

This practice note explains the autonomy of letters of credit under English law and how the fraud exception to autonomy operates.

Introduction

It is well known that English law recognises the autonomy of a letter of credit, i.e. its independence from the underlying transaction for which it has been issued and any dispute in relation to it. The general principle is that a compliant payment demand must be honoured by the issuer of the credit subject only to the fraud exception (and, where applicable, to the doctrine of illegality). (These principles can also apply to instruments similar to letters of credit, such as on-demand guarantees.)

The Essence of the Fraud Exception

Under English law, in determining whether or not an interim injunction should be granted to prevent a bank from making payment under a letter of credit (or a similar instrument), the fraud exception is applicable if “there is a clear fraud of which the bank has notice”: as per Denning, L.J., in *Edward Owen Engineering Ltd. v. Barclays Bank* (1978) 1 Q.B. 159 at p. 171. In other words, the fraud exception requires the existence of two factors: (a) evidence of clear fraud; and (b) the bank’s knowledge of such (evidence of) fraud.

The issuing bank of a letter of credit may well be exposed (at least on a contractual basis) to liability to the party for whose account the letter of credit was issued (the “L/C applicant”) if it honours the beneficiary’s payment demand when they are aware that the payment demand is fraudulent.

Where the relevant paying bank is a correspondent bank (rather than the issuing bank) and the correspondent bank complies with the payment demand when they are aware that the payment demand is fraudulent, the correspondent bank **might** be exposed to liability to the L/C applicant. If English law governs the relationship between the L/C applicant and the correspondent bank, such liability could arise in tort, i.e. for breach of a duty of care potentially owed by the bank to the L/C applicant; although, English law is currently unclear as to whether this proposition is correct. In *United Trading Corporation S.A. v. Allied Arab Bank Ltd.* [1985] 2 Lloyd’s Rep. 554 (the *United Trading* case), Ackner, L.J., seems to have accepted that the proposition was arguable (see p. 560). In *GKN Contractors v Lloyds Bank and Rafidain Bank* (1985) 30 B.L.R. 48, a case involving performance bonds, Parker, L.J., indicated his doubts about whether such proposition was correct, but decided (taking the *United Trading* case into account) to proceed on the assumption that it was arguable.

Where an allegation of fraud is made against the beneficiary of a letter of credit, often the L/C applicant seeks an interim injunction against the paying bank to restrain payment.

Where such an injunction is sought from the English courts, even where the governing law of the letter of credit is the law of another jurisdiction, the courts will apply English law for the purpose of determining whether such injunction should be granted.

In cases where such an interim injunction is sought, to prove the existence of (a) evidence of clear fraud and (b) the bank’s knowledge of such (evidence of) fraud may not be sufficient to persuade the court to grant such injunction. The courts would also consider factors such as: whether the balance of convenience justifies the grant of such injunction (for example, whether the applicants could be adequately compensated in damages subsequently); and whether the conduct of the applicants for the injunction has been such as to make it inequitable to grant the interim injunction, which might be the case if they can be said to have consciously decided (at the time of applying for the opening of the letter of credit) to take risks as to the dishonesty of the beneficiary but did not inform the bank of such risks.

On an application for an interim injunction, the classic test under English law in this context is whether “it is **seriously arguable** that, on the material available, **the only realistic inference** is that [the Beneficiary] could not honestly have believed in the validity of its demands” (emphasis added) (per Ackner, L.J., in the *United Trading* case at p. 561).

The combination of this test and other factors such as the balance of convenience normally makes it extremely difficult to obtain such an injunction on the basis of the fraud exception, especially where the issuer of the relevant instrument is a bank, which would be invariably the case in the case of letters of credit.

The English Court of Appeal recently had an opportunity to determine an appeal based on the fraud exception. The Court held that where the L/C applicant had no **present** obligation under the underlying contract to pay interim invoices that had been validly issued (as payment of those invoices had not yet fallen due under that contract), it was open to the beneficiary of the letter of credit to assert (without dishonesty) in their payment demand under the credit that the L/C applicant was “obligated to pay” those invoices.

The Relevant Points in Time

For the purpose of the fraud exception, there is currently some uncertainty as to the latest point in time at which to assess dishonesty (if any) on the part of the beneficiary. In one recent decision, an English judge said that the latest point in time at which to assess dishonesty is the time of the presentation of the relevant payment demand (rather than the time for payment).

This proposition was challenged in the Court of Appeal in the same case but the Court of Appeal declined to debate it, as the Court had found for the appellant on other grounds.

On the other hand, it is settled under English law that the latest point in time at which to assess a bank's knowledge of fraud on the part of the beneficiary is the time for payment (rather than the time of the presentation of the payment demand).

Therefore, if there is a time gap between the presentation of documents and the time for payment, the party seeking to rely on the fraud exception might have time to submit evidence of fraud to the bank after the presentation of documents by the beneficiary.

Commentary

The fraud exception under English law is a tool that can be invoked successfully only in exceptional circumstances where there is clear evidence of fraud on the part of the beneficiary made available, before payment, to the paying bank to which documents were presented for payment.

For practical reasons alone, it would be much more difficult to rely on the fraud exception in transactions where the letter of credit provides for payment **immediately** upon presentation of a complying payment demand.

It should be noted that there are many jurisdictions (including the US, Australia, Belgium, France, Italy, South Korea and the Netherlands) that recognise legal principles similar or identical to the fraud exception under English law. (In civil-law jurisdictions, such principles are normally based on the obligation to act in good faith.)

In some jurisdictions, the courts will be more readily prepared than English courts to grant interim injunctions to prevent a bank from paying under a letter of credit where there are allegations of fraud or forgery affecting the payment demand.

It is worth noting that if an application for an interim injunction is filed before an English court against a London bank, regardless of the governing law of the letter of credit itself, the court will apply English law for the purpose of deciding whether or not to accept the application.

Contacts

Kwangkyu Park

Of Counsel

T +44 207 655 1107

E kwangkyu.park@squirepb.com

Chris Webber

Partner

T +44 207 655 1655

E chris.webber@squirepb.com