

# LETTERS OF CREDIT: BANKRUPTCY, FRAUD AND IDENTITY OF PARTIES

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*The use of the letter of credit, both internationally and domestically, has increased significantly in recent years. Yet many of the legal aspects of its operation are far from settled. This article considers three areas of controversy: the effect of the bankruptcy of the issuer, the beneficiary or the applicant; the effect of fraud on the duty of the bank to pay; and the question of whether the applicant and the beneficiary may be one and the same person. It is suggested that, in dealing with these issues, the courts ought to bear in mind the need to ensure that the letter of credit remains an effective commercial instrument and ought to avoid imposing unrealistic burdens on any of the parties involved.*

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*L'emploi de la lettre de crédit s'est fortement accru ces dernières années au Canada comme à l'étranger. Il reste cependant à résoudre en droit de nombreux aspects de son fonctionnement. Cet article traite de trois aspects qui créent des problèmes: l'effet de la faillite de l'émetteur, du bénéficiaire ou du requérant; l'effet de la fraude sur le devoir de la banque de payer; et la question de savoir si le requérant et le bénéficiaire peuvent être la même personne. L'auteur avance que pour décider de ces questions, les tribunaux devraient toujours garder à l'esprit l'importance de la lettre de crédit comme instrument de commerce et éviter d'imposer aux parties des fardeaux sans mesure avec la réalité.*

## Introduction

If lawyers and businessmen can be said to be capable of inventing, if not believing, in myth, then the letter of credit has reached mythical proportions in those communities. The grandeur of the letter of credit mechanism has been propagated by several proponents, including international and local bankers, the International Chamber of Commerce and import-export traders. Intellectually speaking, the field of letters of credit is almost as complex and intriguing as that of negotiable instruments, but has an additional characteristic, a glamorous allure.

The purpose of the present article is to review certain grey areas of the letter of credit transaction which have not been dealt with at any satisfactory length in the case law or in the codification of credit rules and which may have substantial ramifications on the future development of the transaction. Those areas are: the rights of the parties upon a bankruptcy, bankers' duties in the event of fraud, and identity of parties.

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### *I. Review of Basic Principles*

Most international bankers and merchants define and interpret letters of credit within the context of one of two basic legal codifications. Outside the United States of America, reference in the body of letters of credit is made to the Uniform Customs and Practice for Documentary Credits, a compilation of rules promulgated by an independent non-governmental body, the International Chamber of Commerce. The Uniform Customs were originally published in 1931 and revised in 1951, at which time they were followed by banks in approximately sixty countries, though not by banks in the United Kingdom and the Commonwealth. A further revision in 1962 incorporated certain elements of the British banking practice, making adherence by a wider range of banks possible. Further revisions were put into effect in 1975, at which time banks in most countries of the world subscribed, with the notable exception of many in the United States. The most recent revision came into force on October 1st, 1984, and will be described in the present article as the Uniform Customs.<sup>1</sup>

The Uniform Customs provide that both "documentary" and "standby" letters of credit mean any arrangement, however named or described, whereby a bank as the issuer, acting at the request and on the instructions of a customer, as the applicant, is to make payment to a third party as beneficiary or is to pay or accept bills of exchange or drafts drawn by the beneficiary or authorizes another bank to do the same against stipulated documents, provided there is compliance with the terms and conditions of the credit.<sup>2</sup>

The other major codification subscribed to by many jurisdictions in the United States is Article 5 of the Uniform Commercial Code dealing with letters of credit. Article 5 defines a letter of credit, or credit, as an engagement by a bank or other person made at the request of a customer that the issuer will honour drafts or other demands for payment upon compliance with the conditions specified in the credit.<sup>3</sup> However, Article 5 deals with some, but not all, of the rules and concepts of letters of credit as such rules or concepts have developed prior to the Code or may thereafter develop; the fact that the Article states a rule does not by itself require, imply or negate application of the rule to a situation not provided

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<sup>1</sup> 1983 Revision, I.C.C. Publication Number 400. As to a review of the consequence of the changes effected by the present version, see Boris Kozolchyk, *The 1983 U.C.P. Revision, Trade Practices and Court Decisions: A Plea for a Closer Relationship* (1984), 9 *Can. Bus. L.J.* 214; E.P. Ellinger, *The Uniform Customs—Their Nature and the 1983 Revision* (1984), 3 *L.M.C.L.Q.* 578; J.E. Byrne, *The 1983 Revision of the Uniform Customs and Practice for Documentary Credits* (1985), 102 *Banking L.J.* 151; C.J. Chapman, *The 1983 Revisions to the Uniform Customs and Practice for Documentary Credits* (1985), 90 *Com. L.J.* 13.

<sup>2</sup> Article 2.

<sup>3</sup> Article 5-103(1)(a).

for or to a person not specified by the Article.<sup>4</sup> Accordingly, the Code recognizes the custom of some American banks in using the Uniform Customs: In fact, there are certain states, such as the state of New York, which have adopted a modified version of Article 5 permitting the full operation of the Uniform Customs where the parties so stipulate.

The basic principles by which the letter of credit transaction operates are widely recognized. They include the notion that letters of credit are transactions autonomous or independent of the underlying contracts on which they are based. The issuer is not concerned with or bound by underlying contracts; it deals exclusively in documents and not in goods or services to which the documents may relate. The issuance of a letter of credit and its acceptance by the beneficiary entitles the beneficiary to a direct claim against the issuer in the event of the issuer's unjustified refusal to pay. There are exceptions to the rule of autonomy including, most notoriously in certain circumstances, fraud by the beneficiary.<sup>5</sup>

## II. *Bankruptcy of the Parties*

One of the chief reasons for soliciting letters of credit, at least so far as the beneficiary is concerned, is to acquire a recourse against a neutral, steady, trustworthy and solvent holder of funds, namely, the issuing bank or a subsequent confirming bank. Once the credit has been opened and accepted by the beneficiary, the beneficiary should theoretically have little concern for the future operation, reputation, fate or demise of the applicant, who may be the purchaser of its goods under a documentary credit, or a local contractor under a standby credit. The beneficiary acquires a recourse against the issuer in addition to its recourse against the applicant under the underlying contract. If the applicant happens to fall under the bankruptcy provisions of the relevant jurisdiction, the beneficiary's recourse against the issuer is thought to remain unaffected. This supposition has recently suffered a minor but disconcerting challenge which threatens to undermine the very basis of the letter of credit system.

### A. *Bankruptcy of the Issuer*

A cautious beneficiary in structuring its arrangements with its debtor applies a checklist of issues to be resolved prior to accepting a letter of

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<sup>4</sup> Article 5-102(3).

<sup>5</sup> See generally, Lazar Sarna, *Letters of Credit: The Law and Current Practice* (2nd ed., 1986); H.C. Gutteridge and M.H. Megrah, *The Law of Bankers' Commercial Credits* (7th ed., 1984); J. Stoufflet, *Le credit documentaire* (1957); F.P. Ellinger, *Documentary Letters of Credit: A Comparative Study* (1970); Boris Kozolchyk, *Commercial Letters of Credit in the Americas* (1966); H. Harfield, *Bank Credits and Acceptances* (5th ed., 1974); F. Eisemann, *Le credit documentaire dans le droit et dans la pratique* (1963); F.M. Ventris, *Bankers' Documentary Credits* (1985); A.G. Davis, *The Law Relating to Commercial Letters of Credit* (1955); W.D. Hawkland, *Uniform Commercial Code Series*, vol. 6, chapter on Article 5 (1985).

credit. It will review the draft credit to determine whether it conforms with the underlying contract and whether it will permit the presentation of documentation for payment in an efficient manner, at a convenient place and within an acceptable time. Foremost in the beneficiary's mind, however, will be the identity of the issuing bank. If the bank is unknown to it, it will request that the applicant submit a credit from a known bank. If a change of banks is not possible or will create unacceptable delays, the beneficiary will seek confirmation of the credit by a reputable intermediary bank.

Let us assume that the confirming bank is adjudged bankrupt following confirmation but prior to payment. A confirmation acts to create a direct and personal recourse against the confirming bank by the beneficiary for payment under the credit. Although a confirming bank has been referred to as an agent of the issuer, it would be more appropriate to consider that a confirming bank by the act of its confirmation simply makes itself available as yet another debtor of the beneficiary under the credit.<sup>6</sup> The circumstances of the credit would indeed have to be exceptional to find that the act of confirmation operated to substitute the confirming bank for the issuing bank as the debtor of the beneficiary. Consequently, the bankruptcy of the confirming bank cannot be said, in any way, to hinder or destroy the recourse of the beneficiary against the issuing bank.

In view of the independent lines of responsibility linking the issuer and confirmer to the beneficiary, the bankruptcy of the issuer would have no impact upon the recourse of the beneficiary against the confirming bank. No stay of execution of the credit by the issuer should be required in the event of the bankruptcy of the confirming bank, or by the confirming bank in the event of the bankruptcy of the issuer. If the beneficiary has not had the wisdom to require confirmation, the financial demise of the issuer will leave it with no other recourse except that against its principal debtor, the applicant. The letter of credit is not considered in most jurisdictions to constitute a security, nor to constitute the beneficiary a secured or privileged creditor against the assets of the issuing bank in bankruptcy or liquidation.<sup>7</sup>

Several problems arise out of the issues just discussed. The beneficiary who has had the foresight to confirm its letter of credit may realize, upon the demise of the issuer, that the confirming bank is simply an affiliate of the issuer in the beneficiary's jurisdiction. Where, for example, a London bank issues a credit to a Canadian beneficiary, and the

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<sup>6</sup> *Bank Melli Iran v. Barclays Bank*, [1951] 2 Lloyd's Rep. 367 (K.B.D.).

<sup>7</sup> The Bank Act, s. 276, as enacted by the Banks and Banking Law Revision Act, 1980, S.C. 1980-81-82-83, c. 40, makes no provision for preferential treatment of beneficiaries under a letter of credit.

beneficiary obtains confirmation through the London bank's Canadian subsidiary governed by Schedule B of the Bank Act, any claim may be compromised to the extent that the demise of the parent may cause the demise of the subsidiary. The credit beneficiary as ordinary creditor of the subsidiary may suffer a loss. It appears evident that a beneficiary who goes to the trouble and expense of obtaining a confirmation should seek out an independent confirmer.

Furthermore, there is recent case law to the effect that the opening of a letter of credit and its acceptance may constitute absolute payment of the principal obligation in the underlying contract, the effect of which is to discharge any obligation owed by the applicant or principal debtor thereunder. The exclusive recourse of the beneficiary would then be limited to that against the issuer or confirmer. Although there is a presumption that the issuance and acceptance of the letter of credit does not operate to novate the principal debt due by the debtor applicant, the decision in *W.J. Alan & Co. v. El Nasr Export and Import*,<sup>8</sup> highlights the possibility of novation. In that case, the contract specified that payment was to be made by a confirmed and irrevocable letter of credit to be opened one month prior to shipment as stipulated. The court found that the beneficiary had waived its rights against the applicant to demand payment under the sales agreement in a more valuable currency by failing to protest against the less valuable currency mentioned in the credit, and could not look to payment beyond the currency value of the letter of credit. There was, however, in that decision no indication that the bank had threatened to refuse payment or was not in a financial position to fulfill its obligations. It is evident that if a beneficiary is deemed to have given up its rights against the applicant, it will be left with little or no satisfaction from an issuer or confirmer in bankruptcy. Where an insurer of bank depositors or other "white knight" assumes control of the assets of the insolvent issuer or confirmer, the assumption of liability for payments under outstanding credits depends on the terms of the specific legislation or agreement.

It should be noted that Article 5-117 of the Uniform Commercial Code deals specifically with the circumstance of an issuer, an advising or confirming bank becoming insolvent before the final payment of the credit. The drafts or demands are entitled to payment in preference over depositors or other general creditors of the issuer or confirming bank to the extent of any funds turned over after or before the insolvency as indemnity against drafts or demands for payment drawn under the designated credit. These provisions would not be applicable where the Code does not have the force of law. A Canadian issuer, which for some reason decided to issue a credit to a Canadian beneficiary subject to the rules of

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<sup>8</sup> [1972] 2 Q.B. 189, [1972] 2 All E.R. 127 (C.A.).

the Code, could not confer upon the beneficiary a preferred status for its claim in the event of the issuer's insolvency.<sup>9</sup>

### B. *Bankruptcy of the Beneficiary*

In many jurisdictions, including Canada, bankruptcy legislation effects an assignment to, or vesting of rights of the bankrupt in the trustee, who for various purposes can be said to stand in the shoes of the bankrupt. In the event of bankruptcy of the beneficiary under the letter of credit, one might readily assume that the beneficiary's rights vest in the trustee, permitting the trustee to act in the stead of the beneficiary for all purposes, including presentation of documents, execution of drafts and demand for payment. There are, however, objections to this assumption. Those objections relate to certain letters of credit which on their face are said not to be assignable, or which are not assignable as a result of the governing code of rules. The other basis of attack is the literal wording of the letter of credit, which requires the personal intervention of the beneficiary at the most crucial stages of the letter of credit transaction, namely, presentation of documents and demand for payment.

As to the issue of assignability, the Uniform Customs provide in Article 55 that the fact a credit is not stated to be transferable shall not affect the beneficiary's right to assign any proceeds to which it may be or become entitled under such credit. On the other hand, Article 54(b) provides that a credit can be transferred only if expressly designated as being transferable by the issuing bank. Accordingly, if a credit is silent on the matter, it is presumed to be non-transferable; on the other hand, the silence of the credit does not prevent the beneficiary from assigning its rights to the proceeds. It is evident that an assignee would have no right to the proceeds unless the demand mechanism is appropriately triggered by the beneficiary itself presenting the documentation and making the appropriate demand for payment. Similarly, the Uniform Commercial Code provides in Article 5-116 that the right to draw under a credit can be transferred or assigned only when the credit is expressly designated as transferable or

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<sup>9</sup> Letters of credit are not dealt with to any great extent by banking legislation: passing reference to credits within the context of disclosure of the cost of borrowing is seen in section 202(3)(c) of the Bank Act, *supra*, footnote 7. It cannot seriously be argued that Canadian banks do not have the capacity to issue letters of credit: *Rolland v. La Caisse d'Economie Notre-Dame de Québec* (1895), 24 S.C.R. 405. The presumption against absolute payment is seen in *E.D. & F. Man Ltd. v. Nigerian Sweets and Confectionery Co. Ltd.*, [1977] 2 Lloyd's Rep. 50 (Q.B.D.). See also an unreported decision of Lacourcière J. in *Northern Sales v. Government Trading Corporation*, C.S.T.R. 400-05-301-854, August 15, 1985, on appeal. As to the assumption of liability for credits upon insolvency, see *In re F & T Contractors Inc.* (1983), 37 U.C.C. Rep. Serv. 855, where the American Federal Deposit Insurance Corporation was not held to have been liable for wrongful termination of letters of credit and retention of collateral securing them.

assignable; even if the credit is stipulated to be non-transferable, non-assignable or is silent on the matter, an assignment of the proceeds of the credit is permitted.

Assuming for the moment that a trustee in bankruptcy finds that the bankrupt is the beneficiary under a letter of credit which is transferable, the trustee may very well find it is unable to enforce the rights of the bankrupt because of the strict compliance rule. That rule permits an issuer to refuse payment justifiably under a credit unless the beneficiary complies strictly with the terms of the credit; for example, each and all documents as described in the letter of credit must be presented without discrepancy or non-conformity. In the recent decision of *Swift Aire Lines v. Crocker National Bank*,<sup>10</sup> the issuer refused to make payment upon being presented a document signed by the trustee in bankruptcy of the corporate bankrupt. While the applicable bankruptcy law constituted the trustee the representative of the bankrupt estate with full power to deal with and enforce claims, the letter of credit was read as requiring the beneficiary to sign documents presented for payment. Since the corporate secretary of the beneficiary was not permitted, following the bankruptcy of the corporation, to act on its behalf, the trustee was prevented from asserting the beneficiary's rights under the credit.

In order to avoid the same difficulty, a trustee in bankruptcy in Canada might consider several options. The first option would be to obtain court authorization by summary motion permitting the trustee to sign as the appropriate corporate officer. If the credit called for the submission of a certificate or draft to be signed by the secretary of the bankrupt corporation, an order issuing from a court having jurisdiction in bankruptcy declaring the trustee to have all the powers of that corporate representative might issue. The power of the court may arise from its equitable jurisdiction under section 153 of the Bankruptcy Act,<sup>11</sup> seen in conjunction with the general right of the trustee to carry on the business and take possession of the property of the bankrupt under sections 14 and 16 of the Act. Of course, a trustee is not an officer of a bankrupt corporation under its charge and would effectively be in a conflict of interest if he were. However, the justification for the application of the strict compliance rule in the present scenario would be difficult, for one would have to contend that the intention of the parties to the credit transaction was to preclude the beneficiary from collecting under the credit in the event of its financial demise. Surely neither the applicant nor the issuer would have any reason to approach or enter into the transaction in such a frame of mind, unless the case were exceptional; for example, if the applicant and

<sup>10</sup> *U.S. Bankruptcy Appl.* (1983), 30 B.R. 490, reported in (1984), 2 I.B.L. 143.

<sup>11</sup> R.S.C. 1970, c. B-3.

beneficiary were not at arms' length and the benefit of the credit were intended personally for the beneficiary but not for its creditors. In the case of a credit in support of a gift between parent and child, or a matrimonial benefit given between spouses, it might be argued that the trustee of the bankrupt beneficiary should not be permitted to draw under the credit. Benefits excluded from the grasp of the beneficiary's creditors are rare, but do occasionally find expression in statutes such as article 553 of the Quebec Code of Civil Procedure.<sup>12</sup>

Another option would be to seek an amendment to the credit, changing the beneficiary to read: "the estate of the beneficiary or his trustee". An amendment would require the consent of the applicant, issuer and the original beneficiary. The beneficiary as bankrupt is not in a position under the law to deal with or compromise its rights. Where the credit is transferable, there is little cogent reason to prohibit the trustee from acting on behalf of the beneficiary in consenting to an amendment. The strategy of amendment, however, depends on the agreement of the issuer and the applicant, neither of which may be willing to give effect to their original commitment without some further consideration. In the event the credit is not transferable, the question arises as to whether or not a court judgment declaring the consent of the bankrupt beneficiary, or effecting its equivalent, is legally binding on the other parties to the credit. It is suggested that judicial consent in substitution for the beneficiary's consent would be adequate and binding, especially since the doctrine of strict compliance appears to be limited to the fulfillment of the conditions of the credit or presentation of documents leading to payment.<sup>13</sup> The power of the trustee to so act might stem from his general power to dispose of the property of the bankrupt or carry on its business under section 14 of the Bankruptcy Act.

### C. *Bankruptcy of the Applicant*

We have already mentioned that one of the prime functions of a letter of credit is to provide the beneficiary with a source of funds that is reputed to be guaranteed, and close in time and place. It is not that the beneficiary mistrusts the applicant for the credit, but rather that it prefers payment to simple expectation of payment. One might say that the issuer of the credit joins the principal debtor as a new debtor, or in some restricted cases intervenes as a substitute for the original debtor. Whatever the perception, it would appear to be axiomatic that in a letter of credit transaction the physical or financial demise of the applicant following the

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<sup>12</sup> R.S.Q. 1977, c. C-25.

<sup>13</sup> As to the parameters of the strict compliance rule, see articles 15, 16 of the Uniform Customs; *European Asian Bank A.G. v. Punjab and Sind Bank*, [1983] 1 Lloyd's Rep. 611 (C.A.); *Midland Bank, Ltd. v. Seymour*, [1955] 2 Lloyd's Rep. 147 (Q.B.D.).

issuance of the credit cannot prevent the beneficiary from obtaining payment under the credit. The proof of the financial well-being of the applicant is rarely, if ever, stipulated as a documentary condition for payment. The courts have yet to welcome a serious argument by an issuer that it is not obliged to pay under a credit because the applicant is fully capable of doing so. The question arises as to whether any logical argument can be made to the effect that the financial demise of the applicant can in some way interfere with the unfolding of the letter of credit mechanism all the way to payment.

One of the purposes of bankruptcy legislation is to permit both the orderly distribution of assets to creditors and to establish ranks of preference among them; only those preferences or secured positions recognized by law are entitled to evade the fate designated for non-preferred or ordinary creditors. Orderly payment is effected by several mechanisms, including a stay of judicial proceedings against the bankrupt, and, in some cases, a postponement of realization on secured property.

#### (1) *Prior to Acceptance of Application*

Let us assume a situation where the applicant is rendered incapable of contracting in law as a result of its bankruptcy prior to the acceptance of an application for the issuance of a letter of credit. Suppose, for example, the applicant submits an application for the issuance of a credit, but during the time delay necessary to obtain the approval of the issuer the applicant, unknown to the issuer, files an assignment for a receiving order or is declared bankrupt. Or, the applicant may be adjudged bankrupt by the effect of a retroactive receiving order, fixing the effective date of bankruptcy prior to the acceptance of the application for the credit. If subsequent to the effective date of bankruptcy a letter of credit is issued and accepted by the beneficiary, one would suspect that both the trustee and the issuer would contest the validity of the credit. The ready response to their arguments must be that neither can oppose against the beneficiary any irregularity or defect in the application for issuance, whether or not it goes to its nullity.<sup>14</sup>

#### (2) *Prior to Issuance*

Let it now be assumed that an applicant enters into an agreement with a banker for the issuance of a letter of credit to a beneficiary. As a result of bureaucratic or stipulated delay, the letter of credit issues several days later and the beneficiary is so advised. Prior to the issuance of the credit, the applicant files an assignment in bankruptcy. Let it further be

<sup>14</sup> To argue otherwise would be to accept the notion that a letter of credit is a stipulation *pour autrui*, which cannot be the case for the reasons mentioned in Sarna, *op. cit.*, footnote 5, p. 29; Kozolchyk, *op. cit.*, footnote 5, p. 585.

assumed that we are dealing here with either a standby or documentary letter of credit. Prior to presentation of documents by the beneficiary, the issuer may be served with a notice by the trustee advising that any property or account of funds of the applicant which the issuer was holding to cover the credit now form part of the bankrupt estate. The issuer will certainly have a business interest in seeking to prevent the beneficiary from drawing. The trustee may have a similar interest in preventing the beneficiary, a creditor of the bankrupt applicant, from receiving full payment, as if it were a secured creditor. My view in these circumstances is that the bankruptcy of the applicant has no effect on the right of the beneficiary under the letter of credit. On the date of the execution of the contract between the applicant and the issuer, the applicant had full capacity to enter into the contract. Even if, as a result of the retroactive setting of the effective date of bankruptcy the applicant was deemed to be bankrupt as of the date of the application contract, the issuer could not oppose a defect in that contract against the beneficiary; the letter of credit is a separate contract not involving the applicant after its issuance, except perhaps for the purposes of amendment. This would accord with the view that an issuer cannot avoid liability under the credit if it discovers prior to presentation for payment that the applicant's security given to secure reimbursement to the issuer is defective or non-existent.<sup>15</sup>

Where the applicant has become bankrupt prior to the issuance of the credit, it is easy to see the objections to the credit raised by the trustee on strategic grounds. Had the credit not been issued, the trustee would have had to contend with an unsecured claim by the putative beneficiary based on the underlying contract. That beneficiary may be outside the jurisdiction or otherwise too remote to pursue its claim. However, with the issuance of the credit and payment thereunder, the issuer has a claim against the estate which may be subject to a statutory preference. This concern does not in itself constitute a basis for permitting the trustee to intervene in the exercise by the beneficiary of its rights under the credit.

### (3) *Following Issuance*

Finally, let us assume the letter of credit has been issued prior to the applicant's bankruptcy to secure performance by the applicant of an underlying contract, with the beneficiary calling for the commencement of performance some time after advice of the credit. If bankruptcy occurs prior to the date of commencement, the issuer would argue that the credit falls simply because the applicant became legally incapable of commencing performance. The issuer would contend that the beneficiary and applicant had between them no contractual arrangements until the advice of the letter of credit. If, as of the date of advice, the applicant was not in a

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<sup>15</sup> For the reasons set out in the immediately preceding footnote.

juridical position to enter into contractual arrangements, there is no underlying contract and the letter of credit would not be enforceable. It would be tempting to accede to the issuer's contention. However, the applicant and beneficiary have evidently entered into an underlying contract with a suspensive condition which has been triggered by the issuer's advice of the credit. Although the net effect of the arrangement is that the issuer bound itself to bond the performance of a party who was totally incapable of performing on the relevant date, this was the choice of the issuer. If the credit is payable on presentation of a certificate stating that the applicant has failed to construct a building in accordance with the specifications set out in the underlying contract, the credit must be honoured upon presentation. Similarly, if the credit stipulates that payment will be made against a certificate stating that the applicant had commenced performance but failed to complete in accordance with the specifications of the underlying contract, payment must be made upon presentation. In the latter situation, if the credit were not standby in nature but a documentary credit covering, for example, a shipment of goods, there is little doubt that the presentation by the beneficiary of documents witnessing shipment to the applicant, even if the latter were then bankrupt, would require payment by the issuer; following issuance of the credit, but prior to shipment, the beneficiary would be justified in shipping, unless, perhaps, bankruptcy was a cause of termination of its underlying agreement with the applicant.

The concerns of the trustee and issuer in the face of the applicant's demise are not frivolous. If the beneficiary is paid, its funds presumably come out of the general revenues of the confirming bank or issuer. Ultimately, the paying bank will seek reimbursement out of the account of the bankrupt, or its property secured in anticipation of reimbursement. At that time, the banker will either be required to file a proof of claim as an ordinary creditor, or, if a secured creditor, may simply ignore the bankruptcy. One of the chief objections of a trustee to payment under a credit is that the liability of the bankrupt to the beneficiary, which ordinarily results in an unsecured claim, is transformed into a claim due to a bank which in many instances has secured status.

The most conservative and acceptable approach to the issue may be seen in a recent Canadian decision, *Re Meridian Developments Inc. and Toronto-Dominion Bank*.<sup>16</sup> In that case Meridian Developments Inc. (Meridian) sold land to a company, the beneficial owner of which was Nu-West Group Ltd. On March 16, 1981, Nu-West Group Ltd. executed under seal an unconditional guarantee in favour of Meridian guaranteeing the amounts due by the purchaser under the agreement of sale. The guarantee provided that, in the event of default under the agreement, Nu-West Group Ltd. would forthwith on demand pay all of the purchase monies owed. As a result of a subsequent act of default, demand was made on the guarantor.

<sup>16</sup> (1984), 11 D.L.R. (4th) 576 (Alta. Q.B.).

Nu-West Group Ltd. failed to pay Meridian, which then instituted action and obtained a default judgment; execution of the judgment led to a seizure of assets of the defendant. Nu-West Group Ltd. filed an application for a declaration that Meridian was not at liberty to execute until it had sold the land in question. Although the application was dismissed, a stay of execution pending appeal of part of the judgment debt was granted on the condition that Nu-West Group Ltd. post an irrevocable letter of credit issued by the Toronto-Dominion Bank in favour of Meridian in the amount of the unpaid balance of the judgment, and that the letter of credit be held in trust by the attorneys for Meridian. The appeal was subsequently dismissed, and a demand for payment was made under the letter of credit. The bank chose not to honour the credit, ostensibly on the grounds of an order made as a result of the insolvency of Nu-West Group Ltd. under the Companies' Creditors Arrangement Act.<sup>17</sup> The order provided that "... any further proceedings in any action, suit or proceeding against the petitioner be restrained until July 31, 1984 . . .", and that "... until July 31, 1984, no suit, action or other proceeding be proceeded with or commenced against the petitioner except with leave of this court". The issue then turned on whether the Toronto-Dominion Bank was justified in dishonouring the credit, or more narrowly put, whether it would be in breach of the judicial order in paying the letter of credit.

The court held that the Toronto-Dominion Bank was obliged to honour its obligations under the credit toward Meridian, even though the cashing of the credit would increase the debt of Nu-West Group Ltd. to the bank and the bank had no means of enforcing its claim against the debtor owing to the judicial order. In so holding, the court found that payment under a letter of credit did not constitute a "proceeding", nor, presumably, an action or suit under the terms of the judicial order. It noted that security in the form of an irrevocable letter of credit is not the property of the applicant; the applicant never had ownership of any funds represented by the credit. As such, even if payment under the credit could be termed a "proceeding" in accordance with section 11 of the Companies' Creditors Arrangement Act, it could not be termed a "proceeding" against the petitioner as stipulated in the judicial order.

The court cited with approval an American decision, *Page v. First National Bank of Maryland*,<sup>18</sup> which dealt with an attempt to prohibit the payment of a letter of credit following bankruptcy of the applicant on the grounds that the bankruptcy legislation prohibited any act to obtain possession of property of the bankrupt estate or to create, perfect or enforce any lien against such property following the granting of the bankruptcy petition. That court found that neither the letter of credit nor its proceeds

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<sup>17</sup> R.S.C. 1970, c. C-25.

<sup>18</sup> Unreported, referred to *supra*, footnote 16, at pp. 587-588.

were property of the estate as contemplated by the bankruptcy legislation and accordingly were not subject to an automatic stay.

However, in an earlier American decision, *In re Twist Cap*,<sup>19</sup> the court enjoined the issuing bank from making payment under a letter of credit following the bankruptcy of the applicant. That decision turned on a standby letter of credit. The debtor, under benefit of Chapter XI of the Bankruptcy Code,<sup>20</sup> successfully pleaded that the contract between the issuer and the beneficiary was executory and was therefore subject to rejection under section 365(a) of the Bankruptcy Code, which provided that the trustee may assume or reject any executory contract or unexpired lease of the debtor. It was further held that to some extent payment to the beneficiary under the letter of credit would constitute a preferential payment, in that once the issuer made payment it would be entitled to reimbursement under Article 5-114 of the Uniform Commercial Code. It was noted that the bankruptcy legislation defined preferential transfer or payment as any mode, direct or indirect, of disposing of or parting with property. The *Twist Cap* decision has been severely criticized, and justly so, on several grounds. So far as the issuer makes payment to the beneficiary out of its own funds, there can be no question of any actual or deemed misappropriation of the debtor's property. Moreover, the letter of credit is not an executory contract which a trustee in the bankruptcy of the applicant may choose to execute or renounce; more specifically, the contractual aspect of the letter of credit transaction binding the issuer to the beneficiary is not an executory contract which permits the intervention of either the applicant or its trustee in bankruptcy.<sup>21</sup> Subsequent decisions have for the most part disowned the principles enunciated in *Twist Cap*, although some cases do continue to suggest that payment under a letter of credit may in appropriate circumstances be subject to attack as a preferential payment.<sup>22</sup>

It is presumed that in Canada the decision in *Meridian Developments* would be applied in bankruptcy matters. A trustee in bankruptcy under the Bankruptcy Act may elect to retain or disclaim any temporary interest in any property of the bankrupt, or carry on a temporary interest in any property of the bankrupt, or carry on its business. The property of the

<sup>19</sup> 1 B.R. 284 (D. Fla., 1979).

<sup>20</sup> Bankruptcy Code, U.S.C., Title 11.

<sup>21</sup> See generally, H.D. Chaitman and J. Sovern, *Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest in a Twist Cap* (1982), 38 Bus. Lawyer 21; G.T. McLaughlin, *Letters of Credit as Preferential Transfers in Bankruptcy* (1982), 50 Fordham L. Rev. 1033.

<sup>22</sup> R.M. Saunders, *Preference Avoidance and Letter of Credit Supported Debt: The Bank's Reimbursement Risk In Its Customer's Bankruptcy* (1985), 102 Banking L.J. 240; S.F. Farrar and H. Landau, *Letters of Credit* (1985), 40 Bus. Lawyer 1177; *In re Joe De Lisi Fruit Co.*, 11 B.R. 694 (Bankr. D. Minn., 1981). But see *In re Marine Distributors, Inc.*, 18 U.C.C. Rep. 183, 522 F.2d 791 (C.A. 9th cir., 1975).

bankrupt includes that extant at the date of the bankruptcy or that which may be subsequently acquired prior to discharge, and all powers in respect of such property as may be exercised by the bankrupt for its own benefit. Finally, it would appear that a court sitting in bankruptcy is entitled to postpone the right of a secured creditor to realize or deal with its security, although the definition of secured creditor would seem to exclude a person whose claim is based on a letter of credit.<sup>23</sup> In short, there is little in the bankruptcy legislation which would permit a trustee in bankruptcy of an applicant to obtain standing to interfere in the orderly payment by an issuer of a demand under a letter of credit, save for an extended interpretation of the preferential payment provisions under section 73(3). It might be argued, for example, that since the law defines a creditor, in whose favour a conveyance or a transfer has been made, as including a surety or guarantor for the debt due to such creditor, the issuer of a standby credit is caught by these provisions. At best this argument, if successfully pleaded, would simply lead to an annulment of the credit so far as the bankrupt is concerned. The other civil law consequences of the credit mechanism, the obligation of the issuer toward the beneficiary, would continue to have full effect. While the trustee might accordingly obtain from the issuer a recovery of collateral security held under the credit, it could not prevent the issuer from duly paying the beneficiary upon presentation of a demand. After all, the beneficiary, even though a creditor of the bankrupt, is also a creditor of the issuer and seeks, when presenting documents in compliance with the credit, to obtain satisfaction of its claim against the latter. The mere fact that the ultimate creditor may be making payment to the beneficiary by debiting the account or liquidating the security of the bankrupt would not make the beneficiary a creditor of the bankrupt acting in that capacity when seeking payment under the credit.

To some extent, this reasoning is supported by a recent decision of the Ontario Court of Appeal in *Re Appleby Estates Limited*,<sup>24</sup> where proceeds of insurance on the life of a shareholder were deposited to the bank account of the bankrupt company. The true beneficiary of the policy proceeds issued a company cheque to herself to cover an approximate amount of the insurance proceeds. The court held that the insurance beneficiary was not a creditor of the bankrupt company for the amount of the insurance proceeds. It was further noted that the fraudulent conveyance provisions of the bankruptcy legislation do not apply to property held in trust by the insolvent person. The point to be made here is not that the issuer makes payment to the beneficiary out of the applicant's monies which are held in trust for that purpose; there has been no serious argument made to date that in law an issuer actually pays to the beneficiary the

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<sup>23</sup> Bankruptcy Act, *supra*, footnote 11, ss. 14, 47, 49.

<sup>24</sup> (1984), 53 C.B.R. (N.S.) 10 (Ont. C.A.).

applicant's money. Rather, the point is that, while the applicant may have inspired and caused the juridical relationship between the issuer and the beneficiary, its demise cannot create in favour of its trustee a legal interest which did not previously exist.

### III. *Fraud: Duty of the Banker*

The principle of autonomy of the letter of credit in relation to the underlying contract dictates that the issuer is obliged to make payment upon presentation of conforming documents without regard to any defences or claims which the applicant may have against the beneficiary. This principle is embodied in the Uniform Customs in Articles 3, 4, 6 and 16 which declare that credits are by their nature transactions separate from their underlying transactions, and that payment by the issuer is to be based solely on a determination of the conformity of the documents presented to the requirements of the credit. Similar provisions are found in the Uniform Commercial Code. Article 5-114(1), for example, declares:

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 case law has recognized, however, that fraud perpetrated by the beneficiary in its demand for payment under the credit does constitute an exception to the autonomy rule and provides justification for dishonour by the issuer.<sup>25</sup> Within the framework of the Uniform Customs, this exception arises more out of a sense of fair play as perceived by the courts rather than out of any codified rule. Indeed, under the Uniform Customs, the issuer is exonerated from liability for paying against forged documents which on their face appear regular. Article 17 of the Uniform Customs declares that banks assume no liability for the form, genuineness, falsification or legal effect of any documents; and Article 15 limits the obligation of document inspection to reasonable care to ascertain documents appear on their face to be in accordance with the terms and conditions of the credit.

Under the Uniform Commercial Code, express recognition is given to the exception of fraud in the transaction between the applicant and beneficiary, creating a right of elective dishonour in favour of the issuer and a right to force dishonour by the applicant. Article 5-114(2)(b) provides, for example, that the issuer acting in good faith against its customer may honour a demand for payment despite notification from it of fraud, but a court of appropriate jurisdiction may enjoin such honour; Article 5-115 sets out the remedies available against the issuer for wrongful dishonour. The issue of dishonour seems to be treated in greater express detail in the Uniform Commercial Code than in the Uniform

<sup>25</sup> E.g., *Rosen v. Pullen* (1981), 126 D.L.R. (3d) 62 (Ont. H.C.); *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*, [1978] Q.B. 159, [1978] All E.R. 976 (C.A.). See also footnote 26, *infra*.

Customs because of the desire of the banking community, which had great input in the drafting of the Uniform Customs, to downplay the suggestion that the letter of credit transaction is not entirely free of disruption and doubt about payment.

There has been extensive discussion in the cases and in doctrinal writing of the definition of fraud, fraud in the transaction and the parties to the fraud.<sup>26</sup> The focus of the discussion in this article is whether there is a duty upon the issuer to dishonour a demand for payment in a situation which would justify dishonour, and if there is, whether the issuer may avoid it by informing the applicant of its knowledge of fraud and permit the applicant to force dishonour.

There is current English dicta to the effect that an issuer who is apprised of a fraud justifying dishonour should not honour the demand for payment. Before reviewing those authorities, it should be pointed out that what is here in issue is whether a moral imperative should be translated into a legal obligation. The most effective way to do so, it is suggested, is by ensuring that a contractual obligation to dishonour upon notice of fraud is imposed upon the issuer by the applicant. It is, however, currently common practice for most bankers to draft their applications for issuance in such a way as to exclude any such obligation. Furthermore, it was understood by the promulgators of both the Uniform Customs and Article 5 that such an obligation should not be imposed because of the extraordinary risk involved to the issuer. The Uniform Commercial Code, for example, does not provide any exoneration from liability for damages to the issuer in the event it chooses to dishonour and is found to have wrongfully done so; the assumption is made that the issuer should not be able to interfere with the credit mechanism with impunity.

In *United City Merchants v. Royal Bank of Canada*<sup>27</sup> it was eventually decided by the House of Lords that the exception of fraud to the rule of autonomy does not extend to fraud to which neither the seller nor beneficiary is party, and accordingly the bank is obliged to make payment in the face of third party fraud. The case disclosed such a wide range of judicial opinion that it may be worthwhile looking at the decisions at trial<sup>28</sup> and in the Court of Appeal,<sup>29</sup> as well as in the House of Lords.

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<sup>26</sup> See generally on the question of fraud, the classic cases of *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, [1983] 1 A.C. 168, [1982] 2 All E.R. 720 (H.L.); *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S. 2d 631 (N.Y.S.C., 1941). See the authorities cited in Sarna, *op. cit.*, footnote 5, chap. 5; Gutteridge and Megrah, *op. cit.*, footnote 5, pp. 183-189; G.W.L. Smith, *Irrevocable Letters of Credit and Third Party Fraud* (1983), 24 Va. J. Int'l. L. 55; M. Pomerleau, *La fraude du bénéficiaire du crédit documentaire irrévocable* (1984), 44 R. du B. 113; L.C. Cansler, *International Letters of Credit* (1982), 17 Tex. Int'l. L.J. 229.

<sup>27</sup> *Ibid.*

<sup>28</sup> [1979] 1 Lloyd's Rep. 267 (Q.B.D.).

<sup>29</sup> [1982] Q.B. 208, [1981] 1 Lloyd's Rep. 604 (C.A.).

The facts were as follows. An English company sold equipment to a Peruvian company and agreed to double the price in order to permit the purchaser to exchange Peruvian currency for the excess amount in contravention of the exchange control regulations of Peru. A letter of credit was issued in Peru and was confirmed by the defendant Royal Bank of Canada. The rights under the credit were assigned by the English company to the co-plaintiffs. The equipment was shipped a day later than the time limit mentioned in the letter of credit, but the loading brokers, who did not act for the plaintiffs, fraudulently entered an earlier date of shipment on the bill of lading in order to permit conformity with the credit requirements. The trial judge found that the plaintiffs were not aware of this fraud, and that the fraud could not, as a matter of law, be attributed to them. They therefore did not know, nor could they be deemed to have known, that the date on the bills of lading was false when they presented the document for payment. The Royal Bank of Canada had, however, become aware of the false statement and, even though the documents were regular on their face, refused payment. When sued, the bank defended on two grounds.<sup>30</sup> The one relevant here raised the issue of whether a beneficiary, innocent and unaware of a fraud committed by a third party, was entitled to payment under a letter of credit.

At trial, Mocatta J. decided that the plaintiffs were entitled to be paid. He said:<sup>31</sup>

Where there has been personal fraud or unscrupulous conduct by the seller presenting the document under the letter of credit, it is right that a bank should be entitled to refuse payment against apparently conforming documents on the principal *ex turpi causa non oritur actio*. But here I have held that there was no fraud on the part of the plaintiffs, nor can I, as a matter of fact, find that they knew the date on the bills of lading to be false when they presented the documents. Further, there is no plea either by way of an implied term or by way of a warranty imposed by the law that the presenter of documents under a letter of credit warrants their accuracy.

In reaching this conclusion, the court rejected a submission by counsel that would have considerably broadened the grounds on which a bank might refuse payment. It was argued that a bank could refuse to pay if it knew that, although regular on their face, the documents were inaccurate in any material particular. Put in positive terms, a bank is required to pay only if (1) the documents are genuine and not forged, and (2) if they appear on their face to comply with the credit, unless the document is inaccurate in a material particular. Mocatta J. rejected that broad proposition. He considered that recent English case law entitled the bank to refuse payment if it knows that a document is forged, or that the request for payment is being made fraudulently in circumstances where there is

<sup>30</sup> The other concerned the effect of the attempt to evade Peruvian currency regulations. As to that see at trial: [1979] 2 Lloyd's Rep. 498 (Q.B.D.); Court of Appeal: *supra*; footnote 29; House of Lords: *supra*, footnote 26.

<sup>31</sup> *Supra*, footnote 28, at p. 278.

no right to payment. He recognized that this might mean that the circumstances in which the bank might refuse payment would be limited.<sup>32</sup>

It cannot often be the case that at the time of or just prior to presentation of documents under a letter of credit the bank in question can show an established fraud. Accordingly, it may well be that procedure by way of injunctions can be of little practical value as a protection against fraudulent claims. However, there seems to be nothing in the authorities to prevent a confirming bank from raising the issue of fraud as a defendant after having refused to pay on the presentation of documents, though it may well be that it would be unlikely that it would take this course except against an indemnity by the customer or issuing banker.

It was evident that in rejecting the broad submission of counsel the court was recognizing the harsh practical implications of imposing upon a bank the obligation of prophesying the outcome of a judicial review of its decision in either accepting or rejecting documents. Referring to counsel's submission, Mocatta J. said:<sup>33</sup>

... I have reached the conclusion that it cannot be supported in view, in particular, of what has been so recently said in the Court of Appeal, particularly in *Edward Owen v. Barclays Bank* [1978] 1 Lloyd's Rep. 166; [1977] 3 W.L.R. 764. To hold to the contrary might greatly hold up the smooth running of international trade and might place on banks exceptionally onerous investigations, which they are ill-fitted to perform. In relation to bills of lading presented against letters of credit, the limited scope of a bank's duty is well exemplified by what was said by Mr. Justice Salmon, as he then was, in *British Imex Industries v. Midland Bank* [1958] 1 Q.B. 542.

The Court of Appeal would have upheld the bank's refusal to pay. It did not, as Stephenson L.J. pointed out, have to accept the argument that an innocent inaccuracy in a material particular in itself justified a refusal. It was sufficient for the purposes of the case to decide that the "fraud" exception was not confined to fraud by the beneficiary. A bank was justified in refusing to pay if, to its knowledge, there was a forgery or a fraud in circumstances when there was no right to payment, and this even though the beneficiary was not involved in the forgery or the fraud. Stephenson L.J. quoted with approval the statement of the fraud exception from the judgment of Lord Denning M.R. in *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*:<sup>34</sup>

... the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment. . . . As Kerr J. said in this case: "In cases of obvious fraud to the knowledge of the banks, the courts may prevent banks from fulfilling their obligation to third parties."

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<sup>32</sup> *Ibid.*, at pp. 276-277.

<sup>33</sup> *Ibid.*, at p. 278.

<sup>34</sup> *Supra*, footnote 29, at pp. 233 (Q.B.), 619 (Lloyd's Rep.). For the citation of *Owen Engineering*, see *supra*, footnote 25. In that case Lord Denning M.R. relied heavily on *Sztejn v. J. Henry Schroder Banking Corp.*, *supra*, footnote 26. That case proceeded on the validity of the allegations of fraud made in the statement of claim.

Stephenson L.J. went on to point out that he was dealing with a clearly established case of fraud. The documents, although not forged, were intentionally misleading, and were not genuine documents against which the bank could be required to pay. He acknowledged that the courts had a duty to assist the smooth functioning of international trade, but that stopped short of assisting established and admitted fraud.

Ackner L.J. and Griffiths L.J. delivered concurring judgments. They both took the matter as not being covered by previous authority, and preferred to decide it by going back to first principles. The bank's duty and obligation was to pay only against genuine documents. The documents in question, although not forged and although not fraudulently prepared by the beneficiary, nonetheless were not conforming documents and the bank was therefore entitled to refuse payment. Griffiths L.J. stated his conclusions as follows:<sup>35</sup>

What is the position if the bank is presented with documents that appear on their face to be in order but which the bank knows to be forgeries? The bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the documents are forgeries it must refuse to accept them . . . . If the documents presented are fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay.

It should be noted that the judgment of the Court of Appeal did not arise in an action against the bank on the basis of its having paid to the beneficiary with full knowledge of a fraud. At best, the Court of Appeal must be taken to have ruled that where a bank has knowledge of fraud that is so clear and established that a court would subsequently come to a similar finding of fraud, it is obliged not to make payment; on the other hand, there is no obligation upon the bank to actively investigate and uncover such clear evidence of fraud even where it is put on notice. The judgment did not expressly declare what liability the bank would incur, or to whom, if it knowingly paid against forged or false documents, nor what practical circumstances and facts would constitute clear and established proof of fraud.

However, whatever the limits of the decision in the Court of Appeal, the House of Lords decided that that court was wrong in holding that the bank was justified in refusing to pay, even given the existence of clear and admitted fraud. Lord Diplock, with whose speech the other Law Lords agreed, pointed out that, in contrast to the position of the Court of Appeal, the confirming bank's argument was based on the broad proposition that a bank would be justified in refusing payment where there was a material inaccuracy in the documents, innocent or otherwise. Lord Diplock rejected that argument, saying that it would be subversive of the whole foundation of the letter of credit.

<sup>35</sup> *Ibid.*, at pp. 254 (Q.B.), 632 (Lloyd's Rep.).

He then considered a narrower proposition:<sup>36</sup>

... If any of the documents presented under the credit by the seller/beneficiary contain a material misrepresentation of fact that was *false to the knowledge of the person who issued the document* and intended by him to deceive persons into whose hands the document might come, the confirming bank is under no liability to honour the credit, even though, as in the instant case, the persons whom the issuer of the document intended to, and did, deceive included the seller/beneficiary himself.

He rejected that argument on essentially the same grounds as he had rejected the broader submission. If the documents were valid on their face, and if the beneficiary were innocent, then the efficacy of the operation of the letter of credit required that the bank pay. That was clearly so on the facts in the instant case where the documents, although false in a material particular, were not forged and therefore were not a nullity. Lord Diplock expressly left open the question of what the position would have been if the documents had indeed been forged, but the inference from his remarks seems to be that even in such a case the bank would still be required to make a payment against them.

In the end, therefore, the House of Lords would at least appear to have decided that a bank may not refuse to pay against documents that are regular on their face, even though the bank is aware of some material and deliberately misleading inaccuracy in the documents, but one for which the person presenting the documents for payment is not responsible. Even if that be accepted, there are still many questions unanswered. It will in fact be rare for a bank to be pressed for payment when it knows that there has been fraud on the part of the beneficiary. In such a case the applicant is usually immediately advised to take appropriate steps, and the beneficiary will in consequence drop its demand for payment. Where a negotiating intermediary bank has already paid the beneficiary, or where the beneficiary resists, the issuer must decide whether to pay. In practice, the decision to pay or not to pay will often be made after the applicant has been informed of the fraud. Where the bank knows of a fraud (assume upon an admission of forgery or material falsity by the beneficiary) and the informed applicant requests that payment not be made, it would seem outrageous to permit the bank to pay without recourse against it by the applicant. If the documents presented are forged or even false, they are not to the knowledge of the bank "documents" required under the letters of credit. However, if the bank knows of a fraud in the underlying transaction (for example, substandard or obsolete goods shipped) but the documents are *bona fide* and do not reflect the fraud (in that the applicant failed to require in the letter of credit presentation of a certificate of inspection), the sense of outrage at payment by the bank cannot be as great. The bank pays against regular documents and ignores the personal claims of the applicant against the beneficiary. The bank may be aware of

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<sup>36</sup> *Supra*, footnote 26, at pp. 187 (A.C.), 728 (All E.R.).

the fraud but not its impact upon the entire underlying transaction, nor whether the beneficiary in any event has a right to set-off.

The case law seems for now to have limited itself to a discussion of the quality of a bank's knowledge, rather than its liability for payment in the face of that knowledge. Both the Uniform Customs and the Uniform Commercial Code reflect the desire of banks that they not be put to the obligation of having to investigate or gather evidence in support or refutation of the validity of documents presented by the beneficiary. There is currently insufficient authority to say that such an obligation exists as far as the validation of a notice of fraud is concerned. What bothers banks, of course, is that if they had an obligation to support or refute, they would have to direct their energies in every case of notice of fraud to the gathering of evidence and evaluation of it in justification of payment. It has been assumed to date by the banking community that such activity and effort is never necessary.

The issues discussed above are to some extent currently before the Supreme Court of Canada. The decision of the Quebec Court of Appeal in *Angelica-Whitewear v. Bank of Nova Scotia*<sup>37</sup> contains the inference that an issuer is not permitted to pay under a letter of credit where it has been given notice of fraud and is furthermore aware of the previous alleged fraudulent activity of the beneficiary in other related transactions. That decision, however, seemed to have turned on other matters, including the existence of discrepancies in the documentation which would have justified and required dishonour.

The courts have not clearly foisted upon banks an absolute obligation to dishonour in all cases of fraud, and there seem to be several reasons for this. First, such an obligation would take the issuer beyond the realm of its currently perceived duties, namely, a surveyor of paperwork. In practice, most questions of fraud are brought to the attention of the letters of credit department of a bank by the applicant, usually on the basis of self-generated or independent sources of rumours. Clear proof of fraud is rarely presented in a neat package to the bank by an impartial third party expert. Furthermore, international departments of banks are rarely staffed with officials sufficiently trained to appreciate fully the significance or subtleties of such proof or, in any event, to take the important and often risky decision to believe and act on such proof. From the point of view of the bank, a request for dishonour by the applicant flies in the face of the very reason for issuing the credit, namely, to provide to the beneficiary a more than reasonable expectation of payment.

Secondly, the risk factor already alluded to is monumental. By imposing a positive obligation upon the issuer to dishonour a credit in circum-

<sup>37</sup> C.A. 09-0037-785, March 3, 1985, unreported.

stances later adjudged appropriate, banks would be forced to prophesy the outcome of litigation on the very issue. By dishonouring, a bank almost automatically makes itself a defendant in a future action by the beneficiary in which it will have to successfully justify its refusal to pay. If the issuer has placed almost total reliance on the word of the applicant in deciding to refuse payment, it may find itself abandoned or misled by the applicant prior to or at the trial of the issue. If proof of fraud at the time of dishonour came from independent sources, the cost, availability, sufficiency and credibility of those sources will be tested at or prior to the hearing. In brutal business terms, there is nothing in it for the bank.

On the other hand, there are circumstances which would appear to justify the imposition upon the issuer of a positive obligation to look beyond documents. Even from the business point of view, a decision to dishonour is often based on a desire to please a valued customer or is cushioned by a full security and an indemnification agreement taken from the applicant. In fact, taking security and indemnification is one of the more effective means of testing the veracity of the applicant's cries of fraud, and, furthermore, promoting a settlement between the applicant and the beneficiary. Admittedly, the international standing of the bank as reliable will not be assisted, unless, of course, it is triumphant in subsequent litigation against the beneficiary.

Where a bank discovers at the time of presentation for payment that its current or former employees have contributed to the fraud, whether by contributing to a forgery or using their influence to procure for the beneficiary dishonest documentation, it, depending on the circumstances, should be obliged in law to refuse payment. So far as judicial economy is concerned, the bank as joint or sole defrauder is certainly saving itself the expense of defending an action by the applicant based on the bank's fraud. If the fraud was committed without the knowledge of the beneficiary (and with or without the collaboration of the applicant) payment must be made to the innocent beneficiary. In this regard, the principle enunciated in *United City Merchants* should be applied.

Where the issuer has an interest in the underlying transaction, where it has counselled or interested the applicant in the underlying transaction, or where the applicant has looked to the issuer for advice with respect to the underlying transaction and the use of the letter of credit mechanism, the issuer, again depending on the circumstances, should be under a positive obligation where it is aware of a relevant fraud to refuse payment under the credit or to appropriately inform the applicant. This would permit the applicant on a timely basis to take reasonable steps, including the institution of judicial proceedings, to force dishonour. The obligation advocated here obviously does not arise from the limited role of the bank as issuer under the credit mechanism. Considering its wider role as agent,

partner, joint venturer, investment counsellor and general advisor, it is not impossible to see a solid judicial foundation for the obligation described.<sup>38</sup>

#### IV. *Identity of the Beneficiary and Applicant*

For various reasons an applicant for a letter of credit may require a credit be made to the benefit of itself. The circumstances requiring that the applicant and beneficiary be the same person may vary. For example, an applicant who is not yet aware of the correct or final name of its beneficiary may think it best to obtain a credit for its own benefit, which may be transferable to the true or ultimate beneficiary once ascertained. Furthermore, for accounting purposes a corporation or enterprise may be required to demonstrate bonding ability or credit-worthiness and accordingly have a letter of credit opened in its own name.

Whatever the reason for the application, banks are reluctant to issue a letter of credit in these terms. The advice usually given to the applicant is that a letter of guarantee made out to whomever it may concern would provide an equivalent instrument, without attendant formalities.

The question that arises is whether a credit in which applicant and beneficiary are the same person is properly termed a credit, and more seriously, whether such an instrument has any legal effect. Such a letter of credit would, from the beneficiary's point of view, be an undertaking by the issuing bank to pay a certain sum of money upon the presentation of documents, or upon demand. Monies to be used to reimburse the bank would be taken by the latter from the account or line of credit of the beneficiary. The beneficiary would have a right of action against the bank in the event that it refused to pay upon demand, although the beneficiary knows it will ultimately be liable to pay to the bank funds equivalent to those paid by the bank to it in its capacity as beneficiary. Between the time of the opening of the credit and the actual demand for payment, the beneficiary can use the letter of credit as proof of credit-worthiness up to the amount stipulated in the credit. It is evident that the credit is of much greater value to a creditor with whom the beneficiary deals than a letter of comfort from the bank to the effect that it has extended a margin of credit in a similar amount. In most circumstances no action may be brought by the creditor against the bank on a letter of comfort, nor is the line of credit irrevocable.

From the point of view of a bank, however, the transaction would appear on its face to be nonsense. The bank is aware the credit is a surreptitious and cheap way for the applicant to borrow money. By issuing such a credit, the bank irrevocably extends a margin of credit, leaving itself exposed in the event that the credit is drawn and the security-to

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<sup>38</sup> For the fiduciary obligations of banks towards customers see D. Waters, Banks, Fiduciary Obligations and Unconscionable Transactions, *supra*, p.; W.G. Horton, Taking and Enforcing Guarantees (1981), 1 Creditor/Debtor Rev. 4.

cover reimbursement proves to be valueless. If the bank is to be persuaded to issue such a credit, its most obvious position would be to take an assignment of funds or liquid assets of the beneficiary held in the same bank.

The Uniform Customs are drafted throughout on the assumption that the beneficiary is a third party. Article 2 refers to an issuing bank acting at the request of the applicant in making payment to a third party or beneficiary. Article 6 notes that a beneficiary can in no case avail itself of the contractual relationships existing between the applicant for the credit and the issuing bank, again on the assumption that the beneficiary is a person other than the applicant. On the other hand, the Uniform Commercial Code does not seem to deal with the beneficiary in a third party position. Article 5-103 defines beneficiary as a person who is entitled under the terms of the credit to draw or to demand payment, and a customer as a person who causes an issuer to issue a credit. It is especially noteworthy that a bank may be considered a customer if it procures issuance or confirmation on behalf of its customer; the latter provision nevertheless cannot be read as permitting an issuer to be a customer. Article 5-102(2) indicates that the provisions on letters of credit do not apply to engagements to make advances or to honour drafts or demands for payments or to guarantees unless it meets the requirements of subsection 1 of that Article. Even though a letter of credit which has the same customer and beneficiary may in fact simply be an engagement to honour drafts on the part of the bank, it would nevertheless be caught by Article 5, if it conspicuously stated that it was a letter of credit.

In this writer's view, a letter of credit transaction involving one person as both customer and beneficiary is nevertheless a valid letter of credit. There are several arguments in favour of this position, the chief one being the very flexibility of the letter of credit mechanism. A letter of credit once issued requires the involvement of no more than two parties, namely, the issuer and the beneficiary. The validity of the obligation of the bank toward the beneficiary is in no way dependent upon the person, resources or perhaps even the very existence of an applicant. The issuer cannot raise defences against payment based on rights of set-off or other claims the bank may have against the applicant. While the applicant has traditionally been a role player in stimulating the issuance of a credit, by no means can it be said that its presence or identity in the letter of credit itself is essential except for permitting amendments. Accordingly, it would appear to matter little that the applicant may be the same person as the beneficiary. The letter of credit instrument does not create a recourse by either the issuer or the beneficiary against the applicant by virtue of the instrument itself; neither the issuer nor the beneficiary could properly complain in law about the identity of the applicant. Even in that most complex of instruments, the bill of exchange, a payee may be fictitious or

non-existing, and the drawer and the drawee may be identical persons, without derogation from the quality of the instrument as a bill of exchange.

By contrast, identity of the issuer and confirmer would negate the confirmation. The identity of the issuer and advising bank would not derogate from due advice of the credit. Identity of the issuer and beneficiary would not seem to permit the creation of a letter of credit, even if the instrument were transferred to a third party.

### *Conclusion*

The letter of credit business has dramatically increased in volume in recent years. That increase is in part due to the creativity of the commercial community in inventing novel uses for the letter of credit, both in the domestic and international fields. The form and identity of the credit is in large part the result of many years of commercial experience accumulated in international trading circles. The basic concepts of autonomy and strict compliance find their development in the case law dealing with international sales, and import-export transactions. In light of the now well-established role of credits, it is surprising that basic legal questions remain without complete answers, especially so far as the issuer's liability is concerned. On the other hand, the nature of the beast has historically been a legal anomaly; witness the acceptance, without full explanation, of the binding nature of the credit transaction in the absence of consideration flowing from the beneficiary to the issuer.

A credit beneficiary regards the letter of credit not only as a payment facility, but also as security against the bankruptcy or non-performance of the underlying contract by the applicant. As we have seen, it is essential for the maintenance of the esteem in which the letter of credit is held that payment not be obstructed due to personal claims or defences the applicant and issuer may have against each other, or due to the bankruptcy of the applicant. In the same vein, care should be taken not to introduce into the credit mechanism a burden too great for the issuer to bear, especially where allegations of fraud in the transaction arise.