

**A Comparative Study of the Fraud Exception Rule
of Letters of Credit:
Proposed Amendments to the Chinese Credit System**

by

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Abstract

This thesis deals with the fraud exception rule of letters of credit, especially focusing on the proposed amendments in Chinese credit system based on a comparative study. In order to reasonably prevent fraud in letters of credit, and to protect the effectiveness and efficiency of credit system, this thesis firstly examines the premise, reasons and foundations of the fraud exception rule, and then analyses its legal philosophy, application criteria and judicial remedies. Finally, based on a comparative study of different domestic laws and the UCP rules, this thesis examines the existing defects and provides proposed amendments of the Chinese credit system in both procedure law and substantive law. In developing this thesis, the author plans to employ comparative, critical, theoretical and prescriptive methodologies.

Resume

Cette thèse traite de la règle de l'exception de fraude des lettres de crédit, et se concentre plus particulièrement sur les amendements proposés dans le système de crédit chinois sur base d'une étude comparative. Afin de prévenir la fraude dans les lettres de crédit, et de protéger l'efficacité du système de crédit, cette thèse examine tout d'abord les raisons de la création de la règle d'exception de fraude et analyse ensuite sa philosophie légale, ses critères d'application et les remèdes judiciaires. Finalement, dans un troisième temps, les défauts existants sont analysés sur base d'une étude comparative de différentes lois domestiques et de règles UCP et les amendements proposés dans le système de crédit chinois à la fois en loi procédurale et loi substantive sont détaillés. L'auteur prévoit d'utiliser des méthodologies comparatives, critiques, théoriques et prescriptives pour aborder ces différentes questions.

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Introduction

1. The Background of Letter of Credit

The letter of credit is one of the facilities used for the financing of international trade. It has served this function of the last 180 years. Nowadays, it has even evolved into an electronic letter of credit. The common variety of the letter of credit is the documentary credit,¹ which is also called commercial credit, or letter of credit (L/C) or just “credit” in the ICC Uniform Customs and Practice for Documentary Credits 600² (hereinafter called UCP 600). The normal documentary credit used as a payment mechanism is the subject of this thesis. The two other forms of the broad meaning letter of credit, which might be referred to in this thesis where relevant and applicable, are the acceptance credit and the standby credit, but the focus of this thesis is on the Letter of Credit as a payment mechanism.

Different from the documentary credit, the standby credit is not necessarily related to underlying contracts of sale or shipments of goods, thus it is not necessarily applicable in payment situation and does not require examination of shipping documents and files. The main function of the standby credit is to prevent one or both parties from attempting to breach a contract due to changes in market or other reasons. The standby credit is

¹ Ellinger E.P. “Letter of Credit”, Horn, Norbert & Clive M. Schmitthoff, eds. *The Transactional Law of International Commercial Transactions*, (The Hague: Kluwer Law and Taxation Publishers, 1982), p242.

² UCP 600, 1933, ICC 600, (2007).

gaining increasing use as performance bonds in the construction field, and fidelity bonds and collateral security in financing operations. For example, in oil transportation, especially in short voyages such as the transportation between European countries, goods might be shipped to the port of discharge in one day while the bills of lading are not yet issued in the loading port. In this situation, it is more practical and convenient for the parties of sale contract to use cash as the payment instrument rather than documentary credits. However, in order to make the seller be more secure and confident to do business, the buyer could still issue a standby letter of credit as a back-up. From which it can be seen that the standby letter of credit is not necessarily applicable in payment situations.

Although the standby letter of credit has an important function as a guarantee, it is by no means equal to a bank letter of guarantee. Because the standby credit requires proof of non-performance of the underlying transaction, rather than solely requiring documentary compliance by the beneficiary.

Furthermore, the proof of fraud is more difficult in standby credits than in documentary credits. In other words, it is really hard to prove that the beneficiary's breach of contract is a fraud. Just as Judge Kerr stated in *Harbottle (Mercantile) Ltd. v. National Westminster Bank*: "this is not a case of an established fraud at all. The seller may well be right in contending that buyers have no contractual right to payment of any part, let alone the whole, of the guarantee. ...But all these issues turn on contractual disputes. They are a

long way from fraud, let alone established fraud.”³

(1) Definition of Letter of Credit

According to the Osborn’s Concise Law dictionary, the letter of credit (herein after adopting the narrow meaning of the documentary credit in this thesis) is defined as “an authority by one person to another to draw cheques (q.v.) or bills of exchange (q.v.) (with or without a limit as to amount) upon him, with an undertaking to honor the drafts on presentation. An ordinary letter of credit contains the name of the person by whom the drafts are to be negotiated or cashed: when it does not do so, it is called an open letter of credit.”⁴ For most documentary credits, the following documents are required: first, a bill of lading, issued by a common carrier to the seller, which serves as a receipt acknowledging that goods have been shipped; second, a commercial invoice, which prepared by the seller, describes the items sold along with the cost of such commercial items; third, an inspection certificate indicating that the goods have passed through a quality inspection before being transported; fourth, a government-issued or other legal document that shows that the goods are ready for export (e.g., export license), and meet the regulatory requirements of the importing country (e.g., foreign exchange license); and fifth, an insurance certificate showing that the beneficiary obtained insurance

³ *Harbottle (Mercantile) Ltd. v. National Westminster Bank*, [1978] 1 Q.B. 146.

⁴ Osborn’s Concise Law Dictionary, 10th ed., s.v. “letter of credit”.

for the transportation of the goods or, where applicable, that the seller has obtained such insurance.⁵

(2) Object and Function of Letter of Credit

A letter of credit is an important method of payment, which plays an increasingly important role in international transactions. The reason why a letter of credit is so popular lies in its object, that is “to solve two problems that arise in most overseas sales: the problem of furnishing security for the payment of the price and the problem of raising credit.”⁶

In international transactions, the parties normally have not met in person or have no experience of dealing with each other, and have widely differing interests and objectives. For instance, the seller (exporter or beneficiary of letter of credit) wants to be paid upon the manufacture and the shipment of goods, while the buyer (importer, or account party of letter of credit) does not wish to surrender his payment before the shipment and wants to pay only upon the receipt and inspection of goods. Moreover, they may not trust each other's credit or reputation, or doubt their chances of seeking redress in each other's court. In this situation, a letter of credit is needed and helpful to reduce both parties' risks and lower the cost of the transaction.

⁵ Sarkar Rumu, *Transnational Business Law: A Development Law Perspective*, (The Hague: Kluwer Law International, 2003).

⁶ Op.cit.n.1, p243.

(3) Parties and Their Relationship under Letter of Credit

For example, when a Canadian seller wants to sell goods to a Dutch buyer: first, the Dutch buyer needs to open up a letter of credit in favour of the Canadian seller in a bank in Netherlands. In this arrangement, the buyer is known as the account party, the buyer's bank is known as the opening bank or issuing bank, and the seller is known as the beneficiary. The bank will send then the letter of credit directly to the seller or through an electronic transmission to a branch of the bank in Canada (the advising bank) to the seller. The bank has the responsibility to pay as long as the beneficiary presents the documents that comply with the terms and conditions of the letter of credit, typically including a bill of lading which indicates that the seller has already transferred possession of the goods to the bank. Whereas, the bank cannot charge the buyer at the same time, but only until the buyer receives the goods. Therefore, both the buyer and seller feel comfortable and safe to do the long distance transaction. Since the seller knows as long as it fulfils its responsibility of sending the qualified goods, it can get payment from the bank; while the buyer only needs to pay when it gets the goods.

(4) Law Applicable to Letter of credit

a. Domestic Laws

Letters of credit are recognized in all legal systems of the world. In the United States, the law governing letter of credit has been codified in

Article 5 of the United State's Uniform Commercial Code⁷ (hereinafter called UCC).⁸ In addition, case law are also important rules that affecting letter of credit, especially the ones in the United States and the United Kingdom which this thesis refers to.

b. International Practice

The most important rule affecting letter of credit is a privately developed set of guidelines based on the customs and commonly accepted practices of merchants and bankers, known as the UCP.⁹ It is the fruit of work by the International Chamber of Commerce's (hereinafter called ICC) Commission on Banking Technique and Practice. UCP 600 is the latest revision of the Uniform Customs and Practice that govern the operation of letter of credit. The 39 articles of UCP 600 are a comprehensive and practical working aid to bankers, lawyers, importers, and exporters, transport executives, educators, and everyone involved in letter of credit transactions worldwide.¹⁰ "Moreover, the ICC has issued a supplement to the UCP to take into account the impact of electronic commerce. This version, known as the eUCP, became effective on March 31, 2002, and applies where there are one or more electronic presentations of documents in the letter if credit transaction."¹¹

⁷ U.C.C. §5 (2001).

⁸ Schaffer Richard, Filiberto Agusti & Beverly Earle, *International Business Law and its Environment*, 7th ed. (Mason: South-Western, 2005), p235.

⁹ Ibid.

¹⁰ Op.cit.n.2.

¹¹ Op.cit.n.5, p27.

With regard to the legal status of the UCP, there are different opinions. The main view is that UCP is not a statute which has the force of law, it is an international practice which recognized by most of the countries¹². For instance, “American law suggests that the UCP should not be construed in the same strict manner as a statute but as a contractual document prepared by businessmen.”¹³ Additionally, in the United Kingdom, “it has recently been observed that the Code does not have the force of law.”¹⁴

In China, the UCP is considered as an international custom. However, with respect to its application, legal scholars have various opinions. Professor Xiuwen Zhao believes that “the UCP is an international custom which is widely applicable in a particular industry, and should be known by everyone in this industry. Therefore, even if the parties in this industry do not make an agreement of the application of this custom, they are still legally bound by the custom.”¹⁵ In the contrast, the Hong Kong scholar Linxiang Zhang believes that “the UCP is not legally binding”.¹⁶ Similarly, the Taiwan scholar Jinyuan Zhang agrees that: “the UCP is not legally binding, since it is only developed by a non-government organization. Only when the UCP is directly chosen by parties, it could be legally binding on the parties.”¹⁷ Moreover, in legal

¹² Donggen Xu, 信用证法律与实务研究 *Law and Practice of Letter of Credit*, (Beijing: Peking University Press, 2005).

¹³ *Marine Midland Grace Trust Co. v. Banco del Pais, SA*, [1996] 261 F. Supp. 844 (S.D.N.Y.).

¹⁴ *M. Golodetz & Co., Inc. v. Czarnikow-Rionda Co., Inc.* [1980] 1 W.L.R. 495, 509, 517, 519.

¹⁵ Xiuwen Zhao, “The Role of Soft Law in International Commercial Transactions” (1999) 2 International Economic Law Essays 121.

¹⁶ Linxiang Zhang, *Theory and Practice of Letters of Credit*, (Hong Kong: Wan Yuan Book Ltd, 1997).

¹⁷ Jinyuan Zhang, *Theory and Practice of Trade Contract*, (Taiwan: San Min Book, 1988).

practice, the Chinese courts believe that international custom is not a statute law and its effect is from the choices of parties.

2. Object and Methodologies of the Thesis

(1) Objects of the Thesis

Although a letter of credit is a developed payment instrument which is broadly used in international trade, the credit system still has some defects that need to be corrected. With the development of the modern economy and technology, a number of frauds happen by abuse of the independence principle and the strict compliance rule of credit, so the fraud exception rule is quite necessary. Especially in China, more than eighty percent of international trade transactions adopt letters of credit as the payment instrument¹⁸; however, the defects of existing legislation can lead to a number of uncertainties and inconvenience in legal practice. Therefore, it is urgent for China to amend the relevant rules regarding the fraud exception rule and establish a complete, consistent credit system.

(2) Structure of the Thesis

In order to protect the effectiveness of letter of credit, and to improve the Chinese credit system, the objectives of this thesis are three-fold: first, to examine the precise reasons and foundations of the application of the fraud

¹⁸ Op.cit.n.12.

exception rule. Second, to review the fraud exception rule, i.e. based on a comparative study of the operation of the fraud exception rule in different domestic laws and the UCP, to analyse the legal philosophy behind the rule and the judicial remedies of the fraud exception rule. And third, to review the Chinese credit system, i.e. based on the analysis and conclusion of the Chinese law concerning the fraud exception rule, to examine the existing defects and to propose amendments of the Chinese credit system in both procedural law and substantive law.

(3) Research Methodology

In developing the thesis, the author plans to employ comparative, critical, theoretical and prescriptive methodologies. With respect to the issue of the Chinese fraud exception rule, the author seeks to identify and criticize the defects of the existing credit system, the gap between legal theory and practice, and propose recommendations on the reform of the credit system, through a comparative examination of national rules and international trade practice. This thesis will compare Chinese laws with different national laws, especially British and American precedents; and international practice under the UCP 600. Furthermore, the author will use theoretical methodology to explore the underlying principles and reasons as well as the broad context of the proposed amendments, such as the principles of equity and good faith to balance the parties' interests under letter of credit.

Chapter One—Premise of the Fraud Exception Rule

The value of the letter of credit lies in the guaranties they afford to both buyers and sellers and in their contribution to the efficiency of international trade. This value is derived from, and developed by, two basic principles, - the independence principle and the strict compliance rule - both of which replace the parties' credit with banks' credit, and thereby facilitate international trade. However, with the development of trade and technology, both the independence principle and the strict compliance rule also leave room for fraud in letter of credit, which can damage the effectiveness of the letter of credit and parties' credit. Therefore, these principles need to be mitigated to some extent, and the adoption of the fraud exception rule is necessary in order to protect the parties' interests and the function of the credit system. However, it does not mean that the independence principle and the strict compliance rule should be completely denied. In fact, these two principles are the cornerstones of the credit system which ensures the purpose and function of letter of credit. Therefore, the insistence upon the independence principle and the strict compliance rule is still necessary and quite important, and they are rightly regarded as the foundation of the fraud exception rule.

I The Independence Principle and the Strict Compliance Rule

The independence principle and the strict compliance rule are the most important fundamental principles which are regarded as the cornerstone of the letter of credit system, including the electronic letter of credit. They are recognized by international instruments like the *ICC Uniform Customs and Practice for Documentary Credits* 600, (hereinafter called UCP 600)¹⁹, and most countries' domestic laws as an international custom²⁰, including the Chinese law, the United States Uniform Commercial Code (hereinafter called UCC) as well as Anglo-American cases.

1. Law applicable to the Independence Principle

(1) The independence principle in international instruments and domestic laws

In international business practices, the independence principle is recognised by UCP 600, especially embodied in Article 4 which states that “A credit by its nature is a separate transaction from the sale or other contract on which it may be based” and Article 5 which stipulates that “Banks deal with documents and not with goods, services or performance to which the documents may relate”²¹, although there is no specific term “independence

¹⁹ Op.cit.n.2.

UCP 600 are the latest revision of the Uniform Customs and Practice that govern the operation of letter of credit. UCP 600 comes into effect on 01 July 2007. The 39 articles of UCP 600 are a comprehensive and practical working aid to bankers, lawyers, importers, and exporters, transport executives, educators, and everyone involved in letter of credit transactions worldwide.

²⁰ Op.cit.n.12.

²¹ Op.cit.n.2.

Article 4: Credits v. Contracts:

a. A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference

principle” used in these provisions. Furthermore, the independence principle can also be found inherently in other provisions, such as Article 14 - Standard for Examination of Documents, Para a, and Article 15 - Complying Presentation ²². Moreover, the independence principle is also recognized by eUCP, embodied in Article 12 which states that “By satisfying itself as to the apparent authenticity of an electronic record, banks assume no liability for the identity of the sender, source of the information or its complete and unaltered character other than that which is apparent in the electronic record received by the use of a commercially acceptable data process for the receipt, authentication and identification of electronic records.”²³

In addition to being recognized internationally, the independence principle has been recognized by countries’ domestic laws no matter in the

whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary.

A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.

b. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like.

Article 5: Documents v. Goods, Services or Performance

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

²² Ibid.

Article 14: Standard for Examination of Documents

a. A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.

Article 15: Complying Presentation

a. When an issuing bank determines that a presentation is complying, it must honour.

b. When a confirming bank determines that a presentation is complying, it must honour or negotiate and forward the documents to the issuing bank.

c. When a nominated bank determines that a presentation is complying and honours or negotiates, it must forward the documents to the confirming bank or issuing bank.

²³ eUCP V1.1 Supplement to UCP 600, March 31, 2002. See <http://www.iccwbo.org>.

form of statute or precedent. The most famous domestic statute is the UCC. In Article § 5-108. Issuer's Rights and Obligations, it states clearly that “(f) An issuer is not responsible for: (1) the performance or nonperformance of the underlying contract, arrangement, or transaction,”²⁴ Besides statutes, case law has also played a very important role in establishing and developing the independence principle. For instance, in *Maurice O'Meara Co. v. National Park Bank of New York I*, the Judge of this case - Judge McLaughlin stated that

[T]he letter of credit...was in no way involved in or connected with, other than the presentation of the documents, the contract for the purchase and sale of the paper mentioned. That was a contract between buyer and seller, which in no way concerned the bank. The bank's obligation was to pay sight drafts when presented if accompanied by genuine documents specified in the letter of credit. If the paper when delivered did not correspond to what had been purchased, either in weight, kind or quality, then the purchaser had his remedy against the seller for damages....The bank was concerned only in the drafts and the documents accompanying them. Therefore, the decision is National Park Bank's obligation to pay the beneficiary's drafts submitted under its letter of credit was separate

²⁴ Op.cit.n.7.

and distinct from the contract of sale between the buyer and seller.”²⁵

Moreover, the decision made in *Trendtex Trading Corp. v. Central Bank of Nigeria*²⁶ made it clear that the courts would be reluctant to support a bank’s refusal to make a payment based on their claim of sovereign immunity of their head office. Besides these two cases, there are a large number of other cases, such as *Bes Enterprises, Inc v. Rony Natanzon*²⁷, *PNC Bank v. Spring Ford Indus*²⁸, *Mead Corp. v. Dixon Paper Co.*²⁹, *San Diego Gas & Elec. Co. v. Bank Leumi*³⁰, and *Admanco, Inc. v. 700 Stanton Drive, LLC*³¹ and other cases.

(2) The independence principle in the Chinese law

Although it has no specific legislation pertaining to letters of credit, most of China’s legal rules related to letter of credit are established by judicial precedent; the majority decisions are set by The Supreme Court of the People’s Republic of China (hereinafter called the Supreme Court of China). These judicial precedents are an important reference point for parties involved in the Chinese credit system, and the dispute settlement system.

²⁵ *Maurice O'Meara Co. v. National Park Bank of New York*, Court of Appeal of New York, [1925] 239 N.Y.386; 146 N.E.636.

²⁶ *Trendtex Trading Corp. v. Central Bank of Nigeria*, [1978] QB. 529.

²⁷ *Bes Enterprises, Inc v. Rony Natanzon*, [2006] Civil Case No. RDB 06-870.

²⁸ *PNC Bank v. Spring Ford Indus. (In re Spring Ford Indus.)*, [2005] 02-1501 DWS.

²⁹ *Mead Corp. v. Dixon Paper Co.*, [1995] 940256-CA.

³⁰ *San Diego Gas & Elec. Co. v. Bank Leumi*, [1996] D020429 Court of Appeal of California.

³¹ *Admanco, Inc. v. 700 Stanton Drive, LLC*, [2009] Appeal No. 2007AP2791, Court of Appeals of Wisconsin.

With respect to the independence principle, the Supreme Court of China stated clearly in *Newco Commodities AG v. Hunchun City* that: “letter of credit have an independent legal relationship.”³² This decision distinguished letters of credit from sales contracts and other legal relationships, meaning that applicants cannot invoke defenses based on sales contracts to confront beneficiaries under letter of credit, and vice versa. Furthermore, in “Forum Summary of National Coastal Areas Economy Referring to Foreign Countries and to Hong Kong and Macao”³³, the Supreme Court of China stated that

[A] letter of credit is independent of the underlying sales contract. As long as the documents presented by beneficiaries apparently comply with the terms of the letter of credit, issuing banks have the responsibility of payment during the period set forth. Otherwise, when documents do not comply with the terms, banks have the right of refusing payment without adopting protective actions taken by courts.³⁴

Moreover, the Court found that “letter of credit and sales contracts belong to different legal relationships. It is better not to summarily freeze the payments of letter of credit issued by Chinese banks, based on the disputes of underlying

³² 瑞士纽科货物有限责任公司与中国建设银行吉林省珲春市支行拒付信用证项下贷款纠纷上诉案 *Newco Commodities AG v. Hunchun City*, Jilin Province Branch of China Construction Bank, [1999] 《最高人民法院公报》 Gazette of The Supreme Court of People’s Republic of China. No.2, p2.

³³ 《全国沿海地区涉外、涉港澳经济工作座谈会纪要》 *Summary of the National Forum on the Adjudication of Economic Cases Relating to Foreigners and People from Hong Kong and Macao in the Coastal Region*, 12 June 1989, the Supreme People’s Court.

³⁴ *Ibid.*

sales contracts which involve foreign countries, since they will seriously affect the reputation of Chinese Banks.”³⁵ This is regarded as the guidance of the Supreme Court of People’s Republic of China in regard to the practice of using letter of credit.

The judicial spirit of the independence principle at all levels of Chinese courts is connected and consistent with the regulations of UCP. For instance, in *Xinjiang Branch of Bank of China v. Xinxing Company*, the Higher Court of the People’s Republic of China (hereinafter called the Higher Court of China) of Xinjiang Uygur Autonomous Region clearly accepted Article 3, Para a of UCP 500, stating that letters of credit are independent of sales contracts, and that banks have no relationship with the sales contracts because the relationship between beneficiaries and advising banks is irrelevant to the relationship between beneficiaries and issuing banks.³⁶ Additionally, in *Qingdao Agriculture Bank Sales Department v. Kaili Office & Zhengde Company & Zhangbin Medical Company & Hentai Company*, Qingdao Intermediate Court of the People’s Republic of China (hereinafter called the Intermediate Court of China) decided that:

[A]ccording to the independence principle, the plaintiff is only responsible for the examination of whether the documents are in compliance with the terms, rather than the examination of the

³⁵ Ibid.

³⁶ *Xinjiang Branch of Bank of China v. Xinxing Company*, [1999] See Jin Saibo, 中国法院尊重和接受《跟单信用证统一惯例》Chinese courts to respect and accept the ‘Uniform Customs and Practice for Documentary Credit’s’, online: <http://article.chinalawinfo.com/Article_Detail.asp?ArticleID=495&Type=mod>.

authenticity of documents. The defendant (the applicant) invoked the beneficiary's fraud as a defense to refuse reimbursing the bank for the payments, was obviously breaking his promise, and violating international practice regarding letter of credit; along with Chinese civil law principles of fairness and good faith.³⁷

Moreover, on appeal, the Shandong Higher Court of China decided that, "letters of credit were independent of sales contracts; banks were only responsible for the payments of commercial transactions, but could not prohibit fraud in sales contract from happening." Furthermore, on appeal, the Shandong Higher Court of China decided that,

[A]ccording to the independence principle, Qingdao Agriculture Bank could not avoid its obligation to reimburse the negotiating bank, since it had already confirmed the negotiating bank's payment. In addition, since Qingdao Agriculture Bank had already paid the negotiation bank in advance, Kaili Company had to reimburse the Qingdao Agriculture Bank, and could not refuse to reimburse base on the beneficiary's fraud.³⁸

2. Law applicable to the Strict Compliance Rule

(1) The strict compliance rule in international instruments and domestic laws

³⁷ See Jin Saibo, 《中国信用证法律和重要案例点评》 *China's Laws and Important Cases Comments of the Letter of Credit*, (Beijing: Foreign Economic and Trade University Press, 2002).

³⁸ Ibid.

The strict compliance rule was first established and gradually completed by Anglo-American case law, and thus there exist a number of important precedents connected to the rule. For example in *Rheingold v. Hanslow*, the certificate of quality was determined to be non-conforming, since it did not indicate there was a mark of “F” on the packaging goods, which was stated in the bill of lading. Therefore, it could not prove that the goods stated in the certificate of quality were the shipment goods showed on the bill of lading³⁹; Additionally, in *Stein v. Hambros Bank*, the appellate court agreed with the serious discrepancy, because on the bill of lading it stated “per steamer ‘Caboto’, leaving Calcutta about the middle of January”, whereas the shipment was actually finished on Jan. 24th, and did not leave Calcutta until Feb.19th because of strikes, which was beyond the seller’s control.⁴⁰

The same spirit regarding the issue of strikes is also recognized by UCP 600: *Article 36 Force Majeure: A bank assumes no liability or responsibility for the consequences arising out of the interruption of its business by Acts of God, riots, civil commotions, insurrections, wars, acts of terrorism, or by any strikes or lockouts or any other causes beyond its control.*⁴¹

Furthermore, *Rayner v. Hambros Bank*⁴² mainly regards the issue of abbreviation and the requirements of banks’ knowledge. A discrepancy was

³⁹ *Rheingold v. Hanslow*, [1896] 12 TLR 422.

⁴⁰ *Stein v. Hambros Bank*, [1921] 9 Lloyd’s Rep.433.

⁴¹ Op.cit.n.2.

⁴² *Rayner v. Hambros Bank*, [1928] 23 F.2d 430.

recognized since the goods were described as “Coromandel groundnuts in bags” on the letter of credit, while on the bill of lading it described the goods as “machine shelled groundnut kernels” with an additional mark of “O.T.C/C.R.S/Aarhus”. Although the different names actually indicated a same thing because C.R.S was the abbreviation of Coromandel ground nuts, the appellate court believed that the different names constituted a discrepancy, with the reason that banks had to deal with thousands of letter of credit and they could not have knowledge of every business area. There are also other precedents regarding different issues of letter of credit that completed the credit system, such as *Moralice (London) Ltd. v. E D and F Man*, and *Soproma SPA v. Marine and Animal By-Products Corpn.*⁴³ Additionally, the most classic statements of the strict compliance rule, which has been referred to many times by following cases, are in the famous words of Lord Sumner in *Equitable Trust Co of New York v. Dawson Partners Ltd* .that: “there is no room for documents which are almost the same, or which will do just as well.”⁴⁴

The strict compliance rule has not only been recognised in common law countries, such as the United Kingdom, United States, and Canada, but

⁴³ See Yang Liangyi, *Letter of Credit*, (Beijing: China Politics and Law University Press, 1998).

⁴⁴ *Equitable Trust Co of New York v. Dawson Partners Ltd.*, [1927] 27 Ll L Rep 49 at 52, HL.

also has been universally applied in the legal practices of civil law countries, such as France, Germany, and Japan.⁴⁵

Moreover, it has also been recognized by UCP 600, especially with regard to the requirement of an invoice in article 14, and article 18, although it does not use the term of strict compliance rule explicitly. In addition, the strict compliance rule is also recognized by eUCP in article 6 which states “a...The failure of the indicated system to provide access to the required electronic record at the time of examination shall constitute a discrepancy. b. The forwarding of electronic records by a nominated bank pursuant to its nomination signifies that it has satisfied itself as to the apparent authenticity of the electronic records.”⁴⁶ Therefore, the strict compliance rule has already become the mainstream practice in different countries and in the international trade as a rule of law.

(2) The strict compliance rule in the Chinese law

In China, although precedent is not considered to be a fundamental rule of law, it does not mean that precedent is not important with regard to the examination of documents in letter of credit. The Supreme Court has already decided a large number of important cases that recognise the strict compliance rule. For instance, in *Songjia Ltd v. Jiangxi branch of Agricultural Bank of*

⁴⁵ Gao Xiaoli, 《信用证严格相符原则之适用》“The application of the Strict Compliance Rule of Letter of credit” (2006) online: Chinese and Foreign Civil and Commercial Decisions <<http://www.cfcjbj.com.cn/list.asp?Unid=6098>>.

⁴⁶ Op.cit.n.23.

China, the Supreme Court confirmed the decision of the Jiangxi Higher Court that documents should strictly comply with the terms of letter of credit. Whereas the documents presented by Songjia Ltd were determined to have four discrepancies that constituted apparent internal discrepancies among documents, and discrepancies between documents and terms of letter of credit, the Jiangxi branch of Agricultural Bank of China dishonored the letter of credit in accordance with the requirement in Article 16 a of UCP 600 that “when a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate.”⁴⁷ Moreover, the strict rule is also recognized by Autonomous Regions in cases such as *Xinjiang Branch of Bank of China v. Xinxing Company*, where the Xinjiang Uygur Autonomous Region Higher Court stated that the documents presented by the beneficiary must comply with the terms of letter of credit.⁴⁸

Furthermore, the *Lawyer’s Guideline of Letter of Credit Business (Trial)* published by the Chinese Lawyers Association also confirmed the strict compliance rule in article 1.4.3, and the importance of case study in article 1.3.6:

1.4.3 Letter of credit are a conditional payment guarantee, as long as the documents presented comply with the terms of letter of credit, the issuing bank must honor the letter of credit. It is the most important cornerstone in the practice and legal mechanisms of letter of credit...Unless there are substantial frauds, the issuing bank, or the court should not get cross the letter of credit, and dishonor the letter

⁴⁷ Op.cit.n.2.

⁴⁸ Op.cit.n.12. p175.

of credit based on its sale contract.

...Although very few cases are decided according to the substantial compliance rule, but the overwhelming number of cases show that the vast majority of courts will apply the strict compliance rule.

1.3.6 Importance of case study

...so far, few countries have the statutes of letter of credit; most of the countries are likely to refer to the UCP. However, in order to settle the disputes between different countries, it is necessary to study the cases, since that is the only way to know countries' actual practice with respect to letter of credit. Especially regarding the issues that the UCP leaves for countries' domestic law, the study of domestic law and jurisprudence is particularly important.⁴⁹

Therefore, it can be concluded that the strict compliance rule has been recognized and confirmed by common law, civil law, international trade practice, as well as the Chinese law.

II Reasons for the Adoption of the Fraud Exception Rule

Although the independence principle and the strict compliance rule are considered as the cornerstone of the credit system, they leave room for fraud in letter of credit, and therefore make the application of fraud exceptions necessary and important. Based on those two rules, a letter of credit is independent of the underlying sales contract, and a bank is only responsible for documents presented by a beneficiary. It means that as long as the presented documents strictly comply with the terms of letter of credit, the bank has to pay, and does not need to examine the goods of sales contract or what the parties promised to do or should do under the sales contract. This kind of

⁴⁹ 《律师从事信用证业务指引》 *Lawyer's Guideline of Letter of Credit Business (Trial)*, 10 November, 2001 (established by Chinese Lawyer Association).

formal examination, which stems from these two principles, facilitates forgery and fraud in letter of credit. The independence principle and the strict compliance rule are capable of being abused by traders willing to commit fraud.

Moreover, in an electronic letter of credit, since the examination of documents is an automated process, strict compliance with the independence principle and the strict compliance rule lead to some unreasonable consequences. For instance, a discrepancy will be justified solely based on an extremely small and meaningless difference between the terms of credit and documents, which would not be recognized as a discrepancy under paper documents⁵⁰. This will undoubtedly affect the smooth conduct of international trade. Additionally, various examining criteria in different banks will deduct the efficiency of credit and increase its costs.

Therefore, the fraud exception rule needs to be adopted to mitigate the independence principle and the strict compliance rule, in order to protect the security and credit interests of the parties to letter of credit, and the system of letter of credit itself.

1. Challenges of the Independence Principle

Although the independence principle is a basic principle guaranteeing the convenience and efficiency of credits, it actually leaves room for fraud in

⁵⁰ Op.cit.n.12.

letter of credit, especially fraud committed by beneficiaries. The forms of fraud are various, but the most common form occurs when beneficiaries do not actually send goods, or send fake goods instead and tender false documents to obtain payments under false pretenses. However, according to the independence principle, as long as the documents apparently constitute a conforming presentation, banks have the responsibility to pay without examining the underlying sales contracts. Therefore, the independence principle is easily abused by malicious beneficiaries, for example through the forging of apparently conforming documents. Nowadays, fraud cases committed by beneficiaries have occurred with increasing frequency. In this case, the strict compliance with the independence principle violates the foundational civil law principle of good faith. It is unreasonable, and unfair to the buyers, and, even in some sense, connives at illegal actions committed by malicious sellers. So the independence principle is facing serious challenges.

First, the abstract characteristic of the independence principle, namely examining documents, such as a bill of lading and certification of inspection, rather than personally examining the goods, emphasizes the seller's obligation of presenting conforming documents. While his obligation to submit qualified goods corresponding with the documents is ignored under the letter of credit. However, with the improvement of technology, documents are easily forged in trade practice. As a result, strict obedience to the independence principle doubtless leaves room for sellers to commit fraud. What makes it worse is that,

although the applicant may still claim remedies or breach of contract to the beneficiary based on their sales contract; however, in legal practice, the chance of winning the payment back through claims is quite small. The simple reason for this is that, normally, if the beneficiary purposely commits fraud or forgery, he probably has prepared to evade his responsibility or might not have enough money to reimburse the payment to the bank at all or not have the required goods but just forge a certification of quality. This rationale can be found in the commentary on the Uniform Commercial Code Revised Article 5. letter of credit §5-109 (a) (1995) (hereinafter called UCC revised), which explains: “[M]aterial fraud by the beneficiary occurs only when the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor.”⁵¹

Second, the independence principle limits the bank’s responsibility under a letter of credit, this consequently puts the applicant, namely, the buyer, in a passive position. For instance, in international trade practice, if the buyer has realized or found out the beneficiary’s fraudulent activities before the payment, and requested that the bank refuse to pay; most banks would ignore this request, and could quote relevant laws, regulations, or international conventions to defend such a position, arguing that banks deal only with documents. Rather than the goods, services, or performance to which the

⁵¹ Paul B. Stephan, JR Don Wallace & Roin A. Julie, *International Business and Economics: Law and Policy*, 2nd ed. (New York: Contemporary Legal Education Series, 1996), p437.

documents might relate.

Why are most banks likely to ignore the buyer's request to investigate goods, or refuse payment? The main reason is that they do not want to take the risk of bearing responsibility for failure to pay. Under letter of credit, the bank has no right to examine the sales contract, which thus means that it has no responsibility when it ignores the buyer's request, and does not personally examine the sales contract based on the principle of rights and obligations. Support for this opinion can be found in *Maurice O'Meara Co. v. National Park Bank of New York*, in which Judge McLaughlin rules that

“[s]o far I am able to discover, that a bank has the right or is under an obligation to see that the description of the merchandise contained in the documents presented is correct. A provision giving it such right, or imposing such obligation, might, of course, be provided for in the letter of credit. The letter under consideration contains no such provision...If it had to make a test as to tensile strength, then it was equally obliged to measure and weight the paper. No such thing was intended by the parties and there was no such obligation upon the bank”,⁵²

Whereas, on the contrary, if the bank refused to pay according to the buyer's instruction, it would take the risk of bearing responsibilities of failure of payment, and would have no right to ask for reimbursement from the buyer

⁵² Op.cit.n.25.

under this circumstance. As Lord Sumner said in *Equitable Trust Co of New York v. Dawson Partners Ltd.* “If it (the bank) does as it is told, it is safer if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk.”⁵³ Therefore, banks are likely to choose the safe way of ignoring the buyer’s request, and just performing its own obligations, rather than take the risk of failure of payment. Furthermore, by acting as a guarantor, the bank has already taken some risks that are not supposed to be its; therefore, it is unfair to add more additional responsibilities and risks for the bank. As a result, there is no legal basis, or necessity, for banks to take the risk.

Through analyzing all the challenges, it is not hard to find out that the real problem, -which causes those challenges and makes the independence principle a breeding ground of fraud-is the absolute nature of the independence principle, namely strict compliance to the independence principle. Therefore, in order to protect the security and credit interests of parties and the purpose of letter of credit, some flexibility needs to be added to the independence principle, namely the adoption of fraud exception rule is quite necessary and important.

The establishment of a letter of credit is based on the presumption of an ideal circumstance that parties to a letter of credit are acting in good faith, without considering the chance that fraud could happen.⁵⁴ Whereas, in actual

⁵³ Op.cit.n.44.

⁵⁴ Op.cit.n.2, p70.

legal practice, in every trade mechanism, as long as one party is in a more advantageous position without effective constraints and supervision, fraud will inevitably happen, which will consequently impede international business. Under a letter of credit, although the independence principle protects the bank's independent status, and the seller's security of obtaining payment, the buyer's benefits and security are barely protected. Such scarce protection and the imbalance of parties' interests leave room for fraud, and likely to frustrate free trade. Moreover, the strict compliance to the independence principle is incompatible with some other legal principles, such as the civil law principle of good faith; nevertheless, the consistency of legal system is a very important value orientation that recognized as a rule.

2. Correct Interpretation and Challenge of the Strict Compliance Rule

The prevailing standard of documentary examinations is the strict compliance rule. According to this rule, documents presented to the bank must apparently comply strictly with the terms and conditions of letter of credit. Although it is different from the precise doctrine of the mirror image rule that requires a word by word compliance, like the independence principle, it still leaves room for fraud in letters of credit.

(1) Correct interpretation of the strict compliance rule

Considering the fraud exception, a correct interpretation of the strict compliance rule should contain three aspects. First, the strict compliance rule should not require absolute, literal compliance; otherwise it will be easily abused by a buyer who intends to defraud and to evade payment by claiming that there is a discrepancy. Just as Lord Summer said in *Equitable Trust Co of New York v. Dawson Partners Ltd.*: “the strict compliance rule does not mean that every “i” must be dotted and every “t” crossed. The strict compliance rule will not extend to obvious typographical errors”.⁵⁵ Additionally, in *Bank of Montreal v. Federal National Bank*, Russel J. found that “a construction of the letter of credit, which treated the error as such, was fair and gave effect to the intention of the parties as it was,...Treating the document as discrepant would have frustrated the object of the transaction”⁵⁶

The common-sense rationale of justifying typographical slips or errors is that, when involving a large number of documents, it is impossible not to find a typographical, or grammar error, especially where English is not the native language. Just as in *Hing Yip Hing Fat co Ltd v. Daiwa Bank Ltd*, the Law Lord rules that “the sort of mistake that could be easily occur in a society where English is not the first language of 98% of the population.”⁵⁷ If the typographical error was treated as a discrepancy, the effectiveness of letters of credit would be damaged: namely, the bank’s efficient documentary examination, and the predictability of the examining outcomes, would be

⁵⁵ Op.cit.n.44.

⁵⁶ *Bank of Montreal v. Federal National Bank*, [1986] 622 F. supp.6.

⁵⁷ *Hing Yip Hing Fat co Ltd v. Daiwa Bank Ltd.*, [1991] 2 HKLR 35.

damaged. Since, in this case, the use of letters of credit would be in complex transactions, rather than guarantees as to their convenience and efficiency, the beneficiaries' reliance interests in being paid would also be damaged, since the presentation would be easy to be dishonored due to the frequency of typographical, or grammatical errors. The rationale of rejecting a typographical or grammatical error as a discrepancy is also demonstrated in Benjamin's *Sale of Goods* statement that "Where it can be shown that the supposed discrepancy results from a patent error, it is unrealistic to treat the entire tender as invalid by reason only of a technical slip or mistake...to treat any typographical error or patent mistake as a discrepancy would convert the commercial transaction covered by the letter of credit into a proof reading exercise."⁵⁸

Second, besides the obvious typographical errors, harmless errors have also been justified, unless they will lead to misunderstandings. Proof can be found in *New Braunfels National Bank v. Odiorne*, in which the credit's number showed in documents as "88-122-5", but actually it should have been "88-122-S" according to the requirement of the letter of credit. This error itself might or might not be meaningful, however in this case, because there were no letters of credit issued by the issuing bank with a number, this error would not lead to a misunderstanding, therefore, it could not constitute a reason for

⁵⁸ Benjamin *et al.*, *Benjamin's Sale of Goods*, 7th ed. (London, Sweet & Maxwell, 2008), p23-155 to 23-157.

rejecting payments.⁵⁹ This kind of mitigation of the harsh obedience of strict compliance rule is also supported in continental treatments. A German authority is cited by an legal scholar Bundersrichter R. Liesecke that,

“[a]s against the buyer, the banker should be entitled to tender documents which include some irregularities if, in reality, the non-conformity cannot result in any loss to the buyer. French authors also favor some mitigation of the rigor of strict compliance. Moreover, in Germany, this view is based on Para 242, BGB, which requires the parties to a contract to observe good faith in performance. Because if the non-conformity is meaningless and definitely harmless and if, furthermore, the object of the credit is attained despite it, then the reliance on such non-conformity is an abuse of rights.”⁶⁰

The rationale of adopting the fraud exception rule and adjusting harmless errors lies in the characteristic of law that in order to achieve a just solution, law sometimes has to sacrifice some individual justice. The implementation and operation of law is actually a process of applying abstract and general rules to a real and specific legal practice; while real life is so colorful and varied that it is hard to find a provision which perfectly corresponds with a specific case in legal practice. Therefore, the fraud exception needs to be applied considering specific cases in trade practice because some harmless errors need to be justified based on the analyses of

⁵⁹ *New Braunfels National Bank v. Odiorne*, [1989] 780 S.W.2d 313.

⁶⁰ Op.cit.n.1, p258-259.

specific situations. Furthermore, since different countries or parties have different trade habits, the documents drawn up by different parties are hard to consider as the same. Additionally, in the practice of international transactions, a beneficiary is unable to supervise the drawing up of any documents except the invoice; therefore, it is unfair to require harsh obedience to the strict compliance rule and to punish the beneficiary by refusing his payments because of the fault which not belongs to him and is out of his control. In this case, just as in the opinion of ICC, “banks should not work as a Robot, but should use their discretion to make a specific analysis of each case.”⁶¹ The ICC China⁶² like the ICC, believes that unsubstantial departures cannot constitute discrepancies used to defend the rejection of payments. The evidence of this kind of mitigation of the strict compliance rule can also be found in the more flexible expression of the standard for documentary examination in UCP 600 comparing with UCP 500, where it seems that the requirement of complete compliance of strict compliance rule is only limited to the invoices pursuant to Article 14, Para d, e, and f.⁶³

⁶¹ Op.cit.n.12, p183.

⁶² ICC China is the ICC China national committee. It represents the most energetic Chinese enterprises. On November 8, 1994 the 168th Session of the Council of the ICC approved China 's application for membership and decided to set up a national committee in China . ICC China was founded on January1, 1995. ICC China's members, state-owned, private or foreign-invested, come from a full spectrum of sectors such as manufacture, trade, finance, transport, insurance, commerce and therefore make the organization truly representative of the Chinese business community. ICC China represents the interests of businesses operating in China and speaks on their behalf vis-à-vis the Chinese government and intergovernmental organizations, facilitate members' participation in international business activities as well as the discussion and formulation of business practices, usages, rules at international levels.

⁶³ Op.cit.n.2

Third, regarding the object of documentary examinations, the strict compliance rule requires that documents tendered by a beneficiary should be consistent with each other. This requirement also leaves room for a malicious buyer to evade payment. Therefore, it can not be interpreted as demanding that every document in the set presented by the beneficiary should demonstrate every detail required. "It may be sufficient that all necessary information is clearly presented by the documents taken as a whole."⁶⁴

From *Midland Bank Ltd. v. Seymour*⁶⁵, it can be concluded that the requirement of consistency between documents lies in the principle of honesty and credit - it is used to protect the parties' expressions, which reflect their real meaning. This means that what the banks and the courts really care about is

Article 14 d. Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit.

e. In documents other than the commercial invoice, the description of the goods, services or performance, if stated, may be in general terms not conflicting with their description in the credit.

f. If a credit requires presentation of a document other than a transport document, insurance document or commercial invoice, without stipulating by whom the document is to be issued or its data content, banks will accept the document as presented if its content appears to fulfil the function of the required document and otherwise complies with sub-article 14 (d).

⁶⁴ Griffin Bernardette, *The Law of International Trade*, 3rd ed. (London: LexisNexis Butterworths, 2003), p185.

⁶⁵ *Midland Bank Ltd v. Seymour*, [1955] 2 Lloyd's Rep 147.

In this case, the letter of credit demanded the statement of "Hong Kong duck feathers-85% clean" and "12 bales each weighing about 190 lbs". However, regarding the documents presented, the bill of lading stated the cargo as "12 bales Hong Kong duck feather", although the description of invoice is perfectly conformity with this term. To the buyer's argument of documentary rejection, Devlin J stated: "the set of documents must contain all the particular, and, of course, they must be consistent between themselves, otherwise they would not be a good set of shipping documents. But here you have a set of documents '[each of] which not only is consistent with itself, but also incorporates the particulars that are given in other'-the shipping mark on the bill of lading leading to the invoice which bears the same shipping mark and which would be tendered at the same time, which sets out the full description of the goods.

whether the departure leaves room for different explanations or understandings regarding the same issue. If yes, it would violate the principle of honesty and estoppels, and would damage the parties' reliance interest in the letter of credit. In this case, the bank has the right to reject documents.

Additionally, the exception to this requirement is that the documents are not necessarily requested to demonstrate every detail, but that missing detail should not cause a misunderstanding. The rationale exists in the effectiveness and purpose of letter of credit, because the effectiveness of letters of credit stems from the bank's efficient documentary examination, the predictability of the examination outcomes, and the lower cost of the examination. However, if each document was required to exhaust all details, it would be both unnecessarily expensive and time consuming for the documentary examination. Moreover, since the documents are quite easily inconsistent with each other, beneficiaries, as a result, would have difficulties getting paid. This would obviously be against the aim of credits to protect the beneficiaries' security.

Consequently, with the development of trade and progress of technology, the independence principle and strict compliance rule leave room for fraud in letter of credit, although they are used to effectively guarantee parties' credit interests and the efficiency of credits mechanism. Therefore, the independence principle and the strict compliance rule need to be mitigated to

some extent, and the adoption of fraud exception rule are needed and necessary.

(2) Challenge of the strict compliance rule

The strict compliance rule is quite precise and easily grasped by banks when examining documents; however, in my opinion, it is unrealistic and unfair to some extent in trade practice.

First, according to the rule, a bank can only automatically and rigidly examine the presented documents, but has almost no room to interpret the documentary examination, which makes it easy to find a discrepancy to refuse the payment. That is quite unfair to the seller, and can create uncertainty, which is against the purpose of protecting credit interests in a letter of credit. Moreover, since rigor is always connected with stiffness, the strict application will not only increase the transaction costs, but also complicate the transaction and reduce the possibility of payment under credits. Therefore, the strict application is against the main purpose of letter of credit that ensure the efficiency and convenience of international trade.

Second, the strict compliance rule is too rigid to implement in legal practice. According to the American legal scholar Frank's theory of the basic myth of certainty and fixity,⁶⁶ the strict compliance rule is unrealistic. In 1990s, in the United Kingdom, upon the first time of documentary

⁶⁶ Zongling Shen, *Morden Western Legal Philosophy*, (Beijing: Peking University Press, 1992).

presentation, the rate of discrepancy of presenting documents was up to 49 percent to 51.4 percent, while in Hong Kong and Australia, the rate was even higher than in the United Kingdom.⁶⁷ That is because the issuance and production of documents is affected by many factors in international trade practice, for example, the varying format of bills of lading issued by different shipping companies, and the format of invoices varies determined by different national trade habits. Although upon the second time of documentary presentation most of the discrepancies could be amended and accepted, the high refusal rate of first-time presentation has still increased transaction costs. Additionally from the economics perspective the increase in transaction costs will absolutely affect the efficiency of the implementation of letter of credit. Therefore, the strict compliance rule needs to be mitigated in some aspects, and fraud exception is necessary.

Especially in electronic letters of credit, the challenge of the strict compliance rule is much more serious. On the one hand, it is hard for beneficiaries to present documents on time once electronic data is damaged by virus or other technical reasons. On the other hand, it is impossible to distinguish an “original” document from a “copy” that any documents are referred to as “electronic record”. Since due to the electronic form, each document can be copied many times without any differences from the original

⁶⁷ Schmitthoff Clive M., “Discrepancy of Documents in Letter of Credit Transactions”, *Clive M. Schmitthoff's Select Essays on International Trade Law*, (Dordrecht, Boston & London, M. Nijhoff, Graham & Trotman, 1998), p432.

one. So Article 8 of the eUCP states that “Any requirement of the UCP or a eUCP credit for presentation of one or more originals or copies of an electronic record is satisfied by the presentation of one electronic record”. Therefore, the fraud exception rule will be more encouraged in an electronic letter of credit; otherwise, payments will be refused arbitrarily and frequently.

III Foundations of the Fraud Exception Rule

The independence principle and the strict compliance rule leave room for fraud in letters of credit which constitutes the reason for fraud exceptions. Thus the strict obedience of the independence principle and the strict compliance rule are not encouraged, and slight mitigation are required in order to protect the purpose of letter of credit. However, it does not mean the independence principle and the strict compliance rule should be completely denied. In fact, these two principles are the cornerstones of the credit system including an electronic letter of credit which ensure the purpose and function of letters of credit. Therefore, the insistence of the independence principle and the strict compliance rule are quite necessary and extremely important. It is the foundation of fraud exception rule.

1. Insistence upon the Independence Principle

The independence principle is the cornerstone of the credit system

and ensures the effectiveness and efficiency of the letter of credit. Although the rigid application of it is not encouraged since it is easily to be abused to defraud, the independence principle is still requested to be insisted and constitute the foundation of fraud exceptions, because “[t]he autonomy of irrevocable credits is strenuously safeguarded by maxims, such as that the independence of the bank’s undertaking in an irrevocable engagement is a cornerstone of international trade.”⁶⁸ Therefore, negating the independence principle is equivalent to strangling the mechanism of letter of credit. The independence principle is therefore unshakable for several reasons.

First, banks do not have the capability or willingness to investigate the documents to see whether they comply with the sales contract or not. Although there should be some bank officers who have the relative skills or knowledge of trade, they are not supposed to or required to be familiar with all the aspects of trade. Even if they are just familiar with the trade area of the sales contract, the banks’ attestation may still not be completely correct or appropriate. In addition, the attestation is expensive and time consuming, so it is easy to extend the applicant’s budget and the 5 days’ limitation of the documentary examine of UCP 600⁶⁹. Moreover, under the letter of credit

⁶⁸ See, on this point, Kerr, in *Harbottle Mercantile Ltd. v. National Westminster Bank Ltd.*, [1978] 1 QB 146, 155-156 and, even more recently, *State Trading Corp. of India Ltd. v. E.D. & F. Man (Sugar) Ltd.*, The Times, July 22, 1981. A documentary credit will be enforced in England even if an injunction was granted by a foreign court; *Power Curber Int’l Ltd. v. Nat’l Bank of Kuwait*, [1981] 2 Lloyd’s Rep. 394.

⁶⁹ Op.cit.n.2.

Article 14 Standard for Examination of Documents b. A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying.

system, the bank's character is more like a guarantor to ensure transactions taking advantage of its own credit rather than as a lawyer or an accountant, whose duty is to give professional advice. So what the banks should care about is only whether the documents facially comply with the terms. They are not bound by the underlying sales contract, and are very reluctant to be involved in the disputes of the underlying sales contract between the seller and buyer.

Second, from the beneficiaries' viewpoint, the independence principle is the guarantee of the beneficiary's obtaining payment. If letter of credit were connected with the sales contract, the bank would lose its independent status and, as a result, the bank would only be a tool used by buyers. In that case, what would remain of the separation of payment and performance that letter of credit are supposed to achieve? It would be equivalent to the situation in which sellers do business directly with buyers. Under the letter of credit system, the sellers' concern about the buyers' credit, and the risks that happen in the normal course of trade, would not be reduced by the banks' credit, and the beneficiaries could not enjoy the security of payment. The buyer could take advantage of the sales contract to arbitrarily damage the seller's rights under letter of credit. Therefore, the independence principle is acting as a guarantee for the beneficiary to get payment.

Therefore, the independence principle is the cornerstone of the letter of credit system and deserves to, indeed has to continue on as a part of the overall system. Strict compliance with the independence principle can be made

flexible, however it is only when the fraud in the sales contracts is very serious and unbearable, or where there is no reason to honor the payments, that the application of the independence principle will not achieve the purpose of ensuring transactions of letter of credit. The independence principle maintains the predictability and certainty of letter of credit as an international payment instrument, and thus maintains the parties' security and credit interests.

2. Insistence upon the Strict Compliance Rule

Although there seems to be some mitigation, the strict compliance rule should still remain unaltered, especially from the perspective of banks. In order to promote transactions by reducing buyers' and sellers' doubt about each other's credit, and doubt about the security of transactions, banks' credits are induced into letter of credit to reduce these parties' risks. So the banks' obligations and capabilities should be limited to the scope that is just sufficient to fit this function.

First, the role of the bank is as a neutral third person, who protects the interests of the parties to a transaction, but not a party to the underlying sale contract itself; therefore, the bank is unnecessary in an understanding of the terms of the sales contract and it is impossible for the bank to know all the details of the underlying sale contract or to grasp all of the knowledge of various transactions in which it is involved. As a result, the bank is incapable of having much discretion in documentary examination as the substantial

compliance rule has established. Moreover, limiting the banks' discretion can also avoid their role in unnecessary arguments with both buyers and sellers regarding whether the presenting documents are substantially complying.

The evidence of this can be found in *J H Rayner & Co Ltd v. Hambro's Bank Ltd*, in which the goods at the heart of the letter of credit were "Coromandel groundnut, while the bill of lading showed "machine shelled groundnut kernels". At first, Atkinson J admitted the evidence that showed that trade practice regarded the terms as identical in meaning, so the bank should accept the documents. However, the Court of Appeal reversed this decision. Mackinnon LJ stated:

it is quite impossible to suggest that a banker is to be affected with knowledge of the customs and customary terms of every one of the thousands of trades for whose dealings he may issue letter of credit...It would be quite impossible for business to be carried on, and for bankers to be in any way protected in such matters, if it were said that they must be affected by a knowledge of all the details of the way in which particular trades carry on their business.⁷⁰

In addition, evidence can also be found in the UCP 600, such as in Article 4, Para a; and Article 5.

Article 4 Credits v. Contracts

a. A credit by its nature is a separate transaction from the sale or other

⁷⁰ *J H Rayner & Co Ltd v. Hambro's Bank Ltd*, [1943] KB 37, 74 Ll L Rep 10 CA.

contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary.

Article 5 Documents v. Goods, Services or Performance

Banks deal with documents and not with goods, services or performance to which the documents may relate.⁷¹

Second, accompanied by the increase of discretionary power, the bank's risk of bearing the obligations of the sale contract also increases, which is obviously unfair to the bank. Because under the letter of credit system, banks only have the right of making payments from buyers of issuing and operating letter of credit, but cannot claim any rights to the goods of sale contracts, such as possession, or the right to use, the bank should not bear any obligations regarding the underlying contract. Otherwise the bank would be likely to adopt high-degree self-defense measures, which would affect the purpose of letter of credit since the banks would be reluctant to pay.

Third, a bank itself would prefer to strictly observe the documents, since it is the safest way to obtain reimbursement from a buyer. Under the letter of credit system, a bank would be liable for a buyer if it accepted

⁷¹ Op.cit.n.2.

documents that are not conformity. So the bank has an interest in the tendering documents, and considers the documents as a security against reimbursements to itself. Just as Lord Sumner said in *Equitable Trust Co of New York v. Dawson Partners Ltd.*: “[i]t is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity [from the buyer] if the conditions on which it is authorised to accept are in the matter of the accompanying documents strictly observed....If it [bank] does as it is told, it is safe; if it departs from the conditions laid down, it acts at its own risk.”⁷²

Aside from the perspective of banks, insistence on the strict compliance rule is also consistent with some countries’ domestic laws. For instance, in the United Kingdom, Article 15 A of Sale of Goods Act states: “...the breach is so slight that it would be unreasonable for him to reject them, then, if the buyer does not deal as a consumer, the breach is not to be treated as a condition but may be treated as a breach of warranty”⁷³ This provision seems seriously in conflict with the strict compliance rule, since if there was a slight discrepancy shown on the bill of lading, it could not be considered as a reason for buyers to reject goods, while under letter of credit, the slight discrepancy might cause a rejection of the bill of lading. However, actually it is not inconsistent. The proof can be found in *Hansa Nord*, where Lord Roskill stated that

⁷² Op.cit.n.44.

⁷³ *Sale of Goods Act*, (1994).

[a] bill of lading clausued as to the apparent good order and condition of the foods shipped would be a bad tender and could at once be rejected by or on behalf of the buyer, yet if Mr Lloyd be right, the defects in the condition of the goods which led to that clausuing of the bill of lading would not automatically justify the rejection of the goods. At first sight this seems inconsistent, but Mr Lloyd ultimately persuaded me that the seller's obligation regarding documentation had long been made sacrosanct by the highest authority and that the express or implied provisions on a CIF contract in those respects were of the class ..., any breach of which justified rejection.⁷⁴

Although the above case regards a CIF contract, the same spirit is also applicable to letter of credit since, for a bank, it is harder to control the discrepancy than a buyer in the CIF, in which case, certainty is more important. So under letter of credit, sellers have a sacrosanct responsibility of the documents, namely that any discrepancy may justify the rejection. Furthermore, the role of a bank is equal to a guarantor of a sale contract, who protects payments by his credit, so, actually, the rejection of documents with a slight discrepancy according to the strict compliance rule perfectly matches the provision that a slight discrepancy may be treated as a breach of warranty, since the utilization of letter of credit as a whole can be regarded as a warranty.

⁷⁴ *Hansa Nord*, [1975] 2 Lloyd's Rep. 455. p457.

So in a word, for protecting the purpose and effectiveness of letter of credit, the strict compliance rule is firmly entrenched, and highlights in four aspects: “First, all stipulated documents need to be tendered. Second, each document has to be valid, effective and regular, which means that it must be a document against which no plausible objections can be raised. Third, all documents need to be consistent with each other. Finally, the invoice must give an accurate description of the goods; the other documents may describe them in general terms.”⁷⁵

⁷⁵ Op.cit.n.1, p260.

Chapter Two—A Review of the Fraud Exception Rule

The intrinsic motivation of letters of credit lies in not only the stability of payment but also the fairness between parties; therefore, the independence principle and the strict compliance rule should be set aside when they threaten a normal commercial order or damage parties' interests. So an exception to these principles, namely the fraud exception rule, is needed and necessary when fraud happens and causes this kind of threat and damage. The fraud exception rule allows banks to be exempted from the obligation of payment or honour in the case of fraud or forgery.

I Law governing the Fraud Exception Rule

The fraud exception rule can be found in several countries' precedents, especially in the Anglo-American case law. Whereas, with regards to statutes, UCC is the only statute that officially confirms the fraud exception rule.⁷⁶ The UCP 600 and eUCP is silent on this issue; however, it does not mean the ICC denies the fraud exception rule. Actually, its confirmation of the fraud exception can be found in the documents 470/371 and 470/373 that published by ICC conference held on December 9th 1980.

1. Anglo-American Case Law

⁷⁶ Op.cit.n.12, p351.

The first leading case of the fraud exception rule is an American case - *Sztejn v. J. Henry Schroder Banking Corp* - in which the documents tendered by the beneficiary described the goods as bristles; whereas, the crates shipped in reality contained rubbish. Judge Shientag believed that “[w]here 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”. Consequently, the decision of the case is that “[a] court can enjoin an issuing bank from honoring a draft if the bank learns that its customer will suffer irreparable harm as a result of fraud”⁷⁷

Comparing with the American precedent, English courts narrowed the applicable scope of the fraud exception rule to frauds in material representations. In the case *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, Lord Diplock ruled that

“[T]o this general statement of principle as to the contractual obligation of the confirming bank to the seller, there is one established exception: that is where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue...”⁷⁸

⁷⁷ *Sztejn v. J. Henry Schroder Banking Corp*, [1941] 31 N.Y.S.2d 631, Supreme Court, Special Term, New York County.

⁷⁸ *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, [1982] 2 W.L.R. 1039, p 627-629.

Whereas, “under the English view, fraud perpetrated by a third party does not constitute fraud in the transaction so as to permit the confirming bank to deny payment.”⁷⁹ The seller’s awareness of the fraud is required.

2. The UCC

The UCC - the only domestic statute which regulates the fraud exception rule of credits - stipulates the fraud exception rule in a separate provision, that is § 5-109. In Para. (a), it confirms the fraud exception by negatively regulating certain situations that enjoin the fraud exception rule from applying. Additionally, in Para. (b), it states clearly that the implementation form of the fraud exception rule is a relief granted by a court.

The statement of this provision is

“(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant: (1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and (2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the

⁷⁹ Ibid, p 627-629.

issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that: (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer; (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted; (3) all of the conditions to entitle a person to the relief under the law of this State have been met; and (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).”⁸⁰

3. UCP 600

The UCP 600 is silent on the issue of the fraud exception. There is no disclaimer based on fraud in neither Article 7-Issuing Bank Undertaking nor Article 8-Confirming Bank Undertaking; and no exceptions are regulated in the articles regarding documentary examination, namely Article 14-Standard for Examination of Documents, Article 15-Complying Presentation, and Article 16- Discrepant Documents, Waiver and Notice. On the contrary, Article 34-Disclaimer on Effectiveness of Documents clearly states that

“A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document ...nor does it assume any liability or responsibility for ... the good faith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person.”⁸¹

⁸⁰ Op.cit.n.7.

⁸¹ Op.cit.n.2.

Even though, it does not mean that the ICC denies the fraud exception rule. Its standpoint on this issue embodied in the ICC Documents 470/371 and 470/373 that published by the conference held on December 9th 1980. When a Bangladesh bank asked questions about issuing banks' obligation of reimbursement to negotiating banks based in a false bill of lading, the ICC replied that

“The Commission expressed its opinion that the negotiating bank passing forward what proved to be a forged bill of lading was protected by Article 9 unless it was itself a party to the fraud, or it had knowledge of the fraud prior to presentation of the document, or unless it had failed to exercised reasonable care, e.g. if the forgery were apparent ‘on the face’ of the document. The Commission noted that this was in line with various court rulings.”⁸²

II Legal Philosophy of the application of Fraud Exception Rule

When fraud happens, a bank can reject the payment based on certain reasons; or when the bank was reluctant or failed to do so, based on an applicant' request, a court could enjoin the bank from its obligation of payment. The legal philosophy of the application of this rule is mainly

⁸² The review of the ICC conference hold on Dec.9th 1980, ICC Documents 470/371, 470/373.

reflected in three theories.

1. Good-Faith Theory in Civil Law

The meaning of good faith is “an act carried out honestly”. In addition, pursuant to Black’s Law Dictionary, “Good faith means a state consisting in (1) honesty in belief or purpose, (2) faithfulness to one’s duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.”⁸³ The good-faith theory⁸⁴ is considered as the “principle of emperor” which originated in German Civil Code Article 242. It has been broadly recognised in civil law theory and implemented in legal practice. The main function of the good faith principle is to balance the parties’ interests and benefits and to be used as the supreme rule to regulate people’s behaviours especially when legislations are incomplete. The German scholar Stammer believed that law should be the highest ideal of mankind, and good faith is the reflection of the highest ideal⁸⁵. Therefore, any actions in violation of the good-faith theory should be banned.

With regard to fraud in letters of credit, since the presentation of fraudulent or forged documents is against the principle of good faith, it should be curbed and the fraud exception rule needs to be applied. Otherwise,

⁸³ Osborn’s Concise Law Dictionary, 10th ed., s.v. “good faith”. See BONA FIDE: In good faith, honestly, without fraud, conclusion or participation in wrongdoing.

Black’s Law Dictionary, 7th ed., s.v. “good faith”.

⁸⁴ Op.cit.n.12, p351.

⁸⁵ Lin Gang & Feng Yuefang, “The Principle of Good Faith” (2000) 4 Morden Law Science 62.

if banks were still requested to pay the unscrupulous beneficiaries according to the independence principle, such rigorous insistence would doubtless encourage fraud and consequently frustrate trade.

First, the rigorous insistence upon the independence principle is quite unfair to an innocent buyer, and consequently undermines the main function of good-faith theory that is to balance parties' interests. Whereas "being the core of justice, and the sole of law, fairness is extremely important."⁸⁶ So the fraud exception rule is necessary. If no exception was applied, a buyer could claim against the fraudulent seller only based on their underlying sales contract. Nevertheless, "the buyer's alleged ability to proceed against the dishonest seller under the contract of sale is a poor consolation where the seller absconds or where he resides in a country in which litigation is hazardous. Furthermore, even if the buyer is able to obtain judgement against the seller it may be difficult to actually recover the debt."⁸⁷

Second, the unfairness will cause unequal power and inequality of status for the involved parties, and will consequently lead to a vicious circle, i.e. the fraudulent party will be more likely to cheat and will be much easier to succeed. That is because in every trade mechanism, as long as one party is in a more advantageous position without effective constraints and supervisions, fraud would inevitably happen.

⁸⁶ Lv Shiwen & Wen Zhengbang, eds. *Philosophy of Law*, (Beijing: Chinese People's University Press, 1999), p494.

⁸⁷ Op.cit.n.1, p267.

Third, fraud in letters of credit will doubtless impede international business, which violates the fundamental purpose of letter of credit to reduce parties' risk and facilitates transactions. In trade practice, interests and benefits are the main motivations of trading, so the loss of a balance of interests will make buyers reluctant or afraid to deal business. Moreover, just as Scrutton LJ said: "to understand business one must realize that it proceeds on the basis of confidence, not of fraud."⁸⁸

2. The Theory of Fraud in Common Law

*Fraus omnia corrumpit*⁸⁹ means fraud makes all invalid. It originated in an ancient maxim of Roman law and has been broadly recognised all over the world, especially in the common law system. It is one of the most basic legal principles; fraud in letters of credit is no exception. Countries have agreed that based on social justice and business ethics, an exception to the independence principle is required when fraud happens. "The British classic statement of people with bad motive have no right to prosecute is just a good reflection of the fraud omnia corrumpit theory and a strong support of the fraud exception rule."⁹⁰ Moreover, the famous British Mareva Injunction⁹¹ was also

⁸⁸ *South African Reverse Bank v. Samuel & Co*, [1931] 40 Ll L Rep 291 at 292, CA.

⁸⁹ Op.cit.n.85.

⁹⁰ Op.cit.n.12, p358.

⁹¹ The Mareva injunction (variously known also as a freezing order, Mareva order or Mareva regime), in Commonwealth jurisdictions, is a court order which freezes assets so that a defendant to an action cannot dissipate their assets from beyond the jurisdiction of a court so as to frustrate a judgment. It is named for *Mareva Compania Naviera SA v International Bulkcarriers SA* [1975] 2 Lloyd's Rep 509, decided in 1975, although the first recorded instance of such an order in English jurisprudence was *Nippon Yusen Kaisha v Karageorgis* in 1975, decided very shortly before the Mareva decision; however, in the UK the Civil Procedure Rules 1998 now define a Mareva order as a "freezing" order. It is widely recognised in other common law jurisdictions and such orders can be made to have

based on the theory of fraud omnia corrumpit. In addition, the same rationale can be found also in other governments. For instance, the American Law Institute Study of Article 5 clarified that the definition of fraud will support an injunction forbidding the issuer from honoring the credit. And the UCC commentary explained “where the beneficiary’s conduct has ‘so vitiated the entire transaction that the legitimate purpose of the independence of the issuer’s obligation would no longer be served.’”⁹²

However, from the bank’s point of view, a concern about banks’ reputation might be raised. Banks might be worried that the rejection of payment based on the fraud exception rule may undermine their business reputation. This thesis asserts that it is not the case.

First, a beneficiary who indeed has committed fraud is unlikely to sue the bank that refused its payment, since he would be afraid of being punished because of fraud pursuant to relevant civil law and even criminal law.

Second, the fraud exception rule is welcomed by honest business parties. In their eyes, the bank’s refusals of payment is both legitimate and necessary. If the honest parties were in the same situation, they would expect banks to do the same thing. So the fraud exception rule not only punishes fraudulent persons, but also protects honest parties and their expectant interests.

world-wide effect. It is variously construed as part of a court’s inherent jurisdiction to restrain breaches of its process.

⁹² Stephan, Paul B, JR Don Wallace & Julie Roin. A. *International Business and Economics: Law and Policy*, 2nd ed. (New York: Contemporary Legal Education Series, 1996) p437.

Third, banks' reputation would not be jeopardized by a legal obligation. When an injunction is issued by a court, the bank's refusal of payment is just its legal obligation that beyond its control. Moreover, according to UCP 600 Article 36 Force Majeure, "A bank assumes no liability or responsibility for the consequences arising out of the interruption of its business by ... or any other causes beyond its control."⁹³ Therefore, no reputation would be undermined.

Forth, contrarily, the fraud exception rule could protect banks' own benefits. On the one hand, when sellers and buyers conspire to cheat, banks themselves become the victim of fraud in letters of credit. In this case, the fraud exception rule actually protects the banks own benefits. On the other hand, banks could also win their markets, since applicants are likely to choose a bank that would concern and protect their interests.

3. The Theory of Public-Order Reservation in Conflict Law.

The theory of public-order reservation is a general provision of conflict law which is regulated almost in every domestic law. It means a domestic law can exclude the implementation of other foreign laws or international practice if these rules violate the country's social interests, public order, basic legal principles or good customs. Meanwhile, almost every country adopts the basic legal principle of good faith or fraud omnia corrumpit

⁹³ *Uniform Customs and Practice for Documentary Credits*, 2007, [UCP 600].

which denies fraud and requests honest and trustworthy. Consequently, when fraud happens, it will be unreasonable for countries to keep applying UCP 600 which does not regulate the fraud exception rule. Under this circumstance, domestic laws can exclude the application of UCP 600 and apply the principle of good faith, fraud omnia corrumpit, or other domestic rules.

In China, there are two opposite views of whether the application of the UCP could be excluded according to the public-order reservation. Opponents argue that since the UCP has already been recognized broadly, its application should not be excluded by public order. The exclusion is bound to affect Chinese banks' reputation, and consequently affect China's international economic and trade relationship. On the contrary, approvers believe that the application of UCP should be excluded according to Article 150 of *General Principle of the Civil Law of the People's Republic of China* (hereinafter called *General Principle of the Civil Law*), which stipulates "the application of foreign laws or international practice in accordance with the provisions of this chapter shall not violate the public interest of the People's Republic of China."⁹⁴ And then invoke the civil law principle of good faith to enjoin banks from paying.

This thesis supports the approvers' opinion with the following reasons: First, the opponents' concern of banks' reputation is not necessary, since as discussed above banks' reputation would not be affected. Second, being an

⁹⁴ *General Principle of the Civil Law of the People's Republic of China* (Adopted at the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 37 of the President of the People's Republic of China on April 12, 1986, and effective as of January 1, 1987).

international practice, UCP does not have direct legal effect although it is applied broadly in the world. Its effectiveness depends on the recognition of domestic laws. It means only when it is expressly or impliedly recognized by domestic laws and is consistent with the domestic laws and public orders, the international practice can have the legal effect. That because on the one hand, the ICC, the institute which draws up the UCP, is a non-governmental organization, whose legislation is not authorized by or discussed with countries' legislative bodies. So the ICC does not have the power to force countries implement the UCP, and there is no agreement among countries to automatically implement the UCP. Furthermore, the application of the UCP in a specific case is only considered as the respect of parties' free will, but does not constitute a country's official recognition. On the other hand, even the UCP itself approves the exclusion of its application. Article 1 states

“The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit.”

Therefore, the UCP is only an international practice that does not have the force of law, and consequently can be excluded by domestic laws based on

countries' public orders.

III Application of the Criteria of the Fraud Exception Rule

The application of the fraud exception rule should be neither too strict to release real fraud nor too loose to challenge the independence principle and consequently destroy the whole credit system. Therefore, in order to achieve a balance between punishing fraudulent persons and protecting the efficiency and credit interests of letter of credit, certain standards need to be satisfied when applying the fraud exception rule.

1. Determination of the Existence of Fraud

In order to judge the existence of fraud, the word fraud should be defined clearly first. This is quite important for a reasonable and fair application of the fraud exception rule. "Fraud" evolved from the Latin word "fraus", refers to all the deception, false or wrongful acts which deceives people. Pursuant to Black's Law Dictionary, "Fraud is a knowing misrepresentation of the truth or concealment of a material fact to induce another to act his or her detriment."⁹⁵ With regard to the concept of fraud in letter of credit, the ICC has no opinion or interpretation about it; and no definition or relative regulation can be found in the UCP. And even the UCC

⁹⁵ Op.cit.n.83, s.v. "fraud".

does not have a particular stipulation of the definition of fraud, although it is the only domestic code which specifically regulates letter of credit. It only regulates in § 5-109 that: “(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons”⁹⁶. The definitions of fraud in letters of credit are mainly established by cases. In the United Kingdom, a classic definition of fraud was stated in case *Royal Bank of Canada v. United City Merchants* as “documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue”.⁹⁷ Although the examination of fraud varies in specific cases, it is not hard to conclude that fraud required in the fraud exception rule contains the following meanings.

First, fraud in letter of credit is not only limited to fraud in documents, but also extends to fraud committed in sales contracts. With regard to this issue, there are two views. A narrow point of view, hold by the first British case on the fraud exception– the *UCM* case, believes that fraud should be only limited to documentary fraud. Because fraud exception is an exception to the independence principle and the strict compliance rule which are based on the transaction of the letter of credit; therefore, the fraud exception rule should

⁹⁶ Op.cit.n.7.

⁹⁷ Op.cit.n.78.

also be limited to the transaction under the letter of credit, but not be extended to sales contracts. On the contrary, a broad point of view, held by the first American case of fraud exception – *Sztejn v. J. Henry Schroder Banking Corp*, argues that fraud should also involve fraud in sales contract.

The Author of this thesis supports the broad view. Because on the one hand, in order to examine whether fraud actually exists, one needs to rely on the examination of the underlying sales contract. For instance, when determining whether the degree of fraud is serious enough to constitute an exception, a complete violation of the sales contract is an important criterion. On the other hand, in legal practice the broad view is supported by both precedents, such as *Sztejn v. J. Henry Schroder Banking Corp*, and UCC § 5-109 Fraud and Forgery, which holds that fraud involves the situation that “(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant.”⁹⁸ This provision leaves room for fraud in sales contracts, since it extends fraud to a material fraud committed by the beneficiary on the issuer or applicant which might be fraud in sales contracts.

Second, fraud has to have actually happened. It means fraud required by the exception rule must be an existing one but not only an inferred fraud. It

⁹⁸ Op.cit.n.7.

is not a fact that may occur, but the fact has already occurred. Therefore, a fraudulent action under a letter of credit must be established, which is normally embodied in three forms: the documents presented by a beneficiary are fraudulent or forged; fraud is committed in the sales contracts; and applicants and beneficiaries conspire with each other to deceive banks. Accordingly, plaintiffs are required to prove the existence of fraudulent action and submit convincing, sufficient evidence, such as transport orders, certificates of insurance, packing lists, and certificates of origin.

Third, a fraudulent person must intentionally commit fraud or at least is in knowledge of the existence of fraud. This is the main difference between fraud in letters of credit and normal breach of contract. In breach of contract, the defendant might not intentionally take advantage of the credits to induce others to act his or her detriment. Nevertheless, in a fraud case, the defendant intentionally deceives others through misrepresentation of the truth or concealment of a material fact, and then cheats money without paying consideration.

Evidence of the fraudulent-intention requirement can be found in a number of precedents. As early as the case of *Sztejn v. J. Henry Schroder Banking Corp*, it stated that “it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer.” Moreover, the idea of intentional fraud was articulated in case *NMC Enterprises v. Columbia Broadcasting System, Inc*. One critical element in this case was

an allegation that the seller had already known the non-conformity of goods prior to the execution of the contract, made by one of the beneficiary's officers. In reply, the New York Supreme Court, although it acknowledged questions as to quality or condition of the goods could not be a reason for an injunction, granted the requested injunction and stated: "Where no innocent third parties are involved and where the documents or the underlying transaction are tainted with intentional fraud, the draft need not be honored by the bank, even though the documents conform on their face and the court may grant injunctive relief restraining such honor."⁹⁹

"It seems that the standard of intentional fraud requires a misrepresentation made knowingly or recklessly with the intention of inducing another to rely thereon. It is thus similar to common law fraud, requiring: (1) a false representation of the fact; (2) knowledge or belief on the part of the defrauder; and (3) an intention to induce the other party to act or to refrain from action in reliance upon the misrepresentation, (4) If cases of common law fraud are treated as equivalent to cases of intentional fraud, the number of cases supporting the standard of intentional fraud is significant."¹⁰⁰

⁹⁹ *NMC Enterprises v. Columbia Broadcasting System, Inc.* [1974] 14 U.C.C. REP. SERV. 1427 N.Y. Sup. Ct.

¹⁰⁰ Gao Xiang & Buckley Rose P., "A comparative Analysis of the Standard of Fraud Required under the Fraud Rule in Letter of Credit Law" (2003) *Duke Journal of Comparative & International Law* 302.

Fn 41: It has been said that "[i]ntentional fraud could be shown by establishing the common law elements of fraud." *Aetna Life & Casualty Co. v. Huntington Nat'l Bank*, 934 F.2d 695, 698 (6th Cir. 1991). On June 4, 2002, the day when the search for "egregious fraud" was done, this author also did

Given that the purpose of the fraud exception rule is to stop dishonest beneficiaries from abusing the credit system, the standard of intentional fraud seems quite appropriate and necessary. Although to prove the fraudulent person's intention and mind is notoriously difficult, it cannot exclude the application of fraudulent-intention requirement; whereas, the standard of intentional fraud does not need to be as high as the one of egregious fraud.¹⁰¹

Forth, fraud must be substantial and material. Not all fraud which satisfies the above three standards could constitute an exception and lead a court to enjoin banks from payment. In order to preclude the fraud exception rule from being abused and to guarantee the efficiency and independence of credits, the severity of fraud has to be defined. The word material fraud came from UCC. In § 5-109, it states that: “(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons”¹⁰².

searches in the same library for the other standards of fraud discussed here using the following phrases: "letter of credit and intentional fraud," "letter of credit and common law fraud," "letter of credit and letter of credit fraud," "letter of credit and flexible fraud," and "letter of credit and constructive fraud," and found 61, 284, 42, 8, and 93 items, respectively. Although these figures could not necessarily reflect what standards of fraud courts actually had applied in the cases and might reflect only the frequency courts had used the terms in their discussions, they could serve as an indication showing what kind of terms and standards courts are more likely to use in the United States.

¹⁰¹ Ibid.

¹⁰² Op.cit.n.7.

Nevertheless, to what extent fraud can be considered as material fraud is a difficult question with various answers. Before the revision of UCC Article 5 was commenced, the severity of fraud was defined as “active fraud” or “egregious fraud”. Afterwards, the revised U.C.C. Article 5 adopted “material fraud” as the standard, whereas the article itself does not define “material fraud”.¹⁰³ The Official Comment on Section 109 has made an effort to interpret material fraud, and it is regarded as a classic statement of the severity of fraud. For commercial letter of credit, it indicates that material fraud “requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction.”¹⁰⁴ While for standby letter of credit, the Official Comment states that “[m]aterial fraud by the beneficiary occurs only when the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor.”¹⁰⁵

However, really getting to grips with material fraud is still far away, although some regulations of the severity of fraud exist. Since comparing with the changing life, legislation is always fall behind, even UCC and its official comment cannot perfectly define the scope and severity of fraud. Therefore, the judgement of fraud more depends on judges’ discretion.

¹⁰³ Turner Patti S., “Revised UCC Article 5: The New U.S. Uniform Law on Letter of credit” (1996) 11 Banking & Fin. L. Rev. 205, 225.

¹⁰⁴ Official Comment to Article 5 of the Uniform Commercial Code, para. 2.

¹⁰⁵ Ibid para. 3.

2. Exceptions to the Fraud Exception Rule

(1) Exceptions to the Fraud Exception Rule

The fraud exception rule can be only raised against fraudulent persons who intentionally commit or realize fraud, but cannot apply to honest sellers or good-faith third parties. “Fraud rule is inapplicable where a sharp practice is committed without the seller’s knowledge by a sub-contractor, by a shipping agent or by a transferee of the credit.”¹⁰⁶ This spirit can be found in case *United City Merchants (Investments) Ltd. v. Royal Bank of Canada* which described that “the instant case, however, does not fall within the fraud exception. [The trial judge] found the sellers to have been unaware of the inaccuracy of Mr. Baker’s notation of the date at which the goods were actually on board *American Accord*. They believed that it was true”¹⁰⁷.

So when a beneficiary is unaware of fraud or a holder of a draft is in good faith, the bank’s obligation of payment becomes absolute and cannot be denied by referring to the fraud exception rule. Especially, when the good-faith holder is a foreign negotiating bank that has already honored the letter of credit, domestic issuing banks have to reimburse the negotiating bank. Otherwise, they might face the risk of being sued and facing litigation in a foreign country, and their reputations in international trade will be undermined even though the loss of state-owned property can be prevented. Additionally,

¹⁰⁶ Op.cit.n.1, p265.

¹⁰⁷ Op.cit.n.78.

if the issuing bank becomes the holder of a letter of credit, even though the tendered documents are actually forged or fraudulent, as long as the bank exercised reasonable diligence but did not find out the fraudulent fact, and it has already paid the draft before receiving the notice of fraud, the bank should be reimbursed, according to the independence principle.

(2) Rules governing the Exceptions to the Fraud Exception Rule

The exceptions to the fraud exception rule are broadly recognized in both domestic laws and international practice. For instance, UCC § 5-109

(a) believes that

“(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person;”¹⁰⁸

Moreover, in UCP 600, the same spirit is articulated in Article 7-Issuing Bank Undertaking Para c that “An issuing bank undertakes to reimburse a nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the issuing bank.” As well as in Article 8 Confirming Bank Undertaking Para ii. c that “A confirming bank undertakes to reimburse another nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the confirming

¹⁰⁸ Op.cit.n.7.

bank.”¹⁰⁹

(3) Reason of the Exceptions to Fraud Exception Rule

The reason or necessity of the exceptions to the fraud exception rule is mainly embodied in two aspects:

First: to effectively protect good-faith holders of credits, namely the dealers who paid equal consideration. Under a letter of credit, the reason why negotiating banks are willing to take the payment obligations and good-faith holders are willing to accept the transference of letter of credit is not because they trust the sellers, but because they rely on their trust to issuing banks' credit and guarantee of the payment. As a result, a good-faith third party has no responsibility to investigate the qualifications of drawers or the authenticity of letter of credit, and it is even impossible to do so because of the independence principle. So sellers' or drawers' fraud should not affect the third parties' rights of achieving payment under letter of credit. The exceptions to the fraud exception rule encourage parties to adopt letter-of-credit transactions, and consequently guarantee the main function of letter of credit as the life blood of international commerce.

Second: to effectively promote the flow of credit. “Trying to make the liquidity of a letter of credit as good as drafts and bills of lading, it is the banking sector's and business communities' goal for the recent two hundred

¹⁰⁹ Op.cit.n.2.

years.”¹¹⁰ If negotiating banks or good-faith holders were required to be responsible for the authenticity of letter of credit, they would be reluctant to do so or would not dare to do business using letter of credit, which would consequently raise the transaction costs under credits, as well as affect the expansion of credit transactions and the flow of letter of credit. Thus the exception to fraud exception rule is quite necessary.

IV Judicial Remedies of the Fraud Exception Rule

When fraud happens, the judicial remedies of the fraud exception rule are normally implemented by the banks’ rejection of payments, which are mainly requested by court injunctions.

1. Banks’ Rejection to Honor or Pay

Whether banks’ rejection is only a right or is also an obligation is a question that has not yet achieved a consistent answer in different countries. It means that if an applicant of credits informs its bank about the existence of fraud and asks the bank to reject payment, in this case is the bank under an obligation to obey the applicant’ order, and will the bank assume any responsibilities for its ignorance of the applicant’s order? The answer in this thesis is no, since the banks’ rejection of payment is only a right, rather than

¹¹⁰ Op.cit.n.12, p351.

an legal obligation, unless the courts issue injunctions.

**(1) Banks' rejection of payment is a right against fraud in letters
of credit**

“To say that X has a legal claim-right means that he is legally protected from interference by Y or against Y's withholding of assistance with respect to X's project Z.”¹¹¹ People are able to have complete control over their rights, which means they are free to excise or even abandon their rights. So independence is the core and essence of right. The protection of a right in fact is the guarantee of people's independence and the respect of their freedom. Based on the analysis of UCP 600's legislative basis, specific provisions and practice effects, a bank has the right to reject payment under letter of credit.

First, from the perspective of the legislative basis of UCP 600, a bank has the right to refuse payment. Being a legal practice, UCP 600 originated in international commercial practice. Its main function is to protect the convenience and efficiency of international trade depending on its independence principle and the strict compliance rule. However, it does not mean the requirement of convenience and efficiency can override trade security and good faith. In fact, no commercial practice can ignore trade security; and the principle of good-faith is the cornerstone of every commercial practice. So when fraud happens, a bank has the right to refuse

¹¹¹ W.N. Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning*, (Aldershot: Ashgate, 2001).

payments in order to protect trade security and good faith.

Second, in the perspective of the specific provision of UCP 600, a bank has the right to refuse payments. Although there is no specific provision that regulates the fraud exception rule in UCP 600, this legislative blank does not mean UCP 600 denies the fraud exception and ignores good faith, but it only shows that the UCP 600 does not regulate the relative responsibilities regarding fraud in letter of credit. The legislative blank actually leaves room for the banks' discretion to decide whether they refuse payments based on fraud or not. Being the most important international practice with regards to letter of credit, the UCP 600 will not violate good faith and ignore the trade security to encourage or require banks to pay when fraud happens.

Third, from the perspective of the practice under UCP 600, a bank has the right to refuse payments. The fraud exception rule has been recognised and implemented by both case law, such as *Sztejn v. J. Henry Schroder Banking Corp*, and national statutes, such as UCC §5-109. The practical effects of UCP are identical and consistent with the effects of the fraud exception rule, i.e. the banks' rejections of payments will barely cause banks' obligations under credits, mainly because the fraudulent persons who violate the law themselves seldom dare to ask for remedies for the banks' rejection. So as long as the fraud indeed exists and a bank exercises its reasonable diligence in the documentary examination, the rejection of payment will not cause any legal obligations to the bank.

From the above analysis, in legal practice, banks indeed have the right to refuse payment and seldom bear obligations due to this right. The rejection of payment is not a violation of the UCP's mandatory requirements; on the contrary, it complies with the potential principle of good faith in commercial practice. So the denial of the right of rejection is inappropriate in both legal theory and legal practice.

However, due to the independence principle, banks should be careful when exercising the right of rejection. When the existence of fraud is unable to be proven or an injunction against payment is not issued by a court, the bank's rejection of payment might give rise to their legal obligations and undermine their reputations. So the right of rejection is limited and still based on the independence principle and the strict compliance rule. Furthermore, unlike courts, banks cannot overthrow their own commitment of payment refer to the preservation of public order. Just as Bernard S. Wheble who was the president of ICC Banking Commission said "letter of credit only executes payment for commercial transactions, but can not act as a police to control the occurrence of fraud."¹¹²

(2) Bank's rejection is not a legal obligation under letter of credit

Bank's rejection of payment is only a right rather than an obligation, unless there is an injunction issued by a court.

¹¹² Qiang Li, "UCP 500 and the Prevention of the Risk of Letter of Credit" (2000) Chinese Lawyer 2.

In contrast with the legal claim-right, duty or obligation, requires people to abstain from interference, or provide assistance in connection with X's project Z.¹¹³ It forces people to execute certain acts according to the law no matter whether they like or not, otherwise punishment will be afforded. In the legal pattern of obligation, people's independence and freedom are excluded and guaranteed by force of law. Different from right, obligation must be regulated and listed clearly by law or other governments, including the content of obligation, ways to fulfill obligation, and penalties based on the breach of obligation. However, since no provision clearly stipulates bank's rejection of payments as an obligation, it cannot constitute a legal obligation, and no penalty can be imposed if banks do not refuse the payments. The legislative blanks in the UCP and domestic legislation should be considered as a refusal of banks' rejection obligation.

The applicant reporting the existence of fraud does not absolutely lead to banks' responsibility of rejection of payment. Without the courts' preliminary review and judicial intervention, the applicants' unilateral claims, in principle, are not sufficient enough to prove the existence of fraud, which, in contrast, might just be the applicants' trick to delay banks' payments. In this case, banks are likely to bear legal obligations due to wrongful rejections of payments. Pursuant to UCC § 5-111. Remedies,

“(a) If an issuer wrongfully dishonors or repudiates its obligation to pay money under a letter of credit before presentation, the beneficiary, successor, or nominated person presenting on its own behalf may

¹¹³ Op.cit.n.111.

recover from the issuer the amount that is the subject of the dishonor or repudiation. If the issuer's obligation under the letter of credit is not for the payment of money, the claimant may obtain specific performance or, at the claimant's election, recover an amount equal to the value of performance from the issuer. In either case, the claimant may also recover incidental but not consequential damages.”¹¹⁴

One thing that needs to be recalled is that banks do not have the right to investigate fraud themselves because of the independence principle, although they have the right to refuse payment. This means that their right to refuse is only feasible based on a court’s judicial intervention. So only when courts conduct judicial interventions, mainly in issuing an injunction, does a bank’s refusal of payment become a legal obligation. In addition, efficiency is a key advantage of letters of credit as a payment instrument, so banks should not be involved in parties’ disputes in order to make the payment efficient and effective. Furthermore, based on the independence principle which is mainly used to protect the efficiency of credits, banks should not assume any responsibility of fraud when presented documents are compliant with certain terms.

All in all, with regards to fraud in letter of credit, the bank’s rejection of payments is only a right, rather than a legal obligation or a combination of right and obligation. So for banks, on the one hand, they have the right to refuse the payments under credits when documents are inconsistent; on the other hand, their rejection is regarded as a legal obligation only when fraud is proved or courts issue injunctions. While in the absence of injunctions, only

¹¹⁴ Op.cit.n.7.

based on applicants' claims or their unconvinced evidence of fraud, banks are still free to honor or pay the credits without any responsibilities.

(3) Restrictions of banks' rejection of payments

Banks have the right to refuse payments. However, in order to achieve a balance between security and efficiency under letter of credit, this right can be executed only under certain circumstance. The restrictions of the rejection of payments are embodied in four aspects:

First, the bank's rejection requires a specific object. It means a rejection of payment can only be raised against fraudulent persons, but not against good-faith third parties such as negotiating banks and draft holders.

Second, the execution of the rejection must be based on sufficient evidence and reasons. It means there must be enough evidence to prove or sufficient reasons to believe that the sellers commit fraudulent actions. For instance, sellers having intentionally not shipped, or not completely shipped goods; or the goods not satisfying the quality requirements, or the sellers forging bills of lading.

Third, the rejection must be executed after the presentation of documents and must be within a statutory time limitation, since efficiency is the key characteristic of letter of credit. For the decision period, this thesis asserts it should be 5 working days, the same period as the time of documentary examination according to UCP 600 Article 14, which regulates

the Standard for Examination of Documents and believes that “b. A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation.”¹¹⁵

Fourth, the exercise of rejection must comply with statutory procedures. It means based only on applicants’ requests or banks’ own decisions, it is not sufficient enough to reject the payment directly. A bank should wait for a court injunction to exercise the rejection. Although it may take a little time, it greatly reduces the randomness of the rejection and banks’ discretion, and consequently reduces banks’ risk of being embroiled in disputes between the parties of sales contract. “In this way, banks are protected against litigation and against any possible damage that may be done to their reputation by non-payment.”¹¹⁶

2. Injunction System in Anglo-American Law

In order to implement the fraud exception rule, Anglo-American law has established a set of corresponding remedies to protect victims’ interests. The victims may apply for various injunctions to against fraudulent persons.

¹¹⁵ Op.cit.n.2.

¹¹⁶ Op.cit.n.1, p266.

(1) The Injunction in British law

In British law, the typical injunction against a beneficiary is the interlocutory injunction which is against the bank with a payment obligation. It is a product of equity law whose object is people's behavior rather than property. It is a temporary injunction - from the beginning of litigation to the start of trial - issued by courts according to parties' claims. Even when the application of the interlocutory injunction was refused, during the period of appeal, the applicant could still be authorized for the interlocutory injunction of the same content within a limited scope.

To apply for an interlocutory injunction, the only thing an applicant needs to do is to claim, but does not need to prove, that his right has been infringed by the potential defendant, which means the injunction can be applied based on a controversial issue. Actually, the purpose of the interlocutory injunction is to restrain the applicant from doing irreparable damage. It is a remedy used to reduce the risk of the infringement of applicant's right before damage has been proved. "Interlocutory injunction not aims to protect identified rights, but way to maintain the status quo after right has been identified in the most convenient. Its intention is to guarantee that parties' right will not be lost due to the delay legal remedies."¹¹⁷

However, according to precedent and legal scholars' opinion, the British courts usually consider the following elements when issuing an

¹¹⁷ Wentao Huang, "A Study of Fraud in Letter of Credit in British Law", Shen Sibao, eds. *International Commercial Law*, (Beijing: Legal Press, 1999), p349.

interlocutory injunction: First, whether the defendant's action alleged by the applicant falls into the scope of the fraud exception rule. It means fraud must be committed intentionally by or at least be aware of by fraudulent persons, must be material fraud and acknowledged by banks¹¹⁸. Second, applicants' certifications of the fact of fraud must satisfy the requirement of his burden of proof. "In the case of *Edward Owen Engineering Ltd v. Barclays Bank Int Ltd*¹¹⁹, the requirement was demonstrated as fraud must be clearly established. While the case of *Bolivinter Oil SA v Chase Manhattan Bank NA*¹²⁰, said that the proof of fraud and banks' acknowledgement of fraud must be clear, and cannot only rely on an applicant's uncorroborated statement."¹²¹ Third, applicants must provide legal causes of his application. Fourth, the result of the test of balance of convenience must be benefit to applicants. And fifth, a court has jurisdiction over the application of the interlocutory injunction. When the bank is about to pay to an overseas bank that is beyond the United Kingdom's jurisdiction, an applicant has to prove the British court's jurisdiction over the injunction pursuant to *The Super Court Rules*¹²². For instance, to prove the loss or damages caused by the bank's payment will happen in the United Kingdom.¹²³

¹¹⁸ Schmitthoff Clive M., *Schmitthoff's Export Trade: the Law and Practice of International Trade* (London: Stevens & Sons, 1990), p375.

¹¹⁹ *Edward Owen Engineering Ltd v. Barclays Bank Int Ltd*, [1979] 100 D.L.R. (3rd) 546, 549.

¹²⁰ *Bolivinter Oil SA v. Chase Manhattan Bank NA*, [1984] 1 Lloyd's Rep 251, CA.

¹²¹ Op.cit.n.117, p356.

¹²² *The Super Court Rules 2009 (U.K.)*, 2009, 1603 (L. 17).

¹²³ Geraldine Andrew & Richard Millett, *Law of Guarantee*, 2nd ed. (London: F T Law & Tax, 1995), p463.

(2) The Injunction in American law

The interlocutory injunction in American law is also called provisional injunction relief. Different from the United Kingdom, the United States has particular statutes regulating letter of credit and injunctions. So whether an injunction can be given is mainly pursuant to two codes: § 5-109 (Fraud and Forgery) of UCC which regulates the restrictions of issuing an injunction on substantive law; and Article 65 (Injunctions and Restraining Orders) of *Federal Rules of Civil Procedure* which stipulates relative restrictions on procedural law. Pursuant to the latter one, interlocutory injunctions in American law are divided into two categories:

“(a) PRELIMINARY INJUNCTION.

(1) *Notice.* The court may issue a preliminary injunction only on notice to the adverse party.

(2) *Consolidating the Hearing with the Trial on the Merits.* Before or after beginning the hearing on a motion for a preliminary injunction, the court may advance the trial on the merits and consolidate it with the hearing. Even when consolidation is not ordered, evidence that is received on the motion and that would be admissible at trial becomes part of the trial record and need not be repeated at trial. But the court must preserve any party’s right to a jury trial.

(b) TEMPORARY RESTRAINING ORDER.

(1) *Issuing Without Notice.* The court may issue a temporary restraining order without written or oral notice to the adverse party or its attorney only if:

(A) specific facts in an affidavit or a verified complaint clearly show that immediate and irreparable injury, loss, or damage will result to the movant before the adverse party can be heard in opposition; and

(B) the movant’s attorney certifies in writing any efforts made to give notice and the reasons why it should not be required.

(2) *Contents; Expiration.* Every temporary restraining order issued without notice must state the date and hour it was issued; describe the injury and state why it is irreparable; state why the order was issued without notice; and be promptly filed in the clerk’s office and entered in the record. The order expires at the time after entry — not to

exceed 10 days — that the court sets, unless before that time the court, for good cause, extends it for a like period or the adverse party consents to a longer extension. The reasons for an extension must be entered in the record.”¹²⁴

The criteria for issuing an injunction in American law are similar to the restrictions in the British law. Besides the procedural elements regulated in Article 65 of the *Federal Rules of Civil Procedure*, American federal courts will also consider the following elements: First, the application of an injunction must satisfy the requirement of substantive law, namely § 5-109 of UCC. With regards to the burden of proof, the official commentary of UCC believes it falls on the applicant. The applicant for an injunction has to provide sufficient certifications rather than just make an allegation.

Second, the application for an injunction must satisfy the requirements of case law. Similar to the British law, the applicant for an injunction is required to prove that there will be irreparable loss if no injunction is issued. Nevertheless, according to the American law, the loss can not only be speculative, the certainty of the immediate, irreparable loss or damage needs to be proved. Otherwise, the basis of equity remedies will not be satisfied. As stated in *Mason County Medical Association v. Knebel*¹²⁵, applicants have to prove the injunction will not cause serious injuries to others. Whereas in other cases, such as *Planned Parenthood League v. Belloti*¹²⁶, the applicants only need prove that the damages caused to him in absence of an injunction will be far greater than the injuries bring to others when an

¹²⁴ *Federal Rules of Civil Procedure* (U.S.), 2007.

¹²⁵ *Mason County Medical Association v. Knebel*, [1977] 564 F2d 256 at 261.

¹²⁶ *Planned Parenthood Leagud v. Belloti*, [1980] 641 F2d 1006, 1009.

injunction is given.

In case *KMW International v. Chase Manhattan Bank* and case *Harris Corp v. National Iranian Radio & Television*¹²⁷, applicants are only required to prove that beneficiary's fraud is active or intentional. Whereas, the request of fraudulent person's subjective fault is strongly challenged by this thesis, because first, subjective fault is too abstract to prove; moreover, it seriously violate the basic legal theory that the idea of crime is not a crime. Second, some scholars¹²⁸ argue that with the development of letter of credit, modern fraud regulation is different from the traditional one which required evil intent; instead, it only requires beneficiary's awareness of fraud.

¹²⁷ Mark S. Blodgett & Donald O. Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud" (1998) 35 American Business Law Journal 454.

¹²⁸ Ralph H. Folsom *et al.*, *International Business Transaction*, 5th ed. (St. Paul, West Publishing Co., 1996), p177.

Chapter Three—The Fraud Exception Rule in China

The history of letters of credit in China started from the Chinese economic reform in late 1970s. Before it, there were no cases of the letter of credit. Because at that time the main economic policy in China was that of a highly centralized, planned economy, which left little room for commercial instruments such as the letter of credit to be widely utilized.

The first known letter of credit case in China was heard by the Zhuhai Intermediate Court in 1986. It was the case of *Yuegang Agricultural Resources Development Co. v. Japanese Technology & Science Co.*¹²⁹, in which the plaintiff's claim of freezing the payment under credits as a measure of property preservation was permitted by the court. Therefore, the payment of the letter of credit was stopped. This decision was stunning and disappointing, as the dispute of this case was only with regard to the quality of goods, which should not have triggered an application of fraud exception rule.

However, in the early days of China's economic reform, courts were likely to simply stop the payment of credit by freezing bank account just according to the *Civil Procedure Law of the People's Republic of China* (hereinafter called *Civil Procedure Law of China*)¹³⁰, but failed to take into

¹²⁹ *Yuegang Agricultural Resources Development Co. v. Japanese Technology & Science Co.*, [1986] 23-3 of the Economic Division of the Zhuhai Intermediate People's Court.

¹³⁰ 《中华人民共和国民事诉讼法》*Civil Procedure Law of the People's Republic of China*, (Adopted at the Tenth National People's Congress, promulgated by Order No. 75 of the President of the People's Republic of China on October 28, 2007, and effective as of April 1, 2008). Article 93: An interested party whose legal rights or interests would, as the result of urgent circumstances, suffer irreparable

consideration the independence principle and the special nature of the letter of credit as a payment instrument. Especially along with the expansion of the Chinese economy and international transactions, the courts were interfering with the payment of credit in more and more cases.

Therefore, the Chinese courts had been a target for criticism for years. The voice of criticism is from applicants, foreign parties, and mainly from banks. Banks are not only against the courts' interference with the payment of letter of credit but have also tried to have the freezing order lifted. As they realized that courts' frequent interference with payment would jeopardize not only the commercial utility of the letter of credit but also their international reputation. "Chinese banks used nearly all their means to express their concerns and frustration. For example, in early 1995, the Bank of China organized a special conference and invited letter of credit specialists from a number of organizations, including judges from various levels of courts, to express its concern over decisions where payment of its letters of credit had been frozen."¹³¹ Moreover, as a result of the banks' concerns and frustration, since 1997, despite the fact that all commercial banks claimed to issue the domestic letter of credit, no one actually did so within four years.

damage unless immediately applying for property preservation, may, before initiating legal proceedings, apply to a people's court for the adoption of property preservation measures. The applicant shall provide security; if the applicant refuses to do so, the application shall be rejected.

¹³¹ Xiang Gao , "The Fraud Rule in Law of Letter of credit in the P.R.C." (2007) *The International Lawyer* 41.

“In January 2000, the Banking Commission of ICC China organized a special meeting in Beijing between judges of the Supreme People’s Court and representatives of all then fourteen major Chinese banks to express the banks’ concern over the issues arising from the courts’ interference with the payment of their letters of credit, and urged the Supreme People’s Court to promulgate the 1998 Draft as soon as possible.”¹³²

In 2005, in accordance with the domestic *General Principles of the Civil Law*, the *Contract Law*, the *Security Law*, the *Civil Procedure Law*; with reference to the UCP 500 and other international practice; and in line with judicial practice, the Supreme People’s Court of China formulated the *Rules of the Supreme People’s Court on Hearing Letter of Credit Dispute Case* (hereinafter called *Credit Dispute Cases*). It regulates the independence principle and the strict compliance rule; and stipulates the judging criteria of fraud, the applicants’ exceptions and the remedies of the fraud exception rule. Additionally, the *Credit Dispute Cases* states other detailed litigation procedures. It is comprehensively related to both substantive law and procedural law. Furthermore, Article 2 of the *Credit Dispute Cases* clearly recognizes the application of the UCP, and stipulates that “When hearing a Credit Dispute Case, a people’s court shall apply the relevant international practice or other rules that the parties thereto agreed upon; and in the absence

¹³² Ibid.

of such agreement, this court shall apply the Uniform Customs and Practice For Documentary Credits of ICC and other international practice.”¹³³

With the development of modern technology, in 2001, the China Merchants Bank combined domestic letter of credit with internet banking, and for the first time applied the electronic domestic credit. Since the China Merchants Bank opened up the first domestic credit to Qingdao Haier Company, the application of the credit has rapidly developed.

However, China still lacks a uniform and well-regulated credit system. Although UCP 600 is recognized as an international practice, it is too general to be directly implemented in China as a final rule. Moreover, UCP 600 is not legally binding, so its implementation in China still relies on China’s domestic laws. All this implies that it is necessary to amend and improve China’s credit system. Although the rapid adoption of a complete set of legislation is impossible, at least the People’s Supreme Court should address a uniform judicial interpretation as soon as possible.

In China, a complete legal system of letters of credit including its judicial remedies should have the following functions: first, it should effectively regulate the fraud exception rule and the remedies of fraud, so to achieve a balance between the fraud exception rule and the principle of independence as well as the strict compliance rule, in order to protect the security of transactions, maintain the order of transactions, and promote the

¹³³ 《最高人民法院关于审理信用证纠纷案件若干问题的规定》 *Rules of the Supreme People’s Court on Hearing Letter of Credit Dispute Cases*, 24 October 2005 (Adopted by the No. 1368 Session of the Adjudication Committee of the Supreme People’s Court Fa Shi [2005] No. 13).

development of international trade in China. Second, strongly deter persons from committing fraud in letters of credit. Third, reduce the negative effects upon the Chinese credit system and enhance foreign parties' confidence in Chinese banks. And fourth, consequently strengthen foreign parties' sense of security to do business and to invest in China, in order to promote China's reform and opening, especially after China's accession to WTO.

I Chinese Application of the Fraud Exception Rule

In China, there is no specific legislation governing letters of credit. Besides referring to the UCP, fraud cases in letters of credit are reviewed mainly pursuant to the Chinese Civil Law, the judicial interpretation of the Supreme People's Court, and relevant regulations of the People's Bank of China.

1. Rules and Regulations of the Supreme People's Court

(1) Summary of the National Forum on the Adjudication of Economic Cases Relating to Foreigners and People from Hong Kong and Macao in the Coastal Region (hereinafter called 1989 Summary)

The 1989 Summary¹³⁴ is the first set of Chinese rules that can be

¹³⁴ Op.cit.n.33.

It is the main legal basis that applicable to the fraud exception rule of credit. However, the 1989 summary is not due to judicial interpretation, but only with a reference value. As a result, it cannot be directly quoted in the judgments or rulings of judicial documents, and its legal effect is extremely

directly applied to fraud cases in letter of credit. It regulates the criteria of the fraud exception rule in a specific section based on the insistence of the independence principle. It has played a role in defining the fraud exception rule in China for almost twenty years. The 1989 Summary demonstrates clearly that banks have to satisfy a number of requirements to freeze payments, which includes: (1) there should be sufficient evidence to prove that a seller is making use of the underlying contract to defraud other parties of credits; (2) banks in China have not yet made payments within a reasonable period of time; (3) the freezing of payments is claimed by the buyer; (4) banks in China have not yet honored the draft in long-term letter of credit. The original text in the 1989 Summary stipulates these criteria can be found in Paragraph 3 (4) (ii) -

Regarding the Freezing of Payment of a Letter of Credit, which states:

“A letter of credit is a documentary transaction independent from the underlying sales contract, under which the issuing bank is obliged to pay the seller within the prescribed time as long as the seller presents the required documents on their face conforming with the terms of the letter of credit...The letter of credit and the sales contract belong to two different legal relationships. Generally payment of a letter of credit should not be frozen without serious consideration merely because there is a dispute over the foreign-related sales contract; otherwise the reputation of the Chinese bank can be jeopardized. In view of the practice at home and abroad, if sufficient evidence shows that the seller is using the underlying contract to defraud the buyer, and the Chinese bank has not paid within a reasonable time, a people's court may freeze the payment of the letter of credit upon the request of the buyer. However, a people's court should not freeze the payment of an acceptance credit when a time draft presented hereunder has already been accepted by the Chinese bank, as the obligation of the Chinese bank in such a situation has become unconditional under the law of negotiable instruments. Hence a

weak.

people's court taking such measures must proceed with caution, should first contact the Chinese bank, and seek advice from higher courts when necessary. A people's court should follow the same steps mentioned when it receives an application from a Chinese foreign arbitration agency for the freezing of the payment of a letter of credit."¹³⁵

The advantage of the 1989 Summary is obvious. It reflects the fraud exception rule of letters of credit and plays two important roles in the development of China's credit system. "First, it told the Chinese courts that the letter of credit was a special commercial instrument, emphasized the paramount importance of the principle of independence in the law of letter of credit, and restrained the surge of cases where courts interfered with the payment of the letter of credit. Secondly, it for the first time set forth the basic elements of the fraud rule in the law of letter of credit in China."¹³⁶

However, the 1989 Summary has a number of disadvantages. First, it is only a low-level judicial interpretation that cannot bind courts; therefore, it is not recognized and implemented as a uniform and authority rule by every court.

"Following the publication of the 1989 Summary, some Chinese courts, especially these at higher levels and with more opportunities to deal with credit cases, took the special nature of letter of credit into account when asked to exercise property preservation measures in letter of credit cases. But in some cases, in particular those decided by courts with less experience and knowledge of the law of letter of credit, the 1989 Summary was not well observed"¹³⁷.

¹³⁵ Ibid.

¹³⁶ Op.cit.n.131.

¹³⁷ Gao Xiang, *the Fraud Rule in the Law of Letter of credit: A Comparative Study*, (Kluwer: Law International, 2002).

Second, the stipulations of the 1989 Summary are too general to act as a guideline. For instance, the reason of justifying the freezing of a letter of credit was stated as “using the underlying contract defrauding the buyer”, which is too vague to be directly adopted as a criterion. Moreover, there is no specific regulation of how to define fraud in letter of credit and how to protect good-faith third parties. These uncertainties and incompleteness create difficulties for judges to solve actual problems in legal practice. As a result, the 1989 Summary is definitely not specific and sufficient enough to solve China's growing number of fraud cases in letter of credit.

(2) Transport and Communication Division of the Supreme People's Court

The Supreme People's Court has made many efforts to restrain Chinese courts from unduly interfering with the independence of letter of credit. It formally discussed the issue in several conferences and published relevant documents following the conferences.

The first conference was held in May 1995, and on which the *Transport and Communication Division of the Supreme People's Court* was discussed. A short summary was published following the conference, stated that “In accordance with the legal characteristics of letter of credit, maritime courts generally should not consider ordering a property preservation ruling

over the proceeds of a letter of credit unless the bill of lading is antedated or forged and the applicant requests such a ruling.”¹³⁸

The effect of this summary is far less than the 1989 Summary. Because first, this summary has never been widely published; second, its content is far less comprehensive; and third, its distribution was only limited to maritime courts. Therefore, it has rarely been mentioned by commentators in the literature.¹³⁹

(3) Li Guoguang’s Speech

The second conference with respect to the courts’ intervention was the National Forum on the Adjudication of Economic Cases organized by the Economic Division of the Supreme People’s Court in November 1998. On this conference, Justice Li Guoguang, the vice president of the Supreme People’s Court, made a very strong and important speech, which put forward three major principles in dealing with the fraud exception rule. This speech represented the Chinese Courts’ attitude that:

“In recent years, the freezing of payment of letters of credits by courts in our country has caused great concern in the circles of law and finance in the world. The improper freezing of payment of letter of credit by some of our courts has already caused damage to both the international reputation and the property of the banks of our country...Dealing with matters of this kind, we must first stick to the

¹³⁸ *Transport and Communication Division of the Supreme People’s Court*, May 1995, Supreme People’s Court.

It was merged in 2000 with the foreign-related group of the Economic Division to form the No. 4 Civil Division, a division of the Supreme People’s Court responsible for all foreign-related commercial and maritime cases.

¹³⁹ *Op.cit.n.131*.

principle of independence. Payment of a letter of credit cannot be stopped because there is a dispute over the international sales contract or other types of underlying contract. Secondly, payment of a letter of credit can only be stopped when sufficient evidence has shown that the seller (or the beneficiary) has used the letter of credit to defraud or has presented false documents, and when the applicant has made such an application and furnished proper security. Thirdly, even if the conditions mentioned in the second point are met, a ruling to stop the payment of a letter of credit is still not allowed if [the draft drawn under] the letter of credit has been accepted and transferred, or has been negotiated.”¹⁴⁰

(4) Provisions Concerning Certain Issues on the Ruling for the Stopping of Payment of a Letter of Credit (hereinafter called 1998 Draft)

In order to solve the problem of fraud in letter of credit, the Supreme People’s Court attempted to issue a special judicial interpretation on the fraud exception rule. Therefore, the 1998 Draft Credit was issued following the conference in November 1998. This judicial interpretation systematically regulates the fraud exception rule. It confirms the independence principle as the foundation of the fraud exception rule in Article 1; regulates the application criteria of the fraud exception rule, the stop of payments and the exceptions to the fraud exception rule in Article 2, Article 3 and Article 4 respectively; and stipulates procedure issues in the rest Articles. The original text of the 1998 Draft is as follows:

“1. In accordance with the long and widely used [Uniform Customs and Practice for Documentary Credits (UCP)] by the International Chamber of Commerce, a letter of credit is a documentary transaction independent from the underlying transaction.

¹⁴⁰ 李国光 Li Guoguang, 《确保司法公正, 加强队伍建设, 进一步推进经济审判工作的全面发展》 *To Ensure Judicial Fairness, to Strengthen Personnel Construction, to Further the Overall Development of Economic Trials* 16 经济审判指导与参考 [Civil & Commercial Trial Rev.], (1999). http://china.findlaw.cn/fagui/gj/22/15228_7.html.

It forms a different contractual relationship from that of the underlying contract. Unless fraud is involved in a letter of credit, a claimant cannot apply to a people's court for a ruling to stop the payment of a letter of credit on the ground that there is a dispute over the underlying contract.

2. A claimant may apply for a ruling to stop the payment of a letter of credit if one of the following occurs:

(a) A document presented by the beneficiary is forged or fraudulent;

(b) The beneficiary has committed material fraud against the applicant in the underlying transaction; or

(c) The beneficiary has colluded with the applicant or the applicant's agent to defraud the issuing bank, and the issuing bank asks for such a ruling.

3. After receiving an application for a ruling to stop the payment of a letter of credit, the people's court should carefully examine the application according to the law, and make a ruling to stop the payment if the following conditions are met:

(a) The evidence submitted by the claimant is sufficient to show that the fraud mentioned in Article 2 exists;

(b) On the basis of the information submitted to the court, the claimant is more likely than not to succeed in the lawsuit;

(c) The beneficiary has no other property to be taken in custody in China; otherwise property preservation measures should be taken against the beneficiary's other property first; and

(d) Adequate security has been provided by the claimant.

4. Although the conditions provided in Article 2 are met, in order to protect the interest of innocent third parties, a people's court should not make a ruling to stop the payment of a letter of credit if:

(a) The paying, confirming or negotiating bank nominated in the letter of credit has already paid or incurred the obligation to pay in accordance with the terms of the letter of credit, unless the bank itself is a party to the fraud or knew of the fraud before making the payment or incurring the obligation to pay; or

(b) In case of an acceptance credit, the issuing bank has indicated its acceptance on the draft or through fax, or the rights and obligations under the letter of credit has already been discounted or transferred.

5. After a ruling to stop payment of a letter of credit has been made by a people's court, if the issuing bank, the nominated bank, the beneficiary, the holder of drafts drawn under a letter of credit or an assignee of proceeds of the letter of credit raises an objection to the ruling and applies for a review, the court at the immediate higher level should accept the application and make a review ruling within

30 days. If the original ruling is found to be in violation of Articles 3 and 4 or other good reasons have been provided by the applicant, the original ruling should be reversed promptly.

6. If, during the hearing of a case involving a letter of credit, a people's court has found that the parties are, by using the letter of credit, undertaking illegal financing or other fraudulent activities amounting to criminal offences, the people's court should hand over the case to the authority of public security; for those cases in which laws or rules have been violated, the people's court should timely provide judicial opinions with regard to those violations to the relevant authorities.

7. When handling criminal cases, if an authority of public security, procuratorate or state security finds it necessary to stop the payment of a letter of credit, the relevant authority should make an application to the intermediate people's court where the issuing bank is domiciled; when an arbitration tribunal receives an application to stop the payment of a letter of credit, it should transfer the application to the intermediate people's court where the issuing bank is domiciled, and the relevant applicant should provide security to the court. The court having received the application should examine it in accordance with This Provision and make a ruling to stop the payment if the conditions are met.”¹⁴¹

Compared with the 1989 Summary, the 1998 Draft made a great progress. For example, it explicitly brought forward the concept of “stop to payment” instead of the confusing statement of “freeze” in the 1989 Summary. In addition, the word of “discount” and the whole Article 4 show that Chinese courts not only take into account the innocent third parties’ interests, but also take note of identifying the innocent third party, namely the holder in due course. Furthermore, the 1998 Draft covers almost every aspect of the fraud exception rule, from civil and commercial law to criminal law, from substantive law to procedure law, relating to the premise and conditions of its

¹⁴¹ 《关于裁定禁止支付信用证项下款项的若干问题的规定》*Provisions Concerning Certain Issues on the Ruling for the Stopping of Payment of a Letter of Credit*, November 1998, the Supreme People’s Court.

application, its exceptions, and regulations with regards to special situations, such as when the application is objected or when it is related to criminal activities. Unfortunately, the 1998 Draft is always a draft since it has never been published.¹⁴²

(5) Rules of the Supreme People's Court on Hearing Letter of Credit Dispute Cases (hereinafter called Credit Dispute Cases)¹⁴³

“In order to meet demands on further economic reform and challenges brought by the China's accession to the WTO, a special division, No. 4 Civil Division (the "Division"), was formed by the Supreme People's Court in August 2000 to deal with foreign-related commercial and maritime matters. One priority of the Division is to make necessary rules to provide guidance for courts of the country dealing with foreign-related commercial and maritime cases. A survey in early 2001 found that 25 percent of the foreign-related commercial cases heard by the Division were related to letter of credit. Following the survey, it was decided that a judicial interpretation concerning letter of credit was to be formulated. After more than four

¹⁴² See fn 25 of Op.cit.n.131.

It became a dead letter soon after it was drafted. “I have been told by one of former my colleagues at the SPC that the reason for its unfortunate fate is the provision of Article 7 that provides that other government departments, including the authorities of public security, procuratorate, and state security, were required to make an application to an intermediate people's court where the issuing bank was domiciled if they found it necessary to stop payment of a letter of credit when handling criminal cases, and these departments could not accept the provision. These departments argued that applying to a court for a ruling would hinder and delay the process of preventing criminals from transferring illegal money through letter of credit facilities; therefore, it was rejected shortly after it was drafted.”

¹⁴³ Op.cit.n.133.

years of drafting and extensive consultation, the document was finally promulgated on October 24, 2005.”¹⁴⁴

Like the 1998 Draft, the *Credit Dispute Cases* is also detailed and comprehensive and related to both substantive law and procedural law. It stipulates the judging criteria of fraud, the application and exceptions to the fraud exception rule, and other detailed litigation procedures.

The *Credit Dispute Cases* confirmed the premise of the independence principle and the strict compliance rule in Article 5, and recognized the fraud exception rule as well as established the judging criteria of fraud in Article 8.

“Article 5: After issuing bank’s commitment to pay, accept or perform its other obligation under a Credit, it shall perform its payment obligation within the time limit as specified by the Credit, provided that document(s) which appear on their face are in compliance with the terms and conditions of the Credit and documents which appear on their face to be consistent with one another. The people’s court shall not rule for any party’s defense on the ground of the underlying transaction between the applicant and the beneficiary, except for the circumstances provided by in Article 8. Article 8: In case of the occurrence of any of the following circumstances, Credit fraud shall be ascertained: (i) the beneficiary forges document(s) or the beneficiary presents document(s) containing false information; (ii) the beneficiary refuses to deliver goods in bad faith or the beneficiary delivers goods with no value; (iii) the beneficiary and the applicant or any other third party in collusion present false document(s) without true underlying transactions; and (iv) other circumstances involving Credit fraud.”¹⁴⁵

However, in order to protect the commercial interests of innocent third parties, exceptions to the fraud exception rule are necessary, which has been broadly recognized. The reason of these exceptions is to maintain the commercial utility of letter of credit, i.e. to enhance the mutual trust of

¹⁴⁴ Op.cit.n.131. Background of the *Credit Dispute Cases*.

¹⁴⁵ Ibid

applicants and beneficiaries. The exceptions are regulated in Article 10 of the

Credit Dispute Cases, saying:

“Article 10: Provided that it ascertains the existence of a credit fraud, a people’s court shall order for suspension of the payment under the credit or adjudicate that the payment shall be terminated, except under any of the following circumstances: (i) the nominated person, or the authorized person of the issuing bank has made payment in good faith under the instructions of the issuing bank; (ii) the issuing bank or its nominated person, or authorized person has accepted the bills of exchange under the Credit in good faith; (iii) the confirming bank has made payment in good faith; or (iv) the negotiating bank has negotiated the Credit in good faith.”¹⁴⁶

In addition, with regards to the remedies of the fraud exception rule, the *Credit Dispute Cases* stipulated the applicants and authority of the fraud exception rule in Article 9, its application criteria in Article 11, and its time limit in Article 12. The relative provisions are as follows:

“Article 9 The applicant, the issuing bank or other interested parties may apply to a people’s court having competent jurisdiction to suspend the payment under the Credit if they find out that the circumstances described in Article 8 occur and could cause irreparable damages to them.

Article 11 A people’s court shall accept the application for suspension of the payment of a Credit by the parties thereto prior to court hearings if the following conditions have been met: (i) the people’s court receiving the application has competent jurisdiction over the Credit Dispute case; (ii) the evidentiary materials presented by the applicant has proved the existence of the circumstances set out in Article 8 hereof; (iii) the applicant will suffer irremediable damage if the court does not take action to enjoin the payment under the Credit; (iv) the applicant has provided reliable and adequate security; and (v) there exist no circumstances set out in Article 10.

In case where a party requests for the suspension of a payment under the Credit in the course of the proceedings, the conditions set forth in (ii), (iii), (iv) and (v) in the preceding Clause shall be satisfied.

Article 12 A people’s court shall render an order within forty-eight (48) hours after its receipt of the application for the

¹⁴⁶ Ibid.

suspension of the payment under the Credit. When the people's court orders the suspension of the payment, such suspension shall be enforced immediately.”¹⁴⁷

2. Rules and Regulations of the People's Bank of China

Besides the Supreme Peoples' Court, the People's Bank of China¹⁴⁸ is another authority that has the right to establish rules to regulate banks' credits business. There are two important documents published by the People's Bank of China considering fraud in letter of credit.

(1) *Domestic Letter of Credit Settlement*¹⁴⁹

According to Article 5 of the *Domestic Letter of credit Settlement*¹⁵⁰,

¹⁴⁷ Ibid.

¹⁴⁸ The People's Bank of China (PBC) was established on December 1, 1948 based on the consolidation of the Huabei Bank, the Beihai Bank and the Xibei Farmer Bank. In September 1983, the State Council decided to have the PBC function as a central bank. The Law of the People's Republic of China on the People's Bank of China adopted on March 18, 1995 by the 3rd Plenum of the 8th National People's Congress has since legally confirmed the PBC's central bank status. With the improvement of the socialist market economic system, the PBC, as a central bank, will play an even more important role in China's macroeconomic management. The amended Law of the People's Republic of China on the People's Bank of China, adopted by the 6th meeting of the Standing Committee of the 10th National People's Congress on December 27, 2003, provides that the PBC performs the following major functions:

- (1) Drafting and enforcing relevant laws, rules and regulations that are related to fulfilling its functions;
- (2) Formulating and implementing monetary policy in accordance with law;
- (3) Issuing the Renminbi and administering its circulation;
- (4) Regulating financial markets, including the inter-bank lending market, the inter-bank bond market, foreign exchange market and gold market;
- (5) Preventing and mitigating systemic financial risks to safeguard financial stability;
- (6) Maintaining the Renminbi exchange rate at adaptive and equilibrium level; Holding and managing the state foreign exchange and gold reserves;
- (7) Managing the State treasury as fiscal agent;
- (8) Making payment and settlement rules in collaboration with relevant departments and ensuring normal operation of the payment and settlement systems;
- (9) Providing guidance to anti-money laundering work in the financial sector and monitoring money-laundering related suspicious fund movement;
- (10) Developing statistics system for the financial industry and responsible for the consolidation of financial statistics as well as the conduct of economic analysis and forecast
- (11) Administering credit reporting industry in China and promoting the building up of credit information system;
- (12) Participating in international financial activities at the capacity of the central bank;
- (13) Engaging in financial business operations in line with relevant rules;
- (14) Performing other functions prescribed by the State Council.

¹⁴⁹ 《国内信用证结算办法》 *Domestic Letter of credit Settlement*, 16 July, 1997, the People's Bank of China.

“The subject of letter of credit shall comply with laws and regulations, as well as the provisions of this settlement, and should not harm the public interest.

The parties of letter of credit should comply with the principles of good faith and fulfil their obligations, and should not use the letter of credit to fraud, or conduct other illegal and criminal activities.”¹⁵¹

This article clearly indicates that when fraud undermines the independence principle and no specific provision can be applied, banks and courts can, pursuant to the principle of good faith, distinguish and punish fraud or other illegal or criminal activities.

Additionally, Article 42 demonstrates the applicable law of fraud in letter of credit, especially fraud in the form of forged or altered documents. It states that:

“For forged or altered letter of credit, or a forged or altered accompanying documents, or the fraud made use of forged letter of credit, the pursuit of these crimes’ legal responsibility should be in accordance with the *Criminal Law of the People’s Republic of China* (hereinafter called *Criminal Law*) and *Standing Committee of*

¹⁵⁰ In order to meet the needs of domestic trade activities and promoting China's socialist market economy and healthy development, according to "People's Bank of China Act of the People's Republic of China " and relevant laws and regulations, the development of this approach.

¹⁵¹ Ibid.

*National People's Congress's Decision on the Punishment of the Crime of Damaging Financial Order*¹⁵².”¹⁵³

(2) Notice on strengthening the management of letter of credit

The *notice on strengthening the management of letter of credit* clearly points out the defects and the necessity of amending and improving Chinese credit system. Instead of regulating the remedies of fraud in letter of credit, the notice focuses on the prevention mechanism of fraud, namely, the strict examination of the issuing of credit. Furthermore, according to the *Notice on strengthening the management of letter of credit*, banks in a higher level are responsible for the lower-level banks' payment when the lower-level banks fail to honor. What is more important is that the *notice on strengthening the management of letter of credit* clearly confirms the application and implementation of the UCP when disputes under credit involving foreign parties. It reads as follows:

“People's Bank of China branches, operations management departments, state-owned commercial banks, other commercial banks:

Recently, some banks' management of letter of credit and examinations of applicants' credit are loose. Their concept of credit is weak. Moratory payment or even non-payment under letter of credit occurs from time to time, affecting the credibility of China's banking industry. In order to regulate the banks' letter of credit business, maintain the image of China's financial system and bank credit, the

¹⁵² 《全国人民代表大会常务委员会关于惩治破坏金融秩序犯罪的决定》 *Standing Committee of National People's Congress's Decision on the Punishment of the Crime of Damaging Financial Order*, (Adopted by the Fourteenth Session of the Eighty National People's Congress on June 30, 1995, promulgated by Order No. 52 of the President of the People's Republic of China on June 30, 1995).

¹⁵³ Op.cit.n.149.

notifications on strengthening the management of letter of credit are as follows:

First, the banks have to strictly enforce the relevant provisions of *Guidelines for Commercial Banks to Implement a Unified Credit System (for trial implementation)*. Bring the business of credits into a unified credit management as soon as possible, to further improve the internal control system of risk....

Second, all issuing banks should strengthen management and strictly examine the applicant's credit... prevent the enterprise's credit risk change into financial risk; prevent the financing which make use of opening a letter of credit in the absence of a real underlying trade contract. Sternly deal with non-authorized and unregulated issuing of credit

Third, in dealing with disputes of letter of credit with foreign parties, banks should strictly follow the UCP500 and other international practice; timely, properly handled the disputes in order to ensure the credit. Without good reason the payment of letter of credit should not be deferred or refused.”¹⁵⁴

3. Other Relevant Provisions

Besides the judicial interpretation and administrative regulations established by the Supreme Peoples' Court and the People's Bank of China, there are other provisions that might be applied to or used to interpret fraud in letter of credit. For instance, Article 6 and Article 56 of *Contract Law of the People's Republic of China* (hereinafter called *Contract Law*), stipulate: “Article 6 Good Faith: The parties shall abide by the principle of good faith in exercising their rights and performing their obligations.” “Article 56 Effect of Invalidation or Cancellation; Partial Invalidation or Cancellation: An invalid or cancelled contract is not legally binding *ab initio*. Where a contract is

¹⁵⁴ 《关于加强信用证管理的通知》 *Notice on Strengthening the Management of Letter of credit*, 16 April 1999, the People's Bank of China.

partially invalid, and the validity of the remaining provisions thereof is not affected as a result, the remaining provisions are nevertheless valid.”¹⁵⁵

Similar principles can also be found respectively in Article 4 and Article 58 Para 3,4 of the *General Principles of the Civil Law*. “Article 4: In civil activities, the principles of voluntariness, fairness, making compensation for equal value, honesty and credibility shall be observed.”¹⁵⁶ Article 58 states that “Civil acts in the following categories shall be null and void: ... (3) those performed by a person against his true intentions as a result of cheating, coercion or exploitation of his unfavorable position by the other party; (4) those that performed through malicious collusion are detrimental to the interest of the state, a collective or a third party;”¹⁵⁷ These provisions can be used to discern fraud and the invalidity of contract, and to support the refusal of payment under letter of credit. However, they are only general rules with nothing specific to fraud in letter of credit. The only legislation particularly regulates fraud in letter of credit was *Criminal Law of the People’s Republic of China* (hereinafter called *Criminal Law*), which regards and punishes serious fraud in letter of credit as a crime. In Article 195, it stipulates that

“Any of the following categories of persons who conducts swindling activities of letter of credit shall be sentenced to fixed-term imprisonment of not more than five years or criminal detention, and concurrently be sentenced to a fine of not less than 20,000 yuan (approx. \$CA 4,000) and not more than 200,000 yuan (approx. \$CA

¹⁵⁵ *Contract Law of the People’s Republic of China*, (Adopted and Promulgated by the Second Session of the Ninth National People’s Congress on 15 March, 1999), <http://www.chinaiprlaw.com/english/laws/laws2.htm>.

¹⁵⁶ Op.cit.n.94.

¹⁵⁷ Ibid.

40,000). If the amount involved is huge or other serious circumstances exist the offender shall be sentenced to fixed-term imprisonment of not less than five years and not more than ten years, and concurrently be sentenced to a fine of not less than 50,000 yuan and not more than 500,000 yuan. If the amount involved is especially huge or other especially serious circumstances exist, the offender shall be sentenced to fixed-term imprisonment of not less than ten years or life imprisonment, and concurrently be sentenced to a fine of not less than 50,000 yuan and not more than 500,000 yuan or confiscation of property: (1) those who use forged or altered letter of credit or attached notes or documents; (2) those who use invalid letter of credit; (3) those who defraud letter of credit; or (4) those who conduct swindling activities of letter of credit by other means.”¹⁵⁸

II Existing Defects and Proposed Amendments of Chinese Procedure Law

1. The Subjects of the Fraud Exception Rule

(1) The Applicant of the Fraud Exception Rule

The applicant for a letter of credit has the right to apply for an injunction if he discovers the existence of fraud, which is broadly recognized by different countries’ statutes and precedent. The reason is that the applicant would be the final victim of fraud if no injunction were issued. However, whether banks also have the right to directly apply for an injunction is the main issue to be resolved. In order to answer this question, two questions need to be answered first. One is whether banks have the responsibility to inform

¹⁵⁸ *Criminal Law of the People’s Republic of China*, amended 29 June 2006, (Adopted by the Second Session of the Fifth National People’s Congress on July 1, 1979 and amended by the Fifth Session of the Eighth National People’s Congress on March 14, 1997). <http://www.com-law.net/findlaw/crime/criminallaw1.html>.

their applicants of fraud when they become aware of it. The other is whether banks have the obligation to investigate the existence of fraud. For the first question, this thesis believes the answer should be yes; while for the second one, a negative answer is given by the thesis.

a. Banks' Responsibility of Notice

In order to define the limitation of fraud exception rule, and to reasonably mitigate the independence principle, this thesis asserts that banks' responsibilities to give notice to the applicant of fraud in letter of credit are to be strongly encouraged. Upon the presentation of documents, the issuing bank has the responsibility to give notice to the applicant about the documentary presentation, and is limited to the responsibility of noticing, but not asking for advice.

First, a legal action should be a uniform body of both rights and obligations. According to this theory, since banks have the right of independently honoring letter of credit, there should be some corresponding obligations during the documentary examination, such as the responsibility of paying reasonable attention, as well as informing applicants of fraud. Otherwise, the independence of the payment would be questioned. In addition, if the bank does not consider the buyer's corresponding benefits, the bank itself would be a victim too, since the bank may fail in competition with other banks that are willing to protect their applicant from at least some types of

frauds.

Second, the establishment of the banks' notice responsibility satisfies the efficiency requirement of letter of credit, because when the documents presented by beneficiaries have some apparent differences, the notice may give the applicant a chance to waive some minor discrepancies, which consequently assures the efficient payment.

Third, the responsibility of notice is also conducive to the restoration of the balance of parties' benefits, since it protects the buyers' interests and equal rights, as well as the banks' credits, without altering their independence status.

Additionally, the applicant's equal rights are protected through this mechanism. In a letter of credit transaction, the seller has no duty to inform the buyers about the shipment of goods, or the presentation of documents. Evidence of this can be found in *Pa via & Co SpA v. Thurmann-Nielsen*, where Denning LJ said that the seller is not bound to tell the buyer the precise date when he is going to ship¹⁵⁹. In this situation, the applicant can easily miss the chance to question the documents presented by the beneficiary, even if he might doubt the authenticity of the seller's documents before documentary presentation or payment. Therefore, the party's reliance interests are very important since they relate to the security of transaction.

Furthermore, the beneficiary's benefits are protected by the bank's

¹⁵⁹ *Pavia & Co SpA v. Theumann-Nielsen*, [1952] 2 QB 84, [1952] 1 All ER 492, CA.

responsibility of giving a notice, namely that, in order to reject or dishonour a presentation, according to the UCP guidelines the bank's first step is to give notice and ask the applicant for a waiver. Therefore, it is unfair that the bank has a responsibility to give a notice for a waiver of discrepancy for the beneficiary's benefits before the dishonour of a presentation, while the bank does not need to provide notice to the applicant about the documentary presentation before making payments. The establishment of the bank's notice responsibility offers the applicant a right of being informed by the bank about the presentation so that it may have some time to investigate in order to exclude the fraud exception, and to prevent the loss of benefits. Meanwhile the applicant's benefits will not be over protected when balancing the overall interests involved, since the applicant could not casually dispose of the payments during the investigation, meaning that the protection of benefits' security would meanwhile not be shaken. Additionally, the release of the injunction should be very strict, in order to prevent the abuse of this mechanism, and to protect the purpose of letter of credit. Therefore, this mechanism would succeed in curbing the fraud without damaging the independence principle.

b. Banks' Obligation of Investigation

In order to maintain the independence principle, this thesis argues that banks should not assume the obligation to investigate the existence of fraud.

After noticing a fraud, the bank does not need to do anything, such as investigate, or even supervise or inquire about the applicants' investigation findings - these are all the applicants' own concern. If an applicant believes that the documents presented by the beneficiary comply with the terms of credit, it should inform the bank as soon as possible to honor the credit, in order to reduce the bank's loss of interests. However, if the applicant doubts the authenticity of the goods, he should investigate the actual situation himself as soon as possible, and then inform the bank whether to pay, or apply for injunction from courts within a time limit.

Under this system, the bank's independence principle is maintained, since the bank has only an additional responsibility of notification, but not required to investigate. In this case, the bank is still responsible only for documents but not goods. There are two reasons why banks should not be required to investigate whether there is discrepancy of the presented documents: on the one hand, they are not supposed to have the duty of investigation based on the independence principle, and this protects them from assuming the responsibilities generated from the duty of investigation, such as the responsibility for mistake of investigation result, ignorance, or refusal of the investigation. On the other hand, the banks do not need to incur extra expenses for an investigation. Moreover, this allocation of responsibility spares the bank from unnecessary disputes with the applicants regarding the issue of investigation fees, or reimbursement of investigation fees, when the

bank undertakes an investigation before asking the applicant for reimbursement.

c. Banks' Right to Apply for an Injunction

With respect to the question of whether banks should be an applicant apply for an injunction, this thesis asserts that there is no certain answer. It depends on whether a bank has a significant interest, namely whether it would be the victim of fraud in letter of credit. If yes, it definitely has the right to apply for an injunction; otherwise, they are not required or not appropriate to apply. Therefore, applying for an injunction is more like a bank's right rather than its obligation.

Standing from the perspective of a bank, it would want the refusal of payment to affect its reputation in international trade. As a result, it would prefer to wait for an injunction rather than go through the process of applying for it, unless its own interests are involved, such as when the bank itself becomes the victim of fraud when beneficiaries and applicants conspire to defraud it. In other words, it is necessary to give banks the power to apply for an injunction in certain circumstances. However, it should not be an obligation, as to be an extra burden on a bank which would be against the independence principle and the strict compliance rule. If applying for an injunction were an obligation, the banks could be forced to compensate a large number of remedies when fail to do so. Since banks may only be left with the earnings

from credit application fees and no other significant benefits, such an injunction would seriously violate the balance of right and obligation between parties of credit.

Based on the above analysis, Chinese rules need to be amended. Although the regulation of “applicants, banks, and other interested parties may apply for an injunction” can still be effective, the degree of relative interests in deterring the eligibility of being the applicant of an injunction needs to be regulated. This thesis assert that a party would only be eligible to be the applicant of an injunction when a party’s interests are significant enough to make it a third party in the litigation with respect to the same issue; it is eligible to be the applicant of an injunction. The rationale lies in the independence principle and strict compliance rule. On the one hand, a letter of credit originally has nothing to do with other parties. On the other hand, if too many parties were able to intervene in the payment under a letter of credit, the efficiency of credit and its main function of reducing beneficiaries’ risk of achieving payments would be fundamentally destroyed, which would consequently shake the foundation of the whole credit system.

(2) The Authority of an Injunction

a. Existing Defects of the Chinese Law

In China, with respect to the authority of an injunction, there is not only conflict between various laws, but also between legislation and legal

practice. Pursuant to the 1989 summary, only the People's Courts have the right to issue an injunction, so that a "People's Court may freeze the payment of the letter of credit upon the request of the buyer."¹⁶⁰ The same spirit is also clearly expressed in the 1998 Draft and *Credit Dispute Cases*, which states "after receiving an application for a ruling to stop the payment of a letter of credit, the People's Court should carefully examine the application according to the law, and make a ruling to stop the payment"¹⁶¹. Article 9 of the *Credit Dispute Cases*, demonstrates that "the applicant, the issuing bank or other interested parties may apply to a People's Court having competent jurisdiction to a suspend the payment under the Credit"¹⁶²

However, according to *Criminal Procedure Law of the People's Republic of China* (hereinafter called *Criminal Procedure Law of China*)¹⁶³ and *State Security Law of the People's Republic of China* (hereinafter called *State Security Law*)¹⁶⁴, besides the People's Courts, agencies which can freeze credit also extend to the Procurator, the National Security Institute and the Police Office. Moreover, in legal practice, these four institutes have all issued the freeze of payment under a letter of credit.¹⁶⁵

¹⁶⁰ Op.cit.n.33.

¹⁶¹ Op.cit.n.141, Article 3.

¹⁶² Op.cit.n.133.

¹⁶³ *Criminal Procedure Law of the People's Republic of China*, (Adopted by the Second Session of the Fifth National People's Congress on July 1, 1979 and amended by the Fourth Session of the Eighth National People's Congress on March 17, 1996, and effective as of January 1, 1997).

¹⁶⁴ 《中华人民共和国国家安全法》 *State Security Law of the People's Republic of China*, (Adopted at the 30th Meeting of the Standing Committee of the Seventh National People's Congress on February 22, 1993, promulgated by Order No. 68 of the President of the People's Republic of China, and effective as of February 22, 1993).

¹⁶⁵ Op.cit.n.12, p389.

Therefore, the Chinese law regarding issuing an injunction needs to be amended and unified. Although the regulations that limit the issuers of injunctions to courts are specific to rules of a letter of credit, and since in China, specific rules take precedence over general rules, it should be noted that such a comparison could be made only within the rules to have the same level of legal outcome. On the other hand, within different level rules, laws would always take priority over regulations, meaning that the legal effects of the regulations would be lower than that of the *Criminal Procedure Law of China* and *State Security Law*. Therefore, decisions would be made according to the laws which unreasonably expand the scope of the issuing institute.

b. Proposed Amendments in Chinese Credit System

This thesis argues that there are three reasons for which only the People's Courts have the right to issue an injunction under a letter of credit. First, it could prevent banks from abusing their discretion to issue an injunction, which would consequently guarantee a bank's independence status and the main function of a letter of credit.

Secondly, this regulation is consistent with other foreign countries' laws and international practice. Applying a law that is consistent with international practice would promote China's integration into the international market, which is quite important to China, especially after its accession to the WTO. In addition, having a law of this kind that is consistent with foreign

laws and international practice would make foreign parties be more secure and confident to do business with Chinese parties and open a letter of credit in Chinese banks. Under this condition, the remedies of fraud in credit under the Chinese law would be more predictable to foreign parties. Furthermore, only the People's Courts have the right to issue an injunction; this is also consistent with the Chinese domestic government of applying international practice. For instance, Article 2 of the *Credit Dispute Cases* regulates "When hearing a Credit Dispute Case, a people's court shall apply the relevant international practice or other rules that the parties thereto agreed upon; and in the absence of such agreement, this court shall apply the Uniform Customs and Practice for Documentary Credits of ICC and other international practice."

Thirdly, the expansion of the authority in legal practice, itself, is a misunderstanding based on the misleading term of "freeze." In the 1989 summary, "injunction," a measure of property preservation, is called "freeze." However, a "freeze" describes a rather active progress in which bank's payment is considered. As a result, the issuer of an injunction under a letter of credit in commercial law becomes confused with the issuer of a freeze in criminal and administrative law.

2. The Application Period of the Fraud Exception Rule

(1) Existing Defects within Chinese Law

One of the main difficulties of applying for an injunction arises from time constraints. Even if a party has the right to apply for an injunction, it might not have enough time to examine the presented documents or the underlying sales contract, and then provide sufficient evidence to successfully get the injunction. According to Article 6 of *Credit Dispute Cases*,

“When hearing Credit(s) dispute case which involves examination on documents, people’s courts shall follow relevant international practice or other rules agreed upon by the parties; in case of the absence of any agreement, people’s courts shall apply UCP and other standards published by ICC to ascertain whether or not the document(s) which appear on their face to be in compliance with the terms and conditions of Credit and the documents which appear on their face are consistent with one another.”¹⁶⁶

In China, as there is no specific law stipulates the period of applying for an injunction, a decision would be made with reference to the UCP. And pursuant to Article 14, Para b of UCP 600, the period for bank to examine the presented documents is up to five working days, that “[A]nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any

¹⁶⁶ Op.cit.n.133.

expiry date or last day for presentation.”¹⁶⁷ Therefore, applicants of injunctions only have a maximum of five working days to investigate and collect evidence if they were not aware of fraud before the presentation of documents.

Moreover, the period before the presentation of documents is very short as well, because in business practice, buyers normally require sellers to tender the documents as soon as possible in order to receive the documents before goods arrive in port. In addition, if sellers intend to defraud, they would honor the letter of credit as early as possible in order to decrease the chances of being discovered. Consequently, it becomes necessary for the applicants of injunctions to investigate before the presentation of documents.

(2) Proposed Amendments in Chinese Credit System

In order to solve this problem, the Chinese law could be amended to improve its temporary property preservation function by referring to the Mareva Injunction in British law and the Garnishment in American law. However, it should be pointed out that both the Mareva Injunction and Garnishment are remedies given after the honoring or payment of a letter of credit. Therefore, strictly speaking, it is not a remedy based on the fraud exception rule, but only used as a backup to make up for the defects of a letter of credit and to make the credit system more complete.

¹⁶⁷ Op.cit.n.2.

a. Mareva Injunction in British Law

The Mareva injunction, alternatively known as a freezing order, is a court order which freezes assets so that a defendant to an action cannot spread their assets beyond the jurisdiction of a court. Its purpose is to guarantee the implementation of a decision if the applicants of this order eventually win the case, and more specifically to make sure there will be property to be executed if the defendant loses the case. This order is named for *Mareva Compania Naviera v. International Bulkcarriers*¹⁶⁸, although the first recorded example of it in English jurisprudence was *Nippon Yusen Kaisha v Karageorgis*, which was decided very shortly before the Mareva decision in the same year. Nevertheless, this order was defined as a “freezing” order by the *Civil Procedure Rules 1998*. It is widely recognized in other common law jurisdictions and has a world-wide effect.¹⁶⁹ Similar provisions can be found also in other European countries’ domestic laws or the European Union Law, such as Article 9(2) of the European Union’s *Directive on the Enforcement of Intellectual Property Rights*¹⁷⁰.

The advantages of using the reference of Mareva Injunction in China under a letter of credit are mainly embodied in three aspects: First of all, this injunction does not impede the beneficiaries’ presentation of documents or

¹⁶⁸ *Mareva Compania Naviera v. International Bulkcarriers*, [1975] 2 Lloyd's Rep 509.

¹⁶⁹ http://en.wikipedia.org/wiki/Mareva_injunction.

¹⁷⁰ EC, *Commission Directive 2004/48/EC of 29 April 2004 on the Enforcement of Intellectual Property Rights*, [2004] O.J. L157/195.

banks' honor or payment; therefore, it would not undermine the stability of trade in a letter of credit. Secondly, a breach of contract can be used as a reason to apply for the injunction, which greatly reduces the difficulties of proving fraud and makes the implementation of an injunction more feasible. Thirdly, the object of Mareva Injunction is not limited to the payment under letter of credit, but also expands to the defendant's other property, making it more conducive to protecting applicants' interests that could make up the defects of acts-preservation injunctions under letters of credit.

However, the Mareva Injunction is by no means perfect and has several disadvantages. First, the requirement of an existing cause of action hampers the Mareva Injunction to being used before banks' payment under a letter of credit. Second, third parties' priority and banks' right of set-off always could make the Mareva Injunction meaningless, since this injunction does not give the applicants any priority to the defendants' property.

b. Garnishment in American Law

Garnishment, in American law, is a court order directing a third party which holds money or property belonging to a defendant to withhold it and appear in court to answer inquiries. It is also a temporary remedy prior to courts' decisions, regarding property but not acts. Different from attachment, the property under garnishment is frequently intangible property, and instead of being controlled by the magistrate, the property is still left in the custody of

the trade party.

When a letter of credit has already been honoured, the applicant could apply to seize the fraudulent person's claim of the credit, and therefore stop the bank from paying. If the bank has already paid, the garnishment will detain the defendant's property and prevent it from being obtained by third parties. The legal source of garnishment lies in the expression of "similar relief" in § 5-109 (b) of UCC, which states: "If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons."¹⁷¹ However, since garnishment would to some extent affect the credibility of a letter of credit in business practice (although it theoretically does not threaten the independence principle), its application should be restricted to the injunction of a letter of credit. This has been recognized by official comment of the UCC.

3. Remedies of the Fraud Exception Rule

In the Chinese legal system, there is a lack of specific and systematic regulations with regard to the fraud exception rule. This can be seen in the legal blank of the fraud exception rule's applicable procedures. Moreover, the

¹⁷¹ Op.cit.n.7.

terminology for the fraud exception rule's remedy is inconsistent, changing from the 1989 Summary's term "freeze" to the "suspension of the payment" in *Credit Dispute Cases*. These inconsistent terms lead to a number of confusions in legal practice. Therefore, the measure of applying the fraud exception rule in China should be amended, unified and improved with reference to the rules of injunction under American and British laws.

(1) Existing Defects of the Chinese Law

Firstly, the word "freeze" in the 1989 Summary is quite confusing. Since a freeze is a unique measure for property preservation, this term would seem to imply that what the 1989 Summary classifies as the remedy for refusing payment would, in turn, be property preservation. However, further down in the 1989 Summary, it can be seen that a freeze can only be implemented before a bank's payments while, at the same time, the beneficiary has no property in the bank's account to be frozen. Even if the fraudulent person is the applicant of a letter of credit, legally the applicant might only deposit some bail in the bank, which is not necessarily equal to the amount of payment, before the bank's payment. Thus, the bank has no property to control before the payment, and the freeze cannot be implemented. The object of the so-called "freeze" should therefore be the banks' payment behavior which is within the acts preservation, not property preservation,

especially when the property does not belong to the fraudulent person. The terminology for such an action should be “injunction” rather than “freeze.”

The confusing term of “freeze” also leads to some misunderstanding in legal practice. Courts frequently refer to the term freeze in relation to the regulation of property preservation in *Civil Procedure Law of China*¹⁷² which enjoins banks from paying, rather than pursuant to the rule of acts preservation. Moreover, this misnomer misleads some courts as to the object of freeze. They wrongly believe that the object of a freeze is the applicant’s property which used as a security in opening a letter of credit. Based on this misunderstanding, the measure of applying the fraud exception rule would lead to an absurd result in which courts would prohibit beneficiaries’ fraudulent activities through the freezing of an applicants’ property.

In addition, whether with a freeze or a suspension of payment, both acts are protective measures implemented before or during litigation, and whose application criteria under the *Civil Procedure Law of China* are ambiguous and loose. Such a loophole is if the applicant claims that the situation is urgent and that he will suffer irremediable damages without an immediacy protection, a freeze or suspension of payment can be issued. According to Article 93 of the *Civil Procedure Law of China*, “Any interested party whose lawful rights and interests, due to urgent circumstances, would suffer irremediable harms without immediately applying for property

¹⁷² Op.cit.n.130.

preservation, may, before filing the lawsuit, apply to the people's court for the adoption of property preservation measures. The applicant shall provide a surety.”¹⁷³ However, this kind of loose standard could foster a courts' perfunctory and arbitrary decision of injunctions and increase the frequency of issuing injunctions, which could consequently seriously affect Chinese banks' reputation and other parties' confidence of adopting a letter of credit as the payment instrument.

(2) Proposed Amendments in Chinese Credit System

A complete injunction mechanism must contain two parts: the decision of an injunction that binds the fraudulent person and the order of the injunction which has a legal consequence on banks. According to Chinese legal theory, an injunction can only bind its target or object, namely the defaulter, rather than any other third parties, such as banks. Furthermore, the object of an injunction is determined by the applicants, and courts have no right to arbitrarily add other objects. Nevertheless, in business practice, applicants commonly apply for an injunction only against the fraudulent persons. A bank is not a party in the legal relationship of an injunction. Therefore, the injunction does not have a direct legal effect on the bank. Theoretically, a bank has the right to ask for a written notice of the injunction from a court, without which a bank could ignore the court's decision of the

¹⁷³ Ibid.

injunction. The notice is essentially equivalent to an order, which gives the banks a good reason to refuse payment without undermining its reputation.

III Existing Defects and Proposed Amendments of Chinese Substantive Law

Similar to procedure law, in substantial law, there is a legal gap between a unified and specific regulation in the fraud exception rule. Although the Chinese law clearly lists the application criteria of the fraud exception rule, it fails to specifically interpret the criteria. For instance, there is no precise interpretation of how to define substantial fraud and sufficient proof in order to apply for an injunction, nor how to correctly understand the ignorance of beneficiary when fraud is committed by a third party, nor how to solve the conflicts between various Chinese laws with respect to the exceptions within the fraud exception rule.

1. The Extent of Fraud

With regard to the extent of fraud, most countries adopt a strict standard. British law, for example, requires strong corroborated evidence leading courts to believe that the only realistic inference to draw is that of fraud. Additionally, the official comment of the UCC rules is that fraud cannot be speculative, and must be proven. This thesis proposes that Chinese

legislation should refer to the British law and American law and adopt a stricter standard. This would effectively prevent parties from abusing the fraud exception rule to evade their duties. It would also help protect Chinese banks' reputation. The bank's reputation plays a key role in the credit system, insomuch as the damage of its reputation would place all domestic enterprises and banks in a very disadvantageous position for international trade. Numerous judicial interventions also would doubtlessly shake the independence principle and affect the efficiency of credit.

(1) Proof of the Substantial Fraud

Substantial fraud can be distinguished and examined from two different perspectives. On one hand, when considering the result of the fraud, substantial fraud is constituted if the fraud seriously jeopardized parties' interests and deterred the achievement of parties' purpose of the sales contract. On the other hand, when looking at fraudulent documents, substantial fraud is recognised as long as the forged and altered documents are critical documents directly affecting the purpose of the underlying sales contract, such as invoices and bills of lading. When there is a particular time requirement shown on the bill of lading, it means the buyer purchased certain goods in order to satisfy a specific-period market, an ante-dated bill of lading or an advanced bill of lading constitutes substantial fraud. In this case, such a forged or altered bill of lading would have already constituted a substantial breach of contract which

would impede the achievement of the underlying sales contract.¹⁷⁴

(2) Proof of the Good-faith Third Party

While the extent of fraud should adopt a stricter definition, the proof of a good-faith third party considering the exception to the fraud exception rule need not be so strict.

All issues involving whether a third party is aware of fraud, or offers equal consideration, or is in good faith, are between the third party and the fraudulent person. It is difficult or even impossible for the applicant of an injunction to collect relevant information and evidence. If the failure of proving a third party's bad faith can constitute a reason to reject the application of an injunction, then, as long as there is a third party, it is unlikely the applicant would receive an injunction. In this case, if the third party does know of the existence of fraud, the refusal to issue an injunction would violate the fraud exception rule and stipulations of *Law of the People's Republic of China on Negotiable Instruments* (hereinafter called *Negotiable Instruments*), which expresses in article 12 that "a person who acquires a negotiable instrument by means of fraud, theft, or coercion, or, with knowledge of the aforementioned situations, acquires the instrument out of ill intention shall

¹⁷⁴ Op.cit.n.12.

have no right thereon.”¹⁷⁵ Therefore, this thesis argues that the burden of proof should fall on the holder of the credit, who would need to prove that he is in good faith. Furthermore, when it is clear the beneficiary committed fraud but still uncertain whether the third party is in good faith, courts can issue an injunction first and then ask the third party to provide the evidence of his legal rights of the credit in order to avoid irreparable damages.

(3) The Chinese Principle of Reciprocity

There is no unified definition of fraud or application criteria for injunctions in different countries: this creates difficulties for international trade. In order to solve such difficulties, China established the principle of reciprocity.

For instance, in Italy, the criteria of applying the fraud exception rule are very loose. When the fraudulent beneficiary is abroad, the applicant can get an injunction as long as he proves that potential damage is irreparable. In 1994, China's Yuan Dong Company imported goods from Italy, and issued a letter of credit in a Chinese bank to pay instalments. However, before the third instalment, the Yuan Dong Company found that the goods did not perform to the performance standard stated in the contract; therefore, it applied for an

¹⁷⁵ *Law of the People's Republic of China on Negotiable Instruments*, (Adopted at the 13th Meeting of the Standing Committee of the Eighth National People's Congress on May 10th, 1995, promulgated by Order No. 49 of the President of the People's Republic of China on May 19, 1995 and effective as of January 1, 1996).

injunction from Beijing's Higher Court. Nevertheless, the court rejected the application since it believed it was a dispute over the quality of goods rather than fraud in the letter of credit. Eventually, the Yuan Dong Company claims a warranty of the products' quality. The reply from the Italian court, however, was that it had already issued an injunction against the warranty according to the sellers' application. Due to this, the Yuan Dong Company again applied for an injunction in the Chinese Court. This time the Beijing Higher Court approved the application and issued an injunction according to the principle of reciprocity.

This case shows that it is necessary for China to keep abreast of the different countries' legislation and legal practices, so as to adopt the principle of reciprocity in order to properly protect Chinese companies' equal rights and interests in the realm of international trade.

2. Exceptions to the Fraud Exception Rule

(1) Existing Defects of the Chinese Law

The Chinese law of the exceptions to the fraud exception rule is too general and conflicts with other legislation, especially with regards to acceptance letters of credit. The absence of a specific and complete regulation can lead to the abuse of the fraud exception rule in legal practice. A large number of foreign negotiating banks or confirming banks have suffered serious losses from such abuse, and can undermine the Chinese banks'

international reputation and cause them to face international litigation and reimbursement. Amendments to current Chinese laws could make them more specific and consistent thereby closing many loopholes that lead to abuses of the law.

With respect to the application of the fraud exception under an acceptance letter of credit, there is no specific regulation in *Credit Dispute Cases*, but the 1989 Summary recognises the acceptance letter of credit as an exception to the fraud exception rule. It states that “a people’s court should not freeze the payment of an acceptance credit when a time draft presented thereunder has already been accepted by the Chinese bank, as the obligation of the Chinese bank in such a situation has become unconditional under the law of negotiable instruments.”¹⁷⁶ In other words, as long as a credit is accepted by a bank, whether the holder is in good-faith or not, the fraud exception rule cannot be applied.

This stipulation conflicts with the defense mechanism in *Negotiable Instruments*. Article 13 which states, “A person liable for a negotiable instrument may set up defences against the holder who has a direct creditor - debtor relationship with him and does not perform the obligations agreed upon. Defence as used in this Law means refusal by a person liable for a negotiable instrument to perform his obligations to the creditor in accordance with the provisions of this Law.”¹⁷⁷ Additionally, Article 10 stipulates “The issue,

¹⁷⁶ Op.cit.n.33.

¹⁷⁷ Op.cit.n.175.

acquisition and negotiation of an instrument shall follow the principle of good faith and reflect the true relationship of transaction and between the creditor and the debtor. A negotiable instrument shall be acquired by payment of consideration, that is, the price corresponding to what is agreed upon by the two parties to the instrument,”¹⁷⁸ meaning if the holder of credit is not in good-faith or does not pay consideration, then a defense, that is fraud exception, can be applied.

(2) Proposed Amendments in Chinese Credit System

This thesis asserts that the acceptance credit can only be used as an exception to protect good-faith holders. If a credit holder intends to cheat or is even aware of fraud, the fraud exception rule can be applied.

While the acceptance credit held by a good-faith third party constitutes an exception to the fraud exception rule, the reason for protecting a good-faith third party lies in the protection of the independence principle and the strict compliance rule of credit. As long as the tendered documents comply with the terms written on the credit, a bank has to pay. Meanwhile, as a negotiable instrument, a letter of credit is a document that does not ask for the underlying relationship, but only focuses on the written meaning shown on the credit, in order to ensure the smooth flow of credit and trade. It determines in the transference of credit. A third party is only able to request and examine the

¹⁷⁸ Ibid.

information written on the credit but not the underlying contract relationship. Therefore, the protection of the third party is based on the recognition and the respect of the independence principle. Although, theoretically, the status of a holder's right is uncertain before the honoring of a letter of credit, yet the credibility of a letter of credit could be seriously jeopardized if a good-faith holder's expectance could still be undermined arbitrarily after the acceptance of credit.

At the same time, the acceptance credit held by a fraudulent third party cannot constitute an exception to the fraud exception rule. To apply the fraud exception rule against a fraudulent third party is to protect the equal rights and interests of an applicant. The fraud exception rule should be applied in order to prevent a beneficiary from abusing the exceptions to the fraud exception if they collude with a third party to defraud. It protects the equality between different transaction parties and banks' credibility, and maintains trade order. Moreover, it is in compliance with other Chinese legislation and foreign countries' laws. For instance, the UCC emphasize the third party's good-faith in § 5-109 (a) (1), that

“the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.”¹⁷⁹

¹⁷⁹ Op.cit.n.7.

3. The Ignorance of Third Parties' Fraud

There is no doubt that the beneficiary or applicant's fraud could give rise to the fraud exception rule. However, with regard to the third party's fault reflected on presented documents, there is no consistent opinion of whether or not it can also cause the fraud exception rule. British law believes that if the buyer had no knowledge of the third party's fraud, the fraud exception rule cannot be applied. Its classic precedent is the *United City Merchants v. Royal Bank of China* and the rationale lies in the premise repeatedly emphasised by the British courts that a letter of credit is the lifeline of international business. Nevertheless, Chinese law fails to regulate whether a third party's fraud can give rise to the application of the fraud exception rule.

(1) Proposed Amendments under Normal Circumstance

Normally third parties' fraud cannot bring about the application of fraud exceptions when the third party is not the holder of the credit. The first reason for this is that it is consistent with most foreign laws and international instruments, adopting a universal standard for China's integration into the international market, especially after its accession to WTO.

Secondly, for China, in order to become a financial centre, the reputation of credits and promissory notes is significant. Just as the Hong Kong scholar Yang Liangyi said, the operation of international trade is the

same as the flow of blood. The courts' frequent and unreasonable intervention is likened to a foreign body obstructing the vein, jeopardizing people's confidence in Chinese banks and, consequently, hampering China's international business.¹⁸⁰ The exclusion of third parties' fraud as a cause of the fraud exception rule can encourage other parties, such as brokers, negotiating banks and confirming banks to participate in the credit trade.

As for the concern about unbalanced protection of an injunction's applicant, this can be solved by other legislation, such as the *Negotiable Instruments*. The applicant can set up a defence against the malicious holder, according to Article 13 of the *Negotiable Instruments* which states, "A person liable for a negotiable instrument may not set up against the holder such defences that are available as between himself and the drawer or between himself and the holder's prior party or parties, unless the current holder acquires the instrument with knowledge of the defences."¹⁸¹ The opposite party of the applicant in credit relationship, on the other hand, cannot completely detach its responsibility from the third party's action to assist the applicant's reimbursement from the third party. Pursuant to Article 14 Para 3 of the *Negotiable Instruments*, "Where other particulars recorded on a negotiable instrument have been altered, a signer thereto before the alteration is made shall be liable for the particulars originally recorded, a signer thereto after the alteration is made shall be liable for the altered particulars. Where it

¹⁸⁰ Op.cit.n.12, p404.

¹⁸¹ Op.cit.n.175.

is hard to tell whether a signature is put before or after the alteration, it shall be deemed as one put before the alteration.”¹⁸²

(2) Proposed Amendments under Exceptional Circumstance

When the third party is the fraudulent party's agencies or carrier, the fraud exception rule should be applied.

The reason why the agencies' fraud will cause the application of the fraud exception rule is because they act on behalf of the real party. Where an agent is acting within his authority, his acts bind both his principal and the third party directly together. The legal effect of direct agency is that the agent's acts only create a legal relationship between the principal and the third party, whereas the agent himself withdraws without acquiring any rights or affording any liabilities. Therefore, the agency's fraud creates a direct legal effect on the principal's opposite party, just as the principal's own fraud, which will give rise to the application of the fraud exception rule.

When third parties are the carriers, the bearer of the third party's fraud should be the party which it is easiest to prevent fraud and request reimbursement. Normally, it depends on the type of trade. If the type of trade is FOB, FAS, FCA or EXW, in which risk and payment of carriage fall on a buyer, the buyer is the party who holds more information and is more likely to be reimbursed by the third party under a sales contract. In this case, in order to

¹⁸² Ibid.

protect the independence and predictability of the letter of credit, fraud exceptions against sellers would not be applied.

On the contrary, if the trade type is CIF or others in which sellers are responsible for the carrier and the risk of goods, the fraud exception rule against the sellers should be applied. One reason for this is if it is not done so, it would be very hard for the buyer to find the carrier and require reimbursement under either the letter of credit or the underlying sales contract since the buyer and carrier are not legally bound to each other. This means that without applying the fraud exception rule, the damage for the buyer would be irreparable. Secondly, it is consistent with the independence principle and the strict compliance rule in credit system. According to these two rules, as long as there is a documentary discrepancy, payment will be automatically refused, even when the discrepancy is caused by carriers. Because the relationship of payment under a letter of credit is only restricted to the holder of credit and a bank, a carrier is not considered a party, hence the holder has to bear the legal consequence of being refused. Also, this would require due diligence on the part of the seller to examine the documents and promote the prevention of fraud in a letter of credit. Therefore, in the long run, it is necessary, reasonable, and significant to apply the fraud exception rule against sellers in order to advance the improvement and amendment of international trade.

In China, more than eighty percent of international trade adopts the

letter of credit as the payment instrument.¹⁸³ Due to the defects of existing legislation, however, there has been considerable confusion in legal practice. Therefore, it is urgent for China to amend relevant rules regarding the fraud exception rule and finally establish a complete and consistent credit system.

¹⁸³ Op.cit.n.12.

Conclusion

The value of a letter of credit lies in the credit interests they afford to both buyers and sellers and in contribution to the efficiency of international trade. This value is derived from, and developed by, two basic principles: the independence principle and the strict compliance rule, both of which replace the parties' credit with banks' credit and thereby facilitate international trade. However, both the independence principle and the strict compliance rule must also leave room for fraud in letter of credit, which would damage both the parties' and the banks' credit. Therefore, in order to protect the credit interests of the parties of credit and the credit system itself, the fraud exception rule is very necessary and important.

1. A Review of the Fraud Exception Rule

(1) Reasons of the Fraud Exception Rule

The rationale of applying the fraud exception rule is mainly reflected in three theories. First, the good faith theory which requires honesty and faithfulness: without a doubt, the presentation of fraudulent or forged documents is against the principle of good faith. Therefore, credit fraud should be curbed and the fraud exception rule is necessary. Otherwise, the rigorous insistence of the independence principle would encourage fraud and consequently frustrate free trade. Second, the theory of *Fraus Omnia Corruptit*,

meaning fraud makes all invalid. It is one of the most basic legal principles: fraud in the letter of credit is no exception. Countries agreed that when fraud happens, based on social justice and business ethics, an exception to the independence principle is required. Also, the theory of public-order reservation, a general provision of conflict law regulated almost in every domestic law means a domestic law can exclude the implementation of other foreign laws or international practice if these rules violate the country's social interests, public orders, basic legal principles or good customs. Honesty and faithfulness are broadly recognized as basic legal principles in different countries, so when fraud occurs, domestic laws can exclude the application of UCP 600 which is the absence of the fraud exception rule, and apply their domestic rules to prevent frauds.

(2) Applicable Criteria to the Fraud Exception Rule

In order to achieve a balance between punishing fraudulent persons and protecting the efficiency and credit interests of letters of credit, certain standards need to be satisfied when applying the fraud exception rule. Firstly, with respect to its determination, fraud in a letter of credit is not only limited to fraud in bills of lading, invoice and other documents, but also extends to fraud committed in sales contracts. Additionally, fraud must be substantial and have had actually happened. The fraudulent person has to intentionally commit fraud or at least has knowledge of the existence of fraud. Secondly, it should

be noted that the fraud exception rule can be only raised against fraudulent persons, but cannot be applied to honest sellers or good-faith third parties. The rationale of the exceptions to the fraud exception rule lies in the objective to effectively protect good-faith holders of credits and to promote the flow of letters of credit.

(3) Judicial Remedies of the Fraud Exception Rule

When fraud occurs, the judicial remedies of the fraud exception rule are normally implemented by banks' rejection of payments, which are mainly requested by courts' injunctions. The bank's rejection of payment is a right, rather than solely a legal obligation or even a combination of a right and an obligation. Banks have the right to refuse to pay. However, in order to achieve a balance between security and efficiency under a letter of credit, this right can be executed only under certain circumstances. First, the bank's rejection requires a specific object. It means a rejection of payment can only be raised against fraudulent persons, but not against good-faith third parties such as negotiating banks and draft-holders. Second, the execution of the rejection must be based on sufficient evidence and reasons. Third, the rejection must be executed after the presentation of documents and take place within a statutory time limitation, since efficiency is the key characteristic of a letter of credit. Lastly, the exercise of rejection must comply with statutory procedures.

2. The Fraud Exception Rule in China

In China, there is no specific legislation on letters of credit. Besides referring to the UCP, fraud cases in letters of credit are reviewed mainly pursuant to the Chinese Civil Law, the judicial interpretation of the Supreme People's Court, and relevant regulations of the People's Bank of China. Unfortunately, the relevant regulations in these laws are inconsistent with each other, which further causes the ambiguity and inconsistency in legal practice. Amendments within the Chinese credit system are necessary in order to prevent such legal ambiguities.

(1) Existing Defects and Proposed Amendments of Chinese Procedure Law

a. The Issuing Institute of an Injunction

In China, with respect to the issuing institute of an injunction, there is a conflict between various laws as well as between legislation and legal practice. Pursuant to the 1989 summary, only the People's Courts have the right to issue an injunction. However, according to *the Criminal Procedure Law of China* and *State Security Law*, in addition to the People's Courts, the power to issue freezes also extends to the Procurator, the National Security Institute and the police. Moreover, in legal practice, all four of these institutions have issued freezes on payments under letters of credit. This thesis argues that only People's Courts should have the right to issue an injunction

under a letter of credit and that amendments should be made to the law so as to prevent these other institutions from issuing freezes. Firstly, it can prevent banks from abusing the right to issue an injunction, which would consequently guarantee the banks independent status and be the main function of a letter of credit. This regulation would also become consistent with other foreign countries' laws and international practice. Finally, the reason these other institutions have been granted the power to issue freezes is mostly due to the misleading term "freeze".

b. Remedies under the Fraud Exception Rule

In the Chinese legal system, there is a lack of specific and systematic legal regulation of the fraud exception rule. This can be seen in the terminology used for the remedy of the fraud exception rule as it is both confusing and inconsistent. The measure for applying the fraud exception rule in China should be amended, unified and improved with reference to the rules of injunction under American and British laws. The word "freeze" in the 1989 Summary is quite misleading. A freeze is a unique measure of property preservation, while the object of the so-called "freeze" should be the banks' payment behaviour, which falls under the acts preservation. This confusion in terms further leads to misunderstandings in the legal practice. It causes the courts to misunderstand the object of a freeze and to frequently refer to the regulation of property preservation, whose application criteria are relatively simple and unrestricted, to enjoin banks from paying.

(2) Existing Defects and Proposed Amendments of Chinese Substantive Law

a. The Extent of Fraud

With regard to the boundaries of fraud, most countries adopt a strict standard. This thesis asserts that Chinese legislation should refer to the British law and American law and also adopt a stricter standard. Not only would this effectively prevent parties from abusing the fraud exception rule to evade their responsibilities. But it would also protect Chinese banks' reputation. In addition, a profuse number of judicial interventions would doubtlessly shake the independence principle and affect the efficiency of credit.

b. Exceptions to the Fraud Exception Rule

With regard to the exceptions to the fraud exception rule, the relevant Chinese law is too general and conflicts with other legislation such as the defence mechanism in *Negotiable Instruments*, especially with regards to the acceptance of a letter of credit. This thesis argues that the acceptance credit should only be used as an exception to protect good-faith holders. If a holder of credit intends to cheat or is aware of any fraud, the fraud exception rule should be applied, in order to prevent a beneficiary from abusing the exceptions to the fraud exception that colludes with a third party.

c. The Ignorance of Third Parties' Fraud

There is no doubt that the beneficiary or applicant's fraud could give

rise to the fraud exception rule, however, there is no consistent opinion with regards to the third party's fault reflected on presented documents. This thesis maintains that normally third parties' fraud should not cause the application of fraud exceptions when the third party is not the holder of the credit. This would build some consistency with Chinese and most foreign laws and international instruments as well as protect China's credit reputation as a possible future financial centre.. Also, its defects of the imbalanced protection of the applicant can be made up by other legislations. Nevertheless, when the third party is the fraudulent party's agencies or carrier, the fraud exception rule should be applied.

In short, in order to maintain a good reputation in international trade and to fully integrate into the global economy and technology, China must refer to relevant foreign domestic laws and international practice to establish a complete and unified credit system.

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