

Universidade Católica Portuguesa. Lisboa.
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**A Comparative Analysis of the Civil Law and the Common Law on
Fraud in the Commercial Letter of Credit**

David Felipe Arellano De Figueiredo.
Bologna Master of Laws. International Trade and Business

Thesis advisor:
Professor Jonathan C. Carlson.
University of Iowa

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I would like to dedicate this paper to my family for their unconditional love and support; to thank the GEFAP- Graduate Programs Office at Universidade Católica Portuguesa for giving me the opportunity to research about this interesting subject and very especially to Prof. Jonathan C. Carlson, for his priceless guidance in writing this paper.

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Abstract

The commercial letter of credit is one of the most commonly used methods of payment in international trade, and it is normally used to finance trade of commodities, such as oil and other raw materials from the emerging economies in Asia, Africa and Latin America because of its inherent security.

This paper is focused on the legal differences among the Civil and the Common Law regarding fraud on letters of credits, specifically between the law of the United States of America, the United Kingdom of the Great Britain and Ireland and Canada; and The Kingdom of Spain, the Portuguese Republic and the French Republic.

Keywords: Fraud, strict compliance, autonomy, evidence, measures to prevent payment, innocent claimants.

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¹ Abogado (2005), Universidad Católica Andrés Bello. LL.M International Trade and Business Law (2007), Universidade Católica Portuguesa. Licenciado em Direito (2008) Universidade Católica Portuguesa.

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I. Introduction.

The commercial letter of credit is one of the most important methods of payment in international trade², particularly of commodities and raw materials, which is why is the preferred method of payment used by countries such as the United Kingdom when trading with the so called emerging economies, like the ones in Latin America (Brazil, Argentina, Venezuela), Africa (Angola) and Asia (China and India), where it represent the method of payment used in 27%, 49% and 46% respectively, of all the operations conducted³, due to its inherent security.

The letter of credit has been used for centuries to facilitate payment and its usage will continue to increase as the global economy evolves⁴, especially since trade with the emerging economies will dramatically increase over the next decades. Another reason for the increase in its usage is the current financial global crisis, which is pushing buyers to insist in using a “safe” method of payment in an environment that is increasingly being perceived to be of high risk.⁵ In the words of Jeremy Shaw, Head of J.P. Morgan's Trade Services Business in Europe, Middle East and Africa: "In these uncertain times, letters of credit are traditional, secure way of doing business and of financing the underlying trade." "The increase in letters of credit usage became noticeable towards the end of 2007 as the surpluses of working capital for open account financing began to dry up. Recently, fewer

² Alfonso Calvo Caravaca, Luís Fernández de la Gándara y Pilar Blanco-Morales Limones. *Contratos Internacionales*. Editorial Tecnos, S.A., 1997, Madrid. Page 733.

³ SITPRO Report on the use of export letters of credit 2001/2002
<http://www.sitpro.org.uk/reports/lettcredr/lettcredr.pdf>, page 9.

⁴ The Credit Reaserch Foundation.

<http://www.crfonline.org/orc/cro/cro-9-1.html> as on September 3rd of 2008

⁵ Times on line

http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5069065.ece, as on November 23rd of 2008.

banks have been willing to extend and guarantee credit so the supply has been declining, and in some cases the cost has risen dramatically".⁶

Nonetheless, there are no international laws covering this subject⁷ and it is only through commercial practice that the banks have established an international standard of obligations which have been codified by the International Chamber of Commerce in the Uniform Customs and Practice or "UCP".

UCP are material regulations that specify the different aspects of the dynamics of the international documentary credit, but they are not law and are only applicable when they have been contractually included.⁸ Furthermore, the UCP does not contain any rules or regulation that directly addresses the problem of fraud in commercial letters of credit.

Therefore, in a case of fraud in a transnational sale of goods, a competent court will apply its own national law to ascertain fraud and rule on the matter⁹. This situation could worsen if we take into account the possibility of having more than one forum with jurisdiction over the matter. This creates an undesirable uncertainty for a party in an international transaction that would have to litigate in a foreign forum.

For the abovementioned reasons it is useful for a lawyer to be aware of the differences regarding each family of law on this topic, as well as the specificities regarding the law of the places where litigation might arise in cases where the parties have agreed on litigating in Europe (Spain, France, Portugal or the United Kingdom) or in North America (United States and Canada) in an eventual case of fraud, and have agreed in applying the law of the forum.

⁶ JP. Morgan. "Turbulent Markets Lure Banks Back to Traditional Financing." http://www.jpmorgan.com/tss/General/Turbulent_Markets_Lure_Banks_Back_to_Traditional_Financing/1159367070346

⁷ The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, was opened for signature by the General Assembly of the United Nations on December 11th of 1995, having been adopted by Ecuador, El Salvador, Kuwait, Panama and Tunisia, and signed by Belarus and the United States and it has been in effect since the 1st of January of 2000. According to its articles 1 and 2, it applies to international undertakings such as independent guarantees and standby letters of credit. It would only apply to a commercial letter of credit if the parties have expressly stated it, which is why it is not relevant to this paper. <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf>

⁸ Alfonso Calvo Caravaca, Luís Fernández de la Gándara y Pilar Blanco-Morales Limones. *Contratos Internacionales*. Editorial Tecnos, S.A., 1997, Madrid. Page 768.

⁹ *Ibidem*. Page 759.

II. The letter of credit.

“The documentary credit is one of the most commonly used methods of payment in international trade because of the guarantees offered both to the seller and the buyer, being possible through this mechanism for the seller to obtain the payment of the price before shipping the goods and for the buyer to obtain the possession of such goods at shipping, with the guarantee that they will conform with the contracted terms.”¹⁰

The mechanics of the letter of credit are described as follows:

“Pursuant to the underlying contract, a credit is established by the buyer instructing his bank, called the issuing bank, to open a credit in the seller's name through a bank in the seller's country, call the correspondent bank. It advises the seller of the existence of the credit, which the seller may draw upon after presenting the correct documents to that bank.”¹¹

The correspondent bank is paid by the issuing bank and can hold the documents as security for such payment. In turn the issuing bank will receive the documents when it has paid the correspondent bank and can hold the documents as security pending payment by its customer, the buyer.

There are different types of letter of credits. Depending on the obligations of the issuing or correspondent bank, the letters of credit can be revocable and irrevocable or confirmed and unconfirmed. A letter of credit can be transferable and revocable or irrevocable and confirmed or unconfirmed:

Revocable and Irrevocable.

A revocable credit can be cancelled or amended by the person who initiates it, ordinarily the buyer. The bank which issues the credit must obey the buyer's instructions; therefore,

¹⁰ Gonalo Andrade e Castro. O cr dito documentario irrevog vel. Universidade Cat lica Portuguesa (1999). Page 16.

¹¹ James L. Roberts. International Payments in International Transactions: Trade and Investment, Law and Finance. Sydney: The Law Book Company Limited (1993), Page 74.

there is no real protection for the seller who relies on the credit. This type of credit is not common. An Irrevocable credit cannot be revoked unless all the parties agree.

Confirmed and Unconfirmed.

With a confirmed credit, at the request of the issuing bank, the correspondent bank confirms the credit, that is, the corresponding bank is undertaking payment in addition to the issuing bank. In these circumstances the correspondent bank becomes known as the confirming bank. An unconfirmed credit is one where the correspondent bank merely acts as the agent for the issuing bank, which pays the credit.

Transferable and non-transferable.

In a transferable credit the seller has the right to request the paying bank (the issuing bank or the correspondent bank) to transfer the credit for the benefit of a third party.

Red clause.

“A red clause documentary credit is a credit with a special condition incorporated into it that authorises the confirming bank or other nominated bank to make advances to the seller before presentation of the commercial documents. The advance payment is usually made against the Seller's Certificate confirming his undertaking to ship the goods and to present the documents to the bank in compliance with the terms and conditions of the letter of credit or Customs Warehouse Receipt of Goods that are intended to be shipped to the applicant of the letter of credit.”¹²

Standby credit.

“This type of letter of credit operates as an autonomous bank guarantee. These are guarantees in which a bank assumes the obligation, ordered by a client, to pay a determined amount of money to a third person under contract with the client, and that client has not performed the obligations under such contract or where they have been poorly performed. This way, if the goods are defective, the buyer can, by a demand in writing on the bank, require payment to cover the loss caused by

¹² NORDEA. Letter of credit.

<http://www.nordea.lv/Corporate%2Bcustomers/Trade%2BFinance/Letter%2Bof%2BCredit/Red%2BClause%2BLetter%2Bof%2BCredit/68632.html>, as on May 20th of 2008

the defect in the goods, assuming that he or she has required the seller to take out the standby letter of credit.”¹³

Revolving Letter of Credit.

“The revolving credit is used for regular shipments of the same commodity to the same buyer. It can revolve in relation to time or value. If the credit is time revolving once utilised it is re-instated for further regular shipments until the credit is fully drawn. If the credit revolves in relation to value once utilised and paid the value can be reinstated for further drawings. The credit must state that it is a revolving letter of credit and it may revolve either automatically or subject to certain provisions. Revolving letters of credit are useful to avoid the need for repetitious arrangements for opening or amending letters of credit.”¹⁴

Transferable Letter of Credit.

“A transferable letter of credit is one in which the beneficiary has the right to request the paying or negotiating bank to make either part, or all, of the credit value available to one or more third parties. This type of credit is useful for those acting as middlemen especially where there is a need to finance purchases from third party suppliers.”¹⁵

Back-to-Back Letter of Credit.

“A back-to-back letter of credit can be used as an alternative to the transferable letter of credit. Rather than transferring the original letter of credit to the supplier, once the letter of credit is received by the exporter from the opening bank, that letter of credit is used as security to establish a second letter of credit drawn on the exporter in favour of his supplier. Many banks are reluctant to issue back-to back letters of credit due to the level of risk to which they are exposed – a transferable credit will not expose them to higher risk than under the original credit.”¹⁶

¹³ *Ibidem.*

¹⁴ SITPRO Report on the use of export letters of credit 2001/2002
<http://www.sitpro.org.uk/reports/lettcredr/lettcredr.pdf>, as on November 24th of 2008.

¹⁵ *Ibidem*

¹⁶ *Ibidem.*

III Principles that govern the letter of credit.

A. The doctrine of strict compliance.

The letter of credit establishes the documents that must be presented before the letter can be paid. Such documents must strictly comply with what is stated in the Letter of Credit. “There is no room for documents which are almost the same, or which will do just as well”¹⁷

According to article 14 of the UCP 600, a “nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation”.¹⁸ This article requires that the issuing bank recognize the documents as ones that strictly comply with the agreed terms and conditions. Banks must also determine “on the basis of the documents alone” whether to take or refuse them. The reason for this is that the banks are not considered to be trade experts and are only expected to consider the accuracy of the documents presented, so they are to be carefully examined.

Article 5 of the UCP 600 states “Banks deal with documents and not with goods, services or performance to which the documents may relate”.¹⁹ Since the banks only deal in documents, they have the duty to ensure that they strictly comply and to examine the documents with reasonable care. “UCP provides that, as long as the bank effects payment against documents that appear on their face to be in accordance with the credit, then it is entitled to be reimbursed. Therefore whether banks are entitled to be reimbursed or to take appropriate action depends upon the application of the doctrine of strict compliance.”²⁰

¹⁷ Lord Summer in *Equitable Trust Co. of New York v. Dawson Partners Ltd.*

¹⁸ UCP 600. http://www.chelinvest.ru/corp/currency/UCP_600_2007_208751_v1.pdf on September the 4th of 2008.

¹⁹ *Ibidem.*

²⁰ Banks are entitled to be reimbursed as long as they make payments against documents that appear on their face to be in accordance with the credit. In examining the documents the bank must use reasonable care. “This duty extends to rejecting documents which are inconsistent with one another.” James L. Roberts. *International Payments in International Transactions: Trade and Investment, Law and Finance.* Sydney. The Law Book Company Limited, 1993. Topic 5, page 36.

There are some exceptions to the doctrine of strict compliance, such as ratification²¹, ambiguous instructions²² and the rule that banks are not required to check the authenticity of documents²³ and fraud, which is the subject of this dissertation.

B. The autonomy of the credit.

The letter of credit is independent from all other contracts and documentary credits are only concerned about documents. According to the Article 4 of the UCP 600 “A credit by its nature is a separate transaction from the sale or other contract on which it may be based”.²⁴ This is a corollary of the doctrine of strict compliance.

The letter of credit creates an independent obligation and it is not bound or concerned by the contract in virtue of which it was signed.

Both the principle of strict compliance and the autonomy of the credit have been recognized by the doctrine as the two foundations over which the institution of Documentary Credit rely, but it has also been admitted by the doctrine that these two principles can be exceptionally waived in cases of fraud as a remedy to prevent an unjust result. Such remedy has a residual character and must be used in a very cautious way in order to not jeopardize the letter of credit as a reliable and safe instrument of payment in international trade.

²¹ The doctrine of ratification provides that a party, after discovering a defect in the original release, can make binding that otherwise voidable release either explicitly or by failing timely to return the consideration received. *Dolores M. Oubre, Petitioner v. Entergy Operations, INC.* <http://www.law.cornell.edu/supct/html/96-1291.ZD1.html> on January 14th of 2009.

²² “If the credit instructions are ambiguous or unclear, the bank should ask for clarification, but if that is not possible, it is protected if it has acted reasonably”. *Commercial Banking Co. of Sydney Ltd. v Jalsard Pty. Ltd.* (1973) Appeal Cases 279. <http://www.lawnet.lk/docs/articles/international/HTML/ia5.html>

²³ Banks are obliged to pay if documents comply “on their face” with the terms and conditions of the letter of credit. They are not obliged to execute any proving activity regarding the actual commercial operation. R.M. Goode, *Reflections on Letters of Credit - 1*, *Journal of Business Law*, page 292. 1980

²⁴ UCP 600. http://www.chelinvest.ru/corp/currency/UCP_600_2007_208751_v1.pdf on September the 4th of 2008.

IV. International Legislation on Letters of credit.

The Uniform Customs and Practice for Documentary Credits (UCP).

The Uniform Customs Practice was born in the 1930's in order to create a unified approach for documentary transactions. It was created by the International Chamber of Commerce's (ICC) Commission on Banking Technique and Practice.

“The ICC, which was established in 1919, had as its primary objective facilitating the flow of international trade at a time when nationalism and protectionism posed serious threats to the world trading system. It was in that spirit that the UCP were first introduced – to alleviate the confusion caused by individual countries' promoting their own national rules on letter of credit practice.

The objective, since attained, was to create a set of contractual rules that would establish uniformity in that practice, so that practitioners would not have to cope with a plethora of often conflicting national regulations. The universal acceptance of the UCP by practitioners in countries with widely divergent economic and judicial systems is a testament to the rules' success.

It is important to recall that the UCP represent the work of a private international organization, not a governmental body. Since its inception, ICC has insisted on the central role of self-regulation in business practice. These rules, formulated entirely by experts in the private sector, have validated that approach.

The UCP remain the most successful set of private rules for trade ever developed.”²⁵

UCP 600 stipulates in Article 1 that its rules “apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit)

²⁵ UCP 600. http://www.chelinvest.ru/corp/currency/UCP_600_2007_208751_v1.pdf on September the 4th of 2008.

when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit”.²⁶

“The Uniform Customs are not law. If the parties expressly incorporate the Uniform Customs, they become terms of the engagement and will apply, except to the extent that they vary Code provisions that do not permit variation. If the credit is silent, to the extent that a party proves that the Uniform Customs describe a regularly observed usage of trade, the Uniform Customs “fill in points which the parties have not considered and in fact agreed upon” If the credit is silent and if there is no proof that the Uniform Customs describe a regularly observed usage of trade, the Customs still serve as persuasive thinking on the practices in question.”²⁷

“The UCP establishes the principle of independence in its articles 4 and 5 (UCP 600), which read: "A credit by its nature is a separate transaction from the sale or other contract on which it may be based.”²⁸

“Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the seller.”²⁹ “A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.”³⁰

“Banks deal with documents and not with goods, services or performance to which the documents may relate.”³¹

Therefore, the bank can only look to the terms of the credit in order to decide to make the payment under the credit and may not raise any defense available to the Applicant in

²⁶ Michael Gordon, John Spanogle and Peter Fitzgerald. International Business transactions. A problem oriented course book. Ninth edition. Ralph Folsom. American Casebook Series. Thomson West, 2006. Page 273.

²⁷ *Ibidem*. Page 273.

²⁸ *Ibidem*. Page 273.

²⁹ UCP 600 Article 4.

³⁰ UCP 600 Article 4.

³¹ UCP 600 Article 5.

respect to the underlying agreement.

“The independence principle is stated in absolute terms but allows certain limited exceptions, being the case that the more widely recognised exception in international jurisdiction is the fraud exception.”³²

Fraud in documentary credits has been configured as an exception derived from very specific circumstances that are located in the underlying relation. Because of the independence principle, fraud in the underlying relation theoretically shouldn't exist, but it affects the essence of the documentary credit and the elements that allow it to achieve its objective as a safe payment mechanism on international transactions.

“It is for this reason that one must be very cautious at the moment of admitting the fraud exception and, if it is finally justifiable, it must be admitted in a very restrictive way. It is for this reason that the ICC hasn't included rules against fraud in the UCP.”³³

³² See *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Lloyd's Rep 166; *Sztejn v. J. Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941); *United City Merchants (Investment) Limited and Glass Fibres And Equipment Ltd v. Royal Bank of Canada, Vitrorefuerzos S.A. and Banco Continental S.A.*

³³ Rafael Marimón Durá. *El crédito documentario irrevocable*. Universitat de València. Tiran lo blanch. Valencia, 2001. Page 509.

V Several issues concerning fraud in letters of credit.

“There is not a universal definition of fraud regarding letters of credit. In a wide sense of the word, the term “Fraud” can acquire different connotations, so its determination would depend more on a case by case definition. Nonetheless, it is possible to define fraud as a misrepresentation of the reality by means of modifying the documents that are to be presented to the bank in order to produce in the bank a conviction that it’s contrary to the reality.”³⁴

It is generally accepted that in the case of fraud from the seller the obligation of the bank to pay disappears, allowing it to refuse payment. The problem lies in how to ascertain the type of abusive behaviour that amounts to fraud.

In the Civil Law it has been established two different categories of fraud, material fraud and intellectual fraud, but there are no strict rules or uniform criteria on the jurisprudence regarding the determination of one or another.³⁵ The reason for this is actually quite simple, let’s imagine a maritime fraud; in such a case, a fraud regarding the documents for the payment of the letter of credit are only a part of the puzzle, which could include the intentional sinking of the boat, the mysterious disappearance of goods, etc.

“The typical ways of fraud regarding documentary credits are the following:

- a. Situations where the buyers are aware of the fact that the goods sent by the seller do not correspond at all with what was agreed in the underlying contract or they just don’t exist (Empty containers or containers full of rubbish) but the seller demand to be paid by presenting documents that seems to conform to the credit conditions.

³⁴ Rafael Marimón Durá. El crédito documentario irrevocable. Ob. Cit. Page 509.

³⁵ The civil law “*Fraude material u objetivo*” (Material or objective fraud) it’s the most common type of fraud and it is the fraud that lies in the authenticity of one of the documents that is to be presented according to the letter of credit. The fraud lays in the modification, falsification; unauthorized copying or production of such document by someone who did not had the authority to do so, with the intention to damage. It would correspond to the “*Forged documents*” fraud in the US doctrine. When the document is materially false, it can deceit about the truly identity of his essential elements and even about its real author”

In the civil law “*Fraude Intelectual*” (Intellectual fraud), the falsity affects the extrinsic elements of the document. It is more difficult to prove because the document is authentic; it is produced by the person entitled to produce it, but its content the content of the document is different from the reality of the transaction. It would correspond to the “*Fraud in the transaction*” of the US doctrine.”

- b. The buyer receive a notice telling him that the ship that was supposed to load the goods on board only arrived to the shipping point a day later than the stated date in the bill of lading.
- c. The buyer demands the opening of a documentary credit in order to pay in accordance with an underlying commercial transaction, but after the credit has been emitted as irrevocable, the buyer realize that the operation did not comply with what was contractually agreed, however, the seller demand payment by presenting documents apparently conforming with the credit conditions.
- d. In a stand by letter of credit, the beneficiary demands to be paid even thou the applicant has correctly complied with the obligations by him demanded on the underlying contract.”³⁶

The subject of this dissertation is to give a comparison between common law and civil law systems regarding the fraud on the letter of credits, specifically on the following issues:

The evidence of fraud.

The difficulties to prove the existence of fraud reside in the number of parties involved in a transaction, the distance that separates them, and the lack of effective control by the banks over the underlying contract. Because the banks can only examine the documents, and because letters of credit are considered entirely independent from the underlying transaction, this creates an opportunity for deception that a dishonest seller can use for fraudulent purposes.

We can also add the fact that courts are usually unwilling to stop a bank from paying on a letter of credit if the documents appear on their face to be right. Such act would be acknowledged as a very serious one from the bank, which is why it is only admitted by the jurisprudence in exceptional cases, where fraud has been proven by the damaged party. None the less, not all courts have the same tests regarding the extension of such proves.

Measures to prevent payment in cases of fraud.

A judge may be asked to take action in a situation where fraud is alleged before the letter of credit has been paid. In this case, the victim will be interested in having a court act to

³⁶ Rafael Marimón Durá. El crédito documentário irrevocable. Ob. Cit. Page 503.

prevent the bank from paying the letter of credit in order to give the victim an opportunity to prove fraud. If payment has already taken place and fraud has been proved, the victim will be limited to recovery of damages from the wrongdoer and may never be able to recover if the wrongdoer has disappeared or it's insolvent. For this reason, it is very important for legislations to include remedies that prevent payment under a letter of credit where fraud is alleged.

The effectiveness of remedies for fraud, including the possibility of preventing payment of the letter of credit, will depend on the national legislation of the country with jurisdiction over the matter and the standard of proof that is required to enforce a remedy. Normally, the victim would be the buyer, but the bank might be interested as well, since he could lose as well if the buyer becomes insolvent and if he has opened a letter of credit to guarantee the payment.

The protection of innocent claimants under the letter of credit.

There are situations where fraud has been proven, but the author is a third party and the beneficiary of the credit is an innocent party, who did not know about the fraud and did not participate in it. In cases like this, which interests should prevail? Should be given deference to the innocent beneficiary, since he has trusted in the safety mechanisms of the documentary credits in order to obtain the satisfaction of its credit, or should the fact that there is fraud, and therefore no real substance to the transaction and no material justification for the bank to pay, provide grounds for the bank to avoid payment, even to an innocent beneficiary?

Different jurisdictions have given different solutions to this problem; we are going to examine some of them in the following chapters.

VI. The Common Law approach to fraud in letters of credit.

The common law approach regarding letters of credit has been developed through jurisprudence. Several problems concerning fraud have been addressed by Courts of the United States and the United Kingdom since the beginning of the XX century. Nonetheless, this didn't stop the evolution of the fraud doctrine, which has undergone great modifications due to the extension of the doctrine to cover not only commercial letters of credits, but also standby letters of credit, and also because of political crises, such as the political crisis in Iran. This evolution produced a modification in the conditions in which the letters of credit were used, ending in a reform of Article 5 of the UCC in 1995, which directly addresses preventive measures in cases of fraud.³⁷

A. The United States approach to fraud in letters of credit.

1. General Doctrine.

In the United States, the jurisprudential developments on letters of credit have been included in Article 5 of the Uniform Commercial Code, specifically in the first wording of section 5-114(2), where there is recognized the possibility of a bank to stop from paying in a case of fraud.³⁸

Since the beginning of the jurisprudence regarding letters of credit, it was affirmed in the United States the need to preserve the principle of independence. This had the consequence that in certain cases where there has been more than suspicious activities committed by the beneficiary, the desire of the issuing bank to refrain from paying has had to be excluded. This situation changed with the years, especially after the second half of the past century, with new judgements that introduced exceptions to the general rules in cases of manifest abuse.

³⁷ Rafael Marimón Durá. El crédito documentario irrevocable. Ob. Cit. Page 510.

³⁸ *Ibidem*. Page 511

a. Jurisprudence.

Old Colony.

“In *Old Colony Trust Co v Lawyers’ Title and Bank Trust Co*, a bank’s refusal to honor a letter of credit when the beneficiary presented a fraudulent warehouse receipt was upheld on the basis that ‘when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit’.³⁹

This is a very important case because it is the first time an American Court recognized Fraud as an exception to the doctrine of strict compliance. The beneficiary tendered a document described as a warehouse receipt; but the issuer knew that the goods were still on board the ship. The court dismissed the Beneficiary’s action for payment, stating:

“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 recognize such a document as complying with the terms of the letter of credit.”⁴⁰

Therefore, it is possible to conclude that the rationale of this decision includes the issue of fraud and illegality.

Sztejn.

In The United States, the landmark case regarding fraud in letters of credit⁴¹ is the typical case on this matter. In *Sztejn v. J. Henry Schroder Banking Corp.* (New York Supreme Court, 1941), a party, called Sztejn contracted the purchase of bristles to a company called India Corp. In order to make the payment, Schroder Banking issued an irrevocable letter of credit on Sztejn’s behalf.

India Corp shipped goods which were “worthless rubbish” but the papers that were presented to the bank stated that the goods actually complied with the contracted terms, so

³⁹ Xiang Gao, *The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit*. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html>

⁴⁰ University of Queensland, Gabriel Moens .*International Trade and Business Law Annual*. Routledge Cavendish. May 2003. Volume VIII. Page 30.

⁴¹ Such as in *Hamzeh Malas & Sons v. British Imex Industries Ltd.* [1958] 2 Q.B. 127 (Ct. App.)

the bank had the obligation to pay because it was a documentary credit ruled by the independence principle.

“It is important to highlight that most of the actual UCC rules regarding fraud are based in this judgment, as well as being the cornerstone for jurisprudence from other common law jurisdictions, being often cited by the UK courts.”⁴²

The court recognized and supported the independence principle, but made the distinction between situations where the seller had breached warranties or conditions, and where there was, as in this case, a blatant fraud putted together to claim payment for goods that did not conform at all or where not even shipped, regardless of what the papers could say.

Judge Shientag J stated that:

"It is well established that a letter of credit is independent of the primary contract between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the letter of credit as an instrument for the financing of trade." "It would be a most unfortunate interference with business transactions if a bank before honouring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped."⁴³

The court found that fraud was sufficient grounds for granting an injunction to prevent payment to the seller, contrary to the independence principle: "the principle of independence of the bank's obligations under the letter of credit should not be extended to protect the unscrupulous seller", and that, despite the broad language used in previous cases to uphold the independence principle, he was not referred to any cases involving intentional fraud on the part of the seller. Therefore, the independence principle cannot be extended to protect the unscrupulous seller who is seeking payment through a clearly fraudulent sell.

⁴² Rafael Marimón Durá. El crédito documentario irrevocable. Ob. Cit., Page 511.

⁴³ Szejn v. J. Henry Schroder Banking Corp. et al., 31 N.Y.S.2d 631 (Sup. Ct., NY 1941) [United States, New York state trial court].

This judgment constitutes the basis for the fraud exception codification in the UCC. However, according to many authors, “Sztejn does not provide a precise standard about what must be understood as fraud.”⁴⁴

It is possible to extract from these judgments three different conclusions:

- The independence principle can only be suspended under exceptional circumstances, in cases of clear and evident abuse of the beneficiary, and not because of goods that only partially comply with the underlying contractual terms. In these cases, the issuer should have the possibility to prevent damages.
- The type of event that is relevant as to justify stopping the execution of the letter of credit is not clearly determined by the US jurisprudence at this point. In Sztejn, the event is the presentation of worthless rubbish, while in Old Colony the event is the inaccuracy of the tendered documents regarding the real location of the delivered goods. What seems to be necessary is the existence of a situation of fraud that can be clearly acknowledged as such by the Court.⁴⁵
- The beneficiary or the person who demands payment from the bank must have the intention to commit fraud on the beneficiary.

b. The fraud rule and its codification: The Article 5 of the U.C.C.

These judgments led to the codification of the fraud rule on letters of credit in the Article 5 of the U.C.C, specifically in section 5-114(2) of the original version, which reads:

“Unless otherwise agreed when documents appear on their face to comply with the terms of a 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 8-108) or is forged or fraudulent or there is fraud in the transaction:

(a) the issuer must honor the draft or demand for payment if honor 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

⁴⁴ George Kimball & Barry A. Sanders, Preventing Wrongful Payment of Guaranty Letters of Credit—Lessons from Iran, 39 Bus. Law. (1984) page 423.

⁴⁵ Rafael Marimón Durá. El crédito documentario irrevocable. Ob. Cit., Page 521.

whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and
(b) in all other cases as against its customer, an issuer acting in good faith may honor 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 honor.”⁴⁶

This section of UCC provides a remedy against fraud and establishes that the fraud rule can be applied in two scenarios:

1. A court of competent jurisdiction could enjoin an issuer from honouring a letter of credit if "documents appear on their face to comply with the terms of a credit but a required document ... is forged ... or there is fraud in the transaction."
2. The issuer could voluntarily invoke the fraud rule and refuse to honor a draft or demand for payment if fraud as above was brought to its attention.

“This codification played an important role in the unification and harmonization of the fraud rule in the law of letters of credit, being widely cited and utilized by courts and users in the United States and serving as a uniform guideline to parties dealing with fraud disputes but it was not entirely faultless, leading in some cases to confusion among courts and users.”⁴⁷

One of the major gaps in the wording of the article is the lack of a definition of fraud, which led to the application of different standards of fraud in different cases.

“Section 5-114(2) established that the fraud rule must apply ‘when... a required document ... is forged or fraudulent’ or when ‘there is fraud in the transaction....’ Separating these two issues led to confusion about where fraud needed to be located.”⁴⁸

⁴⁶ U.C.C. 5-114(2) (1952) (prior to 1995 revision).

⁴⁷ Ross P. Buckley & Xiang Gao. The development of the fraud rule in letter of credit law: The journey so far and the road ahead. Copyright (c) 2002. University of Pennsylvania Journal of International Economic Law. Winter, 2002. 23 U. Pa. J. Int'l Econ. L. 663.

⁴⁸ *Ibidem*.

c. The revised Article 5 of the UCC.

The whole article 5 was revised in 1995; now, the fraud rule is embodied in section 5-109, which reads:

“(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the seller on the issuer or applicant:

(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honoured its confirmation in good faith, (iii) 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, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and

(2) the issuer, acting in good faith, may honor or dishonour the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the seller on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court finds that:

(1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;

(2) a seller, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;

(3) all of the conditions to entitle a person to the relief under the law of this State have been met; and

(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).”⁴⁹

⁴⁹ U.C.C. 5-109 (1952) (revised 1995)

We could list two major differences between both versions. In the first place, this version states that when fraud is found, the normal operation of a letter of credit may be disrupted in two different ways:

- a) By the issuer's refusing to honor a presentation.
- b) By the applicant's asking a court to enjoin the payment or presentation.

Section 5-109 is clearer than the previous version regarding fraudulent behaviours that can justify the paralysation of the credit. These new hypotheses are:

- Forged or materially fraudulent documents, which cover all the different situations where the beneficiary can use forged documents or where he/she can take advantage of documents forged by a third party.
- It establish a standard for fraud, providing that it has to be “material”, thus resolving one of the most problematic issues on fraud on letters of credit. This hypothesis, that replace the classic “Fraud in the transaction” covers any situation in which the fraud lies in the relation of the beneficiary with the bank or in the underlying relation, clarifying the jurisprudential recognition of the possibility to enforce a remedy against fraud when it is not present in the tendered documents but in any other aspect of the commercial transaction.
- The official document of the text also says that the fraud must be substantial, that is, it has to be relevant. For example, a receipt stating a acquisition of 100 barrels of oil when in reality there where only 99 barrels does not amount to a relevant fraud, being relevant if there where only 10 barrels. On the other hand, UCC is silent about the intention of the parties to commit fraud.

The revised article 5 establishes the types of parties who may be immune from the fraud rule:

- a) A nominated person who has given value in good faith and without notice of the fraud;⁵⁰
- b) A confirmer who has honoured its confirmation in good faith;⁵¹
- c) 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.⁵²

⁵⁰ Id.5-109(a)(1)(i)

⁵¹ Id.5-109(a)(1)(ii)

⁵² Id.5-109(a)(1)(iii).

d) An assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.⁵³

“The Revised U.C.C. Article 5, Section 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.”⁵⁴

2. Types of fraud that can justify nonpayment.

It is possible to analyze fraud under the light of the UCC and of jurisprudence under the following classification:

a. Forged or fraudulent documents.

“It is the lack of authenticity of one of the documents stipulated in the Letter of Credit, because such document has been forged, copied or produced by someone without the power to do so. This type of fraud can produce a mistake regarding the truth about the essential elements of the transaction or about its author.”⁵⁵

b. Material fraud.

This type of fraud implies a misrepresentation of the real substance of the transaction. For this reason it is more subtle and hard to prove, the document is really authentic, produced by its real author and it is perfect from a material point of view, nonetheless, its actual content is not true.

An example of this situation would be the abovementioned case of “Old Colony Trust Co v Lawyers’ Title and Bank Trust Co”, in which the warehouse receipt was tendered alone with the rest of the documents in order to collect the money from the letter of credit, the receipt was produced by the person who was authorized to make it and in accordance with the agreed terms and conditions of the letter of credit, but the actual content of the receipt was not correct since it stated that the goods were stored in a warehouse in a moment

⁵³ Id.5-109(a)(1)(iv).

⁵⁴ Ross P. Buckley & Xiang Gao. “The Development of the Fraud Rule in Letter of Credit Law: The journey so far and the road ahead”. Copyright (c) 2002. University of Pennsylvania Journal of International Economic Law. Winter, 2002. 23 U. Pa. J. Int'l Econ. L. 663.

⁵⁵ O crédito documentário irrevogável. Gonçalo Andrade e Castro, ob. Cit. Page 293.

where it was known by the bank that they were still in the ship; it contained a lie about the actual situation of the goods.

The real problem with this type of fraud is the fact that it can only be acknowledged by inspecting the goods, whether at the port of destination or through an international service for this matter at the port of shipping. This does not mean that a bank has to pay if it is aware of the fraud in the underlying transaction. The bank's responsibility is only safe as far as it behaves in good faith.⁵⁶ Therefore, the controversial issue with this type of fraud is the need to make an extra documental analysis in order to ascertain fraud, because the documents were actually made by the person who was responsible of making them and according to the contracted terms of the commercial operation. This makes necessary to get away from the independence principle of the documentary credit obligation in respect to the underlying transaction, which is why it has only been admitted in exceptional cases.⁵⁷

The recognition of this type of fraud, regardless of the fact that it finds its logical support in principles that cannot be waived, such as good faith, necessarily imply a limitation of that which is the fundamental basis of the documentary credit itself, the independence of the documentary credit from the underlying transaction, since it would be such underlying transaction what would have to be investigated in order to ascertain fraud, therefore the application of the fraud exception under this doctrine cannot be used as a mechanism to waive a concept which is in the core of the system, or the documentary credit might lose its effectiveness as a mechanism of payment in international trade.

Some authors defend the position that the bank responsibility can only be excluded when it is not aware of the existence of fraud.⁵⁸ If it is aware of the fraud it must refrain from paying. It is important to highlight that sometimes it is difficult to ascertain if the fraud lies in the documents or in the subjacent transaction. In *Sztejn* the fraud was the delivery of worthless goods, which could be seen as fraud in the underlying transaction, and also as a case of forged documents because the documents misrepresented the true nature of the

⁵⁶ Maria Verónica Asad. *El fraude en el crédito documentario*. Ob. Cit.

⁵⁷ South African law in *Loomcraft Fabrics CC v. Nedbank Ltd and Another*, 1966 (1) SA 812 5A), Appellate Court, JIBL 1996.

⁵⁸ Olarra Jimenez, Rafael. "Manual del Crédito Documentario", Abeledo-Perrot, Buenos Aires, Argentina, 1966, page 229.

goods. The court resolved this issue stating that the fraud was in the documents and not in the underlying transaction.

In this regard, the Canadian case of *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*,⁵⁹ explains how there have been various characterizations of the nature of the fraud required to justify an issuing bank in refusing payment of a draft or a court in granting an injunction to restrain such payment. The court in the abovementioned case admits that the exception for forged documents is clear enough, but that the area for uncertainty lies in the scope to be given to the exception for "fraud in the transaction".

In order to try to clarify the issue, the Court cites different authors and gives different possible interpretations of "fraud in the transaction" (quoting the Court):

- H. Harfield', *Bank Credits and Acceptances* (5th ed. 1974), pp. 82-83, and *Letters of Credit* (1979), pp. 84-85: "fraud in the transaction" should be confined to fraud in the letter of credit transaction or a transaction so intimately related to the letter of credit transaction as to be an implied term of it. Note, " 'Fraud in the Transaction.' : Enjoining Letters of Credit During the Iranian Revolution " (1980), 93 *Harv. L. Rev.* 992. "The required fraud has been described in somewhat vague terms as fraud of sufficient seriousness to destroy the foundation of the letter of credit transaction.
- *Intraworld Industries, Inc. v. Girard Trust Bank*, 336 A.2d 316 (Pa. S.C. 1975), on page 324: "In light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purposes of the letter of credit, we think that the circumstances which will justify an injunction against honor must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served."
- *New York Life Insurance Co. v. Hartford National Bank & Trust Co.*, 378 A.2d 562 (Conn. S.C. 1977), at page 567, "only in rare situations of egregious fraud" that the issuer of a credit would be justified in going behind "apparently regular, conforming documents".

⁵⁹ *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, [1987] 1 S.C.R. 59. Judgments of the Supreme Court of Canada. <http://csc.lexum.umontreal.ca/en/1987/1987rcs1-59/1987rcs1-59.html>

The Court on the Bank of Nova Scotia v. Angelica-Whitewear also commented how the *Sztejn* case illustrates the difficulty of distinguishing in some cases between a case of false documents and a case of fraudulent shipment covered by documents which describe the goods called for.⁶⁰ Normally, one type of fraud would include the other type of fraud, so it is very difficult sometimes to separate one type from the other. Moreover, if the legislator has decided to include both, forged documents and material fraud, it is because he wanted them to be applied in many alternative situations⁶¹. In the words of Lord Denning M.R. in *Edward Owen Engineering*: "the request for payment is made fraudulently in circumstances when there is no right to payment", which suggest that it was intended to give a wide enough scope to the fraud exception to cover "any act of the beneficiary of a credit" that "would... permit the beneficiary to obtain the benefit of the credit as a result of fraud."⁶²

3. The evidence of fraud.

United States courts have established a very high benchmark to ascertain fraud, in which fraud has to be clear and qualified, that is, with the express will to deceive the other party. The US courts have accepted this view and have clearly invoked it on "Sztejn", where the court highlighted the difference between a simple breach of warranty and the intentional fraud on the part of the seller.⁶³

In this point, we are going to analyze the following judgments:

Maurice O'Meara Co v National Park Bank. In this judgment, the New York Court of Appeal rejected the attempt to invoke the fraud exception. This judgment involved the shipment of paper of a particular quality. The defendant bank refused to honour the plaintiff's demand for payment under the letter of credit because there had '...arisen a reasonable doubt regarding the quality of the newsprint paper.' The bank was concerned only in the drafts and the documents accompanying them. The opinion of the Court was that the issuing bank could only assess the genuineness of the documents to determine fraud.

⁶⁰ Bank of Nova Scotia v. Angelica-Whitewear Ltd., [1987] 1 S.C.R. 59. Judgments of the Supreme Court of Canada. <http://csc.lexum.umontreal.ca/en/1987/1987rsc1-59/1987rsc1-59.html>.

⁶¹ Rafael Marimón Durá. El crédito documentario irrevocable. Ob. Cit. Page 525

⁶² Bank of Nova Scotia v. Angelica-Whitewear Ltd., [1987] 1 S.C.R. 59. Judgments of the Supreme Court of Canada. <http://csc.lexum.umontreal.ca/en/1987/1987rsc1-59/1987rsc1-59.html>

⁶² *Ibidem*.

⁶³ Di María Verónica Asad. El fraude en el crédito documentario. El régimen aplicable en los sistemas de derecho civil. Ob. Cit.

In this regard, Justice Cardozo dissented, declaring that if the seller presenting the drafts for payment had committed fraud, the issuing bank may be entitled to refuse payment if the documentary fraud was discovered before payment was due.

In *Sztejn*, Judge Shientag declared that the principle of autonomy of the documentary credit regarding the underlying transaction cannot stop by itself the application of the principle of “*fraus omnia corrumpit*”, and that it would be an unfortunate interference with business transactions if banks were required or allowed to become involved in disputes between the parties regarding the quality of the merchandise. It also seems clear that, as a matter of evidence, Justice Shientag looked to the performance rendered on the underlying sales contract in order to make his determination on the issue of documentary fraud.

UCC Section 5-109(b) sets a high standard that courts must meet in order to grant an injunction with the objective to reduce the frequency with which the fraud rule has been used in the United States since the late 1970s. It states that “on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1)”.⁶⁴ This section of UCC can be interpreted as a requirement for the applicant to show the existence of fraud, which would have to be evident, for the Court to acknowledge that his argument is more likely than not to succeed under its claim of forgery or material fraud and grant an injunction to prevent payment from the beneficiary. Therefore, a party would have to prove the existence of a “material” and “clear”⁶⁵ fraud for the court to grant an injunction.

4. Preventive measures.

“US courts have been pioneers in admitting fraud as an exception to the traditional autonomy principle of the underlying transaction, and the Courts of this country

⁶⁴ Id.5-109(b)(4)

⁶⁵ “According to most authors, the safety of the documentary credit would be achieved by adopting a realist conception, according to which it is not enough to offer a prima facie evidence of fraud, it is necessary to indicate elements that establish its existence. Therefore, to show fraud it must be recognized as evident in front of the eyes of any person, because if it is not its invocation would be the object of all kind of questioning. Giving its exceptional character, most Courts would agree that banks have to have clear evidence of fraud and not only a suspicious of fraud.” Di María Verónica Asad. *El fraude en el crédito documentario. El régimen aplicable en los sistemas de derecho civil*. Ob. Cit.

have legitimized the right of a bank to abstain from paying on the ground of fraud in the documents as well as fraud in the underlying transaction.”⁶⁶

Judges in the US have granted injunctions when the documents about the documentary credit are fraudulent, but also when the fraud lies in the underlying commercial operation. In the famous judgment of “Sztjen v. Henry Schroeder Banking Corporation”, a New York Court granted an injunction to a buyer so that he’s bank could abstain from paying to the seller of the letter of credit in a fraudulent transaction. The judges acknowledged that the bank had acted with proper diligence.

As it was already discussed, the documents presented to the bank complied on their face with what was established under the contract, but the shipped goods did not. The Court held that the principle of independence of the letter of credit could not be extended to protect the unscrupulous seller.

The United States has very harsh requisites to fulfil in order to grant an “injunction” or “similar relief” for fraud, which are established in the Article 5 of the Uniform Commercial Code.

“As stated before, courts would require an elevated showing of fraud, requiring egregious fraud arising from declarations that have no basis in fact and are attempts to run off with the customer’s money, ‘unscrupulous’ sellers fraud that so vitiates the entire transaction that the legitimate purposes of the independence of the issuer’s obligation can no longer be served.”⁶⁷

5. The protection of innocent claimants under the letter of credit.

In order to protect an innocent party who purchases a negotiable instrument for value without any apparent defect in the instrument or any notice of dishonor, the US doctrine has created the doctrine of the holder in due course. If the documents to demand payment or the letter of credit is presented by a holder in due course to the bank, that is, an innocent party who has purchased a negotiable instrument for value without any apparent defect in

⁶⁶ Di María Verónica Asad. El fraude en el crédito documentario. El régimen aplicable en los sistemas de derecho civil. Ob. Cit.

⁶⁷ Ralph Folsom, Michael Gordon, John Spanogle and Peter Fitzgerald. International Business transactions. A problem oriented coursebook. Ob. Cit. page 311.

the instrument nor any advice of dishonor, the bank must pay, even though it has verified a typical situation of fraud⁶⁸, otherwise the bank could be liable.⁶⁹

The UCC 5-109(c) and (d) establish several requisites in order to be a holder in due course:⁷⁰

- The holder must have acquired the title in good faith
- The title must not omit any mention considered fundamental by the law
- The title must not present signs of having been falsified.

“If these conditions are not met, then the person presenting the documents can claim to be a holder in due course.”⁷¹

The most typical requirements of payment by a third party are produced either as a result of the negotiation of the documents with the letters, or through the negotiations of letters that have already been accepted by the issuing bank after tendering documents. “Outside the cases in which the relation of the payment is presented by a holder in due course, the bank that acts in good faith can attend the demand and pay the credit but it is not forced to pay.”⁷²

B. The United Kingdom approach to fraud in letters of credit.

1. General doctrine.

“UK jurisprudence is more uniform than in the United States, even though it hasn’t been codified. As in the United States, the case law on commercial letters of credit complements and feeds the law on standby letters of credit and performance bonds. On the other hand, the interference of the guarantees hasn’t led to a change like the one that took place in the American system. The jurisprudence has been more rigid when granting injunctions.”⁷³

⁶⁸ Court opinion in O’ Meara.

⁶⁹ Rafael Marimón Durá. El crédito documentario irrevocable. Ob. Cit. Page 526

⁷⁰ Id.3-302(a)(2).

⁷¹ Rafael Marimón Durá. El crédito documentario irrevocable. Ob. Cit. Page 526.

⁷² *Ibidem* Page 527.

⁷³ *Ibidem*. Page 542.

“The independence principle is scrupulously respected and the simple disputes between buyer and seller regarding the quality of the merchandises cannot motivate its derogation.” “In these cases the bank must fulfil its promise to pay, which it has assumed in an irrevocable way, since the bank’s promise to pay is the life and blood of international commerce.”⁷⁴ “Nonetheless, the application of this principle can lead to unfair results when it protects abusive or fraudulent behaviours, since it can no longer be held as reasonable”⁷⁵. “In these situations the bank is not obliged to pay.”⁷⁶

“The exception is admitted theoretically, both in documentary credits and guarantees, but in a restrictive way. The procedural formula used is usually a preventive measure by the applicant to stop the bank from paying, usually through an injunction.”⁷⁷

Jurisprudence and doctrine have made an effort to clarify that the beneficiary’s intention to mislead the bank is inherent to the concept of fraud. “One of the fundamentals of the *exceptio doli* is deceit”,⁷⁸ but this does not seem to be the case under British Law. In *United City Merchants*, The House of Lords decided that the fraud exception was limited to any fraud in respect of which the beneficiary had knowledge, and that fraud of a third-party of which the beneficiary was not aware at the time of presentation, is not sufficient.

“The Judgment of *United City Merchants* has allowed the doctrine to define fraud, in a wide sense, as any dishonest behaviour used to obtain an economical advantage, where intervenes a certain degree of deceit.”⁷⁹

“The bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the *documents are forgeries* it must refuse to accept them. It may be that the party presenting the documents has himself been duped by the forger and believes the documents to be genuine but

⁷⁴ *Malas v. British Imex Industries, Ltd.*

⁷⁵ *Malas v. British Imex Industries, Ltd.*: “They may well be cases where the court would exercise jurisdiction, as, for example, where there is a fraudulent transaction”.

⁷⁶ Rafél Marimón Durá, *El Crédito Documentario Irrevocable*. Ob. Cit. Page 544.

⁷⁷ Rafél Marimón Durá, *El Crédito Documentario Irrevocable*. Ob. Cit. Page 545.

⁷⁸ *Ibidem*. Page 549.

⁷⁹ *Ibidem*. Page 550.

that surely cannot affect the bank's right to refuse to accept the forgeries. ***The identity of the forger is immaterial. It is the fact that the documents are worthless that matters to the bank.*** In such case the right of the bank to refuse payment does not rest upon the application of the maxim "*ex turpi causa non oritur action*", but upon the presentation of genuine documents in accordance with the requirements of the letter of credit. If the documents presented are fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay.⁸⁰

For such reason one can conclude that the law in the United Kingdom does not seem to have a very clear rule requiring the will to deceit by the beneficiary. If the documents are forgeries or are materially false and the Bank is aware of the situation, it is obliged to pay anyway, since it is irrelevant what the will of the party was, since it must comply with documentary obligation. Therefore, it is theoretically possible under British Law for a party to use the services of a third party in a discreet enough way as to keep their fraudulent practices to themselves. "A bank which receives firm evidence external to the documents of fraud by a third party does not even have the option of refusing to honour a credit governed by English law as stated in the *American Accord*."⁸¹

2. Types of fraud that can justify nonpayment.

In the United Kingdom, the dominant thesis of fraud in Documentary credit is the one that defend that nonpayment in a case of fraud can only be justified when it lies in the documents tendered by the beneficiary. The bank can refuse payment when the documents appear on their face to be forged but not when they conform to the terms and conditions of the letter of credit and the merchandise is not of the quality agreed or when it is different. Since fraud lies in the documents and not in the underlying transaction, it is, according to the defenders of this thesis in the United Kingdom, the only one that allows an integral respect of the rules and principles of the documentary.⁸² That is, United Kingdom courts have a more restrictive approach to fraud than courts in the United States.

a. In *Hamzeh Malas & Sons v. British Imex Industries*, Lord Justice states that "it seems to be plain enough that the opening of a confirmed letter of credit constitutes a

⁸⁰ Xiang Gao. The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>

⁸¹ *Ibidem*

⁸² . Gonçalo Andrade e Castro, O crédito documentário irrevogável. Page 291, citing Giampieri.

bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to the contract or not”.

Fraud because of forged or falsified documents is acknowledged in article 34 of UCP 600: “A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods...”⁸³, therefore, banks are not responsible if fraud occurs. The problem arises when the banks lack the necessary elements of judgement that allow them to know if the documents that are to be delivered are authentic and if they have been actually produced by the shipping companies, insurance companies, etc. Here we can see how the formalism of the documentary credit protects the banks, who assume only the formal control of the documents, in application of the principle of the autonomy of the credit. “If banks would assume the obligation to review the goods themselves, it would become necessary to hire specialists in each type of commercial transaction, which would imply a rise in the operations costs, making it economically unbearable.”⁸⁴

This principle has an important consequence; banks are not obliged to research about the authenticity or accuracy of the documents, even when they have been warned about a possible fraud,⁸⁵ with the only limits on the principles applicable for mandates in good faith, as well as their responsibility for their own fault or negligence. Therefore, if a bank has paid according to documents that appear to be genuine at sight, they cannot be considered responsible if it can be later proved that such documents are false, if they have acted in a diligent matter and in good faith.⁸⁶

This is a consequence of the independent and formalistic characters of the documentary credit. Acting in good faith by a bank means to carefully examine the agreed terms and conditions of the letter of credit, being the bank obliged to pay when they do. When the documents conform on their face but the bank has manifest evidence of fraud, according to

⁸³ UCP 600

⁸⁴ Olarra Jiménez, Rafael. “Manual del Crédito Documentario”, Ob. cit page. 97.

⁸⁵ United city merchants

⁸⁶ *Sztejn v. J. Henry Schroder Banking Corporation* N.Y. S 2d 631 (1941)

some authors it can refrain from paying, as we shall see later in this section of the paper. In any case, the Bank should inform the applicant if it has received information about an eventual fraud so that the applicant can investigate and apply the judicial remedy deemed necessary.

b. United City Merchants (Investment) Limited and Glass Fibres and Equipment Ltd v. Royal Bank of Canada, Vitrorefuerzos S.A. and Banco Continental S.A.⁸⁷

The facts of the case are as follows. In October 1975, Glass Fibres and Equipment Ltd ('GFE'), an English company, entered into a contract to sell glass fibre making equipment to a Peruvian company named Vitrorefuerzos SA ('Vitro'). Payment was to be made by an irrevocable letter of credit issued by the Banco Continental SA of Peru and confirmed by the Royal Bank of Canada ('RBC'). GFE assigned their rights, entitlements and benefits under the letter of credit to United City Merchants ('UCM'), and notice of the assignment was given to the banks. Shipment, after some amendments, was to be from London to Callao on or before December 15th, 1976.

Once the equipment was complete, GFE sent them for temporary storage to their forwarding agents. GFE told the forwarding agents, who in turn told a Mr Baker, an employee of E H Mundy & Co (Freight Agencies) Ltd, the details of the requirements for the bills of lading, including the latest shipment date. However, the goods were not shipped until December 16th, instead of on December 15th, as required in the contract. Baker, not acting for, and without the knowledge of the sellers or the consignees of the letter of credit, fraudulently entered December 15th as the date of shipment on a notation stamped on the bill of lading.

When documents were presented for payment by UCM, RBC refused to pay on the basis that it had information suggesting that shipment had not in fact been effected as indicated in the bill of lading. The plaintiffs then brought the action against the defendants for wrongful dishonour. In its defence, RBC contended, inter alia, that the presentation was fraudulent in that the goods were loaded on board the *American Accord* on December 16th and not on December 15th as agreed.

⁸⁷ Xiang Gao. The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>

The Queen's Bench.

Justice Mocatta of the Queen's Bench Division, accepted that, although the issuing of a letter of credit constitutes a bargain between the issuer and the beneficiary which imposes an absolute obligation on the issuer to pay the amount of the letter of credit upon the presentation of conforming documents irrespective of any dispute between the parties about the underlying transaction, there was "an exception to the strict rule: the bank ought not to pay under the credit if it knows that *the documents* are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment".⁸⁸

But because Mocatta J found that Mr Baker was not the plaintiffs agent for making out the bills of lading and that there was no fraud on the part of the plaintiffs in presenting them, relying on the principle of *ex turpi causa non oritur actio*, his Honour held that the case was vitally different from the situation in *Sztejn*, and therefore rejected the defendants' arguments, concluding:

"Where there has been personal fraud or unscrupulous conduct by the seller presenting documents under the letter of credit, it is right that a bank should be entitled to refuse payment against apparently conforming documents on the principle "*ex turpi causa non oritur action*". But here I have held that there was no fraud on the part of the plaintiffs, nor can I, as a matter of fact, find that they knew the date on the bills of lading to be false when they presented the documents. ... Accordingly, I take the view ... that the plaintiffs are ... entitled to succeed."⁸⁹

Court of Appeal.

Justice Mocatta's decision was reversed by the Court of Appeal, which construed the applicant's mandate to the bank was only to pay against the presentation of genuine documents; therefore the bank was justified in refusing to pay against forged documents. The Court held that the fact that the fraud had been committed by a third party could not prevent the bank from raising the defence of fraud against the beneficiary. Lord Ackner stated:

⁸⁸ *United City Merchants v Royal Bank of Canada* [1979] 1 Lloyd's Rep 267, 276 (emphasis added), quoting Lord Denning in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976, 982, as cited by Xiang Gao. *The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit*. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>.

⁸⁹ *Ibidem*

“The buyer, unless otherwise agreed, cannot be deemed to have authorized the banker to pay against documents which are known to be forged. If the documents are forged, then obviously they are not valid ... The banker’s authority or mandate is to pay against genuine documents and that is what the bank has undertaken to do. It is the character of the document, not its origin, that must decide whether or not it is a ‘conforming’ document...”

“If I am correct ... then it must follow that if the bank knows that a bill of lading has been fraudulently completed by a third party, it must treat that as a nonconforming document in the same way as if it knew the seller was party to the fraud.”⁹⁰

The Court of Appeal considered the issue of risk allocation between innocent parties:

“Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for documents they present, it is important to all concerned that those documents should accord, not merely with the requirements of the credit but with the facts, and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer.”⁹¹

Stephenson LJ went on to say that even though the Judge was not able to find that Baker was the plaintiffs’ agent in making the bill of lading for presentation to the defendants, the plaintiffs were the innocent party who put him in the position in which he made the bill, and made it fraudulently, and in his judgment it is they who should bear the loss and not the defendants, already impoverished by the dollars remitted to the United States of America.

⁹⁰ United City Merchants v Royal Bank of Canada [1981] 1 Lloyd’s Rep 604, 628-9. Lord Stephenson approached the point as follows: ‘whether or not a forged document is a nullity, it is not a genuine or valid document entitling the presenter of it to be paid and if the banker to which it is presented under a letter of credit knows it to be forged he must not pay’: 623, as cited by Xiang Gao. The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>.

⁹¹ *Ibidem*.

Lord Justice Griffiths on the issue of the identity of the fraudulent party:

“The bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the *documents are forgeries* it must refuse to accept them. The identity of the forger is immaterial. It is the fact that the documents are worthless that matters to the bank. In such a case the right of the bank to refuse payment does not rest upon the application of the maxim *ex turpi causa non oritur actio*, but upon the presentation of genuine documents in accordance with the requirements of the letter of credit. If the documents presented are fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay.”⁹²

The Court of Appeal concluded that the decision of Mocatta J had put the bank in a curious position:

“The latest date for shipment of the machinery was December 15, 1976. The machinery was in fact shipped on December 16, 1976, and if the bill of lading had shown that date the bank would have refused to pay upon presentation of the documents because of the strict rule that the documents must comply in every respect with the terms of the letter of credit ... It would be a strange rule that required a bank to refuse payment if the document correctly showed the date of shipment as December 16, yet obliged the bank to make payment if it knew that the document falsely showed the date of shipment as December 15 and that the true date was December 16.”⁹³

The House of Lords.

On appeal the House of Lords overruled the decision of the Court of Appeal and restored that of Mocatta J on this issue. Lord Diplock, delivering the opinion of the Court, began by reiterating the principle of independence through an emphasis on the autonomous and ‘paper-driven’ nature of the letter of credit arrangement, saying:

⁹² *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd’s Rep 604, 628-9. Lord Stephenson approached the point as follows: ‘whether or not a forged document is a nullity, it is not a genuine or valid document entitling the presenter of it to be paid and if the banker to which it is presented under a letter of credit knows it to be forged he must not pay’: 623, as cited by Xiang Gao. *The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit*. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>.

⁹³ *Ibidem* (Griffiths LJ), (citations omitted). , as cited by Xiang Gao. *The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit*. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>.

“It is trite law that there are four autonomous though interconnected contractual relationships involved. (1) The underlying contract for the sale of goods ... (2) the contract between the buyer and the issuing bank ... (3) if payment is to be made through a confirming bank, the contract between the issuing and confirming bank ... and (4) the contract between the confirming bank and the seller. ... Again, it is trite law that in contract (4), with which alone the instant appeal is directly concerned, the parties to it, the seller and the confirming bank, ‘deal in documents and not in goods’, as article 8 of the Uniform Customs and Practice for Documentary Credits (1974) puts it.”⁹⁴

Lord Diplock went on to observe that to this general statement of principle: “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 misrepresentations of fact that to his knowledge are untrue.”⁹⁵

This means that, if the seller acts with the intent to deceive the bank can refuse to pay. But if the seller lacks that intent, the bank must pay. It isn’t enough that documents are fraudulent; the seller/beneficiary must know they are fraudulent. This is the critical element under British Law.

The House of Lords held that “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*”.”⁹⁶ As “the sellers were unaware of the inaccuracy of Mr Baker’s notation of the date at which the goods were actually on board *American Accord*” and as they in fact “believed that it was true and the goods had actually been loaded on or before December 15, 1976, as required by the documentary credit”, the beneficiaries in the case were innocent.⁹⁷ Accordingly, their Lordships held that “the instant case ... does not fall within the fraud exception”.⁹⁸

⁹⁴ United City Merchants [1983] 1 AC 168, 183 , as cited by Xiang Gao. The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit.

<http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>.

⁹⁵ *Ibidem*.

⁹⁶ *Ibidem*.

⁹⁷ *Ibidem*.

⁹⁸ *Ibidem*.

RBC had argued that a confirming bank was not under any obligation to pay to the beneficiary the sum stipulated in the credit against the presentation of documents “if the *documents* presented, although conforming on their face with the terms of the credit, nevertheless *contain some statement of material fact that is not accurate*”.⁹⁹ This argument was rejected by Lord Diplock, who stated:

“It has, so far as I know, never been disputed that as between confirming bank and issuing bank and as between issuing bank and the buyer the contractual duty of each bank under a confirmed irrevocable credit is to examine with reasonable care all documents presented in order to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit, and if they do so appear, to pay to the seller/beneficiary by whom the documents have been presented the sum stipulated by the credit”

“It would be strange from the commercial point of view, although not theoretically impossible in law, if the contractual duty owed by confirming and issuing banks to the buyer to honour the credit on the presentation of apparently conforming documents despite the fact that they contain inaccuracies or even are forged, were not matched by a corresponding contractual liability of the confirming bank to the seller/beneficiary (in the absence, of course, of any fraud on his part) to pay the sum stipulated in the credit upon presentation of apparently conforming documents.”¹⁰⁰

Lord Diplock also rejected RBC’s amended argument, which was narrower and claimed that if any of the documents presented by the beneficiary contained a material misrepresentation of fact, known to be false by the issuer of the document and intended to deceive persons into whose hands the document might come, the confirming bank was under no liability to honour the credit, even though the persons whom the applicant of the document intended to, and did, deceive included the beneficiary itself. In rejecting this narrower argument, Lord Diplock stated:

⁹⁹ *United City Merchants* [1983] 1 AC 168, 183, as cited by Xiang Gao. *The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit*. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>. Emphasis added.

¹⁰⁰ *Ibidem*

“If the broad proposition for which the confirming bank has argued is unacceptable for the reasons ... discussed, what rational ground can there be for drawing any distinction between apparently conforming documents that, unknown to the seller, in fact contain a statement of fact that is inaccurate where the inaccuracy was due to inadvertence by the maker of the document, and the like documents where the same inaccuracy had been inserted by the maker of the document with intent to deceive, among others, the seller/beneficiary himself?”¹⁰¹

This is a very important statement since it basically says that the intention of the maker of the document is irrelevant, what matters is the document in itself. If it is forged or materially fraudulent then the bank is entitled to refrain from paying, which basically clarifies the law on the terms of what kind of fraud is recognized under British Law.

Finally, the House of Lords held that the legal effect of the forgery in the bill of lading was not such as to make the bill a ‘nullity’;¹⁰² therefore neither its validity nor the bank’s security interest would be affected by the forgery. Although the issuing date on the bill of lading was false, the goods had been shipped and the bill of lading gave the right of possession to the holder. According to Lord Diplock:

“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 was evidence of the terms of the contract under which they were being carried.¹⁰³ The realisable value on arrival at Callao of a glass fibre manufacturing plant made to the specification of the buyers could not be in any way affected by its having been

¹⁰¹ United City Merchants [1983] 1 AC 168, 183 , as cited by Xiang Gao. The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>. Page. 187.

¹⁰² In Lord Diplock’s view, a forged document would be a ‘nullity’ if it were so forged as to deprive it of all legal effect: *ibid*. He also stated that he ‘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 because unknown to him it was forged by some third party; for that question does not arise in the instant case’: *ibid* 188 , as cited by Xiang Gao. The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>.

¹⁰³ *Ibidem*.

loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976.¹⁰⁴

3. The evidence of fraud.

The British jurisprudence has adopted a very restrictive approach on admitting fraud, which means, fraud must be clearly proved and it is not useful the simple allegation by the issuer.¹⁰⁵

“We would expect the Court to require strong corroborative evidence of the allegation, usually in the form of documentary documents, particularly those emanating from the buyer.”¹⁰⁶ “In this case, it is even affirmed that the common instrument of proof in these cases is the documentary proof, of special proving value if the document that proof fraud is originated by the issuer”.¹⁰⁷

In *Malass v British Imex Industries Ltd* (1957) the Court decided that the evidence of fraud must be sufficiently met in order to justify the negative of the bank to pay, even more to admit the effects of an injunction that will stop the bank from doing it. *Malass v British Imex Industries Ltd* (1957) case developed as follows: The buyers had ordered that the goods of the transaction were delivered with two shipments. The goods delivered with the first shipment were not of the contracted quality, which is why the buyers obtained a judicial order in England to stop the seller from using the letter of credit for the second shipment. An extension of the judicial prohibition was denied and the Appellate Court agreed on the grounds that the whole system relied on the bank unavoidable obligation to pay.

From this case one can conclude that Courts in the United Kingdom favour payment on the letter of credit and have declared that in the absence of evident fraud they cannot grant

¹⁰⁴ *Ibidem* 186. It has been unfortunately suggested that ‘[t]o the shipping industry, this case, by contrast with *Sztejn*, might be analogous to an inconsequential “white lie” specifically designed to rectify the unduly burdensome formalities inherent in maritime venture financing’: Joseph A Walsh II, ‘Documentary Maritime Fraud: Redefining the Standard’ (1989) 6 *Arizona Journal of International and Comparative Law* 223, 250. as cited by Xiang Gao. The Identity Of The Fraudulent Party Under The Fraud Rule In The Law Of Letters Of Credit. <http://www.austlii.edu.au/au/journals/UNSWLJ/2001/14.html#fn40>.

¹⁰⁵ Jack R. Documentary Credits. The law and practice of documentary credits including standby credits and demand guarantees. Butterworths London-Dublin-Edinburgh 1993. Pages 204-206.

¹⁰⁶ *United Trading Corporation S.A. v. Allied Arab Bank Ltd.*

¹⁰⁷ Marimón Durá, *El Crédito Documentario Irrocable*, pág. 553. València, 2002.

an injunction to prevent payment.¹⁰⁸ Banks can only refuse to pay when they are confronted with a manifest fraud¹⁰⁹ and are not obliged to deploy any proving activity.

In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*, the court declared that: “it is certainly not enough to allege fraud; it must be ‘established’, and in such circumstances I should say very clearly established.” In *RD Harbottle v National Westminster Bank*, Justice Kerr stated that banker’s irrevocable obligations are the “...life blood of international commerce...” and, that a buyer must establish it “in order to justify injunctive dishonour. It illustrates the hesitation with which United Kingdom’s courts will interfere with letters of credit.¹¹⁰ On the other hand, there are authors who defend the contrary opinion, such as Lord Diplock in *United City Merchants*, who affirm that the bank is entitled but not obliged to oppose payment.

In this regard, in *United City Merchants Ltd v. Royal Bank of Canada*, the Court declared that “the bank when presented with apparently conforming documents by the seller, is legally entitled to the option, exercisable at its own discretion and regardless of any instructions to the contrary from the buyer, either (1) to take up the documents and pay the credit and claim reimbursement from the buyer, notwithstanding that the bank has been provided with information that makes it virtually certain that the existence of such inaccuracies can be proved, or (2) to reject the documents and to refuse to pay the credit.”¹¹¹ In this case, one can conclude that a bank can refuse payment but is not obliged to, therefore, UK law is not very clear regarding the option of a bank to refrain from paying when confronted with documents that appear to conform on their face with the agreed terms and conditions of the letter of credit, but the Bank is suspicious about the possibility of fraud, which is very confusing because United Kingdom courts would apply the fraud exception on cases of fraud in the documents as well as cases of fraud in the underlying transaction. In this regard, Lord Denning MR stated in the case of *Edward Owen* that: “That case shows that there is an exception to the strict rule; the bank ought

¹⁰⁸ “*Edward Owen v. Barclays Bank International*”

¹⁰⁹ “If there is manifest fraud the bank is not only entitled but obliged to refuse payment under the credit R.M. Goode, “Reflections on Letters of Credit - 1”, [1980] *Journal of Business Law* Page 292.

¹¹⁰ The Fraud Exception <http://www.austlii.edu.au/au/journals/BondLRev/1999/5.html#fn1>, as on September 29th, 2008.

¹¹¹ *United City Merchants Ltd v. Royal Bank of Canada*.

not to pay under the credit if it knows that the documents are forged or that the *request for payment is made fraudulently in circumstances when there is no right to payment.*”¹¹²

4. Preventive measures.

Generally, the British judges only justify the banks refusal to pay or authorize an injunction when they’ve found a way to approve and establish the existence of an evident fraud.

An injunction under British law can adopt one of two different modalities:

- A mandate to the bank to stop from paying, or
- A mandate to the beneficiary to stop for claiming payment.

In the United Kingdom, the need to avoid an “irretrievable injustice” is a requirement for the grant of the injunction in case of fraud to the beneficiary. Nonetheless, the doctrine and jurisprudence agree in the absolute exceptionality of this measure, which can only be accorded when:

a. There is proof of fraud: A solid evidence of fraud acquires a special intensity in the common hypothesis in which the issuer demands from the Court the adoption of a preventive measure to stop the letter of credit.¹¹³

b. The bank is aware of the fraudulent situation. Some decisions have affirmed the need of the issuer, that besides showing that the claim of the beneficiary is fraudulent, it has to prove that the bank is aware of the fraud, as a requisite to obtain the preventive protection. Both requirements have to appear perfectly evidenced in order for the Court to accept and emit an injunction.^{114, 115}

c. Utility and need of the preventive measure: When there are important discrepancies between the promised merchandise and the one effectively provided, the injunction will not be conceded if additional circumstances take place that render it useless, like the fact

¹¹² Edward Owen Engineering Ltd v Barclays Bank International Ltd.

¹¹³ Discount Records Ltd v Barclays Bank of Canada.

¹¹⁴ In this sense, the declaration of the Master of the Rolls, Sir John Donaldson, in the *Bolivinter Oil S.A. v. Manhattan Bank and Others* (All ER, 1984, 1, p . 352 ss.) cited by O crédito documentário irrevogável on page 316.

¹¹⁵ United Trading Corporation S.A. v. Allied Arab Bank Ltd.

that the one claiming payment is a holder in due course, since in such case the beneficiary has already received payment beforehand and also because it is unfair that the holder is not reimbursed.¹¹⁶

In addition, a judicial intervention in the normal development of a letter of credit is justified only if there is no alternative remedy that is less distorting of the commercial practice. In other words, the party seeking an injunction must show that, if the preventive measure is not adopted, there would be an irreparable damage to its patrimony¹¹⁷.

The “Mareva Injunction”

It is very similar to the Venezuelan or Spanish “*Embargo preventivo*”.

It is an order to restraint a defendant from removing his money or other assets out of the jurisdiction, or otherwise dealing with them within the jurisdiction subject to a limitation in amount, which is usually the amount of the plaintiff’s claim together with an allowance for likely costs.¹¹⁸

“In documentary credits, it means that a bank will not be stopped from making the payment but the beneficiary is forbidden to take the money abroad until the main question hasn’t been resolved. British jurisprudence declares that in this way the independence principle is not undermined because the bank has already fulfilled with his obligation, but the defrauded party is protected because the money is kept in the local jurisdiction and will be available to reimburse the issuer if it is later proved that fraud occurred”¹¹⁹.

“Because the order [a Mareva Injunction] does not interfere with the operation of the credit, but restraint the use of the proceeds of its operation, the buyer does not have to bring himself with the fraud exception to the autonomy rule to claim a Mareva order. The claim for Mareva order may be supported by a simple claim by the buyer against the seller for breach of contract.

¹¹⁶ Discount Records v. Barclays Bank.

¹¹⁷ Tukan Timer Ltd. V. Barclays Bank Plc.

¹¹⁸ Jack, R., Documentary credits. Ob. Cit. Pages 208-209.

¹¹⁹ Marimón Durá, El Crédito Documentario Irrocable. Ob. Cit. Page 556.

5. The protection of innocent claimants under the letter of credit.

As in the US, the British jurisprudence confers protection to third parties who have acted in good faith if the issuing bank has already accepted the draft or bill of exchange.¹²⁰ This rule is the same in the US under UCC 5-109(c) and (d).

In *European Asian Bank A. G. v. Pinjab and Sind Bank*, the negotiating bank after having paid the credit, remitted the documents to the issuing bank with the bill of exchange issued by the beneficiary against the issuer.¹²¹ Even though containing small discrepancies the documents were adopted even by the issuer, but soon afterwards he obtained a judicial order to stop payment of the credit by the issuing bank because he believed there was fraud by the beneficiary.¹²²

The Court of appeals considered that the negotiating bank had to be paid, because the relevant time for considering this question is the time when payment falls due and is claimed and refused.

“If, at that time, the party claiming payment had negotiated the relevant documents in good faith, the issuing bank cannot excuse his refusal to pay on the ground that in some earlier time the negotiating bank was a mere agent for collection on behalf of the seller and allege against him fraud or forgery (if that indeed be the case) on the part of the beneficiary of the letter of credit.”¹²³

It should be noted, however, that, independently of the bad or lack of bad faith, this is not a typical case of fraud, because the one who claims payment is the negotiating bank, therefore, a bank involved in the negotiation. It is not about the claim of a beneficiary to stop payment to a third party but the right to a reimbursement of the bank that has paid. Note that, likewise of what happens in the US, in the British judgments there is a superposition of a negotiable payment instrument having been put in circulation, which

¹²⁰ *Guarantee Trust Co. v. Hannay*, All ER, 1918-19. pages, 151-166, esp- pág. 162; *European Asian Bank A. G. v. Pinjab and Sind Bank*, Lloyd's L. Rep., 1983-1, 611-622, esp 619; *Discount Records Ltd v Barclays Bank Ltd* [1975] I All ER, 1071, 1076.

¹²¹ Rafél Marimón Durá, *El Crédito Documentario Irrevocable*. Ob. Cited. Page 551.

¹²² The issuer, after being informed that the ship that carried the merchandise had sank, claimed payment from insurance company. But the insurance company opposed to the claim alleging that the merchandise had never existed and that the supposed sinking hadn't happened neither.

¹²³ *Lloyds L. Rep.*, 1983-1, 619, as cited by Marimón Durá, *El Crédito Documentario Irrevocable*. Ob. Cit. Page 550.

makes difficult the exact determination about why it is not possible to enforce the fraud exception, and also the preventive measures that could be associated.¹²⁴

“What is the position of the holder of the beneficiary’s draft? Since a letter of credit is not a negotiable instrument, it would seem that, if the beneficiary is guilty of fraud, the bank is not obliged to accept or pay the bill of exchange tendered by the endorsee of the beneficiary’s draft, even if the endorsee takes for value and without notice, except where the draft was negotiated in reliance on an within the authority conferred by a negotiation credit. On the other hand if the bank accepts the draft it owes a duty to a holder in due course to honour the draft at maturity, and if it pays a sight draft the bank cannot recover the money.”¹²⁵

C. Further comments about other Common Law jurisdictions

Canada.

1. General doctrine.

In Canada, the matter of Angelica-Whitewear is considered the landmark case, while the Judgments in the United States and United Kingdom are often cited by the doctrine. The Angelica-Whitewear its a very interesting case where we can distinguish clearly the considerations used by Canadian courts to identify both the kind of fraud necessary to the fraud exception and the locus of fraud.

The Angelica-Whitewear case involved the latter setting, Angelica having argued that it notified the issuer of the fraud before payment, the banks had paid anyway, despite the notice. In determining the kind of fraud that is necessary to the fraud exception, the Court distinguished actions for interlocutory injunction before the issuer pays the beneficiary from disputes between the issuer and its customer after the issuer pays the beneficiary. The Court decided that Angelica had not given sufficient notice to the bank of the fraud. Such notice must make the fraud clear or obvious to the bank. In such case, those involving applications for an interlocutory injunction, the Court would require a strong prima facie case of fraud.

¹²⁴ Marimón Durá, El Crédito Documentario Irrocable. Ob. Cit. Page 551.

¹²⁵ Goode, R. M., Reflections on letters of credit – 1. Ob. Cit. Page. 292.

2. Types of fraud that can justify nonpayment.

There seems to be some controversy regarding the locus of the fraud that will justify an exception to the autonomy principle. The UCC stipulates in section 5-109 that:

“If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons”

Some authors have argued that the fraud must lie in the letter of credit transaction. Others have argued that fraud in the underlying transaction should also support the fraud exception. The US decisions seem to be split on this matter, though those of the second view are probably the majority. The *Angelica –Whitewar* Court also followed that second view¹²⁶. For a more detailed explanation we remit to the “Types of fraud that can justify nonpayment” of the the United States approach to fraud in letters of credit, on page 24.

Usually, the fraud of the beneficiary in the underlying transaction will contaminate the letter of credit transaction. In this case, the beneficiary had submitted documents describing the goods as polyester and viscose garments, when in fact the garments contained other materials.

In *The Angelica –Whitewar*, the customer argued that the goods did not conform to the terms and conditions of the letter of credit. The Quebec Court refashioned the customer’s argument as one of fraud. The beneficiary had submitted documents describing the goods as polyester and viscose garments, when in fact the garments contained other materials. Thus, the Court considered the documents fraudulent.¹²⁷

3. The evidence of fraud.

In the injunction cases, the showing of fraud functions to support an extraordinary juridical remedy. Hence, the courts have fashioned a rule in the lexicon of judicial

¹²⁶ See *Material vs. Forged documents fraud* on page 20.

¹²⁷ Michael Gordon, John Spanogle and Peter Fitzgerald. *International Business transactions*. Ob. Cited. Page 315.

remedies: “a strong *prima facie* case”. In cases where the applicant sues the bank after payment is made, alleging that the bank’s payment was wrongful, the issue is somewhat different. In such cases, the purpose is to test the objective honesty of the issuing bank. Thus, the courts fashioned a rule requiring clear and obvious proof of fraud before finding that the bank acted wrongfully in making payment.

Given the law’s justification of dishonour in fraud cases, only an objectively dishonest issuer would pay in the face of such evidence. To the extent that the Canadian cases require the applicant to behave in an honest and reasonable fashion, they may depart from the United States rule. In the United States, applicants need only behave honestly in fact, i.e., honestly in a subjectively way.

“In the Unites States, courts generally want an elevated showing of fraud, requiring egregious fraud arising from declarations that have no basis in fact and are attempts to run off with the customer’s money, an “unscrupulous” seller’s fraud that vitiates the underlying transaction, before they are satisfied that they can violate the autonomy principle.”¹²⁸ In any case, both Canadian and American jurisdictions would require a “strong” or “egregious” showing of fraud

4. Preventive measures.

Canadian courts have recognized that fraud is enough as to justify its opposition to the letter of credit principles of independence and autonomy, recognizing the injunction if the bank has been informed of the fraud before the requirement to pay made by the seller. A Canadian court, like the abovementioned Common Law jurisdictions, would normally require a strong *prima facie* case of fraud as a test to apply for an interlocutory injunction to restraint payment under a letter of credit on the ground of fraud by the beneficiary of the credit.

5. The protection of innocent claimants under the letter of credit.

“The fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction of such a character as to make the demand for payment

¹²⁸ Michael Gordon, John Spanogle and Peter Fitzgerald. *International Business transactions*. Ob. Cited. Page 314-315.

under the credit a fraudulent one. The exception, however, should be limited to fraud by the beneficiary of a credit and should not extend to fraud by a third party of which the beneficiary is innocent. It should also not be opposable to the holder in due course of a draft on a letter of credit.”¹²⁹

One can conclude that the protection of innocent claimants under the letter of credit is not very different from the one offered under the US or the British law, being the holder in due course the common legal concept of them all, therefore, the law on this matter in Canada is very much like the already commented UCC 5-109(c) and (d), on page 30.

¹²⁹ Bank of Nova Scotia v. Angelica-Whitewear Ltd., [1987] 1 S.C.R. 59

VII. The Civil Law Approach to Fraud.

A. The Spanish approach to fraud on letters of credit.

1. General doctrine

In Spain, the legal doctrine has recognized the *exceptio doli* as a mechanism to make opposition to the enforcement of an action against a bank during a fraudulent execution of a documentary credit by the beneficiary¹³⁰. Nonetheless, there are no jurisprudential decisions that have specifically ruled on this subject, as in the US or in the UK. In fact, the lack of jurisprudence by the Spanish Supreme Tribunal regarding fraud has been seen by some as a symptom of good health of this payment instrument in Spain.¹³¹¹³²

The Spanish doctrine has used civil law concepts in order to justify the suspension of the obligation to pay of a bank in a case of fraud in a letter of credit transaction. That's the reason why it has been affirmed that the separation of the underlying transaction and the documentary credit obligation must be put aside when confronted with the "elemental foundations of justice"¹³³ or that the bank, as a debtor, can refrain from paying when the claim of the beneficiary is "against good faith" or is a "manifest abuse of rights"¹³⁴. The exception is sometimes grounded in the underlying transaction and supposes a derogation of the independence principle.¹³⁵

"In Spain, as well as in mostly every European country, the bank is obliged to refuse payment in cases of evident fraud."¹³⁶ This solution is supported in reasons of positive law, given that the commission contract includes the obligation to defend the interests of his principal.

¹³⁰ Rafael Marimón Durá. *El Crédito documentarlo Irrevocable*. Ob. Cit. Page 575.

¹³¹ "Porfirio Carpio, L. J. y López Ortega, R. "Aspectos doctrinales y jurisprudenciales sobre los créditos documentarios en la Reglas y Usos Uniformes (Publicación 500 CCI), R.D. Pat., 1999, pág. 91.

¹³² *El Crédito documentario Irrevocable*. Rafael Marimón Durá. Page 575.

¹³³ Tápia Hermida, A., *Reglas y Usos relativos a los créditos documentarios (Revisión 1983)* Revista de derecho bancario y bursátil, ISSN 0211-6138, Año nº 3, Nº 9, 1983. Page 69, as cited by Rafael Marimón Durá. *El Crédito documentario Irrevocable*. Page 576.

¹³⁴ Martín Mingarro, L., "Patología de los instrumentos de pago internacionales, Régimen Jurídico de las Técnicas Bancarias en el Comercio Internacional, Madrid, 1980, pág. 235.

¹³⁵ Hernández Martí. *Créditos documentarios, su incumplimiento y excepciones al mismo*. Estudios jurídicos en homenaje al profesor Aurelio Menéndez / coord. por Juan Luis Iglesias Prada, Vol. 3, 1996. Page 3321.

¹³⁶ Fernandez-Armesto, J. *Los Créditos documentarios*, pág. 290, ob. Cit Rafael Marimón Durá. *El Crédito documentarlo Irrevocable*. Ob. Cit. Page 603.

Some Spanish authors have analyzed fraud in letters of credit from the perspective of the relationship between the documentary credit and the underlying transaction, around the concept of “good faith” as a limit to the exercise of the pretensions of the parties involved¹³⁷. The functioning of this rule is based on the conjugation of these two factors:

- It must be taken into account that the acts of the beneficiary must be adjusted to the demands of good faith, which integrate the content of the whole legal relation beyond of what was expressly established by the parties.¹³⁸
- It must be located in the beneficiary behaviour a subjective element that will allow us to legitimize the bank refusal to pay: The bad faith, the knowledge of the fact of an illegally based or abusive claim to pay.

“In Spain there is not an express norm imposing this obligation but the doctrine has found grounds for it in the principle of good faith (art. 57 of the commercial code) and in an extensive interpretation of article 255, paragraph 2 of the commercial code.”¹³⁹

a. Typical elements of the beneficiary’s abusive claim.

According to the UCP, the beneficiary that tenders the documents according with the terms and conditions of the credit can claim payment. But the content of this relation is not extinguished in what was expressly typified in the UCP or in what was expressly established by the parties. Like in every other legal relationship, the documentary credit will produce all its effects in accordance with the good faith, the custom and the law (arts. 57 Commercial Code and 1.258 Civil Code)¹⁴⁰. The good faith is thus present as an element that surpasses the will of the parties and the good faith in an objective sense.

¹³⁷ Spanish Civil Code, art. 7.1.

¹³⁸ Art. 1259 of the Spanish Civil Code with Art. 57 of the Spanish Commercial Code.

¹³⁹ Ibidem. Page 290

¹⁴⁰ The good faith acts mainly as an interpretative standard in legal relations. In the words of Díez-Picazo “Every legal relation must be objectively interpreted in harmony with this principle. Pacts, clauses and conditions contained in a contract and, in general in any legal relation, must be understood in good faith, that is, in a way that can lead to an empirical result in accordance with the good faith. Díez-Picazo, *La doctrina de los actos propios*, editorial Bosch, Barcelona 1963. Page 140.

But the good faith is not only an interpretative standard, it must be part of the relationship adding, if its necessary, other obligations and duties that where not necessary foreseen by the parties but do correspond with an objectively honest behaviour. It in itself includes duties for the contracting parties: a duty to be honest and also a duty to cooperate, as well as a criterion to highlight the rights and duties of the parties. Rams Albe en Lacruz y otros, *Elementos de Derecho Civil*, II-1, J. M.ª Bosh, 3ª ed., Barcelona, 1994, pág. 534. The Spanish Supreme Court has declared that “The contractual good faith, in an objective sense, consists in interpreting the contract in order to achieve its proposed objective, which demand a fair, proper and loyal behaviour (STS of March 6th of 1999 [RA 1854]) In the international context the presence of the

The canon of good faith, in an objective sense, is used as the criterion to determine the level of hardship that must concur in the conduct of the beneficiary that is relevant as to justify stopping the payment of the credit through the *exceptio doli*. The demand of good faith imposes the formal capacity in the beneficiary to claim the payment that corresponds with some level of material legitimacy in the underlying relationship. The integrative functioning of the principle of good faith is of a subsidiary character and only applies in regard of a pact, so we must start from the autonomy of the parties to determine which can be the role of the principle of good faith as an integrative element in the regulation of the documentary credit.

According to the independence principle, the beneficiary, even in case of a complete breach of contract, has the right to claim payment. It can be affirmed that the principle of good faith is limited by the principle of autonomy of the parties, because the parties have decided that any dispute about the quantity or quality of the merchandise must be resolved between buyer and seller in a posterior moment from the payment of the credit by the bank¹⁴¹. Now, that doesn't mean that the parties have contractually excluded the principle of good faith, especially in situations where there has been an **absolute lack** of performance, since this would exceed the boundaries established by the parties to the independence principle. It must be taken into account that a documentary credit is opened in order to comply with the performance of the underlying transaction by one of the parties, who is seeking consideration for his performance. Therefore the independence principle is inserted in this context. In this sense, it can be said that the independence principle takes out from the underlying transaction the disputes about the contractual performance, but not the complete lack of it, because in that case, the documentary credit does not perform the function assigned by the parties: To serve as a instrument of payment of the commercial transaction.

principle of good faith in the most representative texts, such as in article 1.7 of UNIDROIT (Principles, Interpretation and Supplementation of the Principles) that says that "each party must act in accordance with good faith and fair dealing in international trade, and that the parties may not exclude or limit this duty. In this section, the good faith has an integrative usage, as it is concluded in the official commentary. "*En indiquat que chaque partie est tenue de se conformer aux exigences de la bonne foi, le paragraphe 2 du présent article énonce clairement que même en l'absence de dispositions particulières dans les Principes, les parties doivent, pendant toute la durée du contrat, y compris pendant les négociations, agir de bonne foi*" (Unidroit, Principes relatifs aux contrats du commerce international, Roma 1994, pág. 17), cited by Rafael Marimón Durá. El Crédito documentario Irrevocable. Ob. Cit. Page 581.

¹⁴¹ Rafael Marimón Durá. El Crédito documentario Irrevocable. Ob. Cit. Page 576.

When the foreseen benchmark of the autonomy of the will is surpassed, the principle of good faith maintains its validity. The principle of good faith, in this sense, can supply the objective basis that must be given to enforce the “*exceptio doli*”: the complete destruction of the underlying transaction. But this objective element is not enough. The aforementioned destruction of the underlying transaction must be attributed to the beneficiary through a charging criterion, such as “*dolo*”¹⁴² or “*culpa*”¹⁴³. It is necessary that the beneficiary is aware that his demand to pay is abusive or illegal, that is, it is required a subjective element that allows the bank to be legitimized to refrain from paying to the beneficiary: the lack of good faith *ex legitimante*.

In Spain, the general principle for tort law is the “*responsabilidad por culpa*”¹⁴⁴ (Responsibility because of fault). From this point of view it cannot be justified, in the case of a documentary credit, the automatic attribution of the damage done by the destruction of the underlying transaction to the beneficiary, when, theoretically, the documentary credit is acknowledged as necessary to guarantee his right to receive consideration. There must also be knowledge of the situation that caused damage.

This does not mean that the lack of good faith must be identified in every “*dolo*” case. The concurrence of other forms of culpability can also exclude good faith. There can be situations where the beneficiary cannot allege that it’s seeking payment in good faith because he was not aware of the deceitful situation of the underlying transaction. We are talking about cases in which the diligence level that is required to a trader imposes the duty to know determined facts that can lead him to realize the fraudulent situation.

Finally, it can be added that the lack of a subjective good faith by itself cannot justify the *exceptio doli*, even when there is “*dolo*”. The “*dolo*” or the knowledge of the harm by the beneficiary must fall on a relevant fact that is contrary to the requirements of good faith in an objective sense, hence, the total lack of performance.

In conclusion, a claim presented by the beneficiary in order to be abusive or fraudulent under the Spanish Law must include two elements:

¹⁴² Intention to commit a crime while knowing about its illegality.

¹⁴³ Omission to act in the diligent manner, which implies committing an act that is unfair or that can produce liability.

¹⁴⁴ Arts. 1101 and 1902 of the Spanish Civil Code.

- a. An objective element: A claim to be paid by the beneficiary when that does not correspond at all with the performance that the beneficiary should do in accordance with the underlying transaction.¹⁴⁵
- b. A subjective element: That the beneficiary does not act in good faith when claiming payment.¹⁴⁶

b. Consequences derived from the fraudulent character of the claim for payment of the beneficiary.

The consequences of considering that the claim to be paid by the beneficiary is unjustified, in the terms we have mentioned earlier, are the following:

- The claim that is being tried to be exercised is disabled and the debtor cannot be obliged to execute its obligation, since the beneficiary lacks de right to claim payment. The proper instrument of opposition to the abusive claim is the “*exceptio doli*”, which can be used in an extrajudicial manner or with the support of the preventive measure.
- If the unjustified pretension has been satisfied by the bank, it seems like the third party damaged by this, the issuer, would be entitled to enforce the corresponding claim for damages.

If the bank had the duty to refrain from paying because it was aware of the lack of basis to claim payment, at the moment of being required by the beneficiary, the compensation of the issuer would be normally limited to the (not) necessity to reimburse the amount of the credit, or to the devolution of the quantities eventually anticipated by concept of the fund provision. If the bank has acted diligently, the issuer would only have left a direct action against the beneficiary, because of breach of contract.¹⁴⁷

2. Types of fraud that can justify nonpayment.

a. The Fraudulent utilization of false documents

The presentation of false document can lead to rejection for 2 different reasons:

- If it is manifest, the documents must be rejected because they do not conform to the credit conditions. The bank must be aware of the falsity during the examination of the

¹⁴⁵ Rafael Marimón Durá. El Crédito documentarlo Irrevocable. Ob. Cit. Page 587.

¹⁴⁶ *Ibidem*. Page 587

¹⁴⁷ *Ibidem*. Page 586.

documents. The bank can reject the documents in application of the principle of literality and it is not necessary to use in this case the *exceptio doli*.

- When the documents apparently conform and the bank cannot discover that they are false through a reasonable and careful examination, they can only be rejected through the *exceptio doli*, therefore, only if the falsification is not manifest as a formal deficiency of the documents it would be possible to affirm that it configures the fact that allows the exception.

But, in order for the rejection to be justified, it is necessary a subjective element, the bad faith from the beneficiary or the lack of good faith “**ex legitimante**”. The beneficiary cannot claim payment of the credit if he knows or if he should know that the documents are false. On the other hand, his pretension cannot be denied if he acts in good faith.

It has been argued by the doctrine if the subjective element of the bad faith of the beneficiary must be demanded in order to give grounds to the “*exceptio doli*” when documents, beside of being false, are completely incapable to produce the effects that are natural to them. In this situation there must be present the same subjective element in the beneficiary; the bad faith of the person who knows is tendering false documents, or the bad faith of the beneficiary, if he had acted with the diligence of a competent trader.

b. Total lack of performance

The typical situation is the absolute lack of performance produced when the beneficiary creates the illusion of having performed his part of the underlying contract in order to get paid under the credit, without this illusion having in fact anything to do with reality. If the underlying transaction is constituted by the sale of goods, the lack of performance that is associated to the “*exceptio doli*” is given by the delivery of merchandise that doesn’t exist or that does not correspond at all with the agreed terms.

In most occasions, it is about situations that cannot be qualified as simple defects or vices in the goods since them, if they can be qualified as such, lack any utility or commercial value. Only in these cases banks would refrain from paying because of the delivery of absolutely worthless goods. If we are in a scenario of not performance as relevant as to allow the interposition of the “*exceptio doli*”, the evidence that the beneficiary acts in bad faith or with knowledge of the facts would not be necessary.

“As we have said before, the subjective good faith can also disappear if the beneficiary does not act with the diligence that is required from him. In this sense, if the objects delivered have been packed in the stores of the beneficiary or, in general, the modification of the merchandise has been produced inside of its area of control, it can be assumed that it knew about the modification or at least that it should have known about it. Naturally, the beneficiary would be allowed to destroy such presumption.”¹⁴⁸

“The judgments of the Spanish Supreme Court have been produced in a very different context from the hypothesis of fraud in documentary credits, such as the resolution for breach of a commercial sell of goods demanded as an alternative of a claim because of hidden defects.”¹⁴⁹ In most cases, the parties will use the figure of breach of contract in order to resolve the contract, since they have lost the possibility to allege on the grounds of hidden defects, after having precluded the short lapses that the Spanish Code of Commerce establish for such regard.¹⁵⁰ The Spanish Supreme Court has recognized this type of claim in situations where it is a fact that the delivered goods not only suffered from defects, but where completely incapable of providing an economical application.

Nonetheless, the analysis of the judged hypothesis make clear a tendency for the progressive application of the “notion of the impossibility of the application (of the good) for which it was destined”¹⁵¹, in an animus perhaps of giving a bigger protection to the buyer, which means indirectly the mitigation of the rigorous exigency of celerity in a claim for defects established by the commercial legislation. The “*exceptio doli*” must be reserved for cases in which there is a total not performance of the underlying transaction.¹⁵²

¹⁴⁸ Rafael Marimón Durá. El Crédito documentarlo Irrevocable. Ob. Cit. Page 589.

¹⁴⁹ *Ibidem* Page 590.

¹⁵⁰ The buyer that does not use the due diligence when it has to check the goods received, it loses the possibility of having to interpose an action by rehabilitate hidden vices, by the passing of a relatively short amount of time than for the claiming has been established in the commercial legislation, established to defend the needs of a bigger celerity and safety in the traffic. Having this time passed, the buyer would utilize the reclamation because in case of breach of contract, having 15 years to do so.

¹⁵¹ Vicent Chuliá. F. La unificación del Derecho de obligaciones”, R.d.Par., núm. 2, 1999, pág. 40. Ob. Cited by Rafael Marimón Durá. El Crédito documentarlo Irrevocable. Ob. Cit. Page 293.

¹⁵² Rafael Marimón Durá. El Crédito documentarlo Irrevocable. Ob. Cit. Page 592.

3. The evidence of fraud

It is possible to defend that the bank does not perform his obligation to defend the interests of his client (in virtue of the mandate contract that is established between the bank and its client) if it does not refrain from paying in cases of fraud. The bank must, in this case, defend the interests of his client over his own interests.¹⁵³

Under the Spanish Law it cannot avail himself in the independence principle, since in this type of situations the mentioned principle lacks binding force. If the bank has the right to refrain from paying to the beneficiary, it must use his right to avoid any possible damage to his client. In order for this to be possible, the concurrence of the elements of the factual hypothesis must clearly appear accredited through the presentation of “evidences that cannot be contested about the fraudulent or abusive character of the claiming by the beneficiary”¹⁵⁴. The evidence must be submitted by the applicant.

If the bank is obliged to oppose payment and choose to not perform his obligation, it will be liable for the damages caused on the issuer, by application of articles 1.101 and the following of the Civil Code. The corresponding compensation must include the emerging damage and lost profit in the terms of the article 1.106 CC. Generally, the compensation would be reduced to the devolution of the paid quantities by the client or charged in his account after paying.¹⁵⁵

4. Preventive measures.

In Spain, the “Ley 1/2000 de Enjuiciamiento Civil”, binding since January 8th of 2001, allows the plaintiff to request “the adoption of any preventive measures that its considered necessary in order to secure an effective judicial protection that could be granted in the judgment for the applicant”¹⁵⁶ “A Court would be able to grant a preventive measure in order to achieve the effective judicial protection”¹⁵⁷. The preventive measures must be strictly typified and valued and are able to adopt any configuration, as far as the requirements of the law are met.

¹⁵³ Rafael Marimón Durá. El Crédito documentarlo Irrevocable. Ob. Cit. Page 607.

¹⁵⁴ Sánchez-Calero Guilarte, Juan: "El contrato autónomo de garantía". Madrid. Centro de Documentación Bancaria y Bursátil, cop. 1995 Pages. 390 and 391.

¹⁵⁵ Art. 1108 of the Spanish Civil Code.

¹⁵⁶ Art. 721 LEC 1/2000

¹⁵⁷ Art. 726 LEC 1/2000

Art. 727 of the LEC establish and exemplificative list of specific preventive measures. Among them there is one that could be adjusted in order to avoid the execution of an obligation to pay, even when prima facie it was not designed for that purpose; that is the seventh paragraph of the article, which estate that “a judicial order to provisionally stop an activity; or to temporally abstain from carrying out a conduct...” In this regard, there doesn't seem to be any impediment about requiring the adoption of preventive measures destined to forbid or to refrain from paying a documentary credit. In this sense, there are 2 different modalities adopted by other legal systems.

1. An order to the bank to refrain from paying.
2. An order to the beneficiary to abstain from claiming the execution of the credit.

The most adequate one seems to be the second. The interference of the Court is maintained in the field of the ones that are part of the underlying relation, without transcending to a third person strange to it, such as the bank. On the other hand, from the point of view of the efficacy of the measure, it seems that any measure that does not forbid to whom has the money to execute payment can become completely useless.

5. The protection of innocent claimants under the letter of credit.

In Spain, the situation where it is excluded the power of the bank to refrain from paying in a situation of fraud is only admissible in cases where the credit is payable by the acceptance and the accepted letter has been putted in circulation by the beneficiary. In this case, the bank can only deny payment if the requisites of interposition of the *exceptio doli* are met: When the claimant in good faith that acquired the letter had proceeded knowing of the damage to the debtor¹⁵⁸.

The solution depends on the moment in which the claimant in good faith is aware of the situation of fraud. The claimant would be able to allege his conditions of a third party as far as, at the moment he made the debit or when he received the letter by virtue of another causal, ignored the situation of fraud. This is the only coherent solution according to art. 20 LCCh, when referred to the awareness of the damage to the debtor at the moment of the acquisition of the letter of credit by a third party.¹⁵⁹

¹⁵⁸ Arts. 20 and 67, Ley Cambiaria y del Cheque

¹⁵⁹ Art. 20 of the Ley Cambiaria y del Cheque. *El demandado por una acción cambiaria no podrá oponer al tenedor excepciones fundadas en sus relaciones personales con el librador o con los tenedores anteriores, a*

On the other hand, the “*exceptio doli*” can be alleged without problem to the beneficiary presenting a letter still unaccepted by the bank, because in such case the bank is not directly obliged. The “*exceptio doli*” cannot be excluded if the presenter of the letter acts in behalf of the beneficiary throughout an endorsement “only for collection” or through an apparent endorsement with the purpose of making legitimate the collection by the claimant. In such case there is not an authentic transmission of the letter against the deposit of its value¹⁶⁰, therefore, the presenter cannot be considered a third party.¹⁶¹

B. The Portuguese approach to fraud in letters of credit

1. General Doctrine

In Portugal, there is a judgment by the Superior Court of Porto that addresses many interesting issues regarding fraud in letters of credits, by Judges Trajano A. Seabra Teles de Menezes e Melo, Mário Manuel Baptista Fernandes and Fernando Baptista Oliveira on the 9th of June of 2005, denying a preventive measure.¹⁶²

The case is as following: Company B tried a generic preventive measure against Bank X S.A. Company C, domiciled in Paquistan, requested, without producing any proof, to notify Bank X before the 29 of July of 2004 to refrain from paying the amount of \$USD 37.645,17, sum guaranteed by documentary credit opened by the plaintiff as a guaranty for the payment of textile floss.

The plaintiff alleged that it had acquired from the second defendant textile floss for an amount of \$USD 37.645,17 and the payment was to be done through a commercial letter of credit. The goods were sent on the 4th of July of 2004. The corresponding documents where submitted to the first defendant. As agreed in the contract celebrated with the second defendant, the payment was to be done on July 30th of 2004. The container with

no ser que el tenedor, al adquirir la letra, haya procedido a sabiendas en perjuicio del deudor.
<http://www.gobiernodecanarias.org/educacion/9/Usr/Apdorta/ley/v0000189.htm>

¹⁶⁰ It can be said there is no transmission.

¹⁶¹ This is the hypothesis of the leading case Sztein.

¹⁶² Nº Convencional: JTRP00038173, Relator: TELES DE MENEZES, Nº do Documento:RP200506090533150, Data do Acórdão:09-06-2005.

the goods arrived at the Leixões port on May 8th, 2004, being immediately afterwards sent a part of the floss to the client and the rest was kept stored.

The floss was flawed so it could be of no use. It presented a defect that damaged the “mesh”. This situation was immediately reported by the client of the claimant to the claimant, who sent a debit note to cover the damage of the “mesh”. The claimant, because of the floss defect, could not fulfil its obligations with his client; this caused him damages because the aforementioned will not accept the requested floss, since it was useless.

The plaintiff communicated the defect to the second defendant (the company in Paquistan) through the society that served as an intermediary for the contract, which sent faxes and e-mails that were not answered, being the case that the plaintiff even sent samples of the damaged mesh.

The defendant argued that if the payment was done, it might never be compensated by the damages suffered, since the seller has its domicile in Paquistan and it haven't answered to any message sent so far, running a very high risk of never being able to rescue the money of the documentary credit

The Court construed its opinion stating that in Portugal the documentary credit is analyzed as an obligation assumed by a bank at the request of a client, to pay a determined amount of money to a person previously designated, as far as the conforming documents are delivered according to the terms and conditions established on the Art. 6 of UCP 500. The relation between the issuing bank and the issuing bank is a “*Contrato de Mandato*” (Mandate Contract), as established in Article 1157 of the Portuguese Civil Code.¹⁶³

Because of the independence principle, the bank acquires the condition of debtor of the respective beneficiary under a legal relation that is different from the underlying relationship. Being the bank a debtor of the beneficiary for a different cause than the underlying transaction, the documentary credit is autonomous and the emerging credit from that relation in regards to the issuing bank cannot be taken automatically as not obliged because of its position as a passive subject regarding the beneficiary.

¹⁶³ Portuguese Civil Code Article 1157. *Contrato de mandato*. Mandato is the contract in which one of the parties obliges himself to practice one or more juridical acts in the name of the other.

“Given the fact that the defendant accepted the request to open the documentary credit that was directed by the applicant, it was created among them a contract designated by the Portuguese doctrine as a “*Contrato de Mandato*”.”¹⁶⁴

The conferred mandate to the bank is considered to be a mandate without representation, in which the trustee executes the object of the mandate, not in the name of the petitioner, but in its own name, in a way that its interposition does not originate direct relations between the petitioner and the trustee or between the trustee and a third party.¹⁶⁵ According to article 266 of the Portuguese Commercial Code, when the commercial trustee executes the mandate in its own name, the contract takes the name of commission. It is for that reason that the doctrine qualifies the agreement established between the buyer and the issuing bank as such.¹⁶⁶

In execution of the mandate given to the issuing bank, it assumes an autonomous obligation to pay; therefore, once the relation between the buyer and the bank has been established it is no longer possible to revoke the mandate. Any other act carried by the trustee, such as the verification of the documents or payment, is regarded as independent from the underlying transaction, being barely the performance of the assumed duty by the bank. Therefore, only in exceptional hypothesis the buyer is allowed to stop the bank from paying.¹⁶⁷

In most cases, the buyer of the credit cannot enforce against the bank any action that arises from its relationship with the other intervening parties, nor can the beneficiary use either the relations among the intervening parties or his relations with them as the basis for a claim against the bank.¹⁶⁸ Therefore, “the different relations arising from the letter of credit are autonomous and independent from each other.”¹⁶⁹

¹⁶⁴ STJ de 17.4.1997, CJ/STJ, 1997, II, 55 ; art. 1157.º do CC e 231.º do CCom. – Gonçalo Andrade e Castro, Ob. Cit. Page 130-131.

¹⁶⁵ Portuguese Civil Code, Arts. 1180-1184.

¹⁶⁶ Gonçalo Andrade e Castro, Ob. Cit., Page 132.

¹⁶⁷ *Ibidem*. Page 134-135.

¹⁶⁸ *Ibidem*. Page 135.

¹⁶⁹ *Ibidem*. Page 135.

Regarding the beneficiary, the issuing bank assume the obligations established in the article 9 of UCP 500, and it is allowed to refrain from paying in cases in which the documents differ from the established conditions in the credit (art. 14 d UCP 500). The same autonomy in the obligation of the issuing bank cause that the buyer cannot, once the credit has become irrevocable, hold back the payment because of documents that the bank has acknowledged to be in conformity with the terms and conditions of the credit, nor based in exceptions regarding the contract with the beneficiary, specifically its invalidity, not performance or improper performance by the beneficiary of its obligations, namely regarding the shipped goods.

Continental Europe doctrine authorizes non-payment in the case of fraud in the underlying contract, appealing to the general principles of the respective juridical frameworks, such as good faith, the abuse of right, the concept of “*fraus omnia corrumpit*” and the “*exceptio doli*”. These principles cannot be waived by contract; a Bank which issues a letter of credit is entitled to use them and can be invoked by a bank to resist payment to a beneficiary who makes an abusive presentation of documents under a letter of credit. On the other hand, a bank must be very careful before applying these principles to justify non-payment under a letter of credit. “The letter of credit is an important tool of international commerce and banks must respect the autonomy and the formalism that makes the letter of credit so useful in ordinary transactions.”¹⁷⁰

2. Types of fraud that can justify nonpayment.

In Portugal it has been acknowledged that “there can only be fraud when it implies the complete destruction of the contract, in cases of total failure of consideration or of egregious fraud.”¹⁷¹ It cannot be admitted the simple partial or defective performance as the basis to allege fraud.

“Fraud has to be manifest, that is, there has to be clear and unequivocal evidence of fraud in order for a bank to refrain from paying.”¹⁷²

¹⁷⁰ Gonçalo Andrade e Castro, p. 296, 297

¹⁷¹ *Ibidem supra* 299

¹⁷² *Ibidem* 300

In Portugal it is also asserted that in cases of manifest fraud, the bank that knows of fraud or that has received irrefutable evidence of fraud should refuse to pay the letter of credit, in accordance to the obligations assumed under the mandate contract, being liable when it does not do so. Other authors defend that banks must be free to decide even in cases where there is a manifest and clear fraud.¹⁷³

3. The evidence of fraud.

The evidence necessary in order to grant an injunction has to be strong enough as to clearly and without hesitations show the existence of fraud. It is not enough the mere suspicious of fraud.¹⁷⁴

In Portugal, the evidence of fraud that is required by a Court to grant a “*medida cautelar*” or preventive measure is the typical high standard in which fraud has to be manifest and the evidence must be certain in order for the bank to stop paying without being liable. It is not enough with the mere suspicion of irregularities, eventually communicated by the applicant. Only in exceptional cases the applicant can stop through a judicial method the payment of the credit.¹⁷⁵

4. Preventive measures

In Portugal, the best measures provided by the law to stop the banks from paying in cases of fraud are the “*providências cautelares não especificados*”, legally configured as “truly preventive measures for the provisory defence of any situation not specifically foreseen or disciplined”¹⁷⁶ by the law, which are codified on the article 381 – 427 of the Procedural Civil Code, and in the 619 – 622 of the Civil Code. The legal requisites established in the law in order to enforce such measures are the “*fumus boni iuris*” and the “*periculum in mora*”.¹⁷⁷

There are several issues we could address in this item:

First, is the problem of the identification of the person against whom the measure must be applied, given the fact that the invoked right by the beneficiary is based on the fraudulent

¹⁷³ Gonçalo Andrade e Castro. Page 302-203

¹⁷⁴ *Ibidem*. Page 327.

¹⁷⁵ Mónica Jardim, *Garantia Autónoma*, Almedina 2002. Pages 306-310

¹⁷⁶ Preamble of the DL n° 329-A/95, of December the 12th.

¹⁷⁷ Alberto dos Reis, *Código de Processo Civil Anotado*, 3^a ed., vol. I. Coimbra Editora, p. 619 ss.

lack of complying with the underlying contract, so it is natural that the providence is enforced against the beneficiary, stopping it from demanding payment under the credit. Nonetheless, it is easily understood that the interest in efficiently achieving the preventive measure, normally enforced in a court of the country of the beneficiary and, normally, also in the country of the issuing bank, provide that the beneficiary will enforce the preventive measure against the issuing bank¹⁷⁸, or at least against both, the bank and the applicant.

An effective solution under the Portuguese law would be to act only against the seller, with the intention to stop him from demanding payment, while notifying the issuing bank (and the confirming bank) of such action in order to safeguard its efficacy. This solution could be effective when the basis of the pretension is the fraud committed by the applicant in the execution of the commercial underlying contract.¹⁷⁹

C. Further comments about other Common Law jurisdictions:

France

1. General Doctrine and evidence of fraud.

A vast majority of the Courts in France would apply a very restrictive conception of fraud, which would require a showing of fraud that it is (1) evident, (2) clear and (3) qualified in order to be ascertained and grant an injunction.¹⁸⁰ The French High Court have used this benchmark in at least two different cases: on a decision by the Chambre Commerciale de la Cour de Cassation on the 4th of July of 1987, when it resolved a case in which it was objectively showed that an invoice emitted under an operation using documentary credits was forged, and another one on the “Automobiles Peugeot” case of April 29th of 1997 by the Cour de Cassation.

According to the Civil Law tradition, the law on this matter relies in juridical concepts such as “good Faith”, the abuse of right, the concept of “*fraus omnia corrumpit*” and the “*exceptio doli*” as a mechanism to stop a bank from paying the beneficiary in a case of fraud under a commercial letter of credit.

¹⁷⁸ Alberto dos Reis, ob, cit, p. 623.

¹⁷⁹ O Crédito Documentário Irrevogável. Page 319.

¹⁸⁰ *Ibidem*.

The French “*Cour de Cassation*” has declared that it was only possible to invoke fraud when it resides in the documentary credit and not on the underlying transaction¹⁸¹. Such approach is only comparable to the one taken by the Doctrine and Jurisprudence of the United Kingdom, instead of the more liberal one from Spain or the United States. On the other hand, for a smaller part of the French doctrine, fraud must be understood in a wider sense than just as fraud in the documents. According to this doctrine, once fraud has been established as “Apparent” it can be considered as “Manifest”. This is a more liberal position since it takes in consideration factors that would cause serious suspicions of fraud, but do not amount to irrefutable proof of fraud.¹⁸²

The French jurisprudence has defended such position in cases such as the one from the Cour d’Appel de Colmar of June 14th, 1985. In this case, the seller presented to the confirming bank a document that was not reliable. This bank was alerted before the issuing bank could make the payment, but the confirming bank decided to accredit the amount of the credit to the seller and then demanded in Court to be refunded.

The Cour d’ Appel denied the requirement declaring that if it was truth that by only invoking the existence of a fraud without a clear cause, the bank could not refrain from paying, the judges decided according to the law that the confirming had to be condemned because of having accredited the account of the seller even thou it had no decisive evidence regarding the fraud committed by the seller when it accounted such amount.

2. Preventive measures: The *saisie- arrêt*¹⁸³

The buyers in a documentary credit who believe are victims of fraud would frequently utilize the *Saisie-arrêt*, a measure that require the existence of a credit of the *saisissant* (applicant) against a *débiteur saisi* (beneficiary or seller) who is also a creditor of the *tiers-saisi* (issuing or confirming bank), being alongside with this one that the *saisie-arrêt* is enforced, which has as it’s objective the referred second credit, making it unavailable.¹⁸⁴

¹⁸¹ Verónica Asad. El fraude en el crédito documentario. El régimen aplicable en los sistemas de derecho civil. Ob. Cit.

¹⁸² *Ibidem*.

¹⁸³ Termes Juridiques, Lexique, Ed. Dalloz, 11^o édition, 1998. Cited by Verónica Asad. El fraude en el crédito documentario. El régimen aplicable en los sistemas de derecho civil. Ob. Cit.

¹⁸⁴ This is the consecrated orientation of the Cassation judgment of October 7th of 1987, in JCP 1988, jurisprudence n° 20928, with comments of Stoufflet and dalloz, jurisprudence, p. 295 ss, commented by

This measure has the practical effect to stop the payment to the beneficiary and would be generally requested by the applicant, but it could also be requested by the bank or the applicant. French courts would allow the *saisie- arrêt* by the applicant only in exceptional cases. It has been established a high standard of proof in order to grant this remedy, being necessary to show an evident fraud.

In order to apply this judicial remedy, the applicant is considered as the bank's seller. If the seller has committed fraud to the beneficiary, this one would have to pay to the beneficiary his debt, which is why he can seize the payable amount to the applicant through the bank by blocking payment. Nonetheless, this reasoning has not been always accepted by the *French Cour de Cassation*, which has ordered that if the beneficiary can seize the amount of the credit, he would in fact be in contradiction with the compromises he had assumed when he opened the irrevocable credit.¹⁸⁵

When the presented documents are false, the applicant could request the remedy if he had informed the bank about such inaccuracy before he has made the payment. This tendency can be said to have begun on a judgment by the *Cour d'Appel* on Aix-en-Provence on November the 14th of 1986, when the Court admitted the possibility of blocking a documentary credit based on a decisions of the *Juge des référés*, when it has invoked the commission of fraud by the seller of the documentary credit.

The French High Court has a very different position when the bank is the one who invokes the *saisie- arrêt*. In this case, nothing can stop the bank in charge of checking the documents from exercising a *saisie- arrêt* when it has witnessed irregularities. On the other hand, in a judgment of 1953, the *Cour de Cassation* took a different approach, when it said that a bank had the right to stop from paying merchandise that were supposed to be Swiss watches but where in fact goods of no value¹⁸⁶.

For such reason it is possible to say that the bank can deny payment when it is aware of fraud and do not need a judicial authorization to refrain from paying, but if it knows there is a fraud and decide to pay he might be liable.

Vasseur, for those hypothesis, different from manifest fraud, in which the issuer tried to stop trough an injunction the payment of the documentary credit. Cited by O crédito documentário Irrevogável p. 315

¹⁸⁵ Cour de Cassation, Chambre Commerciale, 14/10/1981, Discount Bank.

¹⁸⁶ Cour de Cassation, 4/3/1953. S 1954 I 121 124, 1^o espèce.

“When the *saisie* of the amount of the corresponding payment is done by a seller of the buyer, the jurisprudence has accepted that it must be considered a third in the operation.”¹⁸⁷

A particular case of *saisie-arrêt* appears in documentary credits of deferred payments since the admissibility of such measure has only been recently accepted by the French jurisprudence. In this case, the bank obligation to pay in a deferred moment becomes unconditional, the credit is neither executed nor cancelled, but a payment in advancement is made and it stays out of the documentary credit *per se*. This allows the applicant to prove the existence of fraud before the payment is finally made to oppose the cancellation or execution of such operation. Therefore, if fraud is discovered after the documents have been accepted but before the payment date, the applicants can stop payment by interposing a *saisie-arrêt* to the competent Judge.

¹⁸⁷ Verónica Asad. El fraude en el crédito documentario. El régimen aplicable en los sistemas de derecho civil. Ob. Cit.

VIII. Final thoughts

We can conclude that the fraud exception to the autonomy of documentary letters of credit rests on a principle that is common to both the Common Law and the Civil Law systems of law, which is expressed in the civil law by the maxim *fraus omnia corrumpit* and in the common law by the maxim *ex turpi causa non oritur action*. There are important differences between the Civil Law and the Common Law concerning the legal nature of the obligation of the issuing bank's to pay to the beneficiary under an irrevocable letter of credit, but the effect of fraud on that obligation is essentially the same under the two systems.

The studied Common Law jurisdictions have developed a very rich law on letters of credit, including the only set of codified law on the matter, which is the law in the United States of America (UCC Article 5) and it is the only one of its kind in the world. In the United Kingdom, the fraud exception has been admitted in a more restrictive way than in the United States, but there are three characteristics that are universal in the Common Law approach to fraud in the letters of credit:

1. The jurisprudential origin of the fraud exception regarding fraud.
2. The fact that the commercial letter-of-credit experience has been used to prevent cases of fraud on standby letters of credit.
3. The fact that the US, the UK and the Canadian doctrines cite each other as case law. It is very interesting how often Common Law judgments are cited by other jurisdictions which support their own judgments on foreign case law, for example, the fact that *Sztejn* is referred as the “landmark case” by UK and Canadian Courts when it is in fact a US judgment.

The Civil Law solutions on fraud on letters of credit are amazingly similar to the ones given by the Common Law, probably because of the fact that they also make reference to *Sztejn* as the lead case on the matter, and because of the need to have, at least in a very broad sense, the same rules in the global economy in order to facilitate Trade.

On the other hand, there are very important differences:

1. In Spain and Portugal, the nature of the relation between the issuing bank and the emitting bank is under the “commission” contract. This has very interesting consequences in regards of the flexibility in the application of remedies.
2. The studied Civil Law jurisdictions do not have specific rules regarding fraud on commercial letters of credit, which is why they rely in juridical concepts such as “good Faith”, the abuse of right, the concept of *fraus omnia corrumpit* and the *exceptio doli*, that are general principles of law that cannot be waived by contract.

In certain aspects, Civil Law rules are almost identical to Common Law rules. An example of this are the requirements of the Spanish law in order to ascertain fraud when they say there must always be an objective element: A claim to be paid by the beneficiary when that does not correspond at all with the performance that the beneficiary should do in accordance with the underlying transaction; and a subjective element: that the beneficiary does not act in good faith when claiming payment. In the UK, as we saw in *United City Merchants*, deceit is regarded as a critical requirement to allege fraud, and of course, it is also necessary to prove the objective existence of a fraudulent situation. Canadian and American Courts judgments are in this matter very close to the studied Civil Law Jurisdictions, requiring the intention to deceive by the beneficiary in order to grant an injunction in a case of fraud (Regardless of the fact that the UCC is silent on this matter)

Regarding the type of fraud that is admitted by the law in the analyzed Common Law jurisdictions in order to grant a preventive measure to stop payment by the bank to the beneficiary of such credit, there seems to be three very different positions:

- The rigid UK position, that would in most cases only admit fraud when the bank has received forged documents, and where only in very exceptional cases it would granted grant a preventive measure because of fraud in the underlying transaction. In this regards, English courts seem to be very reluctant to find fraud on the part of the beneficiary, even under circumstances when the beneficiary's conduct was unconscionable.
- The more relaxed Canadian position, where a Court would probably grant an injunction in a case of fraud because of forged documents as well in cases of fraud in the underlying transaction.
- The less clear US position, where courts would grant an injunction to prevent payment in cases of fraud in the underlying transaction and fraud because of forged documents, but

where Courts would probably be more reluctant than Canadian Courts to do so in order to not jeopardize the independence principle in letters of credit law.

The studied case law seem to suggest that the United States and Canadian courts extend the fraud exception to the underlying commercial transaction in a way that is closer to the one used by the civil law jurisdictions (with the exception of France), where, regardless of the lack of jurisprudential decisions that specifically addresses the issue, they have admitted the possibility of enforcing preventive measures to prevent payment in cases of fraud in the underlying transactions as well as because of forged document.

In the Civil Law countries, the fact that it is only through integrative mechanisms and general principles of law such as the “*Good Faith*”¹⁸⁸, the “*prohibition of abuse of rights*”¹⁸⁹, “*fraus omnia corrumpit*”¹⁹⁰ or the “*exceptio doli*”¹⁹¹ that the doctrine has given answers to fraud in commercial letters of credit has given to the law certain flexibility, making possible for Courts to grant preventive measures to stop banks from paying in cases of fraud in the underlying transaction and not only because of forged documents. “In this regard, it is important to highlight that most European Courts have only applied this standard of fraud in cases of total failure of consideration or egregious fraud.”¹⁹²

Regarding the showing of fraud, the studied Common Law jurisdictions will require an elevated showing, even using a similar language (fraud has to be “egregious” or “clearly proved”). Where a UK court would require an additional showing of an “irretrievable injustice” a Spanish court would require evidence that cannot be contested about the fraudulent or abusive character of the claiming by the beneficiary.

In this regards, the Civil Law doctrine is very similar when it requires, in order to enforce the *exceptio doli*, the complete destruction of the underlying transaction, which has to be

¹⁸⁸ Germany: Treu und glauben: cfr. Zahn, Zablung..., cit, p 229, cited by Gonalo Andrade e Castro. O cr dito document rio irrevog vel. Page, 296.

¹⁸⁹Switzerland: Cour de Justice Civil de Gen ve, July 16th of 1985, cited by Gonalo Andrade e Castro. O cr dito document rio irrevog vel. Page, 296.

¹⁹⁰ France: COUR D ' APPEL d'Colmar, June 14th, 1985, cited by Gonalo Andrade e Castro, O cr dito document rio irrevog vel. Page 296.

¹⁹¹ Italy: Giampieri, ob, cit., page 225, cited by Gonalo Andrade e Castro, O cr dito document rio irrevog vel. Page 296.

¹⁹² Costa,  lt. Ob. Cit., p. 197, reference 195, as cited by by O cr dito document rio irrevog vel. Gonalo Andrade e Castro, page,299.

committed by the beneficiary with “*dolo*” or “*culpa*”. The benchmark for fraud in Spain, France and Portugal in order for a Court to grant a preventive measure is a very high and difficult to meet, since there can only be fraud when it implies the complete destruction of the contract, in cases of total failure of consideration or of egregious fraud, and because fraud has to be manifest.

The autonomy principle and the doctrine of strict compliance are held as fundamental in Both families of law, therefore they are impossible to abolish, which is why the utilization of a documentary credit does not imply the renounce of the issuing bank and, specially, of the buyer, to use them against an abusive pretention of the seller. “Nonetheless, it has been equally accepted by most European Courts that its utilization must be cautious because it cannot jeopardize the autonomy principle, which is why it has been established by the doctrine as a residual and exceptional remedy.”¹⁹³

We can conclude that the doctrine and the jurisprudence in both the Common Law and the Civil Law jurisdictions have agreed in the absolute exceptionality of this measure, which can only be accorded when:

- There is proof of fraud.
- Utility and need of the preventive measure.

“In addition, if a Court has to intervene in the normal development of a letter of credit, it would appear perfectly justified the need of this interference, in a way where there is not an alternative remedy that is less distorting of the commercial practice, that is, if the preventive measure is not adopted, there would be an irreparable damage to its patrimony”¹⁹⁴. Therefore, it is truly a last resort when every other measure has failed.

The reason for the similarity of both systems of law is the importance of not jeopardizing the independence of the letter of credit in order to guarantee that it continues to be a safe mechanism of payment in International Trade. This would also explain why Courts are naturally reluctant to grant preventive measures to stop banks from paying both in the Common Law and in the Civil Law jurisdictions.

¹⁹³ O crédito documentário irrevogável. Gonçalves Andrade e Castro, page,297,

¹⁹⁴ Tukan Timer Ltd. V. Barclays Bank Plc.

In the Common Law it is possible for a bank to consider refraining from paying when confronted with an abusive claim of a beneficiary, which means that it does not have the obligation to refrain from paying in a case of fraud. In the studied Civil Law jurisdictions, the rule is in fact the opposite; the bank is obliged to refrain from paying in cases of fraud. This is a consequence of the commission contract between the bank and the seller since the “*comisionista*” has the obligation to defend the interests of the “*comitente*”.

Regarding the preventive measures, the existence of laws such as the Spanish “*Ley 1/2000 de Enjuiciamiento Civil*”, the French “*Saisie Arrêt*” and the existence of “*Providências cautelares não especificadas*”, codified on the article 381 – 427 of the Portuguese Procedural Civil Code, and in the 619 – 622 of the Portuguese Civil Code allow a Court to modify and adapt with relative ease the preventive measures necessary to stop payment in cases of fraud, with the same flexibility of the injunction in the common law.

In the studied Common Law jurisdictions, a Court in order to grant a preventive measure would normally require the existence of “egregious” fraud, and a “clear showing” of the existence of fraud. In the studied Civil Law jurisdiction, a Court in order to grant a preventive measure would require the existence of evidences that cannot be contested about the fraudulent or abusive character of the claiming by the beneficiary. This means they have similar requirements in regards of the high standard that is necessary for a Court to grant a preventive measure to stop the banks from paying.

Regarding the protection to an innocent third party, the common law doctrine “holder in due course” confers protection in a very similar way as the Civil Law do, which would normally protect the third party that has acted in good faith, as far as the third party was not aware of the existence of the fraud situation.

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A comparative analysis of the Civil law and the Common Law on Fraud in the Commercial letter of credit

	US	UK	Canada	Spain	Portugal	France
1. General doctrine	Jurisprudential developments (See Old Colony and Szejn), included in Article 5 of the Uniform Commercial Code.	Generally, it is more uniform than in the United States, even though it hasn't been codified. The intention of the maker of the document is irrelevant. The intention to deceit is the critical requirement to establish fraud (See United City Merchants). It often cites US and Canadian jurisprudence to support decisions.	Common Law jurisdiction which often cites US and Canadian jurisprudence to support decisions.	The law on this matter in juridical concepts such as "good Faith", the abuse of right, the concept of frauds omnia corruptit and the exceptio doli, as a mechanism to make opposition to the enforcement of an action against a bank during a fraudulent execution of a documentary credit by the beneficiary. There is not an express codification but the doctrine has found grounds for it in the principle of good faith and the "Mandato" Contract. Spanish authors often cite Common Law judgments, such as the "leading case" Szejn and United City Merchants. The law is very clear about which are the requirements in order	The law on this matter Rely in juridical concepts such as "good Faith", the abuse of right, the concept of frauds omnia corruptit and the exceptio doli, as a mechanism to make opposition to the enforcement of an action against a bank during a fraudulent execution of a documentary credit by the beneficiary. The documentary credit is analyzed as an obligation assumed by a bank at the request of a client, to pay a determined amount of money to a person previously designated, as far as the conforming documents are delivered according	The law on this matter Rely in juridical concepts such as "good Faith", the abuse of right, the concept of frauds omnia corruptit and the exceptio doli, as a mechanism to make opposition to the enforcement of an action against a bank during a fraudulent execution of a documentary credit by the beneficiary.

<p>1. General doctrine</p>				<p>to ascertain fraud on the matter. An objective element: A claim presented by the beneficiary in order to be abusive or fraudulent under the Spanish Law must include two elements: An objective element: A claim to be paid by the beneficiary when that does not correspond at all with the performance that the beneficiary should do in accordance with the underlying transaction. A subjective element: That the beneficiary does not act in good faith when claiming payment.</p>	<p>to the terms and conditions established on the Art. 6 of UCP 500. The relation between the applicant and the issuing bank is a legal mandate, as established in. Article 1157° of the Portuguese Civil Code. Portuguese authors cite Common Law judgments, such as the “leading case” Szejn and United City Merchants.</p>	
<p>2. Types of fraud that can justify nonpayment</p>	<p>US Forged or fraudulent documents: Admitted without problems. Material fraud: Admitted but it is somehow controversial. It is very difficult to distinguish one from another in real cases.</p>	<p>UK The dominant thesis of fraud in Documentary credit is the one that defend that nonpayment in a case of fraud can only be justified when it lies in the documents tendered by the beneficiary. It admits the fraud in the</p>	<p>Canada Forged or fraudulent documents: Admitted without problems. Material fraud: Admitted but it is somehow controversial. It is very difficult to distinguish one from another in real cases. Angelica-Whitewear</p>	<p>Spain Admits the Fraudulent utilization of false documents, which required the bad faith from the beneficiary, unlike the British law which does not seem to address this issue very clearly; and the total lack of performance</p>	<p>Portugal There can only be fraud when it implies the complete destruction of the contract, in cases of total failure of consideration or of egregious fraud.” Banks have the obligation to refrain from paying when</p>	<p>France The French Cour de Cassation has declared that it is only possible to invoke fraud when it resides in the documentary credit and not on the underlying transaction. Such approach is only comparable to the one taken by the Doctrine</p>

			landmark case clarifies on this distinction.		they have clear evidence of fraud in execution of it's obligation under the contract of "mandato".	and Jurisprudence of the United Kingdom, instead of the more liberal one from Spain or the United States. A smaller part of the French doctrine has understood fraud in a wider sense than just as fraud in the documents.
	US	UK	Canada	Spain	Portugal	France
3. The evidence of fraud	Very high benchmark: Fraud has to be clear and qualified,	Very high benchmark: Fraud has to be clear and qualified,	Fraud must be clear or obvious. For an interlocutory injunction, the Court would require a strong prima facie case of fraud.	The usual high benchmark: Evidences that cannot be contested about the fraudulent or abusive character of the claiming by the beneficiary.	The usual high benchmark: - It must imply the complete destruction of the contract, in cases of total failure of consideration - Egregious fraud. It cannot be admitted the simple partial or defective performance as the basis to allege fraud. The evidence necessary in order to grant an injunction has to be strong enough as to clearly and without hesitations show the existence of fraud.	A vast majority of the Courts in France would apply a very restrictive conception of fraud, which would require a showing of fraud that it is (1) evident, (2) clear and (3) qualified in order to be ascertained and grant an injunction.
4. Preventive measures.	US	UK	Canada	Spain	Portugal	France
	The injunction. US courts have been pioneers in admitting fraud as an	An injunction under British law can adopt one of two different	The injunction. Not very different from the other studied	The "Ley 1/2000 de Enjuiciamiento Civil", allows the	"Providências caurelares não especificadas",	The buyers in a documentary credit who believe are victims

	<p>exception to the traditional autonomy principle of the underlying transaction.</p>	<p>modalities: - A mandate to the bank to stop from paying, or - A mandate to the beneficiary to stop for claiming payment. The Mareva Injunction: a bank will not be stopped from making the payment but the beneficiary is forbidden to take the money abroad until the main question hasn't been resolved.</p>	<p>common law Jurisdictions.</p>	<p>plaintiff to request “the adoption of any preventive measures that its considered necessary in order to secure an effective judicial protection that could be granted in the judgment for the applicant. Therefore, it is possible to conclude that the law is very flexible on this matter.</p>	<p>configured as preventive measures for the provisory defence of any situation not specifically foreseen or disciplined by the law, codified on the article 381 - 427 of the Procedural Civil Code, and in the 619 – 622 of the Civil Code. Therefore, it is possible to conclude that the law is very flexible on this matter.</p>	<p>of fraud would frequently utilize the <i>Saisie-arrêt</i>, a measure that require the existence of a credit of the <i>saisissant</i> (buyer) against a <i>débiteur saisi</i> (beneficiary or seller) who is also a creditor of the <i>tiers-saisi</i> (emitting or confirming bank), being alongside with this one that the <i>saisie-arrêt</i> is enforced, which has as it's objective the referred second credit, making it unavailable.</p>
<p>5. The protection of innocent claimants under the letter of credit.</p>	<p>US Holders in due course: If the documents to demand payment or the letter of credit are presented by an innocent party who has purchased a negotiable instrument for value without any apparent defect in the instrument nor any advice of dishonor, the bank must pay, even though it has verified a typical situation of fraud, otherwise the bank could be liable. Codified in UCC 5-109(c) and (d).</p>	<p>UK As in the US, the British jurisprudence confers protection to third parties who have acted in good faith if the issuing bank has already accepted the draft or bill of exchange. This rule is the same in the US under UCC 5-109(c) and (d).</p>	<p>Canada Holder in due course. Same as in the US and Britain.</p>	<p>Spain Under Spanish law, the innocent claimant is protected if he is able to allege his condition with the requirement that he had had to ignore the fraud situation at the moment he made the debit or when he received the letter.</p>		