Legal Sources of Fraud Rule and It's Standard in Documentary Credit.

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Ⅰ. Introduction
Ⅱ. Meaning and Rationale
1. Meaning
2. Rationale
Ⅲ. Legal Sources
1. Sztejn Case
2. ICC Rules
3. UNCITRAL Convention
4. Domestic Rules and Cases
Ⅳ. Standard of Fraud
1. American Standard
2. U.K. Standard
3. U.N. Standard
Ⅴ. Conclusion

Ⅰ. Introduction

Documentary credit is the typical payment mechanism in the international commercial transaction. This mechanism is operated under two fundamental principles; the principle of independence and the principle of strict compliance.

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Under the principle of independence, the obligation of the issuing bank to honour the beneficiary's draft or demand for payment is viewed as separate from the underlying transaction between the applicant and the beneficiary. And under the same principle, all parties concerned deal with documents.

Under the principle of strict compliance, every party to the credit transaction wishing to receive payment has to tender strictly complying documents with the requirements of the credit. So to speak, the presentation of a commercial requirement, even if of equal or great values, does not suffice, and the tender must be made strictly in the manner and within the time prescribed in the credit.

The fraud rule, often known as the "fraud exception rule" is an exceptional rule to two principles. Under the rule, although the documents are in strict compliance with the terms and conditions of the credit on their faces, payment may be hindered if fraud is committed in transaction.

The purpose of this thesis is to examine the legal sources of the fraud rule. As the documentary credit is essentially international instruments, the legal sources in international level like ICC and UNCITRAL Rules should be examined first. And the laws or cases of the United States and the United Kingdom should be considered later because the legal systems of these countries have played significant roles in shaping the legal principle of "fraud rule".

Then this writer will try to establish the standard of fraud which every country would willingly respond to. This uniform and established standard would contribute to diminish the fraudulent acts committed by the beneficiary or the third party.

This paper consists of five parts. The first part and the second parts are concerned with introduction and theoretical backgrounds of "fraud rule" respectively on which further discussion in the remaining parts may be based. The third part deals with the legal sources of "fraud rule". The fourth part concerns establishing the standards of fraud rule in light of those legal sources. In conclusion, the fifth part attempts to suggest the

desirable and optimal standards of fraud rule, taking into account the different interests of each party or nation.

Ⅱ. Meaning and Rationale

1. Meaning

"Fraud", in my opinion, is a term that should be reserved for something dishonest and morally wrong, and much mischief is, I think, done, as well as much pain inflicted, by its use ...[1] Fraud, like mistake, may involve one's representations, whether express or implied, of false facts or non-disclosure of true facts. But the decisive distinction between fraud and mistake lies in the nature and purpose of the defrauding party's representation or non-disclosure. What entitles the defrauded party to avoid the contract is the "fraudulent" representation or non-disclosure of relevant facts. Such conduct is fraudulent if it is intended to lead the other party into error and thereby to gain an advantage to the detriment of the other party.[2]

As the fraud rule in the letter of credit is a developing area, it is not possible to state legal effect with certainty. However, in view of current law and practice, if the fraud is found to have been committed in the transaction before payment is made, payment thereunder may be stopped, although the documents presented are facially in strict compliance with the terms and conditions of the letter of credit.

This fraud will usually relate to the documents themselves. They may be forged or untrue in relation to the goods to which they refer, however on

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1) Cranworth C., Boyse v. Rossborough, 6 H.L. Cas. 48. 49 (J. S. James Stroud's Judicial Dictionary, 5th ed, Vol.2, Sweet & Maxwell, 1986, p.1029)

2) Principles of International Commercial Contract (1994) Art.3.8 Comment.

their face they appear to be correct and good tender under the documentary credit.

To say more concretely, the fraud rule means that, where the fraud can be proved successfully, the issuing bank under an irrevocable credit and the advising bank which has added its confirmation, should refuse to honour the undertaking which it has given the beneficiary, viz. to pay, accept or negotiate according to the terms of credit, if the correct documents are tendered before the expiry of the credit.[3)]

2. Rationale

The fraud rule is an extraordinary or exceptional rule as it departs from the fundamental principle of the letter of credit; the principle of independence. This principle means that the banks engaged in the letter of credit transaction are, in principle, not involved in any dispute arising between the parties to the underlying contract of sale or other contract.

It allows the issuer or court to view the facts behind the face of conforming documents and to disrupt the payment of a letter of credit when fraud is seen to be involved in the transaction. The rationale to admit this controversial rule in the letter of credit can be divided as follows: The first reason is to close a loophole in law. In accordance with the principle of independence in the law governing letters of credit, all the parties under the letter of credit are only dealing with documents. If documents tendered appear on their face to be in strict compliance with the terms and conditions stipulated in the credit, the issuer will make payment, irrespective of any disputes or claims with regard to other related transaction

The rigid application of the principle may in some case produce

3) Leo D'arcy et al., Schmitthoff's Export Trade ; The Law and Practice of International Trade, 10th ed., Sweet & Maxwell, 2000, p.210.

unexpected result, which can be contrary to the original purpose of the principle.[4] This happens when fraud is involved in the transaction. Because of the documentary nature of the letter of credit operation, beneficiaries demanding payment do not have to show that they have properly performed their duties in the underlying transaction; all they have to do is to produce facially conforming documents. The separation of the documents from the actual performance of the underlying transaction may creates in law a loophole for those immoral beneficiaries to abuse the system. The classic example is where the seller is paid under a commercial letter of credit from the issuer by presenting forged or fraudulent documents which comply in their face with the requirements in the credit.

The second rationale is to safeguard public policy for the control of fraud. Fraud is wrong and should be prevented. It is trite law that "fraud unravels all".[5] As an American judge has stated; there is as much public interest in discouraging fraud as in encouraging the use of letters of credit.[6] Thus the fraud rule is part of a sound legal system that upholds the public policy of limiting fraud.

In recent years, letter of credit and independent guarantees have been used increasingly by fraudsters as instruments of "a particularly vicious scam which has bilked investors out of million dollars not to mention uncounted hours and costs, has spurred numerous law suits, criminal investigations, and sullied the reputation of legitimate vehicles of trade and commercial finance."[7]

The third rationale is to maintain the utility of letter of credit. The fraud in the letter of credit clashes not only with public policy against fraud, but also poses an equally serious potential threat to the commercial utility of

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4) H. A. Getz, "Enjoining The International Standard Letter of Credit : The Iranian Letter of Credit Cases" (1980) 21 Harv. Int'l. L. J. 189, 204.

5) United City Merchants v. Royal Bank of Canada (1983) AC 168. 184

6) Dynamics Corp. of America v. Citizens & Southern Nat'l Bank (1973) 356 F. Supp. 991. 1000.

7) J. E. Byrne, "Critical Issues in the International and Domestic Harmonisation of Letter of Credit Law and Practice" in commercial Law Annual (1995), 389. 421.

letter of credit.[8]

The prevalence of the letter of credit lies in the fact that it can provide a fair balance of competing interests among the parties involved. The normal operation of the letter of credit not only provides the beneficiary with safe and rapid access to the price sold even when the applicant defaults, but also provides the applicant with credit and/or commercial benefits, protects the applicant against improper calls, by requiring the beneficiary to present documents indicating that the beneficiary has properly performed its obligations under the underlying transaction. It also furnishes the issuer with fee for its document checking service.

If one party avails itself of the loophole in the letter of credit system and defrauds other parties by presenting forged or fraudulent documents, it harms the interests of the other parties and undermines the balance assumed in the letter of credit scheme. In a letter of credit transaction, for example, if the seller ships nothing or only rubbish, but gets payment by presenting forged or fraudulent documents, it hurts the applicant. It might be argued that, under the law of letter of credit, the buyer may take legal proceedings against the seller for fraud under the underlying contract. However this is generally not an attractive proposition. Because in most cases, the fraudster runs away before the fraud or forgery is discovered.[9]

Often the bank agrees to issue the letter of credit on the condition that the goods will serve as security for issuing the letter of credit. If nothing or only rubbish is shipped, the issuer's security interest over the goods will disappear too.

Like the success of any commercial instrument, the popularity of the letter of credit is based on the good faith of its users. If the possibility of the abuse of the letter of the credit system will continue, the good faith in the system of letter of credit will fade, so will the commercial utility of the

8) G. W. Smith, "Irrevocable Letters of Credit and Third Party Fraud : The American Accord." (1983) 24 Va. J. Int'l. L. 55, 96.

9) E. P. Ellinger, "Documentary Credits and Fraudulent Documents" in Chinkin(ed), Current Problems of International Trade Financing (1983), 185, 191.

letter of credit.

Ⅲ. Legal Sources

1. Sztejn[10] Case

This case is the landmark in the course of the development of the fraud rule in the laws of letters of credit. It has been not only codified in the UCC, but also followed throughout the common law world.

In this case Sztejn contracted to buy bristles from Trausea Traders Ltd., an Indian Company. In order to get payment for the goods, Sztejn asked Schroder to issue a letter of credit in favour of Trausea, who placed fifty cases of material on board a steamship, procured the document required and drew a draft to order of Chartered Bank, which presented the draft to Schroder for payment along with the required documents.

Before payment had been made, Sztejn filed a suit for a judgment declaring the letter of credit and draft thereunder void, and for an injunctive relief to prevent the issuer form paying the draft, alleging that the beneficiary had in fact, shipped the 50 cases with worthless materials with intent to simulate genuine merchandise and defraud the plaintiff.

Sztejn also averred that the presenting bank was a collecting bank for Trausea, not an innocent holder of the draft for value. The presenting bank moved to dismiss the complaint on the ground that it failed to state a cause of action against the moving defendant because the Chartered Bank is only concerned with the documents and on their face they conform to the requirements of the letter of credit.

For the purpose of hearing the motion, Shientag J. of the Supreme Court of New York County, assumed that all the allegations of the complaint were

10) Sztejn v. J. Henry Schroder Banking Corp. 31 NYS 2d. 631 (1941).

true, namely, "Trausea was engaged in a scheme to defraud the plaintiff ..., that the merchandise shipped by Trausea is worthless rubbish and that the Chartered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Trausea's account."

Based on the "established" facts that fraud has been committed in the transaction, the Court rejected the Chartered Bank's motion for dismissing the plaintiff's complaint and ruled for the plaintiff.

Although the courts have used language to the effect that the letter of credit is independent of the primary contract between the buyer and the seller, that language was used in cases concerning the breaches of warranty: no case it did not cover an intentional fraud on the part of the seller. Therefore the payment under the letter of credit in the case should be stopped.

The interests of the issuing bank and presenting bank might be damaged by the seller's fraud. In fact the letter of credit requires a bill of lading made out to the order of the issuing bank. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents. And also if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud.

Thus Sztejn was the first case to declare the major elements of the fraud rule. It declared the three principles of a paramount importance. First, payment under a letter of credit may only be interrupted in case of fraud; mere allegation of breach of warranty cannot be an excuse for such an interruption. Second, payment under a letter of credit can only be interrupted when the fraud is proved and established; mere allegation of fraud should not be an excuse for such an interruption. Third, payment should be made in accordance with the terms of credit, notwithstanding the existence of the proven fraud, if demand for payment is made by a holder

in due course.

2. ICC Rules

1) UCP

The UCP is silent regarding to the issues of fraud. The reason is that the UCP has been mainly designed to provide a contractual framework for dealing between issuers and beneficiaries, and between issuers and correspondent banks. It does not concern itself with the rights and duties of the parties to the underlying contract, nor is it the function of the UCP to regulate the issues that are the proper province of national law.

The fraud issue between the seller and the buyer is traditionally considered as the province of the applicable national law and of the courts of the forum.[11] For this reason, although the ICC drafters of the UCP are clearly aware of the fraud issue, they have deliberately left it out.[12] In fact, the fraud rule is very sensitive to local rules which vary among jurisdictions. Even in enacting CISG, the drafters left out the validity issue like fraud or mistake.

A good commercial law is one that serves commerce best. A law that serves commerce best maximises certainty and predicability for the commercial community. To have such an effect, a law should give the best answers it can give to problems that can be predicted. It is questionable whether the UCP satisfies this standard without dealing the fraud issue. The drafters of the UCP knew of the problem of fraud, and knew it had caused problems in letter of credit transactions; nevertheless they chose not to address it by leaving users of letter of credit without any guidance to

11) R. M. Goode, "Abstract Payment Undertaking and the Rules of the International Chamber of Commerce" (1995) 39 Saint Louis U.L.J. 725, 727.

12) K. A. Barski, "Letters of Credit; A comparative of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits." (1996) 41 Loy L. Rev. 735, 751.

fraud problems they might encounter. This has left the fraud issue of letter of credit to individual domestic court with a great degree of uncertainty and unpredicability.

As the letter of credit is a specialized commercial creature, the fraud rule of each country may be different, and every judge even in a same country can't be an expert in the law of letter of credit. It is very difficult to expect a consistent and predictable decision in every court.

2) URCG

The Uniform Rules for Contract Guarantees (URCG) was published by the ICC in 1978 as ICC Pub. No.325. The purpose of the URCG is to respond to the need for a set of standard rules to deal with ambiguities or inconsistencies in the field of guarantees given by banks, insurance companies and other guarantors in the form of tender bonds, performance guarantees and repayment guarantees in relation to projects in another country involving the supply of goods or services or the performance of work.[13]

However the URCG has rarely been accepted or used since its publication. One reason for that is a conceptual problem in that the URCG has not made clear that it is confined to independent guarantees and does not apply to accessory guarantees. But the major hurdle to the general acceptance of the URCG is because of the provision in Article 9, which requires the beneficiary to produce a judgment or arbitral award or the principal's written approval when making a claim. The condition is meant to deal with the problem of unfair calling, but it proved too far removed from the market practice.[14]

Unlike the UCP, the URCG has attempted to tackle the issue of fraud, or

13) J. E Byrne, "Fundamental Issues in the Unification and Harmonisation of Letter of Credit Law" (1991) 37 Loy L. Rev. 1, 4.

14) R. M. Goods, "The New ICC Uniform Rules of Demand Guarantees," (1992) LMCLQ 190, 192.

in this context "unfair calling" of independent guarantees. Strictly speaking, these provisions are not the same as the fraud rule in this paper. The fraud rule is concerned with the circumstances under which payment under the letter of credit may be disrupted. But the Article 9 of the URCG provides the conditions that make the payment of independent guarantees. Nevertheless, the purpose is the same: to preventing fraud.

3) URDG

With the experience of the URCG, the ICC decided to replace the URCG with a new set of rules with a new approach to the question of independent guarantees. The new rules came out in 1992 as ICC Pub. No. 458 and were named as the Uniform Rules for Demand Guarantees.[15] The text of the URDG is strongly influenced by the UCP, but worldwide acceptance has been disappointing.

Having learned from the experience of the URCD, the drafters of the URDG chose to take a similar position to the UCP on the issue of fraud - be silent and leave it to the courts of the various jurisdictions. Divergent views, however, were expressed during the formulation of the rules, reflecting the competing interests of the parties concerned. Banks sought a simple mechanism whereby the issuer has to pay without having to make difficult investigations or take hard decisions based on unclear evidence. Beneficiaries at large claimed that they needed a mechanism whereby they got paid against a simple demand or documents. But applicants were interested in having some kind of safety device so as to prevent unjustified callings.[16]

In order to prevent the beneficiary's unjustified calling, Article 20 of the

15) Demand Guarantee is contrary to Conditional Guarantee. The former is payable upon first demand by the beneficiary against presentation of specified documents to the bank and is unconditional. (IE Contractors v. Lloyds Bank plc. (1989) 2 Lloyd's Rep 205, 207)

16) L. Gorton, "Draft UNCITRAL Convention on Independent Guarantees" (1997) J.B.L. 240, 244.

URDG requires the beneficiary when demanding payment to state in writing both that there is some kind of breach of the underlying transaction and what type of breach is involved, thus giving the other parties some kind of protection by providing a ground for a claim of fraud. However, this provision is similar to that of Article 9 of the URCG in nature, in providing a kind of safety device for the trigger of the payment of the independent guarantee to prevent fraud, whereas it differs from the fraud rule, which addresses what to do when fraud is bound to have been committed. As the URDG is also not well accepted by users of independent guarantees, the effectiveness of this approach remains to be seen.

4) ISP98

The International Standby Practice(ISP98) is a set of rules specifically designed for standby letter of credit. It was created by the U.S. based Institute for International Banking Law and Practice, Inc. with the support of the US Council on International Banking (USCIB, now the International Financial Services Association (ISFA)), then revised and adopted in 1998 by the ICC as ICC Pub. No. 590. The ISP98 came into effect in January 1999, and its reception has been, on the whole, very positive.

Standby letter of credit has been widely used for decades and its popularity continues to grow, but there were no special rules for standby letter of credit. Most Standby letters of credit have been issued subject to the UCP. But the UCP was created originally for use in commercial letter of credit. Thus many provisions of the UCP are neither applicable nor appropriate in the Standby letter of credit.[17]

ISP98 was drafted for standby letter of credit in the same sense as the UCP for commercial letters of credit and the URDG for independent guarantees. However, the application of ISP98 is not limited to standby letters of credit. Like the UCP and the URDG, the ISP98 applies to an

17) P. S. Turner, "New Rules For Standby Letters of Credit : The International Standby Practices" (1999) 14 B.F.L.R. 457, 459.

independent undertaking issued subject to it.[18]

ISP98 takes a similar approach to the UCP and expressly leaves the issue of fraudulent or abusive drawing or defences to honor based on fraud ... or similar matters ... to applicable law.[19]

Under the Rules 4.16 and 4.17 of ISP98, a demand for payment under a standby letter of credit is not required to indicate a default or other event in the underlying transaction if that is not required under the terms and conditions of standby letter of credit.

The omission of the fraud rule from ISP98 has nevertheless been applauded by some commentators as an act because fraud has been addressed in different ways in different countries. To have included provisions on fraud in ISP98 would probably have created needless misunderstandings in countries such as the U.S.[20]

3. UNCITRAL Convention

The UNCITRAL Convention (UN Convention on Independent Guarantees and Standby Letters of Credit) was drafted from 1989 to 1995, and came into effect on 1 January 2000.[21]The Convention applies to an international undertaking such as an independent guarantee or a standby letter of credit, where the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State or the rules of private law lead to the application of the law of a Contracting State. The Convention can also apply to commercial letters of credit if the parties expressly state that their credit is subject to it.

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18) J. E. Byrne, "Preface to International Standby Practice ISP98" (ICC Pub. No. 590, 1998), 6.

19) Rule 1.05 of ISP98.

20) P. S. Turner, op. cit., p.463.

21) As of 30 May 2002, The Convention was rectified by Belarus, Ecuador, El Salvador, Kuwait, Panama and Tunisia, and signed by the U.S. <http://www.uncitral.org.en-index.htm>

The Convention is modeled upon both the UCP and the URDG, but it is distinguished in that both the UCP and the URDG are drafted by the ICC as voluntary rules, whereas the Convention is drafted by the UNCITRAL, as a uniform law or official regulation for those countries who adopt it.

Unlike the ICC rules, the UNCITRAL Convention was made on effort to address the issue of fraud and to prevent fraudulent or unjustified calling of standby letter of credit or independent guarantees.[22] There are three articles in relation to the fraud rule under the Convention.

In Article 15, the Convention first puts up a general requirement for the beneficiary demanding payment under a letter of credit or independent guarantee. Especially Article 15(3) provides that the beneficiary, when demanding payment, is deemed to certify that the demand is not bad faith and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph (1) of Article 19 are present.

Article 19, with the heading of "Exception to Payment Obligation", then enumerates the circumstances under which the issuer may dishonor the beneficiary's demand for payment. Paragraph (1) of Article 19 provides that the guarantor/issuer has right, as against the beneficiary, to withhold payment if one of the following is manifest and clear:

(a) Any document is not genuine or has been falsified;

(b) No payment is due on the basis asserted in the demand and the supporting documents; or

(c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis ... .

Paragraph (2) of Article 19 explains what the term 'no conceivable basis' means.[23]

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22) The word "fraud" has not been used in the Convention in order to avoid confusion resulting from different interpretations developed in different jurisdictions about the meaning of the term. (E. E. Bergsten, "A New Regime for International Independent Guarantees and Stand-By Letter of Credit : The UNCITRAL Draft Convention on Guarantee Letters." (1993) 27 Int'l Lawyer 859, 872.)

23) Paragraph (2) of Article 19 explains what the term 'no conceivable basis'

Article 19 not only provides the issuer with some basis for refusing payment, but also enables the applicant to take court measures against fraudulent beneficiary. Paragraph (3) provides that in the circumstances set out in subparagraphs (a), (b) and (c) of paragraph (1) of Article 19, the principal/applicant is entitled to take provisional court measures in accordance with Article 20.

These provisions of the Convention are by and large in accordance with current practice. They include most of the elements of the fraud rule that have been developed over the years by national courts.

In spite of the detailed provision in the Convention, there are a few areas that may need further improvement. First, it fails to mention who should be immune from the fraud rule, which is an important element that should be considered whenever the fraud rule is applied so that innocent third parties can be protected. Secondly, the Convention itself is specifically designed to regulate standby letters of credit and independent guarantees although commercial letter of credit users may choose to use it they so wish. If the Convention were drafted to cover all letters of credit, its influence might be much stronger.

However, the provisions regarding the fraud rule embodied in the Convention signal a significant and encouraging development in the area. First, the Convention is the first instrument to provide details of the fraud rule at an international level. Secondly, unlike the ICC rules, the Convention becomes law in a country that signs and/or ratifies it. Finally, based on the

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means, stating:
(a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialised;
(b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;
(c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
(d) Fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary; or
(e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

early signs, the influence of the Convention in the letters of credit world ought to be underestimated, because (1) it became effective less than five years after its promulgation; and (2) more importantly, in the list of signatory countries, there are such important letter of credit users as the United States.

4. Domestic Rules and Cases

(1) UCC

The UCC is a collection of model statutes drafted and recommended by the National Conference of Commissioners of Uniform States Laws(The NCCUSL) and the American Law Institute (The ALI) for enactment by the legislatures of the states of the United States. It consists of 11 different Articles, each covering a different aspect of commercial law. Article 5 of the UCC is a uniform statutory scheme governing letters of credit.

When Article 5 of the UCC was first drafted in the 1950s, it was not a complete code like some other articles. Instead, it was intended to set up an independent theoretical framework for the further development of letters of credit.[24]

As result of codifying the case law into a statute, the position of the fraud rule was strengthened in the law of letters of credit. The promulgation of §5-114(2)[25] has greatly fostered study of the fraud rule, a

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24) Official Comment on Prior Article 5, §5-101.

25) In Prior UCC Article 5, the fraud rule was embodied in § 5-114(2), which read:
(2) Unless otherwise agreed when documents appear on their face to comply with the terms of credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction:
(a) the issuer must honour the draft or demand for payment if honour is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated(Section 7-502) or a bona fide purchaser or certificated security

fact illustrated by a greatly increased volume of case law on letter of credit fraud and by much more commentary on the fraud rule worldwide.[26] Its influence has been even greater in civil law countries than in common law countries, as civil law countries which normally look to statutes rather than cases in seeking sources of law.

However, since prior UCC Article 5 was drafted more than 40 years ago and, more importantly, it was simply drafted as a basis for future development[27], the provisions of §5-114(2) were not entirely faultless, in same cases even leading to confusion among courts and letter of credit users. For example;

(1) Section 5-114(2) failed to mention what constituted fraud under the fraud rule, so different standards of fraud were subsequently applied in different cases.

(2) Section 5-114(2) provided that the fraud rule should be applied "when ... a required document ... is forged or fraudulent" or "there is fraud in transaction." Putting the two quotations in parallel led to unnecessary confusion about where fraud needed to be located.

(3) Section 5-114(2) named three types of parties that might be immune from the fraud rule: (a) a holder in due course stipulated in §3-302 of the UCC; (b) a holder of a document of title duly negotiated according to §7-502 of the UCC; (c) a bona fide purchaser of certified security under §8-302 of the UCC. Among them, only the status named in items (a), "a holder in due course" has proven to be relevant to the application of the fraud rule.[28]

(Section 8-302); and
(b) in all other cases as against its customer, an issuer acting in good faith may honour the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honour.

26) J. E. Byrne, "The Revision of UCC Article 5 : A strategy for Success" (1990) 56 Brooklyn L. Rev. 13, 16; R. S. Rendell, "Fraud and Injunctive Relief" (1990) 56 Brooklyn L. Rev. 111, 117.

27) Note, "Letter of Credit : Injunction as Remedy for Fraud in UCC § 5-114 (1979) 63 Minn. L. Rev. 487, 493 Note 27.

28) Report of the Task Force on the Study of UCC Article 5 "An Examination of

Article 5 of the UCC was revised in 1995 to cure the weakness, gaps and errors in the original statute and to meet the challenges of the development of letters of credit. Compared with prior UCC Article 5, §5-114(2), Revised UCC Article 5, §5-109, has fine-tuned the fraud rule in a number of areas.

First, §5-109 has expressly declared that, when fraud is found, the normal operation of a letter of credit may be disrupted in two different ways: by the issuer refusing to honour a presentation, or by the applicant asking a court to enjoin the payment or presentation.

Second, §5-109 has tackled two of the most controversial issues raised in the application of the fraud rule since the promulgation of prior UCC Article 5: the standard of fraud and the locus of fraud. As for the former, §5-109 provides that, to invoke the fraud rule, the fraud involved has to be material. As for the latter, the section indicates that the fraud considered includes fraud in the underlying transaction.[29]

Third, §5-109(a)(1) has listed four types of parties who may be immune from the fraud rule;

(1) A confirmer who has honoured its confirmation in good faith;
(2) A nominated person who has given value in good faith and without notice of the fraud;
(3) A holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person;
(4) An assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or fraud after the obligation was incurred by the issuer or nominated person.

Unlike prior UCC Article, §5-114(2), which named three groups of parties who should be protected under the fraud rule, only one of which proved to be relevant, all four groups named under Revised UCC Article 5, §5-109,

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UCC Article 5 (Letter of Credit)" (1990) 45 Bus. Law 1521, 1521 (Task Force Report)

29) This is indicated in Official Comment 1 on Revised UCC Article 5: "This recodification makes clear that fraud must be found either in the documents or must have been committed by the beneficiary on the issuer or applicant."

are relevant to the fraud rule, a greater improvement.

Finally, §5-109(b) has specified four conditions that must be met when a court considers an injunction. They are intended to reduce the frequency with which the fraud rule has been used since the late 1970s and signal that the standard for injunctive relief is high.[30] Revised UCC Article 5, §5-109, now stands as the most comprehensive code of the fraud rule in the law of letters of credit in the common law world.

2) United Kingdom

The most well-known English case on the fraud rule is United City Merchants (Investments) Ltd. v. Royal Bank of Canada,[31] where payment of the letter of credit was refused when the bill of lading presented had been fraudulently pre-dated by a third party. The beneficiary sued for wrongful dishonour. Before considering the issue of third party fraud, Lord Diplock stated;

"To this general statement of principle of independence, ... there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representation of fact that to his knowledge are untrue ... "

This has shown that the fraud rule is recognised in the United Kingdom and Sztejn is the foundation stone of English law in this area.[32]

Another well known case is Edward Owen Engineering v. Barclays Bank Int. Ltd.,[33] in which Lord Denning said;

"to this general principle of independence, there is an exception in the case of what is called established or obvious fraud to the knowledge of bank. The most illuminating case is of Sztejn v. J. Henry Schroder Banking

30) Official Comment 4 on Revised UCC Article 5, §5-109.
31) (1979) 1 Lloyd's Rep. 267, (1981) 1 Lloyd's Rep. 604, (1983) A.C. 168.
32) R. Jack et al., Documentary Credits 3rd ed., 2001, p.260.
33) (1978) 1 All E.R. 976.

Corp."

Although the fraud rule is recognised in the United Kingdom, it has not often been applied, especially in those early cases. The English courts have traditionally been very reluctant to interfere with the operation of a letter of credit and have adopted a relatively inflexible and narrow approach towards the application of the fraud rule. The reason for that has been explained by the well-known statement of Jenkins L. J. of the Court of Approval in the case of Hamzeh Malas & Sons v. British Imex Industries Ltd.[34]

Striking to the general non-interference approach, English courts have placed plaintiffs with a great burden of proof, requiring them to establish the existence of clear or obvious fraud also known to the issuer in order to invoke the fraud rule.

In ascertaining whether the fraud rule applies, three sets of circumstances have to be distinguished.

First, where there is an allegation, communicated by the buyer to the bank, that fraud has occurred. This allegation is founded on a suspicion. If no more can be established, the bank should pay. The Court of Appeal in the case of Bolivinter Oil S.A. v. Chase Manhattan Bank N.A.[35] stated that it refused an application for an injunction restraining the bank to pay. To apply an injunction, the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge.

Secondly, where it is clearly established to the satisfaction of the bank that a fraud has occurred. There is unambiguous evidence before it, for instance that the documents, or some of them, are fraudulent or forged. But there is no evidence before the bank which shows that the beneficiary knew of the fraud. There is the possibility that the fraud was committed by a third party, e.g. a forwarder or loading broker, who intended to cover up the fact that the goods were shipped out of time, and that the beneficiary himself was unaware of this fraud. The House of Lords decided in United

34) (1958) 2 Q. B. 127.
35) (1984) 1 W.L.R. 392, 393.

City Merchants (Investments Ltd. v. Royal Bank of Canada[36] that in this case the bank must pay.

Thirdly, where the bank has positive proof that a fraud has been committed and that the beneficiary knew of this fraud. If both of these facts are clearly established to the satisfaction of the bank, it must not honour its obligation under the credit.[37]

Ⅳ. Standard of Fraud

1. American Standard

Prior UCC Article 5 cases did not provide a consistent answer to the question of notion or standard of fraud. As Prior UCC Article 5 was silent over what kind of fraud could invoke the fraud rule, almost every Prior UCC Article 5 case involving letter of credit fraud cited Sztejn as authority and the standards of fraud adopted by the courts in those cases were divergent.

Some courts stuck to a strict and restrictive approach and adopted an egregious standard of fraud, while others were ready to take a much different approach adopting a constructive standard of fraud. And others fell somewhere between the two extremes.

It may be easy to tell the difference of the level of fraud between the two extreme standards. If there is any difference, it may be that the former looks more to the state of mind of the fraudster while the latter emphasises the severity of the effect of fraud on the transaction. But it is not easy for me to place the mentioned standards of fraud on a continuum between the

36) (1983) 1 A.C. 168.

37) Rafsanjan Pistachio Producers Co-operatial v. Bank Leumi (U.K.) plc (1992) 1 Lloyd's Rep. 513.

two extremes.

Revised UCC Article 5 has adopted the concept of "material fraud" as a standard of fraud. While the article itself does not define "material fraud", Official Comment on §5-109 has made some efforts to explain it. For commercial letters of credit, it has indicated that material fraud requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction.[38]

Neither the Article §5-109 nor its Official Comment suggests that the beneficiary's intention to defraud should be proved, so it seems that "material fraud" under Revised UCC Article 5 looks more to the severity of the effect of the fraud on the transaction than the state of mind of the beneficiary.[39] Thus the Article §5-109 has not only laid down a standard of fraud in the law of letters of credit, but also set forth a standard of "a unique kind of fraud" — "letters of credit fraud"[40], a standard specially designed to fight fraud in that mercantile specialty.

Revised UCC Article 5 has already been adopted by nearly all the States in the United States, and was first applied by US courts as early as September 1997. Nonetheless, the standard of fraud set out in §5-109 has not often been tested.

The survey of cases[41] reveals that the US court in applying the standard of "material fraud" embodied in Revised UCC Article 5 appears to have generally taken a similar approach to the egregious fraud cases. They have taken the position that the fraud rule may only be applied in limited

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38) Official Comment 1, para. 2.

39) R. P. Buckley "The 1993 Revision of the Uniform Customs and Practice for Documentary Credits" (1995) 6 JBFLP 77, 97.

40) J. E. Dolan, The Law of Letter of Credit : Commercial and Standby Credit (revised ed., 1996) pp.7-47.

41) Western Surety Co. v. Bank of Southern Oregon (257 F. 3d. 933; aff'd 2002 US App. LEXIS 15565; New Orleans Brass v. Whitney National Bank and the Louisiana Stadium and Exposition District (2002) La. App. LEXISm 1764; Mid-American Tire v. PTZ Trading Ltd. Import and Export Agents (2000) Ohio App. LEXIS 5402.

situations where the demand for payment under the letter of credit "have absolutely no basis in fact." This is "an unduly narrow" approach.[42] However, it is more disturbing to find that some judges have interpreted the standard of "material fraud" as equivalent to a violation of the obligation of "good faith, diligence, reasonableness, and care". This is close to the standard of "constructive fraud", and seems inappropriate. This indicates that divergent views as to the standard of fraud may still appear in future in the U.S. although a uniform and appropriate standard of "material fraud" has been set forth in Revised UCC Article 5.

2. U.K. Standard

English courts have traditionally adopted a relatively rigid and narrow approach towards the application of the fraud rule, requiring a high standard of proof of fraud; "clear", "obvious" or "established" fraud known to the issuer. When no fraud is found to have been committed in a transaction, there is no need for a court to consider the standards of fraud or other specific issues relating to the application of the fraud rule.

In United City Merchants (Investments) Ltd. v. Royal Bank of Canada, according to the Lord Diplock, "material misrepresentation" is the kind of fraud that can invoke the fraud rule under the English law. The word misrepresentation is very close to a statement of the elements of fraudulent misrepresentation which constituted the tort of deceit.

"Material misrepresentation" thus appears to have been settled as the standard of fraud in the law governing letter of credit in the United Kingdom. In language the English position is close to that of the U.S. in Revised UCC Article 5, §5-109 : "material fraud". As both of them have not been sufficiently tested, it is too early to make a reasonable comparison.

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42) Barnes and Byrne, "Letters of Credit : 2000 Cases" (2001) 56 Bus. Law. 4, reprinted in (2002) Annual Survey of Letter of Credit Law & Practices 13, 18.

However, if a comparison has to be made, the difference appears to be that the US position is enshrined in a Statute, but the UK position is embodied in the common law.

This may mean that the court in the U.S. will look more on the severity of the effect of the fraud on the transaction rather than the state of fraud of the beneficiary, whilst the courts in the U.K. will require proof of the state of the mind of the fraudulent. Along with the development of the fraud rule, the two systems are coming closer together : lower standards of fraud such as "constructive fraud" seems to have been abandoned by U.S. courts following the promulgation of Revised UCC Article 5; and the more recent English cases to have been applied the fraud rule seem to be shifting from the traditional rigid standard proof, "established" or "clear" fraud, to the less rigid standard of proof, "the only realistic inference ... is that of fraud".

3. U.N. Standard

The UNCITRAL Convention has taken a different approach from Revised UCC Article 5. While the later has provided a general standard of fraud for the application of the fraud rule — material fraud, the former has avoided terms "frauds" and "abuse of right", and listed in Article 19 three substantive grounds as explained above to invoke the fraud rule.[43]

The list may not be exhaustive, but it is an impressive way to define the kind of misconduct that may invoke the fraud rule. It undoubtedly stands as the most detailed provision so far with respect to clarification of the misconduct that may bring the fraud rule into play. These provisions are clear, and narrow in scope and provide an excellent international standard. They will undoubtedly provide good guidance for courts to enhance their

43) E. E. Bergsten, "A New Regime For International Independent Guarantees and Stand-By Letters of Credit : The UNCITRAL Draft Convention on Guaranty Letters" (1993) 27 Int'l Lawyer 859, 872.

application of the fraud rule.

While the Convention requires "manifest and clear" evidence to invoke the fraud rule, it does not mention that the wrongdoer's intention should be proven. The Convention, like Revised UCC Article 5, seems to emphasize more the nature of the misconduct rather than the fraudster's state of mind.

V. Conclusion

The fraud rule is "the most controversial and confused area" in the law governing letters of credit, mainly because the standard of fraud is indeed hard to define. The divergent views expressed by courts and commentators with respect to the essence of the standard of fraud reflect the tension between different policy considerations.

On the one hand, if fraud is defined too widely or the standard of fraud is set too low, the fraud rule may be abused by the applicant who does not want the issuer to pay the credit simply because it will not profit from the underlying transaction. On the other hand, if fraud is defined too narrowly or the standard of fraud is set too high, the effectiveness of the fraud will be diminished. A very rigid standard of fraud may encourage the growth of fraudulent conduct by beneficiaries, discourage the use of letters of credit by applicants and ultimately harm the commercial utility of letters of credit.

A proper standard of fraud therefore should be one reflecting a sensible compromise between the competing interests. Legally, it should serve the purpose of the fraud rule and be workable for the courts. Commercially, it should facilitate the utility of letters of credit. Based on these consideration, extreme concepts or standards of fraud, such as egregious fraud, which may be too rigid to be applied, and constructive fraud, which may lead to the fraud rule being abused, should be avoided, and a proper and practical standard of fraud should be set forth.

A combination of the provision of Revised UCC Article 5, §5-109, and those of Article 19 of the UNCITRAL Convention, provides the best solution in defining the limits of the fraud exception. The standard of "material fraud" of UCC Article 5 has not only avoided extreme ideas such as egregious fraud and constructive fraud but also has reflected the unique nature of letters of credit. But, because "material" is a general term, the implementation of the standard of "material fraud" seems to be uncertain; the different courts may yet interpret it divergently, as they have interpreted Sztejn. However this uncertainty may be some extent be reduced by recource to the provision of Article 19 of the UNCITRAL Convention, where a detailed list of the types of misconduct that constitute material fraud has been listed. The misconduct listed in the Convention provides substantial practical guidance to courts and letter of credit users.

Accordingly, if the fraud rule can be formulated in a way that combines the standard of "material fraud" of UCC a general standards, with the provision of Article 19 of the UNCITRAL Convention as detailed examples, the predicability or the stability of the rule would be greatly enhanced.

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ABSTRACT

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Legal sources of fraud rule in documentary letter of credit, which have their origin in Sztejn Case can be traced to various rules or laws of international or domestic level ; URCG, URDG and ISP98 as ICC Rules, and UNCITRAL Convention as an international uniform law, and UCC as a domestic law and U.K. cases.

Among them the combination of "material fraud" in UCC §5-109 and the detailed list of the types of misconduct in UNCITRAL Convention may provide the best solution or standard in real application of the fraud rule in letter of credit transaction.

Keyword ; Legal Sources, Fraud Rule, Documentary Credit