of origin, particularly when coupled with the Act's reporting requirements, could arguably be construed as a substantial violation of the confidentiality of the bank/customer relationship and therefore an unwarranted intrusion into the field of legislation in relation to banking.

As is the case in the United States under the regime of regulations promulgated under the Export Administration Act, the scheme of the Discriminatory Business Practices Act requires banks handling letters of credit with Arab countries to inquire into aspects of their customers' affairs which hitherto had been considered irrelevant for the purposes of the credit. The Act's potential effect on the bank makes the customer's status as a "person in Ontario", the characterization of the letter of credit, and the proper law of the credit contract matters of substantial concern. The complexities of resolving these matters are burdensome in most cases, and can be damaging in some.

¹⁷ 502 F. Supp. 776 (2nd Cir. Dist. Ct.: 1980).

¹⁸ H.C. Gutteridge and M. Megrah, *The Law of Banker's Commercial Credits* (5th ed., 1976), p. 59.

their nature, are separate transactions from the sales or other contracts on which they may be based and banks are in no way concerned with or bound by such contracts". Further, Article 8(a) states, "in documentary credit operations all parties concerned deal in documents and not in goods". The American position is similar. The UCC provides in Article 5-114(1):¹⁹

An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.

The principle of autonomy has even been held to apply where the credit explicitly incorporates the underlying contract of sale.²⁰

This principle of the autonomy of the letter of credit has made it essential that the parties to an international sales transaction specify as clearly as possible in their commercial agreement the terms that are to appear in the letter of credit. Of course, the practices and policies of the issuing and confirming banks must be taken into account when negotiating the contractual payment terms. Therefore, to achieve congruence between the commercial contract and the letter of credit, all relevant banks should be consulted before the contract is finalized. It has become an accepted corollary of the principle of autonomy that the documents presented under the letter of credit for payment must be exactly as specified in it. In a famous statement in the case of *Equitable Trust Co. of New York v. Dawson Partners Ltd.*,²¹ Lord Sumner said, "[t]here is no room for documents which are almost the same, or which will do just as well". Conversely, as Harfield puts it:²²

... the issuer cannot assert a breach of (the commercial) contract as a defense to payment under the letter of credit, nor can the beneficiary excuse deficiency in his performance of the letter of credit terms by showing that his performance accorded with the terms of his contract with the account party. In like matter, the beneficiary cannot compel payment by the issuer on the ground that the terms of the credit were more onerous than those stipulated in the contract between issuer and account party, nor can the issuer justify nonpayment on the basis of the breach of his contract with the account party.

These propositions are given statutory effect in the United States by UCC Article 5-114(2), and are also expressed in UCP Article 8(b).

Most banks and many other observers have accepted the view that the continued utility and even the viability of the letter of credit as a payment

¹⁹ Uniform Commercial Code, art. 5-114(1).

²⁰ *Courtalds North America, Inc. v. North Carolina National Bank*, 528 F. 2d 802 (4th Cir. C.A.; 1975).

²¹ (1927), 27 Lloyd's List Law Rep. 49, at p. 52 (H.L.).

²² H. Harfield, *Enjoining Letter of Credit Transactions* (1978), 95 Banking Law J. 596, at pp. 600-601.

instrument depends upon the strictest observance of these principles. For example, Henry Harfield recent poetically decried what he perceives to be a judicial trend to make inroads on these principles, saying:²³

. . . failure to apply the rules that a letter of credit is to be construed strictly as an independent contract creates traumatic and unnecessary identity crises. . . The rules identify the device. Unless the letter of credit is "kep' sep'rate", . . . the device can no more survive . . . than a fish can survive out of water, even though the air be purest breath of Heaven.

It is certainly true that banks to which documents are presented for payment undertake an onerous task in reviewing them and making the judgment whether or not to pay against them, and expose themselves to substantial risks where the wrong decision is made. Even if the documents comply in form with the credit, the question remains what circumstances will call their substance into question. As international commerce grows, litigation involving this and related questions will increase as well. Thus, there will be an increasing need to identify and weigh the interests of the various parties to the commercial and banking transactions involved. A contribution to that endeavour can be made by reviewing and placing in context a number of cases in the United States, Britain and Canada, and the statutory or customary framework from which they arose.

A. *The American Evolution*

As indicated above, UCC Article 5-114 provides a basic code describing some of the rights and obligations of a bank to which documents are presented for payment under a documentary letter of credit. Article 5-109 is relevant as well, and provides in part as follows:

- (1) An issuer's obligation to its customer includes good faith and observance of any general banking usage. . .
- (2) An issuer must examine documents with care so as to ascertain that on their face they appear to comply with the terms of the credit but unless otherwise agreed assumes no liability or responsibility for the genuineness, falsification or effect of any document which appears on such examination to be regular on its face.²⁴

Article 1-201(19) defines the "good faith" required under 5-109(1) as "honesty in fact in the conduct or transaction concerned". This subjective test is made applicable to all commercial transactions through Article 1-203. It is certainly clear from Article 5-114(2)(b) that the autonomy of the letter of credit is not sacrosanct, but can be interfered with or ignored in certain cases. The questions are: When? and To what end? These questions have, of course, arisen before and after the appearance of the UCC, and it is useful to look at both the pre and post Code decisions.

²³ H. Harfield, *Identity Crises in Letter of Credit Law* (1982), 24 *Arizona Law Rev.* 239, at p. 254.

²⁴ *Uniform Commercial Code*, art. 5-109 (1).

One of the early pre-UCC cases dealing with these questions is *Maurice O'Meara Co. v. National Park Bank of New York*.²⁵ That case involved the shipment of paper of a certain stated weight or strength. The bank refused to pay against apparently conforming documents, because there had "arisen a reasonable doubt regarding the quality of the newsprint paper".²⁶ The bank defended the beneficiary's action on the ground that the paper was defective. The court rejected this claim, pointing out that the buyer had remedies at law for any alleged defect in quality, and that to hold for the beneficiary would impose a duty on the bank which could defeat the central purpose of the credit. In *Old Colony Trust Co. v. Lawyers' Title & Trust Co.*,²⁷ the court held 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 recognize such a document as complying with the terms of a letter of credit". Although both *O'Meara* and *Old Colony* appear to be cases of intentional fraud, the former involved fraud with regard to the goods, while in the latter the goods were not defective, but rather the payment documents were fraudulent.

However, of the pre-UCC cases, the seminal decision is *Sztejn v. J. Henry Schroder Banking Corp.*²⁸ In that case, Schroder opened a credit on Sztejn's account in favour of Transea Trading Ltd. covering shipment of bristles. Documents, including bills of lading for bristles, were presented to Transea's bank, and were subsequently forwarded to Schroder for reimbursement. Before payment however, Sztejn applied for an injunction restraining payment on the ground that no bristles were in fact shipped, but merely worthless rubbish. The court held that in such a situation, "the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller",²⁹ and added that "the distinction between a breach of warranty and active fraud on the part of the seller is supported by authority and reason",³⁰ again taking account of the reliance the bank places on its security in the goods.

The early cases have been taken to establish an "egregious" or "gross" fraud test, requiring that in order for an injunction to be granted directing the issuing bank not to pay, it must be demonstrated that the documents presented for payment fraudulently state the contract goods have been shipped when in fact no such goods were shipped at all, or that such documents were forged. Otherwise the issuing bank is not affected by disputes between the buyer and seller.

²⁵ 146 NE 636 (N.Y.C.A.; 1925).

²⁶ *Ibid.*, at p. 639.

²⁷ 297 F. 152, at p. 158 (2nd Cir. C.A.; 1924).

²⁸ 31 NY Supp. 2d 631 (N.Y.S.C.; 1941).

²⁹ *Ibid.*, at p. 634.

³⁰ *Ibid.*, at p. 635.

Article 5-114(1) of the UCC sets out the general obligation of the issuing bank to honour drafts or demands for payment which comply with the terms of the relevant credit.³¹ Sub-section (2) of section 114 underscores the imperative nature of that obligation even in cases where a required document is "forged or fraudulent or there is fraud in the transaction". In such cases an issuer must pay those persons falling within paragraph (a) of sub-section (2) and may pay those falling within paragraph (b), subject however in the latter case to a court enjoining payment.³²

Despite the language of section 114 some more recent cases have continued to apply a gross fraud standard. In *Intraworld Industries Inc. v. Girard Trust Bank*,³³ the court stated that:

. . . the circumstances which will justify an injunction against honor must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.

More recently, the Appellate Court of Illinois adopted this approach in *First Arlington National Bank v. Stathis*,³⁴ saying, that the "fraud" exception in Article 5-114 was a narrow one, encompassing only the rare case of egregious fraud or fraud in the formation of the underlying contract.

However, despite the continued adherence of some courts to this traditional point of view, the flexibility offered by the language of Article 5-114 has induced courts in other recent cases to erode the gross fraud standard. In *United Bank Limited v. Cambridge Sporting Goods Corp.*,³⁵ the court stated that "the drafters . . . in utilizing the term 'fraud in the transaction' . . . adopted a flexible standard to be applied as the circumstances of a particular situation mandate". Similarly *Dynamics Corporation of America v. Citizens & Southern National Bank*³⁶ expressed the opinion that the "law of 'fraud' is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society". The court went on to cite with approval a passage from a decision of the United States Supreme Court in which that court stated that fraud had a wider meaning in equity than at law and that it could be found to exist without proof of an intention to defraud or misrepresent.^{36a}

³¹ *Supra*, footnote 19.

³² Paragraph (a) covers a holder in due course, a person to whom a document of title has been duly negotiated and a bona fide purchaser of a security; paragraph (b) covers, as against the customer, all other cases.

³³ 336 A 2d 316, at pp. 324-325 (S.C. Pa.; 1975).

³⁴ 413 NE 2d 1288, at p. 1295 (Ill. App. Ct.; 1981).

³⁵ 360 NE 2d 943, at p. 949 (N.Y.C.A.; 1976).

³⁶ 356 F. Supp. 991, at p. 998 (5th Cir. Dist. Ct.; 1973).

^{36a} *Ibid*. The Supreme Court decision referred to was *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, at p. 193 (1963). The Supreme Court in turn cited a passage from De Funiak, *Handbook of Modern Equity* (2nd ed., 1956), p. 235.

Further support for a broader application of Article 5-114 is found in the case of *NMC Enterprises Inc. v. CBS Inc.*³⁷ There, the beneficiary knowingly supplied the customer with stereo receivers whose power was substantially less than stated in the sales brochures. The facts made out a prima facie case of fraud, but clearly not of the egregious sort. The court in *NMC* acknowledged the principle of autonomy, but felt that the bank need not make payment even against apparently conforming documents "where the documents or the underlying transaction are tainted with intentional fraud. . . ."³⁸ The court also rejected as "specious" the argument that the *Sztejn* rule would apply only to cases of fraud intrinsic to the documents and not as to the commercial transaction.³⁹

Thus it is evident that in the United States the *Sztejn* rule is no longer uniformly restricted to cases of gross or extreme fraud, nor to cases where the fraud related to the payment documents rather than to the sales contract. The more liberal approach is certainly consistent with the provisions of the UCC. Before considering whether this approach is desirable, it will be useful to review the treatment given these problems in England and Canada.

B. The English Approach

R.D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.,⁴⁰ involved sales of goods to Egyptian buyers. The English plaintiffs were required to establish guarantees confirmed by a bank in favour of the buyer to secure performance of the seller's obligations under the contracts. The guarantees were issued by the English bank to an Egyptian bank, which then confirmed the guarantees to the buyer. After a period of time in which the buyer threatened to call the guarantees unless they were extended, calls were in fact made, the plaintiff seller cried fraud, and sought to restrain the issuing bank from making payment, despite the broad and unconditional wording of the guarantees. The fraud claimed was that the buyer had failed to have an irrevocable letter of credit issued for the purchase price of the goods.

Kerr J. felt that this was not a case of established fraud at all, but in any event took a restrictive view as to the circumstances in which an issuing bank might justifiably refuse to pay.⁴¹

It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international

³⁷ 14 UCC Rep. Serv. 1427 (1974).

³⁸ *Ibid.*, at p. 1429.

³⁹ *Ibid.*, at p. 1430.

⁴⁰ [1978] Q.B. 146, [1977] 2 All E.R. 862 (Q.B.D.).

⁴¹ *Ibid.*, at pp. 155-56 (Q.B.), 870 (All E.R.).

⁴² Emphasis added. Kerr J. relied on *Hamzeh Malas & Sons v. British Imex Industries Ltd.*, [1958] 2 Q.B. 127, (Q.B.D.); *Bache & Co. (London Ltd.) v. Banque Vernes et*

commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. *Except possibly in clear cases of fraud* of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts. The courts are not concerned with their difficulties to enforce such claims, these are risks which the merchants take.⁴²

The *Harbottle* case is followed immediately in the Queen's Bench Reports by *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*,⁴³ a decision of the Court of Appeal. Other than a shift of locale from Egypt to Libya, there are few substantive factual differences between the two cases. In *Owen*, Geoffrey Lane L.J. stated that the buyer's failure to open the letter of credit "may be suspicious, it may indicate the possibility of sharp practice, but there is nothing in those facts remotely approaching true evidence of fraud or anything which makes fraud obvious or clear to the bank".⁴⁴ Browne L.J. also accepted that fraud must be "very clearly established". Clearly, the *Harbottle* and *Owen* decisions reflect the more restrictive approach to the availability of injunctive relief to restrain payment against documents fraudulently presented, at least with regard to the matter of proof, if not so explicitly concerning the degree of fraud involved.

The most recent and famous British case involving a discussion of the effect of fraud on a bank's obligation to pay under a letter of credit is, of course, *United City Merchants*,⁴⁵ a decision of the House of Lords. In that case, a British seller of goods to a Peruvian customer was the beneficiary of a letter of credit confirmed by the Royal Bank. The seller assigned its rights under the credit to the plaintiff. It appeared that the bills of lading had been fraudulently altered by a freight forwarder to show a shipment date within the period allowed for shipment. The Royal Bank refused to pay because it had learned of this fraud before presentation of the documents. The assignee of the beneficiary had played no part in the fraud and brought action to claim payment.

With regard to the issue of fraud and the bank's liability under the credit, the trial judge rejected the bank's defense. However, the Court of Appeal reversed his decision on this point.⁴⁶ Ackner and Griffiths LL.J. decided in favour of the bank largely on the basis that the forged bill of lading was not valid and therefore would fail to confer on the bank the security in the goods on which it relied in making advances, and, primarily on the same basis, also concluded that the fact the fraud was committed by

Commerciale de Paris S.A., [1973] 2 Lloyd's Rep. 437 (C.A.); *Discount Records Ltd. v. Barclays Bank Ltd.*, [1975] 1 W.L.R. 315, [1975] 1 All E.R. 1071 (Ch. D.). In the latter case Megarry J. distinguished *Sztejn* on the facts.

⁴³ [1978] Q.B. 159, [1978] 1 All E.R. 976 (C.A.).

⁴⁴ *Ibid.*, at pp. 175 (Q.B.), 986 (All E.R.).

⁴⁵ *Supra*, footnote 2.

⁴⁶ [1982] 2 Q.B. 208, [1981] 3 All E.R. 142 (C.A.).

someone other than the beneficiary was immaterial. Stephenson L.J., after a lengthy review of the authorities, both British and American, concluded:⁴⁷

There was fraud in the transaction, and our courts should adopt the flexible standard to be applied as the circumstances of a particular situation mandate, as did the Uniform Commercial Code now ruling in the United States of America. We should not apply it only to situations . . . in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.

Stephenson L.J.'s judgment is a strong statement in favour of a liberal approach with regard to the severity of fraud required to justify an injunction in restraint of payment.

However, in the House of Lords, the plaintiff's appeal was allowed in a unanimous judgment. Lord Diplock was unimpressed with the argument relating to the bank's security, pointing out that in this particular case the value of the goods on any potential realization by the bank would not be affected by the fact the goods were shipped December 16 rather than December 15, and held that such an alteration did not invalidate the bill of lading. He also pointed out that the seller had taken no part in the fraud and so was in fact also a victim of it. Lord Diplock's conclusion was that a significant increase in the level of the bank's duty to examine documents with reasonable care for conformity on their face with the terms of the credit in accordance with UCP Article 9 would "undermine the whole system of financing international trade by means of documentary credits".⁴⁸

It is noteworthy that Lord Diplock's judgment focuses primarily on the Court of Appeal's application of the fraud exception to cover fraud by the author of a document, and need not be read as applicable to the situation where the fraud is perpetrated by the beneficiary. He does not expressly criticize the use of the fraud exception in the latter circumstance, nor the Court of Appeal's advocacy of an increase in its flexibility. Still, the judgment is not by any means supportive of the liberal view.

C. Canadian Contributions

Not surprisingly, there has been very little litigation in Canada to date concerning the issue of fraud in letter of credit transactions. However, in *C.D.N. Research & Development Limited v. The Bank of Nova Scotia*,⁴⁹ Smith J. said that "[i]t may well be that the test of 'clear fraud' is too high

⁴⁷ *Ibid.*, at pp. 239 (Q.B.), 164 (All E.R.).

⁴⁸ *Supra*, footnote 2, at pp. 184 (A.C.), 726 (All E.R.).

⁴⁹ (1982), 136 D.L.R. (3d) 656, at p. 662, 39 O.R. (2d) 13, at p. 19 (Ont. Div. Ct.). The reference in Smith J.'s dictum to Galligan J. is to *C.D.N. Research and Development Ltd. v. Bank of Nova Scotia* (1980), 18 C.P.C. 62, at p. 65 (Ont. H.C.).

. . .” and that “[t]he test applied by Galligan J. of a strong *prima facie* case appears to be more apt and is less onerous than that of Lord Denning in *Owen* of clear or established fraud”.

The only Canadian case to date which comments on *United City Merchants* is a decision of the Supreme Court of British Columbia, *Henderson v. Canadian Imperial Bank of Commerce*.⁵⁰ After reviewing the origin of the fraud exception in *Sztejn*, Berger J. expressly rejected Lord Diplock’s conclusion that a bank must pay against apparently conforming documents where the bank knows that the seller has committed a breach of contract which would disentitle him to payment from the buyer. Berger J. thought that Lord Diplock’s restriction of the fraud exception to cases of material misrepresentations known to the bank would render the exception “illusory” and narrow it “to the point of virtual insignificance”. It is understood that the bank chose not to appeal Berger J.’s judgment in the *Henderson* case. The Canadian position then, would appear to be that intentional fraud rather than gross fraud, and *prima facie* evidence rather than clear proof, are required for invocation of the *Sztejn* exception. Although tentatively, it appears that Canada may now be moving toward the liberal camp.

Conclusion

The cases discussed above and the provisions of the UCC suggest that the American application of the fraud exception has been expanded since its inception, and no longer requires fraud so gross as to “vitate the entire transaction”. Lord Diplock’s judgment in *United City Merchants* was narrowly decided on the point that the fraud there was committed by a person other than the beneficiary; fraud by the beneficiary might have led to the opposite result, and the Court of Appeal’s exhortation to use the flexible approach in the UCC may yet find favour in Britain. Canadian decisions are still too few to permit firm conclusions, but *Henderson* is an indication of a willingness to consider the modern American approach.

As indicated earlier, this recent trend toward a more generous application of the fraud exception has been greeted with outrage by many bankers. Harfield views “with alarm that borders on panic, the possibility that judges may apply in letter of credit cases the principles of equity. . .”⁵¹ This fear has been given voice in practice as well:

In June 1980, Standard and Poor’s Corp. issued guidelines in which it refused to rank commercial paper backed by bank letters of credit on the basis of the creditworthiness of the bank, where the bank was secured by the debtor’s collateral and the beneficiary of the letter credit was not. . . Counsel to Standard and Poor’s . . . reasoned that where such a situation existed, a Chapter 11 debtor or trustee under the

⁵⁰ (1982), 40 B.C.L.R. 318 (B.C.S.C.).

⁵¹ H. Harfield, *Code, Customs and Conscience in Letter of Credit Law* (1971), 4 UCC Law J. 7, at p. 8.

Bankruptcy Code might seek and obtain an injunction that would prevent the bank from paying on a timely basis.⁵²

Nevertheless, it is submitted that on closer scrutiny these apprehensions are not well founded. It is said that the letter of credit is useful only because it makes payment a certainty. But surely, what is required in fact is *predictability* of payment. Modern financing and insurance techniques have made it possible to reallocate and spread risks of loss in a variety of ways, and the disposition of fraud claims should be viewed as merely one element in the overall framework of risks to be allocated. Clarity and predictability with respect to this matter will establish a level of foreseeability which would enable traders to take steps to apportion risks between themselves or to spread them through insurance and other means. However, the ability to shift a risk does not mean that the law should be indifferent to its initial allocation. Careful thought is needed to establish equitable rules for use by persons and groups whose abilities to shift risks may vary. Both banks and traders have some ability to protect themselves against the risk of a claim for an injunction to prevent payment under a letter of credit. This protection might be obtained through insurance, in which case the premium would become an element of the price the seller charges for the goods or the bank charges for confirmation. Alternatively, the seller or bank could self-insure, again passing on the additional cost in the pricing structure. It is acknowledged that market forces will constrain the ability to pass these cost increases on to customers.

At present, the severely limited conditions under which a bank will be enjoined from paying under a letter of credit impose the bulk of the risk of loss upon the purchaser. The confirming bank's concerns are that if it pays the beneficiary it may be prevented from obtaining reimbursement from the issuing bank which may also be subject to an injunction, and that if it fails to make payment it may be in breach of its contract with the issuer. The seller's major risk, where the injunction is known prior to delivery of the goods to the port of export, is that it will be difficult to mitigate loss through resale. The extent of this risk will depend, of course, on factors such as market demand for the goods, their uniqueness, perishability, and so on.

While in many circumstances the present regime may be appropriate, in others it lacks the desirable and necessary degree of flexibility. A more liberal approach to the fraud rule would lead to more balanced apportionment of the risks facing each of the parties. Subject to the impact of market forces, the seller's risks might be covered through insurance and price increases. Those facing the confirming bank might be handled in the same manner. Furthermore, amendments to the UCP limiting the confirming bank's liabilities to the issuing bank and beneficiary where it is faced with an injunction should be considered. At this date the UCP fails to address the

⁵² H.L. Ash and J.L. Schwartz, *Letters of Credit: Judicial Apprehensions Misplaced* (1983), 5 National Law J. 13, at p. 18.

subject of the various parties' rights and responsibilities in the face of litigation based on fraud. The current International Chamber of Commerce's proposals for a new UCP (to come into effect in October 1984) have made no improvements in this area.

While one cannot argue that business traders are in a position to have better knowledge of their own business arrangements than their bankers do, it is not equally true that they have greater expertise in the mechanisms of trade financing, and it is clearly the case that bankers have a superior understanding of the nature and workings of the letter of credit and the rights and obligations associated with its use. That is the bank's business. The judgment in the recent *Michael Doyle*⁵³ decision shows that the seller/beneficiary was under some confusion as to the effects of an arcanelly worded advice of credit he received from the bank. The expert witnesses called to discuss the letter of credit at the trial were bankers, not businessmen. Surely the bank's expertise in these matters ought to be accompanied by a corresponding obligation. The cases do not discuss the banker's duties to its customer relating to the opening of a letter of credit in any detail. Presumably, though, a bank holding itself out as having expertise in this type of business would be subject to liability under the *Hedley Byrne* doctrine.⁵⁴ This doctrine appears to have been at work in the *Michael Doyle* decision and in *U.S. Industries Inc. v. Second New Haven Bank*,⁵⁵ where the bank's reassurances to the plaintiff seller gave rise to an estoppel against a defense based on documentary nonconformity.

Furthermore, European experience has indicated that interpolation of equitable principles need not render the letter of credit fundamentally inefficacious. Kozolchyk notes that in France, for example, the customer has been able to obtain a *saisie-arrêt* or attachment order from the Court of Cassation to prevent the issuer from paying under the credit where the customer's position is in jeopardy. The remedy is discretionary, and is available not only in cases of fraud or total failure of consideration, but also in cases of partial breach.⁵⁶

It is also suggested that the objectives of harmonization with related areas of law and general legal concepts are not well served by adoption of the strict approach to the fraud exception. A careful reading of the cases suggests that the very narrow view expressed in cases such as *Intraworld* is not justified on precedent. In *Sztejn* itself, the fraud in question was not clearly "gross" in nature. It may well be therefore, that the recent cases

⁵³ *Supra*, footnote 1.

⁵⁴ *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.*, [1964] A.C. 465, [1963] 2 All E.R. 575 (H.L.).

⁵⁵ 462 F. Supp. 662 (2nd Cir. Dist. Ct.; 1978).

⁵⁶ B. Kozolchyk, *Letters of Credit*, in *International Encyclopedia of Comparative Law*, vol. IX, chap. 5 (ed. by J.S. Ziegel) (1979) p. 130 ff.

have liberalized a rule that should not have been taken as "strict" in the first place.

The acceptance of an element of flexibility in the fraud exception, extending it to cases of strongly arguable or prima facie fraud, and requiring not egregious fraud but merely the "common or garden" variety, will still leave the injunction as an extraordinary remedy, available in rather limited circumstances. Under Ontario's Rules of Practice, for example, fraud must be pleaded with greater particularity than is required in other cases.⁵⁷ Injunctive relief, even after the *American Cyanamid* case,⁵⁸ is by no means granted as a matter of right. In addition to determining the balance of convenience and whether there is a serious issue to be tried, the court will, where the grant or refusal of relief will have the practical effect of ending an action, consider the likelihood of the plaintiff's success in a subsequent action, and whether the plaintiff has established a prima facie case. The plaintiff must show that refusal of the injunction would cause him irreparable harm in that usual legal remedies would be of little value.⁵⁹ Normally as well, the plaintiff is required to post security for costs. To the extent that it is not now the practice, the plaintiff could and probably should be required to pay the money which is the subject of dispute into court.

It is submitted that these practical restraints have and will continue to prevent a flood of injunctions based upon the liberalization of the fraud exception. Such liberalization would have the beneficial effect of placing the letter of credit in the legal mainstream, subject to normal concepts and rules applicable to other contracts. This will, it is suggested, encourage clearer analysis of the instrument, thereby making its development more systematic. At the same time, the flexibility inherent in UCC Article 5-114 would provide an opportunity for the courts to achieve desirable results in varying circumstances. As indicated, the proposed UCP does not address these concerns; as a code for use by banks and businessmen operating in different legal systems, it would be well if it were amended to do so.

The implementation of letters of credit in North America has become an extremely complex business, both for banks and for their customers. New judicial, legislative and mercantile trends are beginning to take shape, although often in a haphazard and unwitting way. The rights and obligations of the various parties involved in letter of credit transactions have become more fluid and at the same time more contentious. The autonomy of the letter of credit is coming under increasing attack. In today's commercial environment, it is becoming more and more difficult for sales contracts and letters of credit to be "kep' sep'rate".

⁵⁷ See Rule 140 and cases thereunder.

⁵⁸ *American Cyanamid Co. v. Ethicon Ltd.*, [1975] A.C. 396, [1975] 1 All E.R. 504 (H.L.).

⁵⁹ P.S.A. Lamek, *Equitable Remedies*, Law Society of Upper Canada, Special Lectures (1981), p. 125.

The increasing sophistication of international trade transactions requires businessmen to seek financial advice from their bankers in the formative stages of their trade proposals. The success of an international sale often depends upon the ability of the bank to develop imaginative payment and financing arrangements. In order to fulfill its customer's expectations and provide the best possible advice, the bank must inform itself of all aspects of the transaction from the onset. Legislative innovations in related areas of law, such as boycott regulation, also tend to make the trader's business its banker's business. As the intensity and complexity of international trade increase, banks will become privy to more and more detailed information about their client's affairs, and will be asked to provide more and more sophisticated advice and recommendations. Provision of and reliance upon such advice must be accompanied by the assumption of a corresponding degree of responsibility for its accuracy. Judicial developments concerning the responsibilities of the parties to letters of credit have begun to recognize these practical commercial trends. The interaction of these developments will make some continued evolution toward a greater integration between contract and credit inevitable. This reduction in autonomy of the letter of credit is also defensible on conceptual grounds. Given the maintenance of reasonable, flexible limits in application, such evolution should not be viewed with horror, and it will not prevent the letter of credit from continuing to be a viable and vital instrument in international trade, responsive to the needs of the parties using it.