CHAPTER-4

FRAUD EXCEPTION IN DOCUMENTARY CREDIT
Autonomy of letters of credit is a settled principle. Banks engaged in this transaction are not concerned with any dispute arising between the parties to the underlying contract. It is vital that every bank which issues letter of credit should honour its obligation to pay on presentation of the required documents. The banks are thus concerned only with the documents. There is no obligation on banks to check the factual authenticity of the documents which are presented to them. This position of certainty of payment raises various difficult situations.

The documents required under a documentary credit normally originate from the seller. Therefore if he chooses, he can make a forged document. Unless the forgery is obvious, the bank is entitled to pay. Similarly documents usually indicate dispatch of the goods. In some situations documents may be presented for a non-existent cargo. By the time when the buyer came to know about this, he might have lost his money. The insurers generally do not pay for a non-existing cargo. So fraud is recognized as an exception to the absolute payment principle in letters of credit. Banks are exempted from paying if it knows that the tendered document is false or contains a forged signature.

In documentary letters of credit, fraud occurs in various forms. Therefore banks are expected to act in a reasonable manner in case of allegation of fraud in relation to the commercial documents. However a mere allegation of fraud is insufficient to affect the bank’s obligation to make payment. Evidence of fraud is required for the refusal of payment by banks. But it is not clear as to the degree of evidence of fraud required. Similarly, it is not clear whether knowledge of such fraud to the beneficiary and the bank is necessary to invoke fraud exception. Therefore it is necessary to analyse the fraud rule in order to find out how it helps to minimize the risk undertaken by the concerned parties. Since the U.C.P. principles remain silent regarding the fraud it is essential to find out the legal basis of this rule. Increase in fraud exception application will result in diminution in the commercial utility of this instrument. Therefore a critical evaluation of fraud exception in modern scenario is needed.

**Effect of Fraud in Documentary Credit**

It is a fundamental principle of letters of credit law that a bank’s undertaking to pay beneficiary on presentation of stipulated documents is separate from any underlying contract. The only exception to this principle apart from strict compliance is fraud.

Sometimes the documents will be genuine but the beneficiary perpetrates a fraud which the issuing bank comes to know afterwards. The fraud exception remains too narrow and the banker is liable to pay irrespective of fraud. Thus in

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6 Under strict compliance doctrine the documents presented for payment must exactly comply with the documents stipulated in letters of credit. For a detailed discussion, see, supra, Chapter 3.
Discount Records Ltd. v. Barclays Bank Ltd., Megarry J., refused to grant injunction on an allegation of fraud. He observed:

"I would be slow to interfere with banker's irrevocable credits, and not least in the sphere of international banking, unless a sufficiently good cause is shown; for interventions by the court that are too ready or too frequent might gravely impair the reliance which, quite properly, is placed on such credits."

The buyers failed to establish the evidence of the alleged fraud in this case. When they opened the cartoons they found that it contained only a small quantity of goods ordered. Some of the cartoons were empty and contained goods which were not ordered. But the bank in this case accepted the draft which was in order.

The facts of this case show that the buyer communicated to the bank that fraud had occurred. But on enquiry the bank found that the alleged discrepancies were insignificant. The beneficiary was not a party to such fraud.

**Meaning of Fraud**

The term 'fraud' in letter of credit is not defined and courts have tried to interpret and give meaning to that. In Beauman v. A.R.T.S. Ltd., it was observed that the term "fraud" connotes dishonesty or deceit but may be of far wider application. The burden of proof required to establish dishonesty leading to fraud is different. Fraudulent misrepresentation or deceit which will be the basis of

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7 [1975] 1 All. E.R. 1071 (C. D.)
8 Ibid. at p. 1075.
9 [1949] 1 K.B. 550
many types of fraud was exhaustively defined by Lord Herschell in Derry v. Peek

He said,

".... in order to sustain an action of deceit, there must be proof of fraud and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, (2) without belief in its truth, or (3) recklessly, careless whether it is true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second for one who makes a statement under such circumstances can have no real belief in the truth to what he states."

This statement is however the general classification of fraud. Frauds in relation to letters of credit are frauds involving documents and also or fraud in relation to goods. However frauds in relation to goods are difficult to establish. If such an allegation arises before the payment is made, payment cannot be withheld by the bank unless there is proof that the seller has committed the fraud.

Courts have given a very narrow meaning to the term 'fraud'. Only outrageous conduct which shocks the conscience of the courts are treated as fraud. This narrow interpretation is justified on the ground that a broader rule would defeat the certainty of letter of credit transaction. However there are two wider interpretations of the term 'fraud'. One is breach of standard contract and the other is intentional fraud standard. In case of breach of contract standard, the customer would be allowed to obtain an injunction against payment by showing that it has a valid defense in an action for breach of the underlying

10 (1889) 14 App. Cas. 337 at p.376
11 So long as the documents satisfy the requirement of credit, fraud in relation to goods will not stand.
contract. But the intentional fraud standard follows the traditional "egregious fraud" standard. According to that a beneficiary who presents confirming documents under a letter of credit should be prevented from receiving payment only when his own wrongdoing has led to the creation of these documents. Later broader definition of "wrong doing" was adopted to include a false representation. However courts are reluctant to broaden the definition and narrow definition is insisted. In Roman Ceramics Corp. v. Peoples National Bank, the district court enjoined payment by finding that the beneficiary knew that the invoices covered by letter of credit had been paid. But misrepresenting this fact to the issuing bank has attempted to get payment. While applying the definitions of fraud in the transaction, the court observed:

"[We] think that the circumstances which will justify an injunction against honour 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 obligations would no longer be served."

It can be seen that the "egregious fraud" standard is traditionally followed in letter of credit transaction.

18 Ibid at pp.1212-13.
Development of Fraud Rule in the *Szejn* case

This is perhaps the most important case law relating to fraud universally followed in case of documentary credits as an exception to autonomy principle. The seller in this case shipped rubbish materials under a contract of sale. He obtained a bill of lading from the carrier fraudulently stating that the goods shipped in the container are in good condition. However on suspecting fraud buyer refused to accept the documents and filed an injunction restraining the issuing bank from accepting this documents and making payment to the seller.

The court held that the principle of autonomy is the important element of documentary credit however in case of fraud the autonomy principle cannot be upheld. Shientag J., said,

"...where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller."

However in this case certain questions left unanswered. One is the degree of knowledge of fraud that is necessary to justify the issuing bank in refusing to pay. The other question is whether the payment without knowledge of fraud is protected. Apart from this it does not address the position of the negotiating banker.

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19 *Szejn v. Henry Schroder Banking Corp.* (1941) 31 N.Y.Supp.2d 631 cited in Richard Schaffer *et al., International Business Law and its Environment, Supra n.1*

Documentary Credit Frauds

Documentary credit system is wholly dependent on the integrity of the documents. The volume of documents used in documentary credits is often high. There are documents of different nature. The parties are at the liberty to include the documents of their choice. This will pave way for an increased fraudulent activity by the parties as the payment obligation undertaken by the banks is purely based on documents. Fraudsters use documents to perpetuate the fraudulent activities by using forged documents.

Frauds in Relation to Bill of Lading

One of the important documents used in letters of credit is the bill of lading. The long standing recognition that it may pass both title in the goods and all rights to sue under the contract of carriage has made it a vital document in letters of credit. There can be fraud in relation to this document on various ways.

(i) Non shipment of goods

This is a simple method fraud committed through bill of lading of a known shipping company without actual shipping of goods. Sometimes bill is made by using imaginary names for the carrier and ship. In such cases the carrying vessel named in the bill may not even exist.

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21 For a discussion, see T. K. Thommen, Bills of Lading in International Law and Practice, Eastern Book Company, Lucknow (1986).
In *Hindley & Co. v. East Indian Produce Co. Ltd.*, Kerr J., remarked that

"If no goods had in fact been shipped, the sellers had not performed their obligation."

The argument that seller was not a party to the non-shipment is irrelevant and he cannot avoid his liability to the buyer. The seller has to ship goods of the contractual description and tender the sales, shipping and insurance documents to the buyer. Of course the seller is not concerned with the safe arrival of goods and their subsequent delivery to the buyer. But during initial stage, he should be vigilant. However when a bill of lading document comes into the hands of a banker as part of the letter of credit transaction, the banker will verify only authenticity of the document presented. Actual inspection is beyond the scope of the duty of banker. This increases the scope for committing fraud through bill of lading.

(ii) Short Shipment of Goods

Fraud can be committed through bill of lading by shipping lesser quantity of goods than actually contracted. The bill of lading is the prima facie evidence that the goods referred to has been shipped and the onus is clearly on the carrier to show that it had not in fact been shipped. This requires very satisfactory evidence and proof of extreme probability. Any removal of goods during transit is not sufficient.

Here also the banker cannot deny payment to beneficiary since the bill of lading presented will be in terms with those mentioned in letters of credit. It is the buyer who is put into trouble when he receives lesser quantity of goods. As fraud is not proved, he cannot raise any claims against the banks.

(ii) Falsification of a Bill of Lading

In this situation a bill of lading is altered after it has been issued. It is most commonly used when goods are shipped late. The date is often altered to show that shipment had been made in time. In Kwei Tek Chao v. British Traders and Shippers Ltd.26 it was held that the bill of lading was a forgery when it showed the goods in question as having been loaded on the ship named in the credit within the time limit specified therein whereas in fact the loading had taken place after that time. However in that case fraud was that of the forwarding agent and not that of the seller. Even then the court held that the banker could reject the document as the beneficiary's blamelessness will not be a concern when fraud is proved beyond any doubt.

Apart from this in Bank Russo Iran v. Gordon, Woodroffe & Co. Ltd.27 Browne J. said that a fraudulent beneficiary would be liable to repay money paid by mistake of fact. The U.C.P. frees banks from liability or responsibility for the falsification or legal effect of documents28. This relief may not be enough to avoid all the consequences of fraud.

28 The U.C.P. 600, Article 34.
In an earlier case, one U.S. Court29 refused to invoke the fraud exception. They believed that issuing bank’s liability relates only to the verification of documents and checking whether they are on the face complies with credit only. A mere doubt regarding the quality of goods will not amount to fraud. Hence banks cannot refuse payment. Justice Cardozo dissented and took a different version for fraud.30 He held that fraud means misrepresentation. This view can be ascertained from the following:

"We have to bear in mind that this controversy...arises between the bank and a seller who has misrepresented the security upon which advances are demanded... I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face."

According to Cardozo’s statement, in order to invoke the fraud rule, a misrepresentation should amount to complete non performance of the contract. Although in Maurice’s Case a breach of warranty was involved when the seller shipped newsprint paper of inferior quality whereas in Sztejn case fraud in the translations by presenting the documents covering goods and the shipment of bales of worthless rubbish materials was involved. However according to Richard Schaffer, Maurice O’Meara31 and Sztejn Case32 presents clear distinction between a mere breach of warranty and fraud.33

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29 Maurice O’Meara Co. v. National Park Bank, 239 N.Y. 386, 146 N.E. 636 (1925) cited in Richard Schaffer et al., International Law and its Environment, supra n.1
30 Ibid.
31 Ibid.
32 Supra n.19
33 Ibid.
However whenever the question of fraud comes, the courts looks into the Sztejnis rule. This rule has been expressly adopted in English decisions. In American Accord case, the sellers were unaware of the fraud committed by the shipping agent by fraudulently dating the bill of lading in order to convey the impression that the goods had been shipped before the expiry of the period specified in the documentary credit. Referring to Sztejin's case, Macatta J. observed,

"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."

In another case, the bank paid against a set document including a bill of lading and a certificate of origin. Bill of lading was a forgery and certificate of origin included fraudulent misstatements. The bank refused payment and the seller sued. Lord Denning M. R. observed,

"documents ought to be correct and valid in respect of each parcel. If that condition is brooked by forged or fraudulent documents being presented – in respect of any one parcel – the [bankers] have a defense in point of law against being liable in respect of that parcel."

Thus fraud rule gives a different version to the autonomy of the letter of credit. Only condition is that the fraud must have been perpetrated by the seller or his agent. However this should be contrasted with forgery as a defense. There is some suggestion in The American Accord that banks should pay against forged documents where the seller is not privity to the forgery. Chuah says that the

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36 Ibid.
suggestion of payment where seller is not party to forgery is not correct because forged documents could never be conforming documents. Hence the beneficiary has no right to demand payment by presenting a forged document.\textsuperscript{37}

Fraud rule of Sztejn case has influenced and shaped the fraud exception in all jurisdictions world wide. In the United States this rule has been adopted in the Uniform Commercial Code. It states that if the letter of credit is fraudulent, forged or fraud in the translations exists in the underlying sales contract buyer can restrain banker from making payment.\textsuperscript{38} This Code specifies certain factors which the court must consider in order to determine the applicability of fraud exception. These factors include the effect of injunction on the beneficiary, the prohibition of injunction by another law and the availability of a remedy for fraud or forgery against the responsible party.\textsuperscript{39} Therefore it can be concluded that fraud has been interpreted in Sztejn case to give an effective legal meaning.

Forged Documents

Apart from the bill of lading, various other documents are also used for the payment under letter of credit. There are situations where fraud had been committed and the documents appear on their face as fraudulent. There is no certainty to this position in municipal laws. The U.C.P. 600 also does not attempt to set out the position. The intention of the U.C.P. 600 may be to leave the questions of fraud to the relevant municipal courts.

\textsuperscript{38} The U.C.C. Article 5, s. 109.
\textsuperscript{39} \textit{Ibid.}
Limitations to the Fraud Rule

Though fraud as an exception to autonomy principle is established in Sztejn40, it applies within narrow confines. There are three limitations which are frequently discussed. 41 One limitation is that it is difficult to determine whether an alleged discrepancy between the description of goods in the documents and their actual nature is indicative of fraud. It has been held that unless there is a blatant fraud, the banker cannot assert the deficiency of goods against the seller. 42 Second limitation shows that fraud is difficult to prove. In majority of cases, the letter of credit would be realized before the buyer succeeds in obtaining evidence of fraud. Moreover mere suspicion cannot establish fraud. In Dulien's case43 the learned judge indicated that when an injunction is sought to restrain the bank from paying on an allegation of fraud, it must be closely connected with the letter of credit. A mere contention that the behavior of the beneficiary is a fraud upon the buyer might not be sufficient.

The third situation is that fraud can effectively be raised only against the party who has committed it. This point is made clear in many decisions. 44 Therefore if the fraud is committed by a third party, fraud exception cannot be raised to restrain payment under letter of credit.

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40 Supra n.19.
42 Supra n.7
44 See Discount Records Ltd. v. Barclays Bank Ltd. Supra n.7, American Accord case, Supra n.314
Another question relating to documentary credit fraud is that, if a document tendered by the third party is a "nullity" whether the bank can refuse to pay the beneficiary. This issue was addressed by the House of Lords in United City Merchants (Investments) Ltd v. Royal Bank of Canada.\textsuperscript{45} Hence the sellers were unaware of the inaccuracy of the notation in the bill of lading. Believing it to be true they presented it for payment and the confirming bank refused to pay on the ground that they had information suggesting the fraud committed in the bill of lading. The court was of the opinion that if seller is not a party to fraud then fraud exception cannot be invoked. The argument that to render a transaction a nullity, knowledge on the part of the seller is not required was rejected by the court. Lord Diplock said that such a proposition would seriously undermine the whole system of financing international trade by means of documentary credit. Though the nullity question was reserved by Lord Diplock in this case, it was answered by the Court of Appeal in Montrod Ltd. v. Grundkotter Fleischvertriebs GmbH.\textsuperscript{46} It was held that there is no general nullity exception under English law. The beneficiary may have presented documents that are not genuine and have no commercial value, but he is entitled to payment under the credit unless he was fraudulent.

The Court of Appeal stressed that there were "sound policy reasons" for rejecting the general nullity exception. Potter L. J., delivering the judgment of the

\begin{thebibliography}{9}
\bibitem{46} [2002] 1 All E.R. 257(Comm.).
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Court, 47 considered that a general nullity exception would be incapable of precise definition. This case involved a document presented under "the letter of credit, which was signed by the beneficiary believing that it was authorized to do so by the applicant, while in fact there was a dispute on the validity of the authority for so signing. Though there was no allegation that beneficiary was fraudulent, it was alleged that document tendered was nullity and fraud.

However Richard Hooley 48 points out three reasons for criticising this view point. Firstly the bank's undertaking in the credit is to pay against conforming document and not against those that appear to conform. 50 So if the document is fraudulent but confirms with the letter of credit, payment made by the bank will lead to injustice. Secondly, a document which is a nullity is a worthless piece of paper. It offers no security to the bank which has paid out under the credit. It is to be noted that the principle of autonomy works only because the bank's obligation to pay has some value 51. Third criticism is that there is a chance for circulation of forged documents in international trade undermining the trust in trade. Cresswell J. described antedated and false dated bills of lading as “a cancer in international trade.” 52 This is true in case of a nullity document.

The ultimate result of these decisions seems to protect the beneficiary in case of fraud committed by a third party. But the applicant is made to suffer.

47 Ibid.
49 Ibid.
50 Professor Goods has pointed out that a forged document is not a conforming document.
This may be the reason why Potter L. J. in *Montrod* case did not decide the issue. He suggested that a non-fraudulent beneficiary might be refused payment on tender of apparently confirming documents when he acts recklessly in haste.\(^5\)

Thus though nullity of document was treated as a separate exception to the autonomy principle, it is related and should be treated as part of fraud exception. The reason for giving protection to beneficiary in case of third party fraud is that it is not only the bank and the buyers who will get it affected, but also the sellers who are deceived due to the fraud committed by the third party. This reasoning makes the legal position unclear as it will affect the international trade since no protection is available to the parties for their investments. If beneficiary in collision with third party commits fraud, it is difficult to prove and he can escape.

A fraudulent misrepresentation made by an agent of seller without the knowledge of the seller will not be sufficient to invoke fraud exception. The question, what will constitute material misrepresentation in document, is to be decided according to the circumstances. "material misrepresentation" is a standard of fraud in the United Kingdom.\(^5\) The word misrepresentation is very close to a statement of the elements of fraudulent misrepresentation which constitute the tort of deceit.\(^5\)

\(^5\) *Supra* n.46. This suggestion is only *Obiter dictum* of this case. It is to be noted that nullity exception was not accepted as it would erode the autonomy principle but various observations were made by the judge will arising at a decision.

\(^5\) See the U.C.C. Article 5.

\(^5\) For fraud of deceit there must be three elements (i) knowing the representation to be false (ii) without belief in its truth or (iii) recklessly, careless whether it be true or false.
This shows that in England, third party fraud is narrowly construed. However in Canada, intentional fraud and prima facie evidence is given importance. Thus in *Henderson v. Canadian Imperial Bank of Commerce* Berger J. expressly rejected Lord Diplock’s conclusion that a bank must pay against apparently confirming documents even if it knows that the seller has committed a breach of contract. His Lordship’s thought that Lord Diplock’s restriction of fraud exception to cases of material misrepresentation known to the bank would render the exception “illusory” and “narrow”.

It appears from the above discussion that different countries follow different views with regard to payment to beneficiary in case of fraud by third party. Though the legal proposition is unjustifiable and detrimentally affects the applicant, it is necessary for not disturbing the worth of documentary credit transaction. The peculiar feature of such transaction is the prompt payment.

**Documentary Fraud: Role of Banks**

In making payment to the beneficiary, the obligation of the issuing banks rests solely upon the presentation of correct documents. Problem arises when the documents are correct on their face but actually fraudulent. Placing an absolute duty on the bank to defend against the fraudulent presentation of shipping document based on notice of fraud by buyer will create hardships. Such a step would force the bank to stop payment upon unfounded fears by the buyer. In that case the bank was made a party to litigations. The bank was

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56 *Supra* n.19.
required to take reasonable care to ascertain whether fraud was present on
allegation of fraud by the buyer. However, this requirement would greatly
enhance the obligations of the bank unless strict standard are not imposed on
them. The approach of courts seems to protect the interest of bankers in cases
of fraud.

Standard of Proof

The bank is not obliged to ascertain whether the alleged fraud can be
proved. It may adopt a passive attitude and evaluate the evidence placed before
it. However evidence of fraud must be clear to the bank's knowledge. Then only
banker is justified to refuse payment to beneficiary. This was stated by the Court
of Appeal in Boliventer Oil S.A v. Chase Manhattan Bank NA.

"The wholly exceptional case where an injunction may be granted
is where it is proved that the bank knows that any demand for
payment already made or which may thereafter be made will be
clearly fraudulent. But the evidence must be clear, both as to the
fact of fraud and as to the bank's knowledge. It would certainly
not normally be sufficient that this rests upon the uncorroborated
statement of the customer, for irreparable damage can be done to
a bank's credit in the relatively brief time which must elapse
between the granting of such an injunction and an application by
the bank to have it discharged."

The evidentiary requirement was further elaborated in Tukan Timber Ltd.
v. Barclays Bank Plc where the court stated,

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38 Notes, "Buyer may Enjoin Payment of Seller's Drafts on Ground of Fraud", 42 Columbia Law
Review 149 (1942), Also see Philip W. Thayer, "Irrevocable Credits in International Commerce:
41 Ibid. at p.175.

151
"We would expect the court to require strong corroborative evidence of the allegation, usually in the form of contemporaneous documents, particularly those emanating from the seller. In general, for the evidence of fraud to be clear, we would also expect the seller to have been given an opportunity to answer the allegation and to have failed to provide any, or adequate answer in circumstances where one could properly be expected."

If the bank receives corroborative evidence of fraud which includes some contemporaneous documents emanating from the buyer and on enquiry seller fails to give satisfactory answer to the allegation, banker can refuse payment. Thus solid proof must be furnished to the bank in case of fraud. In Edward Owen Engineering Ltd. v. Barclays Bank International Ltd., the unanimous opinion of the court was,

"... it is certainly not enough to allege fraud: it must be established, and in such circumstances I should say very clearly established."

In this case, Lord Denning M. R. stated:

"That case shows that there is this 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 when there is no right to payment."

Hence it would appear that the major regard to the alleged fraud is one of proof. If the bank has real knowledge, it can reject the document and refuse payment.

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63 Id. at p.984 per Lord Denning M. R.
The Bank's Duty of Care

In most cases the bank would accept the forged or fraudulent tender before the true facts were discovered. Here bank is not liable so long as it has acted in good faith. However buyer will try to establish that in the initial stages of the transaction there had been a breach of a duty of care on the part of the bank. In order to succeed he must show that the bank had failed to give him the necessary guidance as regards the nature of the documents to be demanded in the letter of credit. The basic question that arises is whether the bank owes any such duty of care to its customer.

In *Midland Bank v. Seymour*,64 Devlin J., found on the facts that no request for information had been made and that the bank had not been negligent. His observation was that in any event the bank's duty was confined to its not supplying misleading information whether bank was under a duty to "prosecute enquiries with due diligence" is a doubtful aspect. The facts related to the shipment of rubbish materials instead of 'Hong Kong duck feathers' by the exporter which resulted into the refusal by the buyer to reimburse the bank against the fraudulent documents presented. Some information received by the issuing bank about the exporter was not conveyed to the buyer65. Apart from this, the issue of reasonable practice of accepting documents was also considered by the court. It was held that the banker is not under a duty to verify the authenticity or the legal nature of the document presented. In the second case, *Commercial Banking Co. of Sydney Ltd. v. Jalsard Pty Ltd.*,66 the plea that

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65 Ibid.
the bank had broken a duty of care was rejected by the Privy Council on the facts. It was established that the buyer had specifically instructed the bank to call for a certificate of inspection issued by a firm selected by him. Here it was a consignment of Christmas lights manufactured in Taiwan. When collected the buyer found that they were unusable although a “certificate of inspection” certified that the goods appeared to be in good condition. The buyer refused to reimburse the bank alleging that the bank should have advised him to stipulate for a certificate confirming that the goods had been subjected to an electrical test.

The above two cases discusses the question of duty of care. But the question involved is really a difficult one. The U.C.P. guidelines provide that banks have no liability to check the authenticity of credit. However if it elects to advice the customer it should take reasonable care to check the apparent authenticity of the credit. But the degree of care to be taken is not mentioned. E. P. Ellinger states that,

“It would appear unwarranted to impose on banks a general duty of care to advise their clients in respect of documentary credit transactions as the experienced importer will be familiar with such transactions. However when a new customer who is not familiar with such transaction comes the bank may owe a duty of care to him.”

If an allegation of fraud in relation to the commercial documents is involved, banks are expected to act in a reasonable manner. They must act to

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67 The U.C.P.600, Article 34.
prevent and detect possible fraud. They are not liable if the fraud cannot be detected even after the exercise of due diligence.\textsuperscript{69}

**Suspicious Circumstances**

Sometimes bank may suspect documents without instigation by the buyer. The question regarding banker's obligation in this situation was raised in *Maurice O'Meara Co case*\textsuperscript{70}. The question was whether the refusal of issuing bank to pay on a letter of credit on the basis of a reasonable doubt regarding the quality of goods was justified. It was held that a suspicion if not proved will not justify the refusal to pay. This should be distinguished from the situation of suspicion on documents. The suspicions regarding goods are part of the underlying contract. It is not the obligation of the bank to enquire into those issues and refuse to pay. If the banker is suspicious regarding the document presented, its obligation was not discussed. It is true that a suspicion cannot lead to a refusal to pay. But if it lead to proved fraud, banker should not be made liable for the refusal to pay.

**Effect of Customers Instruction**

If the customer informs the bank regarding fraud, whether the banker is under an obligation to reject the document or to make payment is a difficult question. It is argued that bank is bound by the instructions given to it, when the


bank enters into a contractual relationship with parties\textsuperscript{71}. However, the right to give instructions is limited to the agency agreement in which the buyer gave his instructions.\textsuperscript{72} Therefore buyer's right to give further instructions after opening of the letter of credit is restricted because a new instruction on a concluded contract will call for reconsideration of the earlier contract.

Nonetheless, the banker cannot deny taking into consideration the instruction given by the buyer regarding fraud. If clear evidence is given, bank should take it into consideration. The decision to reject or accept the document can be made by the bank alone. Thus if it ignores a clear evidence of fraud, the bank will be liable.

**Effect of Fraud on Discounted Deferred Letters of Credit**

Sometimes letters of credit provide for deferred payment. This enables the bank to pay on the maturity date stipulated in the credit. There are situations where the beneficiary approaches the confirming bank and request for discounting the deferred letters of credit. On the basis of the terms of credit it may undertake payment. If fraud committed comes to the knowledge of bank after discounting and making payment but before the maturity date, the question of risk allocation will arise. Is it the issuing bank who instructs the confirming bank which acts under the instruction or the confirming bank though acts in terms with instruction, but discounts according to its own discretion will become liable.


\textsuperscript{72} Todd, "Sellers and Documentary Credits", [1983] J.B.L. 468 at p.470
These questions were analysed by the court in *Banco Santander S.A. v. Bayfern Ltd.* In this case the letters of credit stipulated payment as deferred and expressed it to be paid 180 days from the bill of lading date. Meanwhile he presented the documents under the credit before confirming banker. The banker examined and found that the documents were conforming. They discounted the letter of credit and payment was made before the maturity date by following the standard operational procedure. But after a week it was discovered that some of the documents were false and the issuing bank refused reimbursement to the confirming bank. The moot question was which bank is liable to bear the risk. The court held that the confirming bank should bear this risk. Langley J., held that the obligation to reimburse a party which has incurred a deferred payment obligation arises only when that deferred payment obligation has been discharged at maturity. He put the matter as follows:

"The basic authority given by the issuing bank to the confirming bank in a deferred payment letter of credit is to pay at maturity. The consequent obligation to reimburse is to reimburse on payment being made at maturity. If at that time there is established fraud, there is no obligation on the confirming bank to pay or on the issuing bank to reimburse."

The U.C.P.600 fails to address the question of allocation of risk of fraud in relation to deferred payment adequately. Therefore the opinion of Langley J., is the guiding legal principle in this matter.

This decision is to be distinguished from the position under a negotiation credit. In situations of negotiation credit, courts have held that the issuing bank

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72 [1999] 2 All E.R. 18 (Comm.). This decision was upheld and endorsed by the Court of Appeal. [2000] 1 All E.R. 776 (C.A.)
74 *Id.,* at p. 31(a)
must bear the risk of fraud discovered after the date of payment of the
discounted value but prior to the maturity date. This is because discounting of
the negotiation credit was expressly authorized by the issuing bank on terms that
it would be liable at the maturity date for the undiscounted sum of the credit.
This position reflects the meaning of “negotiation” in the U.C.P.76

Fraud will affect the right of reimbursement of the confirming bank. It is
difficult for a confirming bank to protect itself against this type of fraud. But the
ruling is not harsh. It was the consequence of confirming banker acting itself to
make payment before it was bound to do so77. Thus as a matter of legal
reasoning the judge’s approach in this case is sound. It accords with logic and
with the well-established role of the fraud exception to the autonomy of credit.
The banks must deal carefully with the discounted deferred letter of credit
situation.

**Effect of International Convention**

The U.C.P. 600 does not address the issue of fraud. The problems
relating to fraud are left at the discretion of the municipal laws of the concerned
countries. This will generate problems as the municipal laws vary from country to
country. To overcome this problem to an extent generally international
communities refer the United Nations Convention of Independent Guarantees
and Standby Letters of Credit. However the meaning accorded to the term
‘fraud’ has taken different views. This provision is not exhaustive. It has taken an

76 The U.C.P. 600, Article 2.
77 Daniel Aharoni and Adam Johnson, “Fraud and Discounted Deferred Payment Documentary
impressive and encouraging way to define fraud as the kind of misconduct. The provision clarifies the misconduct that may bring the fraud rule into play. To a certain extend they provide good guidance for the courts to decide fraud cases. This position was accepted as 'clear and narrow' in scope and provide and excellent international standard with regard to fraud exception. However while this convention required "manifest and clear" evidence to invoke the fraud rule, it does not mention that the wrongdoer's intention should be proven. Reading the text of the convention it seems to emphasize more the nature of the misconduct rather than the fraudster's state of mind.

Similarly International Standby Practices expressly states that it does not provide for defenses based on fraud, abuse or similar matters. These issues are left to the discretion of municipal law.

**Fraud Exception: A Comparative Analysis**

A large number of letter of credit fraud cases have been decided by courts in the United States. It is perhaps the only country which contains a

78 Article 19, United Nations Convention on Independent Guarantees and Standby Letters of Credit reads: Any document is not genuine or has been falsified; no payment is due on the basis asserted in the demand and the supporting documents; or judging by the type and purpose of the undertaking, the demand has no conceivable basis. Article 19(2) further refined "no conceivable basis", as: The Contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized. The undertaking obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking; The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary; fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary.


80 Hereinafter referred to as I.S.P. 98. This governs international standby letters of credit. It is published by Institute of International Banking Law and Practice, Inc. in the United States.

81 See rule 1.05(c) of I.S.P. 98.
codified legislation in this regard. It contains a state of the art provisions with respect to fraud rule. Sztejn case laid down the basis of fraud rule in the U.S.A. It is codified in U.C.C. However neither the code nor its comments gave any hint as to what type of fraud gave the bank an option to pay. This resulted in formulation of a number of standard frauds. Some courts struck to a strict and restrictive approach and adopted an egregious standard of fraud. Other courts adopted a constructive standard of fraud. There is no certainty in fraud standard eventhough it is recognized statutorily. Later a task force was formed to study the previous case laws and make recommendations for the revision. The task force made several observations regarding the issue of fraud. Thus after extensive discussion and consultation of the recommendations a standard of fraud for letters of credit was set forth in the revised U.C.C. It adopted "material fraud" as the standard of fraud.

Fraud rule adopted in England is relatively rigid and narrow. It requires a high standard of proof. Accordingly it is very difficult to establish fraud. There have been only a limited number of cases in which the fraud rule is applied. R. D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd., is perhaps the

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82 Uniform Commercial Code is the legislation hereinafter referred to as U.C.C.
83 The U.C.C. Article 5.
84 Supra n. 19
85 Ibid. Also see the U.C.C. Article 5, s. 114(2).
87 The U.C.C., Article 5, section 109 reads: If a required document is forged or materially fraudulent, or honor of the presentation would felicitate a material fraud by the beneficiary on the issuer of applicant, the issuer, acting in good faith, may honor or dishonor the presentation .... if an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would felicitate a material of 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”.
88 The article does not define material fraud.
first decision which discusses the fraud rule. Though this case was not a case of established fraud, a restrictive view was taken to enable the circumstances in issuing bank to justify refusal to pay.

In the United Kingdom "material misrepresentation" is the standard of fraud in the law governing letters of credit\textsuperscript{90}. The English position is close to that of the United States\textsuperscript{91}. However courts in the U.S. will "look more on the severity of the effect of the fraud on the transaction rather than the state of fraud of the beneficiary, whilst courts in the U.K. will require proof of the state of the mind of the fraudster.

Canadian courts have generally focused on standard of proof rather than standard of fraud when considering the application of the fraud rule\textsuperscript{92}. They had considered whether the rule is confined to cases of forged or fraudulent documents or extend it to fraud in the underlying transaction\textsuperscript{93}. The issue is normally addressed in a very simple way. For instance, in \textit{CDN Research and Development Ltd. v. Bank of Nova Scotia}\textsuperscript{94}, the court said,

"It is my opinion; in this case, an injunction ought to be granted. In my view, it ought to be granted for at least two reasons. The first is that the plaintiff has made out a strong prima facie case that the demand made by the agent of the Ministry of War is fraudulent. Delivering has clearly been made and claim for a payment of delivery guarantee necessarily implying that delivery was not made is clearly untrue and false. Smith J. said that "[i]t may well be that the test of "clear fraud" is too high ...." and that

\begin{footnotesize}
\begin{itemize}
\item[90] See \textit{United City Merchants (Investments) Ltd. v. Royal Bank of Canada}, supra n. 45.
\item[91] "Material fraud" is the term used in U.C.C.also.
\end{itemize}
\end{footnotesize}
"[t]he test applied to be more apt and is less onerous than that of Lord Denning in Owen of clear or established fraud." \textsuperscript{\textsuperscript{5}}

Later in Henderson v. Canadian Imperial Bank of Commerce,\textsuperscript{\textsuperscript{6}} Berger J., expressly rejected Lord Diplock's conclusion that a bank must pay against apparently confirming documents where the bank knows that the seller has committed a breach of contract.

It can be said that the Canadian position on standard of fraud is somewhat confusing or contradictory. Fraud in Canada means something of "dishonesty or deceit or clearly untrue or false". Being a country of English tradition, the Canadian Courts traditionally follow the approach of their English counterparts. They adopted the standard of common law fraud. But the influence of the U.S. position in the area of letter of credit law can be seen in many cases\textsuperscript{7}.

In Australia, the fraud rule was considered only in a small number of cases. Intentional fraud and gross equitable fraud are the two kinds of standard of fraud there. However the idea that only gross equitable fraud may invoke the rule was rejected by Justice Batt of the Supreme Court of Victoria in Olex Focas Pty Ltd. v. Skoda Export Co.\textsuperscript{8} He stated:

"Now in Victoria, as in England, that law is clear. The principle is clearly established that payment by a bank and a demand therefore by a beneficiary under an unconditional performance

\textsuperscript{5} Ibid.
\textsuperscript{6} Supra n.58.
\textsuperscript{7} It is to be noted that fraud in Canada means something of "dishonesty or deceit or clearly untrue or false" similar to common law fraud requiring intention of the fraudulent party but on other hand, it means "utterly without justification" or "where it is apparent there is no right to payment" can also mean fraud which is similar to American position looking more to the sharpness of the fraudulent conduct. See Ibid.
bond or guarantee, as under a confined irrevocable letter of credit, will not be restrained except in a clear case of fraud of which the bank is clearly aware at the time of, probably the proposed payment, or in the case of forgery of documents (which is probably applicable only to letters of credit) or perhaps, in the case of illegality of the underlying contract. 99

The judge considered a number of English cases and said that only clear fraud could activate the fraud rule.

Therefore in Australia only "intentional fraud" has been applied. Gross equitable fraud, eventhough mentioned twice by the justice Batt was not applied in any case100.

Application of Fraud Rule in India

Documentary credit is usually honoured free from interference by courts in India101. But the courts recognise two exceptions to this principle. One is the fraud exception and the other is irretrievable injustice. Courts have observed that these principles need not be treated as sacrosanct or sacred. When there is any serious dispute and a good prima facie case of fraud or special equities causing irretrievable injustice courts can interfere102. Fraud and irretrievable injury are recognized as exceptions in India also by following English precedents. The

99 Id., at p.108.
observations made by Mukherji, J in U.P.Co-op Federation Ltd. case\textsuperscript{103}, throws light in this regard. He observed,

"...An irrevocable commitment either in the form of confirmed bank guarantee or irrevocable letter of credit cannot be interfered with except in case of fraud or in case of question of apprehension of irretrievable injustice has been made out. This is well- settled principle of the law in England. This is also a well settled principle of law in India...."

Therefore most of the fraud cases decided in India are in tune with English cases. The courts in India are not inclined to move away from the fraud rule. As a result they insist that fraud has to be an established fraud and not a mere allegation of fraud\textsuperscript{104}. Irretrievable injustice also must be genuine, established, immediate and irreversible\textsuperscript{105}. The declaration of law in this regard is made in Svenska Handelsbanken v. Indian Charge Chrome\textsuperscript{106}. It state,

"in a case of confirmed bank guarantee or irrevocable letter of credit it cannot be interfered with unless there is fraud and irretrievable injustice involved in the case and fraud has to be an established fraud. There should be prima facie case of fraud and special equities in the form of preventing irretrievable injustice between the parties. Mere irretrievable injustice without prima facie case of established fraud is of no consequence in restraining the encashment of bank guarantee. Only in the even of fraud or irretrievable injustice the court would be entitled to interfere in a transaction involving a bank guarantee and under no other circumstances".

Courts also try to adopt the meaning for "fraud" in documentary credit by referring to the definition of fraud in the Indian Contract Act, 1882\textsuperscript{107}. This can

\textsuperscript{103} (1988) 1 S.C.C.174.
\textsuperscript{104} Saw Pipes Ltd. v. Gas Authority of India, A.I.R.1999 Del. 30.
\textsuperscript{106} (1994) 1 S.C.C. 502
\textsuperscript{107} The Contract Act,1872, s.17 states, ‘Fraud’ means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract.
be seen in the decision of the Supreme Court in *State Trading Corporation of India Ltd v. Jainsons Clothing Corporation*\(^{108}\). However on analysis of the facts of this case, the court said that none of the conditions of fraud as set out in the definition under section 17 of the Contract Act are satisfied or applicable to the facts. But in another case\(^ {109} \) the court said,

> "Fraud as is well known vitiates every solemn act. Fraud and justice never dwell together. Fraud is a conduct either by letter or words, which induces the other person or authority to take a definite determinative stand as a response to the conduct of the former either by word or letter. It is also well settled that misrepresentation itself amounts to fraud. Indeed, innocent misrepresentation may also give reason to claim relief from fraud. A fraudulent misrepresentation is called deceit and consists in leading a man into damage by willfully or recklessly causing him to believe and act on falsehood. It is a fraud in law if a party makes representations which he knows to be false, and injury ensues there from although the motive from which the representations proceeded may not have been bad. An act of fraud on court is always viewed seriously. A collusion or conspiracy with a view to deprive the rights of others in relation to a property would render the transaction void *ab initio...."*

In *Ram Preeti Yadav v. U.P.Board of High Schools and Intermediate Education*\(^ {110} \), it was held that "fraud is a conduct either by letter or words, which induces the other person or authority to take a definite determinative stand as a response to the conduct of the former either by words or letter and that although negligence is not fraud, but it can be evidence on fraud". It was also held that once fraud is proved, it would deprive the person of all advantages or benefits

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(1) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
(2) the active concealment of a fact by one having knowledge or belief of the fact;
(3) a promise made without any intention of performing it;
(4) any other act fitted to deceive;
(5) any such act or omission as the law specially declares to be fraudulent".

\(^{108}\) (1994) 6 S.C.C.597
\(^{110}\) A.I.R. 2003 S.C. 4268
obtained thereby. This meaning of fraud was applied by the Gujarat high court\textsuperscript{111} in letter of credit case. In this case fraud was played by defendant by preponing date of lodging of goods to obtain benefit of early payment as per conditions of letters of credit. The goods of approved quality were not supplied within the specified time and those goods supplied were less than those contracted for. The Bombay High court\textsuperscript{112} considered the meaning of the word "fraud" while examining whether a strong prima case was made out.

According to courts fraud should be against the beneficiary and of an egregious nature. This is made clear in various cases. For example in \textit{U.P. Co operative Case}\textsuperscript{113} the Supreme Court said,

\begin{quote}
".... Since the bank pledges its own credit involving its reputation, it has no defence except in the case of fraud. The bank's obligations of course should not be extended to protect the unscrupulous seller, that is, the seller who is responsible for the fraud. But, the banker must be sure of his ground before declining to pay. The nature of the fraud that the courts talk about is fraud of an "egregious nature as to vitiate the entire underlying transaction". It is fraud of the beneficiary, not the fraud of somebody else."
\end{quote}

Thus a fraud must be established beyond reasonable doubt\textsuperscript{115}. A finding as to fraud cannot be based on suspicions and conjunctures\textsuperscript{116}. Similarly mere non supply of goods will not result in fraud\textsuperscript{117}.

\textsuperscript{111} Adani Exports Ltd v. Marketing Service Incorporated, A.I.R.2005 Guj. 257.
\textsuperscript{113} Supra n.3. See also Association of Corporation and Apex Societies of Handlooms v. State of Bihar, A.I.R. 2000 Del.106.
\textsuperscript{114} Id.,197.
\textsuperscript{115} J.V.N.Tubes Ltd v. Steel Authority of India Ltd, A.I.R. 1996 M. P. 53
The fraud rule is applied in bank guarantee also. In *Svenska case*¹¹⁸, ICCL issued a global tender for setting up a captive power plant. The tender indicated that credit by the suppliers will be preferred. The suppliers submitted their tenders in this regard. The supplier approached a foreign lender to finance the project. Contracts were entered into between the borrower and the supplier. The foreign lender entered into credit agreements with the borrower. The liability of the borrower to effect payment under the agreement was secured by a demand guarantee. The take-over certificate was issued. Later the borrower filed a suit for a decree of perpetual injunction restraining the bank from making payment. The case of the borrower was that the foreign lender had made fraudulent representations to persuade him to enter into contract. The suppliers were not competent enough to manufacture the plant. The borrower decided to go ahead with the contract relying on the representation and advice given by the defendants. He argued that the agreements between the supplier and the borrower and that of the borrower and the tender were interconnected and constituted one transaction and were vitiated by fraud. Repelling the contention, the Supreme Court took the view that allegation of fraud was made on suspicion could not be accepted.

In *Dwarikesh Sugar Industries Ltd., v. Prem Heavy Engineering Works (P) Ltd.*¹¹⁹, the Supreme Court reiterated the principle that if fraud is involved which would vitiate the very foundation of the bank guarantee and the beneficiary can be restrained from encashing it. But the fraud has to be an established fraud. The principle of unjust enrichment is not applicable to encashment of bank

¹¹⁸ Supra n.106
guarantee. Encashment of guarantee can be restrained only in circumstances where it will result in irreparable harm or injustice to one of the parties concerned. The resulting of irretrievable injury should be decisively established. It must be proved to the satisfaction of the court that there would be possibility whatsoever of the recovery of the amount from the beneficiary by way of restitution.

In Arul Murugan Traders v. Rashtriya Chemicals and Fertilisers\textsuperscript{19}, the plaintiff was a dealer for the sale and distribution of products manufactured by the defendant. The plaintiff furnished a bank guarantee to assure prompt payment of invoices. Clandestine undertaking was adopted by the defendant and the plaintiff refused to pay. The defendant invoked the guarantee. Plaintiff brought to the notice of the court many discrepancies in the invoices supplied by the defendant. Some of the delivery challans were forged. The Madras High Court granted injunction interdicting the enforcement of the guarantee.

In Dai-ichi Karkaria Pvt Ltd v. Oil & Natural Gas Commission\textsuperscript{20}, plaintiff was supplying goods to the defendant. Customs duty was payable on the raw materials imported by the plaintiff which was required to be used for the manufacture of goods. The defendant agreed to make payment of certain amount to the plaintiff provided the plaintiff would undertake to repay the said amount on receipt of refund of the customs duty. The plaintiff furnished a demand guarantee to secure the amount. The terms of the bargain were renegotiated to the complete prejudice of the plaintiff. The plaintiff agreed to

\textsuperscript{19} A.I.R. 1986 Mad. 161
\textsuperscript{20} A.I.R. 1992 Bom. 309
incorporate under duress, the stipulation in the guarantee to provide the liability of the bank to pay even if refund of customs duty was not received by the plaintiff. Extensions of the bank guarantee were also given by the plaintiff out of fear. The defendant invoked the guarantee. The plaintiff field a suit for a declaration that the demand was fraudulent. The court found that the plaintiff had made out a prime facie case establishing economic duress, fraud and coercion and granted injunction. Dispute relating to breach of contract or pending arbitration would not amount to an exceptional case justifying interference by courts.

It can be seen that courts generally permit dishonor of letter of credit only on the fraud of the beneficiary. This principle is a reflection of the American approach. A circular was issued by the Reserve Bank of India in this regard. Thus in Arul Murugan case an irrevocable letter of credit was issued by the UCO Bank. The documents sent to it by the paying bank were confirmed by it. As a result, the Bank of Rajasthan who was acting as the paying bank paid the amount to the beneficiary and claimed reimbursement from the UCO Bank. The UCO bank refused to pay on the ground of fraud by some officers of the Rajasthan Bank. The court refused to accept the contention of fraud or conspiracy. The court further stated that as per the Reserve Bank circular, even if there is some allegation of fraud the liability of UCO bank to reimburse the

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122 Supra n.101. Also see Jindal Stainless Ltd v. ICICI Banking Corporation Ltd., A.I.R.2005 Del. 53
125 Circular dated 15th April 1992 issued by the Reserve Bank of India.
126 Supra n.120. See also Federal Bank Ltd v. V.M.Jog Engineering Ltd., (2001) I S.C.C. 663.
paying bank cannot be denied. The salient portion of the Reserve Bank Circular is as under:

"... that banks should honour their commitments/letters of credit and make payments promptly leaving the opportunity for any complaints in this regard”.

In Synthetic Foams Ltd v. Simplex Concrete Piles (India) Pvt Ltd., the Delhi High Court said stated that misrepresentation, suppression of material facts and violation of the terms of the guarantee could be regarded as species of as fraud which would disentitle a beneficiary to enforce the bank guarantee.

However in most of the cases the courts had refused to accept the existence of fraud on the ground that prima facie case of fraud or irretrievable injustice was not made out. But there are cases where fraud exception was allowed. In Banerjee & Banerjee v. Hindustan Steel Works Construction Ltd., the court said,

"Even if in the petition there is no allegation of fraud, if there is a willful false representation by the beneficiary that the entire guaranteed amount has become due and payable by suppressing the facts of recoveries already made, it is a factor which must be treated on the same footing as 'fraud' giving rise to special equity and must be treated as an exception to the general rule that the court should not interfere in these matters”.

129 A.I.R.1986 Cal. 374. The facts are not relevant for the discussion here.
Similarly in *Rigoss Exports International (P) Ltd. v. Tartan Infomark Ltd.*\(^{130}\), injunction against encashment of guarantee was granted. In this case petitioner was doing exporting business through an agency. All the letters of credit transactions were induced by the agency. There was fraud and a document relating to shipment procured by the agent was found to be forged. In *D.S.Constructions Ltd v. Rites Ltd*\(^{31}\), also the fraud rule was applied. Here the defendant was invoking bank guarantee despite the knowledge that he had no right to this amount as the plaintiffs offer had lapsed.

The courts are not inclined to add additional grounds to the fraud exception. This can been seen in *BSES Ltd v. Fenner India Ltd*\(^{32}\). The court in this case declined to accept the averment that "lack of goodfaith" or "enforcing with an oblique purpose" constitutes further exceptions to the general rule of fraud application.

Thus it can be seen that the court would examine each case in order to find out whether the case falls within any of the classes relating to fraud rule. It can be seen that major hurdle faced in India is regarding the difficulty to produce solid proof of fraud and the rigid approach of courts.

**Remedies and Claims in Fraud Situations**

The fraud exception gives rise to a difficult situation. On the one hand the beneficiary is affected if he is denied payment on the basis of fraud which may

\(^{130}\) A.I.R.2002 Del. 235.


\(^{32}\) A.I.R.2006 S.C.1148
ultimately prove to be false. On the other hand if the bank pays the buyer is left with no remedies

Remedies of Beneficiary

The essence of fraud is that the person perpetrating it is conscious that he is acting wrongfully. Obviously there would be fraud if a beneficiary knowingly present forged document under a credit. But in the case of forgery, the law is less concerned with the beneficiary's state of mind. Therefore if the banker rejects documents where beneficiary is not a party, banker will be liable to compensate the beneficiary. Thus in *Urquhart, Lindsay & Co. Ltd. v. Eastern Bank Ltd.* it was held that the beneficiary can recover general damages from bank if the issuing or confirming bank refuses to accept or purchase drafts from the beneficiary under a letter of credit without lawful excuse. However these damages will usually be the difference between the amount payable under credit and the lower market value of the goods covered by the credit.

The beneficiary cannot recover from the bank additional special damages which could be claimed from the other party to the underlying contract. This is because of the special knowledge of the circumstances known to the beneficiary only. Apart from this as an alternative to suing the issuing or confirming bank for damages the beneficiary may sue the bank for the actual amount of the credit on the basis of shipping documents.

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133 Supra n.45.
134 [1922] 1 K. B. 318
Buyer's Claim

Buyer is the ultimate party to suffer if the fraud occurs. Though the buyer can enjoin payment of the seller on the ground of fraud the burden of proof is high\footnote{Notes, "Letters of Credit - Buyer may Enjoin Payment of Sellers Drafts on Ground of Fraud", 42 Col. L. Rev.149 (1942).}. It is highly desirable that the buyer be protected against fraud of the seller. But to pressure the acceptability letter of credit, the grant of a remedy to the buyer should be limited. Only on reasonable ground, payment under the letter of credit is delayed.

It is believed that injunctive relief appears to be the most adaptable remedy which provides adequate protection for the buyer without placing undue hardship upon the issuing bank\footnote{See, Agasha Mugasha, "Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee," [2004] J.B.L. 515}.\footnote{Notes, "Electronic Letters of Credit", Banking World 80 (1985).}

Fraud: Effect of Electronic Transaction

In documentary credit transaction paper based documents are used. Now electronic letters of credit are used where the parties can open letter of credit from terminals of their desktops directly to their bank's branch on the other side.\footnote{Susan Barkehall Thomas, "Electronic Funds Transfer and Fiduciary Fraud", [2005] J.B.L. 48}. There is ample scope for fraudulent activity as the transactions are conducted through online\footnote{Susan Barkehall Thomas, "Electronic Funds Transfer and Fiduciary Fraud", [2005] J.B.L. 48}. Several attempts have already been made to create a new legal framework for the use of electronic transport documents. The attempts to create electronic transport documents are aimed at developing methods for claiming transferability of right and liabilities electronically with the
objective of creating electronic documents which will be able to perform all functions of paper documents.\textsuperscript{141}

This shows that electronic documentary fraud will evolve as there is difficulty to prove the legal authenticity of the electronic documents presented. It is said that the use of digital signatures can prevent a fraudster from impersonating either a carrier or legitimate trader, or tampering with the contents of an electronic document.\textsuperscript{142} But it is doubtful how far they will alleviate fraud possibilities at payment and at delivery. Though eU.C.P. makes provision for the electronic transmission of documents tendered it is silent regarding the fraud aspect. The eU.C.P. validate the electronically transmitted documents as regards their tender under the documentary credit. They do not combat the commercial risks involved. They protect the bank and effectively pass the risk of fraud to the applicant\textsuperscript{143}.

\textbf{Need For Arbitral Alternatives}

The standards by which courts adjudge a seller’s fraud as sufficient to enjoin payment have been discussed. The courts have preferred injunctive relief when the seller’s fraud has “vitiated the transaction”,\textsuperscript{144} or is “intentional”\textsuperscript{145} or

\textsuperscript{142} Paul Todd, \textit{Maritime Fraud}, LLP, London (2003), at p.144
\textsuperscript{143} See the eU.C.P. Article 12.
"egregious", or where there is "no conceivable basis" for the demand. The concepts are developed through court verdicts in different situations of fraud. However these injunction requests have generated extensive litigation. This injunctive relief will be appropriate only where the court has jurisdiction and there is irreparable injury. In these situations arbitration settlement will be a helpful device to solve these types of cases. International Commercial Arbitration has become the primary method for dispute resolution of transnational contract. There are no legal or contractual barriers to the increased use of international commercial arbitration in letters of credit disputes. However James Byrne is of the opinion that the arbitration measures are not really been successful with respect to letters of credit disputes. It may be one of the reasons for increasing the court litigation than arbitral awards.

**Modern Trends in Fraud Exception: A Critical Evaluation**

The fraud rule is the most controversial and confused area in the law governing documentary credits. Fraud exception to the principle of autonomy arises in the case of established fraud. Except in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration. Courts are not concerned with the enforcement of such claims. It is believed that these must be free from

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147 This test is proposed in Article 19 of UNCITRAL'S Convention on Independent Guarantees and Standby Credits.

148 Supra n.94.


150 Mark S. Blodgett and Donald O'Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud", 35 Am. Bus. L. J. 443

151 Ibid. at p.446
interference by the courts. The judicial decisions of the past have indicated a move away from the courts reluctance to grant injunctions restraining payment under letters of credit in the face of allegation of fraud\textsuperscript{152}. Now courts are signalling a move bank towards the classical position\textsuperscript{153}.

There is sensitivity towards the letters of credit instrument. If fraud is defined too narrowly it will encourage the growth of fraudulent conduct by the beneficiary. Similarly its liberal interpretation will erode the principal of autonomy and affect the use of letters of credit in trade.

Various tests are discussed by courts in different countries in order to arrive at fraud situation. It is always difficult to lay down the standard of fraud\textsuperscript{154}. The U.C.P. remains silent regarding fraud situations and the banker faces difficulties in arriving at a decision.

There were only very few cases which established fraud as an exception to autonomy principle. Courts were reluctant to interfere with autonomy principles. Slowly there is a trend to increase the grounds of exception. Some commentators say that this trend is inevitable because it would afford parties involved in documentary transactions some protection against sharp practices.\textsuperscript{155} But each of the newer grounds is uncertain.

\textsuperscript{154} For discussion see Ibid. See also, Notes, “Letters of Credit”, [2000] J.B.L. 623.
\textsuperscript{155} Supra n.16.
As the question of fraud exception remains the matter to be decided by municipal laws there is uncertainty and inconsistency. The U.C.P. does not deny the existence of fraud in the transaction. The American legislation provides measure to tackle fraud situations. So also the UNCITRAL convention contains provisions to deal with fraud situations. It is suggested that a combination of both these provisions may provide the limits of the fraud exception.

Apart from this there is a need to reform the law in this area to meet the technological documentary fraud which may be crept in. The existing provisions in municipal laws are inadequate. The U.C.P. also needs a revision to include provisions on fraud exception and the principle of autonomy. It may be argued that the fraud exception should be seen as an attempt to restore the balance of equities between the buyer and the seller.

Protection given to buyer on the ground of fraud may sometimes result in increase in litigations. Buyer may approach courts on mere suspicion. If unnecessary delay occurs, the beneficiary will suffer loss. Hence adopting a balanced view is necessary.

\[^{156}\text{See the U.C.C., Article 5. S.109.}\]
\[^{157}\text{See the UNCITRAL, Article 19.}\]