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Fraud in Documentary Credit, Letter of Credit and Demand Guaranty

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Fraud is a notion frequently encountered in the field of law. Roughly speaking, fraud is a concept employed when a legal rule or a legal right is enforced in bad faith and that enforcement damages the interests of another individual or the interests of the public at large. In the commercial arena, fraud can be encountered in any number of contexts. This paper deals primarily with fraud in the context of fraudulent demands for payment under documentary letters of credit and non-documentary demand guaranties. Broadly speaking, letters of credit and demand guaranties secure to the beneficiary a right to payment from a financial intermediary, such as a bank. When a party presents a demand for payment under one of these arrangements, the “fraud exception” is often used to justify nonpayment on a letter of credit or demand guaranty or as a means to object to a payment that has already been made. In essence, the fraud exception preserves ethics when a conflict occurs between ethics and law.

It is not surprising that the fraud exception becomes crucial in cases where a right to payment may be exercised with only minimum requirements for authenticating the alleged creditor’s claim. Such situations occur in transactions involving letters of credit, both commercial letters of credit and stand-by letters of credit, and independent guaranties. The beneficiary of such a letter or guaranty has a right to be paid upon a simple demand or a presentation of the documents that conform to those named in the issuing letter. Only fraud in the underlying arrangement or documents can explain the refusal to pay the beneficiary his due.

What acts constitute fraud in transactions involving letters of credit and demand guaranties? This point was addressed long ago in several jurisdictions. A common situation addressed by early

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cases was one in which a seller, the beneficiary of a documentary credit, intentionally sent nonconforming goods instead of the valuables ordered by the buyer and named in the transaction documents. The rule *fraus omnia corrumpit*, which is clearly grounded in ethics, emerged from these cases indicating that such behavior is fraudulent and that a beneficiary who is guilty of fraud is not entitled to payment under the documentary credit instrument. This rule holds even if all the documents are correct, which is generally the only condition to payment of a documentary credit.

In my opinion, this ethical conception of fraud, implying bad faith on the part of the beneficiary, is too restrictive and should no longer prevail. I shall try to justify this opinion in Part I of this paper by defining the elements of fraud. Part II will then address the consequences of fraud.

I. Notions of Fraud

A. *Distinguishing Between Fraudulent Letters of Credit, Fraudulent Guaranties and Fraudulent Execution.*

Practitioners within the industry know that some letters of credit or guaranties are fraudulent, having been issued either by swindlers, claiming to be first-class banks, or by insolvent issuers. Such behavior is unseemly and blameworthy, however, it is not really characteristic. More typical is a fraudulent demand for payment by the beneficiary of a letter of credit or demand guaranty.

B. *Documentary and Non-Documentary Undertakings*

The fraud analysis is relatively easy when discussing documentary instruments, such as commercial letters of credit and stand-by letters of credit. If the documents themselves are inadequate, in that they do not give a fair description of one or even several elements necessary to perform the contract, then a suspicion of fraud is raised.¹

The situation is very different for non-documentary undertakings, such as demand guaranties, in which the beneficiary has only to demand payment on a bank without presenting documentary authorization. The beneficiary need not mention or justify the basis for the demand. While the letter of credit and the

1. For example, a documentary credit should include elements such as the nature, quality, quantity, condition, and packaging of the goods.

demand guaranty differ in form, there is no real legal difference between the two when fraud is an issue. In both cases, the beneficiary claims money to which he is not lawfully entitled. In the first case, there is an express assertion of the legal grounds for the demand. In the second case, the assertion is implied.

C. Statutory Data, the Definition of Fraud, and the ICC Regulation.

There is no mention of fraud in the International Chamber of Commerce (ICC) regulation. Neither the ICC Uniform Customs and Practices for Documentary Credits² nor the ICC Uniform Rules for Demand Guaranties³ address the issue of fraud. Rule 1.05 of the International Stand-By Practices⁴ leaves the issue of fraud to the applicable law.⁵ The absence of rules and regulations discussing fraud is not difficult to explain. Rightly or wrongly, fraud is traditionally an issue involving public policy, *ordre public*, which precludes regulation by a professional authority.

D. The United Nations Convention on Independent Guaranties and Stand-By Letters of Credit.

Article 19 of the United Nations (UN) Convention on Independent Guaranties and Stand-By Letters of Credit,⁶ contains a description of the situations in which a guarantor or issuer can rely on the fraud exception to deny payment to the beneficiary.⁷ The guarantor or issuer has a right to withhold payment from the beneficiary of the guaranty or stand-by letter of credit if it is clear that:

- (a) One or more of the documents involved in the transaction are not genuine or have been falsified;
- (b) No payment is due based on the demand asserted in the documents supporting the transaction; or
- (c) No basis exists for the demand because of the type and purpose of the transaction.

2. See ICC Uniform Customs and Practices at 500.

3. See ICC Uniform Rules at 458.

4. See ISP98 Rules.

5. See, e.g. James E. Byrnes, Official Commentary, 1998 at p.19.

6. Enforceable January 1, 2000.

7. The word "fraud" is not defined in the Convention itself but it appears in the Explanatory Note by the UNCITRAL Secretariat (§ 45).

Section 2 of Article 19 mentions several situations in which a demand for payment may have no conceivable basis. This includes situations where:

- (1) the contingency or risk against which the beneficiary is secured has not materialized;
- (2) the underlying obligations have been declared invalid by a court or arbitral tribunal;
- (3) the underlying obligations have been fulfilled to the satisfaction of the beneficiary;
- (4) fulfillment of the underlying obligations were prevented by the willful misconduct of the beneficiary; and
- (5) the beneficiary of the counter-guaranty has made payment in bad faith.

E. The Case Law: Stand-by Letters of Credit and Independent Guaranties.

In many countries, the courts have arrived at a definition of fraud in the context of cases in which the account party or the issuer attempted to use the fraud exception to justify nonpayment on a letter or credit or demand guaranty or as a means to object to a payment that has already been made. French case law has many cases factually similar to the scenarios mentioned in Article 19. There is limited value in expounding on the case law however, because the solutions and rules found in the UN Convention closely mirror the established case law.

F. Fraud in the Context of Article 19

There appears to be a common notion of fraud implied in all of the Article 19 scenarios mentioned earlier. In each scenario, the guarantor or the issuer can withhold payment if an objective basis exists for refusing the beneficiary's demand. For example, a French court granted the fraud exception where the beneficiary of a demand guaranty demanded payment even though the beneficiary's own engineer signed a certificate of good performance on the equipment sold by the account party.⁸ Clearly there is a link between the beneficiary's behavior and the justification for the guarantor's refusal to pay. However, neither Article 19 of the UN

8. C.COM., June 10, 1986, Banque Tejarat, Société / SA Pipe Line Service and Banque de Paris et des Pays-Bas, D.1987.jur.17 note Vasseur. See also, C.COM., January 20, 1987, Sté Technique Electrique de l'Oise / Union Méditerranéenne de banque et Wahda Bank, JCP.1987.II.20760 note J. Stoufflet.

Convention nor decisions of the courts view the fraud exception as punishment for bad faith or fraud in the common meaning of the term. Rather, the fraud exception acknowledges an objective reality or a strong probability that the demand for payment is not legitimate. This analysis is confirmed by the application of the fraud exception to transactions involving documentary credits.

G. The Case Law: Documentary Credits.

To define fraud in the area of documentary credits, one must refer exclusively to the documents. The *Cour de cassation* of France has held that a documentary credit should be paid if the beneficiary presents regular credit documents even if the account party claims a fraudulent contract of sale.⁹ In the *Banque de Neuflyze Schlumberger* case, it was argued that a fraud exception exists in cases where there is fraud in the commercial contract if the issuer's undertaking in a documentary credit is independent from the sales contract. The *Cour de cassation* did not accept this position.

H. A Proposed Solution

In my opinion, fraud should not to be considered an ethical matter in the area of documentary credits, letters of credit and guaranties. Rather, fraud is really a technical issue. Under this formulation, it is difficult to understand why fraud in the underlying obligation has no effect on the right to payment by the credit beneficiary.

Consider a case in which an account party attempts to take advantage of a fraud when the fraud has been perpetrated by a third person and not by the beneficiary. Under my formulation, courts would be able to look behind the seeming regularity of the transaction to uncover and address the underlying fraud. The prevailing opinion in France favors of this argument, however, French courts have not clearly decided the issue. In contrast, English courts consider charging the beneficiary with fraud only when the beneficiary himself commits the fraud. In the *American Accord* case, the House of Lords held that an issuing bank must pay a documentary credit if the beneficiary presents the documents in

9. See C.COM., July 15, 1992, *Banque de Neuflyze Schlumberger, Mallet / The Hong Kong and Shanghai Banking Corp.*, arrêt n.1366 not published; See also C.COM., April 29, 1997 *Société des Automobiles Peugeot / Falcon Deutschland, BNP and others*, JCP.E 1997.II.976. note J. Stoufflet.

good faith, even if an agent of the carrier had antedated the bill of lading.¹⁰

I. Courts Should View Fraud Objectively

In my opinion, there are strong reasons for courts to look objectively at fraud in transactions involving documentary credits, stand-by letters of credit and demand guaranties. It should not be necessary to prove that the beneficiary had malicious intent or that the beneficiary acted in bad faith. This position has some consequences as to the effects of fraud.

II. The Effects of Fraud

A. When a Bank is Aware of Fraud, that Bank May Refuse Payment

When a bank is certain that fraud is present, it may refuse payment to the beneficiary. This solution works well in the case of documentary credits because fraud can be presumed when one or more of the documents lack authenticity. If it is clear that the documents are not regular then payment is not due. The same principle applies to stand-by letters of credit and guaranties under Article 19 of the UN Convention.¹¹ The bank's decision is based solely on objective criteria and not on notions of the good faith or fraudulent behavior of the beneficiary. Problems can arise however, with certain types of credit and in the bank's relationship with the account party.

B. Documentary Credit by Negotiation.

A documentary credit is an undertaking to pay a sum of money or to accept or to negotiate a draft. In the case of a draft, problems arise when a fraud is discovered between the date of negotiation and the date of maturity of the draft. Does the negotiating bank or the account party have the right to assert fraud after a negotiation by a corresponding bank or by the issuer? One French court has decided that no such right exists because the negotiation

10. *Royal Bank of Canada v. United City Merchants*, House of Lords, May 20, 1982. The Belgian Court of Appeal of Anvers took the same position in a case on September 23, 1981 (*Revue de droit commercial belge* 1986 p.369).

11. If it is manifest and clear that: a) Any document is not genuine or has been falsified b) No payment is due . . . the guarantor/issuer, acting in good faith, has a right as against the beneficiary to withhold payment.

constituted the performance of the credit and could not be considered as a discount.¹²

C. Deferred Payment Credits

Similar difficulties are encountered in another kind of credit called deferred payment credit. In a deferred payment credit, the beneficiary receives the amount of the credit at some time after the presentation of the documents. What happens when a fraud is discovered after the bank receives the documents but before payment to the beneficiary? Unlike negotiation credits, performance of a deferred payment credit occurs only on the date the credit is paid and not when the documents are presented to the bank. Therefore, receipt of the documents by the bank does not prevent the account party or the issuer from asserting fraud during this interim period. This is possible even against the confirming bank that paid a deferred payment credit in advance.¹³

D. Position of an Issuer as Compared to an Account Party

This situation poses a difficult question. Practically, when an account party, relying on immediately available evidence, is able to show that it is likely that a beneficiary has made or will make a fraudulent demand, the account party can petition the court for a provisional measure. Article 20 of the UN Convention allows parties to stand-by letters of credit, demand guaranties, and documentary credits to petition the courts for provisional measures. Can the account party assert that the bank should have refused to pay in situations where the bank was aware of the fraud and paid the beneficiary anyway? If a fraud is manifest and clear, the bank has a right, as well as an obligation, to withhold payment. Article 19 of the UN Convention does not resolve this issue. That Article deals only with the relationship between the guarantor or issuer and the beneficiary and does not address the relationship between an account party and an issuer. French courts seem to be in favor of placing an affirmative obligation on the bank to refuse payment when fraud is present. The case law, however, is unclear.¹⁴

12. Cass.Com. October 23, 1990 *Crédit du Nord / Sté Standing Meubles*, Bull.civ.1990.IV.n.242, JCP.G.1991.II.21687 note Vasseur.

13. C.COM., April 7, 1987 *Crédit Général / BNP*, Bull.civ.1987.IV.n.84, JCP.G.1987.II.20829 note J. Stoufflet; *See also* App. Cas., Queen's Bench Div., February 25, 2000, *Banco Santander / Banque Paribas*.

14. C.COM., December 2, 1997, *Banque IndoSuez/ SA Entrepose*, JCP.E 1999.758 n.26 obs. Gavalda et Stoufflet; CA.Colmar June 14, 1985,

Personally, I think that a bank has an obligation to refuse payment if there is no doubt about the existence of fraud at the time the payment is due. Banks have a general duty to act in accordance with their customer's interests.¹⁵

III. Conclusion

What relevance does fraud have to letters of credit and guaranties? Sometimes demands for payment are fraudulent. However, what is usually called fraud in this context is really something else, an objective and more extensive concept. The guarantor or issuer may refuse payment when a beneficiary demands payment to which that beneficiary has no right. Therefore, the question should not be one of bad faith or fraud, but rather one of limiting of the independence of the guarantor or issuer in the undertaking.

D.1986.inf.rap.218 obs. Vasseur, JCP.G.1986.I.3265 n.112 obs.Gavalda et Stoufflet.

15. See, e.g., Nicolas de Gottrau, *Le crédit documentaire et la fraude*, Geneva Faculty of Law, nr 719, Helbing & Lichtenhahn, 1999 p. 242.