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Fraud in the Letter of Credit Transaction and its Possible Arbitration

by

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Abstract

The letter of credit continues to play an indispensable role in the financing and securing of international commercial transactions. Its usefulness and efficacy derives primarily from the fact that it is independent from the underlying relationship between buyer and seller. In a considerable number of cases, however, the independence of the letter of credit has been challenged as a result of fraud in the underlying transaction. After analyzing recent reforms of the regulatory framework governing letters of credit, this fraud exception to the independence principle will be reappraised in the light of current developments in Canada and the United States. Finally, the author argues that arbitration can and indeed should play an increasingly important role in the resolution of international letter of credit disputes involving fraud in the transaction.

Résumé

La lettre de crédit joue toujours un rôle indispensable dans le financement et dans la garantie de paiement des transactions commerciales internationales. Son utilité et son efficacité s'expliquent par le fait qu'elle tient son indépendance juridique du contrat sous-jacent entre l'acheteur et le vendeur. Cependant, des doutes ont été soulevés quant à l'indépendance de la lettre de crédit dans de nombreux cas à cause d'une fraude commise dans le contrat sous-jacent. Après avoir analysé les réformes récentes apportées aux régimes réglementaires s'appliquant aux lettres de crédits, l'exception de la fraude au principe d'indépendance sera évaluée de nouveau à la lumière des développements récents au Canada et aux États-Unis. Finalement, l'auteur soutient que l'arbitrage pourrait et, en fait, devrait jouer un rôle de plus en plus significatif dans la résolution des différends impliquant, des lettres de crédit ,ainsi que la fraude dans le contrat sous-jacent.

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United Nations homepage: <http://www.un.org/Depts/Treaty/final/ts2/newfiles/part_boo/x_boo/x_15_1.html> (date accessed: 14 October 1999).

Interviews

Interview: Held with Pierre B. D'Avignon, Assistant General Manager International Trade, Scotiabank Montreal, and Ghassan Azar, Assistant General Manager Import, Scotiabank Montreal, October 12, 1999.

PART I – GENERAL FOCUS OF THIS THESIS

Chapter 1: Introduction

The parties to an international sales contract encounter commercial idiosyncrasies not commonly seen in a domestic transaction. Often they do not know each other very well and, in contrast to many domestic transactions, it is practically impossible for delivery of the goods or services and payment to occur simultaneously. In addition, an international sale involves cultural, political and legal uncertainties that may render the realization of the contract problematic. Thus, reasonable businessmen seek to protect themselves against these pitfalls of international engagements. In other words, risk, and particularly the risk of non-performance or non-payment by the other contractant, is becoming a factor of increasing significance and concern in international trade.[1]

The device to which the business world has traditionally turned in order to overcome these risks is the letter of credit. Because it serves as both a method of payment as well as security for the goods or services sold, the letter of credit takes each parties' interests into account and thus considerably facilitates complex international transactions.

Despite doubts as to its usefulness in times of progressive development of multi-branch and multi-national banks, the letter of credit continues to play a major role in mercantile practice. This is evidenced by the rapid and unprecedented expansion in the volume of letter of credit transactions in recent years. Since 1970, a two-fold ncrease in the use of letters of credit has been observed, and it is estimated that each year transfers exceeding

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[1] See R.I. Bertrams, *Bank Guarantees in International Trade*, 2nd ed. (The Hague: Kluwer Law International, 1996) at 1 [hereinafter Bertrams, *Bank Guarantees*]; P.R. Clarkson, "Export Development Corporation and Letters of Credit" (1988) 7 Nat'l Banking L. Rev. 224 at 226 [hereinafter Clarkson, "Export Development"].

$ 500 billion U.S. are carried out by letter of credits.[2] Consequently, the letter of credit has been termed the "quintessential international instrument"[3] or the "life-blood"[4] of international business.

As letters of credit have been increasingly used, it is not surprising that this relatively uncontroversial area of commercial law has become the stage for a notable number of disputes.[5] Probably the most frequent matter in dispute is the issue of fraud in the transaction, which may manifest itself in varying permutations. Litigation involving both the parties to the sales contract as well as the issuers of letters of credit has been the usual method of resolving these conflicts. In the past fifty years, a substantial number of cases pertaining to this question have been litigated in Canadian and American courts, which culminated in the Iranian Letter of Credit Cases in the early 1980s.[6] Since then, as

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[2] Prefatory Note to U.C.C. Revised Article 5, Letters of Credit 1 (1995) [hereinafter Prefatory Note]. The outstanding amounts of standby letters of credit substantially exceed the outstanding amounts of documentary letters of credit. See Preface to ISP 98, I.C.C. Publication No. 590, at 5. While Canada conducts most of its international trade with the United States without much use of letters of credit, international trade involving letters of credit accounts for about $ 6.5 CAD billion each way in Canada. See P.F. Famula, "The Fraud Exception to the Autonomy of Letters of Credit since Bank of Nova Scotia v. Angelica Whitewear", (1997) 12 Nat'l Cred. & Debt. Rev. 31 at 43 [hereinafter Famula, "Fraud exception"].

[3] See J. Byrne, "The Task Force on the Study of the UCC Article 5 (Letters of Credit)" (1990) 45 Bus. Law. 1521at 1538 [hereinafter Byrne, "UCC Article 5"].

[4] See *R.D. Harbottle* v. *National Westminster Bank*, [1977] 3 W.L.R. 752 (C.A.) [hereinafter *Harbottle*].

[5] See J. Byrne, "Letters of Credit" (1988) 43 Bus. Law. 1353 at 1353 [hereinafter Byrne, "Letters of Credit"]; S.I. Chung, "Developing a Documentary Credit Dispute Resolution System: An ICC Perspective", (1996) 19 Fordham Int'l L.J. 1349 at 1354 [hereinafter Chung, "ICC Dispute Resolution System"]; D.J.Kalson, "The International Monetary Fund Agreement and Letters of Credit: A Balancing of Purposes" (1983) 44 Pittsburgh L. Rev. 1061 at 1061 [hereinafter Kalson, "IMF and Letters of Credit"].

[6] See e.g. *Stromberg Carlson Corp.* v. *Bank Melli Iran*, 467 F. Supp. 530 (S.D.N.Y. 1979) [hereinafter *Bank Melli Iran*]; *American Bell International Inc.* v. *Islamic Republic of Iran*, 474 F. Supp. 420 at 425 (S.D.N.Y. 1979) [hereinafter *American Bell*]; J. Kimball & H. Sanders, "Preventing Wrongful Payment of Guaranty Letters of Credit-Lessons from Iran" (1984) 39 Bus. Law. 417 [hereinafter Kimball & Sanders, "Preventing Wrongful Payment"]; Note, "Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases" (1980) 21 Harv. Int'l L.J. 189 [hereinafter "Iranian Cases"]. During the reign of the Shah, the government of Iran generally demanded performance guarantees for contracts with foreign companies and repayment guarantees for payments in advance. The performance guarantees and repayment guarantees were issued by an Iranian bank, and payment would be made simply on a declaration by the Iranian government that the company had failed to meet its contractual obligations. The Iranian bank was covered by a standby letter of credit from a foreign bank (generally from the country of the foreign company) to the effect that payment would take place merely on the declaration by the Iranian bank that the Iranian government had called on the guarantees issued by the Iranian bank. After the fall of the Shah's regime, innumerable contracts could not be completed and many companies suffered heavy losses. Various companies, particularly American firms,

demonstrated by the recent Lloyd's letter of credit cases[7], the fraud issue has not lost any of its relevance and still puzzles the courts when they are called upon to determine its parameters.

Only rarely have the parties to a letter of credit transaction agreed to submit such conflicts to non-judicial fora of dispute resolution.[8] Although the Banking Commission of the International Chamber of Commerce[9] has received over the years numerous requests for opinions on letter of credit disputes,[10] and although a shift towards extra-judicial dispute resolution is currently discernible,[11] few letter of credit disputes are actually referred to extra-judicial authorities. Therefore, judicial settlement remains the rule in this field. This virtually exclusive reliance on court proceedings is astonishing when one considers other areas of international commerce, in which non-judicial dispute resolution has emerged as a successful and efficient device enjoying broad acceptance.

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endeavoured to prevent the standby letter of credit issued by their order from being honoured. See F.P. de Rooy, *Documentary Credits* (Deventer: Kluwer Law, 1984) at 50 [hereinafter de Rooy, *Documentary Credits*].

[7] See e.g. *Ash* v. *Lloyd's Corp.* [1992], 9 O.R. (3rd) 755 (Ont. C.A.) [hereinafter *Ash*]; *Royal Bank of Canada* v. *Darlington*, [1995] O.J. No. 1044 [hereinafter *Darlington*]; R.B. Smith, "Fraud and Documentary Credits: The Lloyd's Letters of Credit Cases" (1999) 18 Nat'l Banking L. Rev. 1 and 17 [hereinafter Smith, "Lloyd's Cases"].

Lloyd's is an insurance market whereby risks are accepted and underwritten by individual "Names" for personal gain or loss. The essence of the Lloyd's system is unlimited personal liability for the individual underwriter. The Names are contractually obligated to pay valid claims that are presented to them. The Corporation of Lloyd's keeps letters of credit issued on behalf of the Names to use if a name fails to pay claims validly presented. The various Lloyd's cases resulted from calls on these letters of credit by Lloyd's. In the following proceedings the validity of these calls was challenged by the Names.

[8] See W. Park, "Arbitration in Banking and Finance" (1998) Annual Review of Banking Law 213 at 214 [hereinafter Park, "Arbitration in Banking"].

[9] The International Chamber of Commerce [hereinafter I.C.C.] is a non-governmental international organization of thousands of companies and business associations from all around the world. Founded in 1919 and headquartered in Paris, it serves international business by promoting trade and investment and providing a number of practical services in various commercial areas, such as the INCOTERMS or the Uniform Customs and Practice for Documentary Credits. Today, the I.C.C. has national committees in about 60 countries and members in over 140 nations. For more information on the activities of the I.C.C online, see <http://www.iccwbo.org> (date accessed: 29 September 1999).

[10] See Chung, "ICC Dispute Resolution System," *supra* note 5 at 1354.

[11] See Park, "Arbitration in Banking" *supra* note 8 at 240; Note, "Disputes Involving Letters of Credit" (1996) 7 World Arb. & Mediation Report 185 at 191 [hereinafter World Arb. Report].

In particular, arbitration has become increasingly popular in the resolution of international commercial disputes. While rendering binding and enforceable decisions and, thus, standing on an equal footing with judgments rendered by national courts, arbitration avoids many of the shortcomings of judicial proceedings, which often make going to court an unattractive proposition for actors in the commercial world. Because it is in the interest of the international business community to have a secure instrument that can be resorted to quickly and without major complications, arbitration often serves commercial needs better than litigation.

Therefore, this thesis will attempt to address and illustrate the usefulness of arbitration as an alternative form of relief from fraudulent traders in international letter of credit transactions. It will be argued that arbitration is an efficient, effective and acceptable means of resolving letter of credit disputes for all involved parties. In addition, this thesis argues that the use of arbitration in fraud claims would promote the mercantile viability and utility of letters of credit when ongoing challenges to the letter of credit endanger its commercial integrity and reliability as an "equivalent of cash in hand."[12]

Chapter 2: Concept and Methodological Aspects

I) Terminology and Definitions

[12] Donaldson L.J. in "*The Bhoja Trader*", [1981] Lloyd's Rep. 256 at 257 (H.L.) [hereinafter "*The Bhoja Trader*"]. See also N. Faruqi, "Letters of Credit: Doubts As To Their Continued Usefulness" (1987) 8 N.Y.L. Sch. J. Int'l & Comp. L. 328 [hereinafter Faruqi, "Letters of Credit"]; S.H. van Houten, "Letters of Credit and Fraud: A Revisionist View" (1984) 62 Can. Bar Rev. 371 [hereinafter van Houten, "Letters of Credit and Fraud"].

For the purpose of this thesis, it suffices to understand the letter of credit at a basic level as an independent engagement by a bank or financial institution (the issuer) issued on behalf of its customer (the applicant) to honour demands for payment by a third party (the beneficiary) upon compliance with specific documentary conditions that are established in the letter of credit. This basic letter of credit arrangement is assumed when referring to letters of credit in this work. Sometimes, however, it will be necessary to distinguish between documentary, or commercial letters of credit on the one hand, and standby letters of credit on the other.[13]

As discussed below,[14] the reason for making this distinction is to be found in the differing commercial contexts in which these two types of letter of credit operate.

This thesis, however, does not strive to offer a comprehensive survey of other available forms of letters of credit.[15]

Moreover, this thesis only focuses on international letters of credit. The domestic use of letters of credit will, therefore, not be contemplated.

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[13] The language used to describe letters of credit may vary. Some view standby credits as a subset of documentary credits (see e.g. G.B. Graham & B. Geva, "Standby Credits in Canada" (1984) 9 Can. Bus. L.J. 180 [hereinafter Graham & Geva, "Standby Credits"]), while others seem to view them as a different type of letter of credit altogether (J.F. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, 3rd ed. (Boston: Warren, Gorham & Lamont, 1996) [hereinafter Dolan, *Law of Letters of Credit*]).

[14] See *infra* Part II – Chapter 1, I), 1), b) and Chapter 1, I), 2), b).

[15] Nowadays both documentary as well as standby letters of credit can be obtained in a great variety of forms: Revocable or irrevocable; confirmed or unconfirmed; transferable or non-transferable; acceptance or cash credits; deferred payment or negotiation credits; revolving, anticipatory, back-to-back or two-party credits; performance standby, advance payment standby, tender bond standby, financial standby, counter standby, direct pay standby, insurance standby, commercial standby. See A. Oelofse, *The Law of Documentary Letters of Credit in Comparative Perspective*, (Pretoria: Interlegal, 1997) at 29 [hereinafter Oelofse, *Letters of Credit*], L. Sarna, *Letters of Credit: The Law and Current Practice*, 3rd. ed. (Scarborough: Carswell, 1992) in ch. 1 - §4 [hereinafter Sarna, *Letters of Credit*]; R.P. Buckley, "The 1993 Revision of the Uniform Customs and Practice for Documentary Credits" (1995) 28 Geo. Wash. J. Int'l L. & Econ. 265 at 266 [hereinafter Buckley, "The 1993 Revision of the UCP"], Dolan, *Law of Letters of Credit supra* note 13 or J. Byrne, "New Rules for Standby Letters of Credit: The International Standby Practices/ISP98" at 7 online: ISP98 Homepage <http://www.iiblp.org/isp> (date accessed: 29 September 1999) [hereinafter Byrne, "New Standby Practices"] for an exhaustive coverage of possible types of letters of credit.

II) Other Modes of Payment in International Trade

This thesis will not cover other financing and security instruments, as it will concentrate solely on letters of credits. Thus, international payment alternatives such as advance payments, open accounts, drafts, cheques or documentary collections, fall outside the scope of this examination. Likewise, performance bonds and conditional or demand guarantees will not be contemplated. Where helpful, however, reference will be made to the latter due to their conceptual and functional resemblance to standby letters of credit.

III) Other Areas of Letter of Credit Controversies

Of course, disputes concerning letters of credit are not restricted to transactional fraud. Though not an exhaustive list, conflicts also arise regularly in respect of the quality of the goods or services sold, upon the insolvency of one of the parties to the credit, among banks as to their administrative obligations in the transaction, or with regard to the strict compliance standard when interpreting the terms of the letter of credit.[16]

Because of constraints on space that would not allow a thorough discussion of the issues raised, but more importantly for reasons of plausibility and coherence, this work will focus solely on disputes resulting from fraudulent conduct in letter of credit transactions.

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[16] See e.g. J.G. Barnes & J.E. Byrne, "Letters of Credit: 1996 Cases" (1997) 52 Bus. Law. 1547 [hereinafter Barnes & Byrne, "Letters of Credit 1996"]; S. Hazard, "Letters of Credit Disputes: Dispute Resolution and the Proposed ICC Dispute Expertise Rules" (1996) 15 Nat'l Banking L. Rev. 51 at 52 [hereinafter Hazzard, "Letter of Credit Disputes"]; L. Sarna, "Letters of Credit: Bankruptcy, Fraud and Identity of Parties" (1986) 65 Can. Bar Rev. 303 [hereinafter Sarna, "Bankruptcy, Fraud and Identity of Parties"].

The line between what constitutes fraud and that which is a mere violation of the strict duty of compliance, however, often remains unclear.[17] Therefore, the principle of strict compliance, as well as its relation to the fraud claim, will be outlined below.[18]

IV) Other Means of Alternative Dispute Resolution

Alternative dispute resolution (ADR) is understood to include not only arbitration, but also such non-arbitral devices as mediation, conciliation and mini-trials.[19] In contrast to arbitration, these dispute resolution methods are not binding on the parties unless the process results in a settlement agreement.[20] Hence, their success depends to a large extent on the ability and willingness of the parties to co-operate, reconcile and reach unanimous conclusions on the matter in dispute. Ultimately, these means seek not only to settle the particular controversy, but also to preserve and occasionally to restore the underlying business relationship through negotiation and close party interaction.

It is evident, however, that the nature of the fraud claim is such that it does not lend itself to voluntary dispute resolution. Therefore, non-arbitral dispute resolution methods will not be taken into consideration.

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[17] See e.g. *City National Bank* v. *First National Bank*, 732 S.W. 2d 489 (Ark. App. 1987) [hereinafter *City National Bank*]; J.E. Byrne, "Letters of Credit" *supra* note 5 at 1355; Note, "Note: Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114" (1979) 63 Minnesota L. Rev. 487 at 500 [hereinafter Note in Minnesota L. Rev.].

[18] See *supra* Part II – Chapter 1, IV), 1).

[19] See e.g. W. Tetley, *International Conflicts of Law*, (Montreal: Les ditions Yvon Blais, 1994) at 390 [hereinafter Tetley, *International Conflicts of Law*].

[20] See Note, "Protecting Confidentiality in Mediation" (1984) 48 Harv. L. Rev. 441 at 444 [hereinafter "Mediation Note"].

V) Selection of Countries

This analysis will be presented from a Canadian and American[21] perspective. Both countries have been selected for different reasons.

First, only in Canada and the United States is the standby letter of credit common. Elsewhere this financial instrument is unknown and is usually replaced by bank guarantees and performance bonds.

Second, with the notable exception of the United Kingdom, nowhere outside Canada and the United States is arbitration so widely accepted and frequently used as an alternative to litigation.

Third, the United States have been chosen due to their economic significance as the most significant international trading state. This is reflected by the fact that the letter of credit output in the United States accounts each year for roughly half of the world's total; a figure which annually exceeds $ 250 billion US.[22]

Fourth, Canada has been selected since the Lloyd's cases[23] produced the most recent and therefore leading decisions on the issue of fraud in the transaction.

Where case law from other countries, particularly from the United Kingdom, determined or influenced the outcome of comparable cases by the courts in Canada or the United States, these decisions will also be scrutinized.

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[21] In this thesis "American" refers to the United States of America.
[22] See Prefatory Note *supra* note 2.
[23] *Supra* note 7.

VI) Methodological Approach and Structure of Thesis

This thesis reviews the prospects of arbitration being successfully used as a dispute resolution mechanism in cases involving fraudulently procured letters of credit. At first glance, this inquiry is concerned with two legal objects: the letter of credit on the one hand; and arbitration on the other. In order to understand the usefulness of arbitration in resolving letter of credit disputes, however, one must first examine each subject individually. Only after such an analysis has been carried out can one evaluate whether there is a role to be played by arbitration in letter of credit disputes and, if so, what benefits it might bring to the parties involved.

Therefore, this thesis is organized as follows:

Chapter 1 in the Main Part is devoted to the letter of credit. Beginning with an examination of the current national and international legal framework for commercial and standby letters of credits, the historical and commercial foundations of the letter of credit will be reviewed. In so doing, the legal nature of the letter of credit as well as the underlying principles of strict compliance and autonomy will be outlined. This section closes with an in-depth examination of the issue of fraud in the transaction, which forms the focal point of the discussion in this chapter.

Chapter 2 addresses international commercial arbitration. Again, this part begins with a brief historical abstract of international arbitration, after which its present role will be analyzed in the light of national and international legislation. Comparing and contrasting with litigation, it is in this part that the typical features of arbitration will be delineated.

Chapter 3 discusses how the expectations of the parties to a fraudulent credit dispute can be met by international arbitration. This will be illustrated by two hypothetical letter of credit disputes, each of which calls for arbitration. In the first case, however, all the parties

to the letter of credit arrangement have agreed to arbitral settlement of the dispute, whereas the second case imagines the situation in which an arbitration agreement exists only between the parties to the underlying sales contract.

Chapter 4 reviews two recently developed international regimes for the resolution of letter of credit disputes: the 1997 International Center for Letter of Credit Arbitration Rules[24] and the 1997 International Chamber of Commerce Documentary Credit Dispute Expertise Rules.[25] After a brief discussion of the nature of these rules, their usefulness as an alternative dispute resolution mechanism for fraudulently procured letters of credit will be evaluated. In particular, the question of whether these new regimes provide a practical answer to the primarily theoretical considerations undertaken in the previous chapter will be addressed.

Finally, part III concludes.

The general approach of this study is to consult the relevant national and international legislation and to critically analyze case law, doctrine and articles.

Since the examination is partly undertaken from a comparative perspective,[26] it will refer separately to both Canadian and American authorities in order to highlight the legal differences between these two jurisdictions. Where the analysis, however, does not reveal fundamental distinctions between their respective laws, a common approach is undertaken, based on authorities from each jurisdiction.

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[24] For more information and the official text of the International Center of Letter of Credit Arbitration Rules [hereinafter ICLOCA Rules] online, see <http://www.doccreditworld.com//ICLOCA.htm> (date accessed 29 September, 1999).
[25] I.C.C. Publication No. 577 [hereinafter DOCDEX Rules].
[26] See *supra* Part II – Chapter 2, V).

VII) Objective and Emphasis of Thesis

The objective of this thesis is threefold.

Its first and main purpose is to examine the prospects of arbitration being successfully used in resolving letter of credit disputes involving the fraud exception. It will be argued that arbitration provides an efficient and effective alternative to litigation that deserves the same recognition already achieved in other areas of international trade. Moreover, it will be shown that a more frequent use of arbitration would restore the mercantile viability and utility of letters of credit as the quintessential means of international payment and security.

The second purpose of this thesis is to evaluate and update the fraud in the letter of credit issue in the light of recent developments in Canada and the United States. Thus, particular emphasis will be placed on recent court decisions of each state.

Third, this thesis strives to give an overview of recent reforms of the regulatory framework for letters of credit. Over the last six years, amendments to existing regulations such as the 1993 revision of the Uniform Customs and Practices for Documentary Credits[27] or the new version of Article 5 of the Uniform Commercial Code[28] on the one hand, as well as the promulgation of new international legal frameworks, such as the 1995 United Nations Convention on Independent Guarantees and Stand-by Letters of Credit[29]

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[27] I.C.C. Publication No. 500 (1993) [hereinafter UCP 500]. See also *infra* Part II – Chapter 1, II), 1), a).

[28] The official text of revised Art. 5 Uniform Commercial Code [hereinafter U.C.C.] is available in W.D. Hawkland & F.H. Miller, *Uniform Commercial Code Series §-Rev. Art.5*, (Clark Boardman Callaghan 1999) at Rev. Art. 5-1ff [hereinafter Hawkland & Miller, *UCC Series § - Rev. Art. 5*].

[29] The final text of the UNCITRAL Convention appears in [1995] 26 U.N. Comm'n Int'l Trade L. Y.B. 243, U.N. Doc. A/CN.9/SER.A/1995 [hereinafter UNCITRAL Convention]. In 1995, the United Nations General Assembly adopted the Convention and opened it for signature or accession. See [1995] 49 U.N.Y.B. 1357, 1357-1358, U.N. Doc. A/Res/50/48 [hereinafter U.N. Doc. A/RES/50/48]. See also *infra* Part II, ??.

or the 1998 International Standby Practices[30] on the other, has in many respects created a new body of law for letters of credit. The regulatory purpose of these regimes as well as their interrelationship form the third focal point of this analysis.

[30] See Institute of International Banking Law & Practice, Inc., International Standby Practices 1998 [hereinafter ISP 98]. For more information on the official text and commentary online: ISP98 Homepage <http://www.iiblp.org/isp.htm>(date accessed: 29 September 1999). In 1998 the I.C.C. Banking Commission approved the ISP98 as an acceptable formulation of rules for standby letters of credit. Thus, the rules can now also be obtained through the I.C.C. (I.C.C. Publication No. 590). See *infra* Part II – Chapter 1, II), 2), a), dd).

PART II- MAIN PART

Chapter 1: Fundamentals of Letters of Credit

I) Background on Letters of Credit

This part offers a brief review of the history, nature and function of both the documentary and standby letter of credit.

1) Documentary Letters of Credit

a) History and Evolution of the Documentary Credit

There is evidence that merchants in the Mediterranean area, particularly in Northern Italy, used a forerunner of the documentary letter of credit, the so-called letter of payment, which was a simplified form of a bill of exchange, from at least the twelfth century on.[31] This "lettera di pagamento", or "lettera di cambio" as it was later referred to, was a four-party undertaking whereby a partner, agent or business correspondent was ordered to make payment at another place or at a fair to an appointed person in order to settle an exchange between the sender of the "lettera" and a person named in it.[32] In the early seventeenth century, this precursor to the letter of credit was replaced by the three-party bill of exchange, which proved to be more useful because of its negotiability.

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[31] See de Rooy, *Documentary Credits supra* note 7 at 6; B. Kozolchyk, "The Legal Nature of the Irrevocable Commercial Letter of Credit" (1966) 14 Am. J. Comp. L. 395 [hereinafter Kozolchyk, "The Irrevocable Commercial Letter of Credit"]. Though not proven, it is assumed that even at the time of the Phoenicians, Assyrians and Greek a device comparable to the letter of credit was frequently used in trade. See G. Wiley, "How to Use Letters of Credit in Financing the Sale of Goods" (1965) 20 Bus. Law. 495 [hereinafter Wiley, "How to Use Letters of Credit"].

[32] See de Rooy, *Documentary Credits supra* note 7 at 7.

The introduction of the modern documentary or commercial letter of credit can be traced back to the nineteenth century.[33] From that time on, commercial letters of credit were issued as a means of financing and paying for international sales. The commercial credit emerged as a formal promise by a bank or another party of known solvency to accept and pay, or merely to pay, the beneficiary's demand for payment, whose compliance with the terms of the credit formed a prerequisite to the enforceability of the promise.[34] Until the end of the First World War, however, the documentary credit was used almost exclusively by merchant-bankers and was unknown in virtually all other areas of trade.

Due to a lack of economic stability and changing international trade patterns, the documentary credit became increasingly necessary as a means of security within the international commercial community in the post-war period. It was from that point forward that the documentary credit emerged as the predominant mode of payment in international commercial transactions. This development was evidenced and accompanied by the appearance of the first set of rules governing commercial letters of credit.[35]

The historical development of the letter of credit suggests that it was originally a unique mercantile instrument that responded to the needs and pressures of commerce. Earlier transactions must, therefore, be characterized as part of the old law merchant or *lex*

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[33] The first American lawsuit dealing with a documentary credit was the case of *Robbins* v. *Bingham*, 4 Johns. 476 (N.Y. 1809), relating to a transaction in 1804.

[34] See Kozolchyk, "The Irrevocable Commercial Letter of Credit" *supra* note 31 at 400.

[35] In 1920, for example, the New American Commercial Credit Conference set out the "Regulations affecting export commercial credits." This was followed by various regulations in European countries and eventually led to the first edition of the UCP in 1933.

mercatoria[36] - a body of rules, first customary, then legal, which developed in Europe and regulated the dealings of mariners and merchants in the commercial world until the seventeenth century.[37] Though it is debatable whether the modern documentary credit that emerged in the early nineteenth century is part of this old *lex mercatoria*,[38] two conclusions as to the nature of the letter of credit may, nonetheless, be drawn from its historical development.

First, it may be stated that the modern documentary credit was originally a creation of international trade that evolved without much contribution from lawyers and essentially depended on the commercial integrity of the participants to the credit.

Second, the foundations of the modern documentary credit were international from its inception. The letter of credit transaction developed, therefore, on a transnational level and away from domestic and traditional concepts.

Today, the documentary credit remains unchallenged as the international instrument of payment and security. Although we have witnessed increasing uses of alternative means of international security in the early 1990's, the indispensability of the documentary credit as a

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[36] See E.P. Ellinger, *Documentary Letters of Credit* (Singapore: University of Singapore Press, 1970) at 105 *et seq.* [hereinafter Ellinger, *Documentary Letters of Credit*]; R.J. Trimble, "The Law Merchant and the Letter of Credit" (1948) 61 Harv. L. Rev. 981 [hereinafter Trimble, "Law Merchant and Letter of Credit"].

[37] See A.F. Maniruzzaman, "The Lex Mercatoria and International Contracts: A Challenge for International Commercial Arbitration?" (1999) 14 Am. U. Int'l L. Rev. 657 at 660 *et seq.* [hereinafter Maniruzzaman, "The Lex Mercatoria and International Arbitration"]; W. Tetley, "The General Maritime Law-The Lex Maritima" (1994) 20 Syracuse J. Int'l L. Com. 105 at 133 *et seq.* [hereinafter Tetley, "The Lex Maritima"].

[38] Ellinger, *Documentary Letters of Credit supra* note 36 at 106 *et seq.* denies this proposition, while Trimble, "Law Merchant and Letter of Credit" *supra* note 36 at 994 *et seq.* argues that the modern documentary credit is fundamentally similar to earlier letter of credit forms and, thus, forms part of the old law merchant or *lex mercatoria*. It is necessary in the course of this discussion to clearly distinguish between the old and the new, or modern, *lex mercatoria*. Whereas no one doubts the existence of the old *lex mercatoria*, an intense academic discussion currently centers around the question of whether a modern *lex mercatoria* exists and, if so, what it entails. For further details, see Maniruzzaman, "The *Lex mercatoria* and International Arbitration" *ibid* at 670 *et seq.*; Tetley, "The Lex Maritima" *ibid.* at 133 *et seq.*

secure mode of payment has been reaffirmed following the most recent economic crisis in Asia.

b) The Nature of the Documentary Letter of Credit

Traditionally, the documentary credit has been used as a payment mechanism in conjunction with the sale of goods contracted between geographically distant parties.[39] In such a transaction, the buyer of the goods or services, the applicant, requests a domestic institution, the issuer (in most cases a bank), to open a documentary credit for the foreign vendor of the goods or services, the beneficiary. In accordance with the buyer's instructions, the issuing bank promises the vendor to pay a specified amount of money should certain documents as required by the credit be presented to the bank and conform with the stipulations of the letter.[40] These documents usually include commercial invoices, bills of lading or other transport documents, warehouse receipts, insurance documents and customs and inspection certificates. They serve to verify both the agreed upon quality and quantity of the purchased goods, as well as the fact that they have been delivered. If the documents tendered by the vendor conform with the documentary credit, the vendor is then paid by the issuing bank. Since the banks only examine the presented documents, payment will be made irrespective of whether or not the goods or services actually correspond to the declarations in the documents and, thus, are in compliance with the underlying sales transaction. Afterwards, the issuing bank will seek reimbursement from

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[39] See H. Harfield, *Bank Credits and Acceptances*, 5th ed. (New York: Ronald Press Co., 1974) at 18 *et seq.* [hereinafter Harfield, *Bank Credits*].

[40] For the definition of a documentary credit, see art. 2 UCP 500. See also § 5-102(a)(11) Rev. U.C.C. for a definition of a letter of credit.

the buyer and, once the buyer has done so, it will forward the presented documents to the buyer, who may then obtain the purchased goods or services.[41]

Thus, the documentary credit mechanism works on the premise that documents are used to represent goods, which in turn allows the banks to enter into the transaction.[42] Consequently, the letter of credit is essentially a sale of documents or, accordingly, of documentary nature.[43] This documentary nature of the credit serves the primary interests of both parties to the underlying contract, since the seller's delivery of conforming documents to the issuing bank simultaneously provides the seller with prompt payment for the transport of the goods and the domestic buyer with symbolic delivery of conforming goods.[44]

The documentary credit is, however, not only a payment mechanism. It is also a means of providing security for the contracting parties. This becomes evident when one considers the inherent risks for the contractants. On the one side, the documentary credit assures the buyer that the bank will not effect payment at its expense until the vendor presents documents that conform with the stipulations of the credit. On the other side, it ensures that the seller will definitely receive payment upon meeting the documentary requirements of the credit.

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[41] For a more detailed depiction of a documentary credit transaction, see Sarna, *Letters of Credit supra* note 15 ch. 1 - § 2.

[42] See van Houten, "Letters of Credit and Fraud" *supra* note 12 at 373.

[43] See S.J. Leacock, "Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions" (1984) 17 Vand. J. Transnat'l L. 885 at 887 [hereinafter Leacock, "Fraud in the International Transaction"]. See also arts. 4 ("..in credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate."), 13(a), 14 UCP 500.

[44] C.M. Schmitthoff, *Schmitthoff's Export Trade-The Law and Practice of International Trade*, 9th ed. (London: Stevens & Sons, 1990) at 364 [hereinafter Schmitthoff, *International Trade*].

It should be noted that the vast majority of today's commercial letters of credit are issued irrevocably.[45] This is understandable when one considers the security interest of the beneficiary. A documentary credit that can be revoked at any time by the issuer without notice and sufficient reason is of little use to the beneficiary.

In summary, the documentary credit is a payment and security instrument, which is independent from the underlying transaction and is documentary in nature, i.e. documents are used to represent goods or services.

2) Standby Letters of Credit

a) History and Evolution of the Standby Letter of Credit

The standby letter of credit is a relatively young financial instrument that originated in the United States some thirty to fourty years ago. Historically, American banks were prohibited from providing guarantees to their customers.[46] Pursuant to the *National Bank Act* of 1864,[47] which sets out the areas in which they are permitted to operate, banks, in contrast to insurance and bonding companies, were prohibited from guaranteeing the debts of others.[48] For this reason, the American banking industry resorted to standby letters of credit as an alternative to providing guarantees, thereby entering the guarantee market

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[45] See art. 6 UCP 500. See also § 5-106(a): "...A letter of credit is revocable only if it so provides.".
[46] See I.F.G. Baxter, *International Banking and Finance* (Toronto: Carswell, 1989) at 50 [hereinafter Baxter, *International Banking and Finance*]; K.P. McGuinness, *The Law of Guarantee*, 2nd ed. (Scarborough: Carswell, 1995) at 813 [hereinafter McGuinness, *Law of Guarantee*].
[47] Currently codified at 12 U.S.C. 24.
[48] See Bertrams, *Bank Guarantees supra* note 1 at 4.

through the backdoor. This practice progressively developed and was finally approved by the American courts.[49]

From the late 1970s on, the standby letter of credit gradually entered the Canadian scene and gained a significant market share over the years considering the right of Canadian banks to also issue guarantees. Though this development may well be attributable to the strong influence of American commercial practices in Canada, it nevertheless suggests that there are certain features of standby credits that are objectively more attractive than guarantees.[50]

Whereas the standby credit was originally used primarily in domestic transactions in both Canada and the United States, it now plays an equally important role in international commercial transactions.[51]

b) The Nature of the Standby Letter of Credit

Like the traditional documentary credit, the standby letter of credit serves as a means of allocating the risks between the parties to an international commercial transaction. Since it

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[49] See *Fair Pavillions Inc.* v. *First National City Bank*, 251 N.Y.S. 2d. 23 (1967) [hereinafter *Fair Pavillions*]; *Wichita Eagle & Beacon Pub. Co.* v. *Pacific National Bank*, 343 F. Supp. 323 (N.D. Cal. 1971) [hereinafter *Wichita Eagle*]; M.R. Katskee, "The Standby Letter of Credit Debate – the Case for Congressional Resolution" (1975) 92 Banking L.J. 697 *et seq.* [hereinafter Katskee, "Standby Letter of Credit Debate"]. In a ruling, the Comptroller of Currency of the United States had distinguished between guarantees and letters of credit generally as follows:

> Letters of Credit distinguished from Guaranty
>
> A national bank may issue its own letters of credit to or on behalf of its customers in the normal course of business: Provided, that the bank's obligations may be legally described as a letter of credit and not as a mere guaranty.

J.S. Ziegel & B. Geva, *Commercial and Consumer Transactions* (Toronto: Emond-Montgomery, 1981) at 918 [hereinafter Ziegel & Geva, *Commercial and Consumer Transactions*].

[50] See Graham & Geva, "Standby Credits" *supra* note 13 at 184; McGuinness, *Law of Guarantee supra* note 46 at 814.

[51] See Part I – Chapter 1. Though used relatively infrequently in Europe, where the guaranty remains the predominant security instrument, the term and technique of the standby letter of credit is common in countries in Latin American and the Far East, which are influenced by American banking practices.

was based on the traditional documentary letter of credit, the standby credit shares its basic structure and certain important legal aspects with its forerunner.[52] The standby credit is an undertaking, whereby the issuing bank, upon the applicant's request, promises to honour any demand for payment by the beneficiary that complies with the stipulations of the credit.[53] Like the documentary credit, the standby credit is independent of the underlying transaction. Moreover, it too is documentary in nature in that payment will only be effected upon the presentation of the documents that properly conform with the requirements of the credit.[54] In addition, the standby credit also functions, as will be outlined below, as a payment and security device.[55]

This is, however, where the resemblance between the two instruments ceases. The standby credit differs from the documentary credit especially in the commercial context in which it operates and, therefore, in the way in which it allocates risk between the parties. Whereas the traditional letter of credit functions primarily as a payment mechanism and is intended to be used as such in a commercial transaction, the standby credit usually functions as a guarantee mechanism, which will only be called upon if the applicant fails to

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[52] See e.g. *Meridian Developments* v. *T.D. Bank* (1984), 32 Alta. L.R. (2d) 150 at 161 (Q.B.) [hereinafter *Meridian Development*]:

> "[These cases] clearly indicates that the nature of a letter of credit has not been changed by its use in a greater variety of commercial transactions, notably as a guarantee."

[53] See rule 1.06 ISP98, art. 2(1) UNCITRAL Convention for a definition of a standby letter of credit. See also § 5-102(10) Rev. U.C.C. for a definition of a letter of credit.

[54] See *Distribulite Ltd.* v. *Toronto Board of Education Staff Credit Union Ltd.* (1987), 45 D.L.R. (4th) 161 (Ont. H.C.) [hereinafter *Distribulite Ltd.*]; Dolan, *Law of Letters of Credit supra* note 13 at 1-16; R. Goode, "Abstract Payment Undertakings and the Rules of the International Chamber of Commerce" (1995) 39 St. Louis L.J. 725 at 730 [hereinafter Goode, "Abstract Payment Undertakings"].
See also rule 1.07 ISP98, art. 2(b) URDG, § 5-103(d) Rev. U.C.C., art. 3 UNCITRAL Convention (Independence of the Issuer-Beneficiary Relationship).
See also rules 1.06(a),(d) "Because a standby is documentary ..."; arts. 2(a), 9, 11 URDG; §§ 5-102(a)(10), 5-106(a), 5-108(a) Rev. U.C.C., art. 2(1), 3(b) UNCITRAL Convention according to the documentary nature of a standby credit.

[55] See S.P. Jeffery, "Standby Letters of Credit: A Review of the Law in Canada" (1999) 14 B.F.L.R. 505 at 512 [hereinafter Jeffery, "Standby Letters of Credit"].

perform its contractual obligations.[56] In contrast to the traditional letter of credit, the creditor of the underlying obligation is the beneficiary of a standby credit, while the debtor of the underlying contract is the applicant. Thus, rather than serving as a payment device, the standby credit supports and secures the applicant's underlying obligation. It is, therefore, not only exceptional for the issuing bank to be called upon to execute its obligations under the credit, but it is also an indication that something has gone wrong in the underlying transaction.[57]

Thus, conceptually, the standby letter of credit has many parallels with two other forms of independent undertakings: the performance bond[58] and the independent guarantee.[59] Though these instruments are usually not considered to be identical,[60] each of them provides a measure of security against the risk of non-performance, is independent from the underlying transaction, and is documentary in nature.[61] It has been stated, therefore,

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[56] See Graham & Geva, "Standby Credits" *supra* note 13 at 183.

[57] See Baxter, *International Banking and Finance supra* note 46 at 52; Dolan, *Law of Letters of Credit supra* note 13 at 1-16.

[58] A performance bond is issued by a surety company, a private firm or an individual, rather than by a bank, and guarantees a buyer of goods or services that the seller will perform. M. Stern, "The Independence Rule in Standby Letters of Credit" (1985) 52 U. of Chic. L. Rev. 218 at 223 [hereinafter Stern, "Independence Rule in Standby Credits"].

[59] See *American National Bank & Trust* v. *Hamilton Industries International*, 583 F. Supp. 164 (N.D. Ill. 1984) [hereinafter *American National Bank*], where the court expressly ruled that a guarantee letter was a letter of credit; *Canadian Pioneer Petroleums Inc.* v. *Federal Deposit Insurance Corp.*, [1984] 2 W.W.R. 563 at 565 (Sask. Q.B.) [hereinafter *Canadian Pioneer*]. It is worth noting that the 1995 UNCITRAL Convention covers both the independent guarantee and the standby letter of credit. See *infra* Part II – Chapter 1, II), a), cc).
An independent guarantee is an unconditional promise by a guarantor to answer the debts of another person if the latter fails to perform its underlying obligation.

[60] See e.g. *Edward Owen* v. *Barclays Bank International* [1978] 1 Lloyd's Rep. 171 at 172 (C.A.) [hereinafter *Edward Owen*]; *Evert* v. *Banco Popular de Puerto Rico*, 568 N.Y.S. 2d 398 (1991) [hereinafter *Evert*]; *Westpac Banking Corp.* v. *Duke Group Ltd.* (1994), 20 O.R. (3d) 515 (Ont. Bktcy.) [hereinafter *Westpac Banking*]; C. Debattista, "Performance Bonds and Letters of Credit: A Cracked Mirror Image" (1997) J. Bus. L. 289 *et seq.* [hereinafter Debattista, "Performance Bonds and Letters of Credit"]; E.P. Ellinger, "Standby Letters of Credit" (1978) 6 I.B.L. 604 at 622 [hereinafter Ellinger, "Standby Credits"]; Jeffery, "Standby Letters of Credit" *supra* note 55 at 514 *et seq.*. It is noteworthy that the question of where and how to distinguish between these instruments poses considerable difficulties for both judges and academics and is therefore not always consistently answered.

[61] See Bertrams, *Bank Guarantees supra* note 1 at 6; Sarna, *Letters of Credit supra* note 15 in ch. 1 - § 4(g).

that the standby letter of credit is a hybrid obligation, sharing some of the characteristics of both guarantee and traditional letters of credit.[62]

Under a standby credit, the beneficiary must establish that the applicant has not performed its contractual obligations. In contrast to the traditional letter of credit, where the beneficiary must furnish conclusive documentary proof that it has undertaken sufficient steps to meet its obligations under the contract, the beneficiary in a standby transaction must merely assert that the applicant has failed to comply with the terms of the contract in order to obtain payment from the issuing bank.[63] A simple written statement by the beneficiary, the certificate of default, attesting to the applicant's failure to duly perform the contract, commonly suffices in order to meet this requirement.[64] Consequently, the burden of documentary proof to be met by the beneficiary in order to draw on the credit is considerably lower in a standby than in a commercial credit transaction, where neutral third persons control the issuance of the necessary documents. Obviously, this renders the potential risk of an unjustified demand higher, for even when the applicant fulfils its obligation under the contract, it is still in the exclusive discretion of the beneficiary to call upon the credit. This was emphasized by the Court in *Darlington*:

> "Frequently a standby letter of credit can be called upon by the beneficiary, however, simply upon the presentation to the bank of a sight draft reciting the necessary information set out in the terms of the credit. It requires no proof of loss on the part of the beneficiary, and does not involve the presentation of other documentation emanating from third parties – such as is the case with documentary credits securing sale of goods transactions in which bills of lading

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[62] See McGuinness, *Law of Guarantee supra* note 46 at 815.
[63] See Baxter, *International Banking and Finance supra* note 46 at 52; Stern, "Independence Rule in Standby Credits" *supra* note 58 at 222.
[64] See e.g. *Chase Manhattan Bank* v. *Equibank*, 21 U.C.C. Rep. Serv. 247, 550 F. 2d 882 (3d Cir. 1977) [hereinafter *Chase Manhattan*].

> and insurance documents are customarily required. In short the consequences of a call on a standby letter of credit can be harsh, draconian and abrupt."[65]

It is not surprising, therefore, that there is a significantly greater number of disputes dealing with fraudulent or abusive drawings in standby credit cases than those dealing with documentary credits.[66]

The features of the standby letter of credit allow it to be used in a broad range of commercial contexts. In an international situation, standby letters of credit are most commonly used in connection with contracts requiring performance in a foreign country or in order to support borrowings under international loans.[67]

Like the documentary credit, the standby letter of credit is almost always issued irrevocably.[68]

It may therefore be understood that the standby letter of credit shares many of the same basic principles and features with the documentary letter of credit. It operates, however, in a different commercial environment, since it primarily serves to secure the performance of the applicant's underlying obligation. Because the beneficiary to a standby credit needs only to declare that default has occurred in order to draw upon the credit, the standby credit does not merit the same degree of confidence as the documentary credit.

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[65] *Darlington supra* note 7 at 128.

[66] See J.F. Dolan, "Standby Letters of Credit and Fraud (Is the Standby Only Another Invention of the Goldsmiths in Lombard Street?)" (1985) 7 Cardozo L. Rev. 1 at 2 [hereinafter Dolan, "Standby Letters of Credit and Fraud"].

[67] See Graham & Geva, "Standby Credits" *supra* note 13 at 185; S.T. Kolyer, "Judicial Development of Letters of Credit Law: A Reappraisal" (1980) 66 Cornell L. Rev. 144 at 144 [hereinafter Kolyer, "Letters of Credit Reappraisal"].

II)Sources of Law for Letters of Credit

This section reviews the current international and national legal frameworks for both documentary as well as standby letters of credit.

1) Documentary Letters of Credit

a) International Sources of Law for Documentary Letters of Credit: The UCP

aa) History and Nature of the Uniform Customs and Practice (UCP)

The worldwide legal standard, to which more than 95% of issued documentary credits adhere, is the Uniform Customs and Practice for Documentary Credits.[69]

The UCP were initially published by the I.C.C. in 1933 as a private codification of international standard practices for documentary credits. They evolved from the world banking community's recognition that uniform procedures needed to be established in order to govern the use of documentary credits.[70] Thus, the UCP were, and remain primarily a product of the international financial industry.[71] Revised versions were issued in 1951, 1962, 1974, and 1983. The most recent version, the UCP 500, were adopted by the I.C.C. in 1993, and are effective as of January 1, 1994.

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[68] See rule 1.06(a) ISP98 defining a standby as "...an irrevocable, independent, documentary, and binding undertaking...". See also § 5-106(a) Rev. U.C.C.: "...A letter of credit is revocable only if it so provides." and art. 5 URDG.

[69] Hereinafter UCP.

[70] See Chung, "ICC Dispute Resolution System", *supra* note 5 at 1355.

[71] See J.F. Dolan, "Weakening the Letter of Credit Product: The New Uniform Customs and Practice for Documentary Credits" (1994) 2 I.B.L.J. 149 [hereinafter Dolan, "The New UCP"]. Although for the first time bank lawyers and law professors participated in the I.C.C. Working Group that prepared the UCP 500, the very parties that documentary credits are designed to serve, importers and exporters, were again not directly represented at the drafting table. It has been suggested that the UCP will best be served in the future by a broader representation of interested parties in the drafting process. R.P. Buckley, "The 1993 Revision of the UCP" *supra* note 15 at 267.

The real breakthrough of the UCP as *the* regime for documentary credits came with the 1962 Revision. This version not only removed any last doubts regarding the independence of the documentary credit from the underlying contractual relationship. It also incorporated certain aspects of English banking practices, thus rendering the UCP from that point forward equally acceptable to bankers in the United Kingdom and the Commonwealth, who had previously rejected its application.[72] Today banks in more than 160 countries refer to this uniform international standard, which means that virtually every international documentary credit transaction is covered by the UCP.[73] For this reason, it has been stated that even when the documentary credit has not been made subject to the UCP, they nevertheless govern the credit unless the parties thereto explicitly exclude them.[74]

Since the 1993 revision, however, the UCP have become a set of standard terms and conditions applicable to documentary credits solely by incorporation.[75] When incorporated, they are binding upon all the parties to the credit unless otherwise stipulated.[76] The ambiguity of the 1983 version, which plainly stated in the first sentence of art. 1 that the UCP applied automatically to all documentary credits before making its application subject to incorporation by the parties in its second sentence has, therefore, been resolved by the new version.[77]

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[72] See E.P. Ellinger, "The Uniform Customs and Practice for Documentary Credits-the 1993 Revision" [1994] L.M.C.L.Q. 377 at 379 [hereinafter Ellinger, "UCP and 1993 Revision"].
[73] C. del Busto, *ICC Guide to Documentary Credit Operations* (I.C.C. Publishing S.A.: Paris 1994) at 3 [hereinafter del Busto, *ICC Guide*].
[74] See *Harlow and Jones Ltd. v. American Express Bank Ltd.* [1990] 2 Lloyd's Rep. 343 (Q.B.); *Forestall Mimosa Ltd.* v. *Oriental Credit Ltd.* [1986] 1 W.L.R. 631 (C.A.); A. Gozlan & E. Amar, "Rules Applicable to International Letters of Credit in Matters of Conflict of Laws: A Comparative Study" (1994) 13 Nat. Banking L. Rev. 58 at 78 (fn. 80) [hereinafter Gozlan & Amar, "Rules applicable to Letters of Credit"].
[75] See Art. 1 UCP 500.
[76] *Ibid.*
[77] Art. 1 UCP 400 states:

The consequences of this approach are twofold.

First, because of their broad acceptance around the world,[78] the legitimacy of the UCP derives from the parties' voluntary submission to them rather than from any national legislation. Only when the parties agree on incorporating them do the UCP become the law of the documentary credit.

The second consequence of revised art. 1 UCP 500 relates to the disputed question of the nature of the UCP. Since revised art. 1 UCP 500 requires that the UCP be expressly stipulated in the agreement (i.e. they do not apply by default or imperatively), it has been argued that the UCP should be viewed as contractual terms. The formerly prevalent understanding of the UCP as representing supranational and uniform trade usages, suggested by their official title, seems, therefore, to be refuted by the new version. On the other hand, such an interpretation does not take into consideration that documentary credits are commercial instruments based on principles that have been adhered to by the international trade community for a long time and that they do not fit into any standard contract law framework.

It is more persuasive, therefore, to view the UCP as banking rules, some of which are legislative and others reflective of actual practices and customary usages.[79]

The distinction matters insofar as it gives the parties the possibility of circumventing those UCP rules that are viewed as being of a legislative nature.[80]

> "These articles apply to all documentary credits, including, to the extent to which they may be applicable, standby letters of credit, and are binding on all parties thereto unless otherwise expressly agreed. They shall be incorporated into each documentary credit by wording in the credit indicating that such credit is issued subject to Uniform Customs and Practice for Documentary Credits, 1983 revision, ICC Publication No. 400."

[78] See e.g. *San Diego Gas & Elec. Co.* v. *Bank Leumi*, 50 Cal. Rptr. 2nd 20, 24-25 (Cal. Ct. App. 1996) [hereinafter *San Diego Gas*]; Buckley, "The 1993 Revision of the UCP" *supra* note 15 at 266.

[79] See J.F. Dolan & P. van Huizen, "International Rules for Letters of Credit – The UCP: A Final Report" (1994) 9 B.F.L.R. 173 at 175 [hereinafter Dolan & van Huizen, "The UCP: A Final Report"].

[80] See Dolan, "The New UCP" *supra* note 71 at 171.

bb) The 1993 Revision of the UCP

The revised UCP 500 consist of 49 often very elaborate and specific articles, drafted as a "mélange of hard rule and professed advice."[81] Beginning with a number of general provisions and definitions (Part A), the UCP 500 refer to different forms of credit and their notification (Part B), the liabilities and responsibilities of the parties involved (Part C), the documents to be presented under the credit (Part D), rules concerning shipment, presentation and terms of the credit (Part E), and finally provisions dealing with the transfer of the credit and the assignment of proceeds (Parts F and G).

In particular, the 1993 revision of the UCP adapted the former version to changing letter of credit practices, which resulted from new developments in the transport and telecommunications industries. Furthermore like former revisions, it too clarified many of the points left in doubt under the previous version, namely: the procedure with regard to non-conforming documents; the issue of non-documentary conditions; the liabilities of the parties to the credit and particularly the inter-bank relationship. In these respects, the new UCP 500 provide a multitude of minor but very useful adjustments, which substantially consolidate the reliability of the letter of credit as a financial instrument.

cc) Criticisms

Regrettably, as has been previously pointed out, the UCP remain a set of rules considerably influenced by the banking industry. Although balancing the interests of the parties to the documentary credit better than any prior version, they do contain weaknesses when it comes to obligations that the involved banks owe to applicants and beneficiaries.

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[81] Sarna, *Letters of Credit supra* note 15 in ch. 2 - § 13.

Thus, article 16 UCP 500 relieves the banks from liability for any delays, errors or failures in the transmission of messages or documents and, consequently, for faults arising in matters under their control.[82] Here, further amendments should be made in order to maintain an attractive letter of credit product.

Another criticism pertains to documentary credit issues that the UCP 500 do not address. The silence of the UCP on the law that should govern the documentary credit transaction is one such notable example.[83] Since the law of most jurisdictions gives effect to the parties' express choice of law, it would have been useful to have included conflict rules in the UCP.

In addition, it is regrettable that arbitration has not become the subject of regulation in the UCP. It is believed that arbitration would enhance the uniformity in the construction and application of the provisions of the UCP and, thus, should be given due consideration in the next revision.[84]

dd) Summary

Although the UCP 500 represent one of the most successful international bodies of rules, further efforts must nonetheless be made to establish a truly even-handed set of rules. Under the present system, the issuers of documentary credits enjoy the benefit of certain advantageous clauses that do not correspond to the onerous and detailed set of obligations to which the non-issuing parties must abide. In this respect adjustments must

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[82] See also art. 15 UCP, which relieves the banks from responsibility for the effectiveness of the documents. See also Buckley, "The 1993 Revision of the UCP" *supra* note 71 at 313; Dolan, "The New UCP" *supra* note 15 at 171.

[83] See Gozlan & Amar, "Rules applicable to Letters of Credit" *supra* note 74 at 59. See also de Rooy, *Documentary Credits supra* note 7 at 17-19.

[84] Ellinger, "UCP and 1993 Revision" *supra* note 72 at 402.

be made not only for the sake of balancing rights and obligations between the parties to the letter of credit. Moreover, one must bear in mind that the variety of international financial products available to international businessmen is increasing with the expansion of worldwide electronic networks. This implies that the attractiveness of the letter of credit as one of several alternative financial products may play an increasingly important role for the decision of the international trade community to adhere to it.

It also remains to be seen what impact the overwhelming success of the global electronic network (i.e. the Internet), occurring for the most part after the last revision of the UCP in 1993, will have on daily documentary credit practices.[85] Among other developments, electronic presentation, electronic authentication, electronic signatures and the receipt of electronic records are likely to bring unprecedented simplifications to documentary credit practices. Since these electronic means save both time and costs, they will no doubt eventually gain widespread acceptance. Thus, further amendments to the UCP must be made in order to provide a complete and up-to-date legal framework for documentary credits.

b) National Sources of Law for Documentary Letters of Credit

aa) Canada

There is no specific regime governing letter of credit transactions in Canada. Consequently, the legal relationship between the involved parties is determined by the applicable common or civil (contract) law.[86] In general, however, the parties to the

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[85] See generally J.D. Lipton, "Documentary Credit Law and Practice in the Global Information Age" (1999) 22 Fordham Int'l L.J. 1972 *et seq.* [hereinafter Lipton, "Documentary Credits and Global Information Age"].
[86] See Sarna, *Letters of Credit supra* note 15 in ch. 1 - § 3(a).

transaction agree to modify their contractual relations by incorporating the UCP 500 as the applicable law. Thus, provincial common or civil law applies only subsidiarily to legal matters not specifically covered by the UCP 500.

bb) United States

In contrast to Canada, most American states have adopted a body of law that specifically applies to letter of credit transactions. Article 5 of the U.C.C.[87] codifies the rights and obligations of the parties to the letter of credit.

(1) The Uniform Commercial Code (U.C.C.)

The U.C.C. is a compilation of eleven articles, each of which covers different aspects of commercial law.[88] Because private law, or property and civil rights, generally falls within state jurisdiction in the United States, the U.C.C. was intended both to alleviate state jurisdictional differences as well as to ensure the uniformity and simplicity of law particularly in inter-state transactions. Today, the eleven articles serve as a model commercial law common to most states. Though exceptionally, as it turned out with Article 5, some states have refused to implement the suggested provisions of the U.C.C., new or revised U.C.C. articles are generally enacted as part of state legislation without any or with only minor changes. When incorporated by a state, the respective U.C.C.

[87] References to the revised Article 5 or its sections are indicated by a preceding "Rev.".
[88] For example: sale of goods; negotiable instruments; bank deposits and collections; wire transfers; and secured transactions.

provisions stipulate the responsibilities of the parties to the transaction covered by the state statute in question.[89]

(2) Former Article 5 U.C.C.

Under the auspices of the American Law Institute and the National Conference of Commissioners on Uniform State Laws,[90] article 5 U.C.C. was drafted exclusively for letters of credit some forty years ago. It was intended to set out an "independent theoretical frame for the further development of letters of credit,"[91] leaving to other U.C.C. articles other areas of law, as well as to the courts the responsibility for developing intermediary areas of letter of credit law.[92] Prior to its enactment, letter of credit law in the United States was left to be developed almost exclusively by the courts. Thus, article 5 U.C.C. represented the first statutory recognition of the fundamental principles of letter of credit law in the United States. At the time of its enactment, article 5 U.C.C. was, therefore, consistent with both the previous common law of letters of credit as well as the commercial and financial practices out of which the instrument developed.[93] Thus, the approach the designers of the original Article 5 U.C.C. chose when drafting the first rules on letters of credit was more conservative than visionary in that they merely sought to codify existing case law. In particular, the disregard of the UCP, which had already emerged as a comprehensive and

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[89] See P.S. Turner, "Revised Article 5: The New U.S. Uniform Law on Letters of Credit" (1996) 11 B.F.L.R. 206 at 207 [hereinafter Turner, "U.C.C. Article 5"].

[90] The preparation of the U.C.C. was begun in 1942 as a joint project of the National Conference of Commissioners on Uniform State Laws [hereinafter National Conference], composed of delegates from each state of the United States and the American Law Institute [hereinafter ALI]. The project resulted in the first Official Text in 1957. Since then numerous revisions have taken place in order to bring the U.C.C. into conformity with changing commercial practices. Currently, the 1995 Official Text is the latest version.

[91] See § 5-101 U.C.C., Official Comment.

[92] See § 5-102 U.C.C., Official Comment; J.G. Barnes & J. Byrne, "Revision of U.C.C. Article 5" (1995) 50 Bus. Law. at 1449 [hereinafter Barnes & Byrne, "Revision of U.C.C. Article 5"].

[93] See Harfield, *Bank Credits supra* note 39 at 228; Kolyer, "Letters of Credit Reappraisal" *supra* note 67 at 148.

widely accepted body of letter of credit standards, proved to be impractical.[94] Not surprisingly, four states, including the financially influential state of New York, enacted provisions that excluded the application of article 5 U.C.C. whenever the UCP are incorporated into the letter of credit contract, as they almost always are.[95] Therefore, the failure to refer to the UCP not only rendered the initial goal of the uniform application of the U.C.C. obsolete, but more importantly, it also detached the U.C.C. from the principal source of letter of credit law and practice both inside and outside the United States. Moreover, many innovations in letter of credit transactions occurred after the original implementation of article 5 U.C.C. in the early 1960s,[96] thereby rendering a proper and coherent application of article 5 U.C.C. increasingly difficult. As acknowledged by the 1980 task force on letters of credit, article 5 did not reflect letter of credit practice in many important respects.[97]

(3) Revised Article 5 U.C.C.

In response to these shortcomings, Rev. Article 5 U.C.C., which was approved after four years by both the National Conference and the ALI in 1995,[98] emerged as a comprehensive new framework for letters of credit bearing almost no resemblance to the

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[94] Although § 5-109(1) U.C.C. requires that issuers observe "any general banking usage", neither the Official U.C.C. Text nor the Official Comment referred at any point to the UCP. See Barnes & Byrne, "Revision of U.C.C. Article 5" *supra* note 92 at 1450.

[95] Ala. Code §5-102 (1975); Ariz. Rev. Stat. §44-2702 (1967); Mo Ann. Stat. §400.5-102 (West 1965); N.Y. U.C.C. Law §5-102 (4)(1964):

> "Unless otherwise agreed this Article 5 does not apply to a letter of credit or a credit if by its terms or agreement...such letter of credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits... .".

[96] Prefatory Note *supra* note 2 at 1.

[97] See Task Force Report in "An Examination of U.C.C. Article 5 (Letters of Credit)" (1990) 45 Bus. Law. 1521 at 1573, 1577 [hereinafter Task Force Report]; J.G. Barnes, "The Impact of Internationalization of Transnational Commercial Law: Internationalization of Revised Article 5 (Letters of Credit)" (1995) 16 J. Int'l L. Bus. 215 at 222 [hereinafter Barnes, "Internationalization of Article 5"].

[98] For a detailed report on the drafting process as well as the participants, see e.g. Barnes, "Internationalization of Article 5" *supra* note 97 at 217 *et seq.*

original version.[99] By mid-1998, Rev. Article 5 had been enacted into law by thirty-four states, including the commercially important states of Massachusetts, Illinois and California, but not the State of New York.[100]

In the process of remodelling Article 5 U.C.C., it was conceded that the success of the new article would depend on the realization of two underlying concepts. First, it was necessary to clearly define the particular characteristics of a letter of credit that distinguish it from both other security and payment instruments, as well as ordinary contractual engagements.[101] Second, the drafters believed that the objectives of article 5 could best be achieved when the new rules "preserve flexibility through variation by agreement in order to respond to and accommodate developments in custom and usage."[102] This belief, however, is confined to developments that are "consistent with the essential definitions and substantive mandates of the statute."[103]

By making wide use of definitions[104] or, where the use of more general terms was necessary, by referring to terms that reflect current international letter of credit law standards,[105] Rev. Article 5 clarifies the often ambiguous and imprecise wording of the former version. Consequently, the new article ensures that it will be more coherently and

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[99] For an overview on the Rev. Article 5 U.C.C., see e.g. K.A. Barski, "Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Custom and Practice for Documentary Credits" (1996) 41 Loy. L. Rev. 735 *et seq.* [hereinafter Barski, "Comparison Article 5 and the UCP"]; M.R. Schroeder, "The 1995 Revisions to UCC Article 5, Letters of Credit" (1995) 29 U.C.C.L.J. 331 *et seq.* [hereinafter Schroeder, "Revisions to Article 5"]; Turner, "U.C.C. Article 5" *supra* note 89 at 206 *et seq.*

[100] See U.C.C. 5-101 to –117, 2B U.L.A. at 127-129 (Supp. 1998); R.F. Dole, "The Essence of a Letter of Credit under Revised Article 5: Permissible and Impermissible Nondocumentary Conditions Affecting Honor" (1998) 35 Hous. L. Rev. 1079 at 1086 *et seq.* [hereinafter Dole, "Essence of a Letter of Credit"].

[101] See Rev. §5-101 U.C.C. Official Comment.

[102] *Ibid.*

[103] *Ibid.* For an example of a substantial mandate, see §1-102(3) U.C.C., which obliges the parties to act in good faith and with diligence, reasonableness and care.

[104] See e.g. Rev. § 5-102 U.C.C., which among others defines the term letter of credit anew.

[105] See e.g. Rev. § 5-108(b) U.C.C., which also stipulates *reasonable time* and, thus, a phrase identically used in the UCP.

predictably applied. It also distinguishes letter of credit transactions from alternative modes of payment.

There is, however, a second aspect, which indeed reforms letter of credit law in the United States. In contrast to the former version, Rev. Article 5 expressly acknowledges present and future "standard practice."[106] This represents an attempt to make letter of credit law responsive to commercial reality and, in particular, to the customs and expectations of the international banking and mercantile community. This approach is underpinned by the fact that the parties to the letter of credit now enjoy almost complete freedom to supplement or amend the provisions of Rev. Article 5.[107] The revisions, therefore, reconnect the U.C.C. to the U.C.P. as the prevalent international regime. Additionally, it facilitates its adaptation to new forms of letters of credit and evolving technology.[108]

Rev. Article 5 states that it applies "to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit."[109] It follows from its clear wording that Rev. Art. 5 does not purport to regulate all aspects of letter of credit transactions. Instead, the drafters intended a flexible approach as in the original version, in order to give the parties sufficient freedom to make individual adjustments.

Other notable amendments in Rev. Article 5 U.C.C. include the adherence to the strict, instead of the substantial, compliance standard or, as will be outlined later,[110] the fraud

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[106] See e.g. Rev. § 5-108(a), (e) U.C.C.
[107] See Rev. § 5-103(c), Rev. 5-116(a), (c).
[108] See Barski, "Comparison Article 5 and the UCP" *supra* note 99 at 738.
[109] Rev. § 5-103(a) U.C.C.
[110] See *infra* Part II – chapter 1, V).

exception.[111]

Rev. Article 5 U.C.C. marks, therefore, a major, though long overdue, shift towards an internationally uniform letter of credit law. Assuming that in the near future those state legislatures which thus far have not adopted Rev. Article 5 will pass respective laws without or with only negligible amendments, the new article should not only remove from the courts many of the quarrels of the past arising out of discrepancies between the U.C.C. and the UCP, but it will also provide a much more reliable and certain standard to letter of credit practitioners.

c) Relationship of UCP 500 and Revised Article 5 U.C.C.[112]

Under Rev. Art. 5 U.C.C., the parties may incorporate the UCP 500 by expressly making the letter of credit subject to them as a standard practice.[113] For credits which incorporate the UCP, Rev. Art. 5 U.C.C. serves merely to supplement the incomplete coverage of the UCP.[114] In other words, the specific provisions of Rev. Art. 5 U.C.C. are superseded by the incorporation of the UCP whenever Rev. Art. 5 U.C.C. conflicts with the UCP. Since the drafters of Rev. Art. 5 U.C.C. were generally inspired by the UCP,[115] the parties' choice to include the latter in the letter of credit agreement does not really change the legal

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[111] See Rev. §5-108(1) U.C.C., Rev. §5-109 U.C.C..

[112] Since this is an analysis confined to international transactions, the question of whether the old version of Art. 5 U.C.C., which is still applicable in some American states, is consistent with Rev. Art. 5 U.C.C., which has already been adopted in all of the other states, will not be examined. But see Turner, "U.C.C. Article 5" *supra* note 89 at 206.

[113] See Rev. § 5-116(c) U.C.C., § 5-101 U.C.C.

[114] See also *Prutscher* v. *Fidelity International Bank*, 502 F. Supp. 535 (S.D.N.Y. 1980); *Trans Meridian Trading Inc.* v. *Empresa Nacional de Comercialization de Insumos* 829 F. 2d 949, 953-954 (9th. Cir. 1987).

[115] See Rev. § 5-101 U.C.C. Official Comment.

conditions under which the documentary credit operates.[116] Where the UCP and the U.C.C. are inconsistent, or where the UCP provide a greater degree of specificity and detail than does the respective provision of Rev. Art. 5 U.C.C., or where the UCP establish rules that are not mirrored by the U.C.C., then the UCP are generally applicable.

There are limits, however, to the extent to which the parties are permitted to contract out of the U.C.C. Several provisions in Rev. Art. 5 U.C.C. are mandatory and cannot be varied or excluded by the parties.[117] Furthermore, it is only permissible to modify contracts to the extent that such amendments are not inconsistent with the standards of good faith, diligence, reasonableness and care.[118]

Consequently, an agreement in which the documentary credit is made subject to the UCP is valid to the extent to which it does not conflict with any imperative provisions of the U.C.C.

2) Standby Letters of Credit

In this part the international and national sources of law for standby letters of credit will be outlined.

a) International Sources for Standby Letters of Credit

aa) UCP 500

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[116] See Barski, "Comparison Article 5 and the UCP" *supra* note 99 at 739; Schroeder, "Revisions to Article 5" *supra* note 99 at 343.
[117] See Rev. § 5-103(c) U.C.C.
[118] See § 1-102(3) U.C.C.

One of the changes to the 1983 revision that was retained 1993 was the inclusion of standby letters of credit within the scope of the UCP.[119] Art. 1 UCP 500 states that the UCP cover standby credit transactions only "to the extent to which [the UCP articles] may be applicable." Thus, it is even acknowledged in the UCP themselves that they are not entirely applicable to standby letters of credit. The reason for this may be found in the different functions fulfilled by documentary and standby credits. While the documentary credit typically serves as a payment mechanism in a sale of goods, the standby credit operates as a protective financial instrument, which will only be drawn upon should one of the contractants default in the performance of some underlying obligation.[120] Because the UCP were originally written for documentary credits and, thus, not intended to also govern standby letters of credit, most of the provisions of the UCP 500 offer only minimal help or are even counterproductive in resolving disputes involving standby credit transactions. Common problems occurring in standby credit transactions center around art. 13 UCP 500 (document inconsistency) and art. 20 *et seq.* UCP 500 (transport and insurance documents). This follows from the fact that a standby credit does not normally call for documentary proof of sub-standard or non-performance. In addition, the provisions on instalment obligations (Art. 41 UCP 500), stale shipping documents (Art. 43 UCP 500) and force majeure (Art. 17 UCP 500) would not only be inappropriate but potentially harmful to the

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[119] This expansion was motivated by a concern on the part of American banks that their courts might confuse a standby credit with a suretyship guarantee, which most banks in the United States are prohibited from issuing. Therefore, American banks naturally pressed for standby credits to be included in the UCP, so that they would be visibly equated with documentary credits, to which the prohibition did not apply, and the appropriate signal would thus be sent to their courts. Goode, "Abstract Payment Undertakings" *supra* note 54 at 729 *et seq.*

[120] An in-depth examination highlighting the differences between documentary and standby letters of credit will be undertaken at a later stage. See *infra* Part II – Chapter 1, I), 1), b) and Chapter 1, I), 2), b).

beneficiary in a standby situation.[121] At the same time, many of the issues that regularly cause problems in a standby context are not addressed by the UCP.

Nonetheless, many standby credits have contractually incorporated the UCP in the past. This can be explained by the fact that the standby credit is a derivative of and stands on the same basic footing as the documentary credit.[122] Since the UCP reinforce the independent nature of the standby credit, provide standards for examination and notice and protect the issuer from unsound letter of credit practices, issuers of letters of credit have usually perceived the UCP as being more beneficial than detrimental to their obligations *qua* issuer.[123] Consequently, standby letters of credit commonly referred to the UCP, since until recently no other suitable set of rules other than the UCP existed. To alleviate possible pitfalls of the UCP issuers and beneficiaries of the standby credit routinely agreed to exclude those provisions of the UCP that they viewed as inappropriate to their individual transaction.

As for other matters pertaining to the UCP, the above discussion in respect of documentary credits applies equally to standby credits.[124]

bb) Uniform Rules for Demand Guarantees

Like the UCP, the Uniform Rules for Demand Guarantees are a private codification

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[121] Byrne, "New Standby Practices" *supra* note 15 at 2; P.S. Turner, "The New Rules For Standby Letters of Credit: The International Standby Practices" (1999) 14 B.F.L.R. 457 at 459 [hereinafter Turner, "The ISP"].
[122] See Bertrams, *Bank Guarantees supra* note 1 at 25.
[123] See ICC Publication No. 590 at 6 (Preface ISP98).
[124] See *supra* Part II – Chapter 1, II), 1), a).

published by the I.C.C. in 1992.[125] The URDG stipulate rules of practice for independent demand guarantees that can be incorporated into an agreement by the parties. Originally intended to equally cover standby letters of credit because of their conceptual resemblance to independent demand guarantees, the final version of the URDG did not refer to standby credits. Since banks in the United States are prevented from issuing guarantees pursuant to the *National Bank Act of 1864*,[126] the reason for the exclusion of the standby credit from the scope of the URDG was the concern that the explicit equation of the standby credit with the bank guarantee might prompt American courts to contemplate the entire standby undertaking as violating the *National Bank Act*. As a compromise, it was recognized in the introduction to the URDG that they were technically applicable to standby letters of credit, which enabled banks to select the URDG as the governing regime for a standby credit.[127]

Today, the URDG are rarely used in respect of bank guarantees and virtually never in respect of standby credits. Thus, the URDG represent a more theoretical than practical option for standby credits.

cc) United Nations Convention on Independent Guarantees and Stand-by Letters of Credit

(1) General

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[125] I.C.C. Publication No. 458; [hereinafter URDG]. The URDG are a response to the largely unsuccessful Uniform Rules for Contract Guarantees [I.C.C. Publication No. 325; hereinafter URCG], which were adopted by the I.C.C. in 1978. The latter rules proved to be inappropriate in that they rendered the guarantee secondary. The URCG conditioned payment under the guarantee upon the contractual default of the debtor. Only if such a primary default could be established, honour would be made under the guarantee. Guarantees made subject to the URCG, therefore, lacked independence from the contractual obligation that they were intended to secure and, consequently, were unacceptable to the beneficiary as a means of security.

[126] *Supra* note 47.

[127] For a comprehensive survey of the URDG, see Bertrams, *Bank Guarantees supra* note 1 at 22 *et seq.*; Goode, "Abstract Payment Undertakings" *supra* note 54 at 725 *et seq.*

The United Nations Convention on Independent Guarantees and Standby Letters of Credit[128] was drafted between 1989 and 1995 by the United Nations Commission on International Trade Law.[129] It was approved by UNCITRAL in 1995[130] and adopted by the United Nations General Assembly in the same year.[131] The Convention will enter into force on January 1, 2000.[132]

To date, five states have become parties to the Convention. Four states, including the United States, have signed the Convention and thereby signaled their willingness to consider ratification.[133] Canada has neither acceded to nor signed the Convention.

The new Convention aims to harmonize the use of independent guarantees and standby letters of credit by specifically recognizing the basic principles and characteristics shared by both instruments.[134] Thus, the Convention seeks to overcome the divergences between national laws by offering a single legal regime applicable to both independent guarantees

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[128] See *supra* note 29.

[129] The United Nations Commission on International Trade Law [hereinafter UNCITRAL] is an intergovernmental body of the General Assembly of the United Nations that prepares international commercial law instruments designed to assist the international community in modernizing and harmonizing international trade law. Within UNCITRAL, the I.C.C. represents the views of the international banking community. Conversely, UNCITRAL has long been involved in the I.C.C.'s efforts to bring letter of credit and guarantee law into line. For more information on UNCITRAL: See UNCITRAL homepage <http://www.un.org.at/uncitral> (date accessed: 7 October 1999) For a description of the drafting process, see E.E. Bergsten, "A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guarantee Letters" (1993) 27 Int'l Lawyer 859 *et seq.* [hereinafter Bergsten, "The UNCITRAL Draft Convention"].

[130] *Report of the United Nations Commission on International Trade Law*, UN GAOR, 50th Sess., Supp. No. 17, U.N. Doc. A/50/17 (1995).

[131] [1995] 49 U.N.Y.B. 1357, U.N. Doc. A/Res/50/48.

[132] The UNCITRAL Convention states that it is effective on the first day of the month following the expiration of one year after the date of deposit with the Secretary General of the United Nations of the fifth instrument of ratification, acceptance, approval or accession. See Art. 24(4), 28(1) UNCITRAL Convention.

[133] See *Status of Conventions and Model Laws*, U.N. GAOR, 31st Sess., U.N. Doc. A/CN.9/449 (1998) 10, or United Nations homepage <http://www.un.org/Depts/Treaty/final/ts2/newfiles/part_boo/x_boo/x_15_1.html> (date accessed: 14 October 1999).

[134] See *Explanatory Note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Standby Letters of Credit*, U.N. Doc. A/CN.9/431 (July 4, 1996) at para. 2 [hereinafter *UNCITRAL Explanatory Note*]. See also <http://www.un.org.at/uncitral/ > (date accessed: 8 October 1999). See also art 5

and standby letters of credit. The Convention not only purports to provide greater legal certainty in the daily use of each undertaking, but it also intends to allow both instruments to be used together, for example, the issuance of a standby letter of credit to support the issuance of a guarantee.[135]

(2) Scope and Application of the Convention

According to arts. 1 and 2, the Convention applies if the guarantor/issuer of an undertaking, which is known in practice as either an international independent guarantee or as international standby letter of credit, resides in a contracting state, or if the rules of private international law lead to the application of the law of a contracting state.

The automatic application of the Convention in these circumstances, however, is made subject to an escape clause granting the parties full autonomy to exclude the application of the Convention by agreement. Even if the parties decide to do so, however, the Convention's choice of law rules are still applicable. Only if the parties additionally choose a law that shall govern their undertaking, will they be able to entirely exclude the Convention. In the absence of such a choice, and notwithstanding the fact that the contractants may have chosen to opt out of it, the Convention's choice of law rules still apply.[136] In other words, in order to completely exclude the Convention, the parties must make a double choice of law: one with regard to the Convention, and a second with regard to the law that governs their relationship.

UNCITRAL Convention (Principles of Interpretation): "....regard is to be had to its international character and to the need to promote uniformity in its application...".

[135] *Ibid.*, at para. 4.

[136] Arts. 21 and 22 UNCITRAL Convention.

The two fundamental principles which determine the scope of the Convention's application are the principles of "independence" and "internationality."[137] Only undertakings which are both independent from the underlying relationship as well as involve parties whose places of business are in different member states fall within the scope of the Convention.

Even when both requirements are met by an international commercial letter of credit, the Convention does not automatically apply. Because the Convention is expressly restricted to international independent guarantees and standby letters of credit, parties residing in a contracting state must explicitly invoke the Convention in their transaction.[138] It follows from the above that, whenever an international undertaking cannot unambiguously be classified as either a standby or a commercial letter of credit, the contractants to such an undertaking are well advised to make an express statement as to the applicability of the Convention in the agreement.[139] This protects the parties to the transaction against unforeseen surprises as to the applicable body of law.

The Convention is designed to be consistent with existent and future rules of practice on independent guarantees and standby letters of credits. Thus, even though a particular letter of credit may be governed by two Conventions, the parties retain the power to incorporate other applicable regimes, such as the UCP or the URDG. In the view of the drafters of the Convention, this is actually expected, since they view the Convention more

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[137] See arts. 3 and 4 UNCITRAL Convention.

[138] Art. 2(1) UNCITRAL Convention. See also J.F. Dolan, "The UN Convention on Independent International Undertakings: Do States with Mature Letter-of-Credit-Regimes Need It?" (1998) 13 B.F.L.R. 1 at 9 [hereinafter Dolan, "UN Convention on Independent International Undertakings"]; Dole *supra* note 100 at 1089.
The UNCITRAL Convention does neither apply to accessory or conditional guarantees since both instruments are not of independent nature.

[139] See Dole *supra* note 100 at 1090.

as suppletive law than as an initial and primary framework for the covered undertakings.[140] Thus, the Convention addresses issues that are beyond the scope of the mentioned rules of practice, such as the issue of fraudulent or abusive payments.[141]

The Convention, therefore, seeks to give general legislative support to the contractual agreement of the parties. It regulates what can only be effectively achieved on a legislative level and what the parties cannot control in their contract, even if they incorporate the available sets of rules for independent guarantees and standby letters of credit.[142]

(3) Summary

Thus far, only a few states have adopted the new U.N. Convention on Independent Guarantees and Stand-by Letters of Credit. It is questionable, therefore, whether the Convention will actually represent an improvement on existing legal regimes for international independent undertakings as was intended.

The future prospects of the Convention may, therefore, well depend on the willingness of national courts to view the Convention as constituting a truly international body of law, which should be interpreted in the light of both the latest international commercial practices as well as existing international regulations. If the courts in contracting states construe the Convention in such a manner, some of the reservations that have prevented some states from ratifying the Convention to date may be remedied. In addition, a coherent, predictable and uniform body of law, specifically designed for independent

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[140] See *Explanatory Note supra* note 134 at para. 5.
[141] See Art. 19 and 20(3) UNCITRAL Convention.
[142] See "Interview with Gerold Herrmann on why ICC rules and international conventions are both necessary" (1999) 5 Letter of Credit Insight No.2 at 7 [hereinafter "Insight Interview with Gerold Herrmann"].

undertakings, may not only prompt other states to ratify the Convention, but it may also encourage parties in contracting states to view the Convention as better fitting their undertaking than the otherwise applicable national law.

dd) International Standby Practices 1998 (ISP98)

(1) General

The most recent regime to have emerged in the field of letters of credit is the International Standby Practices 1998.[143] After five years of preparation, the ISP98 were promulgated by the I.C.C. and the Institute of International Banking Law & Practice, Inc. in 1998. The new rules became effective on January 1, 1999.

The ISP98 are a new set of rules for standby letters of credit, intended to replace the UCP, which applied to most standby letters of credit in the past. While the UCP represent the worldwide accepted "governing law" for documentary credits, the ISP98 endeavour to accomplish the same for standby letters of credit in the future.[144]

The need for such a body of law has long been evident. Although the UCP strengthened the documentary and independent character of the standby letter of credit, many of the provisions of the UCP, as recognized by art. 1, were inappropriate or even detrimental when applied to a standby letter of credit.[145] In addition, many of the issues that commonly arise in a standby context were not at all or only insufficiently addressed by the UCP.

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[143] *Supra* note 30.
[144] See Turner, "The ISP" *supra* note 121 at 457.
[145] See Part II – Chapter 1, II), a), aa).

Moreover, the rapidly growing economic importance of the standby credit, which has outperformed the international commercial credit in terms of value by a ratio of 5:1 since its appearance, evidenced the need for a new set of rules specifically tailored to standby credits.[146]

The ISP98 seek to fill this legal void. The drafters of the ISP98 intended to create a new legal standard for standby credits, which simplifies and streamlines international standby practices. In the view of the drafting committee, the ISP98 offer neutral and widely accepted solutions to common standby problems. Since the ISP98 rules reflect the current practice, custom and usage of standby letters of credit, they are believed to save the parties considerable time and expense, because the previously difficult process of negotiating and drafting the standby terms will to a large extent be eliminated in the future.[147]

In general, the ISP98 are designed to be consistent with existing national and international regulations, particularly with the U.N. Convention on Independent Guarantees and Stand-by Letters of Credit and the UCP.

(2) Scope and Application of the ISP98

Like the UCP and the URDG, the ISP98 must be incorporated by reference in the standby undertaking, which therefore allows the parties to choose which set of rules will govern their undertaking.[148] This avoids making the often impossible distinction between

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[146] See I.C.C. Publication No. 590 Preface at 7.

[147] *Ibid.* at 6.

[148] See rules 1.01 and 1.04 ISP98. It follows from this that the standby credit may, despite the emergence of the ISP98, be issued subject to the UCP 500 or the URDG. Thus, the parties to a standby undertaking can select among these sets of rules the one they believe to be most suitable to their undertaking.

standby credits and independent guarantees, as well as between commercial credits and independent guarantees.[149]

It is noteworthy that the ISP98 provide for a selective incorporation, meaning that the parties to the undertaking are free to expressly stipulate, which rules shall govern their transaction.[150]

The ISP98 can, by contrast to the UCP 500, [151] generally be considered as contractual terms and not as trade usages, as they have been only recently enacted. Only where the ISP98 represent equally formulated and long established UCP rules may they be exceptionally viewed as codified trade usages.

The ISP98 are divided into ten different rules, each of which is subdivided into the actual provisions, which are also named rules. After stipulating General Provisions and Principles in rule 1, the ISP98 deal with the obligations of the parties to the standby (rule 2), the presentation and examination of the documents (rules 3 and 4) as well as with their disposition, notice and preclusion (rule 5), the transfer and assignment of the credit and its cancellation (rules 6 and 7), the reimbursement obligations of the applicant (rule 8), and, finally, with the timing of the credit and syndication/participation issues (rules 9 and 10).

While the ISP98 are the first set of rules applicable to letters of credit that permit the electronic presentation of necessary documents,[152] the ISP98 fail to cover, as do the UCP 500 and the URDG, the issue of fraudulent or abusive payments under the credit.[153] This matter is left to be settled by the applicable national legal regime.

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[149] See I.C.C. Publication No. 590 Preface at 7.
[150] See rule 1.01(c).
[151] See *supra* Part II – Chapter 1, II), 1), a).
[152] See rules 1.09(c), 3.06.
[153] See rule 1.05.

In contrast to the UCP 500, which do not make any mention of arbitration, the drafters of the ISP98 remarked that the new rules are intended to be used not only in judicial proceedings but also in arbitration or other methods of dispute resolution.[154] It is recommended by the drafting committee that such a choice be made with appropriate detail.[155]

(3) Summary

The ISP98 offer a comprehensive and long overdue unified source of law for international standby credits. Whether the new rules will preserve the worldwide integrity of the standby credit, as stated by the I.C.C., cannot yet be determined, but they certainly lay promising foundations for the successful expansion in the use of the standby letter of credit in the future.

The ISP98 represent an even-handed and commendable set of rules, which should be preferred to the existing regimes by all parties to a standby credit, i.e. issuers, applicants and beneficiaries. In this respect, it proved to be useful that the drafting commission, in contrast to the composition of drafters chosen for the last UCP revision, sought the active participation of every segment of the letter of credit community including bankers, users, attorneys, regulators, international agencies, government officials and academics.[156] Nonetheless, at some point amendments will have to be made, as for example with regard to payment to a fraudulent presenter[157] or to the standards to which the presented

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[154] See I.C.C. Publication No. 590 Preface at 8.
[155] *Ibid.*
[156] See Byrne, "New Standby Practices" *supra* note 15 at 2.
[157] See rule 4.13 ISP98, which states that an issuer who honours a presentation of documents owes no duty to the applicant to ascertain the identity of any person making the presentation. It is, however, the issuer or the paying institution, and not the applicant, who can best assess the identity of the beneficiary and prevent the

documents must comply.[158] The fact that the ISP98 permit a selective incorporation, however, should enable knowledgeable standby users to opt out of provisions perceived as being unfavourable to them.

Though at this point no reliable figures on the actual acceptance of the ISP98 in standby credits exist, it has been reported that the ISP98 are already frequently used in the United States, while their entry into the Canadian standby market is probably another one to two years away.[159]

b) National Sources for Standby Letters of Credit

aa) Canada

There is no specific Canadian legal source regulating standby letters of credit. One may, therefore, refer to the above discussion regarding documentary credits, which applies equally in a standby context.[160]

bb) United States

In the United States, Rev. Art. 5 U.C.C. generally regulates letter of credit law.[161] Rev. Art. 5 U.C.C., therefore also covers the standby undertaking. An extensive discussion

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unjustified honour of the credit. See Dolan, *Law of Letters of Credit supra* note 13 revised edition, cumulative supplement 4.09(3). See for other suggested improvements Turner, "The ISP" *supra* note 121 at 502 *et seq.*.

[158] See rule 4.09(c) ISP98, which stipulates that the presented documents must even recognize blank lines, typographical errors in spelling, punctuation, spacing and the like in order to meet the "exact" and "identical" wording standard.

[159] Interview with Pierre B. D'Avignon, Assistant General Manager International Trade, Scotiabank Montreal, and Ghassan Azar, Assistant General Manager Import, Scotiabank Montreal, October 12, 1999.

[160] See *supra* Part II – Chapter 1, II), 1), b), aa).

[161] See § 5-102(10) Rev. U.C.C. defining a letter of credit.

regarding Art. 5 U.C.C. and its 1995 revision has been undertaken at an earlier stage to which one can refer at this point.[162]

It is noteworthy in this respect that courts in the United States have not hesitated to equally apply former Art. 5 U.C.C. to standby letters of credit, even though the standby evolved after the introduction of Art. 5 U.C.C. and was, therefore, not intended to be governed by that law.[163] Thus, in those states which have not yet adopted revised Art. 5 U.C.C., the original Art. 5 U.C.C. applies to standby transactions.

c) Interrelationship

aa) UCP 500, URDG, ISP98 – Revised Article 5 U.C.C.

When both art. 5 U.C.C. and the UCP 500 apply or are incorporated into a standby credit, the UCP 500 prevail as a specific contractual arrangement insofar as they do not conflict with any mandatory provisions of the U.C.C.[164]

The same is true when the URDG are incorporated into an American standby credit.

Although most of the issues dealt with by the ISP98 are not reflected by national law and thus will not conflict with the more general provisions of Art. 5 U.C.C., and although the drafters generally intended to design the ISP98 so as to be compatible with national laws in order to avoid possible conflicts of law,[165] the mandatory provisions of the U.C.C. will govern a particular transaction if any conflicts arise between such provisions and the

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[162] See *supra* Part II – Chapter 1, II), 1), b), bb).
[163] See e.g. *American National Bank supra* note 59; *Security Finance Group Inc.* v. *Northern Kentucky Bank & Trust Co.*, 875 F. 2d 529 (6th Cir. 1988) [hereinafter *Security Finance Group*].
[164] See *supra* Part II – Chapter 1, II), 1), c).
[165] See I.C.C. Publication No. 590 Preface at 8.

ISP98. If, however, the conflicting provision of the U.C.C. is not imperative, then the parties' contractual agreement to incorporate the ISP98 will prevail.

bb) UCP, URDG, ISP98 – U.N. Convention on Independent Guarantees and Stand-by Letters of Credit

The drafters of the Convention as well as those of the ISP98 directed their efforts to already existing legal regimes so as to avoid inconsistencies and incongruities between the different sets of rules. Thus, the UNCITRAL Convention took into consideration the UCP 500 and URDG, while the ISP98 commission intended to promulgate rules that would be compatible with the Convention on Guarantees and Stand-bys.

Though rather unlikely, conflicts between particular provisions of the UCP 500, URDG and ISP98 on the one hand, and particular articles of the U.N. Convention on the other, may still arise.

In order to comprehend their interrelationship should such a conflict arise, it is necessary to briefly recall their distinct features.

The UCP 500, URDG and ISP98 represent fairly detailed practices that, for the most part, regulate the actual letter of credit procedure from issuance to honour. The parties to the undertaking contractually agree to include these rules into their undertaking. Thus, the rules operate at a contractual level.

This stands in contrast to the UNCITRAL Convention, which is a suppletive body of international law mainly regulating issues that do not lend themselves to the making of a

contractual arrangement. The UNCITRAL Convention has the force of law once it is adopted in a country. Thus, the Convention operates on a statutory or legislative level.[166]

From this follows the interrelationship between these bodies of law. The parties may only contractually incorporate the UCP 500, URDG or ISP98 to the extent that any of these regimes does not conflict with a provision of the UNCITRAL Convention, as the latter applies imperatively. Only when the incorporated rule infringes compulsory provisions of the UNCITRAL Convention does the respective article in the Convention apply.

Thus far, neither Canada nor the United States has ratified the UNCITRAL Convention, and consequently such a conflict of laws will not arise. Since the United States have signed the UNCITRAL Convention, however, this may yet happen. If such occurs it will be interesting to see how the UNCITRAL Convention fits into the already existing national law on letters of credit in Art. 5 U.C.C.

III) The Contractual Relationships in a Letter of Credit Transaction

A basic letter of credit transaction involves at least three parties - the issuer, the beneficiary and the applicant - and as many contractual relationships.[167] In order to assess both fraudulent letter of credit transactions and the prospects of using arbitration in that context, one must understand the different relations that are created by a letter of credit.

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[166] See "Insight Interview with Gerold Herrmann" *supra* note 142 at 7.

[167] See generally on the contractual relationships in a letter of credit transaction *Dynamics Corporation of America* v. *The Citizens and Southern Bank*, 356 F. Supp. 991 (N.D. Ga. 1973) [hereinafter *Dynamics Corporation*]; *United City Merchants (Investment)* v. *Royal Bank of Canada* [1982] All E.R. 720 at 725 (H.L.) [hereinafter *United City Merchants*]; *Robinson* v. *Ontario New Home Warranty Program* (1994), 18 O.R. (3d) 269 (Ont. Gen. Div.) [hereinafter *Robinson*]; Ellinger, *Documentary Letters of Credit supra* note 36 at 131 *et seq.*

1) The Underlying Contract between the Applicant and the Beneficiary

The first relationship is the international sales contract, which creates the rights and obligations between the buyer and the seller. This is commonly referred to as the underlying contract. In the underlying contract, the applicant agrees to procure a letter of credit in favour of the beneficiary in order to pay a certain amount to the latter (documentary credit) or in order to secure an obligation owed by the applicant to the beneficiary (standby credit).[168] The stipulation for a documentary credit is thus a condition precedent to the seller's obligation to deliver the goods.[169] Likewise, the procurement of a standby credit is usually a prerequisite to the beneficiary's performance of the underlying contract.[170]

The contract, and, therefore, the clause obliging the applicant to open a letter of credit, will be governed by the law expressly chosen by the parties to the commercial contract. It must be borne in mind, however, that such a choice does not affect the letter of credit itself, since this is an autonomous and distinct contract between different parties. If no such choice has been made, general conflicts of law rules apply.

2) The Contract between the Applicant and the Issuer

The second contractual relationship is formed between the applicant and the issuing institution, which is commonly a bank.[171]

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[168] See Jeffery, "Standby Letters of Credit" *supra* note 55 at 517; Leacock, "Fraud in the International Transaction" *supra* note 43 at 373.
[169] *Trans Trust S.P.R.L.* v. *Danubian Trading Co. Ltd.* [1952] 2 Q.B. 297 at 304 (C.A.) [hereinafter *Trans Trust*].
[170] See Jeffery, "Standby Letters of Credit" *supra* note 55 at 517.
[171] While the UCP 500 refer only to banks in their function as issuers (art. 9), confirmers (art. 9), advisers (art. 7) and banks nominated to honour letters of credit (art. 9), the scope of the ISP98 includes other institutions that may issue, confirm, advise or be nominated to honour a standby letter of credit. Art. 2 URDG refers to banks, insurance companies or other bodies or persons as guarantor, and § 5-102(9)

In order to comply with its duty arising from the underlying relationship, the applicant contacts a financial institution. On a standard form contract specifying the issuing institutions' terms and conditions, which most commonly incorporate either the UCP 500 or the ISP98, the applicant requests the issuance or opening of a letter of credit in favour of the beneficiary.[172] From the applicant's perspective, it is of critical importance to precisely stipulate the correct amount, date of expiration and, above all, documentary requirements that must be met by the beneficiary before payment will be made by the issuer.[173] Conversely, the issuer must carefully comply with these stipulations, for otherwise it deviates from the applicant's instructions and entitles the latter to refuse reimbursement.[174] Moreover, the issuer must assess the applicant's financial situation. Often the issuer demands security prior to the opening of the credit in order to be able to ensure satisfaction of its claim after the credit has been honoured.[175] Once the application has been approved by the financial institution, the contract between the issuer and the applicant is formed.[176]

Under the contract the issuer is obliged to notify the credit to the beneficiary and to effect payment upon presentation of conforming documents. The applicant agrees to reimburse and indemnify the issuing institution for both bank fees and payments made under the credit.[177] In the absence of a specific indemnity, the issuer is entitled to be

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Rev. U.C.C. defines an issuer as a bank or any other person. Art. 2(1) UNCITRAL Convention speaks of banks or other institutions or persons as issuers. Thus, the latter regimes recognize that, particularly in the United States, non-banks often issue letters of credit.

[172] See Oelofse, *Letters of Credit supra* note 15 at 21 *et seq.*

[173] See art. 5 UCP 500.

[174] See Ellinger, *Documentary Letters of Credit supra* note 36 at 156; H. Harfield, "The Standby Letter of Credit Debate" (1977) 94 Banking L.J 293 at 299 [hereinafter Harfield, "The Standby Debate"].

[175] See Dolan, *Law of Letters of Credit supra* note 13 at 7-84; Leacock, "Fraud in the International Transaction" *supra* note 43 at 888 *et seq.*

[176] See H.C. Gutteridge & M. Megrah, *The Law of Bankers' Commercial Credits*, 7th ed. (London: Europa Publications, 1984) at 58 [hereinafter Gutteridge & Megrah, *Commercial Credits*].

[177] See *United City Merchants supra* note 167 at 725.

indemnified by the applicant, provided it has strictly complied with the terms of the credit.[178]

When no choice of law has been made, the governing law of this contract will usually be that of the place where the issuing bank carries on its business (*lex loci solutionis*).[179]

3) The Relationship between the Issuer and the Beneficiary: The Letter of Credit

The third relationship is formed between the issuer and the beneficiary. It is constituted by the letter of credit itself and may be revocable or irrevocable.[180] The issuing institution will generally incorporate either the UCP 500 or the ISP98 into the letter of credit. Under this contract the issuer is obliged to honour the credit once the beneficiary has completely tendered the requisite documents.[181]

Again, in the absence of any express choice of law, the law of the issuing institution (*lex loci solutionis*) usually governs the relationship, since it is the issuer who must pay the beneficiary upon presentation of the required documents.[182]

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[178] See Ellinger, *Documentary Letters of Credit supra* note 36 at 156 *et seq.*; Jeffery, "Standby Letters of Credit" *supra* note 55 at 519.
This principle of strict compliance will be examined at a later stage. See *infra* Part II – Chapter 1, IV), 1).

[179] See § 5-116(a),(b) Rev. U.C.C stating that in the absence of any choice of law the "...liability of an issuer ...is governed by the law of the jurisdiction in which the person is located.."(§ 5-116(b)); Gozlan & Amar, "Rules applicable to Letters of Credit" *supra* note 74 at 73; C.M. Schmitthoff, "Conflict of Law Issues Relating to Letters of Credit: An English Perspective" in Chia Jui Chang, ed., *Select Essays on International Trade Law* (Dordrecht: Nijhoff, 1988) at 580.

[180] *Supra* notes 45 and 68.

[181] See art. 9(a) UCP 500; rule 2.01 ISP98; § 5-108 Rev. U.C.C. In common law jurisdictions, and thus throughout Canada and the United States with the exceptions of the Province of Quebec and the State of Louisiana, the relationship between the issuer and the beneficiary causes ongoing confusion. Although this relationship is commonly described as contractual, the difficulty at common law is that no consideration is given by the beneficiary. In the United States § 5-105 now states that "Consideration is not required to issue, amend, transfer, or cancel a letter of credit ..." For further information regarding this question, see *Hamzeh Malas & Sons* v. *British Imex Industries Ltd.* [1958] 1 All E.R. 262 at 263 (C.A.) [hereinafter *British Imex*]; *East Girard Sa. Ass'n* v. *Citizens Nat. Bank and Trust Co. of Boytown*, 593 F. 2d 598 (5th Cir. 1979) [hereinafter *East Girard*]; *Angelica-Whitewear Ltd.* v. *Bank of Nova Scotia*, [1987] 1 S.C.R. 59 at 82 [hereinafter *Angelica-Whitewear*] and particularly Ellinger, *Documentary Letters of Credit supra* note 36 at 39 *et seq.*

[182] See § 5-116(b) Rev. U.C.C. *supra* note 179.

4) Summary

A basic letter of credit transaction is comprised of three relationships, which together form and govern the letter of credit transaction. As discussed at a later stage,[183] each of these relationships is, at least in theory, distinct and separate from the others and should be viewed as such notwithstanding the fact that conditions arising in one of the relationships may have an impact on the others.[184] From this it follows that it is of critical importance to clearly distinguish between these three sets of relationships when reviewing fraudulent letter of credit transactions and when analyzing the usefulness of arbitration between the parties in such circumstances.

IV) Letter of Credit Principles

The letter of credit is a commercial device that offers unique trustworthiness and protection as a means of payment and security to international traders. This derives from two key principles: the principle of documentary compliance; and the principle of independence. Together, these two principles govern all letter of credit transactions.

Because both principles must be set aside in order to prevent a fraudulent drawing under a letter of credit, it is necessary to analyze their impact on the letter of credit transaction.

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[183] See *infra* Part II – Chapter 1, II).
[184] See art. 3 UCP 500 (Credits v. Contracts).

1) The Principle of Documentary Compliance

The principle of documentary compliance provides that the issuer is obliged to honour the credit upon a presentation of documents by the beneficiary that *prima facie* appears to comply with the terms and conditions of the letter of credit.[185]

The standard of documentary compliance that must be met by the issuer in the documentary examination process has in the past caused considerable trouble for the courts in Canada and the United States.[186] It is now commonly accepted, however, that the documents tendered must strictly, and not merely substantially, conform with the stipulations of the credit. The doctrine and jurisprudence now refer, therefore, to the rule of strict compliance.[187]

The rule of strict compliance in conjunction with the independence principle, preserves the fundamental nature of a letter of credit as a means of allocating the risks in the underlying transaction between the parties. Since the letter of credit is essentially a documentary transaction, where, depending on the type of credit, both proper and improper performance of the underlying obligation are represented by documents, the rule of strict compliance seeks to ensure that the requirements of the credit are actually and

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[185] See arts. 2, 9, 13, 14 UCP 500; rules 1.06(d), 2.01, 3.01; 4.01, 4.03 ISP98; art. 2(1), 9 URDG; art. 2(1), 15(1), 16(1) UNCITRAL Convention; § 5-108(a), 5-109(a) Rev. U.C.C.

[186] See e.g. *Board of Trade* v. *Swiss Credit Bank*, 728 F. 2d 1241 (9th Cir. 1984) [hereinafter *Swiss Credit Bank*]; Royal *Bank of Canada* v. *Ohammesyan*, [1994] O.J. No. 1728 (Ont. Gen. Div.) [hereinafter *Ohammesyan*] (examples of cases in which the strict compliance rule was used); *Tosco Corp.* v. *F.D.I.C.*, 723 F.2d 1242 at 1248 (6th Cir. 1983) [hereinafter *Tosco Corp.*] (example for a case where the substantial compliance rule was used); G. McLaughlin, "The Standard of Strict Compliance: An American Perspective" (1990) 1 J.B.F.L.P. 81 [hereinafter McLaughlin, "Standard of Strict Compliance"], Sarna, *Letters of Credit supra* note 15 at ch. 3 - § 1(c).

[187] See § 5-108(a) Rev. U.C.C.: "...an issuer shall honor a presentation that....appears on its face to comply with the terms and conditions of the letter of credit..."; *C. Vincent Ltd.* v. *Bank of Montreal* [1994] 1. W.W.R. 374 [hereinafter *C. Vincent*]; Oelofse, *Letters of Credit supra* note 15 at 271; R.W. Reinsch & M. Blodgett, "An International Trade Agreement to Limit "Fraud in the Transaction" in Letters of Credit" (1995) 13 Midwest L. Rev. 92 at 93 [hereinafter Reinsch & Blodgett, "International Trade Agreement for Fraud in the Transaction"].

fully met.[188] Only then is the beneficiary entitled to payment. Thus, the rule of strict compliance reduces the risk of wrongful honour in the case of partial or sub-standard performance by the beneficiary. For instance, payment will not be effected when the documents describe "coromandel groundnuts" instead of the requested "machine-shelled groundnut kernels."[189] Even when the documentary discrepancy is not substantial, and consequently, payment should be made under the credit, an imprecise wording, a missing stamp or any other minor documentary deviation[190] from the terms of the credit automatically renders the presentation non-compliant. This has been acknowledged as follows:

> "There is no room for documents which are almost the same, or which will do just as well."[191]

The reason for this somewhat pedantic approach, however, is not only to be found in the protection it affords to the applicant. The rule of strict compliance also reflects the ministerial and intermediary role of the issuing institution with respect to the underlying agreement.[192] It is established to safeguard the issuer, which would otherwise not be willing to enter into the transaction, since it would lack the necessary specialized knowledge in order to correctly interpret documentary stipulations. The rule of strict compliance, therefore, ensures that the issuer need not concern itself with the usages and terminology of all their clients.[193] In addition, it recognizes the linguistic differences in international

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[188] See M.S. Blodgett & D.O. Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud" (1998) 35 A.J. Bus. L. 443 at 448 [hereinafter Blodgett & Mayer "International Letters of Credit"]; van Houten, "Letters of Credit and Fraud" *supra* note 12 at 377.

[189] *J.H. Rayner & Co. Ltd.* v. *Hambro's Bank Ltd.* [1945] 1 KB 36 [hereinafter *J.H. Rayner*].

[190] See in this respect rules 4.07 *et seq.* ISP98 stipulating precisely the standards for strict compliance.

[191] *Equitable Trust Co.* v. *Dawson Partners*, [1927] Lloyd's Rep. 49, 52 (H.L.) [hereinafter *Equitable Trust*].

[192] See J.F. Dolan, "Strict Compliance with Letters of Credit: Striking a Fair Balance" (1985) 102 Banking L.J. 18 at 20 [hereinafter Dolan, Strict Compliance with Letters of Credit"].

[193] See R.P. Buckley, "Potential Pitfalls with Letters of Credit" (1996) 70 A.L.J. 217 at 221 [hereinafter Buckley, Letter of Credit Pitfalls].

transactions, which would otherwise pose an unwarranted risk of misunderstanding to the examining institution.

The issuer's obligation, therefore, is limited to the examination of whether or not the documents tendered appear on their face to be consistent and in strict compliance with the terms and conditions of the credit. In performing that obligation, the issuer must exercise reasonable care.[194]

2) The Independence Principle

The second essential feature of letter of credit law is the independence principle, or as it is often also referred to, the principle of autonomy.[195] The independence principle states that the contracts formed under a letter of credit are completely independent of one another.[196] The issuer's obligation under the letter of credit, therefore, is not only independent from the underlying contract between the applicant and the beneficiary, but also from the cover relationship that is the contract between the issuer and the applicant. Furthermore, the underlying contract is separate and distinct from the cover relationship. This triple autonomy is discernible in the various laws that usually govern the different relationships.[197]

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[194] *Supra* note 185.

[195] See art. 3 UCP 500; rules 1.06, 1.07 ISP98; art. 2 URDG; §§ 5-103(d), 5-108(f)(1) Rev. U.C.C.; art. 3 UNCITRAL Convention.

[196] See e.g. *Alaska Textile Co.* v. *Chase Manhattan Bank*, NA, 982 F. 2d 813 (2nd Cir. 1992) [hereinafter *Alaska Textile*]; P. Belanger, "The Fraud Exception in Irrevocable Documentary Credits: The Limits of Autonomy, Part I" (1994) 13 Nat'l Banking L. Rev. 13 at 14 [hereinafter Belanger, "The Limits of Autonomy"]; J.J. Ortego & E.H. Krinick, "Letters of Credit: Benefits and Drawbacks of the Independence Principle" (1998) 115 Banking L.J. 487 at 487 [hereinafter Ortego & Krinick, "The Independence Principle"]

[197] See *Attock Cement Co.* v. *Romanian Bank for Foreign Trade*, [1989] 1 All E.R. 1189 (C.A.) at 1199 *et seq.* [hereinafter *Attock Cement*]; McGuinness, *Law of Guarantee supra* note 46 at 819.

The legal analysis of what is embodied in and constituted by the principle of autonomy is usually closely related to the question of under what circumstances it may be set aside. If one would set the independence principle aside, a general, all-embracing consideration of all the contracts of a letter of credit transaction would be permissible in order to determine the rights and obligations of the parties to one of the three contracts.

Since both the applicant and the beneficiary expressly agreed on the opening of a letter of credit in their underlying relationship, and since the actual letter of credit is opened pursuant to the instructions of the applicant, the cover relationship clearly does not give rise to any conflicts with the other relationships. For these reasons the independence principle has very rarely, if ever, been challenged in respect of the cover relationship.

As discussed at a later stage, the independence of the underlying transaction from the letter of credit contract between the issuer and the beneficiary, however, has been repeatedly contested and from time to time entirely ignored.[198]

Therefore, the autonomy principle is often interpreted rather narrowly, in referring solely to the separateness of the underlying sales or performance contract from the letter of credit. This notion of the autonomy principle is adopted by the UCP 500, which state in art. 3(a) that:

> "credits are, by their nature, separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contracts."

Though the UCP 500 are specifically designed for documentary credits, the independence principle is as present in and fundamental to the standby context and thus governs all types of letters of credit.[199]

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[198] See *infra* Part II – Chapter 1, V).

The independence principle dictates that the issuer is under a legal duty to honour demands for payment that comply with the stipulations of the credit independent of any underlying contract.[200] This implies that disputes arising from the underlying contract do not affect the honouring of the credit. In other words, as long as the documents presented comply with the credit, the beneficiary is entitled to payment, irrespective of whether or not they actually represent the quality and quantity of the dispatched goods and irrespective of whether or not the applicant actually defaulted in performing its contractual obligation under the underlying contract. Since the letter of credit has "a life of its own that is separate and abstract from the life of the underlying contract,"[201] a breach of the underlying agreement does not, therefore, really influence the obligation of the issuer under the credit.[202]

Otherwise, the *raison d'être* of the letter of credit as a guarantee of payment would be undermined. This has been outlined in the Canadian case of *Angelica-Whitewear* v. *Bank of Nova Scotia*:

> "The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour a draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued."[203]

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[199] See e.g. *Westpac Banking supra* note 60 at 523, *Bank of Montreal* v. *Mitchell* (1997), 143 D.L.R. (4th) 697 (Ont. Gen. Div.) [hereinafter *Bank of Montreal*]; Dolan, "Standby Letters of Credit and Fraud" *supra* note 66 at 2. See also rule 1.07 ISP98, art. 2(b) URDG, § 5-103(d) Rev. U.C.C., art. 3 UNCITRAL Convention.

[200] See e.g. *Itek Corp.* v. *First National Bank of Boston*, 730 F. 2d 19, 24 (1st Cir. 1984) [hereinafter *Itek Corp.*]; Faruqi, "Letters of Credit" *supra* note 12 at 331.

[201] See *Bank of North Carolina N.A.* v. *Rock Island Bank*, 570 F. 2d 202 at 206 (7th Cir. 1978) [hereinafter *Bank of North Carolina*].

[202] See e.g. Gutteridge & Megrah, *Commercial Credits supra* note 176 at 59.

[203] *Angelica-Whitewear supra* note 181 at 70. See also *Sun Marine Terminals, Inc.* v. *Artoc Bank and Trust, Ltd.*, 760 S.W. 2d 311 (Tex. Ct. App. 1988); *Ward Petroleum Corp.* v. *Federal Deposit Ins. Corp.*, 903 F. 2d 1297 (10th Cir.

Moreover, it would contradict common principles of fairness if an issuing institution would be held liable on an obligation arising in a relationship to which it is not a party and which is, therefore, beyond its control. In many cases, not only would it be practically impossible for the issuer to look beyond the terms of the letter of credit on the controversy in the underlying relationship, but it would also bring the issuing institution into the unfortunate position of having to make quasi-legal determinations, since it would have to evaluate the merits of the underlying dispute between applicant and beneficiary in deciding whether or not to honour the credit. Under these circumstances, the issuer would probably face ongoing legal actions instituted by both applicant and beneficiary resulting from a misinterpretation of the underlying contract.[204]

The indispensability of the independence principle has, for this reason, even been recognized where the credit explicitly incorporates the underlying contract of sale.[205]

Thus, on the one hand, the independence principle provides that the issuer shall not be prevented from honouring the letter of credit, even when the applicant has informed the issuing institution of a clear contractual breach committed by the beneficiary. On the other hand, when the beneficiary's documents fail to comply with the terms and conditions of the credit, the issuer may refuse to pay even though the applicant is satisfied with the

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1990) describing the independence principle as "the cornerstone of the commercial viability of the letter of credit."

[204] See e.g. *F.D.I.C.* v. *Bank of San Francisco*, 817 F. 2d 1395, 1399 (9th Cir. 1987) [hereinafter *FDIC*]; *APV Baker, Inc.* v. *Harris Trust & Savings Bank*, 761 F. Supp. 1293 at 1301 *et seq.* (W.D. Mich. 1991); C.J. Greenleaf, "The Holder-In-Due-Course Exemption to the Fraud Exception to Compelled Honour under Revised Article 5" (1998) 115 Banking L.J. 29 at 32 [hereinafter Greenleaf, "The Holder-In-Due-Course Exemption"].

[205] See *Courtalds North America Inc.* v. *North Carolina National Bank*, 528 F. 2d 802 (4th Cir. 1975) [hereinafter *Courtalds North America*].

tendered documents,[206] as a result of the application of the independence principle and the rule of strict compliance.

V) Fraud in the Letter of Credit Transaction

It has been commonly stated that the only recognized exception to the independence principle is in the case of fraud in the transaction.[207] Though such a view fails to recognize that the fraud in the transaction scenario also constitutes an exception to the rule of strict compliance, it is true that, in the past, courts in Canada and the United States have been willing to disregard the independence principle in order to prevent honour under the credit because of abusive or fraudulent demands. It is the purpose of this section to reappraise the circumstances under which courts in Canada and the United States have been willing to grant this exception in the light of recent jurisprudence.

In order to depict a fraud in the transaction situation, as well as to provide a brief historical review of the origin of the fraud exception, the landmark decision of *Sztejn* v. *Henry Schroeder Banking Corp.*[208] will be discussed. Next the statutory approach to the fraud exception will be outlined before the scope of the fraud exception and its locus[209] will be described. Afterwards the legal remedies available to the parties in a fraud scenario will be examined. This section closes with an analysis of the standard that constitutes fraud and the duties of care that the issuer owes to both the applicant and the beneficiary.

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[206] See *AMF Head Sports Wear, Inc.* v. *Ray Scott's All American Sports Club*, 448 F. Supp. 222 (D. Ariz. 1978) [hereinafter *AMF Head*].

[207] See e.g. *Emery-Waterhouse Co.* v. *Rhode-Island Hosp. Trust Nat'l Venture Partnership*, 757 F. 2d 399 (1st Cir. 1985) [hereinafter *Emery-Waterhouse*]; Famula, "Fraud exception" *supra* note 2 at 31; Jeffery, "Standby Letters of Credit" *supra* note 55 at 524.

[208] 31 N.Y.S. 2d 631 (N.Y. Sup. Ct. 1941) [hereinafter *Sztejn*].

[209] By locus is meant either whether there is a material fraud involving forgery or falsification of documents, or whether there has been some fraudulent misrepresentation in the underlying transaction.

1) Sztejn v. Henry Schroeder Banking Corp.

The exception concerning fraud in the transaction can be traced back to the American decision of *Sztejn* v. *Henry Schroeder Banking Corp.*[210]

In *Sztejn*, the plaintiff, an American buyer, contracted to purchase a number of bristles from *Transea Traders*, an Indian-based corporation. In order to pay for the bristles, *Sztejn* agreed with Henry Schroeder Banking Corp., the American issuer, to open an irrevocable letter of credit, in which it was stipulated that payment will be made by shipment of the goods and upon presentation of a bill of lading and a commercial invoice.

Instead of delivering bristles, *Transea Traders* shipped a number of crates filled with "cowhair, other worthless material and rubbish," in order "to simulate genuine merchandise and to defraud the buyer."[211] Nonetheless, *Transea Trader* managed to acquire documents that were consistent with the terms and conditions of the credit. Before the bank paid the draft, the plaintiff discovered the fraud and sought injunctive relief in order to declare the letter of credit void and to enjoin it from being honoured.

In its analysis the court first revisited the "well established" independence principle. It stated that the application of the independence rule is limited to situations in which the accompanying documents are "genuine and conform with the requirements of the letter of credit."[212] In so doing, the court was actually making two points. First, it assumed that adherence to the rule of strict compliance is a prerequisite to upholding the independence principle. Second, it held that the independence principle is not intended to legitimize the tendering of falsified or fraudulent documents.

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[210] *Ibid.*

The court then went on to say that

> "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."[213]

In so ruling, the court laid the foundations for what is today classified as the fraud exception in letter of credit transactions.

The court remarked that the case before it was not a "breach of warranty" but rather one of "active fraud." Therefore, no

> "hardship is caused...where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish, where the draft and the accompanying documents are in the hands of one who stands in the same position as the fraudulent seller, where the bank has been given notice of the fraud before being presented with the drafts and documents for payment...."[214]

Enjoining payment of the draft in such situations protects not only the interests of the applicant, but also those of the issuing bank, since a bank is

> "vitally interested in assuring itself that there are some goods represented by the documents."[215]

Since *Sztejn* courts around the world, including Canadian and American courts, have recognized and established the fraud exception in both documentary and standby credit transactions.[216] In the United States, the *Sztejn* decision and others following it inspired the

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[211] *Ibid.*, at 633.
[212] *Ibid.*, at 634
[213] *Ibid.*, at 634.
[214] *Ibid.*, at 635.
[215] *Ibid.*, at 635.
[216] For American cases that have expressly referred to *Sztejn*, see e.g. *Merchants Corp. of America* v. *Chase Manhattan, N.A.*, 5 UCC Rep. Serv. 196 (N.Y. Sup. Ct. 1968) [hereinafter *Merchants Corp. of America*]; *Dynamics Corporation supra* note 167 at 999 *et seq.*
See for English cases that expressly referred to *Sztejn* e.g. *Edward Owen supra* note 60 at 172; *"The American Accord"* [1979] 2 Lloyd's Rep. 267 at 276 (Q.B.) [hereinafter *"The American Accord"*].

drafters of art. 5 U.C.C. to include a provision bringing fraudulent transactions within the scope of the U.C.C., which, in amended form, was re-established in the revised 1995 version.[217]

2) Statutory Reference to the Fraud Exception

a) UCP 500, URDG and ISP98

The UCP 500, the URDG and the ISP98[218] do not contain any provision dealing with fraud. Instead, all of these regimes lay specific emphasis on the independence principle by mentioning its applicability at numerous points. The issue of fraud is thus left to be governed by domestic law. This policy has proven to be pragmatic, since the local laws of more than 150 states, in which financial institutions have adopted the UCP 500, and may gradually adopt the ISP98, differ significantly in their treatment of the issue of fraud. It is, therefore, almost impossible to create acceptable uniform rules on fraud.[219] Additionally, courts in states in which the leading credit issuers are located were forced to develop rules on the fraud exception in order to prevent a gradual depreciation in the integrity of the letter of credit. This suggests that guidance on the fraud question is not only essential to the mercantile viability of letter of credit transactions, but that it is best dealt with on a national level. Absent such guidance on the fraud issue, commercial parties will make their

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[217] See § 5-114(2) U.C.C and § 5-109 Rev. U.C.C..

[218] A rule that would have made the respective provisions of the UNCITRAL Convention applicable when the standby credit contains no choice of law clause was finally omitted by the ISP98. The rule would have imported the UNCITRAL Convention's fraud rules into the credit as well as the jurisdictional fraud law made applicable by the Convention. Turner, "The ISP" *supra* note 121 at 463.

[219] See Barski, "Comparison of Article 5 and the UCP" *supra* note 99 at 751; J.F. Dolan, "Commentary on Legislative Developments in Letter of Credit Law: An Interim Report" (1992) 8 B.F.L.R. 53 at 63 [hereinafter Dolan, "Interim Report on Legislative Developments"]; Turner, *ibid.*, at 463. It is noteworthy that exactly this fraud question posed considerable problems for UNCITRAL while drafting the U.N. Convention on

transaction subject to laws that offer substantial protection against fraud.[220] In recognizing these advantages, the I.C.C. preferred to avail itself of those national regimes that have already developed workable rules on fraud and to leave the development of such fraud rules as an incentive for those states that have not yet elaborated them.[221]

b) U.N. Convention on Independent Guarantees and Stand-by Letters of Credit

The UNCITRAL Convention refers to the fraud issue in two provisions: one addresses the fraud question itself;[222] the other sets out provisional measures available to victims of fraud.[223] Pursuant to arts. 19 and 20 of the UNCITRAL Convention, interlocutory relief is available when the documents tendered by the beneficiary are not genuine or are falsified, when the underlying basis of the guarantee/standby credit no longer exists, or when there is "no conceivable basis" for honour, "judging by the type and purpose of the undertaking." Clearly the first two of these three exceptions to payment restate the existing legal practice of most every jurisdiction. The vagueness of the remaining third exception, however, reveals the difficulties faced by the UNCITRAL Working Group when it was

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Independent Guarantees and Stand-by Letters of Credit. There have been reports of lengthy and often fruitless "wrestles" in this regard. See Dolan, *ibid.*, at 63; World Arb. Report *supra* note 11 at 187.

[220] *Ibid.*

[221] See Dolan, "UN Convention on Independent International Undertakings" *supra* note 138 at 18.

[222] Art. 19(1) UNCITRAL Convention (Exception to payment obligation) states:

> "If it is manifest and clear that: a) any document is not genuine or has been falsified; b) no payment is due on the basis asserted in the demand and the supporting documents; c) judging by the type and purpose of the undertaking, the demand has no conceivable basis, the guarantor/issuer, acting in good faith, has a right, as against the beneficiary to withhold payment."

Art. 19(2) UNCITRAL Convention concretizes "no conceivable basis" (Art. 19(1)(c)) as situations, where e.g. a) the secured risk has undoubtedly not materialized, b) the underlying obligation has been declared invalid by a court or arbitration award, c) the underlying obligation has undoubtedly been fulfilled or d) fulfillment of the underlying obligation has been prevented by willful misconduct.

[223] Art. 20 UNCITRAL Convention provides for a provisional court order, preventing the beneficiary from receiving payment, as well as the guarantor/issuer from effecting payment, if "immediately available strong evidence" leads to the assumption that there exists a "high probability" for one of the situations mentioned in art. 19.

attempting to formulate a uniform fraud standard.[224] Consequently, the last exception actually represents more of a compromise than a precise and straightforward set of criteria that delimit fraudulent drawings under a guarantee/standby credit. Determining in which case there is a "conceivable basis" for payment, and in which there is not, remains to be resolved by the courts in member states. Since this exception is the most general and indefinite, it can be expected that it will most frequently be invoked by guarantees/applicants in order to prevent wrongful payments under a guarantee/standby credit. Thus, presumably, courts in member states will soon be required to formulate more concrete standards with respect to this exception. In so doing, the courts will bear the ultimate responsibility of reconciling the beneficiary's security interest with the applicant's interest to be protected against fraudulent drawings. Only then can the future efficacy of independent guarantees and standby credits be assured.

Since both Canada and the United States have already developed extensive and detailed standards governing the fraud issue, it is unlikely that courts in these countries will refer to the more general provisions of the UNCITRAL Convention as an interpretive guide.

c) U.C.C.

In the United States, § 5-109 Rev. Art. 5 U.C.C. regulates fraud and forgery in letter of credit transactions.[225] It replaces § 5-114(2) U.C.C., which essentially codified the *Sztejn* case. The new section clarifies many of the issues left in doubt by the old section. By expressly requiring "material" fraud, for example, it puts an end to the previous debate on

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[224] *Supra* note 219.

[225] See also § 5-110(a)(1) Rev. Art. 5 U.C.C. (Warranties) stating that "the beneficiary warrants to the issuer, any other person to whom presentation is made ....that there is no fraud or forgery of the kind described in § 5-109(a)...".

whether "egregious" or "gross" fraud must be established and whether "intentional" or "ordinary" fraud suffices in order for courts to intervene.[226]

A closer examination of new § 5-109 Rev. U.C.C., however, including a brief discussion of the former U.C.C. fraud provision, will be undertaken in the following sections.

3) The Locus of the Fraud

This section briefly outlines the different loci of letter of credit fraud that allow for an exception to the independence principle.

a) Canada

In Canada, it is generally accepted that fraud appearing on the very face of the tendered documents, i.e. forged or manipulated documents, will justify the issuer's refusal to pay under the credit.[227]

In the ground-breaking case of *Angelica-Whitewear*, the Supreme Court of Canada finally followed American and English authorities[228] and extended the fraud exception to situations involving fraud in the underlying transaction. The court stated that:

> "...the fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but

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[226] See e.g. van Houten, "Letters of Credit and Fraud" *supra* note 12 at 379 *et seq.*; E.L. Symons, "Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief" (1980) 54 Tul. L.R. 338 at 355 [hereinafter Symons, "Letters of Credit"].

[227] See e.g. *Lumpcorp* v. *C.I.B.C.*, [1977] C.S. 993 [hereinafter *Lumpcorp*]; *Aspen Planners Ltd.* v. *Commerce Masonry and Forming Ltd.* (1979), 7 B.L.R. 102 (Ont. H.C.) [hereinafter *Aspen Planners*]. Whether fraud in the stipulated documents is a true exception to the independence principle or forms part of the issuer's strict compliance obligation can, therefore, remain undecided. See Belanger, "The Limits of Autonomy" *supra* note 196 at 16.

[228] For the American case, see *Sztejn supra* note 208 at 634. See also *United Bank Ltd.* v. *Cambridge Sporting Goods*, 360 NE 2d 943 (N.Y. C.A. 1976) [hereinafter *Cambridge Sporting Goods*]; *Rockwell Int'l Systems* v. *Citibank, N.A.*, 719 F. 2d 583 (2nd Cir. 1983) [hereinafter *Rockwell*]. For English cases, see *British Imex supra* note 181 at 262; *Harbottle supra* note 4 at 862; *United City Merchants supra* note 167 at 720 *et seq.*

> should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one."[229]

Furthermore, it has been held that this exception applies not only to documentary credits, but also includes "any act of the beneficiary of any credit" and, thus, the standby credit is equally covered by the fraud exception.[230]

b) United States

Under § 5-114(2)(b) U.C.C., the issuer was exempted from its payment obligation under the letter of credit when a document tendered was forged or fraudulent, or when there was "fraud in the transaction." The new § 5-109(a),(b) Rev. U.C.C. reaffirms that fraud in the documents entitles the issuer to dishonour the credit. It has been added, however, that such fraud in the documents must be material. The ambiguity arising from the wording "fraud in the transaction," which left unanswered the question of whether only fraud in the letter of credit transaction or fraud in the underlying transaction was meant, has been resolved in favour of the latter interpretation.[231] The new section on fraud and forgery now expressly provides that honouring the credit should not facilitate the perpetration of a material fraud on the issuer or applicant. It, therefore, also embraces fraud in the underlying transaction.[232]

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[229] *Angelica-Whitewear supra* note 181 at 83.
[230] *Ibid.*
[231] See e.g. *F.D.I.C. supra* note 204; *Rockwell supra* note 227 at F 2d 583; H. Harfield, "Enjoining Letter of Credit Transactions" (1978) 95 Banking L.J. 596 at 605 [hereinafter Harfield, "Enjoining Letters of Credit"]; Note in Minnesota L.Rev. *supra* 17 at 501 *et seq.*
[232] See Barski, "Comparison Article 5 and the UCP" *supra* note 99 at 751; Turner, "U.C.C. Article 5" *supra* note 89 at 225. See also § 5-109 Rev. U.C.C. Official Comment stating that a court must always examine the underlying transaction when there is alleged fraud "for only by examining that transaction can one determine whether a document is fraudulent or the beneficiary has committed fraud and, if so, whether it was material."

4) The Scope of the Fraud Exception

This part outlines against whom the fraud exception can be raised if there is fraud in the transaction.

a) Canada

In Canada the fraud exception is only available if the fraud has been committed by the beneficiary.[233] Thus, fraud by a third party and of which the beneficiary is innocent does not render the presentation of the documents by the beneficiary under the letter of credit wrongful. The beneficiary shall only be enjoined from receiving payment if it is aware of the fraud and nonetheless demands honour of the credit. Payment can, therefore, be refused where the beneficiary has had knowledge of the fraud or forgery of the third party.[234]

Moreover, it has been held in *Angelica-Whitewear* that the fraud exception cannot be opposed to a *bona fide* holder in due course.[235]

b) United States

Although earlier case law suggested that the fraud exception can only be raised when the beneficiary has committed the fraud,[236] the new section § 5-109 Rev. U.C.C on fraud and

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[233] See *Angelica-Whitewear supra* note 181 at 83. See also *United City Merchants supra* note 167 at 728. For more details, see *Discount Records Ltd.* v. *Barclays Bank Ltd.* [1975] 1 W.L.R. 315 (Ch.D.) [hereinafter *Discount Records*]; Famula, "Fraud exception" *supra* note 3 at 36.

[234] See Belanger, *supra* note 196 "The Limits of Autonomy" at 18; Sarna, *Letters of Credit supra* note 15 at ch. 5-§ 3(c)(ii).

[235] See *Angelica-Whitewear supra* note 181 at 83. See also *Discount Records Ltd.* v. *Barclays Bank Ltd.* [1975] 1 W.L.R. 315 [hereinafter *Discount Records*]; Famula, "Fraud exception" *supra* note 3 at 36.

[236] See e.g. *Aetna Life & Casualty Co.* v. *Huntington National Bank* 934 F. 2d 695 (6th Cir. 1991) [hereinafter *Aetna Life*].

forgery does not follow this approach. It rather provides that fraud embodied in the tendered documents falls in any case under the fraud exception regardless of whether the beneficiary or any third party committed it, and regardless of whether or not the beneficiary knew of the forged documents.[237] If, for example, a carrier issues a forged bill of lading, the fraud exception could be raised. This conclusion can be drawn when scrutinizing the wording of § 5-109 Rev. U.C.C. The fraud exception is either available when "a required document is forged or fraudulent" and, therefore, also when the beneficiary is not involved, or when "honour of the presentation would facilitate a material fraud by the beneficiary."

Therefore, the drafters expanded the scope of the fraud exception rather than favouring the more restrictive approach adopted by both Canadian and American courts in the past.

With respect to *bona fide* third parties who acquire rights under the letter of credit, § 5-109(a)(1), (b)(4) Rev. U.C.C. stipulates that the fraud exception is inapplicable when these third parties acted in good faith and were without notice of the fraud in the transaction.[238]

5) Legal Remedies Available to the Parties in a Fraud Scenario

In order to assess the prospects of arbitration succeeding as an alternative to litigation in a fraudulent letter of credit dispute, it is first necessary to understand the legal remedies available to the parties in such a context.

Misconduct by the beneficiary in a letter of credit transaction can give rise to many

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[237] See Greenleaf, "The Holder-In-Due-Course Exemption" *supra* note 204 at 29; Turner, "U.C.C. Article 5" *supra* note 89 at 229.

[238] For a critical analysis on this approach, see Greenleaf, *ibid.*

kinds of judicial proceedings. It follows from this that the range of possible legal action available to the parties in a fraudulent letter of credit transaction, as well as the procedural and tactical measures to be undertaken, will ultimately depend on the facts of each particular case and, therefore, cannot be covered comprehensively. There are, however, three typical judicial recourses to which the parties commonly resort in order to protect their rights in a fraudulent letter of credit transaction.

a) Interlocutory Injunction by the Applicant

aa) General

The first and most important proceeding available to the applicant is a motion for an interlocutory injunction seeking to prevent the issuer from honouring the beneficiary's demand for payment.[239] This is what occurred in *Sztejn*, in which the applicant learnt prior to honour that the beneficiary had attempted to wrongfully draw under the credit. The court will only order an interlocutory or provisional injunction preventing the issuer from paying the beneficiary upon proof being made by the applicant that it would suffer irreparable prejudice even before the institution of an action as a result of the alleged fraud.[240]

In general, however, courts are reluctant to grant such injunctive relief and in only few cases will the injunction be maintained in subsequent judicial proceedings.

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[239] See D.I. Hamer & D.C. Boswel "Letters of Credit: Some Litigation Aspects" 7 Nat'l Banking L. Rev. 308 *et seq.* [hereinafter Hamer & Boswel "Letters of Credit: Some Litigation Aspects"].

[240] See Famula, "Fraud exception" *supra* note 3 at 38; R.S. Rendell, "Fraud and Injunctive Relief" (1990) 56 Brooklyn L. Rev. 111 at 114 [hereinafter Rendell, "Fraud and Injunctive Relief"].

bb) Canada

In Canada, there is no specific federal law governing the issuing of interlocutory injunctions in a fraud in the transaction scenario. Thus, in such cases provincial law applies.

A distinction, however, must be made between the fraud test in an application for an interlocutory injunction and that in a non-provisional judicial proceeding. In contrast to a court action, in which fraud must be clearly and obviously established, a strong *prima facie* case of fraud suffices on a motion for an interlocutory injunction.[241] It is acknowledged, however, that while the conclusions drawn in earlier cases offer valuable guidance, "the circumstances of each case must be considered in their own unique light" in order to assess whether injunctive relief should be granted.[242]

cc) United States

In the United States, § 5-109(2) Rev. U.C.C. expressly provides for the granting of an interlocutory injunction. It stipulates that a court may temporarily enjoin the issuer from honouring its credit, if an applicant alleges that such honour would facilitate the perpetration of a material fraud by the beneficiary against either the issuer or the applicant. In an attempt to limit the possibilities of injunctive relief, the applicant's right to seek an injunction, however, has been made subject to certain restrictions in the new version.

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[241] See *Angelica-Whitewear supra* note 181 at 83. See also *C.D.N. Research & Development* v. *Bank of Nova Scotia* (1980), 18 C.P.C. 62 at 66 (Ont. H.C.) [hereinafter *C.D.N. Research & Development*]; *Platinum Communications Systems Inc.* v. *Imax Corp.* (1989), 41 B.C.L.R. (2d) 175 (C.A.). [hereinafter *Platinum Communications*]; *Cineplex Odeon Corp.* v. *100 Bloor West General Partner Inc.* [1993] O.J. No. 112 (Ont. Gen. Div.) [hereinafter *Cineplex Odeon*]. The standard of a strong *prima facie* case, which is equally applicable in England, causes considerable problems for the courts when they are actually confronted with an application for injunctive relief. This has been outlined in two English cases: *Bolvinter Oil S.A.* v. *Chase Manhattan Bank N.A.* [1984] 1 Lloyd's Rep. 251 at 257 (C.A.) [hereinafter *Bolvinter Oil S.A.*]; *United Trading Corp.* v. *Allied Arab Bank* [1985] 2 Lloyd's Rep. 554 at 561 (C.A.) [hereinafter *United Trading Corp.*]. See also E.P. Ellinger, "Fraud in Documentary Credit Transactions" (1981) J.Bus.L. 258 at 265 [hereinafter Ellinger, "Fraud in Documentary Credits"].

[242] *Platinum Communications ibid.* at 71. See also Famula, *supra* note 2 at 42.

Therefore, the courts will not usually grant an injunction.[243] Together with the material fraud test, these restrictions constitute a positive amendment to former § 5-114(2) U.C.C., which lacked such guidance and led to the proliferation of inconsistent jurisprudence.

A brief review of § 5-114(2) U.C.C. is useful in order to better understand the inclusion of both the material fraud standard, as well as the more onerous burden to be met for injunctive relief under the new fraud provision. § 5-114(2) U.C.C. conferred the power on a "court of appropriate jurisdiction" to enjoin payment under the letter of credit, if the documents tendered were forged or fraudulent or if there was "fraud in the transaction."

The possibility of injunctive relief in respect of forged or fraudulently procured documents has been retained almost *verbatim* in the new version.

The failure, however, to define the applicable standard of fraud in the U.C.C. has prompted varying judicial responses.[244] These responses may be generally categorized into two groups: those which interpret the standard of fraud narrowly;[245] and those which employ a broader approach.[246] In order to eliminate these inconsistencies found in the previous version and to return to a narrower interpretation of the fraud exception as

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[243] See § 5-109 Rev. U.C.C. Official Comment.

[244] For an overview of these responses, see e.g. Kolyer, "Letters of Credit Reappraisal" *supra* note 67 at 162 *et seq.*; Note in Minnesota L. Rev. *supra* note 17 at 497 *et seq.*; Reinsch & Blodgett, "International Trade Agreement for Fraud in the Transaction" *supra* note 187 at 97 *et seq.*; Symons, "Letters of Credit" *supra* note 226 at 370 *et seq.*

[245] See e.g. *Intraworld Industries Inc.* v. *Girard Trust Bank*, 336 A. 2d 316 at 324 *et seq.* (S.C. Penn. 1975) [hereinafter *Intraworld Industries*] (where the wrongdoing of the beneficiary "has vitiated the entire transaction"); *First Arlington National Bank* v. *Stathis*, 360 NE 2d 1288 at 1295 (Ill. App. Ct. 1981) [hereinafter *First Arlington Bank*] (fraud exception is "a narrow one encompassing only the rare case of egregious fraud or fraud in the formation of the underlying contract"); *Itek Corp supra* note 200 at 25 (where the beneficiary "has no plausible or colourable basis under the contract to call for payment of the letters").

[246] It is noteworthy in this respect that the leading *Sztejn* case, upon which the fraud provision in the old U.C.C. version was modelled, represents a narrow interpretation of the term fraud. Nonetheless, some courts have adopted a rather liberal approach in interpreting "fraud in the transaction." See e.g. *NMC Enterprises Inc.* v. *CBS Inc.*, 14 U.C.C. Rep. Serv. 1427 (N.Y. Sup. Ct. 1974) [hereinafter *NMC Enterprises*] (fraud is established where "the documents of the underlying transaction are tainted with intentional fraud"); *Cambridge Sporting Goods supra* note 228 at 949 ("the drafters ...in utilizing the term fraud ...adopted a flexible standard to be applied as the circumstances of a particular situation mandate"); *KMV Int'l* v. *Chase Manhattan Bank*, N.A., 606 F. 2d 10 (2d Cir. 1979) [hereinafter KMV Int'l] ("intentional fraud")

developed in the *Sztejn* case, the material fraud criterion and a higher standard for injunctive relief were inserted into the new fraud provision. The new section, therefore, reflects a growing concern that the fraud exception might be used too often and may ultimately destroy the unique feature of the credit - that is an instrument assuring payment before the underlying dispute is resolved.[247]

The material fraud standard is not defined by the code, but it is acknowledged that:

> "the standard for injunctive relief is high, and the burden remains on the applicant to show, by evidence and not by mere allegation, that such relief is warranted."[248]

The code, however, does not provide any guidance on the standard of proof that must be met by the applicant in order to obtain such injunctive relief. It will, therefore, be left to the particular court to decide whether material fraud has been established by the applicant. American courts may, however, adopt the strong *prima facie* evidence standard, which prevails in England[249] and Canada.[250]

In addition to this higher standard for fraud, § 5-109(b) Rev. U.C.C. stipulates further criteria to be weighed by the courts when considering an applicant's request for injunctive relief. These conditions which codify equitable considerations that the courts applied in the past when granting interlocutory injunctions, must be satisfied by the applicant before an injunction will be granted.[251] The first of these conditions stipulates that, after the issuer

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[247] See *New York Life Insurance Co.* v. *Hartford Nat'l Bank & Trust Co.*, 378 A. 2d 502 at 566 (Conn. App. 1977) [hereinafter *New York Life Insurance*] (stating that "one of the expected advantages and essential purposes of a letter of credit is that the beneficiary will be able to rely on assured, prompt payment from a solvent party; necessarily, a part of this expectation of ready payment is that there will be a minimum of litigation and judicial interference, and this is one of the reasons for the value of the letter of credit device in financial transactions."; Dolan, "Interim Report on Legislative Developments" *supra* note 219 at 61; Turner, "U.C.C. Article 5" *supra* note 89 at 225.

[248] § 5-109 Rev. U.C.C. Official Comment.

[249] See *Bolvinter Oil S.A. supra* note 241; *United Trading Corp. supra* note 241.

[250] See *infra* Part II – Chapter 1, V), 6), a).

[251] See Schroeder, "Revisions to Article 5" *supra* note 99 at 375; Turner, "U.C.C. Article 5" *supra* note 89 at 225.

has accepted the beneficiary's draft, an injunction prohibiting the issuer from paying the beneficiary may only be permitted if the law applicable to such a draft permits the granting of such an injunction.[252] Moreover, a preliminary injunction will only be granted once the applicant has provided security, usually in the form of a bond, to cover any prejudice the beneficiary or any other involved party may suffer as a result of the requested injunction.[253] Most interestingly, however, the new provision states that an injunction shall only be awarded, if, on the basis of the information presented to the court, the applicant is more likely than not to succeed on its claim of forgery or material fraud and that the person demanding honour does not qualify for protection.[254] This prerequisite confirms the drafter's intention both to restrict the fraud defence to truly fraudulent situations and to exclude allegations of fraud in which the applicant merely seeks to stall. It is, therefore, intended to prevent a flood of injunctive requests by applicants hoping that the court will adopt a lenient approach to the fraud question. Conversely, the reliability of the letter of credit as an instrument, which will neither tolerate nor support substantial fraud by the beneficiary, will be preserved.

Thus, the guidance provided by § 5-109(b) Rev. U.C.C. on the issue of injunctive relief represents a much more precise and unambiguous standard that should not only facilitate the considerations of the courts when called upon to grant such injunctions, but which should also lead to a uniform, that is narrow, construction of the fraud exception, as originally intended by the court in the *Sztejn* case.

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[252] See § 5-109(b)(1) Rev. U.C.C. See *All Service Exportacao, Importacao Comercio, S.A.* v. *Banco Bamerindus Do Brazil, S.A.*, 921 F. 2d 32 at 35 (2nd Cir. 1990) [hereinafter *All Service Exportacao*] (stating that there is no right to enjoin an issuer from paying a draft that the issuer had accepted before the injunction). See also B. Kozolchyk, "Commercial Law: The Immunization of Fraudulently Procured Letter of Credit Acceptances: All Services Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus and First Commercial v. Gotham Originals" (1992) 58 Brooklyn L.Rev. 369 *et seq.* [hereinafter Kozolchyk, "Fraudulently Procured Letter of Credit Acceptances"].

[253] See § 5-109(b)(2) Rev. U.C.C.

b) Action by the Beneficiary Against the Issuer

The second type of legal proceeding that commonly arises in a fraud context is an action taken by the beneficiary against the issuer when the latter has wrongfully dishonoured the letter of credit.[255] Here, the issuer has decided to refuse payment to the beneficiary, since it received notice by the applicant of an alleged fraud committed by the beneficiary. Consequently, the beneficiary seeks to prove that it committed no fraud, and that the issuer, therefore, breached its obligation under the credit to honour any documentary presentation in compliance with the terms of the credit. Therefore, the courts must first determine what generally constitutes fraud and whether the particular case before it meets the definition of fraud.[256] The second, but interconnected, question then is whether the proof or demonstration of such fraud suffices in order to relieve the issuer of its obligation to pay under the letter of credit. In other words, the courts must determine the obligations of the issuer when confronted with proof or an allegation of fraud.[257]

c) Action by the Issuer Against the Applicant

In the third fraud scenario, the issuer institutes an action against the applicant in which

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[254] See § 5-109(b)(4) Rev. U.C.C.
[255] See § 5-111(a) Rev. U.C.C.
[256] See *infra* Part II – Chapter 1, V), 6), a).
[257] See *infra* Part II – Chapter 1, V), 7).

it seeks reimbursement.[258] Although the issuer has honoured the letter of credit, the applicant refuses to indemnify the issuer, since the latter paid the beneficiary notwithstanding the fact that it received prior notice by the applicant that the beneficiary was not entitled to payment because of an alleged fraud. In this action, the issuer seeks to establish that there was a sufficient and justified reason to effect payment under the credit and that it is, therefore, entitled to reimbursement. Again, the question arises whether the allegations made by the applicant actually establish fraud, and, whether the issuer's decision to nonetheless honour the letter of credit was justified in the light of the evidence of fraud presented by the applicant.

d) Summary

It is an interesting fact that each of these typical judicial proceedings arising from allegations of fraud involves the issuer. This is surprising because the fraud originates in the underlying relationship to which the issuer is not privy. It is arguable, therefore, that the fraud question should be litigated between the parties to the underlying transaction rather than between the issuer and the applicant or between the issuer and the beneficiary. One must bear in mind that ultimately, the issuer serves only as a solvent intermediary processing documents and payment. Thus, from the issuer's perspective, the fraud exception to the independence principle is very unfortunate since it is often dragged into judicial proceedings for reasons beyond its control and that have nothing to do with its role as intermediary in the transaction. The consequences of such judicial proceedings are all the more harsh when considering the fact that an issuer may end up with bearing the loss

[258] In case, the issuer has taken security for the letter of credit before opening it, the situation reverses. Then

as a result of these proceedings, i.e. the parties have successfully transferred their problem to the issuer. As it has been stated, there is – in brutal business terms - nothing in it for the issuer.[259]

6) The Fraud Standard

In the previous section it has been pointed out that courts are called upon in three typical contexts to rule on the question of fraud in letter of credit transactions. This section now examines both the parameters that constitute fraud, as well as the standard of fraud that must be met in these proceedings.

a) Canada

With respect to the applicable fraud standard, the court in *Angelica-Whitewear* distinguished between ordinary court actions, in which clear and obvious fraud must be demonstrated, and interlocutory applications, in which a strong *prima facie* case of fraud suffices.[260]

First, the strong *prima facie* fraud standard applicable to interlocutory injunctions will be examined.

The question of what constitutes fraud in a letter of credit transaction has generally posed considerable difficulties for Canadian courts. Thus far, this question has not been

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the applicant will sue the issuer because of wrongful honour of the letter of credit.

[259] See Sarna, "Bankruptcy, Fraud and Identity of Parties" *supra* note 16 at 324.

[260] See *supra* Part II - ??. See also *Rosen* v. *Pullen*, (1981) 16 B.L.R. 28 (Ont. H.C.) [hereinafter *Rosen*]; *Canadian Pioneer supra* note 59 at 563; *Bank of Montreal supra* note 199 at 705.

conclusively or uniformly answered, and it is more than likely that this will remain so in the future. As with the strong *prima facie* fraud standard for interlocutory injunctions, the courts may develop even better and more consistent criteria. However, despite the usefulness of such abstract and general principles to the courts many contentious disputes will nonetheless be before the courts where a decision can only be reached on the individual and specific merits of the particular case.[261]

The difficulty in determining the appropriate fraud standard results from the opposing interests of the parties to a letter of credit transaction. The applicant will allege fraud any time the conduct of the beneficiary does not correspond to its view of the underlying relationship, while the beneficiary will demand payment under the credit even when this is not at all or only partly justified. The distinction to be made is, therefore, between mere breaches of the underlying contract and what must be classified as outright fraud by the beneficiary. The question is, however, not whether the applicant has the better arguments on law or whether it would be fair to prohibit payment under the credit.[262] These are factors that the applicant should have considered before committing itself to the letter of credit transaction.

Under these circumstances, fraud has been defined as something "morally wrong" that "imports impropriety, dishonesty or deceit" into the relationship and is, therefore, not merely a "legitimate dispute over the interpretation of a contract, however one-sided such a dispute may appear."[263] Fraud is something that can be clearly characterized as "illegal" and

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[261] See *Platinum Communications supra* note 241 at 71.
[262] See *Cineplex Odeon supra* note 241 at paras. 29 and 30.
[263] *Cineplex Odeon ibid.*; *Ex* v. *Watson* (1888), 21 Q.B.D. 301 at 309 [hereinafter *Ex*]; *930154 Ontario Inc.* v. *Onofri* [1994] O.J. No. 2095 (Ont. Gen. Div.) [hereinafter *Onofri*]; *Royal Trust Corp. of Canada* v. *Royal Bank* [1993] O.J. No. 718 (Ont. Gen. Div.) [hereinafter *Royal Trust Corp.*]; *Washburn* v. *Wright* (1914), 31 O.L.R. 138 at 147 (Ont. C.A.) [hereinafter *Washburn*].

requires "knowledge and intention."[264] Fraud, however, is something beyond mere "negligence, mistake or error in interpreting the terms of a contract."[265] It follows that only a demand that is "clearly untrue or false", or "utterly without justification," and where it is also apparent that "no right for payment" exists, falls within the scope of fraud.[266]

The standard of proof that must be satisfied in order to obtain an interlocutory injunction in a fraud case differs, however, from that which must be met in order to prove fraud at trial. It suffices for the granting of injunctive relief when there is a strong *prima facie* case of fraud "on the basis of the materials in the record" at the time the application for injunctive relief is made.[267] Thus, where the delivered goods are "unusable and unmarketable as to be worthless material and rubbish," and it is shown that the seller additionally breached a contractual obligation relating to exclusive rights of distributions to the buyer, there is a sufficiently strong *prima facie* case of fraud.[268]

In *Angelica-Whitewear*, the court held that clear and obvious fraud by the beneficiary must be proven in any proceeding on the merits.[269] Thus, an issuer will only be relieved from its obligation to honour a beneficiary's demand for payment when this higher standard of proving fraud has been met.[270] The reason for making this distinction is found in the role of the issuer, which, in contrast to a court, must make its decision as to whether or not to pay the credit rather quickly. Since the issuer is not obliged to fully assess the evidence of fraud, nor does it have the time to do so, it would be unfair and unreasonable to impose on

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[264] *Ibid.*
[265] *Ibid.*
[266] *Cineplex Odeon ibid.*; Jeffery, "Standby Letters of Credit" *supra* note 55 at 529.
[267] *Onofri supra* note 263 at 9 *et seq.*
[268] *Platinum Communications supra* note 239 at 178.
[269] See also *Bank of Montreal supra* note 199 at 716.
[270] *Supra* note 181 at 84.

the issuer the risk of misinterpreting the evidence. It is the party alleging the fraud who has the burden of proving it, and it is this party, and not the issuer, who must bear the risk that the allegations of fraud may eventually prove to be unfounded.[271]

Since the *Angelica-Whitewear* decision, the clear and obvious fraud test has been followed in a number of subsequent decisions,[272] most notably, however, in the *Darlington* case,[273] in which the issuing banks sought reimbursement from their customers after paying Lloyd's under various standby letters of credit.[274] After stating that evidence supporting the allegations of fraud should be provided in the form of contemporary, pertinent and verified documents or affidavits of independent third parties, the court concluded that "proof beyond a reasonable doubt is not at all a too high burden" to be demanded for clarity and obviousness.[275] The clear and obvious test requires plain and unambiguous evidence of fraud that can be easily recognized and understood and that does not necessitate further inquiries or special knowledge and expertise on the part of the issuer.[276] Conflicting or confusing evidence is not satisfactory, nor do mere assertions or statements of fraud unaccompanied by corroborating documentary proof suffice to clearly and obviously prove fraud.[277]

Although referring to different authorities, the court in *Darlington* answered the question of what actually constitutes fraud in essentially the same manner as have courts in

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[271] *Ibid.*
[272] See e.g. *Banco Nacional de Cuba* v. *Bank of Nova Scotia* (1988), 4 O.R. (3d) 100 at 121 (Ont. H.C.) [hereinafter *Banco Nacional de Cuba*] where it was held that "suspicious circumstances" do not meet the clear and obvious fraud test; *Bank of Montreal supra* note 199 at 716.
[273] *Supra* note 7.
[274] For a more detailed discussion of *Darlington*, see J.B. Casey & J. Kirby, "Applying *Angelica-Whitewear*: The Fraud Exception Put into Practice" (1996) 11 B.F.L.R. 459 *et seq.* [hereinafter Casey & Kirby, "The Fraud Exception Put into Practice"]; Smith, "Lloyd's Cases" *supra* note 7 at 6 *et seq.*
[275] *Darlington supra* note 7 at 145 *et seq.*
[276] *Ibid.* at 110 *et seq.*
[277] *Ibid.*

interlocutory proceedings. Fraud is "shown where a false representation has been made, knowingly, or without belief in its truth, or recklessly, without caring whether it is true or false."[278]

b) United States

In the United States, § 5-109 Rev. U.C.C. requires proof of a material fraud committed by the beneficiary. The new standard of material fraud, which replaces the rather indefinite term of "fraud in the transaction" in former § 5-114(2) U.C.C., is applicable in two situations: first, when the applicant seeks injunctive relief; and second, when the issuer is faced with allegations of fraud and must decide whether or not to honour the credit in the light of the evidence at hand.

The code neither defines "material" nor provides further guidance as to what constitutes "fraud." Thus, it is left to the courts to determine the scope of the term "materiality."[279] The official comment, however, gives examples of what "material" means, and the examples suggest that the drafters intended that the fraud exception be given a narrow interpretation. The fraud must be so serious that it would be "pointless and unjust to permit the beneficiary to obtain payment."[280] "Material fraud" requires that the beneficiary's demand for honour has "absolutely no basis in fact,"[281] and that the beneficiary's conduct has "vitiated the entire transaction" to an extent that the "legitimate

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[278] *Ibid.*
[279] See §5-109 Rev. U.C.C. *Official Comment.*
[280] See *Ground Air Transfer* v. *Westate's Airlines*, 899 F. 2d 1269 at 1272 et seq. (1st Cir. 1990) [hereinafter *Ground Air Transfer*]; *Itek Corp. supra* note 200 at 24 *et seq.*
[281] *Dynamics Corporation supra* note 167 at 999.

purposes of the independence principle would no longer be served."[282] For this reason, a mere breach of contract does not amount to material fraud. Only if there is some additional blatant or outrageous misconduct by the beneficiary will the "materiality" standard be met.

In contrast to the position adopted by courts in Canada, American courts have rarely drawn a clear line between the standard of "fraud" that must be met in order to prevent payment under the credit and the actual parameters that constitute fraud in a letter of credit context. Rather than limiting themselves to the fraud test developed in the common law, the courts have instead developed an individual understanding of fraud in a letter of credit context. It has been stated in this respect that "fraud includes all acts, omissions and concealment which involve a breach of legal or equitable duty, trust or confidence, justly reposed, and injurious to another, or by which an undue advantage is taken of another."[283]

c) Summary

The standard of fraud has been considerably clarified and concretized in Canada and the United States in recent years.

Revised article 5 U.C.C., which imposes on the applicant the onus of establishing material fraud, has significantly narrowed the scope of the fraud exception. This will eventually put an end to the rather broad interpretation of the fraud standard in the United States. It will become increasingly difficult for the applicant to obtain injunctive relief and to convince the issuer that there is fraud in the underlying transaction in the future.

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[282] *Roman Ceramics Corp.* v. *Peoples National Bank*, 714 F. 2d 1207 at 1212 (3rd Cir. 1983) [hereinafter *Roman Ceramics*].

[283] *Dynamics Corporation supra* note 167 at 998 *et seq.*

In Canada, there is a relatively broader application of the fraud standard than in the United States. Although the court in *Darlington* established a rather stringent test for clear and obvious fraud, this has not always been followed. The courts in Canada have nonetheless been willing to rule on the underlying agreement in order to evaluate the legitimacy of the beneficiary's demand for payment.

Despite this trend towards a narrower fraud standard, the precise scope of the fraud exception remains indeterminate. Although some of the cases that have in the past troubled the courts will certainly be resolved much more easily with these more precise standards, in many cases the outcome will still depend to a large extent on the facts of the particular case in order to determine whether or not the beneficiary's demand is fraudulently procured.

7) Issuer's Duty of Care

The applicant has two options when it learns that the beneficiary has attempted to wrongfully demand payment under the letter of credit. It may either seek an interlocutory injunction preventing the issuer from honouring the beneficiary's demand for payment, or it can provide the issuer with evidence of clear and obvious fraud. In the latter case, the applicant relies on the issuer to observe for itself that there has been clear and obvious fraud and, therefore, that the latter will refuse to pay under the letter of credit. If the issuer decides to do so, however, it risks being sued by the beneficiary. As discussed above,[284] the issuer's response to such requests by the applicant has given rise to numerous disputes, each of which has focused on the question of whether the issuer was correct in its decision

[284] See *supra* Part II – Chapter 1, V), 5), b), and c).

to honour or dishonour the beneficiary's demand for payment. Therefore, this section examines the issuer's duties when confronted with allegations of fraud committed by the beneficiary.[285]

a) Canada

In Canada, *Darlington* was the first case in which the court had to decide on the duties of an issuer when the applicant does not seek an injunction but rather relies on the issuer to confirm its view of clear and obvious fraud. After determining that the issuing institutions are neither lawyers nor judges and, moreover, that they lack expertise in the particular commerce of the underlying transaction, the court decided that the issuer must act reasonably "in the sense of acting honestly and in good faith in his or her individual capacity."[286] Such reasonableness includes the obligation to obtain a legal definition of what constitutes fraud, to ask for legal advice, to carefully read all the material provided and, finally, to conclude whether or not clear and obvious fraud has been established by the customer.[287] The issuer's duty, however, is not to act as a reasonable issuer would have acted upon close consideration of the material provided. Such an objective standard would transform the function of the issuer into that of a judge and would "turn the exercise into a battle of experts, involving lengthy debate and the weighing of differing views" within the issuing institution.[288]

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[285] See in general J.G. Barnes "Defining Good Faith Letter of Credit Practices" (1994) 28 Loy. L. A. L. Rev. 101 [hereinafter Barnes, "Good Faith Letter of Credit Practices"]; Sarna, "Bankruptcy, Fraud and Identity of Parties" *supra* note 16 at 323 *et seq.*

[286] See *Darlington supra* note 7 at 136 *et seq.*

[287] See *Darlington ibid.*; Casey & Kirby, "The Fraud Exception Put into Practice" *supra* note 274 at 461.

[288] See *Darlington ibid.*; Smith, "Lloyd's Cases" *supra* note 7 at 7.

The standard, therefore, is subjective, not objective. The issuer's decision to dishonour the credit must be based on evidence of fraud, which is of such nature that the issuer itself "would hazard a lawsuit with the beneficiary."[289] In *Bank of Montreal* v. *Mitchell*,[290] which is the most recent case involving standby credits issued in favour of Lloyd's, the court stated as follows:

> "The test for the issuer is not whether a court will or may eventually determine that there was fraud, but rather when the issuer looked at the situation, was it clear and obvious to him acting reasonably that there had been fraud."[291]

The second question that arose in *Darlington* was whether there existed a duty incumbent on the issuer to investigate and gather additional information about the allegations of fraud made by the applicant. The court held that the issuer owes no general duty to make outside inquiries.[292] Only where the materials given to the issuer contain some obvious gaps that appear to be easily explicable is the issuer obliged to make further inquiries.[293]

b) United States

Pursuant to § 5-109(a)(2) Rev. U.C.C. an issuer must act in good faith when honouring or dishonouring a documentary presentation by the beneficiary.[294] In § 5-102(a)(7) Rev.

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[289] See *Darlington ibid.*at 139 *et seq.*; Casey & Kirby, "The Fraud Exception Put into Practice" *supra* note 274 at 463.
[290] *Supra* note 199.
[291] *Ibid.* at 716.
[292] See *Darlington supra* note 7 at 140. See also Sarna, "Bankruptcy, Fraud and Identity of Parties" *supra* note 16 at 323 *et seq.*
[293] See *Darlington ibid*; Smith, "Lloyd's Cases" *supra* note 7 at 7.
[294] See also *Michigan Nat'l Bank* v. *Metro Institutional Food Service, Inc.*, 497 N.W. 2d 225 (Mich. App. 1993) [hereinafter *Michigan Nat'l Bank*].

U.C.C. good faith is defined as "honesty in fact in the conduct or transaction concerned." Consequently, an issuer who acts dishonestly in making or refusing payment fails to discharge its obligation under the letter of credit. This standard of good faith is to be understood subjectively, so that the state of mind of the examining person must be considered.[295] Generally, it is the applicant who must establish by adducing external evidence that a material fraud has been committed.[296] Thus, no positive obligation lies on the issuer to actively undertake further inquiries or investigations. It has been stated in this regard, however, that the question of whether or not the issuer has acted in good faith is ultimately a question of fact.[297]

c) Summary

In both Canada and the United States, issuing institutions are obliged to act honestly and in good faith when weighing the evidence of fraud presented to them. A subjective standard applies to the issuer's agent or employee who must assess the proof of fraud presented to him. The issuer may obtain additional legal advice on the criteria that should guide it in making its decision, but generally there exists no further duty for the issuer to inquire or investigate beyond the scope of the evidence presented to it.

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[295] See Hawkland & Miller, *UCC Series §* - *Rev. Art. 5 supra* note 29 at § 5-109:2 Rev. U.C.C.

[296] See Symons, "Letters of Credit" *supra* note 226 at 350. Most issuers take the position that they will notice honour drawings under the credit despite notice of fraud unless the issuer has actual knowledge that the drawing is fraudulent; the customer is in the best position to know the facts and can seek injunctive relief if the facts warrant that. §5-109 Rev. U.C.C. Official Comment

[297] See *Lustrelon, Inc.* v. *Prutscher*, 428 A. 2d 518 (N.J. Sup. 1981) [hereinafter *Lustrelon, Inc.*].

Chapter 2: International Commercial Arbitration

This chapter offers a brief overview of the history, the statutory framework, as well as the features and characteristics of international commercial arbitration.

I) General

It is increasingly recognized, that in the settlement of commercial disputes between parties to an international transaction, arbitration offers considerable advantages over litigation in national courts. International commercial arbitration "has become so widespread that it has emerged as a primary method for dispute resolution of transnational contracts."[298] The reasons for this increase in the use of international commercial arbitration are manifold. A foreign court can be an unfavourable, alien environment for international traders, since different procedural and substantive rules apply, and sometimes the mentality of foreign judges differs from that if their judges at home.[299] By agreeing to arbitrate, merchants from different states palliate the ill effects of such risks and avoid the uncertainties of foreign jurisdictions, and instead agree to submit any subsequent dispute to a board of private arbitrators. In their arbitration agreement the parties to an international commercial transaction can provide for a mutually acceptable procedure, anticipate which particular law will apply or even whether the *lex mercatoria* of a special trade shall govern

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[298] M.P. Sullivan, "The Scope of Modern Arbitral Awards" (1988) 62 Tul. L. Rev. 1113 at 1122 [hereinafter Sullivan, "Modern Arbitral Awards"]. See also A.J. van den Berg, *The New York Arbitration Convention of 1958* (Deventer: Kluwer Law 1981) at 1 [hereinafter van den Berg, *The New York Convention*].

[299] Van den Berg *The New York Convention, ibid.* at 1; F.J. Higgins, W.G. Brown & P.J. Roach, "Pitfalls in International Commercial Arbitration" (1980) 35 Bus. Law. 1035 [hereinafter Higgins, Brown & Roach, "Pitfalls in Arbitration Higgins"].

their contract.[300] Moreover, the parties can select persons of their choice, often experts in the particular field, to rule on eventual disputes between the parties. Furthermore, international traders often prefer arbitration to litigation, because it is, *inter alia*, perceived as being faster, less expensive, more flexible and, therefore, a more efficient means of resolving commercial disputes that arise in an international context.[301] Although it is debatable how much cheaper and faster arbitration really is,[302] there are nonetheless more profound reasons that render international commercial arbitration preferable to ordinary court litigation for international traders, such as confidentiality, finality (*i.e.* there is no appeal) and the possibility of enforcing the arbitral award around the world.[303]

These particular characteristics of arbitration that distinguish it from ordinary judicial proceedings will be outlined in the following section after a brief review of the history of commercial arbitration, an analysis of the relevant international and national statutory framework for arbitration in Canada and the United States, and an examination of the arbitration agreement.

II) History of International Commercial Arbitration

Since all commercial activities involve a multitude of potential disputes, any successful trade requires the elaboration of some means of dispute resolution. Thus, since the time of the first commercial activities there must have been agreements providing for the

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[300] See J. M. Lookofsky, *Transnational Litigation and Commercial Arbitration* (Copenhagen: Transnational Juris Publications Inc., 1992) at 562 *et seq.* [hereinafter Lookofsky, *Transnational Litigation and Commercial Arbitration*].
[301] See e.g. Higgins, Brown & Roach, "Pitfalls in Arbitration" *supra* note 299 at 1041; M. Kerr, "International Arbitration v. Litigation" (1980) J. Bus. L. 164 at 176 [hereinafter Kerr, "Arbitration v. Litigation"].
[302] See e.g. H.P. de Vries, "International Commercial Arbitration: A Contractual Substitute for National Courts" (1982) 57 Tul. L. Rev. 42 at 47 *et seq.* [hereinafter de Vries, "International Commercial Arbitration"].
[303] See e.g. Chung, "ICC Dispute Resolution System" *supra* note 5 at 1359 *et seq.*

resolution of disputes by neutral third parties.[304] Though arbitration was to a large extent indistinguishable from other forms of dispute resolution, it is likely that some kind of an arbitration-like proceeding existed from these early times on.[305]

As society became more complex and interdependent, the advantages of different forms of dispute resolution, as well as their drawbacks, became more apparent. Traders soon realized that, in commercial matters, judicial proceedings were often unsatisfactory since they were public, expensive, often slow and frequently the court lacked both expertise and impartiality.[306] Conversely, extra-judicial dispute resolution fora such as arbitration offered alternative proceedings that could be better tailored to these particular commercial concerns.[307] It was in Northern Italy in the early sixteenth century where modern arbitration developed. Two forms of arbitration developed alongside the state's judicial apparatus: *ad hoc* arbitration, which was arranged upon the occurrence of a single dispute and decided by an arbitrator selected especially for the dispute at hand; and institutional arbitration by a standing tribunal, the *officium mercanziale*, which specialized in commercial and maritime matters.[308] In resolving disputes submitted to them, these tribunals, which soon also emerged in other areas of Europe, developed an autonomous body of law applicable in particular trades, the *lex mercatoria* or law merchant.[309]

Although in the following various bodies of law on arbitration evolved, these laws dealt almost exclusively with awards rendered and enforced in the same national jurisdiction. Thus, there was no reliable and expeditious method of enforcing in one state awards

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[304] See M.J. Mustill, "Arbitration: History and Background" (1989) 6 J. Int'l Arb. 43 [hereafter Mustill, "Arbitration History"].
[305] *Ibid.* at 44.
[306] *Ibid.*
[307] See de Vries, "International Commercial Arbitration" *supra* note 302 at 44.
[308] See Mustill, "Arbitration History" *supra* note 304 at 45.
[309] *Supra* note 37.

rendered in another. Though the need to establish such rules had for long been recognized, only in the 1920's were the first international rules on arbitration formulated. The first statute effectively dealing with international aspects of arbitration was the Geneva Convention on the Execution of Foreign Awards of 1927.[310] This Convention achieved important results, but nonetheless proved in some respects to be incomplete. It was, therefore, replaced by the United Nations Convention on the Recognition and Enforcement of Arbitral Awards in 1958, which has since become the most successful and effective piece of legislation in the realm of international arbitration.[311]

III) Some Aspects of Arbitration

Arbitration may be defined as a forum of settling disputes between two or more parties before a third party, the arbitrator, whose authority is based on the parties' voluntary submission of the dispute to the arbitrator for binding determination.[312]

In general, arbitration occurs in two different forms. Arbitration is either arranged individually, meaning that the parties themselves constitute the arbitration panel after a dispute has arisen (*ad hoc* arbitration).[313] More importantly, arbitration may be set up institutionally, meaning that the parties agree to submit an eventual dispute for resolution to an institution specialized in arbitration (institutional arbitration).[314]

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[310] See van den Berg, *The New York Convention supra* note 298 at 4.
[311] See *infra* Part II – Chapter 2, IV), 1), a).
[312] See e.g. de Vries, "International Commercial Arbitration" *supra* note 302 at 42 *et seq.*; Tetley, *International Conflicts of Law supra* note 19 at 390.
[313] See P. Behrens, "Arbitration as an Instrument of Conflict Resolution in International Trade: Its Basis and Limits" in D. Friedmann & E.M. Mestmäcker, ed., *Conflict Resolution in International Trade* (Baden Baden: Nomos Verlag, 1993) 13 at 14 [hereinafter Behrens, "Arbitration in International Trade"].
[314] Prominent arbitral institutions are the I.C.C. Court of Arbitration, the American Arbitration Association (A.A.A.) and the London Court of Arbitration (L.C.A.).

In any case, the result of an arbitration proceeding is normally a legally binding award, which may, if necessary, be judicially exemplified and enforced against the award debtor. Thus, the effect is given to the arbitral award by the judicial power of national jurisdictions.[315]

IV) Statutory Framework for International Commercial Arbitration

International commercial arbitration is governed by a variety of different national and international laws. In general, these laws serve to determine whether an arbitration agreement is valid, whether a given dispute is arbitrable and, finally, whether an award is enforceable.

1) International Legal Framework for Commercial Arbitration

a) United Nations Convention on the Recognition and Enforcement of Arbitral Awards

The United Nations Convention on the Recognition and Enforcement of Arbitral Awards[316] was adopted 1958 in New York. To date 121 states, including Canada (1986) and the United States (1970), have acceded to or ratified the Convention[317]. As a result, it has become one of the most successful international conventions ever enacted.

The purpose of the New York Convention is to ensure the enforcement and recognition of arbitral awards.[318] It applies either when the enforcement and recognition of arbitral awards is sought in a state other than that in which the award was rendered, or

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[315] See *infra* Part II – Chapter 2, V).
[316] 330 U.N.T.S. 3 [hereinafter New York Convention].
[317] See U.N. homepage, online: <http://www.un.or.at> (Ratifications and Enactments).

when the award cannot be characterized as domestic in the contracting state in which enforcement is sought, notwithstanding the fact that it was issued in this state.[319] The most important group, however, are clearly those awards which have been issued in a foreign jurisdiction. The New York convention obliges each contracting state to recognize such foreign arbitral awards as binding and enforce them by making available procedures comparable with those applicable to domestic awards.[320] In other words, the Convention's principal purpose is "to encourage the recognition and enforcement of commercial arbitration agreements in international contracts and to unify the standards by which agreements to arbitrate awards are enforced."[321] Only on the basis of very limited criteria can the recognition and enforcement of rendered awards be refused by the courts in a contracting state. These criteria include: a party's incapacity to consent to an arbitration agreement or the invalidity of the arbitration agreement for other reasons; the failure to have given sufficient notice of arbitral proceedings to the party against whom the award is rendered; the fact that an award has been rendered beyond the agreement's scope; unauthorized or illegal arbitral procedures; and a non-arbitrable subject matter or an award otherwise contrary to public policy.[322]

Although the public policy defence in particular raised considerable concern as a potential loophole to the actual enforceability of arbitral awards, the New York Convention 1958 enjoyed great success, which to a large extent is attributable to the willingness of courts in the various contracting states to actively promote international

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[318] See T. Carbonneau, *Alternative Dispute Resolution* (Chicago: University of Illinois Press, 1989) at 65 [hereafter Carbonneau, *Alternative Dispute Resolution*].
[319] See art. I(1) New York Convention.
[320] See art. 3 New York Convention. Tetley, *International Conflicts of Law supra* note 19 at 393.
[321] *Imperial Ethiopian Government* v. *Baruch-Foster Corp.*, 535 F. 2d 334 at 335 (5th Cir. 1976) [hereinafter *Imperial Ethiopian Government*].
[322] See art. V New York Convention.

commercial arbitration by interpreting the article V defences narrowly and restrictively.[323] Thus, today arbitral awards can be almost automatically enforced in most of the contracting states and represent, therefore, a real and reliable alternative to litigation.

b) United Nations Model Law on International Commercial Arbitration

The UNCITRAL Model Law on International Commercial Arbitration[324] was adopted in 1985 by the United Nations. Legislation based on the U.N. Model Law has been enacted in 29 countries, including Canada, which was the first country to adopt it in 1986.[325] The United States, except for the states of California, Connecticut, Florida, Oregon and Texas where respective state law was passed,[326] have not enacted the U.N. Model Law.

The U.N. Model Law is intended unify and harmonise national laws on international commercial arbitration in order to respond to frequent concerns as to the disparities and inadequacies in the national laws on arbitration.[327] It covers all stages of the arbitral process, including the arbitration agreement (chapter II), the composition of the arbitral tribunal (chapter III), the jurisdiction of the arbitral tribunal (chapter IV), the conduct of arbitral proceedings (chapter V), the making of an award and recourses against it (chapter

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[323] See e.g. *Parsons & Whittemore Overseas Co., Inc.* v. *Societe Generale de L'Industrie du Papier (RAKTA)*, 508 F. 2d 969 at 974 (2nd Cir. 1974) [hereinafter *Parsons & Whittemore*]; M. F. Hoellering, "International Arbitration: A U.S. View" (1987) 13 Can. Bus. L.J. 86 at 87 [hereinafter Hoellering, "International Arbitration"]; W. Park, "When the Borrower and the Banker are at Odds: The Interaction of Judge and Arbitrator in Trans-Border Finance" (1991) 65 Tul. L. Rev. 1323 at 1330 *et seq.* [hereafter Park, "Borrower and Banker at Odds"].

[324] U.N. Doc. A/40/17 [hereinafter U.N. Model Law].

[325] Commercial Arbitration Act, S.C. 1986, c. 22. See *infra* Part II – Chapter 2, IV), 2), a).

[326] The effect of these legislations is, however, doubtful due to the predominance of federal law in the area of arbitration. See e.g. J. S. McClendon, "State International Arbitration Laws: Are They Needed or Desirable?" (1990) 1 Am. Rev. Int'l Arb. 245 *et seq.* [hereafter McClendon, "State International Arbitration Laws"].

[327] See *Explanatory Note by the UNCITRAL Secretariat on the Model Law on International Commercial Arbitration*, U.N. Doc. A/CN.9/264. See arts.1 and 7 defining "international" and "arbitration agreement".

VI, VII) and the recognition and enforcement of awards (chapter VIII).[328] Though the drafters recommended that the U.N. Model Law be followed as closely as possible in order to achieve a high degree of consistency, the U.N. Model Law allows, nonetheless, for reservations to be made in matters arising from local concerns of public policy or public order.[329]

It is noteworthy that articles 35 and 36 U.N. Model Law reflect the rules on recognition and enforcement established by the New York Convention.

Since its adoption in 1985 the U.N. Model Law has emerged as a progressive and comprehensive set of rules for international commercial arbitration that greatly facilitates dispute resolution among international traders and, thus, contributes to the smooth functioning of international trade.[330]

2) National Legal Framework for Commercial Arbitration

a) Canada

In Canada one must distinguish between arbitration in federal and provincial law.

At the federal level, the New York Convention has been enacted in the United Nations Foreign Arbitral Awards Convention Act,[331] and the Model Law was enacted in the Commercial Arbitration Act.[332] Pursuant to art. XI(a) New York Convention, the application of the New York Convention Act is confined to international disputes falling

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[328] See *Explanatory Note ibid.*; J.E.C. Brierley, "Canadian Acceptance of International Commercial Arbitration" (1988) 40 Maine L.R. 287 at 289 [hereinafter Brierley, "International Commercial Arbitration"].
[329] See Brierley, *ibid.*
[330] See R. David, *Arbitration in International Trade*, (Deventer: Kluwer, 1985) at 154 *et seq.* [hereinafter David, *Arbitration in International Trade*]; W.C. Graham, "The Internationalization of Commercial Arbitration in Canada: A Preliminary Reaction" (1987) 13 Can. Bus. L.J. 2 at 5 [hereinafter Graham, "The Internationalization of Commercial Arbitration in Canada"].
[331] S.C. 1986, c. 21 [hereinafter *New York Convention Act*].
[332] S.C. 1986, c. 22.

within federal Parliament's legislative jurisdiction. The *Commercial Arbitration Act*, and thus the U.N. Model Law, applies to disputes in which "at least one of the parties to the arbitration is a department or a Crown corporation" or "in relation to maritime or admiralty matters."[333]

In accordance with the federal government's legislation, all of Canada's provinces and territories enacted legislation implementing both the New York Convention and the Model Law.[334]

b) United States

In the United States, the *Federal Arbitration Act*[335] provides a national arbitration law that supplements the New York Convention. The F.A.A. is divided into three parts. Chapter I deals with general provisions relating to arbitration. Chapter II implements the New York Convention, while chapter III reflects the adherence by the United States to the Inter-American Convention on International Commercial Arbitration.[336] In general, the F.A.A. will apply to international arbitration conducted in the United States since the U.S. Arbitration Act pre-empts inconsistent state statutes.[337] In some cases, however, the F.A.A. may prove to be incomplete or the parties may have expressly agreed to the application of

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[333] Sect. 5(2) *Commercial Arbitration Act*. See *Cia. Maritima Villa Nova S.A.* v. *Northern Sales*, [1992] 1. F.C. 550 (F.C.A.) [hereinafter *Maritima Villa Nova*]; Tetley, *International Conflicts of Law supra* note 19 at 398.

[334] See e.g. Carbonneau, *Alternative Dispute Resolution supra* note 318 at 75 *et seq.*; Tetley, *ibid.*

[335] *Federal Arbitration Act* of 1925, Ch. 213, 43 Stat. 883-886 (1925) (current version at 9 U.S.C. §§ 1-307 (1994)) [hereinafter F.A.A.].

[336] (1975) 14 I.L.M. 336 [hereinafter Panama Convention]. The Inter-American Convention on International Commercial Arbitration was adopted in Panama in 1975 and, like the New York Convention, deals mainly with the issue of enforcing foreign arbitral awards. For further information, see e.g. P. Nattier, "International Commercial Arbitration in Latin America: Enforcement of Arbitral Agreements and Awards" (1986) 21 Texas Int'l L. J. 397 *et seq.* [hereinafter Nattier, "International Commercial Arbitration in Latin America"].

[337] See W.L. Craig, W.W. Park & J. Paulsson, International Chamber of Commerce Arbitration (I.C.C. Publishing S.A.: Paris, 1990) at 567 [hereinafter Craig, Park & Paulsson, *I.C.C. Arbitration*].

state arbitration law. In these cases, the law of the particular American state in which the arbitration occurs applies.[338]

V) The Arbitration Agreement

In contrast to the jurisdiction of courts, which is imposed upon private persons by the laws of national states, the jurisdiction of international commercial arbitrators is based on the parties' voluntary submission to the arbitration process.[339] Although the precise legal nature of international commercial arbitration has not yet been clarified,[340] it can be stated that the authority of the arbitral tribunal to decide on an issue before it derives from the arbitral agreement of the parties, rather than from any national legislation.[341] It is, therefore, the arbitral agreement that authorizes the arbitrator to rule on the dispute submitted to him.

Consequently, arbitration must be regarded as part and parcel of the parties' contractual freedom to individually coordinate and organize their relationship.[342] This autonomy or freedom of contract allows the parties to arrange for a private dispute resolution mechanism that suits their individual preferences and needs. Thus, for example, the parties are free to determine in their arbitration agreement the procedural rules to be followed by the arbitral panel, the substantive law that governs the arbitration agreement itself, as well as the law that applies to the matter in dispute.[343]

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[338] See *Volt Information Science* v. *Trustees of Stanford University* 109 S.Ct. 1248 (1989) [hereinafter *Volt Information Science*].
[339] See Behrens, "Arbitration in International Trade" *supra* note 313 at 14; de Vries, "International Commercial Arbitration" *supra* note 302 at 61 *et seq.*
[340] For an extensive coverage of this issue, see Behrens, *ibid.* at 20 *et seq.*
[341] See Lookofsky, *Transnational Litigation and Commercial Arbitration supra* note 300 at 573 *et seq.*
[342] See e.g. de Vries, "International Commercial Arbitration" *supra* note 302 at 62 *et seq.*
[343] *Ibid.*

When drafting their arbitration agreement, the parties are only constrained by mandatory, or public order rules. In this respect the arbitral agreement does not differ from any other contractual relationship. Thus, an arbitration agreement, that clearly violates fundamental procedural principles or principles of natural justice, such as the right of both parties to be heard during the arbitral proceedings, will not be upheld under the national or local law where the arbitration takes place.[344] Likewise, an arbitration agreement, that contravenes mandatory rules of substantive law, for example the law on fraud, duress, unconscionability or incapacity, is equally void and is not binding.[345]

Because of the doctrine of separability, however, it is critical to clearly distinguish between the main contract, e.g. a contract of sale, and the arbitration agreement.[346] The doctrine of separability provides that both contracts represent distinct contractual undertakings that must be legally treated as being independent from one another.[347] Thus, the mere invalidity of the main contract has no effect on the validity of the arbitration agreement. Since both agreements must be viewed separately, arbitral tribunals may be called upon to rule on the main contract that is invalid under national law.

It follows from the doctrine of separability, therefore, that the parties are prevented from challenging the legitimacy of arbitral proceedings merely because of the invalidity of the main contract. This has been confirmed by the courts in various contexts, particularly, however, where it has been claimed that fraud in the main contract also renders the arbitration agreement invalid. The courts have refuted such arguments and considered

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[344] See art. V(1)(b) New York Convention.
[345] See art. V(1)(a) New York Convention.
[346] See e.g. Lookofsky, *Transnational Litigation and Commercial Arbitration supra* note 300 at 566.
[347] See art. 16 U.N. Model Law; van den Berg *The New York Convention supra* note 298 at 145 *et seq.*

them to be "wholly unconvincing,"[348] "fabricated"[349] and a "mere afterthought, wholly without substance, advanced solely for purposes of delay."[350] Only in the rare case when fraud occurs with respect to the arbitration agreement itself may an arbitration clause be invalidated.[351]

In any other case, and specifically when the arbitral clause expressly covers fraud in the main contract, there are no legal or contractual barriers to the use of arbitration.

VI) International Commercial Arbitration versus Litigation

In order to assess the possibilities of arbitrating fraud in a letter of credit transaction, one must understand the typical features that distinguish international commercial arbitration from ordinary litigation. For this reason, this section briefly examines the strengths and weaknesses of international commercial arbitration as compared with litigation.

1) Potential Advantages of Arbitration

One common concern in disputes involving parties from different countries is the multiplication of proceedings with possibly inconsistent results because of differing public

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[348] *McMahon* v. *Shearson/American Express, Inc.*, 618 F. Supp. 384 at 386 (S.D.N.Y. 1985) [hereinafter *McMahon*].

[349] See e.g. *Scherk* v. *Alberto-Culver*, 417 U.S. 506 (1975) [hereinafter *Scherk*]; *Lewis* v. *Prudential-Bache Sec., Inc.*, 225 Cal. Rptr. 69 (Cal. Ct. App. 1986) [hereinafter *Lewis*]; J.W. Stempel, "A Better Approach to Arbitrability" (1991) 65 Tul. L. Rev. 1377 at 1383 *et seq.* [hereinafter Stempel, "Arbitrability"].

[350] *Bigge Crane & Rigging Co.* v. *Docutel Corp.*, 371 F. Supp. 240 (E.D.N.Y. 1973) [hereinafter *Bigge Crane & Rigging*].

[351] See *Prima Paint Corp.* v. *Flood & Conklin Manufacturing Co.*, (1967) 388 U.S. 395 [hereinafter *Prima Paint*].

policies and different procedural or substantive laws in the various countries.[352] International arbitration allows for the pre-selection of a single, mutually acceptable forum for the resolution of disputes. The New York Convention, which to date has been adopted by 121 states, requires that courts in signatory states generally recognize and enforce foreign arbitral awards.[353] Therefore, the risks of parallel judicial proceedings or forum shopping in favourable jurisdictions and of the non-enforcement of arbitral awards have been almost entirely eliminated.[354] In fact, it is today much easier to enforce foreign arbitral awards than to enforce foreign judgments.

Another key feature of international arbitration that distinguishes it from ordinary litigation is its flexibility. The parties to an arbitration are free to determine the procedural rules to be followed during the arbitral proceedings and may therefore opt for a procedure that meets their particular needs more closely than does the traditional judicial system.[355] Although the parties almost never specify the procedural rules in their contract, and instead refer to the rules used by institutional arbitrators. Such rules usually provide for relatively simple and informal proceedings, which favour focusing on the central issues and tend to avoid the proliferation of lengthy and costly procedural manoeuvers.[356]

Furthermore, the parties to an arbitral agreement can designate which substantive law will govern their relationship. In so doing, they can protect themselves against the application of unfavourable and unknown laws, as well as avoid complex choice of law issues that commonly arise in international transactions.

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[352] See S.C. Nelson, "Alternatives to Litigation of International Disputes" (1989) 23 Int'l Law. 187 at 193 [hereinafter Nelson, "Litigation Alternatives"].
[353] See *supra* Part II- Chapter 2, IV), 1), a).
[354] See P. Hamik, "Recognition and Enforcement of Foreign Arbitral Awards" (1983) 31 Am. J. Comp. L. 703 *et seq.* [hereinafter Hamik, "Recognition and Enforcement of Foreign Arbitral Awards"].
[355] See T. Fox, "Dispute Resolution Techniques in International Contracts Involving the Sale of Goods" (1987) 15 Int'l Bus. Law. 259 at 260 [hereinafter Fox, "Dispute Resolution Techniques"].
[356] See Chung, "ICC Dispute Resolution System" *supra* note 5 at 1360.

International commercial arbitration also introduces experienced and knowledgeable professionals of the particular trade into the proceedings. Particularly when faced with complex technical questions this may prove to be an advantage over litigation, since a judge or a jury will rarely possess the necessary expertise to properly evaluate technical information.[357]

Moreover, arbitration is more private and confidential than litigation. This lessens both the risk of publicly disclosing the merits of the dispute, as well as the risk of disclosing trade secrets.[358]

In contrast to judgments, an arbitral award cannot be appealed. This potentially better serves the commercial parties since they prefer having some finality in their commercial decisions.[359]

Finally, arbitration allows the parties to greatly reduce the application of public policy to their relationship, which often significantly influences the outcome of international disputes in ordinary court proceedings. Since arbitrators are under no obligation to enforce public policy, they decide the dispute neutrally and on its true merits and thus may ignore public policy considerations.[360]

2) Potential Disadvantages of Arbitration

Arbitration may prove to be unfavourable when the commercial parties do not foresee the complexities of their relationship and choose an arbitral environment that is not

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[357] See Nelson, "Litigation Alternatives" *supra* note 352 at 197.
[358] See Kerr, "Arbitration v. Litigation" *supra* note 301 at 164.
[359] See Nelson, "Litigation Alternatives" *supra* note 352 at 195.
[360] See W. Park, "National Law and Commercial Justice: Safeguarding Procedural Integrity in International Arbitration" (1989) 63 Tul. L. Rev. 647 at 707 [hereinafter Park, "Safeguarding Procedural Integrity in International Arbitration"].

capable of resolving multifaceted legal issues arising from such a relationship.[361] This may lead to unjustified results that could be avoided in ordinary court proceedings. For example, the parties may agree on arbitral proceedings that permit only limited evidence in order to promote the quick resolution of an eventual dispute. However, such a limitation on proof-taking may backfire if it hinders the arbitrator from properly assessing the facts of a more complicated dispute. In such a case, the chosen form of arbitration may affect the substantive rights and duties of the parties in a manner not originally contemplated.[362]

Moreover, arbitration may prove to be of little use when there are more than two parties involved. The basic problem in such a scenario is to formulate an arbitral clause acceptable to numerous persons. This often causes considerable difficulties, since such a clause must respect the diverging interests of at least three parties. To avoid multiple proceedings based on the same dispute, it is necessary to consolidate the different relationships into one uniform clause. Nonetheless, the complex contractual relationships may give rise to parallel arbitrations and to situations in which the unity of the arbitral proceedings may be affected by the multiplicity of issues, agreements or parties involved in a certain dispute.[363] Therefore, multi-party arbitration rarely provides a workable dispute resolution option, if the parties are unwilling to accept it. In such a case the parties are, therefore usually best advised to refer their dispute to the traditional judicial system, which is generally better prepared to deal with issues of such complexity.

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[361] See Higgins, Brown & Roach, "Pitfalls in Arbitration Higgins" *supra* note 299 at 1039 et *seq.*
[362] See Nelson, "Litigation Alternatives" *supra* note 352 at 201.
[363] P. Leboulager, "Multi-Contract Arbitration" (1996) 13 J. Int'l Arb. No. 4 at 43 [hereinafter Leboulager, "Multi-Contract Arbitration"].

3) Summary

International commercial arbitration offers a flexible, neutral and confidential alternative to litigating international commercial disputes. In particular, when arbitration takes place in the traditional two-party model, it may prove to be a more efficient mechanism of dispute resolution than regular court proceedings. Once an arbitral award has been rendered, it is usually binding upon the parties and cannot be appealed. With respect to states that have signed the New York Convention, recognition of an award rendered in a foreign country is ensured, and this forecloses the possibility of instituting parallel judicial proceedings. Subject to only few restrictively applied exceptions, the New York Convention additionally provides for the enforcement of arbitral awards in foreign states.

International commercial arbitration may, however, produce unsatisfactory results when the parties do not pay sufficient attention to the wording of their arbitral clause. This is particularly true for multi-party proceedings where the complexity of issues would otherwise allow the parties to avoid the effect of unfavourable arbitral decisions.

Chapter 3: Arbitrating Fraud in the Letter of Credit Transaction

In this section the prospects of arbitrating fraud in the letter of credit transaction will be examined. This will be illustrated by two hypothetical letter of credit disputes, each of which calls for arbitration. In the first case, all three parties to a letter of credit transaction agree on one uniform arbitration clause. The second case imagines the situation where an arbitration agreement exists only between the applicant and the beneficiary and, thus, the parties to the underlying transaction.

I) First Scenario: Arbitration Agreement between Applicant, Beneficiary and Issuer

The following scenario is assumed:

Two merchants located in different states conclude a contract of sale. In order to secure payment of the goods or services sold (documentary letter of credit), or to guarantee the performance of some underlying obligation (standby letter of credit), the parties further agree on the issuance of a letter of credit. All three parties to the letter of credit agree on one uniform arbitration clause.

As has been pointed out,[364] multi-party arbitration must deal with a multiplicity of issues and agreements. Thus, a uniform arbitration clause will rarely provide for all procedural and substantive issues that may arise between the involved parties. The willingness of the parties to resolve their dispute through arbitration and to actively support the arbitral proceedings is, therefore, critical. However, a situation in which the applicant alleges that the beneficiary has committed fraud in the underlying transaction clearly requires a dispute

[364] See *supra* Part II – Chapter 2, VI), 2).

resolution mechanism that is preset and that does not depend on the co-operation of the parties. In a fraud scenario, however, the relationship between the applicant and the beneficiary is disrupted, rendering multi-party arbitration ineffective.

Therefore, multi-party arbitration between the issuer, the applicant and the beneficiary does not provide a workable alternative for arbitrating fraud in the letter of credit transaction.

II) Second Scenario: Arbitration Agreement between Applicant and Beneficiary

The following scenario is assumed:

Two merchants located in different states conclude a contract of sale. In order to secure payment of the goods or services sold (documentary letter of credit), or to guarantee the performance of some underlying obligation (standby letter of credit), the parties further agree on the issuance of a letter of credit. The parties also include an arbitration clause in their agreement calling for binding arbitration in the event of any dispute arising out of their relationship. Moreover, the contractants expressly agree that all disputes respecting the letter of credit, including these arising from an alleged fraud in the underlying transaction, must also be referred to binding arbitration. In their arbitration agreement the parties confer jurisdiction to the arbitrator to grant damages and attorneys' fees should the beneficiary's demand for payment under the letter of credit prove to have been wrongful as a result of fraud in the underlying transaction.[365] Fraud will be determined according to the

[365] See Blodgett & Mayer "International Letters of Credit" *supra* note 188 at 462.

standard set forth in art. 19 UNCITRAL Convention.[366]

Such an arbitration agreement must not conflict with any mandatory rules of law.[367] Consequently, it must be examined whether such an arbitration clause would violate any mandatory provisions of Canadian or American law.

In Canada, such an arbitration agreement conflicts neither with general principles of contract law, nor with the specific law on the sale of goods. It falls, thus, within the contractual autonomy of the parties to individually structure their contractual relationship. Since any letter of credit arrangement in Canada is governed by general contract law,[368] the proposed arbitration agreement is permissible under Canadian law and does not violate any mandatory provisions.

In the United States, at first glance the proposed arbitration agreement may violate § 5-111 Rev. U.C.C. because it provides for damages that the arbitrator may award.[369] Although § 5-111 Rev. U.C.C. permits claims for incidental damages,[370] it prohibits actions in which consequential damages are sought.[371] However, § 5-111 Rev. U.C.C. only contemplates lawsuits against the issuer, instituted by either the beneficiary or the applicant and, thus, does not apply to actions for consequential damages arising from the underlying relationship between applicant and beneficiary.[372] Therefore, the arbitration agreement operates outside the scope of § 5-111 Rev. U.C.C. and does not contravene the Uniform

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366 See *infra* Part II – Chapter 1, V), 2), b).
367 See *infra* Part II – Chapter 2, V).
368 See *infra* Part II – Chapter 1, II), 1), b), aa) and Chapter 1, II), 2), b), aa).
369 See Blodgett & Mayer "International Letters of Credit" *supra* note 188 at 462.
370 For a definition of incidental damages, see § 2-710 U.C.C.
371 For a definition of consequential damages, see § 2-715(2) U.C.C.
372 See also § 5-111 Rev. U.C.C., Official Comment stating that consequential damages are "excluded in the belief that these damages can best be avoided by the beneficiary or applicant and out of the fear that imposing consequential damages on issuers would raise the cost of the letter of credit uneconomic."

Commercial Code. In every other respect the proposed arbitration clause is covered by the contractual freedom of the parties and does not infringe any mandatory provision of American law.

For this reason, the arbitration agreement between applicant and beneficiary described above is legally permissible under both Canadian and American law and would be binding upon the parties.

In practice, however, such an arbitration agreement would not prevent any subsequent action from being taken by either the beneficiary or the applicant against the issuer of the letter of credit. Thus, once the applicant suspects fraud in the underlying transaction, it could still apply for injunctive relief against the issuer.[373] Likewise, the beneficiary could still sue the issuer, if the latter had refused to honour the credit because it received notice of fraud in the transaction.[374] Moreover, the issuer would still avail itself of all recourses against the applicant in order to be reimbursed, once it has honoured the credit despite having previously received notice of fraud in the underlying transaction by the beneficiary.[375]

Therefore, arbitration would be theoretically possible, but would make little practical sense in these circumstances. Thus, the arbitration agreement must be supplemented in order to make arbitrating fraud in a letter of credit transaction a viable alternative.

It is assumed, therefore, that the arbitration agreement contains a stipulation expressly

[373] See *infra* Part II – Chapter 1, V), 5), a).
[374] See *infra* Part II – Chapter 1, V), 5), b).
[375] See *infra* Part II – Chapter 1, V), 5), c).

obliging the applicant to include a clause in its cover relationship with the issuer preventing from seeking injunctive relief in any event when the documents tendered by the beneficiary comply with the terms and conditions of the credit.[376] In other words, when opening the letter of credit, the applicant and issuer agree that in no event may the former seek injunctive relief against the latter when documents are presented to the issuer that facially conform with the requirements of the credit. In order to avoid any ambiguities as to the possible events that are covered by such an "injunctive-relief-prohibition-clause," the clause could specify that any legal claim and any other equitable relief based on the beneficiary's alleged fraud, or on the quality or lack of quantity of the goods or services provided by the beneficiary (documentary letter of credit situation), or on the partial or complete immateriality of the beneficiary's statement that the applicant has defaulted under the secured obligation (standby letter of credit situation), will be pursued directly against the beneficiary in a binding arbitration proceeding.[377]

The validity of such an arbitration clause has been confirmed by the courts. In *Recon/Optical, Inc.* v. *Israel*,[378] the court upheld a clause in the underlying agreement between applicant and beneficiary stipulating that the applicant could not seek injunctive relief under a letter of credit, and was restricted to binding arbitration. Aside from the fact that the applicant had expressly agreed to such a stipulation in advance, the court reasoned that binding arbitration provides a viable alternative remedy, so that the agreement did not offend notions of fairness.[379]

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[376] See Blodgett & Mayer "International Letters of Credit" *supra* note 188 at 462.
[377] See *ibid.* at 463.
[378] 816 F. 2d 854 (2nd Cir. 1987) [hereinafter *Recon/Optical*].
[379] *Ibid.* at 857.

There are no other legal barriers that could affect the validity of either the arbitration agreement or the underlying contract between applicant and issuer under Canadian or American law. Thus, both propositions taken together would entitle a court to reject any application for injunctive relief by the applicant.

In practice, such a double modification to the relationships in a letter of credit transaction, that is the arbitration agreement between applicant and beneficiary on the one hand, and the additional clause in the cover relationship between applicant and issuer prohibiting the applicant from seeking injunctive relief on the other, would result in various benefits to both the participants to a letter of credit transaction, as will be outlined first, and to the general usefulness and viability of the letter of credit, as will be outlined second.

From the issuer's perspective, these two modifications would bring about both judicial and financial relief. As has been noted above, the issuer is the focal point of most legal actions arising out of fraud in the letter of credit transaction.[380] A contractual clause preventing the applicant from seeking injunctive relief against the issuer benefits the issuer, in that it need not to concern itself with injunctive interference once the clause is included. Issuers, and specifically banks, place a high value on their public image and, thus, attempt to avoid any public proceedings that could put their reputation in question. This is particularly true when there is fraud involved to which an issuer does not want to be related.

Since the issuer must honour any demand for payment that facially complies with the

[380] See *infra* Part II – Chapter 1, V), 5), d).

stipulations of the credit, it would be relieved from the often complicated task of assessing the tendered evidence of fraud in order to decide whether or not to honour the credit.[381] Consequently, the issuer would not face any lawsuit instituted by the beneficiary pertaining to the question of whether or not it acted properly in dishonouring the letter of credit after having received prior notice of fraud by the applicant. Thus, both propositions taken together would considerably simplify and lessen the issuer's obligations. Either the documents presented by the beneficiary strictly comply with the terms of the credit or they do not. The issuer's role in a letter of credit transaction involving allegations of fraud would, therefore, remain the same as that originally intended and would not be transformed into the role of trier of fact, which, if done improperly could entail serious legal consequences. In other words, the issuer will simply be a solvent intermediary assisting the parties to the underlying relationship in processing payment and documents.

Since the risk that the issuer will be entangled in various judicial proceedings will be eliminated, it may pass on these savings to its customer and offer a cheaper letter of credit product, a welcome side-effect in times of increasing financial pressures.

The beneficiary would benefit from the envisaged modifications in that immediate honour is ensured once it provides documents that comply with the stipulations of the letter of credit. For this reason, the beneficiary need no longer contemplate the possibility that mere and sometimes unfounded allegations by the applicant may convince the issuer to dishonour the credit. Thus, the letter of credit becomes an even more secure and expedient financial means for the beneficiary.

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[381] See *infra* Part II – Chapter 1, V), 5), b).

Moreover, the beneficiary may prefer the advantages that international commercial arbitration offers in resolving international disputes over the traditional judicial process, particularly in foreign countries.

For the applicant the anticipated adjustments would bring the advantage of a forum that is ready and willing to review the allegations of fraud and that can render a final and binding decision on the matter, including the awarding of damages. Thus, the applicant need not pursue the complicated and, more importantly, usually unsuccessful path of asking the courts to grant injunctive relief.[382] Moreover, the applicant would profit from the fact that an arbitral award granted in its favour is much more readily enforceable in the beneficiary's country due to the New York Convention than would be the case with the enforcement of a foreign judgment.

As with the beneficiary, the applicant may also prefer international commercial arbitration to transnational litigation because it may, apart from the reasons already given, be a more convenient forum in which to resolve the dispute.

It should be noted that the proposed amendments would also result in considerable benefits to the courts. The courts would be relieved from having to decide a significant number of applications for injunctive relief which in most cases are not material and of which only a few would be upheld in subsequent proceedings.

Furthermore, both contractual modifications would significantly benefit the usefulness

[382] See *supra* Part II – Chapter 1, V), 5), a).

and viability of the letter of credit as a payment and security instrument. Courts in Canada, but even more so in the United States have considerably undermined the independence principle by creating a rather broad fraud exception in the past.[383] Although with respect to the United States such a development may have been consolidated by revised article 5 U.C.C., it is important to recall that the efficacy and reliability of the letter of credit utterly depends on the premise that payment will be made under the letter of credit independent of what happens in the underlying transactions. Ongoing challenges to the independence principle in the form of multiple applications for injunctive relief do not preserve the integrity of the letter of credit. For this reason, the principal exclusion of the applicant's right to seek injunctive relief when allegations of fraud are raised would contribute a great deal to the future reliability of the letter of credit.

Such an *a priori* exclusion of injunctive relief will, however, prove to be harmful to the applicant where the arbitral panel awards damages in its favour as compensation for fraud in the underlying transaction, but where the beneficiary is insufficiently liquid and solvent to pay for such damages. Nonetheless, one must recall that in only few cases do the courts actually maintain the applicant's allegations of fraud. It is, therefore, rather unlikely that the applicant would ultimately succeed in its court proceedings. Usually, the applicant will only gain time. Moreover, at least the applicant to a documentary letter of credit can stipulate in the letter of credit that extensive and neutral documentary must be provided in order to minimize the risk of fraudulent drawings under the credit. Admittedly, this possibility is not open to the applicant in a standby context, so that a prudent applicant may demand some independent proof of the beneficiary's solvency before opening the standby letter of credit.

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[383] See *supra* Part II – Chapter 1, V), 6).

However, in the light of the overall benefits the envisaged modifications may bring to both the parties and to the reliability of the letter of credit, these are relatively negligible drawbacks.

It follows from the proposed arrangements that the issues of fraud and breach of contract would have to be settled by arbitrators. Neither issue would overburden arbitrators since they demand no more than an ordinary legal understanding. As to the level of fraud that must be established by the applicant in the arbitral proceedings, the parties could incorporate the "no conceivable basis" standard of art. 19 UNCITRAL Convention into their arbitration agreement, which thus far is the only international attempt to define fraudulent conduct by the beneficiary in concrete terms.

A further advantage to arbitrating fraud in the transaction is that the parties would be free to select experts with a technical understanding of the particular trade as their arbitrators. Since specifically standby credits are frequently used to secure major international construction projects, this may indeed prove to be an advantage.

III) Summary

Multi-party arbitration of fraud in the letter of credit transaction between issuer, applicant and beneficiary does not offer a viable alternative to litigation. Arbitration of fraud in the transaction will considerably benefit both the involved parties to a letter of credit transaction and bolster the reliability of the letter of credit as a payment and security instrument, if the arbitration takes place between the applicant and the beneficiary. Successful arbitration under these circumstances presupposes, however, that the applicant

is contractually prevented from seeking injunctive relief against the issuer in the event of an allegation of fraud in the underlying transaction.

Chapter 4: Letter of Credit Arbitration Rules

Recently, two sets of arbitration rules specifically designed to cover letter of credit arbitration, the 1996 International Center for Letter of Credit Arbitration Rules (ICLOCA rules)[384] and the 1997 I.C.C. Documentary Credit Dispute Expertise Rules (DOCDEX rules),[385] have been published. This section introduces these regimes and analyzes their usefulness in arbitrating fraud in the letter of credit transaction.

I) The ICLOCA Rules

1) General

The ICLOCA rules were adopted by the Institute of International Banking Law and Practice, Inc. in 1996.[386] The rules are modelled upon the UNCITRAL Arbitration Rules[387] with modifications necessitated by the expert arbitrators and the frequent possibility of summary disposition based upon documentary and stipulated evidence that is common in this field of law.[388] The rules intend to provide an "expedited, principled resolution of disputes involving trade finance by recognized experts in law and practice in a cost efficient manner."[389] Pursuant to article 1(1) the ICLOCA rules are applicable whenever the parties

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[384] *Supra* note 24.
[385] *Supra* note 25.
[386] For a general survey of the ICLOCA Rules, see Note, "International Litigation: Alternatives for Resolving Letter of Credit Disputes" (December 31, 1996) New York Law Journal. Also available, online: <http://www.lix.com/practice/intrade/1231itlit.html> [hereinafter Note, "Alternatives for Resolving Letter of Credit Disputes"].
[387] 31st Sess., Supp. No. 17, U.N. Doc. A/31/17 (1976). In 1976 UNCITRAL promulgated the UNCITRAL Arbitration Rules for use in ad hoc international arbitrations. In addition to their use in ad hoc arbitrations, some arbitral institutions have adopted the UNCITRAL Rules as their institutional rules while other institutions will administer arbitration under the UNCITRAL Rules, if requested.
[388] See Preamble of the ICLOCA Rules available online, see <http://www.doccreditworld.com//ICLOCA.htm> (date accessed 29 September, 1999).
[389] *Ibid.*

to the letter of credit incorporate them expressly into their agreement or when an existing dispute is submitted by agreement of the parties. Once a request for application is filed, the arbitration is conducted by either one or three trained experts.[390] The ICLOCA rules give the arbitrators wide discretion as to how to carry out the arbitration. Article 15(1) ICLOCA Rules sets forth that "the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate, provided that the parties are treated with equality and that at any stage of the proceedings each party is given a full opportunity of presenting its case." The arbitration is held where the parties agree, or, if they cannot agree at a place to be determined by the arbitration center.[391] The decisions rendered by the arbitral tribunal are final and binding on the parties and not subject to an appeal on the merits to a court.[392] Court enforcement of decisions made under the ICLOCA Rules is secured under the New York Convention.

2) Usefulness of the ICLOCA Rules for Arbitrating Fraud in the Letter of Credit Transaction

The ICLOCA Rules provide for a binding and enforceable award rendered by experts on letters of credit. The rules stipulate for a cost efficient and quick procedure and leave it to the parties to determine the place of arbitration. Additionally, the parties can influence the choice of arbitrators. For these reasons, the ICLOCA Rules represent a useful body of rules for arbitrating letter of credit disputes and, thus, for controversies arising from fraud in the transaction. The parties to the underlying transaction may, therefore, make their

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[390] See arts. 3, 5, 6 and 7 ICLOCA Rules.
[391] See art. 16(1) ICLOCA Rules.
[392] See art. 32 ICLOCA Rules.

undertaking subject to the ICLOCA Rules.

II)The DOCDEX Rules

1) General

The DOCDEX Rules were introduced by the I.C.C. in 1997 through its Center for expertise under the auspices of the I.C.C. Banking Commission.[393]

The rules are concerned either with documentary letters of credit incorporating the UCP or with the application of the UCP or the Uniform Rules for Bank-to-Bank Reimbursement[394] under documentary credits.[395] Thus, they have a tripartite basis: the documentary credit, which is the subject matter of the dispute; the provisions of the UCP; the provisions of the URR. The DOCDEX rules intend to provide an independent, impartial and prompt expert decision on how the dispute should be resolved.[396] Unless the parties agree otherwise, however, a DOCDEX decision is not binding upon the parties and not intended to conform with any legal requirements of an arbitration award.[397] Thus, the DOCDEX rules can be classified as a voluntary expert determination of how a conflict pertaining to documentary credits should be resolved.[398]

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[393] Art. 1.2 DOCDEX Rules. For a review on the drafting process of the DOCDEX Rules, see Chung, "ICC Dispute Resolution System" *supra* note 5.
[394] I.C.C. Publication No. 525 [hereinafter URR 525]. The URR 525 set international standards for defining the rights and obligations of issuing, claiming, and reimbursing banks in letter of credit transactions.
[395] Art. 1.1 DOCDEX Rules.
[396] Art. 1.1 DOCDEX Rules.
[397] Arts. 1.3 and 1.4 DOCDEX.
[398] See A. Connerty, "Documentary Credits: A Dispute Resolution System from the ICC" (1999) J.I.B.L. 65 at 70 [hereinafter Connerty, A Dispute Resolution System from the ICC]; S. Hazzard, "Letter of Credit Disputes" *supra* note 16 at 54.

2) Usefulness of the DOCDEX Rules for Arbitrating Fraud in the Letter of Credit Transaction

Clearly, allegations of fraud in the underlying transaction are of such nature that claims arising out of them cannot be settled by voluntary extra-judicial dispute resolution mechanisms. The successful settlement of fraud in the international letter of credit transaction critically requires that the parties to such fraud are bound by the decisions the extra-judicial body forms. The DOCDEX rules, therefore, do not provide a suitable set of rules for arbitrating fraud in the letter of credit transaction.

III) Summary

While the DOCDEX Rules do not represent a viable set of rules for arbitrating fraud in the letter of credit transaction, the parties may make eventual disputes arising form the letter of credit undertaking subject to arbitration by the ICLOCA Rules.

PART III – CONCLUSION

This thesis concentrated on three main issues.

First, this thesis gives an overview of recent reforms of the regulatory framework governing letters of credit.

In the United States, revised article 5 U.C.C. now codifies the rights and obligations of the parties to both documentary and standby letters of credit. The 1995 revision of article 5 U.C.C. marked a long overdue shift that brought American letter of credit law into line with international letter of credit practices. While the previous version of article 5 U.C.C. did not provide for the incorporation of international standards such as the UCP 500 into the letter of credit undertaking, revised article 5 U.C.C. now expressly acknowledges present and future "standard practices." Thus, the new article should not only remove from the courts many of the disputes of the past that arose as a result of discrepancies between the U.C.C. and the U.C.P., but it also represents a much more reliable and certain standard for letters of credit practitioners.

On the international level, the UCP 500, the URDG and the ISP98 represent fairly detailed standard practices for letters of credit that regulate the actual letter of credit procedure from issuance to honour. All three regimes operate as contractual terms and, thus, must be expressly included by the parties in their undertaking.

To date, the UCP 500 are incorporated in virtually every letter of credit and, therefore, represent the most successful worldwide legal standard applicable to both documentary and standby letters of credit. The 1993 revision of the UCP provided a multitude of minor very useful adjustments, which reflected changing letter of credit practices. In particular, the UCP

were adapted to new developments in the transport and telecommunications industries. Although the new UCP rules contain certain weaknesses in respect of the obligations owed by the issuers to applicants, they nonetheless consolidate to a great extent the reliability of the letter of credit as a financial instrument. It remains, however, to be seen whether the UCP must be supplemented in the near future in order to be accommodated to changing letter of credit practices, which have occurred for the most part with the strong emergence of the global network, i.e. internet and e-mail. These developments have had and will continue to exert a major influence on the processing of documents.

The most recent regime that has emerged in the field of letter of credit law are the ISP98 rules. The ISP98 constitute a comprehensive source of law for standby letters of credit and are intended to fill the regulatory void left by the UCP 500, which are apply only partially to standby credits. In general, the ISP98 represent an even-handed and commendable set of rules that not only should be preferred to the existing regimes by all parties to the standby letter of transaction, but that may also soon set the international standard for standby credits.

The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, which will enter into force on January 1, 2000, purports to harmonize the use of independent guarantees and standby letters of credit by specifically recognizing the basic principles and characteristics shared by both instruments. Thus far, only five states have become party to the UNCITRAL Convention, and it is doubtful for that reason whether the UNCITRAL Convention will actually realize all of the expected improvements to international standby letter of credit law. Despite its failure to have become accepted by a large number of states, the UNCITRAL Convention may serve as a useful interpretative instrument both for courts in countries in which there is only little guidance on letters of

credit and independent guarantees, as well as for arbitrators who settle international standby letter of credit disputes. It is noteworthy that the UNCITRAL Convention is thus far the only international legal framework that provides guidance on the issue of fraud in the underlying transaction.

One may see that major reforms to the regulatory framework governing letters of credit have taken place in the last six years. These reformatory efforts reflect the emergence of the standby credit as the more important form of letter of credit.

The second purpose of this thesis was to reappraise the fraud exception to the independence principle in letter of credit transactions in the light of current developments in Canada and the United States.

Since the landmark decision of *Sztejn* in 1941, which was the first case to have established the fraud in the underlying transaction exception to the independence principle, a number of legal issues have frequently arisen in cases involving allegations of fraud. Most of these issues are now resolved and do not pose too many problems for the courts. In Canada, the recent Lloyd's cases contributed a great deal to such a clarification whereas § 5-109 Rev. U.C.C. settled most of these matters in the United States. However, the precise standard of fraud that must be met before obtaining injunctive relief, or in order to establish fraud at trial remains difficult to determine.

In Canada and the United States, the fraud exception is not confined to falsified or forged documents, i.e. fraud in the tendered documents, but it also includes fraud in the underlying transaction (locus of fraud).

Under Canadian law the fraud exception may only be raised if the fraud has been perpetrated by the beneficiary (scope of the fraud exception). Thus, the fraud exception

cannot be raised when the fraud has been committed by a third party or when it would prejudice against a *bona fide* holder in due course. In the United States, § 5-109 Rev. U.C.C. stipulates that fraud in the tendered documents falls within the scope of the fraud exception, irrespective of whether or not such fraud has been perpetrated by the beneficiary or by a third party. Despite earlier case law that had adopted the narrower Canadian approach, the drafters of revised article 5 U.C.C. expanded the scope of the fraud exception in this respect. As in Canada, however, the fraud exception cannot be raised if it would prejudice the rights of *bona fide* third parties.

In both Canada and the United States, the issuing institutions must act honestly and in good faith when assessing the evidence of fraud presented to them (issuer's duty of care). The applicable subjective standard of good faith is subjective.

With respect to the applicable fraud standard in Canada, a distinction must be made between interlocutory injunctions, in which a strong *prima facie* case of fraud must be established, and ordinary court actions, in which the higher standard of proving clear and obvious fraud must be met. In the United States, § 5-109 Rev. U.C.C. now sets out a material fraud standard applicable to both applications for injunctive relief and ordinary court proceedings. Though revised article 5 U.C.C. has not yet been adopted by all States, it is likely that the material fraud standard will eventually put an end to the rather broad interpretation of the fraud exception in the United States.

In both Canada and the United States, the courts have exerted considerable efforts to clarify and concretize the applicable standard of fraud. Notwithstanding these clarifications, the scope of the fraud exception remains to some, one may now say lesser, extent indeterminate and can only be determined on a case-by-case basis.

Generally, a greater number of cases involving fraud in the transaction are reported involving standby than documentary letters of credit. The reason for this must be seen in the different documentary requirements of each instrument. Whereas the applicant can considerably minimize the risk of fraudulent drawings under the documentary credit by stipulating for extensive and neutral documentary coverage of the transaction in the letter of credit, it is in most standby credit scenarios the beneficiary itself, who can produce the necessary documentary evidence that must be presented in order to receive payment under the standby credit.

Third, this thesis suggests that the parties to the underlying transaction should refer their disputes involving fraud in the underlying transaction to binding international commercial arbitration.

Successful arbitration in these circumstances requires two modifications to the relationships in a letter of credit transaction. First, the parties to the underlying contract, i.e. applicant and beneficiary, should include an arbitration clause into their agreement calling for binding arbitration in the event of any dispute arising out of their relationship. Such an arbitration agreement should expressly include letter of credit disputes arising from the alleged perpetration of a fraud in the underlying transaction. Second, applicant and issuer should include a clause in their contract preventing the applicant form seeking injunctive relief whenever documents are presented to the issuer that facially conform with the terms and conditions of the credit. In order to ensure that the applicant actually includes such a clause into the cover relationship, i.e. the contract between applicant and issuer, the validity of the arbitration agreement should be made conditional upon such a "no-injunctive-relief-clause."

These two proposals taken together would translate into considerable advantages for each party to a letter of credit transaction. The beneficiary benefits in that secure and prompt honour would be ensured once it provides documents that comply with the stipulations of the letter of credit. For the applicant the anticipated adjustments would bring the advantage of a forum that is ready and willing to review the allegations of fraud and that can render an internationally binding and easily enforceable arbitral award, including an award of damages. Conversely, the issuer would no longer face the risk of being entangled in legal proceedings, since any demand for payment by the beneficiary that facially complies with the stipulations of the credit will be honoured, and since the frequent applications for injunctive relief instituted by the applicant as a result of alleged fraud are expressly prohibited under the cover relationship. For this reason, the financial risk of the various judicial proceedings would be eliminated, which would theoretically lower the costs of issuing letters of credit.

Moreover, the courts would be relieved from having to decide on what are often unsuccessful applications for injunctive relief.

Finally, and most importantly, arbitrating letter of credit fraud would significantly enhance the usefulness and viability of the letter of credit as a payment and security instrument, since ongoing challenges to the independence principle in the form of multiple applications for injunctive relief, which have seriously undermined the reliability of the letter of credit in the past, could be avoided.