

THE TWO IMPORTANT DOCTRINES UNDERLYING DOCUMENTARY LETTERS OF CREDIT AND THE FRAUD EXCEPTION

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1 Introduction

Documentary letters of credit are important tools in relation to international trade. The parties who make use of these instruments usually come from different countries and usually have different views on trade and customs. The parties generally do not know each other personally and have opposite interests in relation to the contract of sale. There is a sense of distrust towards each other, as both parties have serious concerns as to the other's performance in terms of the contract. While the purchaser has a fear of receiving goods of an incorrect quantity or quality, or not receiving goods at all, the seller fears non-payment, or that the buyer refuses to accept the goods on a mere technicality.¹

Coupled with the abovementioned is the fact that legal recourse will be expensive and may be complex taking jurisdiction into consideration. A documentary letter of credit eases some of these fears due to the unique doctrines which form the foundation of this instrument, and these will be discussed at length. The most frequently encountered exception to documentary letters of credit not being fulfilled is that of fraud, which will also be discussed at length.

2 The definition of and the parties to documentary letters of credit

A documentary letter of credit is an undertaking between three or more parties.² The parties are traditionally the account party or applicant, being the buyer or importer; the opening bank or issuing

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¹ R Sarkar *Transnational Business Law: A Development Law Perspective* (2003) 17.

² Sarkar (n 1 above) 18.

bank, being the applicant bank; and the beneficiary, being the seller or exporter.³ In some instances the letter of credit may be electronically issued to the beneficiary who presents the draft and documents to any local bank willing to negotiate them for him.⁴ In this event, the issuing bank sends the letter of credit to one of its correspondent banks in the same locality of the exporter. This correspondent then becomes the advising bank, the paying bank and the confirming bank.⁵ The correspondent bank is the advising bank as it informs the beneficiary that the letter of credit has been opened in his favour.⁶ It is the paying bank who may be authorised to pay the beneficiary in local currency when presented with the proper documentation. This correspondent bank in its capacity as advising or paying bank may be required to add its own name to the letter of credit for which it charges the opening bank a fee. In this way the arrangement becomes a confirmed letter of credit where two banks are committed to pay, and thus the correspondent bank also becomes the confirming bank.

2.1 The distinguishable contractual relationships

The most important parties are: the issuing bank, which makes payment on behalf of the applicant to the beneficiary and is therefore a correspondent; and the paying bank, the advising bank and the confirming bank, being different terms for the same bank. Therefore, when dealing with this instrument there are at least three distinguishable contractual relationships present. Firstly, there is the contract between the beneficiary and the applicant.⁷ Secondly, there is the contract between the applicant and the issuing bank.⁸ Thirdly, there is the letter of credit contract between the issuing bank and the beneficiary.⁹ Lastly, there is the contractual relationship described above, between the advising bank and the issuing bank.¹⁰ All of these contracts are completely independent.

2.2 Operation of documentary letters of credit

The issuing bank promises to pay the beneficiary upon presentation of certain documents. Therefore, in simple terms, it is a letter addressed to the beneficiary that is written and signed by the bank

³ Sarkar (n 1 above) 20.

⁴ As above.

⁵ As above.

⁶ As above.

⁷ JP van Niekerk & WP Schulze *The South African law of international trade: Selected topics* (2006) 292.

⁸ As above.

⁹ As above.

¹⁰ As above.

acting on behalf of the applicant.¹¹ In accordance with the letter of credit, the applicant bank will agree that it will accept drafts under the letter of credit if the beneficiary strictly complies with terms set forth under the letter of credit.¹² The beneficiary in most cases is asked to provide certain documents together with the draft.¹³ Examples of these documents are negotiable bills of lading, insurance papers, commercial invoices, a draft of a bill of exchange, a government-issued or other legal document which indicates that the goods are ready for export, an inspection certificate, and any other document that may be specifically required.¹⁴ In this way the issuing bank stands in for its customer, being the applicant, by agreeing to pay the beneficiary, as long as the conditions in terms of the letter of credit are fulfilled.¹⁵ The use of a documentary letter of credit has several advantages for the beneficiary.¹⁶ The beneficiary does not have to ship the goods until the account party has opened the letter of credit and it has received the advice of issuing from the bank.¹⁷

2.3 Legal effect of the issuing of a documentary letter of credit

Since the letter of credit in effect means that the bank will now pay the beneficiary on behalf of the applicant, one needs to question whether, firstly, this constitutes an absolute payment by extinguishing the original debt; and secondly, if so, does the beneficiary have the option of ignoring the letter of credit and merely claiming from the applicant?¹⁸

The abovementioned is of pivotal importance when the issuing bank becomes insolvent or is unwilling to pay.¹⁹ As to the question regarding whether this constitutes absolute payment, one needs to remember that for this to happen, novation needs to take place.²⁰ Novation occurs when the earlier obligation is discharged and replaced with a new one.²¹ Therefore all three parties – namely the issuing bank, the applicant and the beneficiary – must all intend to extinguish the existing debt and replace it with a new one.²² Unless there is a clear intention of novation evident from express wording of the contract of sale and letter of credit or the surrounding

¹¹ As above.

¹² As above.

¹³ As above.

¹⁴ Sarkar (n 1 above) 19.

¹⁵ As above.

¹⁶ S Schnitzer *Understanding international trade law* (2006) 80.

¹⁷ As above.

¹⁸ Van Niekerk & Schulze (n 7 above) 293.

¹⁹ As above.

²⁰ Van Niekerk & Schulze (n 7 above) 295.

²¹ As above.

²² As above.

circumstances, the applicant and the issuing bank are liable towards the beneficiary.²³ It is accepted in our law that when a letter of credit is accepted by a beneficiary, it operates as a conditional payment and not an absolute payment.²⁴

3 Doctrines underlying documentary letters of credit

There are two fundamental principles underlying documentary letters of credit namely the autonomy of the credit and the doctrine of strict compliance. These principles are unique and characteristic of this instrument.

3.1 *Autonomy of the credit*

When looking at the principle of autonomy, all the undertakings in respect of the documentary letter of credit between the parties are considered to be independent from each other. As such, even though all these undertakings are related, failure to fulfil one undertaking does not render the next undertaking unenforceable.²⁵ The doctrine of autonomy has been entrenched in article 3 of the Uniform Customs and Practice (UCP), which states that letters of credit by nature are independent from the contract of sale or any other contract on which they may be based.²⁶ Article 3 also states that banks are in no way concerned with or bound by the underlying contract, even if the letter of credit contains a reference to the underlying contract. Due to this, the undertaking by the bank to pay in cash or to accept and pay bills of exchange or drafts, or to fulfil any other obligation under the letter of credit, is not subject to claims or defences by the applicant resulting from its relationship with the issuing bank or with the beneficiary.²⁷ At the same time the beneficiary cannot avail itself of the contractual relationship existing between the applicant and the issuing bank.²⁸

The doctrine of autonomy underpins the character of the letter of credit in international trade as an independent and separate undertaking by the bank to pay the beneficiary.²⁹ The doctrine serves as a deterrent in a situation where the applicant wants to litigate, due to the beneficiary's breaching the contract, and the applicant seeks

²³ Van Niekerk & Schulze (n 7 above) 296.

²⁴ Van Niekerk & Schulze (n 7 above) 294.

²⁵ Sarkar (n 1 above) 32; Van Niekerk & Schulze (n 7 above) 306.

²⁶ Van Niekerk & Schulze (n 7 above) 306.

²⁷ Van Niekerk & Schulze (n 7 above) 306.

²⁸ Van Niekerk & Schulze (n 7 above) 307.

²⁹ *Phillips & Another v Standard Bank of South Africa & Others* 1985 3 SA 301(W); Van Niekerk & Schulze (n 7 above) 307; Schnitzner (n 16 above) 86.

to interfere with the issuing bank's payment to the beneficiary even though all the conditions on the letter of credit have been met.³⁰

The issuing bank must not concern itself with the underlying dispute. Therefore the issuing bank must pay under the letter of credit regardless of whether the underlying goods that are the subject of the sales contract between the applicant and the beneficiary conform to the conditions of sale.³¹ All that matters is that all the conditions set out in the letter of credit are fulfilled.³² This means that the confirming bank is obligated to the opening bank and the beneficiary alone.³³ The applicant lacks privacy with the confirming bank based on the letter of credit.³⁴ The applicant's only recourse lies with the issuing bank, which can institute an action against the confirming bank for wrongful honour or dishonour of the draft.³⁵ The same can be said with regard to all the other obligations in relation to each party. As mentioned above, the conditions that the seller has a duty to fulfil prior to payment take the form of documents that need to be handed in to the bank. Because most of the evidentiary material take the form of documents, it is possible to obtain summary judgment against a bank that does not honour its obligation to pay.³⁶

3.2 *Caselaw which illustrates the autonomy principle being upheld: Ex parte Sapan Trading (Pty) Ltd*³⁷

In this case, the applicant tried to stop payment of an irrevocable letter of credit to the beneficiary by obtaining an attachment of the beneficiary's claim against the issuing bank in order to found or confirm jurisdiction.³⁸ The Court found that there was no real difference between a situation where the bank is interdicted from paying the beneficiary in its own country, and a situation like this one where the applicant attempted to prevent the issuing bank from effecting payment in a foreign country by rather forcing it to effect payment to the local deputy sheriff who would receive the money on behalf of the beneficiary.³⁹ The Court further contended that an *incola* has the right to attach the property of a *peregrinus*, and that the Court has no discretion in the matter. The Court solved this problem by reading a term into the relationship between the applicant and the beneficiary, in that the applicant by arranging for an irrevocable letter of credit implied that he would not attempt to

³⁰ Van Niekerk & Schulze (n 7 above) 307.

³¹ Sarkar (n 1 above) 33.

³² Schnitzner (n 16 above) 87.

³³ Sarkar (n 1 above) 33.

³⁴ As above.

³⁵ As above.

³⁶ Schnitzner (n 16 above) 87.

³⁷ 1995 1 SA 218 (W).

³⁸ As above.

³⁹ As above.

attach the proceeds from the letter of credit.⁴⁰ This case indicates how firmly entrenched this principle is in our law.

3.3 *Doctrine of strict compliance*

This doctrine provides that the bank can reject any document which is not in strict conformity with the terms set out in the documentary letter of credit.⁴¹ Therefore, firstly, the letter of credit deals purely with documents.⁴² Secondly, this doctrine demands that the documents which are tendered by the beneficiary must be in strict conformity with the terms and conditions of the letter of credit.⁴³ This doctrine is also entrenched in the UCP.⁴⁴ Article 4 provides that in a letter of credit transaction, all the parties concerned deal with documents and not with the goods, services or other performances to which the documents relate.⁴⁵ The issuing bank relies solely on what appears on the face of the documents presented to it by the beneficiary to determine whether the conditions in the letter of credit have been complied with.⁴⁶ The banks that deal with finance, and not with goods, are not aware of all trade customs and usages.⁴⁷ Their expertise extends as far as dealing with the documents, and therefore they do not get embroiled in the facts and practices of a particular trade.⁴⁸ As far as the standard of examination in arranging for the carriage of goods overseas is concerned, the beneficiary needs reassurance that the standards applied by banks in scrutinising documents will not vary from country to country.

3.4 *Effects of the doctrine of strict compliance*

The doctrine of strict documentary compliance requires not only that the tendered documents conform to the terms and conditions of the documentary letter of credit, but that they appear on their face to be consistent with one another. This requires that all the documents are consistent with one another in the sense that they make up a set that apparently refers to the same container of goods. A measure of certainty is needed because, if the documents are rejected, this is likely to cause delay and expense in selling the goods elsewhere. The UCP appears to confirm this view by making reference to international standard banking practice. Therefore the overall effect of the doctrine of compliance is that the bank honouring the documentary

⁴⁰ As above.

⁴¹ Schnitzner (n 16 above) 87.

⁴² Van Niekerk & Schulze (n 7 above) 309.

⁴³ As above.

⁴⁴ As above.

⁴⁵ As above.

⁴⁶ As above.

⁴⁷ Schnitzner (n 16 above) 87.

⁴⁸ As above.

letter of credit must strictly conform to the conditions set out in the letter of credit, and should the documents handed in by the beneficiary not meet this criteria then the bank must not pay out.⁴⁹ Therefore the required standard is that of strict conformity.⁵⁰

The other component to this doctrine as emphasised above is that the bank deals purely with the documents.⁵¹ It is contended that even if the deviation from the letter of credit is small, the bank must refuse to pay.⁵² If the bank pays on non-conforming documents, then it has not fulfilled its mandate towards the applicant.⁵³ The doctrine of strict compliance does not mean that all of the T's in the credit must be crossed and all of the I's dotted. As stated by the Court in *Angelica-Whitewear*,⁵⁴ 'there has apparently been recognition that there must be some latitude for minor variations or discrepancies that are not sufficiently material to justify a refusal of payment'. Due to the fact that the issuing bank deals solely with the documents, it is of no relevance that the goods received by the applicant are not of the quality or quantity as described in the contract.⁵⁵ Therefore, slight discrepancies can and must be disregarded if the instructions on the documents make sense regardless.⁵⁶

3.5 *Case law to illustrate these principles: Loomcraft v Nedbank and Another*⁵⁷

In this case, a documentary letter of credit formed the subject matter of a negotiable combined transport document. This was a start-to-finish document in that it covered every stage of the carriage of goods. By issuing a combined transport document the carrier accepted the responsibility of the performance of the combined transport. Where a creditor calls for a combined transport document and the other stipulations of the credit are met, a bank will only accept a transport document if the following criteria are strictly complied with:

- It appears to have been issued by a named carrier; or
- His agent indicates a taking in charge of the goods; and
- It consists of a full set of originals issued to the consignor.

Subject to the other stipulations of the credit, the bank may not reject the transport document because it indicates a place of taking charge different from the port of loading. An interdict restraining a

⁴⁹ Van Niekerk & Schulze (n 7 above) 309.

⁵⁰ As above.

⁵¹ As above.

⁵² As above.

⁵³ As above.

⁵⁴ 1987 1 SCR 59 (SCC).

⁵⁵ As above.

⁵⁶ As above.

⁵⁷ 1996 1 SA 812 (A).

bank from paying in terms of a credit will accordingly not be granted at the insistence of the buyer, unless it is an exceptional case. It is, however, well established that courts will grant an interdict restraining a bank from paying the beneficiary under a credit in the event of it being established that the beneficiary was a party to fraud in relation to the documents presented to the bank for payment.

The liability of the bank to the beneficiary to honour the credit arises upon presentation to the bank of the documents specified in the credit, including typically a set of bills of lading, which on their face conform strictly to the requirements of the credit. In the event of these documents being presented, the bank will only escape liability upon proof of fraud on the part of the beneficiary. The Court found that a mere error, misunderstanding or oversight, however unreasonable, does not amount to fraud in this case. This case is of great importance as it embodies the doctrine of autonomy as well as the doctrine of strict compliance.

4 The fraud exception

4.1 Content of the exception

The exception of fraud applies to the doctrine of autonomy as well as that of strict compliance. Fraud, roughly speaking, refers to where a legal rule or interest is enforced in bad faith and that enforcement damages the interests of another individual or the interests of the public at large.⁵⁸ To determine what behaviour constitutes fraud, we can look at *fraus omnia corrumpit* which is clearly grounded in ethics and which indicates that a beneficiary who is guilty of fraud is not entitled to payment under the instrument.⁵⁹ Documentary letters of credit secure a beneficiary's right to payment from the respective bank involved.⁶⁰ When the beneficiary presents a demand for payment, the fraud exception is often used to justify non-payment where payment is not due to be made.⁶¹ The most common type of fraud in the context of documentary letters of credit is where the beneficiary has forged or deliberately falsified the documents in order to fulfil the conditions in the instrument.⁶² If the document itself is inadequate as far as the description of one or even several elements necessary to perform the contract, then a suspicion of fraud is

⁵⁸ J Stoufflet 'Fraud in documentary credit, letter of credit and demand guarantee' (2001) 106 *Dickinson Law Review* 21.

⁵⁹ As above.

⁶⁰ As above.

⁶¹ As above.

⁶² Van Niekerk & Schulze (n 7 above) 309.

raised.⁶³ There is no mention of fraud in the International Chamber of Commerce (ICC) Regulation.

4.2 Pertinent aspects of fraud

When dealing with fraud, there are two very important questions that need to be asked. Firstly, is the fraud by the beneficiary discovered before or after the bank pays on the letter of credit?⁶⁴ Secondly, was the fraud committed by the beneficiary on the documents or not?

4.2.1 Fraud discovered after payment⁶⁵

In this instance, the bank will not be liable and can recover the money from the applicant. This is where the bank has made such payment from its own funds. Where, however, payment has been effected from the applicant's own funds and the bank has merely paid it over to the beneficiary, the applicant will not have a claim against the bank. The nature of documentary letters of credit infer this kind of risk because of the difficulty the applicant will incur in attempting to recoup the money from the beneficiary.⁶⁶

4.2.2 Fraud discovered before payment⁶⁷

If the fraud is discovered before payment by the bank, the applicant may approach the court for an interdict to prevent payment. Where the forgery or falsification appears from the face of the documents, the bank is entitled to effuse payment even without court intervention. The basic principle behind both these scenarios is that the unscrupulous beneficiary should not benefit from the use of fraud by using the doctrine of autonomy or that of strict enforcement.

4.2.3 Case law to illustrate the above mentioned principle

A clear distinction needs to be drawn between fraud and innocent breach of contract.⁶⁸ This is obviously pivotal to fraud committed before and after payment, and fraud in general, as it would avoid unnecessary inconvenience and court proceedings if the two were clearly distinguishable.

⁶³ As above.

⁶⁴ As above.

⁶⁵ As above.

⁶⁶ *Phillips & Another v Standard Bank of South Africa Ltd & Others* 1985 3 SA 301 (W).

⁶⁷ Van Niekerk & Schulze (n 7 above) 313-314.

⁶⁸ Van Niekerk & Schulze (n 7 above) 314.

In the case of *Phillips and Another v Standard Bank of South Africa Ltd and Others*,⁶⁹ the South African applicant had imported shoes from an Italian manufacturer, and sought an interdict to prevent Standard Bank from paying as it discovered that some of the shoes were defective. The manufacturer who was willing to consider the complaints did not want to postpone payment. The Court, after reiterating the doctrine of autonomy, dismissed the application as there was no fraud on the part of the beneficiary. Instead it was found to be consistent with innocent breach of contract.

4.2.4 Fraud committed by the beneficiary on the documents

The fraud exception to documentary letters of credit has offered much insight where the forgery or falsification was committed on the document itself.⁷⁰ This is the so-called fraud 'in the narrow sense'. It stands to follow that courts are less likely to allow an interdict preventing a bank from making payment where fraud concerns the performance rather than the document, due to the doctrines of autonomy and strict compliance.⁷¹ There is uncertainty regarding whether we follow a system of fraud in the wide or narrow sense.

In *Loomcraft Fabrics cc v Nedbank Ltd*,⁷² the Court found that it was fraud in the narrow sense. However, the *Loomcraft* decision concerned fraud on the documents, and therefore the Court followed suit without considering anything else. Therefore, I agree that the *Loomcraft* decision cannot form the basis of the system of fraud which we follow.

In *Union Carriage & Wagon Co Ltd v Nedcor Bank Ltd*,⁷³ the Court remarked by way of *obiter dictum* that if the applicant and the beneficiary agreed that the beneficiary would not draw on the documentary letter of credit, and the beneficiary went ahead anyway, the beneficiary would be guilty of fraud.⁷⁴ This provides an indication that our courts may be prepared to look beyond the documentation in deciding on whether fraud has been committed.⁷⁵ I am of the opinion that fraud should be looked at in the wide sense. Because these international transactions usually concern large amounts of money, we should not allow the applicant to be defrauded merely because our courts often operate with blinkers on as it would be easier, and there would be less administration involved, if we just deliberate on the narrow sense.

⁶⁹ *Phillips* (n 56 above) 301.

⁷⁰ Van Niekerk & Schulze (n 7 above) 316.

⁷¹ Van Niekerk & Schulze (n 7 above) 317.

⁷² Van Niekerk & Schulze (n 7 above) para 3.5.

⁷³ 1996 CLR 724 (W).

⁷⁴ Van Niekerk & Schulze (n 7 above) 317.

⁷⁵ As above.

5 Conclusion

Documentary letters of credit play a vital role in international trade. They serve as an instrument that makes the effecting of cross-border payment effortless. The underlying doctrines of autonomy and strict compliance give certainty to the legalities embodied in the document of credit, and also indicate that the applicant should be well aware of what he is getting into before opting for this mechanism. As such, the impact of fraud should not be underestimated. It is my contention that our courts should consider fraud in the wide sense so as to afford the maximum protection to the party acting in good faith.