ABSTRACT PAYMENT UNDERTAKINGS: TO WHAT EXTENT ARE THEY TRULY ABSTRACT?

Thesis submitted for the degree of
Doctor of Philosophy
At the University of Leicester

by

Amer Ibrahim Mofleh

Faculty of Law
University of Leicester

October 2005
To my father and mother for their never ending help, support and encouragement.
# Contents

**Abstract**

**Introduction** .............................. 1

**Chapter 1: Documentary credits as abstract payment undertakings** ............................. 7

1.1 Introduction ............................................. 7
1.2 Basic principles/rules of documentary credits ......................................................... 8
   1.2.1 Terminology ........................................ 8
   1.2.2 Legal principles governing documentary credits reflect commercial practice ........ 9
1.3 Issues regarding enforceability and risk allocation .................................................. 13
   1.3.1 Introduction ....................................... 13
   1.3.2 Historical analysis of the documentary credit ................................................. 14
   1.3.3 The influence of the early history of documentary credits on their modern forms .................................................................................................................. 18
   1.3.4 The question of consideration ....................................................................... 20
1.4 Concluding remarks ................................................................................................. 25

**Chapter 2: Demand guarantees as abstract payment undertakings** ............................. 27

2.1 Introduction ............................................. 27
2.2 Basic principles/rules of demand guarantees ......................................................... 28
   2.2.1 Terminology ........................................ 28
   2.2.2 Role of demand guarantees in international trade .......................................... 31
   2.2.3 Legal principles governing demand guarantees ............................................. 32
       2.2.3.1 The abstraction principle: comparison with documentary credits ......... 32
       2.2.3.2 The principle of strict compliance: comparison with documentary credits .......................................................... 35
2.3 Issues regarding enforceability and commercial use of demand guarantees .......... 37
   2.3.1 The question of consideration ...................................................................... 37
   2.3.2 The problem of abusive calling ................................................................. 38
   2.3.3 Dealing with abusive calling: the international initiatives ......................... 40
2.4 Concluding remarks ............................................................................................... 44
### Chapter 3: "Documentary fraud": a defence to payment

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 Introduction</td>
<td>46</td>
</tr>
<tr>
<td>3.2 &quot;Documentary fraud&quot; and the beneficiary's intent</td>
<td>49</td>
</tr>
<tr>
<td>3.2.1 General principles regarding the fraud exception</td>
<td>49</td>
</tr>
<tr>
<td>3.2.2 The &quot;documentary fraud&quot; test: fraudulent intent necessary to establish fraud</td>
<td>50</td>
</tr>
<tr>
<td>3.2.3 Looking at documentary fraud from another angle</td>
<td>55</td>
</tr>
<tr>
<td>3.3 C.I.F. sales, documentary credits and fraud</td>
<td>58</td>
</tr>
<tr>
<td>3.3.1 Principles relating to the seller's documentary duties under C.I.F. contracts</td>
<td>58</td>
</tr>
<tr>
<td>3.3.2 Exercising the right to reject inaccurate documents under a C.I.F. contract</td>
<td>62</td>
</tr>
<tr>
<td>3.3.3 Should the rules be different where payment is effected through a documentary credit?</td>
<td>67</td>
</tr>
<tr>
<td>3.4 Null documents</td>
<td>72</td>
</tr>
<tr>
<td>3.4.1 Introduction</td>
<td>72</td>
</tr>
<tr>
<td>3.4.2 Defining null documents</td>
<td>74</td>
</tr>
<tr>
<td>3.4.3 Should null documents be treated differently?</td>
<td>76</td>
</tr>
<tr>
<td>3.5 Concluding remarks</td>
<td>83</td>
</tr>
</tbody>
</table>

### Chapter 4: "Fraud in the transaction": a defence to payment

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1 Introduction</td>
<td>86</td>
</tr>
<tr>
<td>4.2 Injunctions against fraud</td>
<td>87</td>
</tr>
<tr>
<td>4.2.1 The fraud in the transaction test</td>
<td>87</td>
</tr>
<tr>
<td>4.2.2 The cause of action requirement: bank knowledge of fraud</td>
<td>95</td>
</tr>
<tr>
<td>4.2.3 The balance of convenience</td>
<td>98</td>
</tr>
<tr>
<td>4.2.3.1 The general rule</td>
<td>98</td>
</tr>
<tr>
<td>4.2.3.2 The main factor: the availability of damages</td>
<td>99</td>
</tr>
<tr>
<td>4.2.3.3 Other factors</td>
<td>107</td>
</tr>
<tr>
<td>4.2.4 Reconsidering the cause of action rule</td>
<td>109</td>
</tr>
<tr>
<td>4.3 Injunctions against abusive calling</td>
<td>112</td>
</tr>
<tr>
<td>4.3.1 Introduction</td>
<td>112</td>
</tr>
<tr>
<td>4.3.2 Approaches taken by other jurisdictions</td>
<td>113</td>
</tr>
<tr>
<td>4.3.2.1 Abuse of rights: a civil law defence</td>
<td>113</td>
</tr>
<tr>
<td>4.3.2.2 Equitable fraud: an American defence</td>
<td>117</td>
</tr>
<tr>
<td>4.3.3 “Good faith” as a potential defence against abusive calling</td>
<td>121</td>
</tr>
<tr>
<td>4.3.4 A lesser abstraction principle: an English approach</td>
<td>126</td>
</tr>
<tr>
<td>4.4 Concluding remarks</td>
<td>136</td>
</tr>
</tbody>
</table>

### Chapter 5: Parties immune from the fraud exception

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Introduction</td>
<td>140</td>
</tr>
<tr>
<td>5.2 Confirming banks, counter-guarantees and fraud</td>
<td>141</td>
</tr>
<tr>
<td>5.2.1 Confirming banks and fraud</td>
<td>141</td>
</tr>
<tr>
<td>5.2.2 Confirming banks under a deferred payment credit</td>
<td>144</td>
</tr>
<tr>
<td>5.2.3 Silent confirmation and fraud</td>
<td>147</td>
</tr>
<tr>
<td>5.2.4 Demand guarantees, mandates, counter-guarantees and fraud</td>
<td>149</td>
</tr>
</tbody>
</table>
5.3 Transfer, assignment and fraud .............................................................. 151
  5.3.1 “Transfer” in abstract payment undertakings and fraud .................... 151
  5.3.2 Assignment of the proceeds and fraud .............................................. 155
5.4 Acceptance credits, negotiation credits and fraud .................................... 157
  5.4.1 Acceptance credits ........................................................................... 157
  5.4.2 Negotiation credits ........................................................................... 158
    5.4.2.1 Terminology ................................................................................ 158
    5.4.2.2 Applying the fraud exception to negotiating banks ....................... 161
    5.4.2.3 Negotiation: with or without recourse .......................................... 162
5.5 Concluding remarks .................................................................................... 166

Chapter 6: Further erosions to the abstraction principle .................................. 169

6.1 Introduction .............................................................................................. 169
6.2 The illegality exception ............................................................................. 170
  6.2.1 Difficulties in relation to “illegality” .................................................... 170
  6.2.2 Illegality in the underlying transaction ............................................... 172
6.3 Set-off a defence to payment ................................................................. 177
  6.3.1 Set-off in the bills of exchange context .............................................. 177
  6.3.2 Set-off by the bank in abstract payment undertakings ....................... 180
6.4 The fraud defence in applications for summary judgments ....................... 183
6.5 Concluding remarks .................................................................................... 186

Conclusion ....................................................................................................... 189

List of cases ..................................................................................................... 196

Bibliography .................................................................................................... 205
Books .............................................................................................................. 205
Articles and notes ............................................................................................ 208
Chapters in monographs .................................................................................. 224
Abstract

This work examines to what extent documentary credits and demand guarantees are, and should, be treated as autonomous or abstract from the underlying contract that leads to their issuance. This question is of vital importance to the commercial parties that utilise these instruments. The answer to it determines many of their duties, liabilities, the risks they undertake and the remedies available to them.

While documentary credits and demand guarantees share some characteristics, both instruments serve different commercial functions. As such, the legal principles governing each instrument should be tailored to fit its functions. This point and the relevant legal and commercial issues relating to it will be examined thoroughly in Chapters 1 and 2.

Chapters 3 and 4 will critically analyse the different approaches developed by the English courts when dealing with the autonomy of these instruments. It will be demonstrated that the rules they have developed in this area of law are inconsistent, in some instances contradictory, commercially unsound and do no reflect the traders’ perceptions of the instruments. This unsatisfactory outcome has resulted from the English courts’ (i) failure to distinguish between documentary credits and demand guarantees; (ii) insistence on applying to these instruments particular doctrines which developed outside their context; and (iii) failure to develop any clear framework by which they can abide when dealing with the issue of autonomy.

Chapter 5 examines the autonomy principle in demand guarantees and documentary credits where third parties are involved. Finally, Chapter 6 examines to what extent a documentary credit and a demand guarantee may be affected by illegality in the underlying transaction. In addition, it will analyse whether banks issuing such instruments are entitled to exercise a right of set-off against the beneficiary of these instruments.

The methods of tackling the commercial drawbacks that ensue from the current legal approaches to this area of law will be dealt with in detail throughout the thesis. Conclusions will be drawn as to what steps can be taken by the English courts to enhance the certainty of position of the different parties to these instruments, reflect their intentions and allocate the risks they undertake without jeopardizing the efficiency of the instruments.
Introduction

The notion of an abstract payment undertaking appears to have been first introduced by Professor Roy Goode and has been adopted in both English and American literature. The concept applies to payment undertakings that are detached from the transaction which leads to their issuance and an investigation as to whether consideration has been given or not by the promisee is unnecessary. Furthermore, the promisee is usually immune from defences arising from any underlying contracts.

It should be said, however, that the term “abstract” is believed to have originated in civil law jurisdictions where it was recognised that a primary undertaking issued in support of an underlying contract can be “abstract”, in other words autonomous in nature. Thus, notwithstanding the fact that such an undertaking may refer to an underlying contract or may be intended to be triggered only upon fulfilment of certain expectations relating to that contract, such issues should not affect the promisee’s certainty of receiving payment: as long as the conditions required in the abstract undertaking are met, payment should be effected.

This doctrine has ignited debate among both commentators and the judiciary. The extent to which a payment undertaking should be detached from a contract to which it fundamentally relates is one of the most difficult issues relating to this area of law. One the one hand, the main function of abstract payment undertakings is to provide immediate payment to the promisee. On the other hand, in developing principles to facilitate immediate payment, the courts should not inadvertently allow unscrupulous promisees to unjustly collect payment. If they do, traders will be less inclined to utilise instruments that can easily lead them to sustaining huge losses.

Loosely speaking, the earliest abstract payment undertaking was the bill of exchange.1 It developed at the time when the law merchant was still in force. It aimed to reduce certain commercial risks that merchants faced: when a merchant wanted to buy from another merchant in a distant city he had to carry large amounts of silver or gold coins. Specie is valuable, and expensive to ship. In addition, it might be irretrievably lost through disaster or theft. Bills of exchange enabled traders to

---

1 A bill of exchange is not truly an abstract instrument since – although the rules on consideration are relaxed – consideration must be furnished at some stage: Bills of Exchange Act 1882 s. 27 (2).
overcome these difficulties. To ensure their acceptability among traders, bills of 
exchange were treated as detached from any underlying contract and their holder was 
immune from defences which prior parties might have in relation to such contracts. 
The fact that the instrument was not easily reconcilable with common law rules on 
consideration did not affect its enforceability in common law courts.

This work, however, is primarily concerned with two more recent abstract 
payment instruments: documentary credits and demand guarantees. Documentary 
credits are the most popular payment method in international trade. Their use exceeds 
billions of dollars annually. Demand guarantees are a security device used in major 
international transactions and, although they are not used as frequently as 
documentary credits, they also involve billion dollar sums annually. These 
undertakings – like bills of exchange – were developed by merchants to meet certain 
commercial needs. They are abstract in the sense that absence of consideration is not a 
defence to their enforceability and also their holder is usually insulated from any 
claim or defence arising out of the underlying contract that gave birth to the 
instrument. Unlike bills of exchange, however, these instruments are relatively new 
creatures in international trade. They developed long after the law merchant was 
incorporated into the common law. While the early history of the different abstract 
instruments overlaps, each instrument was developed by traders to fulfil different 
functions and expectations.

The essence of this work is to examine the extent to which documentary 
credits and demand guarantees are, and should be, treated by the English courts as 
abstract. In other words, in what circumstances a promisee of such an instrument 
does, and should, lose the certainty of receiving payment that he enjoys by holding an 
abstract promise? While the present writer acknowledges that much ink has been spilt 
on this area of law, he will demonstrate that – contrary to the widely accepted view – 
the answer to this question remains by no means clear. Furthermore, the principles 
governing it are inconsistent and in some instances contradictory.

It should be noted that in both demand guarantee and documentary credit 
transactions at least three parties are involved: (i) the applicant; (ii) the promisor 
(usually a bank); and (iii) the promisee (beneficiary). Each of these parties will have a
different expectation in respect of the abstract instrument in question. What may be a
desirable limitation to the abstraction principle from one party’s view may not be
from another party’s view. This makes the task of setting the boundaries of the
abstraction principle very difficult.

English courts tend to treat documentary credits and demand guarantees as if
they are analogous in every respect. This tendency is unfortunate as the function of
each instrument is very different. A documentary credit serves as a payment device
which is usually issued in support of a c.i.f. sale contract. A demand guarantee, on the
other hand, is a security device issued to protect against default in the performance of
the underlying transaction. In the former instrument the beneficiary is usually required
to tender a set of documents of commercial value to trigger payment. In the latter, he
is usually required to tender simply a written demand to trigger payment. As will be
examined in this work, because documentary credits and demand guarantees serve
different functions in international trade, the duties, expectation and the intentions of
the parties under each instrument are very different. Failing to acknowledge these
differences when setting the limits of the abstraction principle may, and indeed does,
result in commercially unsound outcomes.

A number of sets of uniform rules have been developed to govern the different
abstract instruments. In the documentary credit context, as early as the 1930s the
International Chamber of Commerce introduced the Uniform Customs and Practice
for Documentary Credits (UCP). These are a set of uniform rules that reflect best
practice in the area of documentary credits. The UCP is regularly revised to reflect the
needs of the commercial entities that utilise documentary credits. In fact the latest
edition of the UCP, adopted in 1993 (UCP 500), is currently under revision. An
analysis of the articles of the UCP relevant to this study is necessary. This is to
determine whether future revisions of the UCP should address points relevant to this
work, particularly whether the UCP should be amended to include provisions for
dealing with fraud.

The problem of fraud in documentary credits is not new; what is new,
however, is the scale of the problem and its frequency in recent years. When fraud is
perpetrated in the underlying transaction which gives birth to the documentary credit,
the question arises whether the payment undertaking contained in the documentary credit should be affected by such fraud. In other words, should the abstraction principle insulate the payment undertaking from fraud? This is not an easy question to answer. Many issues overlap when seeking an answer: (i) what is meant exactly by fraud; (ii) whose fraud is relevant; (iii) does it matter at which stage of the transaction fraud is pleaded or proven; (iv) what practical and commercial implications must be taken into account when setting the limits of the abstraction principle; (v) what impact may any particular approach have on the different parties involved in the documentary credit transactions?

Fraud in the demand guarantee context raises similar thorny questions. Unlike documentary credits, however, there are four different sets of uniform rules that parties may choose from. In addition, there is an international convention in this field as well. While in the documentary credit context the UCP has avoided regulating the limits of the abstraction principle, in the demand guarantee context most of the regimes which may govern the instrument deal with this issue. The main reason for this is that “abusive calls” have been recognised as a practical problem which undermines the degree to which traders can rely on the latter instrument. Abusive calls in demand guarantee transactions are different from fraud in documentary credit transactions. Although there is no accepted definition of an abusive conduct, it appears to encompass both fraudulent conduct and any unfair conduct that undermines the commercial purpose of the instrument but falls short of common law fraud.

While the traditional approach of the English courts has been to apply the abstraction principle to demand guarantees to the same extent that it is applied to documentary credits, recently there have been calls for the application of a more relaxed version of the abstraction principle to the former instrument. Accordingly, while the traditional approach seeks authority from documentary credit dicta on fraud to establish when payment under a demand guarantee should be avoided, recent approaches seek to establish the limits of the abstraction principle in each instrument differently. Some court decisions have thus held that in demand guarantees defences other than fraud should be a permissible ground to defeat payment under the instrument. This is necessary since fraud in the documentary credit context usually
relates to fraud in the documents. Such type of fraud has no real application in the
demand guarantee context. As will be examined, the approaches which call for a more
relaxed version of the abstraction principle vary both in the extent to which they seek
to set the boundaries of the abstraction principle and in the defences they recognise
against the principle.

The exact limits of the abstraction principle are particularly problematic in
applications for interlocutory injunctions aiming to withhold payment from a
beneficiary of an abstract instrument. The basis for such injunctions and the factors
which determine whether they should be granted in certain cases are issues which
courts have dealt with in a particularly unsatisfactory manner. As will be examined,
courts have developed different – and contradictory – dicta in this area of law. This is
harmful to the certainty required under such instruments. The same can be said in
respect of the limits of the abstraction principle in applications for summary
judgments. Case law has failed to sketch at least an outline of a standard approach to
this complex area of law, where much certainty is required.

In both demand guarantees and documentary credits it is accepted that certain
parties participating in such transactions will be immune from any defence which
would be available against the beneficiary (e.g. fraud). The level of abstraction where
such parties are involved will be analysed in detail. This work will also deal with the
rather less pleaded defences against payment under abstract instruments: illegality in
the underlying transaction and set-off by a party providing an abstract instrument.
While disputes relating to such defences remain very rare, any study into the abstract
nature of documentary credits and demand guarantees would not be complete unless
such defences are examined.

Although this work is not intended to be a comparative study, from time to
time reference will be made to the treatment of abstract payment undertakings in the
United States, Germany, Australia and other jurisdictions. This is because many
English courts when dealing with this subject have sought guidance from cases heard
before foreign courts.

Finally, this work will conclude that a number of refinements to this area of
law are necessary. English case law to date demonstrates that there is no clear
understanding of which principles should govern the different instruments. In addition, the boundaries of the abstraction principle seem as if they are still in their infancy. This results in much uncertainty in this area of law. To overcome such an unsatisfactory outcome courts should be exhorted to embrace Lord Irvine’s observations that when shaping the rules governing abstract payment undertakings, the law should respond by “adapting its rules with keen commercial sensitivity to the customs and expectations of traders”. In this regard, legal principles should be tailored to fit abstract instruments, not the other way around.

---

Chapter 1: Documentary credits as abstract payment undertakings

1.1 Introduction

The law and practice of documentary credits is controversial, not least in areas such as their enforceability and their early history. In this regard it will be necessary to examine the development of documentary credits and their early history to establish a clear understanding of how they came about and the commercial and legal policies underpinning them.

This chapter seeks to establish that the documentary credit is an instrument which developed through mercantile practice and that although its early history overlaps with that of bills of exchange, both instruments in their modern form are very different. Both satisfy different commercial functions and fulfil different expectations on the part of those parties utilising them. Accordingly, both should be governed by special rules that reinforce the expectations and the intentions of the parties. As traders' practice has brought this unique instrument into the legal realm, the legal principles applicable to it should be tailored to fit such practice. Doctrines and dicta derived from bills of exchange transactions should not be extended to documentary credit contexts unless such an approach is commercially justified. These arguments are also applicable when determining the level of the abstraction in documentary credits.

The first part of this chapter examines the functions of documentary credits and their characteristics. The later parts examine the history of documentary credits, their enforceability and legal doctrines that should or should not govern them. The issues examined and the conclusions reached in this chapter are central to the overall theme of this work: that of determining and examining the boundaries of the abstraction principle.

---

1 John Dolan, a leading American scholar in this area of law has stated: 'The generic term, abstract payment undertaking, which applies to standby and commercial letters of credit and to independent or first demand bank guarantees, is Roy Goode's'. See Dolan, J. 'Analyzing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 45 Wayne. L. Rev., p. 1866, note 1.
1.2 Basic principles/rules of documentary credits

1.2.1 Terminology

When a seller agrees to be paid by means of a letter of credit he is looking at a reliable bank that has an obligation to pay him the amount stipulated in the credit. As long as the seller performs his duties to an extent that meets the credit terms, any defences which the buyer might have in relation to the underlying contract of sale may not affect the seller’s rights under the credit. The English name “letter of credit” reflects its function. The name derives from the French word “accreditif”, meaning the power to do an act. The latter word is derivative of the Latin word “accreditivus”, which means trust.2 Thus, when agreeing to be paid through a documentary credit, the seller looks to a reliable paymaster whom he can trust.

When speaking of “letters of credit”, the trend has been to associate the term with an underlying contract of sale. Although generally there is an underlying sale contract, letters of credit are not limited to those issued to fulfil a payment undertaking associated with an underlying contract of sale, in which case sets of certain documents are required. There are other forms of letters of credit, which relate to other underlying transactions, services, or obligations. Hence, a letter of credit can be issued without the need for an underlying contract of sale, or for the beneficiary to tender a set of documents. A credit to pay demurrage claims in respect of carriage by sea contracts is a good example of this process.3 Another example is where a documentary credit is issued to the benefit of a broker who arranges a transaction.4

However, this research is concerned only with documentary credits issued in association with underlying contracts of sale. In recent years legal writers use the terms “documentary credit”, “commercial credit” and “letters of credit” as interchangeable.5 However, from analysing the early history of documentary credits it would seem that the term “documentary credit” should be distinguished from “letter

---

of credit". The former is a new instrument which established its dominance after World War I, while "letters of credit" find their roots alongside the early history of negotiable instruments.

As will be discussed the early "letter of credit" encompasses different characteristics to those found in modern "documentary credits". Thus, the term "documentary credit" will be used in this work to refer to the instrument in its present form, since it is more accurate.

1.2.2 Legal principles governing documentary credits reflect commercial practice

The modern documentary credit incorporates the issuer's firm obligation of payment toward a nominee (seller/beneficiary). The most distinctive feature of the documentary credit is the issuing of a promise of payment by a party independent of the underlying contract, who is known for its solvency (the bank) on behalf of its customer (the buyer/applicant), to the beneficiary, upon the beneficiary's fulfilment of the terms specified in the credit. The terms of the credit always require the beneficiary to tender certain commercial documents in order to claim payment. These documents usually include the same commercial documents that the beneficiary has agreed to provide under the underlying sale contract.

The bank's promise to pay is mostly issued in an irrevocable form. It is independent and autonomous from the underlying sale contract, thus it assures the beneficiary of payment upon presentation of documents specified in the promise. If the documents are in order, disputes regarding the actual condition of the goods are irrelevant. By demanding a documentary credit as a method of payment, the beneficiary eliminates exposure to both the risk of the applicant's repudiation of the sale contract or the applicant's insolvency or non-payment.

Beneficiaries can also eliminate the rare situation where the issuing bank becomes insolvent before payment is made by insisting on a confirming bank. Hence, where an irrevocable credit is confirmed, the confirming bank, upon the request of the

---

6 McCurdy, W. 'Commercial Letters of Credit' (1921) 35 H.L.R., p.544.
7 Mead, C. 'Documentary Letters of Credit' (1922) 22 Col. L.R., p. 298.
8 See section 1.3.1. See primarily Note, 'Revised International Rules for Documentary Credits' (1952) 65 H.L.R., p. 1420.
issuing bank, effectively takes on in relation to the seller all the obligations taken on by the issuing bank where the credit is not confirmed. In other words, the seller needs only to deal with the confirming bank, and its undertaking is abstract (autonomous) from both the underlying transaction of sale and the contract between the issuing bank and the confirming bank. This is unless the confirming bank becomes insolvent or refuses to pay, in which case the beneficiary can demand payment directly from the issuing bank.

Other than fulfilling a payment function, the documentary credit can be used to provide the applicant with a credit facility. In particular where the issuing bank requires that the shipping documents tendered under the credit be made out to its order. In this situation the issuing bank obtains security over the shipping documents and the applicant would only reimburse the bank upon arrival of the goods.

Two legal principles have developed to ensure that documentary credits fulfil their intended purpose in international trade. First, the principle of abstraction, or as commonly referred to the "autonomy" or "independence" principle. It requires banks to deal with documents only; they are not concerned with the goods (facts). The bank's obligation is defined by the terms of the credit alone. Defences that the buyer might have arising out of the sale contract do not concern the bank and in no way affect its liability: if the documents tendered by the beneficiary appear to be in order, then in general the bank is both entitled and obliged to pay without further investigations. Secondly, the principle of strict compliance requires documents to strictly comply with the terms of credit. Hence, if the documents tendered under the credit deviate from the language of the credit the bank is obliged to withhold payment even if the deviation is purely terminological or technical. The general legal maxim

---

9 Article 9 (b) UCP 500. Any reference to the UCP in this work will be to the UCP 500, unless otherwise stated.
10 For further analysis on the position of the confirming bank see Chapter 5, section 5.2.1.
13 Articles 3(a) and 4 of the UCP.
\textit{de minimis non curat lex} has no place in the field of documentary credits.\textsuperscript{15}

From the bank’s perspective both principles aim to make its duty of effecting payment against documents easy, efficient and quick. From the seller’s perspective both principles provide him with the certainty of receiving payment: as long as he performs his documentary duties he is entitled to payment notwithstanding allegations that the underlying contract has not been performed properly.\textsuperscript{16} Finally, from the applicant’s perspective he is assured that payment will not be made unless he receives what he has bargained for: strictly complying documents. This is vital where the applicant is participating in a chain of string contracts: no matter how trivial a discrepancy in the documents is viewed, it could nevertheless jeopardise his rights when claiming payment from other buyers in the chain.

Problems can occur, however, where the interests and expectations of the different parties collide. Perhaps the clearest example of this is where although the documents conform on their face; the fact is that the goods are defective in some respect. In such circumstances, the abstraction principle precludes any reference to the underlying contract of sale: by agreeing to provide a documentary credit the applicant implies that the risk of defective performance in the underlying sale rests on him. His remedies for defective performance will lie in a separate action upon the contract of sale after payment is made.\textsuperscript{17} Strict compliance seeks to reduce the harsh implications that could ensue from this law. Accordingly, where there exists any discrepancy in the documents, the applicant has a strong right to reject them if he fears defective performance in the underlying contract of sale.\textsuperscript{18} Put simply, while applicants cannot raise any defence resultant from defective performance in the underlying contract of sale, they can rely (in appropriate circumstances) on the doctrine of strict compliance to mitigate the harsh results that could ensue from such a rule.

Nonetheless, strict compliance does not provide protection against instances where the beneficiary perpetrates fraud in the underlying transaction. In these

\textsuperscript{18} Although the bank is the party which examines the documents for the purposes of compliance, under Article 14 (c) of the UCP, banks may approach the applicant for instructions as to whether the discrepancies in the documents may be waived and the documents accepted.
circumstances the goods may not only be defective but rather worthless. The whole purpose of the credit transaction will accordingly be undermined. For this reason courts have accepted fraud in the underlying transaction as a defence against payment of the credit. ¹⁹ Yet, documentary credit transactions do not revolve solely around the applicant’s expectations. Furthermore, it is one thing to prove actual fraud and another thing to allege it. Given the fact that in documentary credit transactions payment is made against the documents (usually before the delivery of the good), and given the fact that banks are required to decide whether to pay or not in a relatively short time, it would be extremely hard for an applicant to prove that fraud exists in a given transaction. Courts are thus required to balance between the expectations of the different parties when setting the boundaries of the abstraction principle: protecting the applicant’s interests should not undermine the mechanism of the credit facility. Perhaps to ensure that banks effect their duties in a speedy manner and to protect beneficiaries’ certainty of receiving payment under such an instrument the system of documentary credits should be accepted as “very fraud-prone”. ²⁰ Alternatively, courts may be able to shape the law in a manner which goes a long way in protecting the applicant’s expectation while not affecting the mechanism of documentary credits. For if applicants know for a fact that they are utilising an instrument which is likely to expose them to high risks, the practice of providing documentary credits will become less frequent and traders will lose one of the most effective and commonly used instruments when conducting international trade transactions.

The later chapters of this work will be dedicated to examining the limits of the abstraction principle (mainly where fraud is involved). Analysing this area of law requires examining different questions: the type of fraud in a given case, the beneficiary’s knowledge or participation in it, etc. Nevertheless, the thrust of the different arguments advanced in this area of law usually revolves around the above conflicting legal and commercial principles.

¹⁹ For further analysis on the fraud defence, see Chapter 3. Illegality and set-off are also accepted defences, see Chapter 6.

1.3 Issues regarding enforceability and risk allocation

1.3.1 Introduction

The bank’s promise in documentary credit transactions may be to pay, or negotiate, the credit. Although negotiable credits will be examined in detail in Chapter 5, it should be noted at this stage that the concept of negotiability in documentary credits is different from that in negotiable instruments. As discussed below the historical development of the documentary credit reveals that it has a close relationship with negotiable instruments, in particular with the bill of exchange. In fact, “in their early days, it was sometimes difficult to distinguish between a [documentary credit] and a bill of exchange”.21 However, in their modern form the instruments are very different. First, while a bill of exchange is an unconditional promise to pay,22 a documentary credit is usually a conditional undertaking: the beneficiary cannot claim payment unless the conditions of the credit are met (tendering the required documents). Secondly, a bill of exchange is a negotiable instrument and as such its holder can transfer it by indorsement or delivery to a holder in due course “in such a way that the latter takes clear of personal defences and defects of title of prior parties”.23 A beneficiary under documentary credits on the other hand cannot transfer the documentary credit to another holder unless certain criteria are fulfilled and even when these are fulfilled the credit may be transferred once only.24 Thirdly, the law relating to bills of exchange has been codified in the Bills of Exchange Act 1882, while the law relating to documentary credits has yet to be codified. Finally, while the rules of consideration are relaxed in bills of exchange, the instrument still remains in the form of a contract, which requires consideration at some stage.25 Documentary credits on the other hand do not require consideration.26

Notwithstanding these differences, some courts are inclined to extend

---

22 Bills of Exchange Act 1882 s. 3(1).
24 On transferable credits, see Chapter 5.
25 Bills of Exchange Act 1882 s. 27 (2), which provides that consideration must be furnished but it need not move from the promisee.
26 See section 1.3.4.
principles and dicta derived from bills of exchange context and apply them to documentary credit transactions. The historical background for this approach and the commercial sensibility of it are examined below.

1.3.2 Historical analysis of the documentary credit

There is a great deal of uncertainty as to the origins of documentary credits: their history is “by no means clear”.27 Holdsworth suggests that letters of credit were well-known by the seventeenth century.28 Similarly Ellinger believes that letters of credit became “very popular by the eighteenth century”.29 The period between the seventeenth and eighteenth centuries seems the most accurate account of the time in which letters of credit evolved. A chronological analysis of the development of the English economic system supports this conclusion. Economists suggest that the modern system of commerce has evolved in a three stage development process: the early medieval stage where goods were exchanged for other goods; the later medieval stage of a “cash” (money) economy, when the goods were bought for money; and finally the modern stage of economy when credit became the basis of commercial exchange.30 The last stage is believed to have developed in the seventeenth century. During that period the foreign trade of England stretched across the globe and the reliance on credit instruments became common.31

Law reports suggest that one method of providing credit in the eighteenth century was through banks promising to accept bills of exchange drawn on them at a future date.32 Although courts chose to recognise the enforceability of such promises, as they allowed traders to raise credit abroad, the commercial practice did not operate free from common law technicalities. Thus, there was much emphasis on whether the

---

29 Ellinger, P. Documentary Letters of Credit, p.25.
30 Postan, M. ‘Credit in Medieval Trade’ (1928) 1 Econ. H.R., p. 235.
32 A seller taking bills drawn under such promises could discount them before maturity or could use them to effect payment of outstanding debts due to other merchants. The buyer, once having sold his merchandise could repay his bank for the credit given. See Dolan, J. ‘Standby Letters of Credit and Fraud (Is the Standby only another Invention of the Goldsmiths in Lombard Street?)’ (1985) 7 Cardozo L.R., pp. 33-34.
bills were drawn before or after the promise to accept was given. As a general rule, courts found that if the promise to accept the bill was made before the bill was in existence then the promise was called a "virtual acceptance". If, however, the acceptance was made after the bill was issued then the acceptance was called an "extrinsic acceptance". An extrinsic acceptance was treated as acceptance itself and not a mere promise to accept, thus a holder of the bill could enforce the undertaking without having to establish that the promise was made to him specifically. In contrast, virtual acceptance was unenforceable in English law, the reason being that a person cannot accept what does not exist. In the celebrated case of *Pillans v. Van Mierop* (1765) Lord Mansfield recognised the incompatibility of some common law principles with the rapidly evolving needs of the modern economic system. In that case a buyer wanted to raise some credit in Rotterdam and approached the plaintiffs, merchants, and asked if they would accept bills of exchange drawn by him. The plaintiffs agreed that they would on the condition that the buyer provided a "confirmed credit upon a house of rank in London". The buyer named the defendants. In due course, the plaintiffs honoured the buyer’s draft. They then wrote to the defendant to inquire whether they would honour their draft in a month’s time and the defendants replied that they would. Soon after however, the buyer became insolvent and the defendant refused to honour the drafts drawn on him by the plaintiff. The court had to decide whether the defendant was liable under these circumstances. In the case, the defendant’s promise to accept the drafts was made after the plaintiff had paid the buyer. The promise to accept thus amounted to virtual acceptance and was not supported by any consideration. Lord Mansfield nonetheless enforced the promise as: "[i]n commercial cases amongst merchants...the want of consideration is not an objection". The case is controversial, yet significant. Some writers view it as an authority for enforcing letters of credit, while others argue that it has no relevance to letter of credit law. Rather, it is concerned with the question of a promise to accept a bill of exchange. Finkelstein, for example, has dealt thoroughly with the

---

34 *Grant and Others v. Hunt, Public Officers of the Hampshiire Banking Company* (1845) 1 C.B 42; *Johnson & others v. Collings* (1800) 1 East 98, where Kenyon L. stated: ‘That was a promise to accept a non-existing bill...I know not by what law I can say that such a promise is binding as an acceptance’.
35 (1765) 97 Eng. R. 1035.
36 At 1035.
37 At 1038.
question of a promise to accept a bill of exchange and concluded that Pillans was a case where Lord Mansfield did not clearly distinguish between virtual and extrinsic acceptance.39 And although His Lordship enforced a virtual acceptance in that case, this approach has been generally rejected in subsequent cases.40 Finkelstein thus concludes that the issues raised in that case are irrelevant to the development of documentary credits. Yet, the present author disagrees with this finding. In considering the issue of virtual acceptance, Parke B. in The Bank of Ireland v. Archer and Daly (1843)41 stated:

'The case of Pillans v. Van Mierop appears to be the authority on which the doctrine, that a person can be bound by a promise to accept a future bill, is rested. It is not quite clear from the report of that case, on what ground the defendant was held liable to the plaintiffs, the drawers; whether on his special contract with them to accept, or as actual acceptance... In Beawes' Lex Mercatoria... a promise to accept is apparently put on the ground of a contract, for a breach of which an action lies, and not as being an actual acceptance.'42

This analysis departed from the conventional approach where courts confined their focus to the question of whether a promise to accept amounts to an actual acceptance. Indeed, Parke B. viewed Pillans as accepting the view that in commercial transactions a special contract to accept could be a ground for enforcing a promise to accept a bill of exchange. It is from this point that letters of credit could be said to have started to develop. It is thus submitted that "[a] virtual acceptance is [one of the earliest] species of letter[s] of credit".43 As the promise developed to be viewed as a special contract, it could depart from the requirements of bills of exchange law. Thus, while virtual and extrinsic promises had to be "unconditional" and "definite" in order to be enforceable, the letter of credit could be a conditional contract to accept a bill of exchange.

After the Pillans case references to letters of credit became frequent in law reports,44 and in 1856 it seems that the letter of credit had sufficiently developed to be

43 Anonymous, 'When a Promise Contained in a Letter of Credit is a Virtual Acceptance' (1925) 25 Col. L. Rev., p. 819.
44 See Russle v. Langstaffe (1780) 2 Doug. 514; Maitland v. Chartered Mercantile Bank of India, London and China (1865) 2 H & M 440; Agra and Masterman's Bank (1867) 2 Ch. App. 391.
recognised as one of the most attractive instruments of financing international trade. In that year Parliament rendered all promises to accept bills of exchange ineffective.\footnote{Section 6 of the Mercantile Law Amendment Act, 1856 (19 & 20 Vict c 97). See also Bills of Exchange Act, 1878, 41 & 42 Vict. Ch. 13 & 1, where extrinsic and virtual acceptances were abolished.} Thus, it became clear that promises to accept bills of exchange prior to their existence could only be enforced on the basis that such promises constitute letters of credit.\footnote{Anonymous, ‘When a Promise Contained in a Letter of Credit is a Virtual Acceptance’ (1925) 25 Col. L. Rev., p. 820.}

Accordingly, a letter of credit took the form of a promise contained in a letter made by a bank and given to the buyer. It was addressed either to a named foreign correspondent bank or to the entire world, authorising the addressee to draw drafts on the issuing bank, and undertaking to honour the drafts if the addressee complied with the terms of the credit.\footnote{Mead, C. ‘Documentary Letters of Credit’ (1922) 22 Col. L.R., pp. 298-299.} In Agra and Masterman’s Bank (1867)\footnote{[1867] 2 Ch. App 391.} it was clearly stated that bills of exchange drawn under a letter of credit are enforceable even if they were drawn after the issuance of such letters.\footnote{Finkelstein, H. ‘Performance of Conditions under a Letter of Credit’ (1925) 25 Col. L.R., pp. 724-725.} No legal difficulty was usually aroused in enforcing these letters, as the issuance of such letters is an offer, to the payee and purchaser, which was accepted by taking drafts for value.\footnote{Todd, P. Bills of Lading and Bankers’ Documentary Credits (London, 1998), pp. 268-270.}

As to modern documentary credits, they are believed to have emerged only after the recognition of c.i.f. contracts by courts in 1862 and 1871.\footnote{Tregelles v. Sewell (1862) 7 H. & N. 574; Ireland v. Livingston (1871) L.R. 5 H.L. 395.} Prior to this form of contract the buyer would usually have to personally undertake the shipment of the goods and even accompany them on the voyage.\footnote{Sassoon, D. ‘The Origins of F.O.B and C.I.F terms and the Factors Influencing their Choice’ [1967] J.B.L., pp. 34-35.} As c.i.f. contracts came to be known, buyers were not required to be physically present at the point of delivery, and the practice of payment against documents became widely adopted. Modern documentary credit developed to be one of the main payment methods utilised between parties to such contracts.
1.3.3 The influence of the early history of documentary credits on their modern forms

The history of documentary credits is indisputably entangled with that of bills of exchange. Yet, the instruments in their modern forms are totally different in both their functions and the commercial needs they aim to satisfy. The strong kinship between the instruments in their early forms has led some commentators to suggest that the principles governing bills of exchange could be extended to apply in the context of documentary credit transactions. Kozolchyk, for example, argues that documentary credits belong “to the realm of negotiable instrument law”.

Some courts went a step further and suggested that: “[a] letter of credit is like a bill of exchange...it ranks as cash and must be honoured”; others suggested that a documentary credit “must be treated like a bill of exchange”. While it is true that the origins of documentary credits are intertwined with bills of exchange, and that both instruments were developed by the same class of merchants, nonetheless:

“The analogy of letters of credit to bills of exchange, while of value in many ways, has its limitations. This might be expected in view of the rather specialized function which the modern documentary credit has come to perform.”

Yet, courts persist even today in extending doctrines derived from bills of exchange law to that of documentary credits. The clearest example of this approach is the tendency of English courts to equate the position of the beneficiary of a documentary credit to that of a holder in due course of a bill of exchange.

This approach is misleading and unfortunate. As Schmitthoff points out, in

---

57 In Montrod Limited v. Grundkotter Fleischvertriebs Gm BH, Standard Chartered Bank [2002] 1 W.L.R. 1975, for example, Lord Justice Potter stated: ‘a seller/beneficiary who was ignorant of forgery by a third party of one of the documents presented, or of the fact that the document contained a representation false to the knowledge of the person who created it, should not be in a worse position than someone who has taken a draft drawn under a letter of credit in circumstances which rendered him a holder in due course’. At 1992. See Chapter 3, section 3.4.3 for further analysis.
determining the level of abstraction of any abstract instrument, careful consideration should be given to the commercial needs and objectives of the instrument.\textsuperscript{58} Indeed, to determine the level of abstraction in a given instrument a court should ask itself whether this is the manner in which parties utilising the instrument have intended it to function. And also whether the approach it adopts best reflects parties' expectations and risk allocations. The justification for such an approach is simple: as any abstract undertaking is recognised and given force due to commercial practice,\textsuperscript{59} the legal doctrines governing such an instrument should reflect the needs of the commercial community that has invented this practice.\textsuperscript{60} A moment's reflection will show that there could not be any accurate commercial analogy between the positions of a beneficiary under a documentary credit to a holder in due course of a bill of exchange. Historically, the doctrine of the holder in due course or a bona fide purchaser emerged in the context of bills of exchange to satisfy a major function in international trade. Bills of exchange were in fact a currency substitute that was needed in the seventeenth century when there was both insufficient currency\textsuperscript{61} and inadequate means to move or transport that currency for the economy of the day.\textsuperscript{62} Bills of exchange "acted as money".\textsuperscript{63} The doctrine of the holder in due course encouraged parties to engage in accepting such bills in their transactions: when a bill of exchange is transferred the ultimate holder in a chain of holders would know nothing about the underlying transaction between prior parties. It could have been performed in a geographically distant area, and the expense for obtaining this information could have been enormous.\textsuperscript{64} Thus, to promote the marketability of this much needed money substitute, it was necessary to assure the holder in due course -- transferee -- that he would be protected against defences arising from prior dealings. The fact that prior parties could have protected themselves against any risk of fraud, failure of consideration, or illegality in the underlying transaction before accepting or negotiating the bill, further supported the view that they should bear such risks. Such


\textsuperscript{59} See section 1.3.3.

\textsuperscript{60} Bartholomew, G. ‘Relations Between Banker and Seller under Irreversible Letters of Credit’ (1959) 5 McGill. L.J., pp. 90-93.


\textsuperscript{63} Eggert, K. ‘Held up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instruments’ (2002) 35 Creighton L.Rev., p. 383.

\textsuperscript{64} Ibid., p. 393.
parties have superior access to information relating to the underlying transaction that gave birth to the bill or any subsequent transaction.65

These policies do not apply in the context of documentary credits. The beneficiary claiming on the instrument is principally a seller that has to perform certain documentary duties in order to claim payment. In addition, he is not alien to the underlying transaction, but rather the party responsible for its performance. Finally, the documentary credit itself does not function as a money substitute; it mainly aims to provide both the applicant and the beneficiary with the assurance that the terms of the credit will be met and that what they bargained for will be achieved.

Courts have emphasised that the system of documentary credits:

'...should be kept as free as possible from technicalities, and from unnecessary judicial dicta which may embarrass business dealings in the future.'66

Yet, drawing loose analogies between different instruments without taking into account the commercial justifications for introducing a given doctrine to a given instrument would ultimately lead to precisely the above-mentioned undesirable outcome. For this reason, this work will adopt the view that the needs of business parties and the allocation of risks between them should be given precedence over technical doctrines: this is whether such doctrines are derived from common law or from similar abstract instruments.

1.3.4 The question of consideration

Although it is generally accepted that documentary credits are enforceable once communicated to the beneficiary, there are difficulties in establishing the basis of their enforceability. The undertaking by the beneficiary to deliver the goods to the applicant is insufficient consideration for the bank’s promise because the contract of sale is made before the issuance of the credit, thus consideration in these circumstances is past. There thus seems to be no consideration moving from the promisee (the beneficiary) to the bank. Since the doctrine of consideration is very

---

rigid, and since different types of documentary credits may evolve to accommodate different commercial needs, it is widely accepted that such undertakings should not be subjected to a strict contractual analysis.\(^{67}\) This is because; if a court confines such undertakings to a rigid contractual analysis, it might hinder any new development to the instrument if such development conflicts with the original analysis.

Indeed, legal writers have analysed every possible theory from every legal angle\(^{68}\) and failed to satisfactorily reconcile the bank's undertaking with any contractual analysis. Davis,\(^{69}\) Treitel,\(^{70}\) Goode,\(^{71}\) Finkelstein\(^{72}\) and Ellinger\(^{73}\) have all accepted the view that documentary credits should be analysed outside the legal framework of contractual principles, which require the presence of consideration. Accordingly, whether the documentary credit is referred to as a promise, an undertaking, a chose in action, an engagement, or a contract, it has become accepted in English jurisprudence to treat it as contractual in nature, despite the fact that it possesses distinctive features, which make it *sui generis*.\(^{74}\)

It seems that mercantile usage\(^{75}\) is the most satisfactory theory to explain the enforceability of documentary credits. The theory has been approached from two different angles. Trimble has suggested that documentary credits are enforceable on the basis that they were established at a time when the law merchant had been in use,


\(^{68}\) The theories include: the implied promise, the assignment theory, the novation theory, the reliance theory, agency theories, estoppel and trust theories, anticipatory theory, and the guarantee theory. For extensive analysis see Finkelstein, H. *Legal Aspects of Commercial Letters of Credit*, pp. 275-295; Davis, A. 'The Relationships Between Banker and Seller under a Confirmed Credit' (1936) 52 L.Q.R., p. 225; King, R. *Gutteridge & Megrah's Law of Bankers' Commercial Credits*, p. 408; Note, 'The Rights of the Seller under a Documentary Credit' (1925) 34 Yale.L.J., p. 781.

\(^{69}\) Davis, A. 'The Relationships Between Banker and Seller under a Confirmed Credit' (1936) 52 L.Q.R., pp. 230-240.


\(^{72}\) Finkelstein, H. *Legal Aspects of Commercial Letters of Credit*, p. 289.

\(^{73}\) Ellinger, P. *Documentary Letters of Credit*, p. 122.

\(^{74}\) It is noteworthy that the defence of lack of consideration in documentary credits was raised in only one case but was abandoned. See *Dexters, Ltd v. Schenker & Co* [1923] 14 L.L. Rep. 586, at 588.

\(^{75}\) While it has been argued that the terms 'custom' and 'usage' should be distinguished, the better view is to treat the terms as interchangeable. See Chorley, R. 'The Conflict of Law and Commerce' (1932) 48 Q.L.R., p. 51. For arguments that call for distinguishing between the two terms see Clashfem, M. *Halsbury's Law of England* (London, 1987), pp. 155-160, p. 205.
and thus the old law merchant should govern them.\textsuperscript{76} Ellinger has rejected this analysis on the ground that a documentary credit is a relatively new instrument in international trade.\textsuperscript{77} Although the phases of its development started in medieval times, the legal characteristics of documentary credits have not been fully developed until the twentieth century. While Ellinger agrees that documentary credits are enforceable by virtue of mercantile usage, his emphasis is, however, on modern usage rather than the old law merchant.\textsuperscript{78} At first sight it would seem very difficult to reconcile this analysis with judicial dicta. In \textit{Crouch v. Credit Foncier} (1873)\textsuperscript{79} the court was asked to consider whether a newly developed instrument a - debenture bond - could be recognised by custom as a negotiable instrument. Blackburn J. suggested that the law merchant had for a long time been incorporated in the common law and thus new custom cannot be added to it.\textsuperscript{80} Cockburn C.J. rejected this proposition in \textit{Goodwin v. Robarts} (1875).\textsuperscript{81} He concluded that the judgment in the \textit{Credit Foncier} case:

\begin{quote}
"is founded on the view that the law merchant thus referred to is fixed and stereotyped, and incapable of being expanded and enlarged so as to meet the wants and requirements of trade in the varying circumstances of commerce."\textsuperscript{82}
\end{quote}

This general proposition, it should be noted, was confined to a very strict requirement. Cockburn C.J. emphasised that:

\begin{quote}
"We must by no means be understood as saying that mercantile usage, however extensive, should be allowed to prevail if contrary to positive law."\textsuperscript{83}
\end{quote}

Indeed, it is well accepted law today that for a usage to be recognised by courts it should be certain, notorious, and reasonable.\textsuperscript{84} A reasonable usage in this regard is

\begin{quotation}
\footnotesize
\begin{enumerate}
\item Trimble, R. 'The Law Merchants and the Letter of Credit' (1948) 61 \textit{H.L.R.}, pp. 1002-1003. Support for this argument can be found in \textit{Trendtex Trading Corporation v. Central Bank of Nigeria} [1977] 1 Lloyd's Rep. 581. In this case Lord Stephenson expressed the view that it is the 'law merchant which requires that payments on letters of credit should be honoured'. At 601.
\item Ellinger, P. \textit{Documentary Letters of Credit}, p. 106.
\item \textit{Ibid.}, pp. 108-112.
\item (1873) L.R. 8 Q.B. 374.
\item At 386.
\item (1875) L.R. 10 Ex. 337.
\item At 346.
\item At 357.
\item See, e.g., \textit{Bank of India v. Trans Continental Commodity Merchants Ltd. and Jashbai Nagibhai}
\end{enumerate}
\end{quotation}
one that does not conflict with the principles of common law. Ellinger evades this difficulty by arguing that in order for a usage to involve this sort of conflict it should “contradic[t] a decision on a specific point, or a specific application of a common law principle.” Thus, documentary credits would be enforceable in this analysis, simply because they do not overrule any previous decision on the point of their enforceability. In addition, their enforceability would not suggest that the doctrine of consideration should be overruled. Rather, the enforceability of documentary credits constitutes a mere exception to the doctrine. This approach has been accepted in cases concerning the recognition of new types of negotiable instrument.

In Banco Santander SA v. Bayfern Ltd. (2000) Waller L.J. seems to have clearly endorsed Ellinger’s arguments. The case concerned the liability of a confirming bank under a deferred documentary credit. The confirming bank argued that although no draft is involved in this type of credit, the deferred documentary credit is like a negotiable instrument. Hence, if the confirming bank pays the beneficiary prior to maturity of the credit, it can claim reimbursement from the issuing bank on the basis that it is a holder in due course of a negotiable instrument that is immune from any defence the issuer has against the beneficiary of the credit. Waller L.J. rejected this argument on the ground:

‘that [the confirming bank] tried to establish a market custom to the effect that this was how such promises were treated in the market, but failed.’

The deferred credit was described as a “new type of instrument”, no prior judgment was given to the effect of promises embodied in such instruments. Waller L.J. thought that this new instrument or promise should be construed by reference to the way in

---

90 This case is dealt with in Chapter 5, section 5.2.2.
92 At 160-170.
which it is “treated in the market”.\textsuperscript{93} Had the confirming bank been able to prove a commercial usage that treats a promise to pay a sum of money, although no draft is involved and no consideration is present, as negotiable, Waller L.J. was prepared to enforce such a usage without considering the legal difficulties surrounding this conclusion.

Although some commentators are adamant in seeking a contractual analysis to justify the enforceability of documentary credits,\textsuperscript{94} in the present author’s view, the approach of upholding commercial usage as the basis of their enforceability is preferable. On the first hand usages “might alter several times with developing methods of business”.\textsuperscript{95} Hence, if a court confines an instrument to a rigid contractual analysis it would certainly hinder any new development to the instrument if such development conflicts with the original analysis. The better view is that courts should leave mercantile instruments free from doctrinal complexities. On the other hand, as Sarna argues the mercantile analysis is one that is established on “realism”.\textsuperscript{96} It is quite clear that commercial practice is the driving force behind enforcing documentary credits. Perhaps it is time that the common law acknowledges that commercial practice is a source of law that can introduce new instruments that are not strictly in accordance with its principles. In addition, insisting on a strict contractual analysis to enforce documentary credits would lead to adopting an artificial analysis of current legal principles. This artificial analysis might extend to other areas of law resulting in difficulties. The mercantile theory, on the other hand, can be applied with consistency and can be limited to recognising new instruments commercially used and much needed by traders. Furthermore, the mercantile analysis would put documentary credits “in their own realm”.\textsuperscript{97} This would allow courts to recognise new legal principles that serve the needs of documentary credits without the necessity to borrow principles from other areas of law when disputes arise under the instrument. Finally, such theory would allow all parties involved to use the instrument without the fear that a certain court would not enforce the credit due to an unexpected event, or because a novel point of law has occurred in a certain transaction. As the instrument is

\textsuperscript{93} At 160-170.
\textsuperscript{94} Todd, P. ‘Sellers and Documentary Credits’ [1983] J.B.L., p. 474.
\textsuperscript{95} Chorley, R. ‘The Conflict of Law and Commerce’ (1932) 48 Q.L.R., p. 63.
\textsuperscript{96} Sarna, L. \textit{Letters of Credit} (Toronto, 1986), p. 31.
in constant use and involves huge sums of money, certainty in this area of law is a matter of grave importance.

1.4 Concluding remarks

The documentary credit – as any abstract payment undertaking – developed largely through custom. Its early development was influenced by the law relating to negotiable instruments. However, the documentary credit in its modern form developed only after documentary sales were introduced. This suggests that the instrument lies “between two bodies of...legal doctrine[s]”\textsuperscript{98}: the law of negotiable instruments and the law governing documentary sales. This also gives it distinctiveness and a unique character. However, this creates difficulties too, especially in determining which doctrine should govern particular aspects of the instrument. On the one hand, symmetry with the law of negotiable instruments would result in the instrument achieving most of its security function: that is to assure beneficiaries that payment will be made as long as they strictly comply with the terms of the credits and that any dispute arising from the underlying sale contract will not affect this security. On the other hand, the underlying sale contract, however detached from the credit contract, is nevertheless the basis of the entire subsequent operation. It is the underlying sale contract that leads to the issuance of the documentary credit and without it there would be no documentary credit transaction.

Thayer suggests that in documentary credits:

‘An accurate statement of the situation thus is that the bank, like the c.i.f. buyer, is under an obligation to pay on the tender of documents in which it is interested because they represent certain merchandise.’\textsuperscript{99}

This shows the difficulty which a court may face when determining the level of the abstraction in the instrument. While it is accepted that the abstraction principle exempts banks from looking behind the documents, when a documentary credit is


\textsuperscript{99} Thayer, P. ‘Irrevocable Credits in International Commerce: their Legal Effects’ (1937) 37 Col. L.R., p. 1334.
used as an instrument to finance a sale transaction, banks may nonetheless be interested in the exact nature and condition of the merchandise represented by the documents. In fact, it is a logical inference from the functions of documentary credits that banks and beneficiaries deal with documents because of what they represent and not for what they are.

Accordingly, the abstraction principle should not be emphasised blindly. Loose analogy between the law of documentary credits and the law of negotiable instruments should be avoided. The beneficiary under the documentary credit, unlike the holder of a negotiable instrument, is primarily a seller who undertakes to fulfil certain duties. In fact, the promise of payment contained in the documentary credit requires fulfilling such duties, whereas the promise of payment in negotiable instruments is unconditional. Thus, while both instruments can be said to be abstract, the meaning of abstraction should differ depending on the exact nature of each instrument, and the expectations of the parties using it. In determining the level of abstraction in documentary credits and the defences that could undermine the payment undertaking, such expectations should be taken into consideration. After all, it is these expectations that forced courts to recognise the enforceability of the instrument notwithstanding the fact that it evades strict contractual analysis. Bearing these conclusions in mind, one can proceed in examining to what extent documentary credit are – or should be – abstract.
Chapter 2: Demand guarantees as abstract payment undertakings

2.1 Introduction

Demand guarantees, although not used as frequently as documentary credits, play a vital role in international commerce. Like documentary credits they are abstract payment undertakings. As in the context of documentary credits, courts have tended to draw an analogy between demand guarantees and other abstract instruments. Hence, it has been suggested that demand guarantees “are virtually promissory notes payable on demand”.¹ It has also been suggested that demand guarantees are equivalent to documentary credits and as such should be governed by the same legal principles.²

This chapter seeks to distinguish between demand guarantees and other abstract instruments, for each performs specialised functions in international trade. As such this chapter will demonstrate that the symmetry between demand guarantees and other abstract instruments is flawed: particular rules should govern the instrument to reflect the commercial needs of the parties that developed it. Otherwise the instrument will be less attractive to merchants and its usage will decrease. In fact, the tendency to draw an analogy between demand guarantees and documentary credits has led the former instrument to be increasingly abused. As will be examined, it has resulted in traders questioning the reliability of the instrument as it might expose them to serious losses.

Different international initiatives have realised the scale of the problem and its effects on the traders. Whether such initiatives play an effective role in tackling the problem will be analysed. The final part of this chapter will explore the extent of the problem, and consider what might be the best and most realistic approach to deal with it.

2.2 Basic principles/rules of demand guarantees

2.2.1 Terminology

In English legal literature, traditionally the term “guarantee” denotes an accessory (secondary) or “conditional” type of obligation. The essence of the instrument is the promise to answer for the duty of another should the other default or not be able to perform his duty. The beneficiary of such a promise will not be entitled to payment unless it can adduce proof of the occurrence of the event, which the guarantee secures. Thus, the issuer’s liability to pay arises only in cases of actual default of the principal and not by a mere demand. In addition, the issuer in cases of litigation can raise any defences available to the principal.³

Major differences distinguish this instrument from “demand guarantees”: in the latter instrument the obligation to pay is conditioned merely within the terms of the bank’s promise. Thus, if the demand guarantee is payable upon the beneficiary’s written first demand, he is assured payment notwithstanding any defence raised by the account party in relation to the underlying transactions. Proof of default is not needed and issuers are not concerned with the underlying contract, nor can they raise any defence available to the underlying contractual party.⁴

This type of guarantee is usually used in a wide range of different and often complex transactions. These transactions include: payment upon the seller’s default in a sale of goods transaction;⁵ security for service contracts or construction contracts;⁶ and they have even been used to secure the payment of a ransom.⁷ Each type of transaction may require the issuance of a certain type of guarantee for different stages of the transaction.⁸ The typical demand guarantee is simply used “to provide financial

---

security against default in performance of a non-money obligation", 9 in which case the guarantee is usually given by the seller/contractor (the account party) to the buyer/employer (the beneficiary).

There is much terminological confusion when distinguishing between demand guarantees and accessory guarantees. Indeed, the issue has been disputed in some recent cases. 10 No precise term has yet been adopted to distinguish between the two types of instruments. English courts, however, have agreed that the decisive factor in determining the type of the guarantee is to be found in the terms of the guarantee itself and not in how the guarantee is referred to in a particular transaction. 11

In the United States, demand guarantees are referred to as standby letters of credit and English courts give standby credits the same legal status that is given to demand guarantees. 12 Indeed, a demand guarantee fulfils precisely the same function as a standby credit. 13 Although the general view has been that the distinction between demand guarantees and standby credits is "illusory or, perhaps, of a semantic nature" 14, a few differences do exist. First, the standby credit is usually equated with the documentary credit (especially in American literature) 15 and the potential for applying doctrines derived from the latter instrument to the former is greater in such instruments than in demand guarantee transactions. 16 The principle of strict compliance, for example, is said to apply in standby credits; 17 in demand guarantees, on the other hand, it is widely accepted that this principle should not be applied to the instrument. 18 Secondly, where a beneficiary is located in a foreign jurisdiction and asks for a primary guarantee to be issued in his favour by a bank located at his place of business, the terminology in describing the parties involved in this transaction...
differs depending on whether the primary undertaking is a standby credit or a demand guarantee. In the case of a standby credit, the account party approaches its bank (the issuing bank) to issue the standby credit and this bank will request a bank in the beneficiary’s country (the confirming bank) to confirm the standby credit. In a demand guarantee transaction, however, the account party requests its bank (the instructing bank) to instruct a correspondent bank in the beneficiary’s country to issue the guarantee (the issuing bank). The issuing bank in demand guarantee transactions will only issue a guarantee provided that the instructing bank issue a counter-guarantee in its favour: the counter-guarantee is also upon first demand.

Finally, as in documentary credits if the beneficiary receives a confirmed standby credit he can claim against the issuing bank if the confirming bank cannot fulfil payment (i.e. due to the bank’s insolvency). In demand guarantees, however, as this instrument is rarely confirmed, the beneficiary relies only on the promise of the bank that issued the guarantee. Hence, if he requests the guarantee to be issued by a bank located in his country (the issuing bank), he can claim payment only from that bank. The instructing bank does not promise the beneficiary to effect payment. It only promises the issuing bank that it would reimburse it if it complies with the terms of the counter-guarantee. Accordingly, if the issuing bank fails to meet its undertaking, the beneficiary’s remedies will lie only against that bank.

To rule out any confusion which could ensue from any of the above different terminologies used to describe primary abstract guarantees, the present writer will adopt the term “demand guarantees” when referring to the instrument. The demand guarantee in this regard is triggered by a simple demand for payment made by the beneficiary and used to secure non-monetary obligations.

---


20 For further analysis on counter-guarantees, see Chapter 5, section 5.2.4.

21 As far as this writer is aware, in only one case has a demand guarantee been confirmed in English reports: Esal Commodities Ltd v. Oriental Credit Ltd [1985] 2 Lloyd’s Rep. 546.
2.2.2 Role of demand guarantees in international trade

Demand guarantees developed to replace money deposits, which sellers had to provide to buyers in order to secure the latter against the former's default under the contract.\(^\text{22}\) The substitution of money deposits by demand guarantees helped account parties to maintain their liquidity: they were no longer forced to tie up their money for a considerable period of time pending completion of the underlying contracts,\(^\text{23}\) and where the account party had insufficient money to pay the deposit, it was relieved from the expense of borrowing cash from a bank and paying interest on the loan.\(^\text{24}\) In addition, the account party might not trust the beneficiary enough to agree to provide him with a cash deposit; similarly the beneficiary might doubt the account party's solvency and therefore his ability to fulfil the underlying contract or his ability to rectify defaults in performance. The demand guarantee is used to overcome this difficulty. When the bank issues the demand guarantee, the beneficiary deals with a party whose financial strength he can trust, and a party which would pay upon first demand regardless of an existing dispute between the parties on the performance of the underlying contract. More importantly, however, the demand guarantee is also used to reallocate the risks between the parties.\(^\text{25}\) The premise in such transactions is that by agreeing to provide a demand guarantee both the account party and the beneficiary agree that the latter should not be deprived of his money (money due under the guarantee) by litigation against him at the suit of the account party.\(^\text{26}\) Thus, by utilising a demand guarantee the account party avoids being exposed to judgment, execution, and jurisdictional risks. Such risks might include the difficulty involved in taking the dispute to a foreign court, losing on a procedural issue,\(^\text{27}\) evidentiary problems, political risks that could prevent an action being brought against a party, and the risk that a plaintiff could not execute a judgment against the defendant. In short, where the beneficiary is issued a demand guarantee by a bank in his own


\(^{23}\) Bertrams, R. Bank Guarantees in International Trade, p. 43.


locality, the guarantee aims "to shifting of risks and the cost of bearing them from [the beneficiary to the account party]". 28

2.2.3 Legal principles governing demand guarantees

2.2.3.1 The abstraction principle: comparison with documentary credits

The abstraction principle, long established in documentary credit law, has been applied to demand guarantees in an analogous manner. In Edward Owen Engineering Ltd. v. Barclays Bank International (1978), 29 for example, the issue under question was the level of abstraction in demand guarantees and the instances in which payment under the instruments could be defeated. Lord Denning reached the conclusion that "performance guarantees stand on a similar footing to a letter of credit". 30 Accordingly, it was ruled that the same level of abstraction should be applied to both instruments. Similarly, in Bhoja Trade (1981), 31 Donaldson L.J. was of the view that demand guarantees are analogous to documentary credits: both are regarded as "the life-blood of commerce" 32 and unless there is a strict application of the abstraction principle "thrombosis" 33 in international trade will occur.

It is true that both demand guarantees and documentary credits are abstract payment undertakings. Thus, both instruments are binding upon communication to the beneficiary notwithstanding the fact that there is no consideration moving from the beneficiary to the issuing bank. 34 It is also true that in both instruments the issuing bank undertakes to pay the beneficiary irrespective of any dispute between the parties regarding the performance of the underlying contract. 35 Yet, such similarities cannot lead to the conclusion that demand guarantees and documentary credits are analogous in every respect. Both instruments were developed by different groups of merchants to satisfy different commercial functions and needs. Thus, in determining the level of

---

28 Dolan, J. 'Standby Letters of Credit and Fraud (Is the Standby only another Invention of the Goldsmiths in Lombard Street?)' (1985) 7 Cardozo L.R., p. 5.
30 At 171.
32 At 257.
33 At 257.
34 See section 2.3.1.
abstraction of each instrument, special consideration should be given to its characteristics and functions.

As in documentary credits, fraud has been the main defence that may potentially defeat payment under a demand guarantee.\(^{36}\) Unfortunately, the view that demand guarantees and documentary credits are equivalent has led courts to apply the fraud defence in a similar manner to both instruments without any regard to their functions or to the parties’ expectations under the instruments.\(^{37}\) This approach is questionable as there are many differences between the instruments. First, the documentary credit is a payment method, therefore the issuing bank will always receive a demand for payment, and this is exactly what the parties expect. On the other hand, the demand guarantee is a security device that is given to secure against certain events or risks relating to the underlying transaction. The expectation of the account party is that no demand will be made, unless the grounds for which the guarantee has been given occur.\(^{38}\) Thus, unlike documentary credits the demand guarantee is primary in function but secondary in intent.\(^{39}\) Accordingly, it is suggested that the emphasis should not be on applying a strict abstraction principle, but rather the emphasis should be on “effectively protecting the intent of the parties”.\(^{40}\)

Secondly, and allied to the first difference, is that the purpose of a documentary credit is to dilute the transaction to a purely paper transaction, in which the performance of the seller’s physical duties becomes of no interest to banks paying under the credit.\(^{41}\) On the other hand, the demand guarantee usually aims to put pressure on the account party to ensure that he properly performs his physical duties under the underlying contract. Thus, the guarantee is closely related to the underlying contract and more

---

\(^{36}\) For further analysis on the fraud exception, see Chapter 4.


scrutiny should be undertaken of the underlying contract when a demand is made.\footnote{Ibid., p. 303.} Thirdly, because parties always expect payment under documentary credits, any delay in payment would be of catastrophic consequences to the parties involved, especially in a chain of buyers and sellers situation. This cannot be the case in demand guarantee transactions, where the court’s interference by imposing an injunction against payment would not affect the beneficiary’s rights under the guarantee; it only postpones payment. It is not as if the foreign beneficiary has lost his security. He has merely lost the immediate right to turn it into cash.\footnote{Prakash, J. 'Restraining Payment under a Performance Bond: the Developing Singapore Law' (1999) (November) I.T.L.Q., p. 199.} Fourthly, the so-called “fraud exception” developed in the context of documentary credits. It refers mainly to “fraud in the documents”. Because no commercial documents are usually required in demand guarantee transactions, the fraud exception can only be connected to the conduct of the beneficiary in relation to the underlying contract. Therefore, unless, an examination is made of the disputes and facts relating to the underlying contract, the fraud exception would have no meaning in the demand guarantee context.\footnote{Wu, T. & Loh, Q. 'Injunctions Restraining Calls on Performance Bonds - is Fraud the only Ground in Singapore?' [2000] L.M.C.L.Q., pp. 352-353; Debattista, C. 'Performance Bonds and Letters of credit: a Cracked Mirror Image' [1997] J.B.L., p. 304.} If courts are not prepared to investigate the underlying contract when there is strong evidence of beneficiaries abusing demand guarantees, the account party will in many instances have little chance of recovering losses sustained under the instruments.\footnote{For further analysis on fraud in the demand guarantee context, see Chapter 4.} Fifthly, in documentary credit transactions the beneficiary is usually required to tender a whole range of commercial documents which are issued by third parties. In demand guarantees, however, the only document involved is usually created by the beneficiary. This makes the demand guarantee far easier to abuse.\footnote{Note, ‘The Role of Standby Letters of Credit in International Commerce: Reflections after Iran’ (1980) 20 Va. J. Int’l L., p. 470.}

The above differences must be kept in mind. As suggested earlier, any abstract payment undertaking is given force by the commercial needs it satisfies.\footnote{See Chapter 1, section 1.3.4.} Such needs should determine to what extent the instrument is abstract. Accordingly, rather than drawing a loose analogy between demand guarantees and documentary credits, courts should always take into consideration the expectations of all parties involved under each instrument. Adopting a contrary approach would inevitably result in
"'conceptual pollution' of one body of law by the other".48

2.2.3.2 The principle of strict compliance: comparison with documentary credits

Some of the uniform rules which may govern demand guarantees provide that the principle of strict compliance should apply to the instrument.49 However, as in most instances demand guarantees are issued without being subject to any set of uniform rules, it is questionable whether the principle of strict compliance should apply in these circumstances. In *IE Contractors v. Lloyds and Rafidain Bank* (1990),50 the issuing bank's demand guarantee provided:

'We undertake to pay you, unconditionally, the said amount on demand, being your claim for damages brought about by the [account party].'51

When the beneficiary claimed on the guarantee he stated that the account party had breached the underlying contract without referring to the word "damages". The court had to consider whether such a demand complied with the terms of the guarantee. At first instance Leggatt J. cited Lord Justice Roskill in *Howe Richardson Scale Co. Ltd. v. Poli- Mex-Cekop* (1978)52 where he stated that:

'The demand must conform strictly to the terms of the bond in the same way that documents tendered under a letter of credit must conform strictly to the terms of the credit.'53

Mr. Justice Leggatt concluded that as the beneficiary made no reference to the term "damages" the demand did not comply with the guarantee. Staughton L.J., on appeal, rejected this strict approach. He observed that there is less need for applying the doctrine of strict compliance in the case of performance bonds, since they are used less frequently than documentary credits. His Lordship concluded that the demand made did say in "substance",54 although not in express terms, that the beneficiary was claiming due to damages endured. Some commentators have questioned this approach: they argue that the similarities between documentary credits and demand

---

49 A demand guarantee may be issued subject to the UCP. In such a case the principle will apply.
50 [1990] 2 Lloyd's Rep. 496.
51 At 496.
guarantees require the application of the principle.\footnote{Goode, R. \textit{Commercial law}, p. 1026; Jack, R. \textit{Documentary Credits} (London, 2001), pp. 366-367.} This view, however, overlooks the fact that the rationale behind adhering to strict compliance in documentary credit transactions does not extend to demand guarantees. As mentioned earlier, part of the reason for applying the principle in the former transactions is to protect banks.\footnote{See section 1.2.2.} In addition, the applicant requires documents which comply to the letter of credit because he might be a seller in a chain of buyers and sellers and unless the documents do strictly comply, he might not be able to enforce his sale agreement against his buyer. Furthermore, an applicant might not be able to clear some goods inside a given jurisdiction unless the documents strictly comply with governmental requirements. Finally, the principle assures the applicant that he is getting what he bargained for, goods that are represented by complying documents. In contrast, in demand guarantees the document to be tendered is usually a demand for payment, which neither has any commercial value, nor is passed to any third party.\footnote{See Hirst J.'s observations in \textit{Siporex Trade SA. v. Banque Indosuez} [1986] 2 Lloyd's Rep. 147, at 159.} In addition, banks would not have to make difficult judgments when deciding whether a certain demand substantially complies with the terms of the guarantee. They are simply required to examine whether the substance of the call reflects the reasons behind providing the guarantee. As Goode puts it: "[t]he standard must be applied with a measure of common sense".\footnote{Goode, R. \textit{Abstract Payment Undertakings and the Rules of the International Chamber of Commerce} (1995) 39 \textit{Saint Louis U.L.J.}, p. 740.} Finally, it would, indeed, severely undermine the beneficiary’s expectations if payment were rejected on the basis of a principle derived from a different instrument and which serves no commercial purpose as far as demand guarantees are concerned. Any suggestions to the contrary "would only elevate form over substance".\footnote{American Bell International \textit{v. Islamic Republic of Iran} 474 F. Supp. 420 (1979), at 424.}

This approach, however, is subject to two qualifications. First, there should be no risk of the bank being misled or confused.\footnote{\textit{Siporex Trade SA. V. Banque Indosuez} [1986] 2 Lloyd's Rep. 147, at 159.} Thus, Staughton L.J.’s approach applies as long as a bank could easily conclude that a given demand complies substantially with the guarantee’s terms and reflects the reason behind its issuance. Secondly, if the guarantee provides that a demand for payment should strictly comply with the terms of the guarantee, the issuing bank should make sure that this

\footnotesize{\begin{itemize}
\item \footnote{Goode, R. \textit{Commercial law}, p. 1026; Jack, R. \textit{Documentary Credits} (London, 2001), pp. 366-367.}
\item \footnote{See section 1.2.2.}
\item \footnote{See Hirst J.'s observations in \textit{Siporex Trade SA. v. Banque Indosuez} [1986] 2 Lloyd's Rep. 147, at 159.}
\item \footnote{American Bell International \textit{v. Islamic Republic of Iran} 474 F. Supp. 420 (1979), at 424.}
\item \footnote{\textit{Siporex Trade SA. V. Banque Indosuez} [1986] 2 Lloyd's Rep. 147, at 159.}
\end{itemize}}
requirement has been satisfied; otherwise it will not be able to claim reimbursement from the account party. Courts should always seek to uphold the intentions of the parties utilising such an instrument.61

2.3 Issues regarding enforceability and commercial use of demand guarantees

2.3.1 The question of consideration

Although analogy is usually drawn between abstraction in documentary credits and demand guarantees, the origins of the abstraction doctrine in the instruments differs: where abstraction in documentary credits finds its roots in the medieval law of merchants and primarily in the bill of exchange instrument, the doctrine of abstraction in demand guarantees supposedly originated in Germany, where a legal distinction had developed between “ancillary” guarantees and “abstract” guarantees. Stamler is considered the founder of this doctrine.62 Although the instrument is accepted to be enforceable upon communication to the beneficiary, no consideration moves from the beneficiary towards the issuing bank. As in documentary credits, the lack of consideration in demand guarantees has led to fierce theoretical debate. It has been suggested that the roots of enforceability of demand guarantees can be traced back to the freedom of contract theory.63 However, there seems to be insufficient evidence to support this view. Perhaps the better view is that, as in documentary credits, the instrument is accepted as a mercantile development, which satisfies decisive commercial needs and therefore cannot be denied enforceability. It is enforceable by virtue of the mercantile theory and the commercial advantages of the instrument override the need to fit it into the traditional doctrines that govern the formation of contracts.64 Demand guarantees have been described as “commitments,65 a type of a

---

61 Staughton, L.J. in IE Contractors was mainly concerned with ‘common intentions of [the] parties’. Accordingly, had he inferred an intention requiring strict compliance, he would have applied the principle. IE Contractors v. Lloyds and Rafidain Bank [1990] 2 Lloyd’s Rep. 496, at 502.


sui generis contract and engagements. Whatever the exact nature of the instrument, it is accepted both in legal and commercial forums as a promise of payment, which is considered binding upon communication to the beneficiary and the doctrine of consideration should not affect its enforceability. Simply, it is an abstract payment undertaking which is detached and abstract from the underlying contract.

The point, which remains unsettled, is to what extent is it acceptable to uphold the abstraction principle? Carrying it too far to separate the underlying contract and the performance entirely is questionable because this would open the instrument to abuse.

### 2.3.2 The problem of abusive calling

The flawed analogy between documentary credits and demand guarantees, adhered to by English courts, has resulted in the application of a very strict abstraction principle. Courts have adopted the view that it is only in “exceptional cases” that they would interfere with the machinery of demand guarantees. This has led the instruments to be open to abuse by dishonest beneficiaries. Such abuse usually results in serious inequities. Particularly if the account party is a relatively small economic enterprise, an abusive call can result in its insolvency. Even the largest of enterprises would be affected by an abusive call especially if it had paid substantial amounts of money in the performance of the underlying contract. Moreover, if a number of such calls are made on a particular bank, the bank’s solvency may be affected. The long-term effect of abusive calling is that demand guarantees will become less popular and cease to be utilised by account parties. While it is not questionable that the problem of abusive calling “remains very real”, the question is whether this problem should be addressed and if so, the ways in which it can be tackled. Several commentators reject any call to examine the problem: they argue that demand guarantees are a “function of the bargain” made between the parties. Accordingly, by agreeing to provide a

---

66 See Bertrams, R. Bank Guarantees in International Trade, p. 56.
70 For further analysis on this point, see Chapter 4, section 4.3.1.
demand guarantee the account party should bear the risks associated with it. Furthermore, allowing account parties to restrain payment (by seeking an injunction),\textsuperscript{73} would shift judgment risks, execution risks and jurisdictional risks. It is thus suggested that it is an implicit term in the guarantee that the account party’s remedies will lie in a separate action based on the underlying contract.\textsuperscript{74}

This view, however, is based on a fallacious premise. While an account party agrees to bear the above risks in the event of actual default in the underlying contract, he cannot be said to have undertaken the risk that a guarantee would be called upon even if he performed the underlying contract. The guarantee is intended to make compensation for the beneficiary easier when the account party has defaulted, and not to give an absolute right of payment regardless of default. As for the argument that suggests that the account party’s remedies lie in a separate action on the underlying contract, such an action might not be always available i.e. due to the beneficiary’s insolvency.

These arguments have found support among judges and commentators and, as a consequence, three different approaches have been suggested to tackle the problem. First, it has been argued that extending the application of the strict compliance principle to demand guarantee transactions would mitigate abuse.\textsuperscript{75} Secondly, there is a view that calls for a wider application of the fraud exception in demand guarantee transactions.\textsuperscript{76} Finally, there is a school of thought which calls for recognising defences other than fraud in demand guarantee transactions.\textsuperscript{77} As examined earlier, courts have, justly, rejected the first approach.\textsuperscript{78} In fact, even if courts have submitted to the first approach it would provide limited protection against abusive calling since all a dishonest beneficiary has to do in order to secure payment would be to make sure that the call on the guarantee complies strictly with the terms of the guarantee. The second and third approaches are thus more realistic. These approaches will be

\textsuperscript{73} For further analysis on this point, see Chapter 4.


\textsuperscript{78} Section 2.2.3.2.
examined thoroughly in the forthcoming chapters. At this stage, however, it is necessary to examine the role of the different uniform rules that could govern demand guarantees in tackling abusive calling.

2.3.3 Dealing with abusive calling: the international initiatives

The different sets of uniform rules that govern demand guarantees adopt different attitudes towards the problem of abusive calling. The first set of rules to be developed was the Uniform Rules for Contract Guarantees 1978 (URCG). It focused on tackling the problem of abusive calling to the extent that it overlooked the commercial purposes for providing demand guarantees. Article 9 of the URCG requires the beneficiary to produce a court decision or an arbitral award or a written confirmation from the account party that payment is due, in order to claim payment. These requirements render demand guarantees conditional. Faced with such limitations on the right to collect payment, beneficiaries tend to reject any demand guarantee issued subject to the rules. They are simply viewed as “attempts to force into the market concepts that are alien to its expectations and established usage”.

The Uniform Rules on Demand Guarantees 1992 (URDG) on the other hand is said to “provide a fair balance of competing interests”. Two articles were adopted to mitigate abusive calling without jeopardising the beneficiary’s right to receive payment upon a simple demand. Article 17 obliges banks to inform the account party that a demand for payment has been made, giving the latter the chance to challenge any abusive call by seeking relief from the courts. It should be noted, however, that the decision to make payment immediately after the account party has been informed remains in the hands of banks. There is nothing in the URDG that requires the bank to withhold payment; banks are given the right to pay immediately in these circumstances. Therefore the aim of Article 17 is without much force if a bank decides to pay before the account party has been able to obtain interim relief. Article 20 provides even greater protection: it requires the beneficiary to state in writing both that there is a breach of the underlying transaction and the type of breach which is

---

79 Article 9 URCG 1978.
involved. This is even if the terms of a certain demand guarantee do not call for such statements. Three advantages ensue from this Article: first, the psychological impact of the requirement could affect the beneficiary's decision on whether to make an abusive call or not. A beneficiary might be more hesitant in demanding payment in cases where there has been no breach. Secondly, judges can be expected to be more in favour of the principal's plea for an injunction where he acquires documents that contradict the statement of the beneficiary. Indeed, proving that the beneficiary has acted unfairly (or fraudulently) would be easier in situations where a false written statement is made; rather than in situations where a simple demand for payment has been made. Finally, even if the account party does not succeed in obtaining an injunction, the beneficiary's false statement would make it much easier for the account party to regain the amount paid in a post-payment recovery claim.

The UCP states that it can equally apply to standby credits, and thus may be applied to demand guarantees. As examined elsewhere, the UCP provisions place emphasis on the principle of abstraction. This is simply because they have been tailored to deal with documentary credit transactions, hence no consideration has been given to abusive calling and no article has dealt with the problem. The International Standby Practice 1998 (ISP98) adopts a similar approach. Despite the fact that these rules were drafted to apply to standby credits and demand guarantees, they ignored the problem of abusive calling. Reviewing the rules clearly indicates that they are much less balanced than the URDG. No requirement similar to Article 20 of the URDG is to be found; further banks are not required to notify the account party that a demand for payment has been made. In short, from the account party's point of view, the rules have been said to be "ill advised and unfair".

The 1995 the UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit came into force on 1 January 2000. The Convention has

---

82 Ibid., p. 203.
84 Riddall, W. & Affaki, G. 'Two Experts Debate why the Uniform Rules for Demand Guarantees are not Widely Used and Propose Solutions' (2001) 7 D.C.I., p. 15.
85 Article 1 UCP.
86 See Chapter 1, section 1.2.2.
87 Article 3.10 of the ISP98.
been ratified by five countries only, so is of limited significance at the moment. It applies to demand guarantees if the place of business of the issuer is in a country that has adopted the Convention or if the rules of private international law lead to the application of the law of such a country. However, parties to the demand guarantee can exclude the application of the Convention. The Convention dealt with the problem of abusive calling in great detail. It provides that an issuer acting in good faith has a right to reject payment if the beneficiary’s call on the demand guarantee has “no conceivable basis”. Article 19 (2) goes on to spell out a set of situations where this is the case. This Article has been criticised as it introduces new difficulties for a bank in determining whether it should pay the beneficiary in certain cases: banks might be embroiled in assessing an account party’s allegation of abuse by the beneficiary. Goode has expressed his concerns with the Convention’s reference to the principle of “good faith” as this might create uncertainty in jurisdiction where the principle is not well developed. Debattista concludes that the Convention represents “a step back from the [URDG] and towards the [URCG]”.

It could be said that the different regimes adopt two extreme ends of the abstraction principle. At the one end of the spectrum the UCP and ISP98 uphold the abstraction principle to an extent that unfair callings are able to flourish. At the other end of the spectrum the URCG and the UNCITRAL Convention diminish the abstraction principle to such an extent that demand guarantees lose their commercial purpose. The URDG seeks to achieve a balanced approach by introducing Articles 17 and 20, which to some extent seek to mitigate the problem of abusive calling and

---

90 Article 1 (1)(a).
91 Article 1 (1)(b).
92 Article 1 (1).
93 For example, paragraph c to Article 19 (2) states that where the underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary, then the demand must be said to lack a ‘conceivable basis’. What is problematic here is that the scale of proof has not been clearly established in the convention. The reference to ‘undoubtedly’ is unclear, what is the standard of care anticipated by banks?
ultimately result in demand guarantees being less abstract. Yet, a more accurate account of the above analysis is that the true remedy against abusive calling lies in the hands of courts. Even if the guarantee is governed by the UCP or ISP98, where the problem of abusive calling is not addressed, the account party might have a chance of protection against an abusive call if a certain court in a certain jurisdiction develops exceptions against payment which include unfair or abusive acts by the beneficiary. Similarly, even if the guarantee is governed by the URDG, in which case the bank notifies the account party that a beneficiary has called on the guarantee and under which an account party can in appropriate circumstances challenge an abusive statement made by the beneficiary, unless courts are willing to intervene, the rules offer little comfort to account parties facing a dishonest call by beneficiaries.

The above conclusion is also supported by commercial practice. Bankers, practitioners dealing with demand guarantees, and legal commentators, all seem to suggest that bankers and beneficiaries will usually resist the issuance of a demand guarantee subject to any of the above rules. SITPRO Ltd has conducted research on the use of demand guarantees in 2002 in the United Kingdom and found that the URDG was used in respect of less than 10 percent of both guarantees and counter-guarantees. Their report suggests even less frequent use of the UNCITRAL Convention. Banks have expressed the view that this is due to the fact that they would simply “see little if anything to be gained” and “potentially much to be lost” by encouraging the use of the above regimes. Legal commentators also suggest that the use of the above rules will remain limited.

It seems that bankers and beneficiaries are more comfortable in using demand guarantees subject only to their terms: in these circumstances the account party’s remedies against abusive calling will ultimately lie in the hands of courts that are

---

96 SITPRO is one of the Non-Departmental Public Bodies for which the Department of Trade and Industry has responsibility. SITPRO is dedicated to making international trade more effective and simple. It focuses on areas such as documentation associated with international trade. For further information, see www.sitpro.org.uk.


2.4 Concluding remarks

Adhering to a strict abstraction principle in demand guarantees has the benefit of increasing the beneficiary’s certainty under the instrument. Nonetheless, such an approach opens the door for the instrument to be easily abused. An account party that agrees to provide a demand guarantee expects that it can be called upon only when he actually defaults in performing the underlying contract. Unless the law protects this expectation, the instrument would cease to fulfil its commercial purpose. This would ultimately result in a decrease in the use of the instrument in international trade. For this reason various international initiatives have addressed the problem of abusive calling. The regimes adopted are inconsistent in their approaches: some have sought to tackle the problem by including certain provisions that render the demand guarantee very similar to a secondary or accessory guarantee, thus frustrating the beneficiary’s expectations; others have maintained a strict abstraction principle, thus undermining the account party’s expectations.

At any rate, the most effective remedy in practice which an account party may have against an abusive call lies in the hands of the courts. First, commercial practice suggests that bankers and traders prefer to use demand guarantees that are issued without being subject to any of the regimes. Secondly, and more importantly, even if the guarantee is issued subject to a regime that provides for measures to tackle abusive calling, unless courts are prepared to interfere in cases of clear abuse, such provisions would provide the account party with no protection whatsoever against instances of abuse.

While it is accepted that documentary credits, negotiable instruments and demand guarantees are abstract payment undertakings, each abstract instrument has been recognised by courts for the special commercial functions it fulfils. These functions should reflect what is meant by “abstract” in each instrument. In other words, the extent of the abstraction principle in each instrument should ultimately depend on its commercial functions and on the expectations of the parties utilising it.
Accordingly, the misplaced analogy between demand guarantees and documentary credits should be rejected. This analysis should be adopted by the courts when shaping the law relating to demand guarantees. If not, abusive calling will undermine the true functions of the instrument, leading to the aforementioned “thrombosis” occurring in international trade.
Chapter 3: "Documentary fraud": a defence to payment

3.1 Introduction

It has been suggested that in today's world:

‘of sophisticated printers and colour copiers, it is arguable that a fully operable letter of credit in the hands of a fraudulent seller is not dissimilar to a blank cheque.’

Indeed, by virtue of the abstraction principle, banks are required only to examine facial compliance of the documents in order to effect payment. This makes the instrument open to abuse by fraudsters. While the principle of abstraction arguably aims to relieve banks from becoming embroiled in disputes relating to the performance of the underlying contract of sale, one must not ignore the fact that in recent years fraud has been increasing rapidly in the context of documentary credits.

It constitutes a real risk for both traders and banks. It has become a challenging problem which is by no means uncommon. In *Komercni Banka, A.S v. Stone & Rolls Ltd.* (2002), for example, a bank was litigating to recover losses of approximately $100 million which it had sustained due to the beneficiary’s fraud. More seriously, the 1999 sudden collapse of Solo Industries Ltd revealed that the company was largely engaged in sham transactions which had as their purpose the defrauding of banks and financing institutions that deal with documentary credits. More than twenty banks were deceived into involving themselves in this large-scale fraud which amounted to a total loss estimated in the hundreds of millions of dollars. Citibank alone faced a loss of around $49.3 million. Such instances represent only a fraction of the extent of the problem of fraud: many frauds go unreported and without litigation as it is extremely difficult to bring a case against a fraudster in a distant jurisdiction. On most occasions the fraudster vanishes after collecting the proceeds. For this reason it is perhaps not

---

5 ‘[W]hile cases of fraud are not uncommon in practice it is rare for them to reach the courts’. Buckley, R. ‘Potential Pitfalls with Letters of Credit’ (1996) 70 *A.L.J.*, p. 225.
surprising that most jurisdictions have recognised fraud as an exception to the abstraction principle.

The aim of this chapter is to examine the “documentary fraud” defence as established in English law: the merits of the English approach and its drawbacks. Fraud in the transaction will be dealt with in the following chapter. It is true that fraud in the underlying transaction will almost certainly amount to fraud in the documents and vice-versa. However, this should not affect the apparently accepted distinction between the two types of fraud. To establish the former type it is necessary to examine performance of the underlying sale and the actual condition of the goods. This makes this type of fraud very difficult to establish, as it requires examining detailed evidence and facts. Such issues are best heard before a court at a full hearing and banks cannot and must not make decisions or look into such frauds when alleged or suspected.

Instances of documentary fraud, however, do not relate to the quality and condition of the goods, but rather to the documents themselves. This makes this type of fraud much easier to establish and may not require a full hearing to be proven. Backdated and fictitious bills of lading are perhaps the clearest examples of this type of fraud. In The American Accord, for example, it was alleged that the bill of lading was backdated; this is a case of “fraud in the documents”. Similarly, in Etablissement Esfka International Anstalt v. Central Bank of Nigeria (1979) the applicant alleged that the bill of lading was issued for a fictitious cargo since evidence produced by him proved that the ship in which the goods were supposed to have been loaded had not called at the port in question. This again is a case of “fraud in the documents”. In both cases it was not necessary to examine the condition or the quality of the goods in the underlying transaction to establish whether there was fraud in the transaction or not.

In Discount Record Ltd v. Barclays Bank Ltd. (1975), however, the applicant alleged that the beneficiary had practised fraud by shipping severely defective goods.

---

9 Discount Record Ltd v. Barclays Bank Ltd. (1975) 1 Lloyd’s Rep. 444.
This case falls into the “fraud in the transaction” category. The American case *United Bank, Ltd. v. Cambridge Sporting Goods* (1976),\(^{10}\) also falls into this category as the applicant there alleged that the beneficiary shipped old boxing gloves, instead of new ones as required under the credit. These cases raise difficulties, as courts faced with an allegation of fraud would be required to look into the underlying contract to ascertain the strength of the claim.

In addition to the above distinction between the two types of fraud, it should be said that there are instances where the documents may not be fraudulent despite the fact that fraud exists in the underlying transaction. This can arise where the applicant misrepresents a fact to the bank inducing it to issue a documentary credit,\(^{11}\) or when the beneficiary misrepresents a fact to the applicant in order to deceive him into opening a documentary credit. In these circumstances, the documents tendered under the credit could be free of fraud, but nonetheless the underlying transaction itself would be tainted with fraud. Similarly, cases involving fraudulent calls under demand guarantees should be classified as cases concerning “fraud in the transaction”: the fraud involved relates to the actual performance of the underlying transaction.

For the sake of clarity, this chapter will proceed as follows: first, documentary fraud will be examined in the documentary credits context only and not in respect of demand guarantees. The reason for this approach is that documentary fraud in relation to demand guarantees is of very limited application in practice. It occurs only when the guarantee requires the beneficiary to tender documents other than the actual demand for payment. These may include certificates indicating default issued by third parties, or an arbitration award. Only when such documents are forged can it be said that documentary fraud exits. Having said that, however, the findings of this chapter will apply to documentary fraud generally; whether it exists in relation to documentary credits or demand guarantees. Secondly, it will not be of relevance to the purposes of this chapter whether there are two banks or one; for simplicity most of the arguments in this chapter will assume that only one bank is involved: the issuing bank. The position of other banks where fraud is involved (confirming banks, negotiating banks etc.) is dealt with separately in Chapter 5. Finally, it will be

---

\(^{10}\) 392 N.Y.S.2d 265 (1976).

assumed that no interlocutory injunction is sought by the applicant to restrain payment. Injunctions are dealt with in Chapter 4.

3.2 "Documentary fraud" and the beneficiary’s intent

3.2.1 General principles regarding the fraud exception

Banks’ duties in documentary credit transactions are clear: they scrutinise the documents to ensure that they conform to what is required by the terms of the credit. If they conform, the bank pays the beneficiary and is entitled to claim reimbursement from the applicant. Even if it later appears that the documents were fraudulent the bank is still entitled to reimbursement. An allegation of fraud by the applicant does not affect these duties and “visual inspection” of the documents is sufficient to secure reimbursement. In short, if a bank “does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk.” If payment is made and it later appears that the documents were indeed fraudulent, the applicant’s remedy lies in a separate action against the beneficiary on the underlying contract of sale. Admittedly, recovery is not always available as the beneficiary might become insolvent or disappear; yet commercial policy requires that the risk of fraud must be borne by the applicant rather than the bank. First, banks undertake to act on facts: they do not act as finders of fact. Secondly, it is the applicant who chooses to deal with the beneficiary, and thus it is he who should be deemed to have assumed the risk of any fraud perpetrated by his business associate.

Where fraud is alleged or suspected there is no authority that prevents banks from refusing payment if it elects to do so. Rather, the bank has the choice of rejecting the documents at its own risk. But if it happens and a bank decides to reject the

---

15 As will be examined: ‘The common law fraud action is one of the most difficult to prove, and the issuing banks cannot be expected to evaluate the soundness of the...claim’. See Asbury Park & Ocean Grove Bank v. National City Bank 35 N.Y.S. 2d 985 (1942).
documents,\textsuperscript{18} it would be required to establish fraud at trial in order to escape liability against the beneficiary.\textsuperscript{19} In this regard it would be irrelevant if the bank obtained the evidence of fraud at the time of presentation or at a later time. As long as it can prove fraud it is protected against any claim brought by the beneficiary.\textsuperscript{20}

Finally, and most importantly, if there is evidence of established fraud and the issuing bank elects to pay the beneficiary notwithstanding this evidence, it cannot claim reimbursement from the applicant.\textsuperscript{21} Accordingly, banks should refuse payment where fraud is clearly established otherwise they will be held liable to the applicant for the amount paid.

On this basis the suggestion that banks are not concerned with fraud allegations is not totally accurate. Banks in certain circumstances may be forced to assess the strength of a particular allegation. The crucial question to be answered in this regard is: what constitutes established documentary fraud which would oblige banks to refuse payment?

\subsection*{3.2.2 The "documentary fraud" test: fraudulent intent necessary to establish fraud}

Several English courts have cited the American case \textit{Sztejn v. Henry Schroeder Banking Cop} (1941)\textsuperscript{22} with approval.\textsuperscript{23} It has even been argued that the case is "the foundation stone of English law in this area [fraud]."\textsuperscript{24} The extent of the accuracy of this statement is however questionable.\textsuperscript{25}

In the \textit{Sztejn} case, Sztejn applied for an irrevocable documentary credit to be issued by Schroder to Transea Trading, Ltd., whereby Schroder undertook to pay

\begin{itemize}
\item This may occur where the bank has interest in the performance of the underlying transaction; in other words, where the bank looks to the goods as part of its security.
\item See Rix J.'s observations in \textit{Czarnikow-Rionda v. Standard Bank} [1999] 2 Lloyd's Rep. 187, at 203. See also Chapter 4, section 4.2.3.2.
\item \textit{Sztejn v. J. Henry Schroeder Banking Corp} 177 Misc. 719, 31 N.Y.S.2d 631 (1941).
\item Fellinger, G. 'Letters of Credit: the Autonomy Principle and the Fraud Exception' (1990) 1 \textit{J. Banking & Finance L. & Practice.}, pp. 15-16.
\end{itemize}
against an invoice and bill of lading covering shipment to Sztejn of a quantity of bristles. Documents conforming to the credit requirement were presented by the Chartered Bank of India, Australia and China. Before payment, however, Sztejn applied to the New York court for an injunction restraining payment on the ground that the documents were fraudulent: the contention was that worthless material had been shipped. The allegations were that of established fraud; they were, as a procedural requirement, deemed accurate. Shientag J. gave judgment to the plaintiff. After emphasising the importance of the principle of abstraction, Shientag J. noted that the seller:

'has intentionally failed to ship any goods ordered by the buyer... the merchandise is not merely inferior in quality but consists of worthless rubbish.'

In these circumstances it was held that the fraud exception applied. However, Shientag J. also added:

'of course, the application of this doctrine [abstraction] presupposes that the documents accompanying the draft are genuine and conform in terms with the requirements of the letter of credit.'

Thus, where the documents are not genuine they should be rejected either on the ground of non-conformity with the credit terms or on the ground of fraud. The emphasis is on the genuineness of the documents: the beneficiary’s intentions are not mentioned, as they are irrelevant to this point.

In The American Accord, the English courts adopted a view contrary to the one expressed in the Sztejn case. The facts of the case are as follows. A Peruvian buyer entered into an f.o.b. sale contract with a seller located in England. The method of payment was through a documentary credit issued by Banco and confirmed through the London branch of the Royal Bank of Canada. Payment was against sight drafts

---

26 At 723.
27 At 721 (emphasis added).
28 Shientag J. referred to Old Colony Trust Co. v. Lawyers Titel and Trust Co. 297 F. 152 (1924) to reach this conclusion. In that case it was stated that: ‘obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognise such a document as complying with the terms of the credit’. At 155 (emphasis added). In fact, Shientag J. cited this statement in his judgment.
drawn on the Royal Bank of Canada and required a full set of clean, on board, ocean bills of lading. The credit was subject to the UCP. It required that shipment should be made not later than 15 December 1976. The beneficiary tendered the documents as required under the credit but the confirming bank rejected payment, alleging that shipment took place on 16 December 1976 and therefore that the bill of lading was a forgery. It soon became clear that the carrier’s agent had indeed fraudulently altered the date on the bill of lading, but the beneficiary insisted that he had no notice of the alteration, and that he had presented documents complying on their face with the terms of the credit therefore, he should be paid. The beneficiary brought an action against the bank for payment. The case was eventually heard by the House of Lords, but the judgments at first instance and the Court of Appeal are also of great interest.

At first instance, Mr Justice Mocatta concluded from the facts of the case that fraud was committed by the loading brokers who were not acting as agents of the beneficiary. Upon this finding Mocatta J. distinguished the case from the *Sztejn* case: as the latter dealt with fraud committed by the beneficiary himself and the statements as to the genuineness of the documents there should be considered as obiter. Mocatta J. also found that neither English, nor American case law provided a direct answer to the point in question. He thus ruled that for the documentary fraud exception to apply: (i) the beneficiary himself or a person for whom he is responsible should commit actual fraud; or (ii) the beneficiary should have knowledge of the existence of fraud committed by third parties. His justification for this approach was that:

‘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.’

The suggestion that the judgment relieves banks from an “onerous” duty to investigate the underlying facts is untenable. The decision whether to reject or to accept the documents would have been far easier if it had been limited to the documents only and not the beneficiary’s state of mind. In fact, *The American Accord* provided a clear example of the difficult position the bank might find itself in. Mocatta J. noted when examining the facts of the case that the bill of lading was so poorly “altered that one can discern the figure 16 below the superimposed 15”. Counsel for the bank argued that the beneficiary’s failure to verify the true date of

---

shipment can be seen as amounting to fraud. Mocatta J. in considering this argument stated somewhat surprisingly:

'It was suggested by Mr. Brodie [for the bank] that the plaintiff could readily have verified the date the containers were loaded on board by getting in touch with United Stated Lines at Felixstowe [the port of loading]. This is no doubt true but the same can be said of the defendants [the bank]...For some reason no check was made on this vital point in this direct way.'

With respect, the above statement contradicts his previous observation in which he emphasises that the banker’s duty is to deal with documents only (without having the burden of investigating the underlying facts). One must also question whether it could not be said that the beneficiary was indeed reckless in not verifying the actual date of shipment, especially where the bill of lading was so poorly altered. If so, could he be said to have practised fraud in these circumstances? The court found that the beneficiary was not fraudulent without examining what constitutes fraudulent conduct. However, the answer to this question is very vague. To constitute fraud in documentary credit transactions, common law fraud is the test to be applied. In Derry v. Peek (1889) it was held that common law fraud can be proven when a “false representation is made (i) knowingly, or (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false”.

To establish a person’s knowledge of fraud, examination of “the particular circumstances of [each] case” is necessary. In this regard, questions such as the party’s “personal attributes... his experience and intelligence, and the reason why he acted as he did”, are all relevant. To determine whether a person’s reckless conduct amounts to fraud is even more difficult to answer. In addition to the above factors, careful consideration should be given in determining whether the conduct is a genuine error, reckless but not to the degree that it constitutes fraud, or finally reckless to a degree that does constitute fraud. Some courts have adopted the view that certain reckless conduct could be fraudulent without the need to establish the element of dishonesty, while others suggest that a dishonest

31 At 274.
32 (1889) L.R. 14 App. Cas. 337.
33 At 374.
intent is necessary. No clear-cut test can provide an answer to whether a certain conduct in a certain case might amount to fraud. As suggested, the answer will ultimately lie on the facts of each case.

In cases where the documents tendered under the credit are clearly fraudulent, the bank would be placed in a dilemma if the applicant alleges fraud. This is especially the case if there is an element of recklessness in the beneficiary’s conduct. If the bank is satisfied that the conduct amounts to fraud and thus elects to refuse payment, a court may disagree with this conclusion and hold the bank liable to the beneficiary for wrongful dishonour. If on the other hand the bank is satisfied that no fraud is present and elects to pay, the court might reach the opposite conclusion and hold the bank liable to the applicant for wrongful payment. In addition, the judgment clearly violates the abstraction principle. If banks “deal in documents” only, why did the court require the bank also to establish the beneficiary’s knowledge of fraud? As Buckley put it:

‘This decision requires banks to base their actions on the beneficiary’s state of mind – an extraordinary departure from the fundamental doctrine that a credit is a purely documentary transaction.’

Commercial certainty requires that the bank’s decision on whether to accept the documents or not should be based on objective criteria and that notions of good faith or fraudulent behaviour of the beneficiary should be irrelevant to the issue.

Although the Court of Appeal reversed the decision, the House of Lords approved it. Notwithstanding the above objections, Lord Diplock – who gave the leading judgment – held that beneficiaries under documentary credits should be certain as to when they can claim payment. He concluded that the proposition, which does not call for knowledge on the part of the beneficiary of the fraudulent

39 Admittedly, even if there is strong evidence of the bank’s knowledge of the beneficiary’s fraud, it is less likely that a court will infer fraud on the part of the bank. See chapter 4.
41 See section 3.2.3.
misrepresentation, would render the exception "superfluous". The judgment placed too much emphasis on the fact that the fraud committed by the third party was largely designed to deceive the beneficiary, as much as it was designed to deceive any other party. In these circumstances it was concluded that the party who should bear the risk of fraud is the applicant. Accordingly, banks are obliged to pay against documents which appear on their face to comply with the terms of the credit despite being in fact fraudulent. The fraud defence is limited to cases where a bank can establish that (i) either the beneficiary or his agent committed the fraud manifested in the documents; or (ii) the beneficiary or any agent presenting the documents on behalf of the beneficiary had knowledge of such fraud when tendering documents for payment; and (iii) the fraud was "material". In this case, since the beneficiary had no knowledge of the fraud existing in the documents, the House of Lords made no comment on the issue of materiality.

In summary, English law's position on documentary fraud is that a fraudulent intent by the beneficiary is necessary in order for the exception to apply. Support for this approach is derived from the argument that an elaborate commercial system has been built on the basis that the beneficiary in a documentary credit is "selling under the assurance that nothing will prevent him from receiving the price". Where he is not fraudulent, these expectations should be protected. Whether such an approach is commercially justifiable is analysed below.

3.2.3 Looking at documentary fraud from another angle

The approach adopted by the House of Lords in The American Accord has been strongly criticised. The criticism is targeted at the commercial implications of the ruling. It has been argued that the judgment in the case was "unnecessary and

---

43 At 184.
44 At 187. However, the requirement of materiality of fraud has not been followed in subsequent cases. English law only requires the establishment of fraudulent intent on part of the beneficiary to be successful in raising the fraud defence. See Chapter 4.
45 Todd, P. Bills of Lading and Bankers' Documentary Credits, p. 209.
erroneous" as it “neither makes practical sense nor springs as the logical natural consequence of the letter of credit”. It is submitted that this argument is correct. In the view of the present author, Goode is correct in arguing that the knowledge of the beneficiary of the defect in the documents should be irrelevant. The documents remained defective and non-compliant with the credit terms:

'The root of the difficulty underlying Lord Diplock’s reasoning [in The American Accord] lies in the conflation of two distinct principles of documentary credit law. The first is that the documents must conform to the credit; the second, that fraud on the part of the beneficiary or his agent absolves the bank of its duty to pay. Where a document is forged, the fraud involved is potentially relevant not only qua fraud but as rendering the document non-conforming. Forgery as fraud is not a defence within the second principle unless perpetrated by the beneficiary or his agent. What was overlooked by the House of Lords in The American Accord is that the selfsame forgery also means that the document is not genuine and cannot, therefore, be a conforming document...Thus, what should have been the threshold question, namely conformity with the credit, was submerged beneath what should have been the second-stage question, the defence of fraud."

Indeed, fraud and non-conformity of the documents are two distinct defences or grounds which entitle banks to refuse payment. It is difficult to understand why the House of Lords decided to disregard the defence of non-conformity when it overlapped with the fraud defence. The Court of Appeal in The American Accord held that the documents were indeed non-conforming. The Bench was composed of Stephenson, Ackner and Griffiths L.J.J. They all concluded that – as it was clear from the facts of the case that the bill of lading was fraudulent – the bank should have been able to refuse payment without any further investigation. Lord Justice Ackner unequivocally stated:

'It is the character of the document, not its origin, that must decide whether or not it is a “conforming” document, that is a document which complies with the terms of the credit.'

Griffiths L.J. was also of the opinion that:

---

51 At 623, Stephenson L.J.
52 At. 628 (emphasis added).
'it would be a strange rule that required a bank to refuse payment if the
document correctly showed the date of shipment as Dec. 16, yet obliged the
bank to make payment if it knew that the document falsely showed the date of
shipment as Dec. 15 and that the true date was Dec. 16.'

Todd, however, argues that the law is in no way strange. He suggests that the
approach adopted by the House of Lords is consistent with dicta applied in cases
concerning c.i.f. sales transactions. In other words, where payment is against
documents (whether under a documentary credit transaction or where no credit is
utilised) the risk allocation between the parties has been that the innocent
seller/beneficiary can claim payment by tendering a fraudulent document that
complies only on its face with the terms of the contracts. Two points should be made
regarding this argument. First, the suggestion that dicta derived from cases concerning
c.i.f. sales transactions should be relevant in the documentary credits context must
surely be correct. As Rowlatt J. has stated in *Urquhart Lindsay & Company Limited v.
Eastern Bank, Limited* (1922):

'[[In the present case...the credit was irrevocable; and the effect of that was
that the bank really agreed to buy the contemplated series of bills and
documents representing the contemplated shipment, just as the buyer agreed to
take and pay for by this means, the goods themselves.]

Finkelstein agrees with this analysis. He argues that "the position of the seller, when
he tenders documents to the bank under a letter of credit, is analogous to that in which
he is placed...under a c.i.f. contract" as the ultimate question under a documentary
credit should be "whether the documents conform to the requirement of the sales
contract". Indeed, documentary credits developed mainly as a method of financing
c.i.f. contracts and to simply fulfil the payment obligation. They are mostly utilised in
relation to these contracts. It would thus be reasonable to suppose that the test of
compliance of the documents under both contracts is identical, if not more strictly
adhered to where a documentary credit is utilised.

53 At 632.
56 At 323 (emphasise added).
As to the second part of Todd's argument in which he suggests that the approach adopted in *The American Accord* is in line with principles applied in c.i.f. sale contracts, this suggestion is questionable. In fact, many commentators have reached a contrary conclusion.  

Most of the academic debate on the approach adopted by the House of Lords in *The American Accord* has been confined to examining the risk allocation between the parties with regard to documentary credit transactions with little reference to c.i.f. sales cases. Yet, the present writer argues that an analysis into such cases is essential. In addition to the above points, such an approach will provide a further layer of analysis when examining the commercial soundness of the dicta established in *The American Accord*. Furthermore, in interrelated contracts such as c.i.f. sales and documentary credits contracts it is essential that they "work harmoniously together to sustain the commercial enterprise underpinning them". Thus, the two areas of law are intertwined (at least from a commercial point of view). On this basis the subsequent sections of this chapter will analyse the issue of conforming documents in c.i.f. contracts and the relevance of documentary fraud in this context. The findings of this analysis will be used in assessing the implications of the judgment of the House of Lords in *The American Accord*.

### 3.3 C.i.f. sales, documentary credits and fraud

#### 3.3.1 Principles relating to the seller's documentary duties under c.i.f. contracts

The key characteristic of c.i.f. contracts is that the seller claims payment against fulfilment of his documentary duties: that is the tender of the required shipping documents, without the need to wait until the actual arrival of the goods. The risk that the goods perish, get lost or damaged during shipment is borne by the buyer. Since the seller has two obligations to fulfil (documentary and physical), the buyer may exercise his right to reject when the seller breaches a condition in performing

---

58 For further discussion on this point see section 3.3.2.


60 *Smyth (Ross T) v. Bailey (TD) Sons Co* [1940] 3 All E.R. 60. The contract is defined as 'a contract for the sale of goods performed by the delivery of documents', at .70. See generally D'Arcy, L. *Schmittoff's Export Trade: The Law and Practice of International Trade* (London, 2000), pp. 30-33.

either one of his duties. However, the focus here is on the seller’s documentary duties.

In almost all cases, a documentary breach by the seller co-exists with a breach of at least one of his physical duties. For example, if the seller tenders documents which falsely state shipment within the agreed period of the contract, where in fact the shipment took place outside the time agreed upon, the seller is in breach of both his duties: physical and documentary. In *Hindley & Co. Ltd. v. East Indian Produce Co. Ltd* (1973), the buyer paid against shipping documents, but when the ship arrived no goods were found. The buyer sued the seller for damages. The seller pleaded that the bill of lading was proper on its face and therefore the requirements of a c.i.f. contract were met. Furthermore, the seller argued that as he was not the shipper of goods, but was merely a party in a string who is unconnected with the circumstances giving rise to the issue of the bill of lading, he should not therefore be held liable to the buyer. In giving judgment for the buyer the court stated:

'It is sufficient to say that a seller under such contracts has what can be broadly described as a duality of obligations relating respectively to the goods which are the subject-matter of the contract and the documents covering the goods which have to be tendered to the buyer. On the facts of the present case I consider that the sellers are in breach of both these aspects of their obligation... The bill of lading was in fact never any document of title to any goods. It was not a “valid and effective document.”' 64

Notwithstanding the seller’s actual failure to deliver the goods, the court felt that it was necessary to mention the inaccuracy of the bill of lading as one of the grounds for giving judgment to the buyer. As the bill of lading contained untrue and inaccurate statements it was not a “proper” document and this fact should deprive the seller from the right to claim payment. 65 The court also rejected the contention that a seller in a chain should be treated differently from a seller who is the shipper. It emphasised that the seller had a choice at the time of contracting as to how he could fulfil his duties. Since he chose to take the documents from a third party rather than effecting shipment

---

62 Accordingly, the buyer has two separate rights of rejection: (i) the right to reject the documents that do not conform to the contract requirements; this right arises when the documents are tendered; and (ii) the right to reject defective goods. The right to reject the goods only occurs after the buyer receives them and examines them. See, e.g., *Kwei Tek Chao v. British Traders and Shippers* [1954] 2 Q.B. 459; See Generally, Treitel, G. ‘Rights of Rejection under c.i.f. Sales’ [1984] L.M.C.L.Q., p. 565.


65 At 519.
himself, he should bear the risk of his choice.\textsuperscript{66} In this regard, the risk allocation between the parties is very similar to that in the law of negotiable instruments: between the two innocent parties (buyer/seller) the risk of defects in the documents lies with the party that first dealt with the person responsible for the defect.\textsuperscript{67}

In \textit{James Finlay & Co. Ltd. v. M.V. Kwik Hoo Tong Handel} (1928),\textsuperscript{68} the agreement was that shipment would be made in September. The goods were shipped on 1 October, but the bills of lading were falsely dated 30 September. The buyer discovered this defect after payment against the documents and brought an action for damages against the sellers for breach of their obligation to deliver a correct bill of lading. The court held that the sellers had breached their implied contractual duty to tender an accurate bill of lading as well as their physical duty to ship the goods on time. Damages were awarded to the buyer, Scrutton L.J. saying:

\begin{quote}
'it was a condition of the contract not only that the goods be shipped in September but that a genuine bill of lading should be delivered showing the right date of shipment.'\textsuperscript{69}
\end{quote}

Thus, where the bill of lading contains a false date, it is not "genuine": it neither conforms to the contract terms, nor represents what the buyer has truly bargained for.\textsuperscript{70} Greer L.J. emphasised that if the documents had shown the real date of shipment, the buyer would have been entitled to exercise his rights of rejection on the basis of non-conformity.\textsuperscript{71} This principle was reinforced in \textit{Kwei Tek Chao v. British Traders and Shippers} (1954),\textsuperscript{72} where the court had been called to consider the damages for payment against a backdated bill of lading. Payment was by a documentary credit against the seller's draft accompanied by shipping documents. After payment was made it became clear that the tendered bills of lading were fraudulently altered with the knowledge of the shipping agents, but not of the seller. The facts of the case also showed the seller could not be held to blame for the

\textsuperscript{66} At 518-519.

\textsuperscript{67} For further discussion on the analogy usually made between the position of the seller in a chain of contracts and the position of a holder of a bill of exchange, see section 3.4.3.

\textsuperscript{68} [1929] 1 K.B. 400.

\textsuperscript{69} [1929] 1 K.B. 400, at 409.

\textsuperscript{70} At 409.

\textsuperscript{71} At 412-413. Damages were given to compensate the buyer for losses which occurred as a result of being deprived of this right.

\textsuperscript{72} [1954] 2 Q.B. 459.
alteration. Due to this falsification, the buyer was not able to negotiate the bill of lading. He thus brought an action for damages against the seller. It is noteworthy that the facts of the case were very much similar to those in *The American Accord*: in both cases the seller was innocent of the fraud which had been committed by a third party. Nonetheless, as in the above cases the court found the seller in breach of both his physical and documentary duties. Devlin J., in giving judgment to the buyer, stated that the seller failed to:

'forward a bill of lading which at once conformance with the contract and states accurately the date of shipment.'\(^7\)

Because the lading was not “accurate,” the buyer would have been entitled to exercise his rights of rejection on the basis of non-conformity had he known of such inaccuracy on tender.\(^7\)

In *Procter & Gamble Philippine Mfg. Corp. v. Becher* (1988)\(^7\) the bill of lading stated that shipment occurred on 31 January when the actual day of shipment was 10 February. Although the two dates were within the agreed contractual period, the buyer brought an action for damages against the sellers on the grounds that he had lost the right to reject the documents. The court found that although the seller was not in breach of his physical duties, he was in breach of a separate duty: that is to tender accurate documents. The bill was an “inaccurate” document. Had the buyer known of this defect at the time of tender, he would have been able to reject the documents.\(^7\)

It is clear from the above cases that documentary duties are in the nature of conditions. Any breach of such duties, even if minor, gives the buyer the right to reject the documents on the basis of non-conformity.\(^7\) Furthermore, the rule applies whether the seller has knowledge of the existence of a defect in the shipping documents or not. The emphasis in c.i.f. contracts is on the conformity of the documents and not on the seller’s knowledge of such conformity.\(^7\) The reasons behind adopting such principles are purely commercial and reflect the party’s risk

\(7\) At 480-81 (emphasis added).

\(7\) At 468, 482.

\(7\) [1988] 2 Lloyd’s Rep. 21, at 33.

\(7\) At 28.


\(7\) Kwei Tek Chao v. British Traders and Shippers [1954] 2 Q.B. 459.
allocation under documentary sales. When the buyer discovers a latent defect in the bill of lading, he holds an unmerchantable bill or more accurately, a non-transferable one: this is because the inaccuracy in the bill of lading will render it defective. In such circumstances the buyer may find himself "locked in" on a falling market by having to hold the bill when he might have been able to sell the goods had the bill been accurate. When the buyer is an intermediate in a chain, he might be unable to enforce the contract against his buyer where it becomes clear that the documents are inaccurate. The approach adopted by courts thus promotes certainty in international sale contracts: a buyer pays against the documents safe in the knowledge that such documents are accurate and - when a document is found to be inaccurate - he knows when he is entitled to reject it. The buyer does not have to deal with difficult questions about the seriousness or the effect of the breach, or whether the seller was responsible or had any knowledge of the existence of the breach. The seller on the other hand is required to ensure that the documents are accurate, otherwise he will be deprived of the right to claim payment from the buyer. This approach encourages sellers to be more careful in fulfilling their documentary duties. Furthermore, it only allows accurate documents to circulate between merchants. Finally, it does not undermine the seller's expectations, as any merchant will know that a breach of condition entitles the other party to reject performance. On this basis, the risks between parties in c.i.f. sale transactions are well balanced and promote both honesty between traders and the certainty that they will receive what they bargained for.

3.3.2 Exercising the right to reject inaccurate documents under a c.i.f. contract

Lord Justice Diplock made some controversial statements in *Gill & Duffus SA v. Berger & Co. Inc* (1984). These statements cast doubt on the question of whether the buyer has a right to reject documents that conform on their face, where in fact such documents are defective. The case concerned a c.i.f. contract for the sale of 500 tonnes of beans. The contract required an inspector's certificate issued by the inspector at the port of discharge, it was agreed that this certificate was to be "final".

---

Upon performance the bill of lading was correctly issued and fell within the shipment period. However, the goods arrived at the buyer's destination before the documents themselves. Although the seller shipped the full 500 tonnes, only 455 tonnes were originally discharged at their intended destination, the remaining 55 tonnes being over-carried to another destination. When the first large portion of the beans arrived, the buyer rejected the documents and refused to pay on the grounds that the seller did not tender the inspection certificate. As the inspection certificate was not one of the shipping documents, this was clearly an invalid ground for refusing to pay.\(^8\) The seller nevertheless managed to obtain the inspection certificate for the portion and represented the documents. The buyer again rejected the tender. The ground for rejection was that the goods themselves did not conform to the terms of the contract of sale. The seller this time rescinded the contract and sued the buyer for damages for wrongful repudiation of the contract. As it was established that the documents were correct and no indication was given that they were defective, the case mainly concerned the question of whether a buyer can reject accurate documents on the basis that the goods were defective.\(^4\)

The House of Lords refused to grant such a right and held that in these circumstances, the buyer is obliged to pay against conforming documents. However, Lord Diplock without any reference to previous authority stated that the refusal of a c.i.f. buyer to pay "upon presentation...of shipping documents which on their face conform to those called for by the contract, constitutes a fundamental breach of contract".\(^5\) This statement has been construed in two very different ways. Todd adopts a literal interpretation of the statement and suggests that as long as the documents conform on their face to the contractual requirements and the seller is innocent of any fraud, the documents are indeed conformant and entitle the seller to claim payment.\(^6\) Treitel, on the other hand, argues that the statement should be understood in the context of the relevant facts of the case. Accordingly, the statement merely suggests that a defect in the goods alone may not entitle the buyer to reject...
conforming documents: “non-conformity of the goods does not justify refusal to pay against conforming documents”. Where the documents are defective, however, the buyer can reject them notwithstanding the fact that they are conforming on their face. Bridge concurs with this analysis. Goode also rejects the suggestion that the buyer may be compelled to pay against documents that only conform on their face; whereas they in fact do not conform to the contractual requirement The facts of Gill & Duffus and the weight of authority favour this latter interpretation. As stated earlier, the issue before the House of Lords in Gill & Duffus was whether the buyer can reject the documents because the goods were defective; there was no suggestion whatsoever by Diplock L.J. that the documents tendered were non-conforming or defective. Accordingly, the statements regarding documents conforming only on their face are obiter. In Procter & Gamble Philippine Mfg. Corp v. Becher (1988), which was subsequent to Gill & Duffus, the court was assessing the amount of damages available to the buyer where the bill of lading concealed from him the right to reject it. Kerr L.J. said:

‘The whole basis of the decision in James Finlay was that one of the sellers’ obligations under a c.i.f. contract is to present a correctly dated bill of lading. This obligation has the character of a condition, in the sense that the buyer is entitled to reject a tender of documents which include an incorrectly dated bill of lading.’

he later added:

‘Mr Russell [for the buyers] said that it followed that if the buyers had known in this case that the bill of lading had been misdated they would have rejected the documents, refused to pay the price and left the sellers to face the loss resulting from the fall in the market. As a statement of what would have happened if the buyers had known the true facts this is obviously true.’

The statements clearly suggest that the buyer has a right to reject the documents if he knows that the bill of lading is backdated. Indeed, adopting Todd’s above-mentioned argument would question the test applied by courts when measuring damages in cases where the buyer had lost the right to reject due to a latent defect in the documents.

89 Goode, R. Commercial law, p. 945.
92 At 28.
93 At 28 (emphasis added).
Similarly, in *Kwei Tek Chao v. British Traders and Shippers* (1954), where the court had been called to assess damages available to the buyer who paid against a backdated bill of lading which was good on its face, Devlin J. said that the buyer has “a right to reject documents, and a right to reject goods, and the two things are quite distinct”. He added that the former right arises when “the documents are tendered”, while the latter arises when the goods “are tendered and when after examination they are found not to be in accordance with the contract”. These statements reinforce the view that the buyer has a right to reject defective documents, although they are proper on their face. This right is separate and distinct from the right to reject non-confirming goods. Adopting Todd’s argument, however, leads to the conclusion that where the documents are conformant on their face, there is only one right to reject.

Admittedly, however, Todd — in reaching his above-mentioned conclusion — touches upon a difficult issue. He finds it difficult to distinguish between the bill of lading tendered in *Gill & Duffus* and a backdated bill of lading. As he put it: why should “a backdated bill...be treated differently from one which is incorrect in any other material particular”. From examining the different authorities dealing with the documentary duties of the seller under c.i.f. terms thus far, it seems that the courts are reluctant to find a document non-conforming if an inaccuracy in the document relates to the quality of the goods. This approach can only be justified on the ground that sellers agreeing on c.i.f. terms should avoid the risk of being deprived of payment for reasons relating to the quality or conformity of the goods. As Bridge argues: “the nature of a CIF contract imposes upon the buyer the commercial risk of having to pay before exercising rights to recover the price when the goods turn out to be non-conforming”. Indeed, questions as to the quality of the goods are of such inherent uncertainty that recourse is often made to courts in order to establish whether indeed the seller was in actual breach of his physical duties regarding the goods. If such questions are to affect the conformity of the documents, the c.i.f. contract loses one of its chief characteristics: that it requires examination of the goods by the buyer be made only after payment is effected. On this analysis, there is a great difference

---

95 At 480 (emphasis added).
96 At 482.
97 At 482.
between a backdated bill of lading and one which fails to correctly describe the actual quality of the goods: the latter requires examination of the goods while the former does not. If a buyer is entitled to reject documents because of issues relating to the quality of the goods, he would enjoy a degree “of protection greater than that which he had bargained”\(^{101}\) for when agreeing to buy on c.i.f. terms. It should be noted, however, that this rule does not extend to the extent of frustrating the expectations of the buyer. Thus, courts have found that where no goods have been shipped or where the goods are fundamentally different from those that had been sold, the documents are considered non-conforming and the buyer is entitled to reject them even if documents conform on their face.\(^{102}\)

To sum up, the law as it stands protects parties’ expectations and the risk allocation between them. The buyer can reject non-conforming documents even though they are good on their face. Questions as to the quality of the goods may not affect the conformity of the documents, while questions relating to the actual date of shipment or the existence of the goods do. To preserve the buyer’s expectations, courts have held that while the buyer bears the risk of non-conformity of the goods, he is protected against risks relating to inaccurate or non-conforming documents. This law reflects what the buyer has bargained for and has the benefit of promoting certainty in international trade; the documents “pass through many hands while the goods are in transit and their physical state remains unknown”.\(^{103}\) Sellers are thus required to adhere to their documentary duties in order to be entitled to claim payment. These duties require that they tender accurate conforming documents and, as suggested in an earlier part of this work,\(^{104}\) this rule applies whether the seller has knowledge of the existence of a defect in the shipping documents or not. The emphasis in c.i.f. contracts is on the \textit{actual} conformity of the documents and not on the seller’s knowledge of such conformity.

\(^{101}\) \textit{Benjamin’s Sale of Goods}, pp. 1357-1358.


\(^{103}\) \textit{Benjamin’s Sale of Goods}, p. 1356.

\(^{104}\) See section 3.3.1.
3.3.3 Should the rules be different where payment is effected through a documentary credit?

The above analysis clearly shows that the test applied to establish what constitutes a conforming document in c.i.f. transactions differs from that applied in documentary credits law. In documentary credits where an innocent beneficiary is involved, the issuing bank cannot reject a document which is good on its face even though it is defective in some material particular. Yet under c.i.f. contracts where no documentary credit is involved, a buyer can reject such documents. Bridge has suggested that, by accepting the documentary credit as a method of payment for the underlying c.i.f. contract, the “presumptive CIF rules on payment are superseded by the rules applicable to letters of credit.” While the ruling in The American Accord supports this conclusion, it is difficult to understand the policies behind adopting such an approach. It is also difficult to see why it is that the seller’s duties regarding the documents should be weakened by the fact that payment is effected through a documentary credit rather than any other means. One would expect that the contrary view is the more logical. In fact, one could argue that documents are more valuable in documentary credit transactions than in c.i.f. contracts. In c.i.f. contracts, for example, there is room for applying the de minimis rule, whereas in documentary credits the principle is that the documents must strictly comply to the terms of the credit.

The integrity of the documents should be the essence of such transactions. Banks should not be obliged to take less than accurate documents and although this requirement is not spelled out explicitly in credit transactions it is submitted that “every letter of credit implicitly requires the documents presented to be genuine.” Indeed, every document required under a documentary credit is expected to perform a particular commercial function. The bill of lading is a document of title, a carrier’s receipt and evidence of the contract of carriage. The bank may take it as part of the security for advances it provided to the applicant. A certificate of origin or an

---

107 Interestingly however, Debattista, argues that the strict compliance rule should apply equally to documents tendered under the c.i.f., Debattista, C. The Sale of Goods Carried By Sea, pp. 197-199.
109 Gao., X. Supra note 46, pp. 75-76.
inspection certificate may be necessary for clearing the goods; authorities in a certain jurisdiction might not allow the goods to enter unless all documents are genuine. To oblige banks to pay against these documents when they are fraudulent would frustrate the whole purpose of utilising the documentary credit: if indeed “documents cannot be taken to mean what they say, the commercial foundation of letters of credit will vanish”.  

The buyer/applicant will appreciate the approach which obliges him to reimburse the issuing bank if the fraud in the documents was established after payment was made. However, the buyer will be surprised to learn that he has no remedy even if evidence establishing fraud is discovered before actual payment is made. While it is true that the buyer in cases such as *The American Accord* will usually have a remedy against the issuer of the document, this however does not reflect his expectation and cannot constitute what he has bargained for.  

Some commentators have suggested that the approach adopted by the House of Lords is justified on the grounds that, unlike c.i.f. transactions where adequate and balanced protection of the interests of both buyer and seller is assumed, in documentary credit contracts “protection of the [beneficiary’s] interests is, indeed, inherent to the credit transaction”. Thus, the argument proceeds that in documentary credit transactions the innocent beneficiary’s certainty of receiving payment should override the buyer’s expectations to receive accurate documents. However, upon further analysis, it will become clear that this line of thought is untenable. The issue of third party’s fraud is most likely to occur in string contracts. In these forms of contracts the beneficiary/seller is, in effect, a middleman who obtains an order from the importer/applicant and places it in his own name with another seller in the chain or an ultimate supplier. The documentary credit is thus opened in the middleman’s name. Bennett argues that in these circumstances the applicant should appreciate that his seller/beneficiary will tender those documents he receives from his own seller in the chain. Accordingly, it would be difficult for him to

---

ascertain whether the documents are indeed fraudulent and in these circumstances the better view is that the risk of third party’s fraud should fall on the applicant. These views have also been shared by Potter L.J. in Montrod Limited v. Grundkotter Fleischvertriebs GmBH, Standard Chartered Bank (2001). In this case Potter L.J., in approving Lord Diplock’s findings in The American Accord, suggested that accepting the documentary fraud defence against an innocent beneficiary:

‘would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question. Such a development would thus undermine the system of financing international trade by means of documentary credits.’

With respect, such statements are self-contradicting. If it is indeed accepted that in many documentary credit transactions the beneficiary could be in a chain of contracts and thus is not responsible for the accuracy of the documents, it should be also accepted that the buyer himself could be a seller in the chain. Thus, if the applicant/buyer in The American Accord was himself a seller in a chain, the risk of fraud would have still been borne by him. This is because such a buyer by challenging payment on the basis of fraud would be deemed to have knowledge of fraud prior to tendering the documents to the bank. As established in The American Accord, a buyer with knowledge of the fraud – even if he is not responsible for it – cannot claim payment under a documentary credit. Jack J. who was the judge of first instance in Montrod Limited agrees with Potter L.J.’s statements and argues that in string contracts the ultimate buyer should bear the risk of fraudulent documents complying on their face. If this proposition is to be accepted, it can be achieved in only one way: if a buyer is a seller in a chain and finds himself in circumstances similar to those in The American Accord, he should restrain himself from raising defences as to the accuracy of the documents (ignoring the fact that they are fraudulent). This is to ensure that he himself is paid when he tenders the documents. If he raises any defence by alleging that the document are fraudulent, he would then be seen to know

---

116 [2002] 1 W.L.R. 1975, at 1993. The case dealt with the issue of null documents. For further analysis see section 3.4.3.
117 It should be reiterated that knowledge of fraud would be established where a ‘false representation is made (i) knowingly, or (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false’. See section 3.2.2.
118 Jack, R. Documentary Credits, p. 270.
that the documents are fraudulent and thus would not be protected under the requirements of the fraud exception. On this basis the argument that suggests that the ultimate buyer bears the risk of fraud committed by a seller in a chain is untenable: it implies the promotion of fraudulent conduct in international trade. Furthermore, the argument which suggests that the approach adopted in *The American Accord* promotes certainty among sellers is misleading. In string contracts it is by and large the reckless seller who enjoys the benefits of this certainty, while honest and more vigilant ones are denied it. Sellers are thus advised not to check the activities of third parties involved in their transaction so long as the documents appear on their face to conform to the terms of the credit "for any knowledge of wrongdoing would jeopardise the seller’s chances of being paid". Yet, had the House of Lords adopted the contrary approach it would have facilitated an incentive for sellers to assure by all means available that the documents are accurate. This approach would have no element of harshness towards sellers whatsoever. It would be consistent with the approach adopted in cases concerning c.i.f. contracts and surely sellers would not be surprised to learn that in order to claim payment under a documentary credit, they are required to tender valid and accurate documents too.

Viewed from the bank’s perspective, the approach taken in *The American Accord* is undesirable. It:

'It creates a very uncomfortable situation. Banks will not like the idea that they have to honour a credit although they know that the documents tendered are fraudulent.'

---


121 It is important to reiterate that in *Hindley & Co. Ltd. v. East Indian Produce Co. Ltd* [1973] 2 *Lloyd's Rep. 515*, the seller on c.i.f. terms was found in breach of his documentary duties, notwithstanding the fact that he had acquired the documents from a seller down the chain and had no knowledge that they were defective when claiming payment against them. The court there found that there is: ‘no basis for drawing any distinction between sellers who were the shippers or produced the shipment of the goods and sellers who are merely intermediate parties in a string of sales’. At 519, see section 3.3.1.

122 Schmitthoff, C. ‘Fraud in Documentary Credit Transactions; Obligation to Pay with Knowledge of Fraud’ [1982] *J.B.L.*, p. 321.
Indeed, in instances where the bank relies on the documents as its main security for advances it has made, it might be exposed to the risk of losing this security. The law as it stands discourages banks from engaging in transactions where they act as financiers that rely on the commercial documents tendered under the credit as part of their security. This is because such a security may prove worthless. In an increasingly competitive trading environment, such as exists in the United Kingdom, financing trade should be encouraged.

Finally, as one American court has stated: “there is as much public policy in discouraging fraud as in encouraging the use of letters of credit”. Indeed, there is evidence that documentary credit fraud runs into “hundreds of millions of dollars annually”. Courts have a duty to facilitate rules that undermine fraudulent practice; rules that cannot be easily abused. English law seems to adopt an approach that encourages fraudulent conduct and makes it more difficult to invoke the exception, even where a bank can prove that the documents are fraudulent. The ICC for its part has been alerted by the rise of the problem of documentary fraud; it is calling upon buyers and banks to embrace the Commercial Crime Service (a division of the ICC). This service can determine whether a document tendered for payment under a credit is genuine or not. This is normally done in a few hours and not exceeding two days at most. Ironically even with access to such services, England will still be a high-risk market in relation to documentary fraud. This is because the bank or applicant will be required to provide actual proof of the state of mind of the beneficiary before being entitled to refuse payment. The fact that the documents are fraudulent is insufficient to invoke the fraud exception. Even in cases where it could be strongly assumed that the beneficiary should have known of the existence of fraud (e.g. where the documents relate to a fictitious ship), the applicant or bank will still find it extremely difficult to invoke the fraud exception against a seller/beneficiary in a chain of contracts. It should also be emphasised that it is not a consolation for a buyer that he could sue a

---

125 *Kuo, S. ‘Shiao-Lin Kuo on the Scope of Letter of Credit Fraud’* (1995) 1 *D.C.I.*, p. 3. Mrs. Shiaolin was an assistant director of the Commercial Crime Bureau, at the time the interview took place.
fraudster in a separate action on the underlying sale transaction. After all, by the time an action is brought the fraudster will presumably have long disappeared.128

For all the above reasons it is submitted that the test applied by the Court of Appeal in The American Accord is the more preferable. There is no reason why the test of what constitutes conforming documents should differ from that applied in ordinary c.i.f. sale contracts. The better view is, thus: when either bank or applicant proves that the documents are fraudulent, the bank should be allowed to withhold payment. The UNCITRAL Convention on Independent Guarantees and Stand-By Letters of Credit has adopted this approach. Article 19 provides that it is the nature of the documents, not the identity of the fraudulent party, which is relevant when invoking fraud. Accordingly, for the fraud exception to apply, it is sufficient to prove that the document tendered is forged or fraudulent.129 American courts have also held that the bank is entitled to reject the documents where it can establish that they are fraudulent; the beneficiary's knowledge and beliefs are irrelevant in this regard.130

3.4 Null documents

3.4.1 Introduction

In The American Accord, Lord Diplock pointed out that:

‘The bill of lading with the wrong date of loading placed on it by the carrier's agent was far from being a nullity. It was a valid transferable receipt for the goods giving the holder a right to claim them at their destination.’131

---


129 Article 19(1)(a) provides that the issuer has a right to withhold payment from the beneficiary if it is clear that: 'any document is not genuine or has been falsified'.

130 Other than the Sztejn case, where Shientag J. stated that the bank is required to pay its obligation under the credit provided the documents are 'genuine', in Boston Hides & Furs Ltd v. Sumitomo Bank Limited 870 F. Supp. 1153 (D. Mass. 1994) it was held that: 'Falsified documents are the same as no documents at all'. The American statute also supports this view. See U.C.C. 5-109. For detailed analysis, see also Buckley, R. & Gao, X. 'The Development of the Fraud Rule in Letter of Credit Law: the Journey so Far and the Road Ahead' (2002) 23 U. Pa. J. Int'l Econ. L., p. 663. American scholars have commended their courts' approach. Dolan concludes that The American Accord 'is not consistent with the language of the Code (U.C.C.) and is probably not good authority in the United States'. See Dolan, J. The Law of letters of credit: Commercial and Standby Credit (Boston, 1996), Para 7-61. See also Harfield, H. 'Identity Crises in Letter of Credit Law' (1982) 24 Arizona L.R., p. 241.

There is an implication here that the dictum established in the case does not apply where the beneficiary tenders null documents. His Lordship was clearly concerned with the situation where a bank may have a genuine interest in the documents: they could be the only security the bank would have if the buyer failed to reimburse. Lord Diplock clarified his position by stating:

'I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity...for that question does not arise in the instant case.'\footnote{At 188.}

If, indeed, the approach adopted in *The American Accord* does not include null documents, it arguably provides a balanced protection for all parties involved in documentary credit transactions. The applicant when receiving a backdated bill of lading does not lose the entire benefit of his bargain. In most instances a backdated bill of lading results only in the applicant sustaining some losses. As supporters of the judgment in *The American Accord* would argue, a backdated bill of lading does not result in a “total failure of consideration”,\footnote{Mautner, M. *Letter of Credit Fraud: Total Failure of Consideration, Substantial Performance and the Negotiable Instrument Analogy* (1986) 18 *L. & Pol'. Int'l. L. Bus.*, p. 630.} nor can payment against such a document result in “unjust enrichment”.\footnote{Kee, H. *The Fraud Rule in Letter of Credit Transaction* in Chinkin, C. Davidson, P. & Ricquier, W. (eds.) *Current Problems of International Trade Financing* (Singapore, 1983), p. 201.} The approach thus operates to ensure that in circumstances such as those in *The American Accord* (where the documents are not nullities), applicants would not abuse the fraud defence. It also protects the interests of good faith beneficiaries. Furthermore, the argument that the outcome of the case is undesirable because banks would potentially lose their security interest in the documents loses its credibility. Surely a backdated bill of lading may affect the bank’s security but this does not come near to the situation where a bank is called upon to pay against a document which has no commercial value whatsoever.\footnote{Support for the view that a bank can refuse to pay an innocent beneficiary where the latter tenders a null document under a credit can be derived from Lord Denning M.R. obiter statements in *Etablissement Esfka International Anstalt v. Central Bank of Nigeria* [1979] 1 Lloyd’s Rep. 445. See Todd, P. *Maritime Fraud* (London, 2003), p. 80.}

Whether the above analysis is correct, and whether a null document may affect the scope of the fraud exception is examined below.
3.4.2 Defining null documents

Unfortunately, in the common law it is not clear when a document could be described as a nullity. In Ruben and Another v. Great Fingall Consolidated and Others (1906), the document under consideration was a share certificate issued fraudulently by a secretary of a given company. The House of Lords held that a “forged certificate is a pure nullity”. However, in Kwei Tek Chao v. British Traders and Shippers (1954), having paid against a backdated bill of lading, the buyer tried to recover back payment from the sellers. He argued that as the bill of lading was fraudulently altered, it was a nullity. Devlin J. rejected the proposition that every “forged document is null and void”; rather he stated that these “general dicta must be related to the circumstances in which they are made”. And for a document to be rendered a nullity, one must:

‘examine the nature of the alteration and see whether it goes to the whole or to the essence of the instrument or not. If it does, and if the forgery corrupts the whole of the instrument or its heart, then the instrument is destroyed; but if it corrupts merely a limb, the instrument remains alive, though no doubt defective.’

Similarly, in Lombard Finance v Brookplain Trading (1991), it was held that only a forged alteration which goes to the essence of a document renders it a nullity. In The American Accord, Ackner L.J. in the Court of Appeal found that:

‘...a bill of lading on which the date of shipment has been forged is not a nullity, since such a forgery would not go to the essence of the document.’

The House of Lords concurred with this approach, Lord Diplock stating that:

‘The bill of lading with the wrong date of loading placed on it by the carrier’s agent was far from being a nullity. It was a valid transferable receipt for the goods giving the holder a right to claim them at their destination, Callao, and

\[\text{References:}\]

137 At 443, Lord Loreburn.
140 At 476.
was evidence of the terms of the contract under which they were being carried.\footnote{[1983] 1 A.C. 168, at 188.}

Goode, however, has in some instances used the term “forged documents” to mean null documents.\footnote{Goode, R., \textit{Supra} note 46, p. 230, see also Ellinger, P., \textit{Supra} note 46, p. 145.} Mugasha suggests that any forgery renders the document a nullity.\footnote{Mugasha, A. \textit{The Law of Letters of Credit and Bank Guarantees}, p. 144.} Although it is common for commentators to treat the concepts “nullity” and “forgery” as interchangeable, it should be said that the two are quite different. As Jack notes, “a document may contain a forgery without being a nullity”.\footnote{Jack, R. \textit{Documentary Credits}, p. 270.} To establish whether a document is indeed a nullity, the threshold question should be whether the document has some \textit{commercial value}. As Devlin J. concludes, only forgery which goes to the essence of a document renders it a nullity.\footnote{See Buckley, R. ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 28 \textit{GW. J. Int’l. L. & Econ.}, p. 309; Byles, J. \textit{Byles Bills of Exchange} (London, 1988), p. 276; \textit{Benjamin’s Sale of Goods}, pp. 1244-1245.} This clearly means that for a document to be a nullity it should have no commercial value whatsoever.\footnote{Kwei Tek Chao and Others \textit{v.} British Traders & Shippers, \textit{Ltd} [1954] 2 Q.B. 459.}

It should be emphasised that although “a document is unlikely to be a nullity unless it is forged”,\footnote{Jack, R. \textit{Documentary Credits}, p. 270.} it could be null for reasons other than forgery.\footnote{Ibid., p. 270; Bridge, M. \textit{The International Sale of Goods}, p. 363.} It could be a nullity due to a genuine mistake. An example of this is where a document is required to be signed by a named person, but is signed, mistakenly, by another person.\footnote{See \textit{Montrod Limited} \textit{v.} Grundkotter [2001] 1 All E.R 368, at 375.} Examples of null documents due to forgery are many. The classic example is where a document is required to be issued by a particular party, but where in fact it is issued fraudulently by a different party.\footnote{Hooley, R. ‘Fraud and Letters of Credit: Part 1’ (2003) 4 \textit{J.I.B.F.}, p. 93.} Or where, for example, a bill of lading is fraudulently issued to represent certain goods but no goods are in fact shipped. Although it might be assumed that the situations which render a document a nullity are clear and easy to identify, this is not the case.

In \textit{The American Accord} the bill of lading, although altered, still had commercial value; one day’s delay would affect the price of the goods; the buyer could face difficulty in selling it, but this in itself was far from rendering the bill of lading totally null and without any commercial value. The buyer can sell the goods for

\footnotesize

\begin{itemize}
  \item \footnote{[1983] 1 A.C. 168, at 188.}
  \item \footnote{Goode, R., \textit{Supra} note 46, p. 230, see also Ellinger, P., \textit{Supra} note 46, p. 145.}
  \item \footnote{Mugasha, A. \textit{The Law of Letters of Credit and Bank Guarantees}, p. 144.}
  \item \footnote{Jack, R. \textit{Documentary Credits}, p. 270.}
  \item \footnote{Kwei Tek Chao and Others \textit{v.} British Traders & Shippers, \textit{Ltd} [1954] 2 Q.B. 459.}
  \item \footnote{Jack, R. \textit{Documentary Credits}, p. 270.}
  \item \footnote{Ibid., p. 270; Bridge, M. \textit{The International Sale of Goods}, p. 363.}
  \item \footnote{See \textit{Montrod Limited} \textit{v.} Grundkotter [2001] 1 All E.R 368, at 375.}
  \item \footnote{Hooley, R. ‘Fraud and Letters of Credit: Part 1’ (2003) 4 \textit{J.I.B.F.}, p. 93.}
\end{itemize}
a reduced price; the market price for the goods could unexpectedly rise and he thus
could sell the goods for a profit. However, what would be the position if the goods
were in fact shipped one month later than the date stipulated on the face of the bill?
Would the bill of lading still be of commercial value? Or would this fact render it a
nullity? In these circumstances an additional factor must be examined to determine
the commercial value of the bill of lading: that is, the nature of the goods. If the goods
were perishable and a two-week delay in their shipment would result in their total
damage, then the altered bill of lading would have no true commercial value. On the
basis of the above authorities it would be deemed a nullity. Even a one-day alteration
might render the bill of lading of no commercial value. Take the example of a buyer
that imports pig meat into a country with a limited market for such a product. If he
had agreed to supply a sub-buyer with the meat, and the latter discovered that the bill
had been altered, he might reject the bill (he might immediately buy the product from
a different seller for a lower price). Due to the fact that the market is limited, the
original buyer might find himself unable to sell the goods, and although the goods
may not necessarily perish immediately, they might perish while he is trying to sell
them. In these circumstances the bill of lading again has no real commercial value,
and the courts would most likely recognise it as a nullity. Here a given court, in order
to determine whether the documents were null or not, will not only investigate the
nature of the goods, but will also take into consideration the extraordinary factors
involved in the envisaged case (the nature of the given market).

Because the commercial value of many documents will ultimately depend on
the facts related to each transaction in which the documents are used, the question of
what constitutes null documents will most likely be a question of fact and not law.
Consequently no precise formula can be given to establish when a certain document
would be rendered a nullity.

3.4.3 Should null documents be treated differently?

The issue of null documents in relation to documentary credits has been dealt with
fairly recently, in Montrod Limited v. Grundkotter Fleischvertriebs Gm BH, Standard
Chartered Bank (2001). In the case Grundkotter Fleischvertriebs (GK), and

Ballaris, entered into a contract for the sale of pig meat. Payment was to be made by a documentary credit. The applicant of the credit was Montrod which was engaged in the underlying transaction as a financer. The credit named GK as the beneficiary of the credit. It required the presentation of inspection certificates signed by the applicant (Montrod).

At time of performance Ballaris misled GK into believing that the latter was authorised to sign the required inspection certificate on behalf of Montrod. Consequently, GK signed the inspection certificate and presented the documents for payment. As a result the goods were delivered to Ballaris. However, between the date of presentation and the date of payment, it became clear that Montrod had not given its authority for GK to sign the certificate. Notwithstanding this fact the bank decided to pay anyway. Montrod disputed its right to reimbursement. It argued that a bank should not pay against a null document.

At first instance, Jack J. found that since the seller, until the time of presentation, had no knowledge of fraud and was innocent of it, and since he honestly believed that he had the authority to sign the certificates, he was entitled to payment under the credit. Because no fraud could be proven on part of the beneficiary, it followed that SCB was correct in making payment. As to the nullity point, Jack J. found that there was no authority to support a so-called “nullity exception”. He further noted that there is nothing in the UCP to suggest that such an exception should be recognised. On Appeal, Potter L.J. affirmed the judgment. His Lordship concluded that in English law only fraud is recognised as an exception and it applies only where it is established that the beneficiary himself commits fraud or has knowledge of its existence. The conclusion was justified on three grounds. The first was that the authorities establish that only fraud could be alleged as a defence against the beneficiary. In this case, however, although the document was a nullity it was not a forgery. Potter L.J. thus found that:

‘While [Lord Diplock] left open the position in relation to a forged document where the effect of the forgery was to render the document a ‘nullity’, there is nothing to suggest that he would have recognised any nullity exception as extending to a document which was not forged (i.e fraudulently produced) but

---

was signed by the creator in honest error as to his authority; nor do I consider that such an exception should be recognised.156

Hooley has criticised the judgment on the same grounds that Goode had used to criticise the judgment of the House of Lords in *The American Accord*. 157 He thus concludes, “a forged document is not a conforming document”.158 However, it is clear that Potter L.J. distinguished between forged and non-forged documents. At first sight it would seem that this distinction is legitimate since it would be difficult to insist on the application of the fraud exception where in fact the documents themselves cannot be described as forged. However, this argument over-emphasises the usage of a rather technical term “forgery”. Whether the documents were forgeries or not, the fact remains that fraud was involved in their issuance. In addition, they were worthless pieces of paper, which banks could not rely on as security for advances paid under the credit.159 They neither reflect what both applicant and bank have expected under the credit, nor could it be argued that the applicant bargained for such documents. For this reason even if such documents could not be accurately described as forgeries, the fact that they were without any commercial value rendered them non-conforming to the terms of the credit.

Jack has rejected this analysis. He argues that in any case banks should not be concerned with the “worth” of the documents, as a tendered “document can still be worthless even if it is not a nullity”.160 In support of this proposition, he draws analogy with cases where a c.i.f. seller can oblige his buyer to accept the shipping documents although the goods perished before tender of the documents. Reference was made to *Manbre Saccharine Co Ltd v. Corn Products Co Ltd* (1919),161 which reinforces this principle.162

With respect, the analogy is fallacious and cannot stand legal analysis. In fact, the case of *Manbre Saccharine* leads to a different conclusion. In *Manbre Saccharine*...
the dispute arose on whether a c.i.f. seller could tender the required shipping documents and claim payment from his buyer notwithstanding the fact that to his knowledge the goods were lost at time of tender. McCardie J. concluded that in c.i.f. contracts the seller's duties end by tendering the required documents under the sale contract. He further noted that:

‘If the vendor fulfils his contract by shipping the appropriate goods in the appropriate manner under a proper contract of carriage, and if he also obtains the proper documents for tender to the purchaser, I am unable to see how the rights or duties of either party are affected by the loss of ship or goods...For the purchaser in case of loss will get the documents he bargained for; and if the policy be that required by contract, and if the loss be covered thereby, he will secure the insurance moneys.’

It is trite law that the seller under a c.i.f. contract promises the shipment of the goods and not their arrival. However, this is conditioned by the requirement that the documents are the ones that the buyer had bargained for. In fact, the judgment in Manbre Saccharine was given to the buyer. This was because the seller was "obviously bound to tender a proper policy of insurance together with the other documents required" since it was clear from the facts of the case that the insurance policy did not adhere to the requirements of the contract the buyer was entitled to reject.

It is difficult to understand how Jack analysed this case in support of his argument above. The case clearly establishes that buyers in international transactions should be able to rely on proper documents. If goods are lost after shipment, the proposition that the buyer should bear this risk in these circumstances is accurate since he would be able to recover their price if he bargains for and receives an accurate insurance policy that covers such risks. This risk is inherited in c.i.f. contracts. Similarly, if the party in question were a bank that paid advances under a documentary credit in return for shipping documents, it would be protected since it can claim against the carrier or the insurer as the case may be. There is nothing in Manbre Saccharine to suggest that either buyer or bank is obliged to accept worthless

---

163 [1919] 1 K.B. 198, at 204-205 (emphasis added).
165 [1919] 1 K.B. 198, at 204 (emphasis added).
documents. It is thus clear that the argument that banks would not be interested in the
documents because the goods may be lost after shipment is misleading.

The second ground for Potter L.J.'s judgment was that the seller might have
been participating in a chain of contracts and in these circumstances he “should not be
in a worse position than someone who has taken a draft drawn under a letter of credit
in circumstances which rendered him a holder in due course”.¹⁶⁶ This proposition is
untenable. A beneficiary in a documentary credit, unlike a holder in due course of a
bill of exchange, is not alien to the underlying sale contract. He is required to fulfil
certain duties: that is to tender the documents required by the credit. The holder in due
course doctrine developed to protect parties who do not – and cannot – be presumed
to know the facts of the underlying transaction.¹⁶⁷ If analogy is permitted with the law
of negotiable instruments, it should be in the way the law of negotiable instruments
allocates the risks of loss owing to forgeries and alterations on the bill itself. These
losses are usually on the person who takes the negotiable instrument from the forger.
This is because such a party is in a much better position to detect such activity.¹⁶⁸ By
the same token, under documentary credits, the beneficiary is in a much better
position to check the authenticity of the documents than the applicant; it is further his
duty to do so under the underlying contract of sale.¹⁶⁹ It should be added, however,
that the beneficiary in Montrod Limited did not receive the documents from any third
party but was deceived by a third party to issue a null document. The law of
documentary credits thus does not protect the applicant or banker even if the
documents were nullities due to an act of the beneficiary himself (as long as he acts in
good faith). This is a further extension to the dicta established in The American
Accord.

Finally, one should add that Potter L.J. found it difficult to define what
constitutes a “nullity”. On this basis he concluded that if such an exception were

¹⁶⁷ See Chapter 1, section 1.3.3.
¹⁶⁸ Bills Of Exchange Act 1882 s. 54 and s.55. See also Smith, G. ‘Irrevocable Letters of Credit and
¹⁶⁹ Note that in Motis Exports Ltd v. Dampskibsselskabet AF1912, Akieslskab [1999] 1 All E.R. 571
the court was called to consider whether the shipowner had breached his obligation by virtue of
delivery against presentation of forged bills of lading. Rix J. held that policy provided that when an
innocent party had to suffer through fraud of a third party, it was better that the loss fell on the
shipowner who dealt directly with the fraudster. This was because he was in a better position to
determine the genuineness of the bills of lading.
recognised, then banks would be placed in a dilemma as to the necessity to investigate
the underlying facts to assess a nullity claim. Nonetheless, Potter L.J. had the
following reservation:

'I would only add, with reference to Lord Diplock’s reservation, that I would
not seek to exclude the possibility that, in an individual case, the conduct of a
beneficiary in connection with the creation and/or presentation of a document
forged by a third party might, though itself not amounting to fraud, be of such
character as not to deserve the protection available to a holder in due
course.'170

With respect, this reservation is untenable. True, banks in certain circumstances might
find it difficult to establish what is meant by null documents, however to expect them
to play the role of courts in relation to the beneficiary’s conduct is far more
burdensome. As Hooley observes:

‘When will the conduct of the beneficiary in connection with the creation of
the presentation of a nullity document, although not amounting to fraud, be of
such character as to prevent him claiming under the letter of credit? …How is
the bank meant to know about the conduct of the beneficiary?’171

In light of current authority, these questions remain impossible to answer. English law
in relation to non-genuine and forged documents tendered under documentary credits
remains uncertain and open to further controversy. Future litigation on this point is to
be expected, as applicants and banks dealing in a multi-million dollar transaction
would certainly rely on the above statements made by Potter L.J. to challenge
payment against documents which are of no commercial value.

Admittedly, however, the ruling in Montrod Limited might just possibly be
sustainable on the ground that there is no clear definition of what constitutes null
documents. Indeed, whether a document is a nullity or not will usually turn out to be a
question of fact rather than law.172 In addition, a document could be altered and thus
rendered a nullity whether fraudulent or not.173 On this basis it could be strongly
argued that the abstraction principle militates against recognising an exception which

172 See section 3.4.2.
173 See section 3.4.2. However it is noteworthy that Article 19 of The UNCITRAL Convention on
guarantees and standby credits does not require the documents to be fraudulent in order to entitle the
bank to reject it: when the bank knows the document not to be genuine it could reject it.
would impose upon banks a duty to take into consideration elements other than facial compliance of the documents to determine whether they should pay or not. But could this fact alone justify the rejection of the nullity exception? Certainly not: other than the above objections, the conclusion reached by Potter L.J. tolerates the circulation of fraudulent and null documents in the international market. In a fairly recent case, Cresswell J. has described forged bills of lading as "a cancer in international trade." The statement deals only with one of many documents usually required under documentary credits. In the present writer's view, Hooley is correct in arguing that allowing fraudulent and null documents to circulate among merchants would undermine the "trust" on which trade is founded. This outcome outweighs the certainty which Montrod Limited supposedly provides.

The general view prior to the ruling in Montrod Limited was that the bank would be entitled to refuse payment where a tendered document is a total nullity. However, the judgment has overruled these expectations. The ruling is unfortunate. But Montrod Limited "is legally the progeny of [The American Accord]." Indeed, further analysis would suggest that the root of the problem lies in the test applied by Lord Diplock in The American Accord, where intentional fraud by the beneficiary was the test necessary for rejecting the documents. On the facts of that case His Lordship wanted to make a fair outcome, he thus implied that a distinction could be drawn between null documents and documents that have some commercial value. What His Lordship overlooked was the fact that this proposition would undermine the foundation of the abstraction principle since the only way that a bank could examine the extent of an alteration on the commercial value of a given document is by assessing different factors relating to the underlying sale contract. The whole purpose of introducing the abstraction principle was to avoid embroiling banks in such controversies. This fact was recognised by the court in Montrod Limited and as a result it held that banks under English law could not reject fraudulent documents

177 Ibid.
presented by innocent beneficiaries. This is even if such documents have no commercial value whatsoever, and even if the bank is looking to the documents as security for its advances. The locus of the problem is not in *Montrod Limited* but in the test established in *The American Accord.*

3.5 Concluding remarks

Where commercial contracts are interrelated, it is necessary that the rules applicable to both these contracts are tailored in such a manner as not to undermine their commercial utility. In the context of documentary credits and c.i.f. contracts, this can be achieved by narrowing the gaps between the treatment of documents under c.i.f. contracts and documentary credit contracts. This approach would reflect the parties’ expectations and risk allocations. Applicants mandate banks to pay out against the tender of certain documents. They expect such documents to be valid and genuine.

The beneficiary’s state of mind should have no relevance here, the issue being one of documentary validity. This has been the approach in c.i.f. transactions and it should be the approach in documentary credit contracts. This is necessary not only to protect the applicant’s expectations and to ensure that the seller does not escape the duties placed on him in international transactions but also to protect banks that might be relying on the documents as security for advances they provide. The approach adopted by the Court of Appeal in *The American Accord* is thus preferable. There it was held that a bank may refuse to pay against a fraudulently backdated bill of lading, not merely because such a document is fraudulent but also because it does not conform to the requirement of the credit. It is submitted that this analysis must be correct and that not only should a bank have the right to reject documents that are fraudulent, but rather that any material alteration in the documents, whether innocent or fraudulent, and whether the beneficiary had knowledge of this fact or not, should render the documents non-conforming to the requirements of the credit. Any contrary approach tolerates the circulation of non-genuine documents in international trade and might expose banks to huge losses.

---

180 It is noteworthy that the Singaporean Court of Appeal in *Beam Technologies v. Standard Chartered Bank* [2003] 1 S.L.R. 597 departed from the English position and took a contrary approach. There the court held that there is a nullity exception which entitles banks to reject null documents and the fact that the beneficiary has no knowledge of the documents being null may not undermine this entitlement. For further analysis of the case, see Chin, L. & Wong, Y. ‘Autonomy – a Nullity Exception at Last’ [2004] *L.M.C.L.Q.*, p. 14.
This is not to say, however, that banks are required to examine the underlying transaction. The approach advanced here merely suggests that only when banks are certain that a tendered document is altered or non-genuine should they reject it.

Courts should not turn a blind eye to the risks that non-genuine documents present to both banks and applicants. In today’s world losses emanating from such risks are reaching hundreds of millions of dollars. Unless reform is adopted, the foundation of documentary credits could be seriously undermined. As Murray has suggested:

‘Letters of credit developed in an age when it was impossible to confirm speedily that the presented documents were legitimate – this is no longer true.’

Indeed, utilising rather recent services such as the Commercial Crime Service, would allow banks to ascertain in hours whether a document is genuine or not. Banks seeking to protect their own interests or the interests of their applicant by using such services should be given the right to reject the documents when they receive evidence confirming that the documents are inaccurate in any material manner. In these circumstances, there should not be an added burden on banks in working out who was responsible for the inaccuracy.

While the arguments in this chapter have been limited to documentary credits, they apply equally to demand guarantees. Thus, when a guarantee calls for a certificate confirming the account party’s default to be issued by a third party, a bank receiving evidence confirming the fact that a signature on such a document has been forged should be entitled to reject it.

Finally, it is “hoped that...the revision committee chooses to deal with the issue of fraud, and in doing so takes its lead from the UCC and the UN Convention”.

Otherwise the risk allocation function of documentary credits may be

---

seriously affected. Different jurisdictions have adopted different views regarding the documentary fraud issue. Unlike English law, under American law banks are entitled to reject the documents when they are fraudulent. The Australian law has adopted the American framework. Different standards in different jurisdictions increase uncertainty for beneficiary, applicant and bank. Documentary credits are used because parties can rely on them. An American applicant would indeed be surprised to learn that he is protected from third party fraud when he deals with a beneficiary located in Australia but will lose such protection when he deals with a beneficiary located in England. Applicants might be required to pay high legal fees for advice on their legal rights and obligations in certain markets. An issuing bank might also, in some circumstances, be uncertain as to his rights and duties in relation to a confirming bank that has paid against fraudulent documents where the beneficiary is innocent.

The UCP could adopt a framework similar to Article 19 of the UNCITRAL Convention on Independent Guaranties and Stand-By Letters of Credit, where a paying bank could refuse payment if the documents are not “genuine”. This approach would have the merit of allowing banks to reject documents that are non-genuine, whether fraudulent or not. It would also provide certainty to parties utilising documentary credits who expect that in documentary credit transactions they deal with genuine conforming documents and not forgeries or nullities.


Chapter 4: “Fraud in the transaction”: a defence to payment

4.1 Introduction

Demand guarantees, although sharing with documentary credits their abstract nature, perform a different function in international trade. Although the English courts have been inclined to apply the same degree of abstraction to both instruments,¹ this work argues that a contrary approach is preferable. It is undoubtedly true that the issuance of the guarantee indicates that the parties have agreed that in the event of a default occurring in the underlying transaction, the account party will be governed by the maxim “pay now argue later”. It is also true that this approach is necessary to protect the allocation of risk between the parties and to ensure that the bank issuing the guarantee does not get involved in any underlying disputes. However, as Bertrams points out: “‘paying first’...would make no sense if the outcome of ‘later arguments’ is already evident”.² It would be even more senseless where it is clear that an account party has no chance of “arguing later”. Hence, where it is clear that the instrument has not been utilised to give effect to its intended purpose, courts in different jurisdictions have developed certain defences that would allow the account party to enjoin payment. The traditional view in England has been that fraud is the only defence available to an account party faced with an abusive calling. As has been discussed earlier, “documentary fraud” is of limited application in relation to demand guarantees.³ In these transactions in order to establish whether fraud indeed exists a court would be required to investigate the underlying transaction.

The first part of this chapter will examine the scope of the “fraud in the transaction” defence. While it will examine its application in respect of both documentary credits and demand guarantees, particular emphasis, will be placed on situations where the defence is raised against an abusive call under a demand guarantee. This is because both the strict compliance principle and the documentary fraud defence generally provide sufficient protection for applicants against the abuse of documentary credits. Accordingly, the fraud in the transaction defence should be of very limited application in such transactions. Otherwise too many defences available

¹ See Chapter 2, section 2.2.3.1.
³ See Chapter 3.
to the applicant will undermine the certainty beneficiaries enjoy when paid by documentary credit means.

As will be seen, for a bank to reach a conclusion on whether “fraud in the transaction” exists in a certain situation it will be necessary for it to examine the conduct and state of mind of the beneficiary claiming payment under the abstract payment undertaking. In these circumstances it is almost impossible for a bank to reach a firm conclusion on whether fraud exists or not. Consequently, even if the evidence of fraud is strong, banks are unlikely to take the initiative and refuse payment. Rather, where the beneficiary’s fraud is suspected (or even proven), the practice has been for banks to advise their customers to apply for an injunction to restrain either the bank from paying the beneficiary or, in appropriate circumstances, restrain the beneficiary from tendering the documents necessary to trigger payment. Consequently, even if the evidence of fraud is strong, banks are unlikely to take the initiative and refuse payment. Rather, where the beneficiary’s fraud is suspected (or even proven), the practice has been for banks to advise their customers to apply for an injunction to restrain either the bank from paying the beneficiary or, in appropriate circumstances, restrain the beneficiary from tendering the documents necessary to trigger payment. Hence, the examination of the “fraud in the transaction” defence would not be complete without analysing the judicial response to these applications: as well as clear evidence of fraud, what will a court require to grant an injunction? Has English law developed consistent guidelines in this area? What are the merits and drawbacks of the English approach?

The second part of this chapter will focus exclusively on the problem of abusive calling. It will examine the defences and approaches developed in other jurisdictions in response to the problem. Whether such approaches could be introduced into English law will also be examined. If not, what alternative approaches have – or could be – developed in English law to respond to the problem?

4.2 Injunctions against fraud

4.2.1 The fraud in the transaction test

Interlocutory injunctions are designed for the maintenance of the status quo existing between the parties pending a trial. The general guidelines on when to grant an injunction were established in *American Cyanamid v. Ethicon Ltd.* (1975). In that case Lord Diplock, who delivered the key judgment, said that the proper approach to

---

applications for injunctions was to establish whether there was a serious issue to be tried. Secondly, a court would assess the adequacy of damages against the party sought to be injunction. If the plaintiff could recover damages from the defendant in a separate action and if indeed damages were an adequate remedy, a court will not grant an injunction. Finally, even with the applicant satisfying these two requirements, the balance of convenience might militate against granting an injunction. At this stage it will only be necessary to examine the first requirement: the seriousness of the issue to be tried.

The authorities have clearly established that the test adopted in American Cyanamid as to the first requirement has no application in cases where fraud is alleged to restrain a bank from making payment under an abstract payment undertaking. It is not sufficient for the claim to be serious. Rather the view has been that for a bank to be restrained from making payment under an abstract payment undertaking it should be arguable that fraud is “the only realistic inference”.

The traditional view adopted by English courts was that a court will only grant an injunction where fraud is “established”. In Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd and Others (1977), the plaintiff, an English seller, had applied for three bank guarantees to be issued to the benefit of an Egyptian buyer. Disputes arose with regard to the performance of the underlying contract and the beneficiary called on the guarantees. The plaintiff succeeded in its application for an interlocutory injunction restraining the bank from making payment. The bank applied to have the injunction discharged. As the case was “not of an established fraud at all”, Kerr J. gave judgment for the bank. Similarly, in Edward Owen Engineering Ltd. v. Barclays Bank International Ltd. And Umma Bank (1978), the plaintiff had entered into a contract to supply the buyers in Libya with particular goods. The contract provided payment to be made through a confirmed documentary credit. However, for the credit to be issued, the plaintiff was first required to provide a demand guarantee for a percentage of the contract price. The

---

6 At 398.
9 At 761.
guarantee was provided, but the buyer failed to provide the credit in the form required, and instead made a call on the guarantee. The plaintiff applied for an injunction to restrain the bank from making payment. Browne L.J., in refusing to grant an injunction, found that:

‘it is certainly not enough to allege fraud: it must be “established,” and in such circumstances I should say very clearly established.’\(^{11}\)

Lord Denning found that banks should pay their obligations immediately upon demand and without any proof of condition, stating:

‘it is obvious that that course of action can be followed, not only when there are substantial breaches of contract, but also when the breaches are insubstantial or trivial, in which case they bear the colour of a penalty rather than liquidated damages: or even when the breaches are mere allegations by the customer without any proof at all: or even when the breaches are non-existent. The performance guarantee then bears the colour of a discount on the price of 10 per cent. Or 5 per cent., or as the case may be.’\(^{12}\)

The suggestion by Lord Denning that a beneficiary should receive payment even where “breaches are non-existent” seems absurd however. It would seem that His Lordship was not only applying a very rigid fraud test, but overlooked the fact that fraud can only be established by carefully examining whether there was indeed actual default in the underlying transaction. This rigid approach is mainly due to treating documentary credits and demand guarantees as analogous instruments and consequently applying the fraud exception to both instruments in an identical manner.\(^{13}\) The inherited view in respect of the former instrument is that as long as the documents conform on their face, any fact relating to the underlying transaction should be irrelevant. Requiring a stringent test of fraud in documentary credits is justifiable as there is a thin line between a breach of contract and fraud. The extent to which a breach of contract could amount to fraud requires courts to examine the whole purpose of the underlying transaction, the degree of the breach and the intent of the beneficiary. Further, in documentary credit transactions the availability of the “fraud in the documents” defence safeguards against the committal of fraud. On the

\(^{11}\) At 774.
\(^{12}\) At 772 (emphasis added).
\(^{13}\) See Chapter 2.
other hand, as Debattista correctly suggests, such a defence is not available in demand guarantee transactions:

"[T]he fraud exception" in letters of credit means in effect documentary fraud whose existence is known to the seller on tender for payment. A moment's reflection will show that this exception, repeatedly said to apply to performance bonds, is somewhat devoid of meaning in the context of performance bonds.¹⁴

As commercial documents are not usually involved in these transactions, the only way a court can determine the existence of fraud is by examining the rights and wrongs of the beneficiary in the underlying contract. To suggest that Lord Denning's approach is understandable since it reflects what the parties have bargained for is unrealistic: a party agreeing to provide a demand guarantee could not be said to have bargained for the guarantee to be called upon even where fraud exists.¹⁵ In addition it is established law that a beneficiary of a demand guarantee could only retain the amount which would compensate him for the damage he suffered in the underlying contract. Any surplus should be returned to the account party.¹⁶ This clearly indicates that both account party and beneficiary enter the transaction on the understanding that a call on the guarantee could only be made when actual damage has occurred. While the beneficiary's expectations under a guarantee deserve protection, this should not, however, allow him to secure payment even if such payment has no basis.

The requirement that fraud should be established creates a second difficulty in relation to the above approach. Even if courts are willing to examine the underlying contract to infer fraud, they are unlikely to reach this conclusion. As a practical matter, the time between the actual demand for payment and the application for an injunction is short. Requiring an applicant for an injunction in such a short period to prove that fraud has been "clearly established" would render the fraud exception "a theoretical construct".¹⁷

Courts have responded to these criticisms and the test applied in United Trading v. Allied Arab Bank (1985),\textsuperscript{18} has indicated that the fraud rule would be applied “less stringently”\textsuperscript{19} than has hitherto been adopted in previous cases. In this case the account party had in fact defaulted in performing the underlying contract. However, when the guarantee was called upon, the account party applied for an injunction alleging that his breach resulted from the beneficiary’s conduct. The account party accordingly sought to restrain United Arab Bank (the bank) from making payment. Ackner L.J. rejected the bank’s proposition that a court would not infer fraud “unless every possibility of an innocent explanation is excluded”.\textsuperscript{20} Such an approach would be “overstating the standard of proof”.\textsuperscript{21} The test to be applied is: where a court finds “on the material before it the only realistic inference is fraud”\textsuperscript{22} then the account party would have made a sufficient case of fraud. Ackner L.J. supported his dictum concerning the relaxation of the fraud rule by referring to the more relaxed approach adopted in the United State. He noted that American courts were ready to grant an injunction where there is strong suspicion of fraud. He concluded that such an approach did not result in commercial disruption. He added that the narrow approach, established by earlier English authorities, was subject to the following criticism:

‘[W]e would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the Courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening.’\textsuperscript{23}

The difference between Ackner L.J.’s test and the test adopted in prior authorities is clear: the old test required “established fraud”. Accordingly, the court would ask in applications for injunctions: has the account party established that fraud existed beyond reasonable doubt?\textsuperscript{24} The new test, however, does not require the establishment of fraud, rather the court will assess the evidence: where it is arguable that fraud is

\textsuperscript{18} [1985] 2 Lloyd's Rep. 554.
\textsuperscript{20} [1985] 2 Lloyd’s Rep. 554, at 561.
\textsuperscript{21} At 561.
\textsuperscript{22} At 561.
\textsuperscript{23} At 561.
\textsuperscript{24} See Browne L.J.’s analysis in Edward Owen where he seemed to reject inferring fraud unless every innocent explanation on part of the beneficiary could be excluded, at 765-776.
the only realistic inference a court will grant an injunction provided the balance of convenience does not militate against such a grant.

What is meant by fraud is common law fraud as established in *Derry v. Peek* (1889). Thus, courts require that the lack of "honest belief" on the part of the beneficiary should be clear. As discussed earlier, in order to establish this requirement not only do courts need to consider the underlying contract, but also to examine all the relevant circumstances of each case and in addition questions such as the beneficiary's "experience and intelligence, and the reason why he acted as he did" may well be relevant.

On this finding, the approach which calls for extensive examination of the underlying contract in demand guarantee transactions for the purposes of inferring fraud must be correct. Most courts in recent decisions have followed this dictum. And injunctions have been granted in two recent cases. In *Themehelp Ltd v. West* (1995), the parties had agreed to sell a business. Payment was agreed to be by instalments on stipulated dates. The buyer (account party) provided a demand guarantee to secure the beneficiary in the event that the former defaulted in paying the instalments. Soon after performance of the contract had commenced, the account party started proceedings for rescission of the contract and claimed damages on the grounds of alleged fraudulent misrepresentation by the beneficiary. The fraud alleged was in the nature of concealment of information when entering the underlying contract. The beneficiary denied fraud, nonetheless the account party applied for an interlocutory injunction to restrain the beneficiary from making a demand. At first instance Kay J. gave judgment for the account party. On appeal, both Balcombe and Waite L.J. upheld the injunction, while Evans L.J. dissented. The test applied by both judges upholding the injunction was that fraud was "seriously arguable".

---

25 See chapter 3, section 3.2.2, where this point has been examined.
27 *Royal Brunei Airlines Sdn. Bhd. Appellant v. Philip Tan Kok Ming* [1995] 2 A.C. 378. For further analysis on this point, see Chapter 3, section 3.2.2. The standard for inferring fraud in abstract payment undertakings is thus in line with the standard usually applied in civil actions; that of balance of probabilities.
While the case is a welcome development in English law, there has been no indication that courts are prepared to accept a lower test of fraud in relation to demand guarantee transactions. Rather, Balcombe L.J., after considering the policies behind applying a strict abstraction principle, stated:

'The same considerations of policy do not apply where...as here, injunctive relief is sought to stop the beneficiary from making such a demand pending the trial of the action in which the issue of his fraud will be determined. In such a case I see no reason why the ordinary principles for the grant of interlocutory injunctive relief should not apply.'

This argument was the reason behind Evans L.J. dissenting, as he saw no reason why a court should apply a lower test of fraud where the injunction is sought against the beneficiary rather than the bank. It is submitted that this argument is correct: the level of abstraction should not depend on the party sought to be enjoined. The effect on commerce is the same, whether the party sought to be enjoined is the account party or the bank. It would have been a better approach if the court had sought to distinguish between the fraud test in relation to documentary credits and that in demand guarantees. After all, Waite J. found that the injunction was permissible due to the fact that such an injunction would only delay the right of the beneficiary to receive payment, where such delay would not cause him any irreparable damage. Commentators who call for a distinction to be drawn between principles relating to documentary credits and those relating to demand guarantees usually put this argument forward.

The approach adopted in Themehelp was not followed. In fact, the judgment has been subsequently criticised for broadening the test adopted in United Trading v. Allied Arab Bank. Hence, courts have, in most cases concerning abstract payment undertakings, adopted the test established in this latter case. Accordingly, a court will infer fraud when on the material available the only realistic inference is fraud, e.g.

31 At 771 (emphasis added).
32 For further discussion on this point, see section 4.2.4.
33 At 766.
lack of honest belief. Such inference is reached by examining the underlying transaction. While this test is to some extent broader than that adopted in Edward Owen, no distinction has been drawn in its application between cases involving documentary credits and those involving demand guarantees. Courts have reiterated that "it is well settled that [demand guarantees] stand on the same footing as letters of credit". Moreover, no distinction has been drawn between cases where fraud has been alleged to exist in the formation of the underlying contract, or its performance.

It has been said that this high test for establishing fraud is the sole reason why abusive calling is more likely to occur in transactions governed by English law, than those governed by other laws. However, it should be said that the English approach to this area of law has been consistent. It has the virtue of providing certainty to all parties involved. In addition, it would seem that the only way that the problem of abusive calling can be resolved is by examining the realities of the problem. The inescapable fact is that the concept of fraud itself is not comprehensive enough to mitigate the problem. Fraud is almost certain to result in injustice, but not every injustice is caused by fraud. Cases such as Edward Owen demonstrate the fact that, while a court might find that the call on the demand demonstrates "sharp practice", this finding is a long way from saying that a call is fraudulent. The best way to tackle the problem would be through adopting exceptions other than fraud. Such an approach will be considered separately.

---

40 Themehelp Ltd v. West [1995] 3 W.L.R. 751, for example, was a case where fraud has been alleged to exist in the form of inducing the account party into entering the underlying transaction. Fraud by the account party on the issuer, in his application to issue an abstract payment undertaking, cannot constitute a defence of fraud against the beneficiary, unless it can be established that the beneficiary has conspired with the account party to induce the issuer into issuing its undertaking, see Refasnjan Pistachio Producer v. Bank Leumi [1992] 1 Lloyd’s Rep. 513.
42 [1977] 3 W.L.R. 764, at 777, Geoffrey Lane L.J.
44 See section 4.3.4.
4.2.2 The cause of action requirement: bank knowledge of fraud

In English law, to obtain an injunction a cause of action is needed against the defendant.\(^{45}\) This rule is not absolute and courts have accepted (in cases not concerning abstract payment undertakings) exceptions to it.\(^{46}\) For the sake of clarity this section will examine only whether such a rule has been adhered to in cases relating to abstract payment undertaking. What ensues from the adherence or rejection of the rule will be considered separately when dealing with the balance of convenience point.

In the application by the account party for an injunction against the issuing bank, the cause of action is said to be the bank’s (imminent) breach of its duty to the applicant in making payment where the beneficiary’s fraud is evident to it. Thus, in *Harbottle Mercantile Ltd. National Westminster Bank Ltd* (1978) Mr Justice Kerr stated that an injunction would not normally be granted, “except possibly in clear cases of fraud of which the banks have notice”.\(^{47}\) Similarly, in *Edward Owen*, Lord Browne – in refusing to grant an injunction – stated:

> ‘I find it quite impossible to say that fraud on the part of the [beneficiary] or [the Libyan bank] has been established, still less that Barclays Bank had knowledge of it.’\(^ {48}\)

Yet, Lord Diplock in *The American Accord* has explained the rationale of the fraud exception in the following terms:

> ‘The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred “fraud unravels all”. The courts will not allow their process to be used by a dishonest person to carry out a fraud.’\(^{49}\)

---


\(^{47}\) [1977] 3 W.L.R. 752, at 761 (emphasis added).

\(^{48}\) At 775 (emphasis added).

Although the case was not an application for an injunction, common sense suggests that the basis for an injunction is to prevent a fraudulent beneficiary from benefiting from his fraud rather than showing that the bank, notwithstanding its knowledge of fraud, is willing to pay.\(^5\) In *Bolivinter Oil S.A. v. Chase Manhattan Bank* (1984), Sir John Donaldson M.R. seems to have questioned the bank’s knowledge of the fraud requirement where an injunction is sought. He, arguably, accepted the following proposition made by Counsel for the plaintiffs:

‘The Court should grant an injunction restraining payment under a letter of credit or performance guarantee where the result of payment is likely to be to permit the ultimate beneficiary to profit from his own fraud at the expense of the Plaintiff... *The basis of the jurisdiction is not the power of the Court to grant an injunction restraining a breach of contract. The Plaintiff does not have to establish that the payment enjoined would constitute a breach of contractual duty owed to the Plaintiff by the Bank. The basis of the jurisdiction is wider — the power of the Court to intervene where necessary to prevent fraud. The Plaintiff has to show that his legal rights are threatened by the fraud of the beneficiary.*’\(^5\)^2

This view was endorsed by Phillips J. in *Deutsche v. Walbrook* (1995),\(^5\)\(^3\) where he stated:

‘Furthermore, the requirement that there must be clear evidence of the bank’s knowledge of fraud is academic once the proceedings have reached the inter partes stage. At this point the evidence of fraud will be placed simultaneously before the Court and before the bank, which is party to the proceedings... If the Court concludes that there is clear evidence of fraud, it will necessarily conclude that the bank has acquired knowledge of the fraud.’\(^5\)\(^4\)

Phillips J. concluded that the basis for an injunction where fraud is pleaded is not whether the applicant has a cause of action against the bank. Rather, preventing the beneficiary from committing fraud.\(^5\)\(^5\) This conclusion is not, however, accepted by all judges. Apart from those in *Edward Owen* and *Harbottle Mercantile*, Rix J. in *Czarnikow-Rionda v. Standard Bank* (1999),\(^5\)\(^6\) was adamant that the bank’s knowledge of fraud is a necessary requirement for granting an injunction. In that case

---

\(^5\) At 254 (emphasis added).
\(^5\) At 162.
\(^5\) At 162-165.
Czarnikow-Rionda Sugar Trading Inc. (Rionda) sought to maintain an injunction against Standard Bank London Ltd (Standard) to prevent it from paying out to two Swiss banks at maturity, the proceeds of three deferred documentary credits. Rionda was the applicant of these credits. The Swiss banks advised and confirmed the credits at Standard's request. However, they discounted the credit prior to the maturity date. Rionda obtained strong evidence that suggested that his seller had committed fraud in the underlying transaction. Accordingly, it applied for an injunction to restrain Standard from reimbursing the Swiss banks. Indeed, had Rionda been able to establish fraud, it is extremely likely that it would have been able to restrain Standard from reimbursing the Swiss banks: this is due to the fact that in deferred credits, if the confirming bank discounts the credit prior to the maturity date without authorisation from the issuer and it later becomes clear that fraud was committed by the beneficiary, the risk of fraud falls in these circumstances on the discounting bank.57

In the case, Rionda argued that where an injunction is sought on the basis of fraud it was not necessary to establish a cause of action against the bank. After an extensive analysis of fourteen authorities dealing with the fraud exception, Rix J. rejected this proposition. He said:

‘Although the requirement of the knowledge of the bank of the beneficiary’s fraud was not specifically referred to by Lord Diplock [in The American Accord]...it was implicit in the argument before the Court and in Lord Diplock’s citation with approval of the Sztejn and Edward Owen cases. When, therefore, Lord Diplock stated that the fraud exception was an application of the doctrine that “fraud unravels all”, he was not, in my respectful opinion, speaking as broadly as might be thought. It would be less pithy but more accurate to fill out the dictum by saying that fraud unravels the bank’s obligation to act on the appearance of documents to be in accordance with a credit’s requirement provided that the bank knows in time of the beneficiary’s fraud.’58

He then added:

‘I accept that in Deutsche v. Walbrook Mr. Justice Phillips raised the question whether it is necessary for the claimant to have any cause of action, and sought to answer it in the negative by reference to the acceptance of his proposition in Bolivinter: but I have already ventured to suggest that Sir John Donaldson’s judgment in Bolivinter does not support that view of the matter.

57 On discounting banks liabilities, see Chapter 5.
If the source of the power to injunct were purely the law's interest in preventing the beneficiary from benefiting from his own fraud, I do not see why there should be the added requirement that the fraud be patent to the bank.  

It is clear that these statements contradict the above-cited views expressed in Bolivinter and later endorsed by Phillips J. in Deutsche v. Walbrook. Bearing these contradictory views in mind, one can proceed in considering the true effects of what is often said to be an "academic" point.

4.2.3 The balance of convenience

4.2.3.1 The general rule

If in an application for an injunction the court finds that there is a serious issue to be tried, then the court should consider whether the balance of convenience justifies the grant of the injunction. The guidelines established by Lord Diplock in American Cyanamid v. Ethicon Ltd. (1975) on this point provide that a court should first consider whether, if the plaintiff were to succeed at the trial in establishing his right to a permanent injunction, an award of damages (to be paid by the defendant) would be an adequate remedy for the losses the plaintiff sustained as a result of the defendant's continuing to commit the act or conduct sought to be enjoined.

If damages would constitute an adequate remedy and the defendant would be able to pay them, no injunction should normally be granted. The strength of the plaintiff's claim may not affect this rule. If, however, damages were not an adequate remedy, then the court should consider the effects of granting an injunction on the defendant. It would consider whether if the defendant were to succeed at trial (establishing his right to commit the act or conduct which was sought to be enjoined), the plaintiff would be able to adequately compensate him for any loss he sustained by way of damages. If so, then the court would usually grant an interlocutory injunction.

---

59 At 203 (emphasis added).
However, if there is doubt as to the adequacy of the remedy in damages available to either party, it is then that factors other than the availability of damages are examined to determine where the balance of convenience lies. These factors and their relative weight would vary from case to case depending on the facts of each case. Thus, as long as damages would be recoverable, the other factors which might affect the balance of convenience should not be considered.

Jack suggests that the factors affecting the balance of convenience keep recurring in abstract payment undertaking cases and "ought therefore to result in predictable decisions by the courts". However, as will be shown, courts to the contrary, have developed different and quite contradictory trends when dealing with the issue.

4.2.3.2 The main factor: the availability of damages

The first trend is adopted by those courts that adhere to the cause of action requirement. Here, as the cause of action for the injunction is the bank's (imminent) breach of its duty to the applicant or account party - in making payment where the beneficiary's fraud is evident to it, the court when applying the above guidelines expressed in American Cyanamid would always find that the balance of convenience is against the grant of an injunction. This is because if the bank pays against a fraudulent demand, it would almost certainly be able to compensate the applicant, by way of damages for this breach. This view is best explained by Kerr J. in Harbottle Mercantile Ltd c. National Westminster Bank Ltd (1978):

'The plaintiffs then still face what seems to me to be an insuperable difficulty. They are seeking to prevent the bank from paying and debiting their account. It must then follow that if the bank pays and debits the plaintiffs' account, it is either entitled to do so or not entitled to do so. To do so would either be in accordance with the bank's contract with the plaintiffs or a breach of it. If it is in accordance with the contract, then the plaintiffs have no cause of action against the bank and, as it seems to me, no possible basis for an injunction against it. Alternatively, if the threatened payment is in breach of contract ...
then the plaintiffs would have good claims for damages against the bank. In that event the injunctions would be inappropriate, because they interfere with the bank's obligations to the Egyptian banks, because they might cause greater damage to the bank than the plaintiffs could pay on their undertaking as to damages, and because the plaintiffs would then have an adequate remedy in damages. The balance of convenience would in that event be hopelessly weighted against the plaintiffs. 66

This analysis was the reason why Rix J. in Czarnikow-Rionda v. Standard Bank (1999) 67 insisted that the court would interfere by way of injunction only where a cause of action (against the bank) was available. Accordingly, and by applying the above-cited observations, he found that the balance of convenience in the case militated against the grant of the injunction. What was novel about the case, however, was the fact that Rix J. reached this conclusion without even considering the merits of the fraud allegation. The judgment has been criticised, correctly, by Hooley as this approach would by "less helpful to the bank". 68 Indeed, the bank would be left to assess the strength of the evidence of fraud in these circumstances. While courts state that:

"it is not the role of a bank to examine the merits of the allegations and counter allegations of breach of contract. To hold otherwise would place banks in a position where they would in effect have to act as Courts in deciding whether to make payment or not", 69

the approach adopted by Rix J. achieves the same result that courts have tended to avoid. Hence, banks are left uncertain as to whether the evidence of fraud is that which would justify rejection or not. Thus, it was not a surprise that Rix J.'s approach was not followed in Consolidated Oil Limited v. American Express Bank Limited (2000). 70 In this case the plaintiff invoked fraud in the underlying transaction and sought an injunction to restrain his bank from making payment under a demand guarantee. The court considered the merits of the fraud allegation and refused to grant an injunction on that basis. Nonetheless, Lord Justice Clarke seemed to suggest that even if the case had been of the type where a court can conclude that fraud was the only realistic inference, he would have rejected the injunction on the basis that:

---

'in the traditional phrase, damages would be an adequate remedy for the claimant', as:

'If the bank pays when it ought not to have done, it will be liable to compensate the claimant in the amount of its loss, together with interest at an appropriate borrowing rate.'

In other words, the balance of convenience would again lie against the grant of an injunction. Jack, among others, argues that the approach of rejecting injunctions on the basis that damages would be an adequate remedy for the claimant "must be correct". He explains:

'If the evidence of fraud is clear, then the applicant can expect that the issuing bank will not pay; if it does pay despite the evidence then the applicant will not be required to reimburse it.'

It is, with respect, suggested that such an approach is open to the same criticism which has been made of Rix J.'s judgment. It would, further, create unsound results and could undermine the foundation of the abstraction principle. Suppose in practice a court finds to its satisfaction that a sufficient case for fraud was made yet refuses to grant an injunction on the balance of convenience basis. Should the bank refuse to pay in these circumstances as suggested by Jack? And, if it refuses, would it be protected in law? Unfortunately, what Jack and the courts overlook is the fact that the court’s findings in a pre-trial injunction stage are not conclusive. Applications for injunctions to restrain banks from paying under abstract payment undertakings are usually heard and determined on an urgent basis. The court will not usually have before it the full range of the evidence that may be adduced at the final hearing. And although courts apply a very high test of fraud, the test they usually apply (as expressed by Ackner L.J.), does not necessitate success in the final action.

---

71 At 496.
72 At 497. Similar observations have been made by Parker L.J. in GKN Contractors Ltd. v. Lloyds Bank Plc & Another [1985] 30 B.L.R. 48, at 64, 65.
73 Jack, R. Documentary Credits, p. 294.
74 Ibid., p. 294. Johnson also argues that the approach is 'grounded in commercial common sense'. See Johnson, A. 'Fraud and Documentary Credit' [2001] J.I.B.L., p. 40.
75 Jack, R. Documentary Credits, p. 294.
If the bank, working on Jack's advice, decides not to pay and the court finds at
the final hearing that the beneficiary was not in fact fraudulent, then the bank would
be liable to the beneficiary in damages. In *Lloyd's v. Canadian Imperial Bank of
Commerce* (1993)\(^77\) the issuer of a demand guarantee\(^78\) decided not to pay. At trial the
issuer did not allege fraud but instead argued that the applicant had provided it with
evidence which — to a reasonable banker — would amount to a notice of clear fraud on
part of the beneficiary. It thus contended that it should be protected, notwithstanding
the fact that it could not establish actual fraud at trial. The court correctly refused this
argument, as it would produce "absurd or unacceptable results". \(^79\) Banks would be
able to escape their undertakings despite the fact that the conditions required to trigger
such undertakings were fulfilled. This, in essence, undermines the abstraction
principle.

On these findings, it is clear that the dictum expressed in *Consolidated*, and
approved by Jack, could place banks in a dilemma as to whether they should make
payment, or refrain from doing so. In the event that a court finds that fraud was very
clearly established, yet refuses the grant of an injunction on the balance of
convenience basis, what would be the position of the bank?

On the one hand, if it refrains from making payment, and the court finds at the
final hearing that fraud was non-existent, it will be liable in damages to the
beneficiary. In addition, its reputation will be affected as it will be viewed as a bank
which does not fulfil its promises. Yet, on the other hand, if it pays, and the court at
trial finds that it was unreasonable for it to do so (as fraud was clear, at least to the
court); it could not claim reimbursement from its customer. It would have to establish
proceedings against the beneficiary to recover payment.\(^80\) Furthermore, its reputation
among its customers will again be affected, as it would be viewed as a bank which

---

\(^78\) The guarantee was in the form of a standby credit.
\(^79\) At 581.
\(^80\) The claim for recovery would be for restitution for money paid under mistake: *Bank Russo-Iran v. Gordon Woodroffe & Co Ltd* [1972] 116 Sol. Jo. 921. The bank will also have a claim for damages in
deceit against the beneficiary and any third party who has issued a document which contains a false
statement with the knowledge that it would be presented to the bank under an abstract payment
makes poor financial judgments. In these circumstances, the best the bank can do is to conduct its own investigation to be certain that there indeed existed actual fraud, rather than fraud being the "only realistic inference". Even if it conducts such investigations, its findings will not necessarily be either accurate or conclusive. On this analysis, one can concur with the view that English courts have:

'developed the reputation for being slow to find that a beneficiary has committed fraud and quick to shift the fraud risk from the applicant to [the] bank.'

Indeed, it seems that English courts have striven to apply the rule that banks should be left free to fulfil their commitments, yet have tailored rules and guidelines, which might hold banks liable for fulfilling such commitments. The root of the problem as regards the difficulties discussed above is not founded in the complex nature of abstract payment undertakings, nor does it have to do with the fact that fraud is "the most controversial and confused area" in the law relating to these undertakings. The root of the difficulty lies in the fact that courts insist on applying to these instruments principles and doctrines that have developed outside their context. It is the rule that a cause of action against a bank is necessary for a court to intervene by way of an injunction that results in the difficulties.

Abstract payment undertakings are unique and to ensure their efficiency the rules that apply to them should also be sui generis. The fraud exception is a by-product of the instrument and courts should apply it in a form that will sustain the efficiency of the instrument and reflect the way in which the parties allocated the risks between them. The abstraction principle provides that banks should not get involved in any dispute between the buyer and seller on the performance of the underlying transaction. The exception to this principle should maintain this approach. If courts recognise that their power to injunct in cases of fraud is not on the basis of the availability of a cause of action against the bank, but rather as suggested in Bolivinter: "the basis of the jurisdiction is wider — the power of the court to intervene to prevent

---

81 Arguably, courts would always try to protect the banks by finding that the bank had no knowledge of the alleged fraud. If this is indeed the law, then English courts do not in reality recognise any fraud exception. In addition, banks are always immune from any liability, even if they act fraudulently.
fraud", the factors in determining the balance of convenience would differ. More importantly, issuing banks would not be placed in a difficult position. This has been the approach of both American and Australian law. In Australia, although a cause of action is usually necessary for an injunction to be obtained, courts do not require such a rule in applications to restrain a bank from making payment under an abstract payment undertaking; rather the cause of action is predicated upon the unlawfulness of the beneficiary's action in making the demand for payment on the bank. Accordingly, in an application for an injunction to restrain a bank from making payment, the Australian courts would first ask: is there a sufficient case of fraud? If yes, they would then ask: could the plaintiff recover damages from the beneficiary? If yes, the injunction is rejected. If, however, the beneficiary is insolvent or of doubtful solvency, then the court would assess other factors in determining whether the balance of convenience favours granting an injunction. What is noteworthy about the Australian approach is the fact that, contrary to the English approach, the bank does not have to make any difficult judgments; an Australian court, when refusing to grant an injunction on the balance of convenience, does not recognise any cause of action against the bank, but rather clearly enforces the view that it is the plaintiff who agreed to make payment utilising an abstract payment undertaking and it is thus he who should bear the risk of any difficulty in recovering payment from a fraudulent beneficiary. Banks are exempted from any liability and are allowed to fulfil their commitments freely, notwithstanding the evidence of fraud. Moreover, as the courts examine the availability of damages against the beneficiary rather than the bank, an injunction could be granted in appropriate circumstances, i.e. where the beneficiary is of doubtful solvency. By contrast, in English law, the fact that the courts examine the availability of damages against the bank, an injunction could be granted only where the solvency of the bank is doubted, which virtually means that an injunction would be rarely granted, if ever.

---

87 See the statements of Waite L.J. in THEMEHELP LTD v. WEST (1995) 3 W.L.R. 751, at 763.
As to the American approach, Ackner L.J. has noted it in the following terms:

'It is interesting to observe that in America, where concern to avoid irreparable damage to international commerce is hardly likely to be lacking, interlocutory relief appears to be more easily obtainable... [American] cases appear to indicate that, for the purpose of obtaining relief in such cases, it is not necessary for an American plaintiff to demonstrate a cause of action against a bank, whereas it is, as previously stated common ground that a plaintiff must in this country show a cause of action.'

Indeed, American courts require three main requirements in an application for an injunction against a bank in an abstract payment undertaking transaction. First, there must be sufficient evidence of fraud. Secondly, the applicant must demonstrate that he does not have an adequate remedy at law and that he will thus suffer irreparable damage if the injunction is not granted and, finally, that the balance of convenience should tip in favour of the plaintiff. The courts do not address the question as to whether there is a cause of action against the bank or not, but rather apply guidelines similar to the Australian approach.

Interestingly, American courts have considered the question of whether an applicant for an injunction can ever satisfy the second requirement: irreparable damage. In very few cases was it argued that an applicant for an injunction would not suffer irreparable damage as he can always sue the bank for damages if it pays against a fraudulent claim. Most American courts were quick to highlight the difficulties that might ensue from accepting this line of argument. They recognised that such arguments would undermine the fraud exception to the degree that it would exist as a theoretical norm only. For the fact that a court denies the injunction would actually mean that the bank has the right to pay against the claim for payment even if fraud was clearly established. This conclusion is based on the inherited understanding that banks are required neither to look at nor to take into consideration any facts that are not on the face of the documents.

---

91 For arguments that American courts should apply the cause of action rule in abstract undertakings litigations, see Thorup, R. ‘Injunctions against Payment of Standby Letters of Credit: How can the Banks Best Protect Themselves’ (1984) 101 Banking L.J., pp. 17-21.
92 See, e.g., Interco, Inc v. First National Bank 560 F2d 480 (1st Cir. 1977).
Having adopted such a view, the American approach has been to inquire whether the applicant has a remedy against the beneficiary in damages. Irreparable damage could only be satisfied where the applicant has a very slim chance of recovery from the beneficiary.\(^9\)\(^4\) Thus, American courts have articulated an approach where it is possible to restrain payment in cases of fraud.\(^9\)\(^5\) In addition, they are clear on the point that if they decline from intervening by way of injunction then banks can freely fulfil their commitments and are exempted from any liability notwithstanding the existence of fraud to their knowledge, unless fraud can be established from the face of the documents.\(^9\)\(^6\)

On these findings, the approach adopted by Phillips J. in Deutsche v. Walbrook (1995), where no cause of action against the bank was required, seems to be the preferable analysis. Courts should adopt this approach as it would: first, reflect the true meaning of the abstraction principle. Secondly, promote certainty among bankers as they would always know in which circumstances they are allowed to fulfil their commitments. Thirdly, protect the efficiency of abstract payment undertakings, as courts would only interfere in extreme cases where there is evidence of fraud and evidence that the chances of recovery are non-existent. Finally, the instrument would be indeed effective in the hands of the beneficiary, yet not to the degree that it can be easily abused.

In light of recent authorities, however, it appears unlikely that the English courts will adopt this approach. It remains to be seen whether English courts - although insisting on the cause of action requirement – are likely to develop the view that the availability of damages against the bank should be construed as a theoretical remedy. If such a view is indeed developed, the guidelines on whether to grant an injunction or not would be similar to those adopted by American courts and the


\(^9\) U.C.C. 5-109(a)(2) (1995), states that an issuer is always protected if it honors the credit in good faith. Nothing in the good faith requirement of the Code requires the bank to look beyond the documents. The only circumstances where it could be said that a bank has acted in bad faith is where the bank conspires with the beneficiary to defraud the applicant. See Dolan, J. The Law of letters of credit: Commercial and Standby Credit (Boston, 1996), Para 7-91 to 7-93.
question of the bank’s knowledge of fraud would be relegated to being an academic point.

4.2.3.3 Other factors

On the assumption that damages will not be an adequate remedy for the applicant, courts will assess different factors to decide whether the balance of convenience favours the grant of an injunction. Reference to these factors has been made in almost all cases where an injunction has been sought in an abstract payment undertaking transaction: whether the injunction is sought against the beneficiary, or the bank.

The most commonly reiterated factor is that an injunction would seriously damage a bank’s reputation in the international market.\(^97\) However, this conclusion is questionable. It would be unrealistic indeed to suggest that a bank’s reputation could suffer if the bank obeys a court order.\(^98\) What damage could a bank suffer if it is restrained from making payment where fraud is most likely to exist? In practice, recent cases have demonstrated that where the evidence of fraud is strong, banks are more likely to assist their customers in gathering the evidence of fraud. Further, they might indicate to them that they would not oppose any application for an injunction and might even try their best to bring themselves within the fraud exception.\(^99\) Even if a bank chooses to challenge an injunction,\(^100\) a court should not always find that the balance of convenience lies against giving an injunction. Banks are paid for issuing abstract payment undertakings, they profit by participating in such transactions, and presumably their services are priced in such a manner as to take into account the few instances when an injunction is granted to prevent the beneficiary’s fraud.\(^101\)

The second factor is related to the beneficiary’s solvency. Courts should only intervene where the applicant is unlikely to recover from the beneficiary.\(^102\) If there is

---


\(^{98}\) Jack, R. Documentary Credits, p. 293.


\(^{100}\) See, e.g., Discount Record Ltd v. Barclays Bank Ltd. [1975] 1 Lloyd’s Rep. 444.


\(^{102}\) See, e.g., Themehelp Ltd v. West [1995] 3 W.L.R. 751.
evidence that the beneficiary is solvent and operating in a jurisdiction where recovery is possible, then there should be no reason why courts should interfere and shift both litigation and jurisdictional risks. These risks are part of the reason why beneficiaries agree on payment being made by an abstract payment undertaking. The mere existence of a strong case of fraud should not shift these risks. It is only when the applicant has no chance of recovery that courts should restrain payment.

The third factor is that to restrain a bank operating outside the jurisdiction, a foreign court might not recognise the injunction. Why should courts grant injunctions when it is most likely that such injunctions would be disregarded? In these circumstances, if courts did grant such injunctions, the only consequence resulting from such an attitude would be to “lower the reputation of [English] courts”. The approach is clearly correct.

The fourth factor involves calculating whether the applicant could give a cross-undertaking to pay damages where it is found at the final hearing that the beneficiary was not fraudulent. In these circumstances the damages would be the loss of interest between the time when payment should have been made and the actual hearing. This could amount to a very large figure. If the applicant could not give a cross-undertaking for these damages, the balance of convenience would most likely be against the grant of any injunction.

Finally, English courts are unclear on whether the availability of a freezing injunction should be considered as a factor which would tip the balance against the grant of an interlocutory injunction. In *Themehelp Ltd v. West* (1995) both Balcombe and Waite L.J.J. found that the availability of a *Mareva* injunction (now called freezing injunction) should not lie as a factor against granting an interlocutory injunction. Evans L.J., on the other hand, thought that the availability of such an injunction does not permit granting an interlocutory injunction. Rix J. in *Czarnikow-

---

103 *Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd and Others* [1977] 3 W.L.R. 752, at 763. It is noteworthy that if an injunction is given against a foreign bank and the bank was found to have breached his undertaking in a foreign court, the bank could apply to get the injunction discharged. See *Bourbaud v. Bourbaud* [1864] 10 L.T. 781. Yet, courts would be more reluctant to grant an injunction where there is a real probability that a bank could get caught in the middle due to conflicting judgments.

104 In *Themehelp Ltd v. West* [1995] 3 W.L.R. 751, the ability of the applicant to meet such damages was a factor favouring granting the injunction. At 766.

Rionda also followed this view. It is submitted, however, that this conclusion is undesirable. If there is compelling evidence of fraud, there seems to be no reason why courts should adopt a half-way house and grant an order which would not provide full protection against fraud. The freezing order does not give the plaintiff priority over creditors of the plaintiff. In addition, if the order aims to target assets located outside the jurisdiction, courts have no ready means of enforcing such orders.\textsuperscript{106}

Although Lord Diplock made it clear in the \textit{American Cyanamid}\textsuperscript{107} that the factors that should be taken into account in deciding where the balance lies and their relative weight would vary from case to case, cases concerning an application for an injunction in abstract payment undertaking transactions are almost always similar in facts. Accordingly, courts should develop clear guidelines on what factors are relevant and the weight such factors should be given. The failure to adopt such an approach renders the law governing this area uncertain: an application for an injunction depends ultimately on the judge's personal attitude to this area of law.

\textbf{4.2.4 Reconsidering the cause of action rule}

A case of real relevance here is \textit{Kvaerner John Brown Ltd v. Midland Bank plc} (1998).\textsuperscript{108} In this case the account party was required to provide a demand guarantee.\textsuperscript{109} The guarantee required the beneficiary to give notice of default to the account party at least fourteen days prior to any call on the guarantee. The beneficiary called on the demand stating that he had given such notice when in fact he had not done so. In due course, the account party applied for an injunction. Cresswell J. examined both the underlying transaction and the demand guarantee and concluded that it is: "clearly arguable in the present case that the only realistic inference is that the demand was made fraudulently."\textsuperscript{110} In these circumstances the bank was restrained from making payment. Cresswell J. considered neither the question of balance of convenience, nor the cause of action rule. It is arguable that His Lordship did not consider the issue due to the difficulties discussed above.\textsuperscript{111} Indeed, had he

\begin{itemize}
\item \textsuperscript{106} Mugasha, A. \textit{The Law of Letters of Credit and Bank Guarantees}, pp. 172-173.
\item \textsuperscript{107} [1975] A.C. 396. Considered in section 4.2.3.1.
\item \textsuperscript{108} [1998] C.L.C. 446.
\item \textsuperscript{109} The guarantee was in the form of a standby credit.
\item \textsuperscript{110} At 450.
\item \textsuperscript{111} See section 4.2.3.2.
\end{itemize}
applied the cause of action rule as applied in other cases, it is most likely that he would have concluded that the injunction was not appropriate. This approach, although commendable in that it avoids placing the bank in a difficult position, is nonetheless, unsatisfactory. Cresswell J. did not explain the justifications for not raising the balance of convenience point. It would have been a better approach if he had applied the rule and sought to elaborate on it. He could have stated that the availability of damages against the bank is a theoretical remedy and that banks could not be held to have knowledge of fraud even when it is clearly established. A more satisfactory approach, however, was adopted in *Lorne Stewart Plc v. Hermes Kreditversicherungs AG, Amey Asset Services Ltd* (2001). In this case the account party applied for a demand guarantee to be issued to a beneficiary. Disputes arose in regard to the performance of the underlying contract and the beneficiary called on the guarantee. The account party contested the beneficiary’s right to call upon the guarantee and applied for an injunction to restrain the issuer from making payment. He argued that the demand for payment did not tally with the terms of the guarantee in that it was made out of time. Garland J. had to consider whether (i) an injunction can be given in the absence of fraud; and (ii) if so, does the balance of convenience tip against granting such an injunction? His Lordship found that there is no reason why a court should not grant an injunction where the demand for payment is invalid. Upon construction of the terms of the guarantee, he concluded that it is “strongly arguable” that the demand was indeed made out of time. As to the second point, he found that:

‘the balance of convenience is in favour of preserving the status quo rather than provoking further litigation between [the beneficiary] and [the account party], or [the issuer] and [the beneficiary].’

On this basis the injunction was granted. Although the case concerned the validity of the demand and not fraud, the approach adopted by the court in regard to the balance of convenience point is to be commended. This is not only because it avoids embroiling banks in disputes that concern legal matters, but also because it ensures

---

112 See section 4.2.3.2.
113 [2001] WL 1251939 (only available at Westlaw).
114 See *GKN Contractors Ltd. v. Lloyds Bank Plc And Another* [1985] 30 B.L.R. 48.
115 [2001] WL 1251939 (only available at Westlaw), Para 32.
116 [2001] WL 1251939 (only available at Westlaw), Para 32.
that the degree of abstraction will not vary depending on the party sought to be
injuncted. In *Themehelp Ltd v. West* (1995),\textsuperscript{117} it was suggested that the test of fraud
should be lower in actions where the purpose of the injunction is to restrain the
beneficiary from demanding payment under an abstract payment undertaking, the
argument being that in such circumstances the bank’s position and integrity would not
be affected.\textsuperscript{118} These submissions are untenable as:

> ‘the effect on the life blood of commerce will be precisely the same whether
the bank is restrained from paying or the beneficiary is restrained from asking
for payment.’\textsuperscript{119}

For this reason, the approach adopted in *Themehelp* was strongly criticised in
*Czarnikow-Rionda* and it seems that the case will not be followed. It should be noted,
however, that in cases where an injunction is sought against the beneficiary the
chances of obtaining an injunction are much greater than where an injunction is
sought against the bank. In the former type of action the cause of action for the
injunction would be on a *quia timet* (threatened) basis; the threat that the beneficiary
would call on the demand when it is unlawful for him to do so.\textsuperscript{120} Accordingly, in
such applications, to establish where the balance of convenience lies, courts will not
consider whether the applicant would have a claim of damages against the bank.\textsuperscript{121}
Rather, the test will be whether the applicant has a remedy in damages against the
beneficiary. If it could be shown that the proceeds of the guarantee cannot be
recovered from a fraudulent beneficiary in a subsequent action, it is most likely that a
court will grant an injunction. This test is clearly easier to satisfy than one where an
injunction is sought against the bank: in practice it would be in very rare situations
that the bank would be of doubtful solvency.

\textsuperscript{117} [1995] 3 W.L.R. 751.
\textsuperscript{118} At 771. See also, Thomas, A. ‘Letters of Credit - Injunctions - the Purist & The pragmatist: can a
Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor’ [1999]
\textsuperscript{119} *Groupe Josi Re v. Walboork Insurance* [1996] 1 W.L.R. 1152, at 1161, Staughton L.J.
\textsuperscript{120} Jack, R. *Documentary Credits*, p. 291; Bailey, J. ‘Unconditional Bank Guarantees’ (2003) 20
*I.C.L.R.*, pp. 256-257. Although this point has not been considered in most applications for such
injunctions, in the very few cases where the point was considered, the court was inclined to adopt the
view that a cause of action is not necessary in applications for injunctions in the context of abstract
\textsuperscript{121} See *Groupe Josi Re v. Walboork Insurance* [1996] 1 W.L.R. 1152.
On this basis it is submitted that the approach adopted in *Lorne Stewart* is a step in the right direction. Admittedly, however, the weight of authority suggests that the approach might not be followed. This was especially so when Garland J. did not clarify his position on the traditional phrasing “damages would be an adequate remedy for the applicant”. As examined earlier, in an application for an injunction the court should first consider whether damages are an appropriate remedy for the applicant. Only when they are not found to be so should it examine the other factors which might tip the balance of convenience either in favour of, or against, granting the injunction. Garland J., however, reached his conclusions without examining or satisfying the first requirement. Had the case reached the Court of Appeal, it is questionable whether his analysis would have been affirmed.

The above cases demonstrate the fact that English judges are in disagreement among themselves on how to approach the balance of convenience requirement in relation to the cause of action rule. One can safely assert that the law governing this area is not yet fully developed. New approaches are still plausible. Meanwhile parties that provide abstract payment undertakings remain uncertain as to when an injunction could be granted and in what circumstances they will be protected against fraud. Such uncertainty is harmful to the practice of abstract payment undertakings.

### 4.3 Injunctions against abusive calling

#### 4.3.1 Introduction

If the beneficiary claims payment under a demand guarantee and his conduct, although unjustifiable, falls short of (common law) fraud, the account party will usually have no remedy. Any reference to the account’s party remedy at law is ironic considering the difficulties usually involved in recovering from a bad faith beneficiary located in a foreign country. Further, the issue at point is not the position of a certain account party in a certain case. Rather, the issue concerns mercantile perceptions of the instrument in a certain jurisdiction. If courts shape the law on a certain instrument making it too favourable to one party, then the other party would refrain from utilising such an instrument. Indeed, it has been suggested that English suppliers engaged in

---

122 See sections 4.2.3.1 and 4.2.3.2.
building and engineering projects use demand guarantees less frequently than suppliers in other jurisdictions. It has also been suggested that this is mainly due to the fact that:

"The perception in England seems to be that unconditional bank guarantees are open to abuse by principals."\(^{123}\)

A point rarely emphasised is the hidden cost of an abusive call on the demand guarantee. Over and above the actual financial loss which the account party incurs, an abusive call would almost certainly damage his reputation. He thus might find it difficult to obtain demand guarantees in the future. Even if a guarantee is obtained, it will usually be for a more expensive price.\(^{124}\) More serious, however, the account party might find it more difficult to obtain contracts in the future. One commentator suggests that it is "relatively common" for contractors to require the account party to disclose any previous occasion where there had been a demand guarantee called against them.\(^{125}\) In a jurisdiction where account parties are not protected against such risks, it is understandable why guarantees become less attractive. To maintain the place of demand guarantees in the English market, and to reflect both parties' expectations under the instrument, reform is required.

Other jurisdictions have applied different approaches to tackling the problem of abusive calling. Some have adopted defences other than fraud. Others have sought to broaden the exception itself. The approaches are considered below. Once there is a clear understanding of these approaches, one can proceed to examine the most pragmatic approach that English law might adopt to combat abusive calling.

### 4.3.2 Approaches taken by other jurisdictions

#### 4.3.2.1 Abuse of rights: a civil law defence

Realising the difficulty in proving fraud, especially at an injunction stage, civil law countries have been of the view that payment on a demand guarantee should be restrained where such a demand constitutes an "abuse of rights". Although some commentators have tended to use the terms "fraud" and "abuse of rights" as

\(^{124}\) Ibid., p. 260.
\(^{125}\) Ibid.
interchangeable,\textsuperscript{126} in both France and Germany “abuse of rights” is considered a separate exception through which payment under the guarantee could be restrained.\textsuperscript{127} The doctrine finds its origin in property law.\textsuperscript{128} It was brought into being at the end of the nineteenth century by French jurists who were the first to develop the theory underlying the concept. The idea behind it was that a person cannot exercise his rights in any manner he sees appropriate. Rather, the view developed that any exercise of rights which is contrary to the social functions of these rights is abusive and accordingly should be subject to sanctions.\textsuperscript{129} The classical example of abuse of rights is the case where a property owner who - simply in order to deprive his neighbour’s house of light - builds a false chimney on his building. Such a conduct was seen by French courts as going against normal principles of morality and fairness, and was thus held to be unlawful.\textsuperscript{130} This idea of confining the exercise of rights to reflect reasonable moral principles soon gained acceptance in most areas of civil law.\textsuperscript{131} Thus, in modern French and German legal theory the concept of abuse of rights is applied in notably (but by no means exclusively), family law, labour law, contract law and commercial law.\textsuperscript{132} As abstract payment undertakings are part of general commercial law, abuse of rights has developed as a defence which could restrain payment under such undertakings.

Broadly speaking, civil law courts have developed three different views on the requirements necessary to establish an abuse of rights. A person holding a legal right may abuse it if he has (i) “committed a ‘fault in exercise of the right’”\textsuperscript{133}; (ii) practiced his right in a manner contrary to its social purpose; (iii) possessed an


\textsuperscript{127} Schwank, F. ‘Bank Guarantees in an International Context’ (1984) 3 Int. B.L., pp. 92-93. However, it should be noted that the “abuse of rights” defence is available in most civil law countries, see Schwank, F. ‘New Trends in International Bank Guarantees’ (1987) 3 Int. B.L., pp. 38-39.


\textsuperscript{131} In Germany the defence is part of the general principle of good faith. Provision 242 of the BGB stipulates for a duty of good faith. However, there is no provision in the BGB or the French Civil Code which addresses ‘abuse of rights’. See Zimmermann, R. & Whittaker, S. Good Faith in European Contract Law (Cambridge, 2000), pp. 23-25.


intention to harm another person. In relation to abstract payment undertakings, the second view has been applied to establish the existence of an abuse. Under this view, as it is clear that in demand guarantee transactions, “the guarantee cannot exist without the main contract”, a German or a French court will accordingly investigate the underlying contract to establish whether indeed a call on the guarantee by the beneficiary is justified. If it is clear that the call is unjustifiable then the beneficiary’s right to call on the guarantee could not be said to reflect the social purpose of the guarantee and courts will restrain payment. Thus, to determine whether the exercise of a given right (whether ensuing from an abstract payment or any other area of law) accords with its social purpose, courts will ask for what purpose was the right in question recognised by law. If the exercise of the right collides with its intended purpose, it is more likely to be abusive.

The concept of abuse of rights in modern legal theory does not merely examine the moral values of a certain jurisdiction but rather seeks to give courts the power to apply the rules of equity in certain situations. This is necessary especially if existing legal doctrines could not achieve justice in such situations. Unlike the fraud exception, the elements of abuse of rights do not require the establishment of any kind of intent on part of the beneficiary. Nor do they examine his state of mind. Rather, courts seek to apply an objective test to determine the existence of an abuse. They do not focus their attention on the conduct of the beneficiary and his state of mind. Rather, the focus is on the beneficiary’s act and its consequences. In the given circumstances, is the act excessive? Should the court sanction such conduct? These are the questions the judges ask themselves when deciding whether an act amounts to an abuse of rights. The German Supreme Court stated on one occasion:

---

138 See Voyame, J., Supra note 129, p. 31; Bertrams, R. Bank Guarantees in International Trade, pp. 260-264.
'If the substantive contingency in the underlying transaction has not materialised, the demand for payment is unsuccessful because of the defence of abuse of rights.'

No reference is found to the beneficiary's state of mind. French courts have applied the same approach. This test leads to the conclusion that there are no general rules as to what constitute an abuse of rights, rather the issue could be determined only by examining the facts of each individual case. What is notable, however, about the approaches in both Germany and France is the fact that the demand guarantee is to some extent ancillary to the underlying contract. Such an approach, if applied too loosely would result in the demand guarantee becoming indistinguishable from ordinary surety guarantees. To avoid such shortcomings, courts have required that the abuse of rights be "obvious" and "irrefutably proven". The notion "obvious" requires that the abuse of right to be clear to everyone; "irrefutably proven" requires strong evidence of abuse. Thus, unlike the usual procedural requirements for cases on the merits, proof usually has to be provided by documentary evidence. Evidence provided through affidavit or the testimony of witnesses will be insufficient to establish abuse. However, the better view is that as long as abuse of right is "clear" and there is no ground to suspect this fact the court should restrain payment even if documentary evidence is not available.

Consequently, the situations where German and French courts have found an abuse of rights include: frustration of the underlying contract; where the underlying

---

140 Bertrams, R. Bank Guarantees in International Trade, p. 263.
contract is illegal; where the fulfilment of the underlying contract has been prevented by the conduct of the beneficiary.\textsuperscript{147}

It should be said that abuse of rights (especially in Germany) is part of the wider concept of “good faith”.\textsuperscript{148} In English law, as will be examined below, the approach of introducing such concepts into commercial law is questionable as the general perception is that such concepts are incompatible with the certainty required in commercial transactions.\textsuperscript{149}

\textbf{4.3.2.2 Equitable fraud: an American defence}

Much of the literature on the problem of abusive calling is American. The fact that demand guarantees have been used extensively in the US domestic market has resulted in an overwhelming number of reported cases on the subject. Commentators have advocated two different views on the issue. The dominant view calls for a strict application of the fraud defence and rejects any suggestion of a distinction between documentary credits and demand guarantees. This is necessary to maintain the allocation of risks between the parties and reflect their bargains. Furthermore, adopting such an approach ensures the effectiveness of abstract payment undertakings.\textsuperscript{150} The other view calls for a distinction to be made between documentary credits and demand guarantees. In the latter instrument the test of fraud should be broader. This is necessary as both the purposes for utilising the instruments and the expectations of the parties are different.\textsuperscript{151}

Generally speaking, for the purposes of applying the fraud exception, both pre-revised Article 5 of the U.C.C. and American courts have not drawn any clear distinction between documentary credit and demand guarantee transactions. Courts

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{147} Bertrams, R. \textit{Bank Guarantees in International Trade}, pp. 259-263; Schwank, F. ‘Bank Guarantees in German and Austrian Law’ (1982) \textit{1 Int. B.L.} p. 7.
\item \textsuperscript{148} Zimmermann, R. & Whittaker, S. \textit{Good Faith in European Contract Law}, pp. 23-25
\item \textsuperscript{149} See section 4.3.3.
\end{itemize}
\end{footnotesize}
have developed three different tests of fraud: intentional fraud, egregious fraud and constructive fraud. The most widely adopted tests are the intentional and egregious fraud tests. The tests are said to be indistinguishable. Accordingly, in relation to both documentary credits and demand guarantees, where a plaintiff alleges that fraud exists in the underlying transaction, courts have been ready to restrain payment where the wrongdoing of the beneficiary “has...vitiated the entire transaction”. Under such a test an intention to deceive or defraud on part of the beneficiary has been said to be necessary to grant an injunction.

Realising that this approach could not tackle the problem of abusive calling, American courts have also developed the constructive fraud test. Under this test, the requirement of establishing an intention to defraud has not been adhered to. Rather, the court would examine the acts of the beneficiary and their consequences. If it is clear on the facts of the case that the call on the demand has no conceivable basis, then an injunction would be granted. In Dynamics Corporation of America v. Citizens and Southern National Bank (1973) the plaintiff (DCA) entered into a contract to manufacture and sell military equipment to the President of India (India). Pursuant to the contract, the plaintiff agreed to have the defendant bank issue standby credits by which the issuer promised to pay against a certificate that stated that DCA had defaulted in performing the underlying contract. On performance of the contract, war broke out between India and Pakistan. The US government announced an embargo of military supplies to India. This made the fulfilment of the underlying contract impossible. India nonetheless tendered the required documents demanding payment. DCA sought an injunction to enjoin the defendant bank from payment. The court, in granting the injunction, held:

'[I]n a suit for equitable relief...it is not necessary that plaintiff establish all the elements of actionable fraud required in a suit for monetary damages...Fraud has broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element. Fraud, indeed, in the

---


118
sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence.'\textsuperscript{156}

It was added:

'The court views its task in this case as merely guaranteeing that India not be allowed to take unconscientious advantage of the situation and run off with the plaintiff’s money on a pro forma declaration \textit{which has absolutely no basis in fact}.\textsuperscript{157}

American courts thus seek to tackle the problem of abusive calling by expanding the definition of fraud. Fraud in such transactions does not involve the establishment of the common law requirement of intent. Nor does it examine the beneficiary’s state of mind. Rather, it seems to resemble the civil law elements of “abuse of rights” where the focus is on the act itself. The outcome of such an approach, although commendable as it achieves justice, is nonetheless problematic. As American courts do not distinguish between documentary credits and demand guarantees, it became less clear when the courts could apply such a test. This has resulted in uncertainty: could the test apply to documentary credit cases? If so, when would a court apply the “egregious fraud” test, and when should it apply the “constructive fraud” test? When applying the “egregious fraud” test, is it still necessary to establish intentional fraud in order for a court to grant an injunction?

The lack of consistency in this area threatened the whole foundation of the instruments.\textsuperscript{158} Beneficiaries could no more rely on the certainty that the instruments provided and in some cases it seemed that ordinary breaches in the underlying contract would defeat their right to receive payment.\textsuperscript{159} Such concerns were noted by the task force which was formed to study the case law and make recommendations for the revision of pre-revised U.C.C. Article 5.

\textsuperscript{156} At 998-999 (emphasis added).
\textsuperscript{157} At 999 (emphasis added).
The task force recommended that for the purposes of applying the fraud exception, a distinction should be made between cases concerning documentary credits and cases relating to demand guarantees. For documentary credits, fraud in the transaction should apply where "the purpose of the underlying transaction must be rendered virtually without value". For demand guarantees, the question should be "whether the drawing has occurred with no colorable basis whatsoever". Although Revised Article 5 did not explicitly distinguish between the two instruments for the purposes of applying the fraud exception, the approach it adopted seeks to echo the above recommendations. In fact, the Official Comments on the Article have indeed distinguished between the two instruments. Revised Article 5, Section 109 requires that the fraud should be "material" for a court to grant an injunction. The Official Comment on Section 109 suggests that materiality in relation to documentary credits could only occur in cases where the beneficiary ships worthless goods. Fraudulent intention is not a necessary requirement to establish fraud.

In relation to demand guarantees however, the Comment quotes the same test as that applied in Dynamics Corporation. Thus, a call on the guarantee would be fraudulent where such a call "has absolutely no basis in fact". In these circumstances a court would grant an injunction without the requirement of establishing a fraudulent intent on part of the beneficiary. The legislator thus clarified that the test of "constructive fraud" or -- as some would call it -- "equitable fraud", should apply in relation to demand guarantees in those extreme circumstances where the beneficiary has no basis whatsoever for demanding payment.

---

161 Ibid., p. 1615.
162 Article 5 U.C.C.
163 See Official Comment to Article 5 U.C.C. Para. 2.
165 Official Comment to Article 5 U.C.C. Para. 3.
The approach is commendable and could by no means upset the abstraction principle. Strong evidence of abuse is required to restrain payment.\(^{168}\) And even with the availability of such evidence, the beneficiary can enforce payment if he shows some basis for his claim.\(^{169}\) Accordingly, a court will infer fraud only in rare cases where it is clearly established that the demand is unjustifiable. The test balances both parties’ interests under the instrument: an account party agreeing to provide a demand guarantee knows that he is protected against any abuse of the instrument. The beneficiary, on the other hand, knows that he has an assured right to receive payment. This right could only be defeated in the most extraordinary circumstances, where he is not using the instrument for its intended purpose.

American jurisprudence has thus developed a clear understanding of both the abstraction principle and the fraud defence. The principle will be defeated where:

‘[T]he legitimate purposes of the independence of the issuer’s undertaking would no longer be served.’\(^{170}\)

In relation to fraud, on the other hand, there has been no immediate transplant of “common law fraud” to the law on abstract payment undertakings. Rather, it has been recognised that the existing definition of fraud could not be strictly applied to fit these specialised financial instruments. Accordingly, fraud had to be reformed to give effect to the parties’ expectations and risk allocations under the instruments. Hence, while, in theory, English courts have recognised the same fraud exception that the American courts have recognised, the American conception of fraud has been broadened to the degree that abuse or sharp practice under demand guarantees can be prevented.

4.3.3 “Good faith” as a potential defence against abusive calling

To date, English courts have rejected any approach which calls for distinguishing between demand guarantees and documentary credits where fraud is alleged.\(^{171}\) Furthermore, they are adamant that what constitutes fraud in the instruments is

---

\(^{168}\) See generally Dolan, J. The Law of Letters of Credit: Commercial and Standby Credit, Para 7-67


\(^{170}\) *Ground Air Transfer v. Westates Airline* 899 F.2d, 1272(1990). This statement has been quoted in Official Comment to Article 5 U.C.C. Para. 3.

\(^{171}\) See Chapter 2.
common law fraud. As examined elsewhere, this approach – particularly in demand guarantees – results in the instrument being open to abuse and ultimately being less attractive to account parties. To avoid the drawbacks of their approach, and to assure account parties that English law provides the same degree of protection that other jurisdictions provide, they seem to have embraced the principle of good faith.

The principle of good faith, although of limited application, is indisputably part of English law. As early as 1766, Lord Mansfield stated that good faith “is applicable to all contracts and dealings”. English law has not yet developed a clear understanding of any general principle of good faith in contracts; however, the UK has implemented European Union directives and regulations, some of which have a duty of good faith. The European Directive on Unfair Terms in Consumer Contracts Regulations imposes a duty of good faith on particular parties. Goode argues that once courts get used to handling good faith in consumer contracts, “they may find that they can live with it after all”. It is further suggested that the principle could find a place in the law that governs abstract payment undertakings. In fact, there has been reference to the principle in three cases concerning payment under demand guarantees. In Dodsal PVT Ltd v. Kingpull Ltd (1985), the account party sought to restrain payment, alleging fraud by the beneficiary. The court found insufficient evidence of such fraud. Nonetheless, Neill L.J. observed:

‘[T]he cases show that in the absence of bad faith the bond or guarantee will be enforced.’

Similarly, in Cargill International v. Bangladesh Sugar and Food Industries Corp (1998), the account party applied for an injunction to restrain a call on a demand guarantee. The account party argued that although it had defaulted in its performance, its act did not result in the beneficiary losing any money. Thus, the beneficiary was

---

175 Bailey, J. ‘Unconditional Bank Guarantees’ (2003) 20 I.C.L.R., p. 273. It should be noted, that the UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit, includes many provisions that refer to the principle of good faith. See Article 19 paragraph (2)(b) & (2)(c).
177 [1985] (unreported available at Lexis-Nexis).
not entitled to claim payment under the guarantee. Morison J., in refusing to grant an injunction, said:

'The Court will not grant an injunction in either case unless there has been a lack of good faith.'179

Although the facts of both cases suggest that the courts have used the term good faith to mean dishonest conduct,180 Thornton J. reached a different conclusion in TTI Team Telecom International Ltd and another v Hutchison 3G UK Ltd (2002).181 In this case the beneficiary threatened to call on a demand guarantee. The account party disputed his right to do so and applied for an injunction to restrain the beneficiary from demanding payment. Thornton J. cited the above statements made in Cargill International. He concluded that the “current” approach of English courts to applications for injunctions to restrain beneficiaries from calling on the guarantee requires the investigation of whether the beneficiary acted in good faith.182 Relying on an obiter statement in Elian & Rabbath v. Matsas & Matsas (1966)183 he concluded that “lack of faith has for a long time provided a basis to restrain a beneficiary from calling a bond or guarantee.”184 Further in his judgment, he states that the court will grant an injunction where “the beneficiary has acted so unfairly or with conduct that is so reprehensible or lacking in good faith that a Court of conscience would either restrain or refuse to assist the party in question”.185 He further concluded that decisions in “England, Australia, Singapore and Malaysia”186 suggest that a breach of faith can arise in the following situations:

'[A] failure by the beneficiary to provide an essential element of the underlying contract on which the bond depends; a misuse by the beneficiary of the guarantee by failing to act in accordance with the purpose for which it was given; a total failure of consideration in the underlying contract; a threatened call by the beneficiary for an unconscionable ulterior motive; or a lack of an honest or bona fide belief by the beneficiary that the circumstances, such as

180 However, O’Driscoll suggests that it is possible to argue that the statements in Dodsal could indicate a lesser standard of fraud. O’Driscoll, P. ‘Performance Bonds, Bankers’ Guarantees, and the Mareva Injunction’ (1985) 7 N.W. J. Int’l. L. & Bus., p. 386.
181 [2003] 1 All E.R. (Comm) 914.
182 At 927-929.
183 [1966] 2 Lloyd’s Rep. 495. See section 4.3.4 for further analysis of this case.
185 At 927-928.
186 At 928.
poor performance, against which a performance bond has been provided, actually exist.\textsuperscript{187}

Upon examination of the facts of the case, Thornton J. concluded that the beneficiary did not act in breach of good faith and accordingly an injunction was not granted. To examine the merits of this approach, it is necessary to examine the wider debate concerning the application of good faith to contract law generally.

Supporters of the principle of good faith argue that English law should embrace it for four reasons. First, it creates a cause of action where a cause of action would not otherwise exist.\textsuperscript{188} In other words, it gives courts the power to achieve justice where existing legal principles could not achieve it. Allied to this is the argument that good faith would allow the purposes and values underlying the law to be clearly identified, without there being any fictionalisation of existing legal concepts and rules.\textsuperscript{189} Clarity in law would thus be sustained for future cases. Third, a general concept of good faith would assure that the expectations of the parties in a given transaction would be maintained. Accordingly, the law would give effect to the spirit of the agreement between the parties.\textsuperscript{190} Finally, and perhaps most importantly for the commercial community, is the argument that if good faith is adopted, it will provide to contracting parties greater security. Bad faith conduct would be deterred and this will ultimately enhance trust between traders themselves and trust in the legal system itself. These are the ingredients and features of any successful economy.\textsuperscript{191}

While all the above arguments lend support to embracing good faith as part of English contract law, they oversimplify legal reality. There are real problems attached to the principle and strong policy reasons behind the English tradition of rejecting it. Mainly, the principle is too vague. Good faith “means different things to different

\textsuperscript{187} At 930.
people in different moods at different times and in different places”. Others would argue that the principle maintains reasonable expectations. Thus, it is concerned with “making parties live up to the actual standards of the contracting community of which they are members”. A third interpretation of the principle is that it means honesty. Finally, the principle could be viewed as a combination of all three interpretations. As the principle is not clear, introducing a general principle of good faith to English law would almost certainly breed unpredictability in commercial dealings. Even if one of the above definitions is agreed upon, many uneasy questions will still need to be addressed. As to the first meaning: how could fair dealing be interpreted? To what extent should it be allowed to override the parties’ autonomy? Are there any clear boundaries between what is fair and what is not in the commercial context? In addition, such an interpretation of good faith should be rejected on the simple ground that commercial transactions have to do with hard-headed bargains, not with what would be considered as fair to other parties. Most of these arguments could also be forwarded to reject the reasonable expectation version of good faith. As to the view that good faith could mean honesty, such an interpretation is also troublesome. English law already applies other doctrines to ensure honest practice among contracting parties. These include: fraud, duress, undue influence, etc. The idea that good faith should enhance honest values beyond their existing framework is questionable.

Bridge has correctly pointed out that this approach would be no less than promoting uncertainty among traders as it would still remain unclear how (new) honest values can be determined in a given contractual community? Even more difficult, how could a relevant community be determined? To sum up, good faith is:

---

195 O’Conner, J. Good Faith in English Law (Dartmouth, 1990), p. 99.
196 Ackner L.J. has made this point clear in Walford v. Miles [1992] 2 A.C. 128.
198 Ibid., p. 142.
'Too vague and insufficiently sensitive to different contexts. Different writers entertained very different views about the meaning and potential of good faith. Good faith [gives] too much power to the individual judge freed from the disciplined traditions of contract law.\textsuperscript{199}

This conclusion becomes even more appealing if the contractual context under consideration is an abstract payment undertaking.\textsuperscript{200} The approach adopted by Thornton J. in \textit{TITI Team Telecom} will undoubtedly breed uncertainty. When is it that the beneficiary can be said to have acted unfairly, unconscionably or reprehensibly to the degree that an injunction should be granted?\textsuperscript{201} Could "sharp practice" as in the instance demonstrated in \textit{Edward Owen} amount to any of these concepts? Such concepts evade any clear legal definition and, if indeed introduced to the law governing demand guarantees, would undermine the certainty that the beneficiary enjoys. It is submitted that demand guarantees developed to ensure that parties must abide by the deal they have reached. This simply means that an account party's remedy for any unfair practice by the beneficiary should lie in an action on the underlying contract. Otherwise the risk allocations agreed upon by the parties will be shifted. While preventing abuse of demand guarantees is desirable, it requires adopting an approach which is clear, reflects the parties' intentions, and permits courts to intervene only to reflect such intentions. This requires a clear framework of law without there being the fear that the payment would be restrained only because a certain judge in an individual case regards his approach as achieving justice.

Unfortunately, under English law, good faith as a principle has yet to provide any predictable outcome in general contract law. It is thus questionable whether it can do so in the law of abstract payment undertakings.

\textbf{4.3.4 A lesser abstraction principle: an English approach}

Although it is often said that courts would not intervene by way of injunction unless fraud exists in a demand guarantee transaction, there have been many cases where it was suggested that an unjustified call on a guarantee could be a ground for granting

\textsuperscript{199} \textit{Ibid.}, p. 140.
an injunction, notwithstanding the absence of fraud. The earliest indication was made in *Elian & Rabbath v. Matsas & Matsas* (1966). The shipowners shipped goods to the buyers. When the ship reached its destination, there was delay in unloading, and the shipowners claimed a lien on the goods for demurrage. The shippers were not liable to pay demurrage but they wanted the goods released to maintain good relations with their buyers. The parties agreed that the lien would be lifted if the shippers provided a demand guarantee for the benefit of the shipowners. In a telex message sent by the shippers, it was stated “we will give a bank guarantee if you will release the lien and instruct the Captain not to exercise a lien on the cargo”. In due course a demand guarantee was issued to this effect. The shipowners lifted the lien in respect of the demurrage but immediately exercised a further lien over the goods for a different purpose. In order to get the goods released from this subsequent lien, the buyers had to pay a considerable sum. Notwithstanding these facts the shipowners still wanted to demand payment under the guarantee. The shippers applied for an injunction restraining the beneficiaries from claiming or receiving payment. Lord Denning M.R. found that although the “bank guarantee is very much like a letter of credit” and “courts will do their utmost to enforce it according to its terms”, this was “a special case in which an injunction should be granted”. This was because the beneficiary’s acts amounted to “a breach of their promise, express or implied, to release the goods”. On this basis Lord Denning M.R. added:

> ‘There is *prima facie* ground for saying that, on the telex messages which passed (and I would add, on the first three lines of the guarantee) the shipowners promised that, if the bank guarantee was given, they would release the goods. I know that the only lien they had in mind at that time was the lien for demurrage. But would anyone suppose that the goods would be held for another lien? It can well be argued that the guarantee was given on the understanding that the lien was raised and no further lien imposed: and that when the shipowners, in breach of that understanding, imposed a further lien, they were disabled from acting on the guarantee. In these circumstances I think an injunction should be granted.’

---

203 At 496.
204 At 497.
205 At 497.
206 At 497.
207 At 497.
208 At 497.
It is clear that Lord Denning M.R. applied a lesser abstraction principle: he was of the view that if an express or implied condition of the underlying agreement was not fulfilled by the beneficiary, his right to receive payment could be defeated. Support for this approach, albeit obiter, is found in many other cases. In *Bache & Co. v. Banque Vernes* (1973), the court was considering the enforceability of a demand guarantee. The guarantee contained a conclusive evidence clause, meaning that the call on the demand would be conclusive evidence of the account party’s default. Megaw L.J. found that the guarantee could be called upon unless:

‘[T]he defendant bank showed fraud on the part of the [beneficiary] or if it showed a mistake on the face of the notice of default.’

As there was “no suggestion of any mistake on the notice of default” the guarantee was enforced. These statements were followed by the dictum of Eveleigh L.J. in *Potton Homes Ltd v. Coleman Contractors Ltd.* (1984). Here it was disputed whether the beneficiary could call on the demand guarantee. The account party applied for an injunction to restrain the beneficiary from doing so. Eveleigh L.J. considered the extent to which the guarantee is to be regarded as abstract from the underlying sale contract. One notable aspect of His Lordship’s approach was to draw a line between documentary credit transactions and demand guarantee transactions:

‘Unlike the letter of credit, the bond is in its infancy, although it is developing rapidly. There are several features of the bond which have not yet been universally established. One is the extent to which it is to be regarded as independent of the underlying contract.’

His Lordship then added:

‘As between buyer and seller the underlying contract cannot be disregarded so readily. If the seller has lawfully avoided the contract *prima facie*, it seems to me he should be entitled to restrain the buyer from making use of the performance bond. Moreover, in principle I do not think it possible to say that in no circumstances whatsoever, apart from fraud, will the court restrain the

---

209 Danckwerts L.J. found that although the shipowners might be entitled to immediately exercise a different lien, their act would amount to ‘at least a breach of faith’, at. 498.


211 At 440.

212 At 440.


214 At 26.
buyer. The facts of each case must be considered. If the contract is avoided or if there is a failure of consideration between buyer and seller for which the seller undertook to procure the issue of the performance bond, I do not see why, as between seller and buyer, the seller should not be unable to prevent a call upon the bond by the mere assertion that the bond is to be treated as cash in hand.\textsuperscript{215}

Although an injunction was not given as there was no total failure of consideration, the dictum established in the case "deserves serious consideration."\textsuperscript{216} Eveleigh L.J. recognised two practical points in relation to demand guarantee transactions. First, the fraud exception itself is incapable of providing justice where the instrument is abused. Rather, the better test would be to examine the intentions of the parties in the underlying transaction and accordingly decide whether a call on the demand is justifiable. Secondly, His Lordship drew a clear distinction between two different and often overlapping levels of abstraction: banks are not concerned with any disputes relating to the underlying contract, while courts, on the other hand, should interfere where there is clear evidence of injustice or total failure of consideration. The distinction between elective dishonour (that effected by the bank's discretion) and injunctive dishonour (that effected by a court order) is an area that has remained underdeveloped in English jurisprudence. It has been suggested that the approach, which requires courts to intervene in only those rare cases where fraud is clearly established, is necessary to protect banks: it relieves banks from any difficulty as they know that it is only in cases of clear fraud that they should reject payment.\textsuperscript{217} However, it is difficult to agree with these conclusions. An injunctive dishonour "does not embroil the bank in the dispute between other parties."\textsuperscript{218} In other words, the courts' intervention by way of injunction does not impose any duty on banks (in future transactions) to reject a claim for payment if such claim could be said to be abusive. Yet, admittedly, the authorities are not clear on this point. In \textsl{GKN Contractors Ltd. v. Lloyds Bank Plc and Another} (1985),\textsuperscript{219} for example, although Parker L.J. found no fraud in the case, he stated:

\begin{flushright}
\textsuperscript{215} [1984] 28 B.L.R. 19, at 28.
\textsuperscript{218} Ellinger, P. "Fraud in Documentary Credit Transactions" [1981] \textsl{J.B.L.}, p. 265
\textsuperscript{219} [1985] 30 B.L.R. 48.
\end{flushright}
‘There can, however, clearly be cases where, albeit the ultimate beneficiary was not fraudulent, the bank itself may have been fraudulent. The claim presented by the ultimate beneficiary may have been presented in good faith and honesty albeit owing to some mistake was an invalid claim...if [the] bank were to pass on the claim as a valid claim and demand payment, it would be guilty of fraud which would justify non-payment of the demand, notwithstanding that the demand on its face appeared to be valid.’

Parker L.J. did not clarify the circumstances in which a demand — although complying on its face — might be held as invalid. However, it seems that the most reasonable case would be where a beneficiary mistakenly demands payment believing that he is entitled to do so, where in fact he is not entitled to do so. The reason being, that contrary to the beneficiary’s belief, the account party did not actually default in performing the underlying transaction. Although it seems that he agrees with Eveleigh L.J.’s dictum in that the wording and purpose of the guarantee could allow payment to be restrained notwithstanding the absence of fraud, the two judges have applied two different approaches. In Potton Homes the dictum established by Eveleigh L.J. was that the bank should not be concerned in any dispute regarding the underlying transaction, whereas the court — in appropriate circumstances — can intervene by way of injunction. In GKN Parker L.J. found the bank should reject payment where the demand is invalid due to the mistake of the beneficiary. The bank thus could be held liable if it elects to pay in cases of an invalid call on the demand notwithstanding the fact that the call complied on its face.

Future refinements are necessary, case law having failed to at least sketch an outline of a standard approach to this complex area of law. Recently, however, the above points have been subjected to thorough examination. In Sirius International Insurance Corporation (Publ) v. FAI General Insurance Co. Ltd. (2003), the court was called to consider many issues relating to a reinsurance agreement. One of the points considered, was whether a beneficiary can claim payment under a demand guarantee without fulfilling particular conditions agreed upon in the underlying

---

220 At 63.
223 Although the abstract instrument in question was referred to as a documentary credit, it nonetheless, resembled the features of a demand guarantee. In fact, no commercial documents were required to trigger payment; rather, payment was triggered by the beneficiary’s simple demand.
transaction. The beneficiary argued that the principle of abstraction as established in *The American Accord* and the UCP provides that any dispute in relation to the underlying contract should be irrelevant to the bank’s liability in making payment. Further, abstract payments undertakings operate under the well-accepted maxim “pay now, argue later”. Accordingly, the demand guarantee in the case should be treated as cash in hand.224 Jacob J. rejected these submissions. He stated:

> ‘Whilst I accept [the beneficiary’s] submission that the principle of autonomy is of vital importance, I cannot see that it is undermined in the very special case where a party expressly agrees not to draw down unless certain conditions are met...Cash, like a letter of credit, is autonomous, perhaps even more so, but people can agree not to touch identified pots of it, if that is what they want to do. If such an agreement is made, there is no reason why the law should not enforce it.’225

Although judgment was given to beneficiary as Jacob J. found that upon the facts of the case it had claimed payment properly and in accordance with the conditions stated in the underlying contract, the above statements indicate that courts will recognise exceptions other than fraud when examining a demand for payment under a demand guarantee. On appeal, May L.J. endorsed Jacob J.‘s general approach. However, after examining the underlying agreement His Lordship held that Jacob J. was mistaken to conclude that the beneficiary was entitled to demand payment. May L.J. stated:

> ‘The terms include express contractual restrictions on the circumstances in which [the beneficiary] would be entitled to draw on the letter of credit. To that extent the letter of credit was less than equivalent of cash...Although [the] restrictions were not terms of the letter of credit, and although the bank would have been obliged and entitled to honour a request to pay which fulfilled its terms, that does not mean that, as between themselves [account party], [beneficiary] were entitled to draw on the letter of credit if the express conditions of this underlying agreement were not fulfilled. They were not so entitled.'226

On the question of whether the court would have adopted the same approach had the case been an application for an injunction, May L.J. said:

225 At 93, 94.
226 [2003] 1 W.L.R. 2214, at 2226 (emphasis added).
I should add that, had it been necessary to do so, I should have been very
strongly inclined to agree with the judge's implicit finding that, had the
question arisen out the facts in the present case, the court would have granted
an injunction restraining [the beneficiary] from drawing on the letter of credit
in breach of [the] conditions.227

The judgment is welcome as it is clearly in line with both Potton Homes and Elian &
Rabboth. It shows that there is a strong view among judges that courts should be more
ready to examine the underlying transaction between the parties as this is necessary to
prevent any abuse of the instrument. The approach established in the case is clear:
when parties agree that a call on the guarantee should be made only after certain
conditions have been fulfilled, courts will interfere by way of injunction if the
beneficiary demands payment prior to the fulfilment of these conditions. Intervention
on this basis will not undermine the efficiency of the instrument; on the contrary, such
intervention is necessary to safeguard the commercial reliability of the instrument and
give effect to the intentions of the parties. Furthermore, May L.J. made it clear that,
had the bank made payment, it would have been protected as it is obliged to effect
payment where no fraud is involved. Nonetheless, he correctly observed that this
should not militate against the court's duty to intervene by way of injunction. This
variable approach in applying the abstraction principle is the key to maintaining the
efficiency of abstract payment undertakings without any severe infringement of the
abstraction principle. Put simply, banks' duties should be limited to examining the
documents tendered under an abstract payment instrument when deciding whether to
make payment; courts, on the other hand, should investigate the whole transaction to
determine whether the beneficiary's claim for payment is justifiable.

It should be noted, however, that although this lesser abstraction approach was
stated in Elian & Rabboth, Potton Homes and Sirius, each court had its own
perception of the approach. In Elian & Rabboth, Lord Denning M.R. granted the
injunction because the beneficiary breached an underlying promise. His Lordship was
unclear whether this was an express or implied promise. He indicated that as long as
the parties' intentions could be clearly established, this point was trivial. However, the
facts of the case suggest that it is most likely that the promise was an express one.228

Although the case suggest that it is most likely that the promise was an express one.

227 At 2226.
“achieving justice in ‘hard cases’” in English law, there are difficulties in implying terms into demand guarantee transactions. The most formidable is the fact that a term could not be implied if it conflicts with the express terms of the contract. Accordingly, if the account party and the beneficiary agree that the guarantee is on demand, it would be very difficult indeed to see how a court could in certain situations imply any term into the underlying agreement. The better view must be that courts are only allowed to intervene where it is clear that the beneficiary had not fulfilled an express condition in the underlying agreement.

In *Potton Homes*, Eveleigh L.J. suggested that a lesser independence approach could defeat the beneficiary’s right to receive payment where there is “total failure of consideration” or where “the contract is avoided”. This approach is open to the same criticism as that of Thornton J. in *TTI Team Telecom*; the approach goes too far. Parties engaging in demand guarantee transactions are usually large entities that employ counsels which can evaluate and respond to any risks such as those expressed by Eveleigh L.J. While one would accept that a court should intervene and prevent payment where such entities have explicitly included a term in the underlying contract that could protect them against such risks, to argue that such protection should be extended to risks that they have not bargained for is untenable. Courts do not, and should not, make contracts for parties, especially if the contract in question is an abstract payment undertaking. In addition, what is “total failure of consideration”? When could a contract be said to have been avoided? Does this defence include political risks? Both defences are too vague, very wide and if recognised would

---

231 See, e.g., *State Trading Corporation of India Ltd v. ED & F Man (Sugar) Ltd & Another* [1981] Com. L.R. 235, where Lord Denning M.R. seems to have departed from his earlier view. Here, he rejected any approach which calls for implying terms in the underlying transaction as it would ‘strike the efficacy of the performance bond’.
233 See section 4.3.3.
234 Recently, however, Clarke has suggested that in *Marinteknik Shipbuilders (S) Pte Ltd v. SNC Passion and Sarl Transport Maritime Bruder Frères (The Passion)* [2005] (unreported), an injunction has been granted to restrain the beneficiary from calling on a demand guarantee, where the underlying contract has been frustrated. It is questionable, however, whether the case indeed involved a demand guarantee. Clarke in his comment on the case has stated that the guarantee in question was issued as: ‘a payment as security for a claim under the underlying agreement’. Such an instrument relates to the underlying transaction and cannot be an “on-demand” guarantee. See Clarke, G. ‘Injuncting Calls on a Performance Guarantee in the Absence of Fraud: The Passion’ (2005) 7 *J.I.B.L.R.*, pp. 338-340.
ultimately provide an unlimited number of defences to an account party seeking to prevent payment under a guarantee. Only the lesser abstraction approach as established in *Sirius* provides a clear framework to tackle the problem of abusive calling.236

The approach is also balanced and could not undermine the utility of demand guarantees. Any commentator who argues for a strict application of the abstraction principle would acknowledge that the approach adopted in *Sirius* is of very limited and clear application. It could not undermine the certainty which the beneficiary enjoys. His right to receive payment is only defeated where he has failed to fulfil a condition which he has expressly undertaken to fulfil. For a court to disregard the clear and express intentions of the parties in these circumstances would certainly undermine trust between traders and trust in the instrument itself. Similarly, any commentator who argues for adopting defences other than fraud to tackle abusive calling, would have to acknowledge that – under the approach adopted in *Sirius* – all the account party has to do to prevent an abusive calling is to persuade the beneficiary to include a condition in the underlying transaction that limits his right to receive payment pending the fulfilment of such a condition. Absence of such conditions would clearly mean that the account party has assumed the application of the maxim “pay now, argue later”.

Supporters of the application of a strict abstraction principle to demand guarantees focus their arguments on the contract between the beneficiary and the bank. It is thus suggested that as this contract is on-demand and without any qualifications, in the absence of clear evidence of fraud courts should not intervene and undermine the parties’ intentions.237 Such arguments overlook commercial reality. Between the account party and the beneficiary, to determine what the parties have indeed agreed to, it is insufficient to examine the terms of the guarantee itself. It should always be kept in mind that a third party is involved, that is the bank. Practically, even if the underlying parties agree to include some conditions in the

guarantee, the bank would only agree to issue “simple” demand guarantees: banks know that the slightest reference to the underlying transaction might result in embroiling them in complicated disputes of fact which they are ill-equipped to deal with. Stipulating for a document to be tendered in the guarantee which proves actual default or that the conditions for which the guarantee has been made have occurred is not always an available option. Arbitration or litigation is usually expensive and in many instances may only be available after payment is made.

Accordingly, and for this reason, it is found that the parties could agree in the underlying contract on the conditions and circumstances that would allow a call on the guarantee. This reality is best manifested in *Sirius*. The Judgment in the case is thus significant as it indicates that English law is taking a step in the right direction.

On this analysis it would seem that, if the approach adopted in *Sirius* were followed, it would indeed go a long way in tackling the problem of abusive calling. However, one should caution against any loose application of the principles laid down in the case. Courts should intervene only when (i) the intentions of the parties are clear (in the form of a written agreement in the underlying contract); and (ii) it is indisputable that the beneficiary has not performed the conditions agreed upon. If the account party cannot clearly establish that the beneficiary has not performed the agreed conditions, or if it is disputed whether indeed such conditions were preformed, then the abstraction principle should forbid any interference with the payment obligation. The true purpose of the guarantee in these circumstances would be to protect the beneficiary against such risks. If the legal framework were applied in this manner, demand guarantees would be an efficient and attractive instrument to both beneficiaries and applicants.


241 It is noteworthy that Australia has adopted this approach. In *Wood Hall Ltd v. Pipeline Authority* [1979] 141 C.L.R. 443, the High Court applied a test similar to that adopted in *Edward Own*. Nonetheless, Stephen J. stated that ‘had the construction contract itself contained some qualification upon the beneficiary’s power to make a demand under a performance guarantee, the position might well be different’. At 459. Several subsequent cases have upheld this view. See, for example, *Hughes Bros Pty Ltd v. Teleda Pty Ltd* [1991] 7 B.C.L. 210; *Road Surfaces Group Pty Ltd v. Brown* [1987] 2 Qd R 792; *Selvas Pty Ltd v. Hansen Yuncen* (SA) Pty Ltd [1987] Australian. Construction. L.R. 36. Australian commentators have advocated the approach. See, e.g., Buckley, R. ‘Potential Pitfalls with
4.4 Concluding remarks

English courts apply a consistent approach to the degree of fraud in the transaction required to justify an injunction restraining payment. This approach is commendable as it provides certainty to the parties involved in abstract payment undertakings, especially in the documentary credit context. In such instruments, allowing applicants or banks to raise defences relating to the actual condition of the goods will undermine the foundation of the abstraction principle. Beneficiaries will no longer be able to rely on the certainty the documentary credit is intended to provide. It is submitted that the documentary fraud defence and the principle of strict compliance provide both applicant and bank with a high degree of protection against abuse of such instrument. If fraud in the transaction were to operate it should, as English courts have correctly noted, be only allowed as a defence in cases where fraud is the "only realistic inference". As to demand guarantees, tackling the problem of abusive calling can be achieved by acknowledging that many instances of abuse do not involve fraud. Calls for tackling abuse by widening the fraud exception to the degree that it can include non-fraudulent conduct are undesirable. Such an approach might breed confusion and inconsistency in the law relating to such instruments. The better view is that exceptions other than fraud should be introduced; exceptions which have a clear scope and can be applied with consistency.

Approaches adopted in other civil and common law jurisdictions show that courts there give greater protection to account parties in demand guarantee transactions by adopting defences other than "common law fraud" as a legitimate ground for granting an injunction. There is no evidence to suggest that "thrombosis" to "the life-blood of commerce" have occurred from such an approach. On the contrary, commentators have suggested that there is a decrease in the use of demand guarantees in England where similar approaches have not yet been clearly adopted.242

Arguably many English judges have noted this fact. While the Elian & Rabbath case is the only authority where a court has granted an injunction in the


\[242 \text{See section 4.3.1.}\]
absence of fraud, other subsequent authorities have echoed its call for recognition of
defences other than fraud in the demand guarantee context when abuse is apparent.
Admittedly, while all such calls demonstrate that it is a widely accepted view that in
demand guarantee transactions fraud is not the only defence to payment, different
calls have varied in their scope. Such inconsistency is harmful to the law relating to
abstract payment undertakings where certainty for all parties is requisite. Two recent
cases have suggested two very different approaches to tackling abusive calling. In the
first case it has been suggested that good faith as a principle can play a vital role in
this area of law.243 This approach, as suggested earlier, should be rejected as (i) the
principle of good faith in itself is not fully developed to the degree where it can be
clearly understood what is exactly meant by it and when should it apply; and (ii) the
law of abstract payment undertakings requires such a high degree of certainty that
even when “good faith” can be defined, fails to offer. In *Sirius* both the court of first
instance and the Court of Appeal were of the view that where the underlying contract
shows that the beneficiary had agreed to fulfil some conditions before claiming
payment, the applicant can succeed in his application for an injunction to restrain
payment where such conditions have not been fulfilled. At first sight it would seem
that such an approach might undermine the abstraction principle. First, the approach
calls for examining the underlying transaction. This is objectionable since the
intentions of the parties when utilising a demand guarantee is that such an
examination should be dealt with after payment is made. Secondly, the approach
might place on banks an onerous duty in future transaction to examine the merits of
account parties’ claims that a particular beneficiary has not fulfilled certain condition
agreed upon in the underlying transaction. This is also objectionable because banks
should be exempted from assessing such claims. Both objections are untenable. First,
if it can be clearly established that a beneficiary has not fulfilled a condition agreed
upon in the underlying contract, a court should grant an injunction. Where this is the
case, the court’s investigation in the underlying contract cannot be said to undermine
the parties’ intentions. In fact, the true intentions of the parties (account party and
beneficiary) cannot be determined unless such examination is made. This is because
banks issuing the guarantee would usually resist any reference to the underlying
contract as any such reference may expose them to the risk of being embroiled in

243 TTI Team Telecom International Ltd and another v Hutchison 3G UK Ltd [2003] 1 All E.R.
(Comm) 914. See Section 4.3.3.

137
disputes relating to the underlying contract. As to the second objection, this objection has been blurred to some considerable degree by both commentators and the judiciary. It has been assumed that withholding payment in cases of clear abuse will impose on banks (in future dealings) a duty to investigate the underlying transaction. But the judgment in *Sirius* was quick to highlight the misconception of this suggestion: while a bank should be obliged to pay as long as fraud is not clear to its knowledge, a court should intervene and grant an injunction if there are special circumstances which would result in the account party bearing grave injustice. This variable approach in applying the abstraction principle assures that both institutions perform their intended duties. A bank in demand guarantee transaction deals with documents; this is what it had bargained for and it is well equipped to do so. A court on the other hand, investigates cases of abuse by the beneficiary; such cases usually involve questions of fact and law that only a court can deal with.

Finally, in regard to applications for injunctions in the context of abstract payment undertakings (both documentary credits and demand guarantees), courts in such applications have generally developed rather absurd rules. Many cases indicated that for an injunction to be successful, the applicant should, other than establishing that fraud is the "only realistic inference", demonstrate that damages cannot be recovered in case the injunction were rejected and it later appears that the beneficiary was fraudulent. The crucial question to be asked is: which party is it that the court will assess whether an applicant can recover damages from? Is it the paying bank or the supposedly fraudulent beneficiary? In many cases English courts have, unfortunately, reached the conclusion that the party in question is the bank. This view, as discussed above, is reached on a rather technical emphasis on the principle that requires that a cause of action should be available against the party sought to be injuncted. The implication of the adherence to such a rule is that a court will always refuse to grant an injunction against the bank. This is because the bank will usually be able to compensate the applicant for any loss he has sustained due to effecting payment against a clearly fraudulent beneficiary. Accordingly, even where fraud is found to be the "only realistic inference", the court will leave the decision whether to refuse payment or not to the bank, and no injunction will usually be granted. As the court's finding at an injunction stage can be different than that when the case reaches full

---

244 See section 4.2.3.2.
trial, banks may be exposed to the risk of being liable to either applicant or beneficiary: depending on whether the bank elects to pay or not, and depending on whether at trial the claim of fraud is affirmed or rejected.\footnote{See section 4.2.3.2.}

Courts are required to re-examine their approach to the cause of action rule, otherwise the foundation of the abstraction principle would be undermined. As in America and Australia, the basis for injunctions in abstract payment undertakings should be whether the beneficiary is fraudulent or not. In the event that he is most likely to be fraudulent or abusive, the court will then assess if damages can be recovered from him or not. If English courts adopt this approach, banks will have the privilege of paying under an abstract payment undertaking even where a court finds that fraud is the only realistic inference, yet refuses to grant an injunction (e.g. where the balance of convenience lies against such a grant). This privilege gives true meaning to the abstraction principle. Furthermore, such an approach will assure applicants that they have a real defence against fraud rather than one which lies between reality and theory.
Chapter 5: Parties immune from the fraud exception

5.1 Introduction

So far, the focus has been on the application of the fraud exception in situations where only three parties are involved in the abstract payment undertaking. However, where a second bank participates as a fourth party, e.g. as a negotiating bank, or a confirming bank, the fraud exception might not apply even if fraud is involved. The exception cannot apply against a party which “belongs to the protected class”.1 Furthermore, in the documentary credit context, different types of credits developed to fulfil different commercial expectations. When an applicant applies for a particular type of credit, he assumes certain risks that come with it, including the risk of fraud. Courts are thus required to carefully examine the intentions of the parties that utilise a particular type of credit. When tailoring the limits of the abstraction principle, they should apply the fraud exception in a manner that takes into account the different risks undertaken by the parties. This is not an easy task. In fact, it has been suggested that the law relating to this area of law “is one of the most challenging...for the courts”.2

This area of law is also controversial because in particular types of credits, the law of negotiable instruments is entangled with that of documentary credits. This is mainly the case where the credit in question is a negotiable one. When a draft is involved in the documentary credit process, the rights of the different parties on the different instruments might collide. This may breed difficulty in determining which rights should be given precedence over others. Such issues will be examined thoroughly in this chapter.

In the demand guarantees context, special rules have been developed to protect an issuing bank claiming reimbursement from an instructing bank under the counter-guarantee agreement. Furthermore, a demand guarantee may be transferred or the proceeds of the guarantee might be assigned to a third party. In these circumstances special rules apply where fraud is involved. This is necessary to maintain the efficacy of such instruments.

---

This chapter will seek to establish that as the risk of fraud has become very real in abstract payment undertakings realm, courts should apply the fraud exception in a manner that takes into account both the commercial aim of the different types of abstract instruments and the expectations of the parties under each type. Furthermore, where banks other than the issuing bank are involved in an abstract payment undertaking transaction, the exception should be applied in a manner that does not undermine the efficiency of the instrument, nor affect the risk allocation between the parties. Rather, courts are required to develop a balanced approach which aims to uphold both policies. It should be noted, however, that this chapter also deals with the nature of the bank’s obligations, duties and rights under the different types of credit. Accordingly, where appropriate, some theoretical and practical issues not relating to the fraud exception will be examined.

5.2 Confirming banks, counter-guarantees and fraud

5.2.1 Confirming banks and fraud

The relation between the issuing bank and the confirming bank is viewed as if the issuing bank is a customer of the confirming bank: the “[confirming bank’s] duties and rights towards the [issuing bank] are analogous to the [issuing bank’s] duties and rights to the applicant”.3 On this basis, if the beneficiary presents the documents to the confirming bank and claims payment, the latter cannot refuse to pay unless it can establish that the beneficiary is fraudulent, or has knowledge of any fraud perpetrated in the underlying transaction. Where the confirming bank has already made payment and the issuing bank or applicant allege fraud on the part of the beneficiary, the rights of the confirming bank are not affected and it can still claim reimbursement from the issuing bank.4 Unless the issuing bank can prove that the confirming bank had actual knowledge of fraud prior to effecting payment, reimbursement should be due.5 Indeed, the confirming bank – reflective to the position of the issuing bank – has no duty to either applicant or issuing bank to examine the facts behind the documents, nor is it equipped with the personnel necessary to perform this duty. As long as the

4 European Asian Bank AG v. Punjab and Sind Bank No.2 [1983] 2 All E.R. 508; Articles 10(d) and 14(a) UCP.
documents are facially conforming with the terms of the credit, it should have a right to reimbursement. It is an agent of the issuing bank, and by paying against apparently conforming documents it has properly performed its duty, and should thus be entitled to reimbursement.

A difficult position would arise where the applicant alleges fraud on the part of the confirming bank: can it apply for an injunction restraining that bank from making payment? Here again the cause of action rule, examined earlier, affects the outcome of the application. As discussed earlier most English courts have ruled that in applications for injunctions it is necessary for the applicant to demonstrate a cause of action against the paying bank: where the target of the injunction is a confirming bank, a court will not grant an injunction if it finds that the confirming bank does not owe a duty of care to the applicant. However, determining the precise nature of such a duty and making judgments as to whether or not it has been fulfilled is problematic.

The point has been discussed in the context of demand guarantees. In *United Trading Corp SA v. Allied Arab Bank Ltd* (1985), the Court of Appeal accepted that it was arguable that when an instructing bank instructs an issuing bank to issue a demand guarantee, the latter bank owes a duty of care to the applicant not to pay a fraudulent beneficiary. This was questioned by the Court of Appeal in *GKN Contractors Ltd v. Lloyds Bank Plc* (1985). The problem lies in the fact that there exists no privity of contract between the confirming bank and the applicant. It would be difficult to impose any duty of care in these circumstances. However, since the case of *Hedley Byrne & Co. Ltd v. Heller & Partners* (1964), it seems that courts have been more willing to recognise a duty of care even where there is no privity of

---

7. See Chapter 4, section 4.2.2.
10. [1964] A.C. 465. In this case the plaintiffs had asked their bank to give an opinion on the financial standing of another firm. The bank gave a positive report, and the plaintiff entered into a contract with the firm. Shortly afterwards the firm went into liquidation, owing substantial sums to the plaintiff. They sued the bank, alleging that statements as to the financial status of the firm had been made negligently. On the facts of the case, the House of Lords held that the bank was protected by a "without responsibility" disclaimer which it had attached to the advice. It was held, however, that in the absence of this disclaimer, the bank would have been liable to the plaintiff, notwithstanding the absence of privity of contracts.
contract between the parties to the dispute.\textsuperscript{11} Admittedly, however, recent cases indicate that the courts are not ready to recognise such a duty.\textsuperscript{12} Whether such a duty will indeed be imposed on a confirming bank is still pending judicial clarification.

Both Goode and Dolan, without however stating any justification, argue that the better view is that the law should not recognise such a duty.\textsuperscript{13} However, others disagree. Sassoon argues that the "demands of society for protection from carelessness"\textsuperscript{14} requires the recognition of such a duty.\textsuperscript{15} As the confirming bank is usually located in the place of business of the beneficiary, it deals with him directly; it could have additional business dealings with him. If no duty of care were imposed on the confirming bank, it might be inclined to undertake acts in favour of the beneficiary. In documentary credit transactions:

"[b]oth the beneficiary and the customer rely on the issuing bank’s neutrality to reduce their risk in the underlying transaction. Similarly, both parties should be able to rely on the neutrality of any intermediary banks involved in the transaction."\textsuperscript{16}

Indeed, public policy and risk allocation principles require the recognition of such a duty. In documentary credit transactions, banks are utilised to perform a neutral role. The law should thus recognise a duty of care on the confirming bank: it should protect the applicant’s expectations to the same degree it protects those of the beneficiary.

In practice, where the confirming bank commits fraud by paying against apparent fraudulent documents, the applicant can always seek an injunction against the issuing bank restraining it from reimbursing the confirming bank. Thus, the above discussion could be said to be of theoretical interest only. This is however, not entirely the case. The existence of a duty of care by the confirming bank is essential to allow the applicant to recover from the confirming bank in the event that the latter party pays in breach of the terms of its undertaking to the beneficiary, or where it pays


\textsuperscript{16} Ibid., pp. 1241-42.
in the face of obvious fraud. Taken the fact that a fraudulent beneficiary is very likely to vanish after receiving payment, unless a duty of care is imposed on confirming banks, an action for recovery by the applicant will not be possible.

5.2.2 Confirming banks under a deferred payment credit

Parties willing to take advantage of the financial function of documentary credits may use a deferred payment credit. Under this type of credit the issuer provides that the due date for payment is some time after the documents have been presented, this is provided that the conditions of the credit have been complied with. The time gap between the beneficiary’s presentation of the documents and actual payment allows the applicant to sell the goods and thus raise the funds necessary to pay the issuing bank for any advances it has made. Deferred payment credits, unlike other types of credit such as negotiation credits and acceptance credits, do not call for a draft. Accordingly, the beneficiary does not obtain a negotiable marketable instrument when he tenders the documents, he thus cannot discount the credit unless authorised by the issuing bank.

If the goods are defective or the market price of the goods has fallen rapidly, the applicant might try to rely on the defects in the goods to withhold payment. However, the basic principle of abstraction in these transactions remains intact. The bank is under an autonomous obligation to pay at maturity, it should thus disregard any objections raised by the applicant regarding the performance of the underlying transaction. The fraud exception is the only defence to payment.

If fraud is not involved, early payment of the amount of a deferred credit to the beneficiary may not affect the confirming banks’ right to reimbursement. But would a confirming bank be immune from the fraud defence in these circumstances? This

---

issue has been dealt with in *Banco Santander v. Banque Paribas* (2000). Banque Paribas (Paribas) opened a 180-day deferred payment credit available at and confirmed by Banco Santander (Santander). Santander entered into an agreement with the beneficiary, to discount the credit prior to maturity. When Santander did the discounting, it asked the beneficiary for a letter requesting the assignment to it of the proceeds under the documentary credit, and the beneficiary provided this letter. Santander then passed the documents on to Paribas. Upon examining the documents, Paribas notified Santander that the documents were fraudulent. On this basis, Paribas refused to reimburse Santander. Santander brought an action for reimbursement and the court had to decide who should bear the risk of the fraud involved. The trial court found that:

‘The basic authority given by the issuing bank to the confirming bank in a deferred payment letter of credit is to pay at maturity.’

It construed both Article 14 (a) and Article 10 (d) of the UCP as establishing that a confirming bank claiming reimbursement under a deferred payment credit, is entitled to it only at maturity. If payment is made prior to that, the confirming bank bears any risk of fraud. With regard to the fraud upon any assigned rights, the court found that the assignee takes subject to equities against the assignor. Hence, the confirming bank would have no better position than the beneficiary. If the fraud defence is available against the beneficiary, it should be equally available against the assignee.

Santander further argued that there was a banking practice which entitled confirming banks to discount a deferred credit prior to maturity. There was thus customary authority that allowed confirming banks to discharge their undertakings by discounting the credit. And it was market practice for the issuing bank to reimburse them in these circumstances. The court rejected this submission. It found that there was no evidence of market practice which supported a finding of "implied, usual or customary" authority for the confirming bank to pay the beneficiary before the maturity date.

---

23 See section 5.3.2 which deals with assignment.
The Court of Appeal reached the same conclusion. As the confirming bank exceeded its authority by not adhering to Santander's instructions, it undertook the risk that the beneficiary might not be entitled to payment at maturity. Waller L.J. found that, as no bill of exchange was present in the case, Santander could not be deemed a holder in due course. His Lordship concluded that the question was one of fact, thus:

'Ultimately the question to be asked is what precisely the issuing bank has requested the confirming bank to do, and what the issuing bank has promised to do if the confirming bank does what is requested of it. The answer, as it seems to me, is that the issuing bank has requested the confirming bank to give its own undertaking to pay [at maturity], in addition to that of the issuing bank, and has promised to reimburse the confirming bank when it pays on that deferred payment undertaking...on [maturity]. There is no request from Paribas that Santander should discount or give any value for the documents prior to [maturity].'

It has been argued that this decision "sent a wave of turbulence through the London banking community"; others have criticised the court's approach in shifting the risk of fraud to the confirming bank rather than the applicant. However, it is submitted that the decision is "grounded in commercial common sense" and should be welcomed. The confirming bank is expected to adhere to the doctrine of "strict compliance". The doctrine applies to every instruction given by the applicant to the issuing bank. Accordingly, if the principle of strict compliance were applied to Santander's claim for reimbursement, the court would have reached the same judgment. It is also well-established law that an agent cannot deviate from the instructions given to him, even if such deviation is in the principal's interests. By the same token, a confirming bank cannot deviate from the instructions it receives from

---

the issuing bank and any departure from the credit mandate should bar reimbursement.

The judgment in Banco Santander is also supported by commercial policy. Documentary credits – as many would argue – are risk allocation instruments. The risk of fraud is, arguably, one that is taken into consideration in every credit transaction. An applicant unwilling to apply for an acceptance credit may have good reasons for that. He might be doubtful of the beneficiary’s intentions. He knows that once the documents are presented by the beneficiary (and eventually accepted by the issuing bank), the beneficiary can immediately discount the accepted draft. In these circumstances, if it later appears that the beneficiary was fraudulent, the applicant will have no chance of recovery since any holder of the drafts would be immune from the fraud defence. On the other hand, when an applicant agrees to apply for a deferred payment credit the chances of the beneficiary’s fraud are very minimal. Here the applicant receives the goods prior to any payment; payment is made only at maturity. In these circumstances, the applicant has eliminated any risk of fraud; unlike ordinary circumstances he would be able to check the goods, and given the time gap between acceptance and actual payment, he might be able to prove fraud, if such fraud did indeed exist. The decision in Santander reflects this risk allocation between the parties. Indeed, Santander had taken the risk of fraud that neither Paribas, nor the applicant wished to take and as such rightly bore the consequences of its actions.

5.2.3 Silent confirmation and fraud

In some cases issuing banks or applicants may refuse the beneficiary’s demand for a confirmed credit. This practice seems to have arisen for three main reasons. First of all cost: any confirmation fee is usually paid by the applicant. Thus, some buyers may be reluctant to pay it or to permit confirmation. Secondly, national policy may militate against the issuing bank in a particular country requesting confirmation of its credit because this “utilises valuable and limited lines of credit”. Thirdly, prestige: some

---

30 See Chapters 1 and 2.
31 See section 5.4.1., which deals with acceptance credits.
32 It is noteworthy that under American law a confirming bank and any discounter of a deferred documentary credit is immune from the fraud exception provided it satisfies the requirements of a holder in due course. See Revised U.C.C. Article 5 & 5-109(a)(1).
issuing banks will not allow their credits to be confirmed, feeling that their own undertaking is enough. Nevertheless, a beneficiary may still be hesitant not to have an undertaking from a bank based in his place of business and so will approach a local bank independently to "silently confirm" the credit. The practice is common and is usually conducted without notice to the applicant or issuer.

A silent confirmation falls outside the UCP since Articles 9 and 10, which deal with liabilities of confirming banks, cover only confirmations authorised by an issuing bank. Silent confirmation is an agreement solely between the silent confirmer and the beneficiary. As such, the contract between the confirming bank and the beneficiary is totally detached from any other contract in the original documentary credit transaction.

Since the confirming bank has no right to reimbursement under the UCP, and since the issuing bank has not authorised confirmation, the confirming bank’s position will be similar to that of Santander in the Santander case discussed above. It will be regarded as the beneficiary’s collecting agent and its right to claim payment will be subject to equities available against him. Accordingly, if the issuing bank refuses payment on the basis of the beneficiary’s fraud, the silent confirmer cannot enforce payment against it. In these circumstances, the latter has to pursue its remedies against the beneficiary.

It seems that silent confirmation exposes banks to high risks, not simply the risk of the beneficiary’s fraud. Ellinger argues that the silent confirmation “must be construed as akin to a confirmation as defined in the UCP”. As will be examined, Article 9(b)(iv) of the UCP, which deals with the liabilities of confirming banks, provides that a confirming bank undertakes to pay the beneficiary “without recourse”. Without recourse, bars the bank from recovering its payment from the beneficiary if the documents are found to be discrepant. This means that a confirming

---

34 Jack, R. Documentary Credits, p. 147.
36 See section 5.2.2.
38 For further analysis on payment with recourse, see section 5.4.2.3.
bank cannot recover payment from the beneficiary in case the issuing bank refuses to reimburse it. Thus, adopting Ellinger’s analysis suggests that the same principle would apply where the bank silently confirms a credit. This conclusion must be correct: although a silent confirmation is not governed by the UCP, allowing a silent confirmer to recover its payment on the basis of a discrepant document would be contrary to the intentions and expectations of the parties. As documentary credits aim to provide the beneficiary with certain and secure means of payment, these expectations should be the same; whether confirmation is silent, or authorised by the issuing bank.

Nonetheless, if the silent confirmer and the beneficiary agree that recourse will be available, a silent confirmer should be entitled to this right. The above conclusion should only be adhered to where the silent confirmation agreement does not provide for the right to recourse.

5.2.4 Demand guarantees, mandates, counter-guarantees and fraud

In the demand guarantees context, where an instructing bank located in the account party’s country requests a foreign bank located at the place of business of the beneficiary to issue a demand guarantee, the instructing bank will issue a counter-guarantee to the benefit of the issuing bank. Upon payment to the beneficiary, the issuer may claim reimbursement from the instructing bank by calling on the counter-guarantee. However, it should be noted that, when the issuing bank carries out the instructions of the instructing bank, it is already entitled to reimbursement by virtue of the mandate that exists between them. Accordingly, if the issuing bank pays the beneficiary in accordance with the mandate, it can claim reimbursement either by virtue of the instructing bank’s mandate, or by calling on the counter-guarantee.\(^\text{39}\)

Before considering the issue of fraud in relation to counter-guarantees, it is necessary to examine the relation between the counter-guarantee and the mandate. It is well-established law that the counter-guarantee is abstract from the primary guarantee, the contract between the account party and the instructing bank, and the

underlying contract of sale.\textsuperscript{40} Like primary demand guarantees, it is governed only by the terms of the counter-guarantee: as long as the issuing bank complies with its terms, it is assured that reimbursement will be made.\textsuperscript{41} There is disagreement between commentators, however, as to the extent to which a counter-guarantee should be said to be abstract from the mandate. Goode, for example, suggests that the counter-guarantee is abstract from the mandate, “except so far as the counter-guarantee incorporates the terms of the mandate”.\textsuperscript{42} Accordingly, where the counter-guarantee does not incorporate the terms of the mandate, an issuing bank complying with the terms of the counter-guarantee can claim reimbursement under it, even if it has breached the underlying mandate.\textsuperscript{43} This approach is rejected by Bertrams who argues that any claim on the counter-guarantee should be subject to compliance with the terms of the mandate.\textsuperscript{44} Hence, if, for example, the issuing bank breaches its mandate by paying the beneficiary of the primary guarantee after the expiry date, it cannot claim reimbursement on the counter-guarantee, even if it complies with its terms. It is submitted that this approach is more sensible. First, both legal literature and case law suggest that there is no real distinction between the counter-guarantee and the mandate. In fact, in cases such as \textit{GKN Contractors Ltd. v. Lloyds Bank Plc and Another} (1985),\textsuperscript{45} where the court was called to consider whether a demand for payment on the counter-guarantee was valid, the court also examined whether the issuer had breached the instruction received from the instructing bank. Secondly, this approach reflects the intentions of the parties. It is difficult to infer that the parties had intended that the counter-guarantee could be called upon even when the issuing bank breaches instructions given to it by the instructing bank.

In relation to fraud, the position of the issuing bank claiming on a counter-guarantee is identical to that of a confirming bank claiming under a documentary credit transaction.\textsuperscript{46} Thus, where the issuing bank has already made payment, and

\textsuperscript{43} \textit{Ibid.}, pp. 734-735.
\textsuperscript{45} [1985] 30 B.L.R. 48.
\textsuperscript{46} See section 5.2.1.
fraud is alleged on the part of the beneficiary, the rights of the issuing bank are not affected and it can still claim reimbursement from the instructing bank. This is unless the instructing bank can prove that the issuing bank had actual knowledge of fraud prior to effecting payment.47

5.3 Transfer, assignment and fraud

5.3.1 “Transfer” in abstract payment undertakings and fraud

The transferable documentary credit is used mainly where the seller/beneficiary is not the supplier of the goods.48 It is usually cheaper for the beneficiary to ask the applicant to provide a transferable documentary credit, rather than himself applying for a new documentary credit to be issued to the supplier.49 Transferable documentary credits are usually governed by Article 48 of the UCP. Under the provisions of the article a credit may be transferred only if “expressly designated as transferable by the issuing bank”.50 Even if the credit is designates as transferable, the bank retains the right to reject the beneficiary’s request to transfer the credit. The beneficiary cannot oblige the bank to effect transfer.51

Where a credit is transferred, the supplier (second beneficiary) is substituted for the beneficiary (first beneficiary). The second beneficiary tenders his own documents to the issuing bank, and his right to claim payment from it is in his own name. The first beneficiary’s right in these circumstances is to obtain the payment balance between the amount stipulated in the original credit and the amount transferred to the second beneficiary.

In practice to effect transfer, the first beneficiary is required to return the documentary credit to the transferring bank (whether the issuer, or a nominated bank)

49 King, R. Gutteridge & Megrah’s Law of Bankers’ Commercial Credits, p. 116
50 Article 48(b) UCP.
51 Article 48(c) UCP. See also Bank Negara Indonesia 1946 v. Lariza (Singapore) Pte Ltd [1988] A.C. 583. However, see Ellinger, P. ‘Transfer Documentary Credit’ [1986] J.B.L., pp. 309-311, who argues that a bank may only refuse the request to transfer on a reasonable ground. This argument should be rejected; the provisions of the UCP are clear on the matter. See Schmittoff, C. ‘Is a Transferable Credit Transferable?’ [1986] J.B.L., pp. 62-65.
and request it to issue a new credit for the benefit of the second beneficiary. The exact nature of the transfer is unclear. Some argue that the transfer is an equitable assignment of the letter of credit. This view, however, has been rejected on the grounds that a party cannot assign "the contract" as a whole; he may only transfer a right or a benefit under a given contract. Moreover, under the rules of assignment the assignee is not in a better position than the assignor, he acts merely as his agent, whereas in a transferable documentary credit, the second beneficiary tenders the documents in his own name. A second theory has been advanced which suggests that the transfer amounts to novation. However, this view is also questionable as the first beneficiary does not step entirely out of the transaction: he claims the balance between the amount transferred to the second beneficiary and the amount due to him. He thus remains a party that has interest in the performance of the contract. As examined earlier, lack of consideration by the beneficiary does not affect the issuing bank's undertaking (contract). This rule also applies to transferable documentary credits. Accordingly, consideration by the second beneficiary is not a prerequisite to the transferring bank's undertaking and may not affect it. Schmitthoff has suggested that this type of credit "is an institution sui generis": this must surely be the correct analysis. It is submitted that like any type of documentary credit, a transferable credit is a commercial instrument, developed by merchants to fulfil certain commercial needs, and perhaps it is misleading to insist on applying common law doctrines when analysing its nature.

As far as the fraud exception is concerned, it should apply in a manner which reflects both the commercial needs of the parties involved and the risk allocations between them. Accordingly, as the issuing bank can refuse payment where the beneficiary is fraudulent, the transferring bank should be able to refuse to pay the

---

52 Goode, R. Commercial law, p. 1001.
56 See section 5.3.2.
58 Jack, R. Documentary Credits, p. 316.
59 See Chapter 1, section 1.3.4.
second beneficiary when the latter is fraudulent.\textsuperscript{61} Where payment has been made and it is later found that the second beneficiary was fraudulent, this should not affect the position of the transferring bank, it should be able to claim reimbursement from the issuing bank.\textsuperscript{62} The transferring bank looks to the issuing bank for reimbursement, not to the first beneficiary, and the issuing bank looks ultimately to the applicant for reimbursement. Thus, to ensure that the banks’ positions are maintained and to guarantee speedy reimbursement, the risk of fraud should be borne by the applicant, not the first beneficiary. The applicant’s remedy, in these circumstances, will usually lie in a separate action on the underlying transaction against the first beneficiary and not the second beneficiary. This is due to the fact that there exists no privity of contract between the applicant and the second beneficiary.\textsuperscript{63}

In the American case \textit{Banca del Sempione v. Provident Bank of Maryland} (1998),\textsuperscript{64} it was held that the second beneficiary’s claim under a transferable standby credit was not affected by the first beneficiary’s fraud. It is submitted that this approach should be followed in England should such facts occur. The transfer of a documentary credit results in a new contract where the second beneficiary acts and tenders the document in his own name. In these circumstances commercial policy requires that an innocent second beneficiary should be able to rely on the certainty that a documentary credit provides and thus be immune from any fraud defence relating to prior parties.\textsuperscript{65}

In the case of demand guarantees, what transfer means is the transfer of the right to claim payment under the guarantee. This can be achieved in two ways. The first does not require the bank’s issuance of a new guarantee in favour of the second beneficiary. Rather, where the guarantee is designated as transferable, the \textit{transferor} is the first beneficiary who transfers his right to make a claim on the guarantee to the

\textsuperscript{62} When the issuing bank is the transferring bank it can claim reimbursement from the applicant.
\textsuperscript{63} Goode suggests that the applicant by agreeing to provide a transferable credit, he cannot be taken to have intended that the first beneficiary shall be released from his obligations in performing the underlying contract. This analysis must be correct: there is no privity of contract between the applicant and the second beneficiary, and unless the applicant has a remedy against the first beneficiary, he would have no remedy in law if performance of the underlying contract is found to be defective or fraudulent. Goode, R. \textit{Commercial law}, p. 1009.
\textsuperscript{64} 160 F. 3d 992 (4th Cir. 1998).
\textsuperscript{65} See also \textit{Cromwell v. Commerce & Energy Bank} 450 So. 2d 1, 6 (La. Ct. App.1984); Gao, X. ‘Presenters Immune from the Fraud Rule in the Law of Letters of Credit’ in Byrne, J. & Byrnes, C. (eds.) \textit{Annual Survey of Letter of Credit Law and practice}, p. 103.
second beneficiary. The second method of transfer can be achieved where the issuer or any other nominated bank (transferor) issues a new guarantee for the benefit of the second beneficiary. This last method is identical to transfer in documentary credit transactions.

All of the sets of the uniform rules that could optionally govern the guarantee (URDG 1992, ISP98 etc.) state that for the guarantee to be transferable it should be issued to that effect. Furthermore, this entails that the guarantee should also indicate which of the above methods of transfer is permissible. Commentators agree that this should be the case even if the guarantee was issued without being subject to any of the uniform rules. The main reason for such an approach is that allowing unlimited transfer (particularly under the first method of transfer, where the transferor is the beneficiary and not the issuing or nominated bank) will make the guarantee very similar to a negotiable instrument. This will significantly increase the chances of the guarantee ending up in the hands of a dishonest beneficiary that can fraudulently call on the instrument. Accordingly, unless the account party expressly agrees to the issuance of a transferable guarantee, it cannot be inferred that he has accepted the bearing of such risk. This conclusion also supports the argument that the issuing bank should give its consent to each transfer, even if the guarantee is issued in transferable form. Hence, under the first method of transfer, when the beneficiary transfers his right to claim payment, he is required to gain the consent of the issuing bank; otherwise the transfer is not effective. Under the second method of transfer, the beneficiary would have a right to request transfer from the issuing bank or any other nominated bank but such banks should retain the right to refuse this request.

---

67 It should be noted, however, that Article 4 of the URDG confusingly states that the 'right to make a demand under a guarantee is not assignable unless expressed in the guarantee'. Assignment here is said to mean transfer. Affaki, for example, states that 'where the benefit of the guarantee is assigned (often called "transfer" in line with UCP terminologically) then only the assignee is entitled to act as beneficiary under the guarantee'. The use of the terms assignment and transfer interchangeably is unfortunate and leads to confusion in this area of law. Affaki, G. A User's Handbook to the URDG, p. 65 (emphasis added).
69 Article 6.03 (b) of the ISP98 requires such consent; Article 4 URDG does not; Article 9(2) of the UNCITRAL Convention on Independent Guarantees and Standby, requires the issuer's consent.
When transfer is effected, the second beneficiary's rights are similar to those of the second beneficiary under an ordinary documentary credit transaction. The fraud exception thus applies in a similar manner. It should be noted that *Banca del Sempione*, dealt with above, was a case concerning a standby credit (a demand guarantee).

### 5.3.2 Assignment of the proceeds and fraud

By way of contrast to transfer, an assignment of the proceeds of an abstract payment undertaking does not amount to relieve the beneficiary from tendering the documents. As the original beneficiary is the party expected to tender the documents, assignment does not affect the expectations of the applicant. Assignment of the proceeds thus should be available even if the instrument in question was not issued in a transferable form. Similarly, as the expectations of the bank are not affected by such assignment, the bank is not required to give its consent in order for the assignment to be effective. However, parties agreeing on the assignment of the proceeds should notify the paying bank of the assignment, otherwise the assignee cannot object if the bank pays the assignor.\(^70\)

In English law there are two types of assignment: legal assignment and equitable assignment. The practical distinction between the two is well understood. In legal assignment the assignee can bring an action in his own name. In equitable assignment, however, he must be joined as a party to the action. At any rate, whether the assignment is legal or equitable, in both types of assignment the assignee does not acquire greater rights than the assignor. In other words, the assignment takes effect subject to equities. Accordingly, in the abstract payment undertaking context, the assignee of the proceeds does not claim payment in his own name; rather he acts as an agent of the beneficiary who is subject to all the defences which the paying bank has in relation to the original beneficiary.\(^71\)

---

\(^70\) Jack, R. *Documentary Credits*, p. 321; *Chitty on Contracts*, pp. 1168-1173.

In most cases the assignee is a bank that finances the beneficiary. The purpose of the assignment is to provide this bank with a security for any amount it advances. Banks relying on the assignment as a security for advances made to the beneficiary should be particularly careful in noting that they are vulnerable: fraud and set-off against the original beneficiary are common defences that will undermine the assignee's right to claim payment. Nonetheless, assignee banks might have a better position than that of the assignor in certain circumstances. In the documentary credit context, if the credit is issued a negotiable credit, a bank who is an assignee of the proceeds can argue that it is acting as a negotiating bank, rather than a mere assignee. It is questionable, however, whether English courts would accept such an argument. The case will ultimately depend on construing Article 10(b)(ii) of the UCP which requires, banks authorised to negotiate, to give value in order to be rendered a negotiable bank. If such banks' acts amount to "the giving of value", they will satisfy the requirements of negotiation, and accordingly, be immune from the fraud defence.

In the demand guarantee context, the recent case of Standard Bank London Ltd v. Canara Bank (2002) has indicated that the assignee of the proceeds of a demand guarantee could be immune from any defences that the issuer might have against the original beneficiary. In that case the account party induced the issuing bank to issue a demand guarantee in favour of the beneficiary. The beneficiary had assigned its right to claim the proceeds under the guarantee to Standard, which provided finances to the beneficiary in return. In due course it was found that both the account party and the beneficiary were involved in a large-scale fraud. In fact, it was alleged that the underlying transaction between the account party and the beneficiary was a sham. On this basis, the issuer contested Standard's right to claim under the guarantee; it argued that an assignee should take subject to equities available against the assignor. Moore-Bick J. noted that although all the documents produced at trial refer to an assignment of the guarantee, and although neither party intended a

---

73 See chapter 6 on set-off.
75 See section 5.4.2.1.
novation of the guarantee in favour of Standard, the real question was whether the assignment was intended to enable Standard to claim free of equities available against the assignor.\textsuperscript{77} Upon examining the facts of the case, His Lordship found that (i) Standard had relied on the assignment of the guarantee as security for the advances it provided; (ii) the form of the acknowledgment letter of the assignment went beyond a mere acknowledgment: it was sent by telex and stated that it was an amendment of the guarantee; (iii) paragraph three of the letter read: “We agree with the Assignee that all sums payable by us to the Assignee pursuant to the Assigned Property shall be paid in full without any set-off or counterclaim and free and clear of all deductions or withholding on account of taxes”. On this basis, His Lordship ruled that the intentions of the parties were clear in that Standard would take the benefit of the assignment free of any defence available against the beneficiary, including fraud.\textsuperscript{78}

The case clearly shows that English law could accept the argument that an assignment in certain circumstances was intended to purge any defences available against the original beneficiary. In this regard the assignment could be said to amount to a transfer. Issuing banks are thus advised to clearly state their intentions when they acknowledge an assignment; mere reference to the term “assignment” is not conclusive of the case. Rather, the court would examine the intentions of the parties to establish the true effects of the assignment in question.

5.4 Acceptance credits, negotiation credits and fraud

5.4.1 Acceptance credits

Parties willing to take advantage of the financial function of documentary credits may use either an acceptance credit or a deferred payment credit. In acceptance credits the issuing bank undertakes an obligation to accept drafts drawn on itself, provided that the terms and conditions of the credit are satisfied.\textsuperscript{79} The drafts will be time drafts and payment will thus be made some time after the drafts are accepted. When the beneficiary presents the documents together with the drafts to the issuing or confirming bank (if involved), the latter parties will accept the documents, and return

\textsuperscript{77} Para 80.
\textsuperscript{79} Article 10 UCP.
the draft to the beneficiary. The bank, the beneficiary and the applicant benefit from this arrangement. The time gap between acceptance and actual payment, allows the applicant to sell the goods and provide the bank with the funds necessary to effect payment at maturity. The beneficiary on the other hand, can discount the draft in the market and realise immediate benefit of his sale. Finally, the bank will pay the beneficiary only after it receives funds from the applicant. This type of credit is mainly used where the buyer does not have enough cash to pay the issuing bank in advance.

As to the application of the fraud exception in this type of credit, if after acceptance, it appears that the beneficiary was fraudulent, the fraud exception can be pleaded only against the beneficiary himself. Accordingly, if any third party discounts the draft, it will be immune from the fraud defence; it will be a holder in due course of a negotiable instrument (the accepted draft). Thus, provided it acted in good faith and satisfies the requirements of a holder in due course under the law of negotiable instruments, it can claim payment at maturity. The law of documentary credits would have no relevance here.

5.4.2 Negotiation credits

5.4.2.1 Terminology

The term “negotiation” is used in both negotiable instruments law and in the law applicable to documentary credits. Traditionally the term has emerged in relation to negotiable instruments, negotiation in this context meaning to transfer a negotiable instrument from one party to another in a manner that qualifies the transffeere as a holder. In the documentary credit context however, the term is used to distinguish

---

80 Mclauglin, G. ‘Should Deferred Payment Letters of Credit be Specifically Treated in a Revision of Article 5?’ (1990) 56 Brooklyn. L.Rev., p. 151.
84 Unless of course the holder is a negotiating bank. If the holder is a negotiating bank, it will have a choice on whether it could claim reimbursement by virtue of its status as a negotiating bank, or as a holder in due course of an accepted draft. It is well understood that the bank’s acceptance is additional to and independent of the bank’s promise given in the documentary credit. See Gao, X. ‘Presenters Immune from the Fraud Rule in the Law of Documentary Credit’ [2002] L.M.C.L.Q., p. 32.
85 Bills Of Exchange Act 1882 s. 31 and s. 32.
between two types of credit: “straight credits” and “negotiation credits”. In a straight credit, the bank’s payment undertaking is directed only to the beneficiary, and he is the only party that is entitled to payment. In negotiation credits, however, the issuing bank’s undertaking is directed not merely to the beneficiary, but also to any bank authorised to negotiate the beneficiary’s documents in accordance with the terms stipulated in the credit. Of course, the credit itself is not negotiable. Thus, a beneficiary that receives a freely negotiable credit cannot negotiate it to another seller/beneficiary. Rather, upon the beneficiary’s fulfilment of the terms of the credit, he can negotiate the documents to any bank that pays him in exchange for the documents. Such a bank can demand reimbursement from the issuer as a negotiating bank and not as a mere beneficiary. This type of credit almost always calls for a draft to be tendered with the required documents, and this draft has given the negotiation credit its name.

For an authorised bank to be a “negotiating bank” it should negotiate the beneficiary’s documents. What is meant by negotiation here is a matter of controversy. Article 10(b)(ii) of the UCP provides:

‘Negotiation means the giving of value for Draft(s) and/or document(s) by the bank authorised to negotiate. Mere examination of the documents without giving value does not constitute a negotiation.’

Unfortunately, banking practice and understanding of “giving of value” is inconsistent. For some American banks, when they claim to be “negotiating banks”, they only act as the beneficiary’s collecting agents. Accordingly, they will not pay the beneficiary upon presentation of the documents, but rather, they will examine the documents and tender them to the issuer demanding payment. It is only after the issuing bank accepts the documents and pays them, that they pay the beneficiary. It

---

89 Article 10(b)(ii) UCP.
90 For detailed analysis on banking practice around the world. See Kami, C. & Turner, P. ‘Two Commentators Discuss How the Term “Negotiation” is Used – or Misused’ (2001) 7 D.C.I., p. 18.
is submitted that such banks have not given any value at all and accordingly they should not be treated as "negotiating banks". Other banks construe negotiation as taking the documentary risk. Hence, they will credit the beneficiary’s account, yet reserve the right of recourse against him in case the documents are rejected by the issuer on any ground other than the existence of a documentary discrepancy. Although the beneficiary in these circumstances does not receive immediate payment, it is argued that he receives value in that the bank has undertaken the documentary risk. Indeed, such a bank would usually have a right of recourse against the beneficiary if the documents are found to be discrepant and therefore rejected by the issuer. Whether such value is sufficient to constitute negotiation in the documentary credits context is questionable. The concept of giving value finds its roots in the law relating to negotiable instruments. In the Bills of Exchange Act 1882, value is defined as giving "any consideration sufficient to support a simple contract", in addition: any remission of an "antecedent debt or liability". Although no authority is found on what is meant by value in the context of documentary credits, it is submitted that negotiation in this context means actual payment of the proceeds of the credit in return for the required documents. Such is the expectation of any beneficiary dealing with a bank that is involved in the documentary credit business. In fact, to rule out confusion, some commentators have tended to use the term "buy" rather than negotiate. Accordingly, what is meant by negotiating banks in this work is banks that: "negotiate, that is, to buy, the [beneficiary’s] documents and present them under the credit in their own right". Whether such banks are entitled to recourse to the beneficiary in cases of fraud, or when the documents are found to be discrepant, is dealt with below.

---

92 See Article 10(b)(ii) UCP, where it is stated that: ‘mere examination of the documents without giving value does not constitute negotiation’.
94 See section 5.4.2.3.
95 Bills Of Exchange Act 1882 s. 27(1).
96 Bills Of Exchange Act 1882 s. 27(1).
98 Del Busto, C. states: ‘if you want to have the rights and protections under the laws of the respective countries as a negotiating bank, you must do something more than examine the documents. You must buy those documents, must purchase those documents’. See Note, ‘The Insight Interview’ (1995) 1 D.C.I., p. 4 (emphasis added).
99 Jack, R. Documentary Credits, p. 163.
100 See section 5.4.2.3.
5.4.2.2 Applying the fraud exception to negotiating banks

With respect to whether the fraud exception applies where an intermediary bank is involved, much is dependent on the terms of the credit itself. In the case of straight credits, any third party that pays against the documents and seeks reimbursement from the issuing bank should not be in any better position than the original beneficiary himself. The credit itself was addressed to the beneficiary alone and any third party presenting the documents (even if it paid the beneficiary in return for the documents) would be deemed a collecting agent of the original beneficiary, and would thus stand in the shoes of the beneficiary. Such a bank is not a negotiating bank and as a result does not enjoy any special immunity from the fraud rule. In short, under straight credits the third party who has purchased the beneficiary's draft, along with the documents required under the credit, takes the risk of fraud by the beneficiary.

In cases where the third party demanding reimbursement is an authorised negotiating bank, it would be immune from the fraud rule. Thus, negotiating banks have the right to claim reimbursement from the issuing bank even if, after negotiation, it becomes clear that the beneficiary has committed fraud. This is unless the issuer can prove that the negotiating bank had knowledge of the existence of fraud prior to negotiation. The reason behind protecting negotiating banks against fraud is that such an approach enhances the marketability of the beneficiary's documents and makes them more acceptable to negotiating banks. This allows beneficiaries to shop among banks for favourable discount and exchange rates. If negotiating banks were exposed to the risk of fraud, then such financial merits would be lost.

---

Ellinger among others, however, has argued that negotiating banks should not enjoy any immunity from the fraud rule.\(^{106}\) As the negotiating bank is closer to the beneficiary and usually located at his place of business, it is suggested that such a bank has a better opportunity of verifying the genuineness of the documents than the issuing bank. In addition, it would have a better chance than the applicant or issuing bank to recover from a fraudulent beneficiary.\(^{107}\)

It is submitted that Ellinger's approach is undesirable. First, it would undermine the commercial benefits which the beneficiary enjoys under a negotiation credit. Secondly, Article 10(d) of the UCP provides that the issuing bank's mandate requires a negotiating bank to:

```
'pay, accept Draft(s) or negotiate... against documents which appear on their face to be in compliance with the terms and conditions of the credit and undertakes to reimburse such bank...'\(^{108}\)
```

Thus, the mandate of the issuing bank in negotiation credits requires any negotiating bank to examine the documents only to make sure that they are good on their face. If they are, and the negotiating bank effects payment, it can claim reimbursement regardless of any defence which the issuer might have against the beneficiary. Finally, if applicants want to maintain the ability to restrain payment where fraud is involved and where the issuer has not yet made payment, they should apply for a straight credit. By agreeing to provide a negotiation credit, it can be argued that by implication they accept the risks involved in such transactions. Any suggestion to the contrary would undermine the significance of the distinction between "straight" and "negotiation" credits.

### 5.4.2.3 Negotiation: with or without recourse

Negotiating banks know for a fact that there is always a risk that the issuing bank will reject the documents and decline from reimbursing them on the grounds that the


\(^{108}\) Article 10(d) UCP (emphasis added).
documents are discrepant and thus non-compliant with the terms of the credit. Indeed, empirical research shows that rejection on the ground that the documents are discrepant remains one of the most common and seriously problematic areas of documentary credits law.\(^{109}\) In practice, however, this risk is negligible since negotiating banks seeking reimbursement from their principals always know that they have a right to claim recourse from the beneficiary in cases where the documents are ultimately rejected. Since the beneficiary usually tenders a draft with the documents required under the credit, he is in practice usually a drawer of that draft. He draws the draft on the issuer, payable to himself. He then indorses the draft in blank, or to the order of the negotiating bank, and delivers it to that bank together with the documents required under the credit. Under negotiable instruments law, the drawer and indorsers undertake to honour the draft in the event that the drawee (usually the issuing bank) dishonours it. The holder therefore has a “right of recourse” against them.\(^{110}\) Such a rule applies even where the draft is in relation to a negotiation credit. Thus, where a negotiating bank takes the beneficiary’s documents together with a draft, he is a holder and the beneficiary is both the drawer and indorser. As such, the negotiating bank will have a right of recourse against him on the bill of exchange in cases where the drawee (usually the issuing bank) refuses to pay.

Dolan, however, argues that negotiating banks under documentary credit law can only negotiate the documents on a “without recourse” basis.\(^{111}\) Otherwise such banks will lose their status as negotiating banks and the protection against the fraud risk that goes with it. He suggests that a negotiating bank that fails to negotiate on a “without recourse” basis will be rendered in a similar position to any discounting bank under a straight documentary credit. This argument is based on a rather questionable construction of Article 9(a)(iv) of the UCP, which provides:

> ‘if the credit provides for negotiation – to pay without recourse to drawers and/or bona fide holders, Draft(s) drawn by the beneficiary and/or document(s) presented under the credit,’\(^{112}\)


\(^{110}\) Bills Of Exchange Act 1882 s. 43(2) and s. 47(2), the draft could be drawn on the applicant, however, the practice commission discourages such practice.


\(^{112}\) Article 9(a)(iv) UCP (emphasis added).
This article addresses only the liabilities of issuing and confirming banks. Such banks should not have a right of recourse to the beneficiary where (for example) an applicant of the credit refuses to take the documents due to a discrepancy in the documents which the banks failed to notice. Banks that commit themselves to make payment under the credit (confirming and issuing banks) cannot have this right of recourse for the simple fact that the main object of a documentary credit is to provide speedy and certain payment to the beneficiary. A right of recourse would undermine such certainty.\textsuperscript{113}

Dolan, however, suggests that the above-cited article is intended to apply to negotiating banks (banks \textit{other than} the issuing or confirming bank). He emphasis that the article states that negotiation requires payment to be without recourse. He then states the following:

\begin{quote}
\textquote{the notion of the issuer's negotiation of the draft is, at least in negotiable instruments parlance, an absurdity...the drawee does not negotiate the draft; it either pays the draft (if it is a sight draft) or it accepts and pays the draft (if it is a time draft).}\textsuperscript{114}
\end{quote}

By applying such analysis to the documentary credit context, he suggests that in negotiation credits the issuing bank (drawee) cannot negotiate: it either pays or accepts the draft. On this basis, he concludes that Article 9(a)(iv) of the UCP “makes perfect sense”\textsuperscript{115} if it is understood to apply to other intermediate banks involved in the transaction that might be authorised to negotiate. Such banks as the article reads can only be labelled negotiating banks if they pay on without recourse basis.

The practical consequences of Dolan's construction of the article are as follows: a bank authorised to negotiate should pay without recourse to be rendered a negotiating bank. In these circumstances it can claim reimbursement from the issuer even if the beneficiary has committed fraud. However, as payment is without recourse, the negotiating bank bears the risk of the issuer's rejection of the documents if the latter finds discrepant documents not complying with the terms of the credit. In these circumstances, the negotiating bank cannot claim the payment back from the

\textsuperscript{113} Jack, R. \textit{Documentary Credits}, pp. 133-135.
\textsuperscript{115} \textit{Ibid.}, pp. 423-424.
beneficiary because it does not have a right of recourse against him. If, however, banks authorised to negotiate pay with recourse they will not comply with the provisions of Article 9(a)(iv) and accordingly lose their status as negotiating banks. While such banks are able to claim the payment back from the beneficiary in the event the documents are rejected by the issuer, they cannot enforce payment against the issuer in the event of fraud. This is simply because they are not negotiating banks and are thus treated as an agent of the beneficiary that stands in his shoes.116 Accordingly, negotiating banks have to bear one of the two inherited risks in documentary credit transactions, that is: the fraud risk and the documentary risk. They cannot be protected against both.

With respect, it is submitted that such arguments should be rejected.117 As Ellinger notes, Article 9 of the UCP addresses only the liabilities of the issuing and confirming banks.118 There is nothing to suggest that it applies to other negotiating banks. As to the proposition that an issuing bank cannot negotiate, and that it should be thus concluded that the article was intended to apply to other intermediary negotiating banks, this analysis is built on an erroneous premise. That premise is that the term "negotiation" applies in documentary credits law in a manner identical to that in the law of negotiable instruments. As stated earlier, most commentators have defined negotiation in the context of documentary credits as buying or purchasing the draft and/or the documents presented under the credit.119 Accordingly, if the provisions of Article 9(a)(iv) are read as requiring the issuer to "buy" and pay against the drafts and/or documents without recourse, it becomes clear that the article applies to issuers without any technical difficulty. Banking practice suggests that this is the correct construction of the article.120 The negotiating bank’s position should not be

117 Most, if not all, English commentators’ view is that the negotiation bank’s position is not affected whether it negotiates with or without recourse. See, e.g., King, R. Gutteridge & Megrah’s Law of Bankers’ Commercial Credits, pp. 105-112; Ward, A. ‘The Nature of Negotiation under Documentary Credits’ [1999] J.I.B.L., p. 293.
119 See section 5.4.2.1.
affected whether it pays the beneficiary with, or without, recourse. It would be most
unfortunate if its position were compromised due to a technical vagueness in
interpreting what is meant by negotiation in the documentary credit context.

5.5 Concluding remarks

Different types of abstract payment undertakings may require banks other than the
main issuer participating in the transaction. Where this is the case, courts – when
allocating the risks between the different parties – should ensure that this is done in a
manner that reflects the intentions of the parties and does not jeopardise the intended
purpose of the instrument in question. The approaches developed by English courts in
this area of law are satisfactory. Hence, it has been held that a confirming bank under
a documentary credit and an issuing bank under a demand guarantee that complied
with the terms they received from the banks which instructed them to issue a payment
undertaking can claim reimbursement from such banks. This is even if, after they had
paid, the beneficiary is found to have been fraudulent. Such banks enter the
transaction on the understanding that if they comply with the terms they received,
they will have an assured speedy reimbursement from the bank instructing them to pay.
The essence of the abstraction principle in these circumstances is to uphold such
expectations. For the same reason, it is submitted that where a transferee (second
beneficiary) of an abstract payment undertaking (whether a documentary credit or a
demand guarantee) is found to be fraudulent, the fraud risk should lie on the applicant
of the instrument and not on the first beneficiary. The transferring bank looks to the
issuing bank for reimbursement, not the first beneficiary. In such circumstances it
would be against the intentions of the parties if the risk of fraud were placed on the
first beneficiary. This is since such an allocation of risk would result in the issuing
bank (after reimbursing the transferring bank) losing its right to reimbursement from
the applicant of the instrument.

In Banco Santander v. Banque Paribas (2000),121 it was held that in
documentary credit transactions where the credit is a deferred payment credit, a
confirming bank which pays the beneficiary prior to the maturity date, bears the risk
of the beneficiary’s fraud. This conclusion is again justifiable because it reflects the

intentions of the parties and the intended aim of such type of credit. An applicant of this type of credit might not trust the beneficiary enough to provide him with an acceptance credit, where in such credits a draft is involved, and where the beneficiary could discount the draft prior to the maturity date. In these circumstances any discounter (provided he acts in good faith) would be protected against fraud by virtue of being a holder in due course of an accepted draft. Applicants cannot raise any defence of fraud against such parties. A deferred credit, arguably, has as its aim (among some financial advantages) the protection of the applicant from the risk of the beneficiary’s fraud. In such credits, the time gap between receiving the goods and actual payment would allow the applicant to successfully raise fraud as a defence against payment, if such fraud is indeed committed. On this basis, the decision in *Banco Santander* is commendable since the judgment took into consideration the different functions performed by the different types of credit.

It was also noted in *Banco Santander* that all the confirming bank had to do in order to protect itself against fraud is to request the issuer’s authorisation to pay the beneficiary prior to maturity. Since no such authorisation was requested or given, the court was right to find that the confirming bank should bear the risk that neither issuer, nor applicant was prepared to bear. Such policies should be adhered to where a silent confirmer pays a beneficiary and it later appears that the beneficiary is fraudulent. Neither applicant, nor issuing bank have agreed to the utilisation of a silent confirmer and as such cannot be held responsible for risks that such a confirmer undertakes. Similarly, where a beneficiary assigns his right to receive payment under an abstract payment undertaking, the assignee should not have any better position than that of the beneficiary, unless such terms are bargained for and authorised by the bank effecting payment.

Finally, in relation to negotiation credits, the law relating to parties immune from the fraud defence may raise difficulty where a draft is involved. The rights on the draft might collide with those on the credit. Where this is the case, the preferable view is that the rights on the draft should not undermine the intended purpose of the credit. Take the following example (albeit no fraud is involved): a credit is governed by the UCP, it is a negotiation credit, it requires a draft drawn on the issuer to accompany the required documents, and it is confirmed. Suppose in these
circumstances the confirming bank negotiates the credit but after negotiation it appears that it had failed to notice a discrepancy in the documents. The issuing bank refuses to reimburse it due to this fact. Can the confirming bank claim recourse against the beneficiary in these circumstances? On the one hand, Article 9(a)(iv) of the UCP, as discussed earlier, negates any such right.\(^1\) On the other hand, the confirming bank as a holder of the bill has a right of recourse against the drawer (beneficiary).\(^2\) It is submitted that should these facts occur before a court, the court should uphold the function of the documentary credit as providing an assured right of payment to the beneficiary. Thus, the rights which the confirming bank might have on the draft should be supplanted with the expectations and intentions of the parties under the credit: in the given circumstances, it would be hard to infer that an issuer or confirming bank promises the beneficiary anything more than an assured right to receive payment where the documents have been accepted by such banks.

As has been discussed, Dolan has attempted to analyse the liabilities of negotiating banks by reference to pure negotiable law principles and terminology. The conclusions he has reached, as explained, expose negotiating banks (other than the issuer or confirmer) to the risk of fraud when they pay on recourse terms. Such conclusions should be rejected, not merely because they are based on a rather unaccepted construction of Article 9(a)(iv),\(^3\) but also because such an analysis undermines both the commercial expectations of the parties involved in such transactions and the functions which a negotiation credit aims to provide. Such credits have as their purpose the aim of providing the beneficiary with the privilege of shopping around for favourable discount rates. Unless banks are protected against the fraud rule where they pay on recourse terms, negotiation credits will be less attractive to them. Thus, beneficiaries would find it more difficult to negotiate the credit and this type of credit will subsequently lose its intended purpose.

\(^1\) See section 5.4.2.3.
\(^2\) Bills of Exchange Act 1882 s. 43(2) and s. 47(2). See section 5.4.2.3.
\(^3\) See section 5.4.2.3.
Chapter 6: Further erosions to the abstraction principle

6.1 Introduction

Any study into the abstract nature of documentary credits and demand guarantees would not be complete without a thorough investigation of defences other than fraud. Regrettably few writers refer to these exceptions. Many writers when examining the abstraction principle have tended to state that the fraud exception is the “only one exception” or defence that could undermine the bank’s promise to honour payment. Such statements are simply incorrect and recent cases such as Mahonia Ltd. JP Morgan Chase Bank and Another (2003), where illegality was clearly recognised as another exception to the abstraction principle, beg specialists in this field to revise their view on the subject.

Other than illegality, the exercise of a right of set-off by a bank against the beneficiary is another exception which has been clearly recognised by the courts. The issue of set-off (especially equitable set-off) overlaps with the issue of fraud in applications for summary judgments made by the beneficiary. In recent years it has been suggested that the test of fraud in such applications is much more flexible than the test applied in applications for interlocutory injunctions. In one case it was suggested that this is primarily the case where the bank has a right of equitable set-off against the beneficiary. In another case it was suggest that deterring fraud and protecting the bank’s interests is the basis for applying the more flexible test of fraud in such applications.

This chapter will deal with the above defences. The first part of this chapter will be dedicated to examining the illegality defence, the second part will deal with both set-off and the fraud exception in relation to application for summary judgments. The main issues under examination will be the scope of such defences; the policies behind them and whether they are consistent; whether there is a coherent theme underlying them? Finally, whether the law relating to these defences has developed in a satisfactory manner?

---

6.2 The illegality exception

6.2.1 Difficulties in relation to "illegality"

Illegality has been said to be “a treacherous ground for legal decision”.3 Devlin L.J. has also stated that “[t]here are many pitfalls in this branch of law”.4 Uncertainty is however the main pitfall of this area of law and it is the reason behind the ground being “treacherous”. This uncertainty is reflected in three aspects of this legal defence. First, there is uncertainty in determining the question of whether there is an actual illegality in a given transaction. A contract is illegal either due to a statutory provision or to common law rules. A third way that a contract may be illegal is tainting. Illegality could exist in the formation of the contract, or it could exist because the purpose of the contract, or its performance, leads to an illegal act.5 When identifying a statutory illegality, for example, an investigation into the legislative intention might be necessary.6 Identifying an illegality under common law rules is no less troublesome. This is especially where the doctrine of public policy is involved. Illegalities due to this doctrine would depend on the facts of each case. This is because the doctrine is defined not by a specific rule of law, but rather by general objectives and public interests that courts endeavour to secure.7 As a result, the doctrine is variable and shifting; this is necessary in order for it to keep abreast of changing social and economic conditions. In fact, it has been suggested time and again that the doctrine is “vague”,8 “does not admit definition”9 and “is not easily explained”.10

The second aspect of the difficulty relating to this area lies in determining the effect of illegality on a certain contract. Where the contract is illegal, it is either "void" or "unenforceable". Whether the contract is void (a total nullity that does not give rise to any legal rights) or unenforceable (a contract that can procure certain
rights such as property rights) would depend upon two main factors: (i) the knowledge of the parties of the existence of the illegality in question; and, entwined with this; and (ii) the type of illegality in question.\footnote{See generally Treitel, G. \textit{The Law of Contract}, pp. 480-481.} Where both parties know that the formation of the contract, its purpose, or its performance would result in illegality taking place, then neither party can sue on the contract or enforce it.\footnote{\textit{Ritchie v. Smith} [1848] 6 C.B. 462.} However, where only one of the parties has knowledge of an illegality that could result from a certain contract, then there are instances where the innocent party could enforce the contract. Where illegality occurs in the formation of the contract, however, the position is not clear. Some writers argue that neither party could enforce the contract.\footnote{\textit{Chitty on Contracts} (London, 2004), pp. 942-944.} On the other hand, case law suggests that no general test could be given on the effects of any type of illegality on a contract: the question will rely entirely on the circumstances of each case and the policies which a given court would seek to uphold.\footnote{See, for example, the contrast in judgments between \textit{Re Mahmoud And Ispahni} [1921] 2 K.B. 716, and \textit{Bloxsome v. Williams} (1824) 3 B. & C. 232.}

The last aspect of the difficulty relating to this area occurs where there is a foreign element in a given case. This is by itself a fairly large subject, and it would be beyond the scope of this work to cover the different rules applicable in this context; it is therefore proposed only to indicate that different rules apply in determining whether a contract is illegal or not depending on the law governing the contract, the knowledge of the parties of any illegality, whether or not the contract would be illegal in the place of performance, and whether enforcing a contract would be contrary to public policy; public policy here being taken to include both English public policy conceptions and foreign ones.\footnote{For detailed analysis of this area of law, see Proctor, C. \textit{International Payment Obligations – a Legal Perspective} (London, 1997), pp. 179-195.}

The three aspects discussed above make it quite clear that the defence of illegality is a very difficult and uncertain subject. If the complications of abstract payment undertakings are added to the above analysis, one can imagine the thorny questions that may be involved. Bearing these difficulties in mind, one can proceed to examine the illegality defence in the context of abstract payment undertakings.

14 See, for example, the contrast in judgments between \textit{Re Mahmoud And Ispahni} [1921] 2 K.B. 716, and \textit{Bloxsome v. Williams} (1824) 3 B. & C. 232.
15 For detailed analysis of this area of law, see Proctor, C. \textit{International Payment Obligations – a Legal Perspective} (London, 1997), pp. 179-195.
6.2.2 Illegality in the underlying transaction

If illegality is in the abstract payment undertaking itself, it would undoubtedly be recognised as a defence against payment. Thus, where abstract payment undertakings violate applicable lending limits when issued, or when the instruments violate a governmental ban on payment to certain entities, the illegality involved does not require an analysis of the abstraction principle in the instruments. Rather, the issues involved relate to ordinary common law rules on illegality. The difficulty arises when an abstract payment undertaking is issued in support of an illegal underlying transaction. In such circumstances, could illegality in an underlying transaction defeat payment under an abstract payment undertaking?

In Group Josi v. Walbrook Insurance Co Ltd & others (1996) a reinsurer agreed with another insurance company that the latter would pay over to him certain loss reserves in exchange for a documentary credit. The credit provided that the insurance company (beneficiary) would be entitled to draw down against debt notes stating that the reinsurer was liable for amounts in question. In due course the reinsurer applied for an injunction to restrain the beneficiary from drawing under the credit. It argued that it was not authorised to carry on business in Great Britain under the Insurance Companies Act 1982, thus the underlying contract was illegal. On this basis it argued that the documentary credit was tainted with the illegality and should not be met. Clarke J. at first instance found that illegality did indeed exist, however such illegality would render the underlying contract unenforceable only at the suit of the reinsurers and not the beneficiary. In addition, the documentary credit was a separate contract insulated from the underlying transaction and thus could not be affected by any illegality existing in the underlying contract. The Court of Appeal later reversed this judgment. Staughton L.J. found that on the facts of the case there had been no illegality in the underlying transaction. However, had indeed such illegality existed, he would have granted an injunction as “illegality is a separate ground for non-payment under [abstract payment undertakings].” Although His

---

18 The credit resembled the features of a demand guarantee.
Lordship did “hesitate to enter upon a discussion of what is turpis causa, or what is taint”, it is submitted that the approach he applied is correct only where both applicant and beneficiary enter the contract with full knowledge of the illegality. In these circumstances an abstract payment undertaking would be deemed illegal by way of taint. To argue for the contrary would allow a beneficiary to benefit from an illegal transaction. This argument becomes more impregnable if one draws parallels with the fraud exception. Courts have upheld this exception only where the beneficiary seeks to defraud an innocent applicant or bank. In illegal transactions, however, it would seem that there are greater policies behind upholding such an exception as the beneficiary is seeking to defraud not a single applicant, but the general public.

Perhaps Staughton L.J.’s true hesitation was in examining the maxim ex turpi causa non oritur action (no one can found a cause of action on an illegal cause) and not taint. As suggested earlier, courts have tended to allow parties in some cases to enforce contracts notwithstanding the fact that the contract was affected by illegality, provided they were innocent. Staughton L.J.’s conclusion that, had the reinsurer indeed been unauthorised to carry on business in Great Britain, then the beneficiary could not claim payment under the credit is unfortunate. Where the beneficiary is innocent – as in the case – it is submitted that an illegality that relates to regulations that are of a technical nature (e.g. import, export regulations; acquiring a special licence) in the country of the party providing the abstract payment undertaking, this should not affect the beneficiary’s right to claim payment. Bertrams argues, in the present author’s view correctly, that “these are precisely the kinds of risk which [the beneficiary] seeks to guard against”. Indeed, this analysis is rooted in the history of abstract payment undertakings; they were developed in periods of political unrest (the First World War, in the case of documentary credits; the oil crises, in the case of demand guarantees), and one of the main objects of the instruments was to overcome

21 At 1164.
22 Tainting in common law rules provides that where there are two contracts that are so dependent on each other (this usually occurs in collateral agreements) then illegality in one contract vitiates the other contract notwithstanding the fact that the vitiated contract is innocent and free from any illegality; Spector v. Ageda [1973] Ch. 30. See generally Chitty on Contracts, pp. 1030-1031.
24 See section 6.2.1.
any uncertainty that the beneficiary might endure due to a regulation which is totally
alien to him, or due to the sudden insolvency of the party providing the instruments.
In cases such as Group Josi where the illegality in question relates to special licences
to be obtained by one party, common law rules on illegality should be superseded
with special rules that reflect the commercial purpose of abstract payment
undertakings.26

This is not to say, however, that when an innocent beneficiary is involved, all
illegalities should be ignored. Staughton L.J. stated that illegality that violates
established public policy notions should be recognised as a defence. Commentators
such as Bertrams suggest that only illegality which violates “(international) public
order” should be recognised as a defence.27 Although such a notion has no equivalent
in the English common law on illegality, judges should embrace it or develop a
similar notion that would apply conclusively to abstract payment undertakings. Such
instruments – as suggested throughout this work – have defied many common law
rules and if courts were to maintain traders’ reliability on the instruments they should
recognise illegality as a defence in the rarest of cases.

A more satisfactory approach was applied in Mahonia Ltd v. JP Morgan
Chase Bank and Another (2003).28 There it was found that (i) English courts would
not enforce a contract governed by English law and legal under it but the purpose of
which was to commit an illegality in a foreign state: common law principles provide
that English courts would not enforce such contracts as such an approach would be
contrary to public policy;29 and (ii) if such an illegality exists in the underlying
contract which led to the issuance of a documentary credit, then it would affect the
credit, for:

that an innocent beneficiary could claim payment under a demand guarantee even where illegality is
involved. At Para 70, 71.
27 Bertrams, R. Bank Guarantees in International Trade, p. 294. American writers have also expressed
the view that an illegality should not be accepted as a defence unless it is of a type that is recognised
McLaughlin argues that only criminal illegality should be allowed to defeat payment. McLaughlin, G.
L., pp. 1228-1229.
K.B. 470.
‘If a beneficiary should as a matter of public policy (ex turpi causa) be precluded from utilizing a letter of credit to benefit from his own fraud, it is hard to see why he should be permitted to use the courts to enforce part of the underlying transaction which would have been unenforceable on grounds of its illegality if no letter of credit had been involved, however serious the material illegality involved. To prevent him doing so in an appropriately serious case such as one involving international crime could hardly be seen as a threat to the lifeblood of international commerce.30

It was added that:

‘the conclusion as to whether enforcement is permissible at least arguably depends on the gravity of the illegality alleged.’31

The last statement, arguably, reinforces the view that where an abstract payment undertaking is involved and the beneficiary is innocent, courts should develop a strict test on the types of illegality that could render his right to receive payment unenforceable. As to the bank’s rights and obligations where illegality is concerned, it was correctly noted that for the bank to succeed under the defence it should clearly establish the existence of illegality. Thus, in this respect mere speculations of the existence of illegality are not sufficient to allow the bank to refuse payment. It should be kept in mind, however, that the test of “established illegality” will apply only where the case reaches trial (a full hearing). In cases such as Mahonia Ltd where the beneficiary applies to strike out the defence of illegality at a summary judgment stage, the court would not allow him to succeed if the bank shows that there is “sufficiently clear evidence”32 or it is “strongly arguable”33 that illegality existed.34 Accordingly, banks should not reject payment unless they are confident that they can establish illegality at the time of trial. The purpose of this rule is to protect banks: unless banks can say that illegality is established in the underlying contract and such illegality will not be enforced by the courts, they can safely effect payment.35 In fact, when the above case reached trial, Cooke J. concurred with the view that illegality is a well accepted defence to the abstraction principle in documentary credit transactions.36

---

30 Mahonia Ltd v. JP Morgan Chase Bank and Another [2003] 2 Lloyd’s 911, at 927, Colman J.
31 At 927.
32 At 928.
34 On the test required in summary judgments applications see section 6.4.
36 Mahonia Ltd v. JP Morgan Chase Bank (No.2) [2004] WL 1808816 (available at Westlaw), Para.422.
However, after examining the facts of the case he ruled that no illegality in the underlying transaction was involved. Accordingly, the beneficiary succeeded in his claim for payment. Banks are thus required to be careful when deciding whether to pay or reject on the grounds of illegality. As in fraud, unless illegality is clearly established, they should pay the beneficiary. This view is rooted in the abstraction principle as its whole purpose is to avoid imposing upon banks duties to conduct time-consuming inquiries that any other rule would require.

The effect of an underlying illegality on the reimbursement agreement (e.g. the agreement between the issuing bank and the applicant in a documentary credit transaction) depends on the bank’s knowledge of the illegality in question. Where the bank pays with knowledge of the illegality it is no better than a guilty beneficiary. Thus, it cannot claim reimbursement. This is simply because the same public policies behind restricting payment to a guilty beneficiary will apply to the bank in these circumstances. However, where an innocent bank is involved, the position is crystal clear: it is immune from all defences (fraud, illegality) no matter how grave the illegality in question. The same applies to innocent intermediary banks such as negotiating banks, confirming banks etc: the rules of abstract payment undertakings on reimbursement overcome all common law rules on illegality in these circumstances. Tainting thus has no application where an innocent bank is claiming reimbursement from its applicant. Simply, parties that are immune from the fraud exception are equally immune from the illegality defence. The public policy arguments cannot be affected by the application of such an approach, as the illegality

---

38 However, certain cases may raise difficulties for banks. In The American Accord it was alleged that payment under the documentary credit would offend against the Bretton Wood Agreement Order in Council 1946 (the I.M.F Agreement); the reason being that the credit transaction was a monetary transaction in disguise. The House of Lords ruled that the documentary credit was unenforceable under the I.M.F Agreement, but not illegal. As the bank’s promise was not illegal, it remained enforceable except in so far as it contravened the I.M.F Agreement. See United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord) [1983] 1 A.C. 168. For arguments that suggest that the findings of the House of Lords in the case were “wrong”. See Mann, F. The Legal Aspect of Money (Oxford, 1992), pp. 370-374. He argues that as the documentary credit in the case was a promise provided by an English bank to a beneficiary in England, it cannot be a contract of exchange in disguise. Rather, it is the underlying contract that was a monetary contract in disguise, and this fact should not have affected the documentary credit transaction, nor compromised the sanctity of the abstraction principle.
39 See the observations of Sir Thomas M.R. in Gulf Bank K.S.C. v Mitsubishi Heavy Industries (No. 2) [1994] 2 Lloyd’s Rep. 145, where he suggested that illegality in the underlying transaction would not effect the position of an innocent bank claiming reimbursement under a counter-guarantee. At 151-152.
40 See Chapter 5.
in the underlying transaction would already have been performed. More importantly, any contrary approach will result in the bank bearing the risks relating to the underlying transaction. In effect, this undermines the abstraction principle.

6.3 *Set-off a defence to payment*

6.3.1 *Set-off in the bills of exchange context*

Set-off is “the right of a debtor who is owed money by his creditor on another account or dealing to secure payment for what is owed to him by setting this off in reduction of his own liability”.

Two types of set-off are relevant in the context of abstract payment undertakings: independent (statutory) set-off and transaction (equitable) set-off.

Statutory set-off is a procedural defence that can be pleaded where both claim and cross-claim are liquidated and due. Existing as a defence, the party pleading statutory set-off in his cross-claim (the defendant) does not deny liability; rather, his action amounts to an admission that he is liable on the claim with a plea that his cross-claim should reduce or extinguish the amount to be paid to the plaintiff. Equitable set-off resembles most of the characteristics of statutory set-off but with some significant differences. It is a substantive defence which arises from a sufficiently close connection between the claim and cross claim. Being substantive, “it does not result in a merger of claim and cross-claim”; rather both are kept alive until judgment is given for any balance.

It should be added that parties to any transaction could contract out of the right to both types of set-off. Accordingly, if the parties agree that payment would be made without deduction or set-off, the courts will uphold such agreements.

---

42 Ibid., pp. 257-258.
43 The right now exist by virtue of s. 49(2) of the Supreme Court Act 1981.
Arguments for applying set-off in abstract payment undertakings are very similar, if not identical to those where the instrument in question is a bill of exchange. Thus, to analyse how set-off can apply in the context of the former instruments, it is relevant to examine its application in the less abstract instrument: the bill of exchange.

In relation to equitable set-off, the general rule has been that an unliquidated cross-demand cannot be the basis for pleading equitable set-off in an action to enforce payment of a bill of exchange. Thus, a claim for damages arising from the underlying contract cannot be a ground for allowing set-off. Such an approach exists by virtue of the abstraction principle which necessitates that the bill of exchange should be separated and immune from any claim or defence available in the underlying contract. As the abstraction principle establishes that both the bill of exchange and the underlying transaction are two distinct and separate contracts, the conclusion that equitable set-off is unavailable in the above circumstances is in fact due to the non-fulfilment of one of the preconditions of this type of set-off: that the claim and cross claim should be closely connected.

However, where the holder is not a holder in due course and there is total or partial failure of consideration, the defendant can plead equitable set-off where he is claiming to recover a liquidated amount. Nonetheless, as Goode notes the defendant's cross-claims in these circumstances constitute a substantive defence on the claim on the bills and as such cannot be accurately described as set-off. On this basis, equitable set-off has no real or beneficial application in the context of bills of exchange.

As to the availability of statutory set-off in this context, the opinions are divided. Goode and Derham have suggested that there seems no good reason why such a right should not be available. Accordingly, it is argued that when a defendant's cross-claim is not based on the underlying transaction that leads to the acceptance of the bill, but relates to a due and definite liquidated claim based on an

---

51 See generally Goode, R. Legal Problems of Credit and Security, p. 271.
52 Ibid., p. 271; Derham, R. The Law of Set-Off, pp. 167-172.
unconnected contract, the defendant should be allowed to set-off this amount against the claim on the bill. Wood, however, suggests that the contrary conclusion is more accurate.\textsuperscript{53} His conclusion is founded on obiter dictum to this effect which was expressed in \textit{Cebora SNC v. SIP (Industrial Products) Ltd} (1976).\textsuperscript{54} Unfortunately, this obiter dictum has been echoed in two recent cases. The first dealing with a documentary credit transaction,\textsuperscript{55} and the second dealing with a demand guarantee transaction (both cases are dealt with in the subsequent section).\textsuperscript{56} As no case has dealt directly with the issue, the justifications for this restricted approach remain unclear. The only argument, which can be forwarded to justify the approach, is that bills of exchange rank as “cash in hand” and accordingly the obligation on the instruments cannot be met unless the plaintiff receives \textit{actual} payment.\textsuperscript{57} This view, however, is not persuasive as allowing set-off in the above circumstances will arguably amount to actual payment. First, the defendant (drawer) is given value as he is credited to his indebtedness to the plaintiff.\textsuperscript{58} Secondly, whether actual payment is made or not, the net effect of set-off would be to discharge the parties’ liabilities toward each other. Thus, this makes set-off indistinguishable from payment of the respective amount.\textsuperscript{59} Finally, as will be discussed below, statutory set-off has been allowed to operate in a documentary credits transaction: an instrument more abstract than bills of exchange.

\subsection*{6.3.2 Set-off by the bank in abstract payment undertakings}

In the context of abstract payment undertakings, the fact that the paying bank would rarely have an existing relationship with the beneficiary outside the credit or the guarantee makes the right of set-off of very limited application.\textsuperscript{60} Nonetheless, where such relation exists, set-off may be available for the paying bank. The first case in

\textsuperscript{54} [1976] 1 Lloyd's Rep. 271.
\textsuperscript{56} In \textit{Solo Industries UK Ltd v. Canara Bank} [2001] 2 Lloyd's Rep. 578, Mance L.J. suggested that in relation to bills of exchange set-off is not admissible ‘other than between immediate parties in cases of partial failure of consideration when the amount involved is both ascertained and liquidated’. At 584
\textsuperscript{60} Jack, R. \textit{Documentary Credits} (London, 2001), p. 137.
which set-off was successfully pleaded by a paying bank was *Hongkong and Shanghai Banking Corp. v. Kloeckner & Co. AG.* (1989). In that case, there were complicated arrangements between the bank and Kloeckner (the beneficiary). These included (i) a demand guarantee provided by the bank in favour of the beneficiary; and (ii) an agreement by the beneficiary under which he undertook to pay the bank against delivery to him of a bill of lading due from another closely connected transaction. Disputes arose between the bank and the beneficiary in relation to the underlying agreements and the court had to consider whether the bank was entitled to set-off against the beneficiary’s demand for payment. The beneficiary argued that such right should not be available. Indeed, in *Power Curber International Ltd. v. National Bank of Kuwait* (1981) Lord Denning M.R. in the Court of Appeal held that:

> "A letter of credit is like a bill of exchange given for the price of goods. It ranks as cash and must be honoured. No set off or counterclaim is allowed to detract from it."  

Hirst J. rejected this argument. He pointed out that the dictum in *Power Curber* was that the bank’s undertaking towards the beneficiary was independent of that between the applicant for the credit and the beneficiary. Accordingly, the statements should be construed as prohibiting set-off by the applicant against a claim for payment by the beneficiary: the dictum does not extend to instances where the bank initiates such set-off.

Hirst J. noted that in *Kloeckner* the claim for set-off by the bank arose from “the very banking transaction which gave rise to the letter of credit” and that the bank’s claim was liquidated and ascertained. In these circumstances the bank was entitled to statutory set-off. The judgment has been strongly criticised by Mugasha. He objects to the judgment on the basis that “the letter of credit may be relied on by other parties.” This could occur where the proceeds have been assigned to a party that provides the beneficiary with finance. Such objection should, however, be

---

63 At 398.
64 At 331.
66 Ibid., p. 320.
dismissed. First, the beneficiary could agree with the bank from the outset that any right of set-off should be precluded. Secondly, as McCormack argues, it is the duty of the beneficiary to disclose any possibility of set-off to the third party for whose benefit the proceeds have been assigned. The principle that the assignee should never be in a better position than the assignor is well recognised. Accordingly, if the assignee is deprived of an expected payment by the bank’s right to set-off, he “might rightly be thought to have been commercially naïve”. Finally, as examined earlier, an assignee of the proceeds can agree with the issuing bank that set-off cannot be permissible. On this basis, it is submitted that the judgment in Kloecrner is correct and statutory set-off did not affect the abstraction principle: the beneficiary is given value as he is credited to his indebtedness to the bank and this in effect has resulted in actual payment.

Whether statutory set-off would be available to the bank in circumstances where its underlying cross-claim is not closely connected to the payment claim is still to be determined. However, there seems to be no good reason why such a right should be denied in these circumstances. The implications of such ruling would be similar to those of the Kloecrner case: as the bank’s right to statutory set-off will be on liquidated and definite sums, the beneficiary’s right to receive payment will not be postponed or compromised.

On the availability of the right of equitable set-off by the issuing bank against the beneficiary, English courts have – as early as Etablissement Esefka International Anstalt v. Central Bank of Nigeria (1979) – expressed the view that they would recognise the existence of such right. The approach has been reiterated in recent cases in which beneficiaries applied for summary judgments in order to force banks to pay under abstract undertakings. In Safa Ltd v. Banque du Caire (2000) the bank that

---

68 Chapter 5, section 5.3.2.
70 See section 6.3.1.
71 See section 6.3.1; It should be noted that Article 18 of the UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit, provides the right of set-off to the paying bank.
72 It has been held that a collecting bank acting on behalf of the beneficiary may exercise the right of set-off against him. See Marathon Electrical Manufacturing Corp v Mashreqbank PSC [1997] 2 B.C.L.C. 460.
issued a documentary credit to the beneficiary, had been involved with him in a wider underlying transaction. When the beneficiary claimed payment under the credit, the bank, among other defences, alleged that the beneficiary was fraudulent. The beneficiary applied for a summary judgment to enforce the credit. Waller L.J. in the Court of Appeal stated:

"When a bank is involved in [a] related transaction it may be unjust for that bank to be forced to pay on a summary judgment where it has a real prospect of succeeding by reference to a claim on the underlying transaction, and particularly if that claim is a liquidated claim, the court should not give summary judgment either because a set-off has a reasonable prospect of success or because there is a compelling reason to have a trial of the letter of credit issue."

After citing a number of cases including the Kloeckner case, Waller L.J. found that the bank had established a "real prospect of success", he thus concluded that set-off was permissible. Accordingly, the beneficiary was not able to enforce payment by way of summary judgment. It is not clear, however, whether the right of set-off was allowed only on the ground that the bank had a real prospect of establishing that fraud existed in the underlying transaction. From reading the report, it seems that other grounds emanating from the complex relationship between the bank and the beneficiary would have also justified set-off. Furthermore, it seems that Waller L.J. in his above-cited statement regarded the availability of a liquidated claim as only an additional factor to permit the bank to plead set-off.

The reasoning in the case was too generalised, unclear and leads to unsatisfactory outcomes. The suggestion that when the bank is involved with the beneficiary in a wider underlying transaction that leads it to issue a documentary credit, it can assert set-off against the beneficiary, even if its claim is for an unliquidated sum, would result in the abstraction principle being seriously violated. To preserve the certainty which the beneficiary enjoys under an abstract payment undertaking, courts should not confuse the availability of the right of equitable set-off

---

75 Although the credit resembled the features of a demand guarantee, the rules of set-off should be similar whether the abstract payment undertaking in question is a demand guarantee or a documentary credit.
76 At 608 (emphasis added).
77 At 609.
78 At 609-610. See also Derham, R. The Law of Set-Off, pp. 174-176.
with the fraud defence. They should apply an approach similar to that applied to bills of exchange where courts find that it is equitable to allow set-off only in circumstances that do not upset the established principles of such instruments. Simply, courts should clearly state that payment under abstract payment undertakings will not be disturbed unless fraud is pleaded and only when such plea has been examined and found to satisfy the fraud test as established in abstract payment undertakings law. As to the proposition that a bank would be entitled to set-off even when its cross-claim is unliquidated, this approach undermines the certainty the beneficiary enjoys under abstract payment undertakings. In absence of fraud, only liquidated, definite and due claims should allow the bank to set-off against the beneficiary’s claim for payment. In other words, courts should only apply the dictum established in the *Kloeckner* case.

To sum up, statutory set-off should only be available to the bank against the beneficiary where the bank’s claim is for a liquidated and due sum. Where the circumstances are such as to allow equitable set-off, courts should clearly state that – short of clear evidence of fraud – such set-off will be rejected.

### 6.4 The fraud defence in applications for summary judgments[^80]

In *Safa Ltd v. Banque du Caire* (2000),[^81] discussed above, it is unclear whether set-off was permitted due to fraud or due to claims which the bank had arising from the underlying transaction, or due to both. The better view should be that the case concerned an application for summary judgment by the beneficiary for payment under a guarantee which the bank successfully avoided due to the fraud defence. However, such an analysis would suggest that the test of fraud in applications for summary judgments is easier to meet than that in applications for interlocutory injunctions. Waller L.J. in the above-cited statement stated that a “*reasonable prospect of success*” will allow the bank to avoid a summary judgment, whereas (as examined earlier) in applications for interlocutory injunction, for an applicant to succeed it should establish that the “*fraud is the only realistic inference*”.[^82]

[^80]: See CPR Pt 24.2 where it is stated that a court may give a summary judgment against a defendant on the whole of a claim if it considers that the defendant has no real prospect of successfully defending the claim or issue and that there is no other reason why the case or issue should be disposed of at trial.


[^82]: See Chapter 4, section 4.2.1.
Jack has criticised any approach which calls for a lower test of fraud to be applied in applications for summary judgments as this will undermine the beneficiary's certainty of receiving payment.\textsuperscript{83} The Court of Appeal in \textit{Solo Industries UK Ltd v. Canara Bank} (2001)\textsuperscript{84} has also concurred with this analysis. Its justification for the approach adopted in \textit{Safa} has been stated in the following terms by Mance L.J.:

'special considerations arise in circumstances such as those in \textit{Safa} itself, where the beneficiary and bank are both intimately involved in a wider underlying transaction.'\textsuperscript{85}

It should be said, however, that while Mance L.J. had his reservations about the approach which calls for a lower test of fraud in applications for summary judgments, he applied an approach similar to that in \textit{Safa}, albeit on a different ground.

In \textit{Solo Industries}, Canara (the bank) issued a demand guarantee naming Solo as the beneficiary. Upon Solo calling on the demand, the bank refused payment alleging that the account party and Solo had conspired to defraud it, and that the underlying transaction was in fact a sham. Solo applied for a summary judgment to enforce payment. The court of first instance found that although the bank did not have a "strong case", it nonetheless showed a "real prospect of success". It was held that this test was sufficient to refuse the award of a summary judgment for: "[i]t seems...somewhat offensive for the claimants, proven fraudsters, being able to steamroller a claim in this way".\textsuperscript{86} On appeal, Mance L.J. was adamant that the test applied in applications for summary judgments should not be lower than that in cases relating to applications for interlocutory injunctions. He nonetheless distinguished the fraud allegation in the case from usual fraud allegations: the allegation related to the validity of the instrument itself and not to performance in the underlying transaction. In such circumstances, it was held, a lower test of fraud was acceptable.\textsuperscript{87}

\textsuperscript{83} Jack, R. \textit{Documentary Credits}, pp. 273-275.
\textsuperscript{84} [2001] 2 Lloyd's Rep. 578, at 586.
\textsuperscript{85} At 585.
\textsuperscript{86} \textit{Solo Industries UK Ltd v. Canara Bank} [2000] WL 33281322, (only available at Westlaw), Hallgarten, J.
With respect, this distinction between fraud which invalidates the abstract payment undertaking and fraud relating to the performance of the beneficiary is rather artificial: in both instances the beneficiary is a fraudulent party which is likely to act in such a way as to result in the bank’s financial loss. The better view is that where the bank has a real interest in the performance of the underlying transaction it should not be forced to pay where the beneficiary has committed fraud. This is so, whether such fraud was in conjunction with the account party, or was committed by the beneficiary only. Interestingly, Mance L.J. made the following statement:

‘The fact that the present issue only now requires decision itself suggests either that banks rarely attempt to avoid instruments such as credits and performance bonds or that beneficiaries have recognized that the cash principle cannot enable summary judgment to be obtained where banks have a real prospect of justifying such an avoidance. Common sense suggests that the former probably applies. The present facts are obviously extreme. The law has developed the cash principle and the limited fraud exception in response to perceived commercial need.’

If indeed commercial needs are the true factors which influence where to set the boundaries of the abstraction principle, banks should be allowed to resist a summary judgment when they have a “real or reasonable prospect for success” in proving that the beneficiary has committed fraud. First, as Mance L.J. noted, the instances where a bank might elect to refuse payment due to fraud are extremely rare for the simple reason that banks know that such a practice will undermine their reputation as a reliable paymaster and create a situation which will ultimately result in beneficiaries not utilising their services. Banks accordingly will be very cautious when deciding not to pay; such practice would only be conducted when the bank is certain it can prove fraud at trial, but has not at the summary judgment stage acquired sufficient evidence to this effect. Secondly, the bank is still required to produce a “real prospect of success”; thus, it cannot refuse payment where its allegation is baseless. Both points assure beneficiaries that their right to receive payment will be defeated only in the rarest of situations.

A fraudulent beneficiary should not be allowed to easily collect the proceeds by applying for a summary judgment, at which stage the bank might not be able to collect sufficient evidence to establish that fraud is the only realistic inference. With

the proliferation of fraud cases in recent years, this approach is much needed to
protect banks and to encourage them to provide financial and credit services to traders.

6.5 Concluding remarks

The English approach to the illegality defence, although not sufficiently established,
is satisfactory. The courts have maintained the view that abstract payment
undertakings should be defeated only in the rarest of cases. Thus, for an illegality to
undermine payment, it should be clearly established. This is in line with the principles
governing the fraud exception. This requirement protects both the innocent
beneficiary and the banks. A bank short of clear evidence of established illegality
which a court would recognise can pay secure in the knowledge that it can enforce
reimbursement against its applicant. Similarly, in application for injunctions, the
innocence of the beneficiary of any illegality committed by the party providing an
abstract payment undertaking should weight heavily against granting an injunction.

There should be no distinction between documentary credit and demand
guarantees transactions when developing the scope of the defence. The practical
implications of any approach adopted by courts will affect the instruments in an
identical manner. However, it should be reiterated that to ensure reliability on abstract
payment undertakings, the defence should be as narrow as the fraud defence, if not
narrower. Only in the most extreme cases should the bank be required to reject
payment on the basis of illegality. Thus, even if there is a statute which prohibits
certain acts being conducted by the party providing the abstract payment undertaking,
banks should be expected to always pay unless they can clearly establish that the
beneficiary was an accomplice or had knowledge of the illegality in question.
Admittedly, the innocence of the beneficiary should not be the determinative factor of
the issue. Certain illegalities should not be sanctioned. The test for recognising such
illegalities as a defence against payment should be very high: it should be whether the
illegality in question violates “(international) public order”. Accordingly, common
law rules on illegality should be supplanted by special rules where abstract payment

89 Bertrams, R. Bank Guarantees in International Trade, p. 294. It should be noted that American
courts are unclear on whether illegality should be recognised as a defence or not. Some have
1990), aff’d, 976 F2d 561 (9th Cir. 1992). Others have declined from recognising it Murphy v. FDIC
12 F3d 1485 (9th Cir, 1993).
undertakings are involved. It is true that there are difficulties with this approach: a bank would not be certain which illegalities are grave enough to entitle it to refuse payment and which are merely of a technical nature. Banks should, however, appreciate that in issuing an abstract payment undertaking they assume very limited risks: assessing an illegality in certain situations is perhaps one of these risks.

Provided that the bank had paid the beneficiary in good faith, it can claim reimbursement and is not affected by issues of illegality no matter how grave the illegality in question is. Common law rules on tainting cannot extend to undermine such rights. Similarly, the position of innocent intermediary banks (negotiating banks, confirming banks etc.) is identical to that where fraud is alleged. Thus, where they have acted within their mandate, they should be protected against the illegality of the beneficiary or applicant.

Set-off in the context of abstract payment undertakings should be limited to statutory set-off. Where both claims - claim and cross-claim - between an issuing bank and a beneficiary are on matured, liquidated and due sums, there seems to be no strong reason why an issuing bank should meet its obligation to pay under an abstract payment undertaking and then establish legal proceedings to reclaim the amount owed to it by the beneficiary. On this basis, the approach adopted in Kloeckner must be correct. Equitable set-off on the other hand, should be analysed in the context of the fraud exception. Accordingly, whether it is allowed or not should depend on whether the bank has satisfied the requirements necessary to raise the fraud defence.

The judgment in Safa is troublesome in that it suggests that the bank may be entitled to equitable set-off if it merely has claims against the beneficiary emanating from the underlying transaction. Such an approach is untenable and would undermine the foundation of the abstraction principle. The better view is that even if banks have extensive dealings with the beneficiary in the underlying transaction, they are not entitled to set-off any claims that are related to such dealing; unless fraud is pleaded and the required test is satisfied, they should pay the beneficiary.

Reading both Safa and Solo Industries together, leads to the conclusion that courts have accepted that where the beneficiary applies for a summary judgment to force a bank to pay, the bank can avoid judgment by showing a "real or reasonable
prospect for success” in establishing that the beneficiary is fraudulent. Although, this test is lower than that in applications for interlocutory injunctions sought against the beneficiary, the approach is laudable. As noted by Mance L.J. the fraud exception developed “in response to perceived commercial need”. It would indeed undermine commerce and affect the banks’ decisions on whether to provide future financial and credit services to traders, if fraudulent beneficiaries were allowed to collect the proceeds under an abstract instrument in this extreme manner. Commercial policy thus lends support to applying a lower test of fraud in summary judgment applications.

Conclusion

To what extent are abstract payment undertakings truly abstract? This is the question posed in the title of this thesis. The body of this thesis demonstrates that the answer to this question has a profound impact on the functioning of these instruments. In particular it affects: the duties of the different parties, the commercial functions of the instruments, the remedies that the different parties have in the law relating to such instruments and the basis underpinning their commercial utility.

Two commercial principles have played a vital role in the development of the limits of the abstraction principle. First, certainty is much needed for parties utilising such instruments. To ensure that thromboses will not occur in the blood of international commerce, parties engaged in multi-million dollar transactions need to know exactly the legal implications of utilising an abstract instrument, the risks they undertake and the remedies that they are entitled to. Secondly, trust is the foundation of any successful commercial system. It is true that when shaping the law relating to any commercial undertaking, the courts should not view the prevention of fraud or unscrupulous conduct as their main concern. Rather, legal principles should be developed on the understanding that trust, and not distrust, is the basis of commerce. This conclusion however should not overshadow two commercial facts. First, unless any commercial system combats fraudulent conduct, thromboses will occur in that system. Secondly, in the abstract payment realm, as parties engage in such transactions on the basis of trust, the abstraction principle is agreed upon on this basis as well. Put more simply, parties that utilise an abstract instrument – similar to parties to any commercial transaction – enter such transactions without allocating the risk of fraud between them; rather, they enter on the basis that it is most likely that the different participants in such transactions are trustworthy. The abstraction principle is thus agreed upon on this basis. For this reason, where fraud is involved, the fraud exception has been recognised in most – if not all jurisdictions – as a limitation to the abstraction principle. Courts have thus recognised that limitations to the abstraction principle are necessary to give effect to the intentions of the parties utilising abstract payment undertakings and to ensure that the instruments fulfil their intended commercial purpose. After all, it is commercial needs that have forced courts to
recognise the enforceability of such instruments, notwithstanding the fact that they evade strict contractual analysis.

Nonetheless, one should caution against any simplification of the task of setting the boundaries of the abstraction principle. It is not easy to reconcile certainty, trust and the commercial intentions of the different parties to abstract payment undertakings. As a general principle most commentators and the judiciary have accepted that established fraud is the only exception to the abstraction principle. This much-reiterated statement, however, oversimplifies the issues involved when determining to what extent abstract payment undertakings are truly abstract. To maintain certainty in this area of law a five-stage analysis should be conducted when examining this issue. At the first level, it should be asked: what is the type of abstract instrument in question? Is it a documentary credit or a demand guarantee? At the second level, it should be asked: what are the defences that are recognised – or should be recognised – to the abstraction principle under each instrument? Are they similar, or are there certain defences recognised in the law relating to one instrument but not to the other? At the third level, it should be asked: at which stage is the defence in question being pleaded? Is it at an injunction stage, at a summary judgment stage, or before a trial court? At the fourth stage, it should be asked: what other factors should affect the availability of a given defence under a given instrument at a given stage? Take for example the question of the balance of convenience in applications for interlocutory injunctions to restrain payment to a fraudulent beneficiary under a documentary credit. As examined in this work, the courts’ inconsistency in examining this point alone suggests that applicants do not have any real remedy even in instances of clearly established fraud on the part of the beneficiary. Even more serious, it appears that banks may be forced to assess the strength of the applicant’s allegation of fraud and, even with such assessment, the risk of fraud may rest on them. At the fifth stage, it should be asked: are there banks other than the issuing bank involved in the abstract payment undertaking transaction? As has been demonstrated in Chapter 5, where this is the case, different factors and elements may affect the availability of a given defence against them at a given stage.

In Chapters 1 and 2 it was seen that documentary credits and demand guarantees are both abstract payment undertakings; they are recognised to be binding
upon communication to the beneficiary; they aim to provide the beneficiary of such undertakings with the certainty that payment is forthcoming if he fulfils the requirements stipulated in the undertaking. However, as demonstrated, the functions of the instruments are different and so are the expectations of the parties utilising them. A documentary credit is mainly a payment device which aims to dilute the documentary credit transaction to a purely documentary process, in which the beneficiary’s fulfilment of his documentary duties will be sufficient to trigger payment. A demand guarantee on the other hand, is a security device, which is primary in form and secondary in intent. It aims to secure the beneficiary against any default by the account party. It also aims to shift judgment, jurisdictional and litigation risks from beneficiary to the account party. No documents are usually required to trigger payment, other than the beneficiary’s single demand. As both instruments function differently, the defences against the abstraction principle have developed differently. As shown in Chapter 3, in the documentary credit context fraud in the transaction is of very limited application. After all, fraud in the transaction usually relates to the beneficiary’s physical duties in relation to the quality of the goods and their condition. Applicants for documentary credits assume that risks associated with such issues are borne by them, except in those extreme circumstances where fraud in the transaction is the only realistic inference. Similarly neither banks, nor courts can usually establish the existence of fraud in the transaction before all the relevant facts are heard and assessed at a full hearing. However, both the bank and applicant enter the transaction on the understanding that payment will be made against documents which have commercial value. Thus, it has been held that fraud in the documents entitles the bank to reject them. This general rule has, unfortunately, been subjected to a commercially unsound limitation. The House of Lords in *The American Accord* held that only when the beneficiary has knowledge of the existence of fraud in the documents, should the bank be entitled to reject them. The argument is that certainty for both banks and beneficiaries requires the application of this rule. As examined in detail, this argument is contradictory and commercially unjustified. In addition, it does not reconcile with the principle that establishes that documentary credit transactions are purely documentary in nature.

The abstraction principle exempts banks from looking behind the documents, but the principle does not oblige them to pay against non-conforming documents,
especially if such documents are null and without any commercial value. Banks
should be able to refuse a non-genuine document, whether fraudulently produced or
not, and whether it is null or not. As examined, when dealing with the nullity
exception, any attempt to distinguish between null and non-null documents,
fraudulently produced or not, will ultimately breed confusion both as to the duties and
liabilities of banks and the remedies available to applicants of documentary credits. In
a time where beneficiaries, applicants and banks can easily, speedily and cheaply
ascertain whether a document in question is altered or non-genuine, such documents
should not be allowed to circulate between traders.

It is time that the UCP addresses this issue and adopts a framework similar to
Article 19 of the UNCITRAL Convention on Independent Guaranties and Stand-By
Letters of Credit, where a paying bank can refuse payment if the documents are not
"genuine". In addition to the above points, the scale and frequency of modern fraud
necessitates the introduction of such a framework. This is not to say, however, that
banks should be required to verify the genuineness of the documents; rather upon
acquiring clear-cut evidence that the documents are non-genuine or altered, they
should reject them for the simple reason that such documents do not – and cannot –
conform to the credit requirement.

In demand guarantee transactions, as no documents other than the
beneficiary’s demand for payment are usually involved, the fraud in the documents
defence has neither real application, nor any relevance to the function of the guarantee.
The focus in this instrument is not on whether the beneficiary has to tender
conforming genuine documents, but rather on whether the instrument should rank as
cash in hand in all circumstances. In other words, the focus should be on why does the
account party agree to provide a demand guarantee? What are the intentions of the
parties that are engaged in the demand guarantee transaction? Again, the abstraction
principle is allowed to operate in demand guarantees to maintain the efficacy of the
instrument, especially because a bank cannot assess the facts which lead a particular
beneficiary to call on a particular guarantee. Yet, as the instrument is provided on the
understanding that it will assure the beneficiary of speedy compensation in cases of
actual default, different jurisdictions have recognised limitations to the abstraction
principle where this expectation has not been maintained.
As examined in Chapter 4, in some civil law jurisdictions abuse of rights has been recognised as a defence to payment under demand guarantees. This defence can be successfully pleaded where a beneficiary acts unfairly by calling on the guarantee where the account party has not defaulted, or where the beneficiary’s conduct results in the account party defaulting in performing the underlying transaction. In the United States the view developed that fraud is the only defence to payment in both documentary credit and demand guarantee transactions. However, American courts have adopted the view that abstract payment undertakings are the creation of merchants; that they do not reconcile easily with common law doctrines and for this reason the rules governing such instruments should be *sui generis*. This view has been applied even when setting the limits of the abstraction principle and defining fraud. Thus, in demand guarantee transactions what is meant by fraud in the United States is not common law fraud applicable to ordinary contracts, but rather fraud is defined by examining the acts of the beneficiary and establishing whether they have any colorable basis whatsoever. If not, the courts will restrain payment in such circumstances on the basis of fraud. The American approach to applications for interlocutory injunctions to restrain payment under abstract payment undertakings has also been that *sui generis* rules should be applied in such applications. Thus, the requirement that a cause of action against the party sought to be injuncted is not adhered to in this context. These views are commendable, and the legal and commercial implications that ensue from the English court’s failure to embrace such views have been set out in Chapter 4.

Some English courts recognised the drawbacks and the commercial harshness of adhering to the view that only common law fraud should be a defence to payment in the demand guarantee context. What is meant by fraud here is common law fraud in relation to the beneficiary’s conduct in the underlying transaction. Accordingly, they called for different exceptions to be applied in the demand guarantee context. Nonetheless, in seeking this purpose the English courts have developed different notions of where the boundaries of the abstraction principle in demand guarantee transactions should be set. There thus developed inconsistent, and in some instances contradictory, principles in this area of law. Refinement is necessary and the courts should clarify their position on this issue. The best-balanced approach to this area of law has been the one proposed in 2003 by May L.J. in the *Sirius* case. There it was
held that a court should restrain payment by way of injunction where the beneficiary calls on a demand guarantee notwithstanding the fact that he failed to fulfil certain conditions agreed upon in the underlying transaction. This approach, as examined in detail, has the merit of reflecting what the parties had indeed bargained for. It also can be applied with consistency, thus providing certainty to all parties involved in such transactions. In the same case it was suggested that a bank should be entitled to pay where fraud is not obvious to its knowledge, while a court should investigate claims of abusive calling. This analysis must be correct and courts should always uphold the view that the abstraction principle aims mainly to relieve banks from being embroiled in controversies relating to the underlying transaction. For the same reason, the English courts should apply to abstract payment undertakings *sui generis* rules that are free from the technicalities of law. As seen in this work, the failure to uphold this view in applications for interlocutory injunctions – particularly in relation to the cause of action rule – suggests that the parties to an abstract payment undertaking will lose the sense of certainty that they enjoy under these instruments. Certainty here encompasses the duties of the different parties, the remedies they enjoy and the risks that are borne by them. Future refinements are necessary and when setting the limits of the abstraction principle, courts should embrace the view that “the law has developed...the limited fraud exception [and any other defence] in response to perceived commercial need[s]”.

1

On the above basis, the view which has called for a relaxation of the fraud exception in applications for summary judgments by beneficiaries to enforce banks to pay under an abstract instrument, is welcomed. As demonstrated in Chapter 6, it is commercial policy that lends support to this approach. This approach reflects the risks undertaken by the different parties and is necessary to maintain the efficiency of abstract payment undertakings.

Where there is an illegality in the underlying transaction, the abstraction principle should be applied in a manner similar to that applied where fraud is involved. Banks should thus not be required to assess any claim of illegality in relation to the underlying transaction. As for courts, they should recognise only illegalities of a grave nature as a defence to payment, this especially where an innocent party is involved.

Such a view is preferable as it is consistent with the rules relating to the fraud exception. As argued in Chapter 6, abstract payment undertakings are the creation of merchants, the common law rules on illegality should thus be supplanted with *sui generis* rules that maintain the commercial utility of these instruments. This includes the types of illegalities that may affect payment under an abstract undertaking and the impact of the illegality in the underlying transaction on the reimbursement agreement between banks where an illegality is involved.

Each abstract instrument developed to serve particular functions in international trade. Accordingly, both the duties of the parties under each instrument and their expectations are different. For this reason the defences against payment under each abstract instrument should be different. This is because the defences are there to reflect the parties' duties and expectations. To generalise the issues involved when setting the boundaries of the abstraction principle without keen sensitivity to their commercial utility leads to unsatisfactory outcomes. It also results in much uncertainty which must be avoided in this particular branch of law. English courts have upheld the view that the enforceability of these instruments is supported by commercial practice and not legal dogma. This view was essentially embraced to protect traders' certainty when using these instruments. The failure of the English courts to consistently apply this view when setting the limits of the abstraction principle has, unfortunately, undermined the same sense of certainty which the courts proclaim to protect.
List of cases


Agra and Masterman’s Bank (1867) 2 Ch. App. 391


American Cyanamid v. Ethicon Ltd. [1975] A.C. 396

Archbolds (Freightage) Ltd v. Spanglett Ltd [1961] 1 Q.B. 372


Bache & Co. v. Banque Vernes [1973] 2 Lloyd s 437


Banca del Sempione v. Provident Bank of Maryland 160 F. 3d 992 (4th Cir. 1998)


Bank of Ireland v. Archer (1843) 11 M & W. 383


BICC Plc v. Burndy Corp [1985] Ch. 232

Bigos v. Bousted [1951] 1 All E.R. 92

Bloxsome v. Williams[1824] 3 B. & C. 232


196

Bourbaud v. Bourbaud (1864) 10 L.T. 781


C. Groom Ltd v. Barber [1915] 1 K.B. 316

Caja de Ahorros del Mediterraneo & ors v. Gold Coast Ltd. [2001] EWCA CIV 1806

Camidge v. Allenby (1827) 6 B. & C. 373


Carter v. Boehm (1766) 97 E.R. 1162

Cebora SNC v. SIP (Industrial Products) Ltd [1976] 1 Lloyd's Rep 271


Channel Tunnel Group Ltd. V. Balfour Beatty Constraction Ltd.[1993] A.C. 334

Chao and Others v. British Traders & Shippers, Ltd [1954] 1 Lloyd’s Rep. 16

Coca-Cola Finance Corp. v. Finsat International Ltd. [1996] 3 W.L.R. 849

Commercial Banking Co of Sydney Ltd. V. Jalsard Pty. Ltd [1973] A.C 279

Consolidated Oil Ltd v American Express Bank Ltd [2002] C.L.C. 488


Credit Agricole Indosuez v. Generale Bank [1999] 2 All. E.R. 1009

Cromwell v. Commerce & Energy Bank 450 So. 2d 1, 6 (La. Ct. App.1984)

Crouch v. Credit Foncier (1873) L.R. 8 Q.B. 374


Davies v. Davies (1887) L.R. 36 Ch. D. 359
Derry v. Peek (1889) L.R. 14 App. Cas. 337

Deutsche v. Walbrook [1995] 1 Lloyd’s 153


Dodsal PVT Ltd v. Kingpull Ltd [1985] (unreported available at Lexis-Nexis)

Donald H. Scott & Co. v. Barclay’s Bank [1923] 2 K.B. 1

Dong Jim Metal Co Ltd v. Raymet [1993] (unreported available at Lexis-Nexis)


Egerton v. Brownlow (1853) 4 H.L.C. 1, 123


Emirates Bank International v. First Union National Bank [2000] WL 542235 (only available at Westlaw)


Esal Commodities Ltd v. Oriental Credit Ltd [1985] 2 Lloyd’s Rep. 546


Forestal Mimosa Ltd Oriental Credit Ltd [1986] 1 Lloyd’s Rep. 329


Forman & C. Wright (1851) 11 C.B. 481

Foster v. Driscoll [1929] 1 K.B. 470


198


GKN Contractors Ltd v. Lloyds Bank Plc and Another [1985] 30 B.L.R. 48


Goodwin v. Robarts (1875) L.R. 10 Ex. 337

Gorgier v. Mieville (1824) 3 B&C 45 (107 ER 651)

Grant and Others v. Hunt, Public Officers of the Hampshinher Banking Company, [1845] 1 C.B. 42

Ground Air Transfer v. Westates Airline 899 F.2d, 1272 (1990)


Heskell v. Continental Express Ltd [1950] 1 All E.R. 1033


Howe Richardson Scale Co Ltd v. Polimex-Cekop [1978] 1 Lloyd’s Rep. 161

Hughes Bros Pty Ltd v. Teledy Pty Ltd [1991] 7 B.C.L. 210 (Australia)


Interco, Inc v. First National Bank 560 F2d 480 (1st Cir. 1977)


Themehelp Ltd v. West [1995] 3 W.L.R. 751

Ireland v. Livingston (1871) L.R. 5 H.L. 395


James Finlay & Co. Ltd. v. M.V. Kwik Hoo Tong Handel [1929] 1 K.B 400


Johnson & others v. Collings (1800) 1 East 98

KBC Bank v. Industrial Steel (UK) Ltd [2001] 1 All E.R. (Comm.) 409


Kreditbank Cassel G.m.b.H. v. Schenkers, Ltd [1927] 1 K.B. 826


Kvaerner Singapore Pte Ltd v UDL Shipbuilding (Singapore) Pte Ltd [1993] 3 S.L.R. 350

Kwei Tek Chao v. British Traders and Shipper [1954] 2 Q.B. 459

Linden Gardens Trust v. Lensta Sludge Disposals [1994] 1 A.C. 85


Lorne Stewart Plc v. Hermes Kreditversicherungs AG, Amey Asset Services Ltd [2001] WL 1251939 (only available at Westlaw)

Mahonia Ltd v. JP Morgan Chase Bank and Another [2003] 2 Lloyd’s Rep. 911

Mahonia Ltd v JP Morgan Chase Bank (No.2) [2004] WL 1808816 (available at Westlaw)
Maitland v. Chartered Mercantile Bank of India, London and China (1865) 2 H& M 440

Manbre Saccharine Co Ltd v. Corn Products Co Ltd [1919] 1 K.B. 198

Mannesman Handel A.G. Kaunlaran Shippinh Corp. [1993] 1 Lloyd’s Rep. 89


Maxim Nordenfelt Guns and Ammunition v. Nordenfelt [1893] 1 Ch. 630

McConnell Ltd v. Sembcorp Ltd [2002] B.L.R. 450 (Sing HC).

Midland Bank Ltd. v. Seymour [1955] 2 Lloyd’s Rep. 147


Motis Exports Ltd v. Dampskibsselskabet AF1912, Akieslskab [1999] 1 All E.R. 571

Murphy v. FDIC 12 F3d 1485 (9th Cir, 1993)


Nadler v. Mei Loong Corp 177 Misc. 263, 30 N.Y.S.2d 323 (Sup.Ct.1941)


Owners of Cargo Lately Laden on Board the Siskina v Distos Compania Naviera SA [1979] A.C. 210


Pillans v. Van Mierop (1765) 97 Eng. R. 1035

Potton Homes Ltd v. Coleman Contractors Ltd [1984] 28 B.L.R. 19


Procter & Gamble Philippine Manufacturing Corp v Becher [1988] 2 Lloyd’s Rep. 21


R. v. Mackinnon and others [1958] 3 W.L.R. 688


Re Mahmoud And Ispahni [1921] 2 K.B. 716


Road Surfaces Group Pty Ltd v. Brown [1987] 2 Qd. R.792 (Australia)

Roman Ceramics Corp. v. peoples National Bank 714 F.2d 1207 (3d Cir. 1983)


Ruben and Another v. Great Fingall Consolidated and Others [1906] A.C. 439

Russle v. Langstaffe (1780) 2 Doug. 514


Samwoh Asphalt Premix v. Sum Cheong Piling [2002] B.L.R. 459 (Sing CA)

Seaconsar Far East Ltd. V. Bank Markazi Jomhouri Islam Iran [1993] 1 Lloyd’s Rep. 236


Shaw v. Shaw [1965] 1 W.L.R. 537


Smyth (Ross T) v. Bailey (TD) Sons Co [1940] 3 All E.R. 60


Spector v. Ageda [1973] Ch. 30


Standard Chartered Bank v. Pakistan National Shipping Corp (No 2) [1998] 1 Lloyd’s Rep. 684

Stocks v. Dobson (1853) 4 De GM & G 11

Sztejn v. J. Henry Schroeder Banking Corp 177 Misc. 719, 31 N.Y.S.2d 631 (1941)

Old Colony Trust Co. v. Lawyers Title and Trust Co. 297 F. 152 (1924)


The Bank of Ireland v. Archer and Daly (1843) 11 M & W 383, 152 E.R. 852

The Hermione [1922] P. 162


Trafalgar House Construction (Region) v. General Surety & Guarantee Co Ltd [1995] 3 All E.R. 737


Tregelles v. Sewell (1862) 7 H. & N. 574


Tukan Timber v. Barclays Bank [1987] 1 Lloyd’s 171


Walford v. Miles [1992] 2 A.C. 128

Werner v. A.L. Grootemaat & Sons, Inc. 80 Wis. 2d 513, 259 NW2d 310 (1977)

Wood Hall Ltd v. Pipeline Authority [1979] 141 C.L.R. 443 (Australia)
Bibliography

Books

Affaki, G. *A User's Handbook to the URGD (Demand Guarantees)* (Paris, 2001)


*Chitty on Contracts* (London, 2004)
Chung-Hsin, H. *The Principle of Independence of Demand Guarantees and Standby Letters of Credit* (Cambridge University, 1999)


Dolan, J. *The Law of letters of credit: Commercial and Standby Credit* (Boston, 1996)

Ellinger, P. *Documentary Letters of Credit* (Singapore, 1970)


Finkelstein, H. *Legal Aspects of Commercial Letters of Credit* (New York, 1930)


Harfield, H. *Bank Credits and Acceptance* (New York, 1974)

Hedley, W. *Bills of Exchange and Bankers’ Documentary Credits* (London, 2000)


Jack, R. *Documentary Credits* (London, 2001)


Mann, F. *The Legal Aspect of Money* (Oxford, 1992)


O'Connor, J. *Good Faith in English Law* (Dartmouth, 1989)

Pierce, A. *Demand Guarantees in International Trade* (London, 1993)


Row, M. *Letters of Credit* (London, 1997)

Sarna, L. *Letters of Credit* (Toronto, 1986)


Spalding, W. *Bankers' Credit and all that Appertains to Them in their Practical, Legal and Every-Day Aspects* (Bath, 1921)

Spry, I. *The Principles of Equitable Remedies: Specific Performance, Injunctions, Rectification, and Equitable Damages* (Sydney, 2001)
Todd, P. *Bills of Lading and Bankers' Documentary Credits* (London, 1998)


Ventris, F. *Bankers' Documentary Credits* (London, 1990)


Wheble, B. *Documentary Fraud in International Trade, Whose Fault, Whose Responsibility?* (Essex, 1983)


*Articles and notes*


Arora, A. ‘Fraud & Forgery in Commercial Documentary Credits’ (1983) 9 *C.L.B.* 271


Arora, A. 'False and Forged Documents under a Letter of Credit' (1981) 2 _Co. Law._ 66

Austin, L. 'Letters of Credit: Gold Bullion' (1985) 45 _La. L. R._ 927


Barclay, A. 'Court Orders against Payment under First Demand Guarantees Used in International Trade' [1989] _J.I.B.L._ 110


Bartholomew, G. 'Relations between Banker and Seller under Irrevocable Letters of Credit' (1959) 5 _McGill. L.J._ 89


Bennett, H. 'Documentary Credits, Fraud & String Contracts' [1991] _L.M.C.L.Q._ 43

Bennett, H. 'Original Sins under the UCP 500' [2001] _L.M.C.L.Q._ 88


Beutel, F. 'The Development of Negotiable Instruments in Early English Law' (1938) 51 H. L.R. 813

Blau, W. & Jedzig, J. 'Bank Guarantees to Pay Upon First Written Demand in German Courts' (1989) 23 Int'l. Law. 725

Bolgar, V. 'Abusive Rights in France Germany, and Switzerland: A Survey of a Recent Chapter in Legal Doctrine' (1975) 35 La. L. Rev. 1016


Brown, W. 'Documentary Conditions of Payment in Commercial Letters of Credit' (1939) 13 Tul. L. Rev. 495


Buckley, R. 'The 1993 Revision of the Uniform Customs and Practice for Documentary Credits' (1995) 28 GW. J. Int'l. L. & Econ. 265.


Buckley, R. 'Potential Pitfalls with Letters of Credit' (1996) 70 A.L.J. 217


Busto, C. 'Are Stand-by Letters of Credit a Viable Alternative to Documentary Credits' [1990] J.I.B.L. 145


Byrne, J. & Barnes, J. 'Letters of Credit' (1994) 49 Bus. Law. 1907


Champness, C. ‘Fraud & Recklessness’ [1961] *J.B.L.* 40


Chin, L. & Wong, Y. ‘Autonomy – a Nullity Exception at Last’ [2004] *L.M.C.L.Q.* 14


Chorley, R. ‘The Conflict of Law and Commerce’ (1932) 48 *Q.L.R.* 51

Chuah, J. ‘Documentary Credits and Illegality in the Underlying Transaction’ (2003) 9 *J.I.M.L.* 518

Chuah, J. ‘Performance Guarantees and the Fraud Exception’ (1999) 26 *Student L.R.* 49


Colman, M. ‘Performance Guarantees’ [1990] *L.M.C.L.Q.* 223


Davis, A. ‘Commercial Letters of Credit’ (1965) 5 *Sydney. L. Rev.* 14

Davis, A. ‘The Relationships Between Banker and Seller under a Confirmed Credit’ (1936) 52 *L.Q.R.* 225


Dolan, J. ‘Standby Letters of Credit and Fraud (Is the Standby only another Invention of the Goldsmiths in Lombard Street?)’ (1985) 7 *Cardozo L.R.* 1


Eberth, R. ‘Documentary Credit in Germany and England’ [1977] *J.B.L.* 29


Eggert, K. ‘Held up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instruments’ (2002) 35 *Creighton L.Rev.* 363

212


Ellinger, P. ‘The Tender of Fraudulent Documents under Documentary Letters of Credit’ (1965) 7 Mal. L.R., 24


Enoch, Y. ‘Guarantees versus On-Demand’ (1998) 3 Scottish Law & Practice Quarterly 236

Enock, R. ‘Illegality is no Longer a Defence’ (1995) 12 Int. I.L.R. 436


Fellinger, G. ‘Letters of Credit: the Autonomy Principle and the Fraud Exception’ (1990) 1 J. Banking & Finance L. & Practice. 4

Finkelstein, H. ‘Acceptances and Promises to Accept’ (1926) 26 Col. L.R. 684

Finkelstein, H. ‘Performance of Conditions under a Letter of Credit’ (1925) 25 Col. L.R. 724


Gilmore, G. ‘The Commercial Doctrine of Good Faith Purchase’ (1954) 63 *Yale L.J.* 1057


Goode, R. ‘Surety and On-Demand Performance Bonds’ [1988] *J.B.L.* 87


Greenleaf, C. ‘The Holder-in-Due-Course Exemption to the Fraud Exception to Compelled Honour Under Revised Article 5’ (1998) 115 *Banking. L.J.* 29

Hare, C. ‘No Black and White: the Limits of the Autonomy Principle’ (2004) 63 C.L.J. 288

Harfield, H. ‘Enjoining Letter of Credit Transaction’ (1978) 95 Banking. L.J. 596


Hershey, O. ‘Letters of Credit’ (1918) 32 H.L.R. 1


Holdsworth, W. ‘Origins and early History of Negotiable Instruments I’ (1915) 31 L.Q.R. 12

Holdsworth, W. ‘The Origins and Early History of Negotiable Instruments III’ (1915) 31 L.Q.R. 376


Hooley, R. ‘Fraud and Letters of Credit: is there a Nullity Exception?’ (2002) 61 C.L.J. 279


215


Kapoor, P. ‘Definition and Classification of Maritime Fraud’ [1984] L.M.C.L.Q. 29

Karni, C. & Turner, P. ‘Two Commentators Discuss How the Term “Negotiation” is Used – or Misused’ (2001) 7 D.C.I. 18


Kuo-Ellen, S. ‘It is Insufficient to Rely only on Documents’ (2002) 5 J.M.L.C. 221


Llewellyn, K. ‘Meet Negotiable Instruments’ (1944) 44 Col. L.R. 299


Lord, A. ‘The No-Guaranty Rule and the Standby Letter of Credit Controversy’ (1979) 96 Banking L.J. 46


Maggs, G. ‘The Holder in Due Course Doctrine as a Default Rule’ (1998) 32 Ga.L.Rev. 783


Mann, F. Documentary Credits and Bretton Woods’ (1982) 98 L.Q.R. 526


McCurdy, W. ‘The Right of the Beneficiary under a Commercial Letters of Credit’ (1923) 36 H.L.R. 323

McCurdy, W. ‘Commercial Letters of Credit’ (1921) 35 H.L.R. 539

McGowan, G. ‘Assignability of Documentary Credits’ (1948) 13 Law & Contemp. Probs. 666


McLaughlin, G. ‘Should Deferred Payment Letters of Credit be Specifically Treated in a Revision of Article 5?’ (1990) 56 Brooklyn L.Rev. 149


Mead, C. ‘Documentary Letters of Credit’ (1922) 22 Col. L.R. 297


Midwinter, S. ‘Fraudulent Bills of Lading and Bankers’ Commercial Credits: Deceit, Contributory Negligence and Directors’ Personal Liability’ [2003] L.M.C.L.Q. 1

Moses, M. ‘The Irony of International Letters of Credit: they Aren’t Secure, but they (Usually) Work’ (2003) 120 Banking. L.J. 479


Note, ‘Letters of Credit: Injunctions as a Remedy for Fraud in U.C.C. Section 5-114’ (1979) 63 Minn. L. Rev. 487

Note, ‘Letters of Credit’ (1920) 34 H.L.R. 533

Note, ‘Revised International Rules for Documentary Credits’ (1952) 65 H.L.R. 1420

Note, ‘The Rights of the Seller under a Documentary Credit’ (1925) 34 Yale.L.J. 775


Penn, G. ‘Performance Bonds: are Banks Free from the Underlying Contract’ [1985] L.M.C.L.Q 132


Postan, M. ‘Credit in Medieval Trade’ (1928) 1 Econ. H.R. 234


Rendell, R. ‘Fraud and Injunctive Relief’ (1990) 56 Brooklyn. L. Rev. 111


Riddall, W. & Affaki, G. ‘Two Experts Debate Why the Uniform Rules for Demand Guarantees are not Widely Used and Propose Solutions’ (2001) 7 D.C.I. 12


Rogers, J. ‘The Myth of Negotiability’ (1990) 31 B.C.L.Rev. 265


220


Schmitthoff, C. ‘Documentary Credit; Presentation of Forged Documents’ [1974] J.B.L. 314

Schmitthoff, C. ‘Documentary Credit; Presentation of Ineffective Documents’ [1982] J.B.L. 512

Schmitthoff, C. ‘Fraud in Documentary Credit Transactions; Obligation to Pay with Knowledge of Fraud’ [1982] J.B.L. 319


Schwank, F. ‘Advance Payment under Deferred Letters of Credit: Fraud & its Effects’ (1989) 12 Int. B.L. 185

Schwank, F. ‘Bank Guarantees German Approach to the Unjustified Exercise of Legal Rights in Claims under Bank Guarantees’ (1983) 1 Int. B.L. 92


Schwank, F. ‘Bank Guarantees in German and Austrian Law’ (1982) 1 Int. B.L. 7


Stewart, J. ‘The UCP in Court’ (2001) 7 D.C.I. 12

Stoufflet, J. ‘Fraud in Documentary Credit, Letter of Credit and Demand Guarantees’ (2001) 106 Dick. L. Rev. 21


Takahashi, Koji. ‘Right to terminate (avoid) international Sales of Commodities’ [2003] J.B.L. 102

T, R. ‘Letters of Credit – Negotiable Instruments’ (1926) 31 Yale.L.J. 245

Teik, H. ‘Transnational Fraud’ [1985] L.M.C.L.Q. 418


Thayer, P. ‘Irrevocable Credits in International Commerce: their Legal Effects’ (1937) 37 Col. L.R. 1326

Thayer, P. ‘Irrevocable Credits in International Commerce: their Legal Nature’ (1936) 36 Col. L.R. 1031

Thomas, A. ‘Letters of Credit – Injunctions - the Purist & the pragmatist: Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor’ [1999] J.I.B.L. 210


Todd, P. ‘Sellers and Documentary Credits’ [1983] J.B.L. 468


Treitel, G. ‘Rights of Rejection under c.i.f. Sales’ [1984] L.M.C.L.Q. 565

Treitel, H. ‘Consideration: A Critical Analysis of Professor Atiyah’s fundamental Restatement’ (1976) 50 A.L.J. 439


Trimble, R. ‘The Law Merchants and the Letter of Credit’ (1948) 61 H.L.R. 981


Wehling, A. ‘Fraud and Forgery in Documentary Credits – A Comparison’ (1996) 15 Tr. Law. 378


White, K. ‘Bankers Guarantees and the Problem of Unfair Calling’ (1979) 11 Journal of Maritime Law and Commerce 121


223

Wu, T. & Loh, Q. ‘Injunctions Restraining Calls on Performance Bonds – is Fraud the only Ground in Singapore?’ [2000] L.M.C.L.Q. 348


Chapters in monographs


Byrne, J. ‘Why the ISP Should be Used For Standbys’ in Byrne, J. & Byrnes, C. (eds.) Annual Survey of Letter of Credit Law and Practice (Institute of International Banking Law & Practice, Inc, 2001) 28


225

Farrar, S. ‘Multibank Credits’ in Reade, H. & Ryan, R. (eds.) Letters of Credit and Bankers’ Acceptances (New York, 1988) 523


