

GLOBAL TRADE AND FINANCE SERIES

# THE FRAUD RULE IN THE LAW OF LETTERS OF CREDIT

**A Comparative Study**

By Xiang Gao

Kluwer Law International

**The Fraud Rule in the  
Law of Letters of Credit  
A Comparative Study**

*By*

**Xiang Gao**

*BA (Beijing Foreign Studies); LLM (China University of Political Science &  
Law) LLM, PhD (The University of New South Wales)*

*Judge, The Supreme People's Court of the People's Republic of China  
Senior Fellow, Tim Fischer Centre for Global Trade & Finance,  
Bond University*



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# Global Trade and Finance Series

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## VOLUME 2

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## Preface

This book discusses the fraud rule, often known as the 'fraud exception', in the law of letters of credit, embodied in the relevant international rules and the UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit (UNCITRAL Convention), and in the statutes and cases of the United States, the United Kingdom, Canada, Australia and the People's Republic of China (PRC).

The book addresses the fraud rule in commercial letters of credit and standby letters of credit. In addition, as independent guarantees have generally been treated by the courts as involving the same principles as letters of credit, independent guarantees are referred to wherever relevant.

When the fraud rule is applied, two branches of laws interact: the substantive and the procedural. Substantive laws constitute the basis for the ruling in a case, while procedural law safeguards the proper application of the substantive law. This work focuses on substantive aspects of the fraud rule; procedural issues are discussed only when necessary.

The law of letters of credit is ideally suited for a comparative study, as letters of credit are essentially international instruments. Because of their international nature and the role that the International Chamber of Commerce has played in the development of the law in the area, letters of credit cannot be discussed without considering the ICC rules, in particular the Uniform Customs and Practice for Documentary Credits (UCP). With respect to the fraud rule, the relevant provisions in the UNCITRAL Convention also cannot be neglected. The United States and the United Kingdom have been selected because the legal systems of these countries have played a very important role in shaping the law of letters of credit. The United States occupies a particular position in the development of the fraud rule because of the case of *Sztejn v. J Henry Schroder Banking Corp* (31 NYS 2d 631 (1941)) and the relevant provisions in Article 5 of the Uniform Commercial Code (UCC). For a comprehensive survey of the best practice in the area, the positions of Canada and Australia should also not be overlooked. The PRC is a country of civil law tradition, but its commercial law has widely drawn from common law jurisdictions. In the area of letters of credit it entirely follows international practice. Therefore, although its legal system as a whole is distinctive from the other jurisdictions covered in this book, its law governing letters of credit is comparable and similar.

This book has a distinctive style and structure due to the background of the author and the original purpose of the work. The book began life as

a doctorate undertaken at the University of New South Wales (UNSW) in Sydney, Australia. The author, before undertaking his doctoral studies, had worked in the Supreme People's Court (SPC) of the PRC, handled a number of letter of credit fraud cases, and found the PRC provisions with respect to the fraud rule inadequate and in need of reformulation. Therefore, the basis of this work, the doctoral thesis was, on the one hand, written as research for the purpose of earning a doctorate, and on the other hand as a law reform report for the purpose of reforming the fraud rule in the PRC. The thesis first reviewed the relevant provisions in the ICC rules and the UNCITRAL Convention at the international level, and the statutes and decided cases of the United States, the United Kingdom, Canada, Australia, to search for the best international provisions and practice in the area, and to thoroughly research the issues involved in the reformulation of the fraud rule in the PRC. It concluded by discussing what the fraud rule in the PRC was like and how or where it could be improved. When the author finished his PhD and returned to the Supreme People's Court, he wrote the draft of the SPC's *Provisions Concerning Certain Issues in Hearing Letter of Credit Cases*, a great proportion of which are provisions relating to the fraud rule. His doctoral research provided the theoretical basis for the drafting.

Letters of credit have been most often studied by bankers or banking lawyers. By contrast, this work adopts the perspective of a court or judge handling letter of credit cases. Because of this distinctive perspective, this book differs somewhat from works by other commentators: while commentators other than judges often offer good analysis of issues, judges must give an answer when a case is put before them. This suggests a distinctive written style: a more detailed account of the facts of a case, as they are crucial to a court's decision; and a clearer answer to an issue, even if it is not absolutely the best answer, but simply the best available.

This book follows the original structure of the thesis. It consists of three parts. The first part consists of Chapter 1, which discusses the fundamentals of letters of credit and serves as a theoretical background for later discussions. The second part comprises chapters two to six, and considers various aspects of the fraud rule outside the PRC – the 'international standards' of the fraud rule. Chapter 2 deals with general issues with regard to the fraud rule. Chapter 3 deals with the standard or notion of fraud under the fraud rule. Chapter 4 studies the locus of fraud, the issue of in which transactions and where fraud must appear for the fraud rule to be invoked. Chapter 5 discusses the relationship between the identity of the fraudster and the application of the fraud rule. Chapter 6 examines who can be immune from the fraud rule. The third part consists of the final chapter, Chapter 7, which examines the fraud rule in the PRC.

During the course of my studies I received enormous help from many people, and I would like to record my sincere thanks to all of them. Foremost among them is my supervisor, Mr Ian Cameron of the Faculty of Law of UNSW, not only for his searching comments and excellent guidance in my completion of the thesis, but also for his unreserved help to me and my family in many respects over the years of our life in Australia. My profound thanks go also to my co-supervisor, Professor Ross Buckley of Bond University, for his encouragement, his stimulating and thoughtful

comments on the thesis and for all the other help he gave me during my stay in Australia. As well, I am deeply indebted to Professor Paul Redmond, then Dean of the Faculty of Law of UNSW, for his generous support of me in many respects.

I would also like to thank many other staff members of the Faculty of Law, the Law Library, the Interlibrary Loan Unit of the Library at UNSW, and my colleagues at the then Economic Division of the SPC, for their enormous assistance to me in the completion of the thesis. I am grateful to AusAID for providing me the financial support for both my LLM and PhD studies in Australia, and to the SPC allowing me more than five years to complete the degrees.

I would like, again, to express my sincere thanks to Professor Ross Buckley for arranging the publication of this book and assisting in revising the entire text for publication. Without him, the publication of this work outside the PRC would not have been possible.

As Chapters Five and Six of this book were first published as part of the articles entitled 'The Identity of the Fraudulent Party under the Fraud Rule in the Law of Letters of Credit' and 'Presenters Immune from the Fraud Rule in the Law of Letters of Credit' respectively in (2001)24(1) *The University of New South Wales Law Journal* at pp119–141 and [2002] *Lloyd's Maritime and Commercial Law Quarterly* at pp10–38, I would like to thank the two journals for their permission to reproduce those relevant parts here.

Finally, I would like to express my sincere thanks to my wife, Yihong Luo, and my lovely daughter, Sa Gao, for the joy they have brought into my life in the course of my work on this project.

Xiang GAO  
Beijing  
June 30, 2002

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# 1. The Letter of Credit and its Legal Framework

This chapter is not intended to give a comprehensive analysis of all the basic issues of letters of credit, something which has been done many times already and can take volumes.<sup>1</sup> However, an adequate treatment of the fraud rule requires a careful regard for the fundamentals of the letter of credit. Accordingly, this chapter is meant to serve as a theoretical background for later discussion and to outline some of the basics that will be necessary for the study of the fraud rule in the law governing letters of credit.

This chapter is divided into two parts. The first part briefly examines the nature of the letter of credit – to see what a letter of credit is and what it is not, by looking at its definition, operation, history and its distinction and similarity from two other commercial constructs: negotiable instruments and contracts. The second part introduces the customs, rules and regulations governing letters of credit in order to see how letters of credit are currently regulated, and to provide a legal basis for later analysis. Given their significance, the two fundamental principles of the law of letters of credit, the principle of independence and the principle of strict compliance, will be specially discussed.

## THE NATURE OF LETTERS OF CREDIT

### Definition

Letters of credit have been defined in a number of ways. Article 2 of the Uniform Customs and Practice for Documentary Credits (UCP) provides

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<sup>1</sup> For some leading works, see J.F. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* (rev edn, 1996); E.P. Ellinger, *Documentary Letters of Credit – A Comparative Study* (1970); Gutteridge and Megrah, *The Law of Bankers' Commercial Credits* (7th edn, 1984); H. Harfield, *Bank Credits and Acceptances* (5th edn, 1974); R. Jack et al., *Documentary Credits* (3rd edn, 2001); B. Kozolchyk, 'Letters of Credit' in J.S. Ziegel (ed.), *International Encyclopaedia of Comparative Law*; L. Sarna, *Letters of Credit: The Law and Current Practice* (2nd edn, 1986); B. Wunnikle et al., *Standby and Commercial Letters of Credit* (2nd edn, 1996).

that a letter of credit means:

any arrangement, however named or described, whereby a bank (the 'Issuing Bank') acting at the request and on the instructions of a customer ('the Applicant') or on its own behalf,

- I. is to make a payment to or to the order of a third party (the 'Beneficiary'), or is to accept and pay bills of exchange (Draft(s)) drawn by the Beneficiary, or
- II. authorises another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s)), or
- III. authorises another bank to negotiate, against stipulated document(s), provided that the terms and conditions of the Credit are complied with.<sup>2</sup>

The revised Article 5 of the Uniform Commercial Code defines a letter of credit as a 'definite undertaking... by an issuer to a beneficiary at the request or for the account of an applicant or, in case of a financial institution, to itself or for its own account, to honour a documentary presentation by payment or delivery of an item of value'.<sup>3</sup>

Whether the letter of credit is defined as an 'engagement' or an 'undertaking', it has to be described by general legal terms and different people use different terms. It is not an easy task to define a letter of credit. The writer would prefer to define the letter of credit functionally as an instrument, issued to a beneficiary by an issuer for the account of the applicant, by which the issuer promises it will honour a draft or a demand for payment provided the terms specified in the credit are met.<sup>4</sup>

## Operation and Classification

One way to discover the nature of letters of credit is to examine how they operate. Letters of credit may be categorised in many ways and into many different types. They have been compared with automobiles because both have been used for a long time and their functions have expanded and adapted to meet changes of the society.<sup>5</sup> Different types of letters of credit may operate differently. However, modern letters of credit can be divided into two basic forms according to their distinctive function and usage: commercial letters of

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<sup>2</sup> The UCP has been revised a number of times. The quoted is from the 1993 version.

<sup>3</sup> Section 5-102(a)(10). Cf, s 5-103(a) of the original Article 5 of the UCC, which defined a letter of credit as an 'engagement'; Official Comment 1 on the original Article 5 of the UCC, s 5-114, described a letter of credit as 'essentially a contract between the issuer and the beneficiary'. Hereinafter the Uniform Commercial Code will be referred to as 'UCC', the original Article 5 of the UCC as 'Prior UCC Article 5', and the revised Article 5 of the UCC as 'Revised UCC Article 5'.

<sup>4</sup> For some earlier common law definitions, see, for example, *Second Nat'l Bank v. M Samuel & Sons Inc* (1926) 12 F 2d 963, 966; *Border Nat'l Bank v. American Nat'l Bank* (1922) 282 F 73, 77; *Lafergue v. Harrison* (1885) 9 P 259, 261; *Liggett v. Levy* (1911) 136 SW 299, 301.

<sup>5</sup> H. Harfield, 'Who Does What to Whom: The Letter-of-Credit Mechanism' (1985) 17 UCCLJ 291, 291.

credit and standby letters of credit. Other types of letters of credit are best regarded as variations or 'derivatives' of these two primary forms adapted to meet the special needs of particular transactions.

Given the scope of this work, only those letters of credit the special characteristics of which may affect the application of the fraud rule will be considered. The two basic forms of letters of credit, commercial letters of credit and standby letters of credit, will be discussed here; the other types of letters of credit, such as straight and negotiation letters of credit, acceptance and deferred payment letters of credit, will be discussed in Chapter 6. As independent guarantees have been legally treated as the same as letters of credit, they will also be introduced briefly in this chapter.

### *Commercial Letters of Credit*

Commercial letters of credit are the traditional form of letters of credit created as a payment and financing mechanism for international sales of goods. A prototypical commercial letter of credit operates as follows.

Assume a seller in Sydney wishes to sell some goods to a buyer in Shanghai. The seller and the buyer, however, may not know each other and each is concerned over the other's financial strength and reliability. The seller is worried that, after it has gone to the expense of loading and shipping the goods, the buyer may become insolvent or refuse to pay for the goods upon arrival. If the buyer does not pay, the seller may have to go to great expense to sue the buyer in Shanghai, an unfamiliar foreign jurisdiction, and incur further expense in disposing of the goods in an unfamiliar territory. Similarly, the buyer has no reason to trust the seller's solvency and reliability and is concerned that it may not get the number and quality of goods contracted if it pays in advance or even worse, that the financial collapse of the seller will leave it without both the money and the goods.

When variables such as distance, language, currency, culture and foreign laws are taken into consideration, a merchant's lack of confidence may be understood. In order to assuage each other's legitimate fears, the parties may agree to a compromise and arrange their transaction by way of a letter of credit. Under such an arrangement, the buyer agrees to go to a third party, normally a bank of good reputation in Shanghai, and apply for a letter of credit in favour of the seller. When the bank approves the creditworthiness of the buyer, accepts its application and issues the letter of credit, it agrees to assume the primary, direct and independent obligation to honour the seller's draft presented under the letter of credit provided that complying documents specified in the letter of credit are tendered. The documents specified in a commercial letter of credit usually include a commercial invoice, an insurance policy and a set of clean on board bill of lading, which is a document of title evidencing the ownership of the goods.

This example illustrates that in essence a typical commercial letter of credit transaction involves three parties and three transactions.<sup>6</sup> The three

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<sup>6</sup> In practice, more often than not, more parties and transactions are involved. For example, the issuing bank notifies the seller, usually through a correspondent bank in the seller's location.

parties are:

- (1) the buyer, known as the 'applicant', the 'account party' or the 'customer';
- (2) the seller, known as the 'beneficiary'; and
- (3) the bank, known as the 'issuer', the 'issuing bank' or 'opening bank'.

The three transactions are:

- (1) the underlying transaction between the buyer and the seller, under which the seller agrees to sell the goods to the buyer and the buyer agrees to pay to the seller the purchase price by way of a letter of credit arrangement;
- (2) the transaction between the buyer and the bank, under which the bank agrees to issue the letter of credit in favour of the seller and the buyer agrees to reimburse the bank for the payment made under the letter of credit plus a commission; and
- (3) the transaction between the bank and the seller, that is, the letter of credit itself, under which the bank agrees to take the primary responsibility to honour the seller's draft provided it is accompanied by the required documents specified in the letter of credit.<sup>7</sup>

Such an arrangement has a high degree of commercial utility, and in the normal course of business benefits all the parties concerned. Under this arrangement, the seller/beneficiary retains the ownership of the goods until it presents the documents to the issuer, at which time it is paid or its draft is accepted by the issuer. The seller faces almost no risk of non-payment as the credit of the issuer is substituted for that of the buyer. The buyer/applicant is, subject to the problem of fraud, assured that its money will not be released until the required documents, which not only are the evidence indicating that the seller has completed its obligation under the sales contract, but also represent the ownership of the contracted goods, are presented to the paying bank. This also usually satisfies the seller's desire for

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*Contd.*

The correspondent bank may be instructed to act as an advising bank, which is a mere intermediary transmitting information, or to add to its own undertaking as a confirming bank, or to participate in the transaction as a negotiating bank by purchasing the drafts drawn by the beneficiary. Sometimes, a letter of credit transaction may only involve two parties. This kind of letter of credit is known as two-party letter of credit. For illustrations of two-party letters of credit, see G.T. McLaughlin, 'Two Party Letters of Credit: Two More Problems than Three' (1993) 4(3) JBFLP 226; and McLaughlin and Cohen 'Commercial Law' (1993) 9 NYLJ 3.

<sup>7</sup> However, in some types of letters of credit, no draft may be involved. Where a draft is involved in the letter of credit transaction, according to Ellinger the issuer may be committed to perform its promise in one of the following ways: (1) to pay cash against the tender of documents; or (2) to accept the draft drawn on it by the beneficiary in the amount of the purchase price; or (3) to negotiate the draft drawn by the seller on the buyer. The first type prevails in Continental Europe and South America, the second type is the most common type in the United Kingdom, in many Commonwealth countries and the United States, and the third type is common in South East Asia. See E.P. Ellinger, 'Letters of Credit' in Horn and Schmitthoff (eds), *The Transnational Law of International Commercial Transactions* (1982), 241, 244.



cash and the buyer's desire for credit. Abuse of the system is restrained by the fact that neither the seller nor the buyer is ever in control of the goods and the money at the same time.<sup>8</sup> The bank, whose business is providing services, in turn gets paid a fee. Although it may seem that the bank assumes the risk of extending credit to the buyer until reimbursed, the bank usually takes security, a pledge, over the tendered documents, and often over other assets from the buyer as general security as well.<sup>9</sup>

### *Standby Letters of Credit*

Standby letters of credit were developed in the 1950s because of 'the restrictive scope of the powers conferred on American banks by statutes and by charters'.<sup>10</sup> They became widely used in US in 1960s and have been increasingly popular worldwide since 1970s.<sup>11</sup>

Standby letters of credit legally operate in the same basic framework as commercial letters of credit. A simple standby letter of credit transaction also involves three parties (the applicant, the issuer and the beneficiary)

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<sup>8</sup> But one prominent letter of credit expert has asserted that, because of the principle of independence in the law of letters of credit, the buyer is in 'an absurdly vulnerable position' under the letter of credit arrangement. M. Megrah, 'Risk Aspects of the Irrevocable Documentary Credit' (1982) 24 *Ariz L Rev* 255, 256. The writer agrees on this point, and intends to explore what may be done through this research.

<sup>9</sup> However, some commentators are of the view that the bank's security interest over the goods or the documents evidencing the ownership of the goods is in practice not an important component of a letter of credit arrangement. 'It may be misleading to suggest that bank issuers are always concerned about their security interest in the goods. It is probably fair to say that they do not mind having the security interest but are more concerned about the applicant's ability to reimburse the issuer when it pays the beneficiary'. Dolan, *supra* note 1, 8-23, note 111.

<sup>10</sup> E.P. Ellinger, 'Standby Letters of Credit' (1978) 6 *Int'l Bus Lawyer* 604, 611. See also Prefatory Note to Revised UCC Article 5. Foreword by Byrne to B. Kozolchyk, 'Bank Guarantees and Letters of Credit: Time for a Return to the Fold' (1989) 11 *U Pa J Int'l Bus Law* 1, 4 (Byrne's Foreword); E.E. Bergsten, 'A New Regime for International Independent Guarantees and Stand-By Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters' (1993) 27 *Int'l Lawyer* 859, 865.

<sup>11</sup> R.P. Buckley, 'Potential Pitfalls with Letters of Credit' (1996) 70 *ALJ* 217, 227. They are so popular that the money amount involved in standby letters of credit is far greater than that of commercial letters of credit. It was stated in 1989 that 'standby letters of credit in the United States alone have grown to approximately \$175 billion, dwarfing the approximately \$30 billion outstanding in commercial credits' (Byrne's Foreword, *ibid.*), which is consistent with a more recent figure provided by the ICC Banking Commission in 1998: 'The amounts of standbys outstanding in value terms exceed those of commercial credits by a ratio of more than 5:1' <<http://www.iccwbo.org/home>>. However, different views seem to exist with respect to the reasons for their original development. It has been stated that '[s]tandbys are not, however, by any means a U.S. device since they are used extensively in more than 30 countries in North America, South America, Australia and Asia. Nor is their use, as is sometimes suggested, as a result of peculiarities in the U.S. regulatory scheme under which U.S. banks are generally restricted from issuance of guarantees. The standby represents a deliberate attempt engineered in the early 1950's in large part under the auspices of Leonard A. Back of Citibank and Henry Harfield of Shearman & Sterling who almost single-handedly led and shaped U.S. letter of credit law during the vital decades that standbys were coming to the fore. Their remarkable success was to create a genre of independent or abstracted assurances not by the fashioning of a new instrument but through the extension of the tried and true letter of credit'. Byrne's Foreword, *Ibid.*