Piercing the Autonomy in Payment Undertakings: Fraud and Others?

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This article reviews and challenges the position taken in the current English law in documentary payment undertakings that autonomy stands as a cardinal rule and fraud as the only exception. While admitting that the autonomy principle which secures a smooth, speedy and dependable documentary payment remains the backbone of the international financing system, it submits that it would adversely affect the integrity of law in a broader sense if such justifiable grounds of exception as illegality, nullity and unconscionability are entirely disregarded. It is necessarily beneficial to the international trade and the instrumental payment system as a whole if a principled and incremental approach would be adopted by courts when weighing the strength of justification for each individual new ground, rather than shutting a blind eye to their potential merits.

Keywords: documentary payment undertakings, fraud, illegality, nullity, unconscionability

INTRODUCTION

It is the current English law in documentary payment undertakings, as represented in *Edward Owen Engineering Ltd v. Barclay's Bank International Ltd* [1978] QB 159, that autonomy stands as a cardinal rule and fraud as the only exception. However, it remains debatable whether fraud should be the only exception and to what extent new grounds, such as illegality, nullity and unconscionability, should be allowed to pierce the autonomy.

It is submitted in this paper that it is in the interest of commercial efficiency for the courts to adopt a principled and incremental approach in adopting new grounds of exception to autonomy by weighing their strength of justification, rather than to show a firm reluctance to allow room for recognition when the trend of their gradual expansion is inevitable, as witnessed in the judicial practice among different jurisdictions.

This paper is divided into three parts: First, the autonomous nature of documentary payment undertakings as stated in the relevant international rules and the English case law is discussed. Secondly, it examines the fraud exception and its high threshold for proving fraud in the English law. Thirdly, some judicial practice which endeavor to extend the narrow boundary of the fraud exception would be explored, with an aim to evaluate whether it is necessarily beneficial to documentary payment undertakings when new grounds are gradually recognized alongside with the fraud exception.

THE *RAISON D'ÊTRE* OF BANKS' UNDERTAKING: IRREVOCABILITY AND AUTONOMY

An Assured Right to Be Paid

The whole purpose to bring banks and their credit in is to bridge the 'distrust divide' in the international trade. By issuing a credit or a demand guarantee, the bank creates an assured right to be paid to the beneficiary, before the seller parts with control of the goods in the case of letters of credit, and before the buyer proves any breach by the seller in the case of demand guarantees. They are autonomous in nature and are separate from and independent of the underlying contract. The right and duty of banks to make payment under the documentary payment undertakings do not at any rate depend on performance of beneficiaries under the underlying contract.

The fundamental rules of irrevocability and autonomy are stipulated in both the Uniform Customs and Practice for Documentary Credits 2007 (UCP 600) and the Uniform Rules for Demand Guarantees 2010 (URDG 758). UCP 600 art 4(a) provides that 'a credit by its nature is a separate transaction from the sale' and is 'not subject to claims or defenses by the applicant'. URDG 758 art 5 contains similar words for a demand guarantee. The irrevocable undertaking to pay and its independence of the sale determine that banks deal with documents and not with goods, services or performance of the contract, as prescribed in UCP 600 art 5 for a letter of credit and URDG 758 art 6 for a demand guarantee. Moreover, UCP 600 art 34 expressly excludes banks' liability for 'the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document'.

It is such assurance from banks that injects life into the commercial utility. As described by Kerr J. in *RD Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd* [1978] QB 146, the irrevocable obligations assumed by banks are 'the life-blood of international commerce', and 'trust in international commerce could be irreparably damaged' (p. 155) if they are not allowed to be honored. That system of financing these operations, as Jenkins L.J. observed in *Hamzeh Malas & Sons v. British Imex Industries Ltd* [1958] 2 KB 127, 'would break down completely' (p. 129) if the dispute arising from the underlying contract has the effect of freezing the sum promised to be paid. Lord Denning chose to regard these demand guarantees as virtually promissory notes payable on demand. In *Edward Owen Engineering Ltd*, his lordship summarized the general position: 'A bank which gives a performance guarantee must honor that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice' (pp. 170-1). Messages from the English courts reinforce that irrevocability and autonomy are the *raison d'être* of banks' undertaking.

A 'Bargained-for Risk Redistribution Device'

It follows that the risks on the underlying contract have been redistributed: the risk of non-payment has been reversed from the seller to the buyer by a letter of credit, and the risk of non-performance from the buyer to the seller by a demand guarantee. The 'pay first, sue later' situation, as pointed out by Professor Benjamin, strengthens the beneficiary's negotiating position in the subsequent claim on the underlying contract when it possesses the funds paid by the bank, and they are regarded as a 'bargained-for risk redistribution device' (2018, paras. 23-076, 24-002). The courts have shown marked reluctance to interfere with such freely assumed commercial risk in a normal arm's length commercial transaction.

Compared with letters of credit, demand guarantees are more vulnerable to abusive calling since they are 'virtually promissory notes payable on demand' (*Edward Owen Engineering Ltd*, p.170). Though the URDG 758 purports to provide a fetter or disincentive on abusive calling of the guarantee in art 15(a) and 15(b) requiring a statement of the seller's breach and its nature to be presented with the guarantee, its effect could be eroded by the high threshold of proving subjective dishonesty of the beneficiary when making the demand, let alone the exclusion allowed by URDG 758 art 15(c). As confessed by Kerr J. in the *Harbottle* case, the vulnerability to abusive calling in demand guarantees results 'as though they represented a

discount in favor of the buyers' (p. 150). The fraud exception, therefore, is devised to strengthen the immunity from such abusive calling.

A TIGHTLY DEFINED FRAUD EXCEPTION BASED ON THE *EXTURPI CAUSA* PRINCIPLE

It is a matter of general principle and public policy that the courts shall not allow fraud-afflicted claims. It is the *exturpi causa* principle, i.e., fraud unravels all, that provides the rock foundation to the fraud exception. However, it is in the vital interest of preserving the value of certainty in commercial transactions to define the boundary of the fraud exception. Both UCP and URDG are silent about the fraud exception, and proper recourse could only be made to the national law. It is widely recognized that the English approach is extremely strict.

A Delineation Between Innocent and Non-Innocent Beneficiaries

An enshrined formulation of fraud exception is provided by Lord Diplock in *United City Merchants (Investments) Ltd v. Royal Bank of Canada*, *The American Accord* [1983] 1 AC 168, which declared that 'there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue' (p. 183). Two elements define the success of a fraud claim: clear evidence of subjective dishonesty of the beneficiary and the bank's knowledge of it. An honest but mistaken belief would not suffice. Nor will a fraud which belongs to a third party, such as carriers.

Such a delineation between innocent and non-innocent beneficiaries has been criticized to be 'problematic' in that 'fraud is fraud, regardless of who the perpetrator is' (Donnelly, 2008, p. 323). It might undermine the documentary integrity if a beneficiary who is ignorant of a third party's fraud is still entitled to payment even though such fraud renders the relevant document worthless. Professor Goode comments that such a formulation was 'seriously flawed' and 'untenable' (Goode, 2016, p. 1062-3).

A High Threshold of Proving Fraud

The fraud must be very clearly established. In *Edward Owen Engineering*, Lord Denning MR confessed that 'the banks will rarely, if ever, be in a position to know whether the demand is honest or not', and 'at any rate they will not be able to prove it to be dishonest' (p. 170). Only cases of truly compelling evidence of fraud would suffice. Banks by no means stand in an investigation position to detect suspicions or to make inquiries.

The threshold for the applicant in proceedings for an interim injunction based on fraud is a high one. As Ackner L.J. formulated in *United Trading Corp SA v. Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, it must be established that 'it is seriously arguable that, on the material available, the only realistic inference is that the defendant could not honestly have believed in the validity of its demands on the performance bonds' (p. 561). A test involving a three-stage enquiry has been laid down by the House of Lords in *American Cyanamid Co v. Ethicon Ltd* [1975] AC 396, namely: (1) the evidence of the merits, (2) the adequacy of damages as an alternative remedy and, (3) the overall balance of convenience. It has been noted by the Privy Council in *Alternative Power Solution Ltd v. Central Electricity Board* [2015] 1 WLR 697 that the result of the balance of convenience 'will almost always militate against the grant of an injunction' (para. [79]).

The combined effect of difficulties brought by the substantial and procedural requirements as to establish fraud and to justify an interim injunction is that 'a successful plea of fraud appears to be illusory' (Chong, 1990, p. 416) Fraud, as observed by Professor Goode, is 'the one least likely to succeed' (2016, p. 1057) among all the defenses to payment. The irresistible necessity arising from the general *exturpi causa* principle and the almost unconquerable castle of proving fraud generate a collective appeal to the adoption of an expanded view of the orthodox fraud exception.

A TREND MOVING FROM STRICT APPROACH TOWARDS ENFORCING BROAD STANDARDS?

The tightly bound fraud exception in the English law has felt the pressure of the force of extension by judicial practice at home and abroad. No matter how arguable the development would be, it has been observed a trend moving 'towards enforcing broad standards of conduct which appeal to public perceptions of fairness and justice' (Mugasha, 2004, 516). Across the spectrum of strength of justification, there lies illegality or violation of public policy on the strong end, unconscionability on the other end, and nullity in the center involving heavy debates.

Illegality or Violation of Public Policy: A Strongly Justified Breakthrough?

It seems a natural and irresistible inference from the *exturpi causa* principle that if fraud unravels all, illegality or violation of public policy does the same. The first sign of recognition of illegality in the underlying transaction is noticed in *Group Jose Re v. Walbrook Insurance Co Ltd* [1996] 1 WLR 1152, where Staughton L.J. admitted that there must be cases when illegality can affect a letter of credit, and illegality would be a defence if it is clearly proved. His position obtained positive echo from Colman J. in *Mahonia Ltd v. JP Morgan Chase Bank* [2003] EWHC 1927 where he considered it wrong to follow 'a rigid inflexibility in the face of strong countervailing public policy considerations' (para. [68]). In his view, if a beneficiary should not be allowed to profit from his own fraud, 'it is hard to see why he should be permitted to use the courts to enforce part of an underlying transaction which would have been unenforceable on grounds of its illegality' (para. [68]).

Even not to be regarded as an independent exception, illegality could at least be seen as a broadened fraud exception in the sense that a fraud could be perpetrated against the public as a whole rather than merely against the bank as a party to the credit (Enron, 2004). It seems a preferable development to enable illegality to be a valid ground within or without the collective label of fraud exception, which could hardly be seen as a threat to the lifeblood of international commerce. Otherwise, banks' payment undertaking might be abused to provide financial aid to illegal transactions.

Nullity: A Service or Disservice to Documentary Integrity?

Under the tightly laid boundary of the fraud exception in the English law, nullity of an apparently complying document will not defeat the beneficiary's claim for payment if its dishonesty is not clearly proved. In *Montrod Ltd v. Grundkötter Fleischvertriebs GmbH* [2002] 1 All ER 257, where a forged signature rendered an inspection certificate null and void, Porter L.J. refused to extend the law by creating a general nullity exception based on 'sound policy reasons' (para. [58]). A nullity exception, in Porter L.J.'s view, is 'susceptible of precision, involves making undesirable inroads into the principles of autonomy and negotiability', and 'would thus undermine the system of financing international trade by means of documentary credits' (para. [58]). Though the *Montrod* decision has undergone strong criticism (Hooley, 2002; Todd, 2008), it stands the current English law representing an unleaking boundary to the fraud exception.

In contrast with the English position, the Singapore Court of Appeal in *Beam Technology (MFG) Pte Ltd v. Standard Chartered Bank* [2003] 1 SLR 597 held that the bank was entitled to refuse to pay if 'a material document required under the credit is forged and null and void and notice of it is given within that period' (p. 610) However, the court confessed that 'it is not possible to define when is a document a nullity' (pp. 610-1) and choose to resort to the standard of reasonableness.

The academic responses to these two approaches are heavily divided. Those who advocate the Singapore approach believe that it is a 'distortion of the autonomy principle' if the beneficiary is allowed to collect payment by tendering 'worthless pieces of paper' (Goode, 2016, p. 1063) as long as he acts *bona fide*, and recognition of a nullity exception is necessary 'for maintaining the integrity of the law as a whole' (Donnelly, 2008, p. 342) when the trust and sanctity of financing international trade via payment instruments could be maintained. Those who choose to safeguard the English approach endeavor to remind that the law governing documentary undertakings is rule-oriented and commercial policy and efficiency

considerations that demand prompt honor of instruments are of paramount importance (Mugasha, 2004, p. 537). Further, it is observed that even the Singapore cases have not offered any definition of nullity that is reasonably sensible and workable, the lack of which is considered 'fatal to the proposition that there should be a nullity exception' (Ren, 2015, p. 19).

On the balance of the above stated arguments, it seems better for the courts to adopt a principled and incremental approach which, on the one hand, does not open the wide door to an undefining nullity exception; on the other hand, does not shut the window to ad hoc situations which deserve strong policy considerations.

Unconscionability: 'Too Interventionist for English Tastes'?

Unconscionable demand as a defense to autonomy has not been embraced by the English courts. An obvious reason is that the notion of unconscionability is too wide and discretional to be a workable or measurable concept in the context of documentary payment which requires a high degree of certainty, efficiency, and predictability. Though some recent English cases, such as *TTI Team Telecom International Ltd v. Hutchison 3G UK Ltd* [2003] 1 All ER 914 and *Simon Carves Ltd v. Ensus UK Ltd* [2011] EWHC 657, hint (in *dicta*) that the previous reluctance to apply a concept of unconscionability may not last forever, it is commented to be 'too interventionist for English tastes' (Goode, 2016, p. 1065).

Nonetheless, the unconscionability jurisdiction has gained judicial support in both Singapore and Australia. In *Dauphin Offshore Engineering v. Sultan* [2000] 1 SLR 657, the Singapore Court of Appeal described the notion of unconscionability as unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. The court sees no reason why it should be so sacrosanct and inviolate as not to be subject to the court's intervention except on the ground of fraud. The approach has been confirmed by the same court in *BS Mount Sophia Pte Ltd v. Join-Aim Pte Ltd* [2012] 3 SLR 352 where the test in a nuanced fashion has been emphasized. Similarly, an Australian court in *Olex Focas Pty Ltd v. Skodaexport Co Ltd* (1996) 134 FLR 331 considered unconscionability in a statutory context and injected such requirements as reasonable behavior in accordance with ordinary human standards and that reasonable expectations of others should not be defeated when one exercises his strict legal rights.

The elaborations provided by the Singaporean and Australian courts could not have alleviated the worry of its overuse and the courts' accompanying discretionary power. It has been criticized that when the courts is prepared to examine the issue of unconscionability, they have to dive into the underlying transaction details which shall be kept outside the realm of autonomy of letters of credit or demand guarantees (Mugasha, 2004, p. 520). The resultant eroding effect is believed to be more a disservice than a service to the business efficiency and certainty.

CONCLUSION

The autonomy principle which secures a smooth, speedy and dependable documentary payment remains the backbone of the international financing system. To uphold its efficiency as far as can be, the fraud exception has been tightly defined in the English law and a high threshold is adopted. However, it would adversely affect the integrity of law in a broader sense if such justifiable grounds of exception as illegality, nullity and unconscionability are entirely disregarded. It is necessarily beneficial to the international trade and the instrumental payment system as a whole if a principled and incremental approach would be adopted by courts when weighing the strength of justification for each individual new ground, rather than shutting a blind eye to their potential merits.

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