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THE AUTONOMY OF LETTERS OF CREDIT PRINCIPLE: HOW ABSOLUTE OR SACROSANCT?

OBIAGELI PHINA ANAGHARA-UZOR, Ph.D*

Abstract:

International trade involves business transactions which transcend boundaries of countries. Parties are often a great distance apart and most often may prefer a more secure mode of payment for the goods which are the subject of their sale contract. The letter of credit offers a more secure payment option where a financial institution stands in place of the buyer to effect payment for the goods, on presentation of documents which conform to the stipulations in the letter of credit. A key feature of the letter of credit is its documentary nature- the banks are only concerned with the set of documents presented to it for payment and not the performance of the contract of sale. Once conforming documents are presented, the bank is entitled and obligated to pay and must not concern its self with the underlying contract. This is the autonomy or independence principle of letters of credit and it is considered sacrosanct. This article considers the extent of the sacrosanctity of letters of credit. It finds that this principle, as with all general rules, have limits of operation. In an event of an occurrence of an established limiting factor- fraud and illegality- the independence of the letter of credit is set aside and the underlying contract is examined to determine whether payment is to be made under the credit.

Key Words: Letters of Credit, Autonomy, Fraud, International trade.

Introduction:

Trade or exchange of goods have prehistoric origins. In medieval times, inter-tribal trade occurred at the boundaries of tribes and communities. As nations developed, trade between nations also progressed. International trade is thus not a recent occurrence. There is evidence of the existence of international trade as far back as the 800 BC during the Greek Civilization.¹ From 1000-2000 BC, trade networks is found to have existed via the ‘Silk Route’ in China and by 3500 BC, archaeologists

* LLM [International and Comparative Business Law-London Metropolitan University, UK]; LLM [Petroleum Taxation and Finance-University of Dundee, Scotland, UK]; MBA [Oil and Gas Management-University of Dundee, Scotland, UK]; PGDiMATHE [Islamic University in Uganda]; Ph.D [University of Abuja, Nigeria]. Lecturer/Deputy Dean, Faculty of Law-Main Campus, Islamic University in Uganda. email:phinaoanaghara@gmail.com. Phone: +256 786784544, +234 7035420411.

¹ Surya P. Subedi (ed.), *Textbook, International Trade and Business Law*, (The People’s Public Security Publishing House, 2012) 21

discovered the existence of trade networks in the ancient Mesopotamia [the present day Iraq and Iran].² Thus the exchange of goods and services by countries, government agencies and other natural and legal entities across State borders forms the crux of international trade and business transactions. Naturally flowing from these commercial transactions are the financial aspects or payment options deployable in the final settlement of international commercial activities.

Due to the distance between the trading parties in international trading situations, the traditional exchange of physical cash for the goods is usually not the case. This same distance accounts for the lengthy period of time that the goods are in transit from the place of origin [from the seller], to the final destination [to the buyer] and this scenario creates some 'anxiety' for the seller as well as the buyer. Ideally the seller would prefer his cash 'in-hand' before shipping off the goods and the buyer, on the other hand, would be more comfortable to actually 'see' the goods and confirm that he has received what he ordered for in terms of quality and quantity before making payment. This utopian ideal is not practical in international trade, hence the availability of a number of payment options³ which parties may choose from in the settlement of their international business transactions.

Letters of credit, also called documentary credit or commercial credit presents a preferred payment option for financing international commerce as it lessens the risks inherent in international trade,⁴ thereby assuaging the anxieties of the seller and the buyer. As a popular payment method, the rules relating to documentary credits have been harmonized by the International Chamber of Commerce through the Uniform Customs and Practice of Documentary Credit [UCP] and the current version is UCP 600 which came into effect on the 1st of July, 2007. The UCP to a certain extent, coincides with the common law regime.⁵ Under both the UCP 600 and the common law, documentary credits are based on two fundamental tenets, to wit: the doctrine of strict compliance and the autonomy of letters of credit.⁶ The focus of this article is on the sacrosanctity of the autonomy principle and to what extent, if any, this principle may be derogated from.

² Ibid.

³ These include open accounts, bills of exchange, documentary bill of exchange, e.t.c.

⁴ Such risks may include possibility of default on the part of either of the parties, different time zones and currencies, possible need for additional intermediaries, the nature of multi-jurisdictional transactions, and the fact that the parties- the buyer and seller, are strangers to each other and as such cannot gauge each-others trust worthiness, political risks, e.t.c. See Roberto Luis Frias Garcia, 'The Autonomy Principle of Letters of Credit' [2010](3) (1) 69-70 *Mexican Law Review* <<https://biblat.unam.mx/hevila/Mexicanlawreview/2010/vol3/no1/4.pdf>> accessed 7 July 2020. See also Felicity Monterio, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' <<http://www.nzlii.org/nz/journals/AukULawRw/2007/7.pdf>> accessed 7 July 2020

⁵ Steffano Ferrero, 'Some Considerations On The Doctrine Of Strict Compliance And The Autonomy Principle In Documentary Credit,' <<https://www.bussinessjus.com>> accessed 7 July 2020

⁶ Ibid.

What are Letters of Credit?

The term 'letter of credit' originates from a French word '*Accreditif*' which means 'the power of doing something, which in turn comes from a Latin word '*accreditivus*' which means '*Trust*'.⁷ A letter of credit is basically a binding guarantee by a bank to make a payment for goods, on the behalf of a customer [the buyer] and in favour of a beneficiary [the seller]. According to Daniel Murray, 'a commercial letter of credit is a written promise by a bank (or other issuer) made at the request of a customer that the issuer will pay drafts or other demands for payment if the person drawing the draft or making the demands for payments complies with the conditions articulated in the letter of credit.'⁸ Stefano Fererro describe a letter of credit as 'a contract between the buyer and his bank (the so-called issuing bank) which allows documents and money to move in opposite directions, giving the buyer a thorough documentary screening before payment is made and giving (at least in the case of confirmed letter of credit) the seller an additional debtor within his own jurisdiction (the so-called confirming bank).⁹ In essence the letter of credit allows a substitution of the buyer with a bank which guarantees and makes the payment.¹⁰ It forms a separate agreement between the issuing bank and the applicant/buyer, distinct from the underlying contract of sale of goods, which arose between the buyer and seller/beneficiary, for which the documentary credit is intended to settle.¹¹ They belong to the class of documents described by Zsuzsanna Tóth, as 'quintessential international instruments'.¹²

The value of letters of credit in international trade lie in the twin tenets of documentary credits- it offers greater security of payment to the seller who is assured of payment for his goods upon shipment and presentation of complying documents to the bank. On the other hand, it affords the buyer the peace of mind that documents which 'truly' evidence the goods have been tendered and examined before payment is released to the seller. This ensures unimpeded international commercial trade. For this reason, the courts have referred to it as the 'lifeblood of international commerce.'¹³

⁷ Roberto Luis Frias Garcia, op. cit. n 4

⁸ Daniel E. Murray, 'Letters of Credit in Nonsale of Goods Transactions' < <https://heinonline.org/HOL/LandingPage?handle=hein.journals/busl30&div=74&id=&page=>> accessed 7 July 2020

⁹ Stefano Fererro, op. cit. n 5

¹⁰ Felicity Monterio, op. cit. (n 4) 146

¹¹ See also Article 4 of the UCP 600

¹² Zsuzsanna Tóth, 'Documentary Credits In International Commercial Transactions With Special Focus On The Fraud Rule' < <https://jak.ppke.hu/uploads/articles/12332/file/T%C3%B3th%20Zsuzsanna%20PhD.pdf> > accessed 14 July 2020.

¹³ *United City Merchants (Investment) Ltd. v Royal Bank of Canada* [The American Accord] 2 QB 208 at 222. See also *Harbottle v National West Minster Bank* [1978] QB 146; *Intraco Ltd v Notis Shipping Corporation of Liberia: The Bhoja Trader* [1981] 2 Lloyd's Rep 256, 257.

Commercial credits are by their very nature documentary. Article 5 UCP 600 stipulates that the bank deals with documents and not with goods, services or performance to which the documents may relate. Thus, documentary credits are as the name implies ‘documentary’. It negates any obligation on the part of the bank to concern itself with the actual goods which forms the legal basis for the application of the credit. It suffices when the seller tenders conforming documents in tandem with the instructions on the credit itself. Payment is made against conforming documents and not against the actual transfer or receipt of the goods.

The Autonomy Principle:

The autonomy of documentary credits is enshrined in articles 4 and 5 of UCP 600. Article 4 provides:

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 whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or 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 the banks or between the applicant and the issuing bank. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, pro forma invoice and the like.

Article 5 UCP 600 provides:

Banks deals with documents and not with the goods, services or performance to which the document relate.

In other words, the undertaking by the issuing bank and the confirming bank to pay against the tendering of complying documents is fundamental and separate from any dispute that may arise under the underlying sale of goods contract. As long as the documents presented comply with the buyer’s instructions, the bank must pay. Alavi Hamed summarizes the general outcome for the application of the autonomy principle as ‘pay now, argue later’.¹⁴ This principle thus safeguards the smooth operation of letters of credits in international trade¹⁵ and of course forms the ‘cornerstone of

¹⁴ Alavi Hamed, ‘Limits of the Autonomy Principle in Documentary Letters of Credits; Perspective of English Law’ [2017] (19) (33) 19 *Journal of Legal Studies* < DOI: 10.1515/jles-2017-0002 > accessed 7 July 2020.

¹⁵ *Ibid.*

validity of the letter of credit'.¹⁶ It underpins the character of the Letter of Credit in international trade as independent and separates the undertaking by the bank to pay the beneficiary from the underlying contract or any other agreement.¹⁷

In *Hamez Malas and Sons v British Imex Industries Ltd.*,¹⁸ the court per Jenkins L.J stated in favour of the principle thus:

...the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not... A vendor selling against a confirmed letter of credit is selling under the assurance that nothing will prevent him from receiving the price.

In *National Infrastructure Development Company Limited v Banco Santander S.A.*¹⁹ NIDCO, a state owned company of Trinidad and Tobago, contracted Construtora OAS Ltd (“OAS”) to build a new road in Trinidad and Tobago. Five banks issued standby letters of credit (“SBLC”), including Banco Santander S.A. (“Santander”), who issued both performance and retention security. NIDCO terminated the construction contract on 21 June 2016 on the basis that OAS had abandoned the project. On 6 July 2016, NIDCO sent a letter to OAS which divided up the sums that OAS allegedly owed to NIDCO as being either due or requiring quantification in due course. Subsequently, NIDCO issued Letters of Demand under the SBLCs. As specified in the SBLCs, the wording of the Letters of Demand provided:

“We refer to the above Letter of credit in our favour. We hereby notify you that the amount of US\$ [state amount] is due and owing to us by the contractor and demand immediate payment under the Letter of credit of that amount.

Santander refused to pay out under the SBLCs on the basis that the demands had been made fraudulently/recklessly. NIDCO therefore commenced High Court proceedings against Santander and applied for summary judgment. Mr Justice Knowles, at first instance, found in favour of NIDCO and summary judgment was awarded. Santander was granted permission to appeal and appealed the first instance decision to the Court of Appeal. The court reiterated the autonomy principle. It found that in the absence of fraud or illegality, the issuing bank’s obligation is to make payment under the letter

¹⁶ *Ward Petroleum Corp. v. Federal Deposit Ins. Corp.* 903 F.2d 1299, 1990.

¹⁷ Leon Fieties, ‘Letters Of Credit-The Fraud Exception: A Time For Conformity’ <http://etd.uwc.ac.za/xmlui/bitstream/handle/11394/3505/Fieties_LLM_2013.pdf?sequence=1 > accessed 7 July 2020

¹⁸ [1958]2QB 127

¹⁹ [2017] EWCA Civ 27

of credit upon presentation of a conforming demand. The letter of credit contract is independent from the underlying contract (in this case between NIDCO and OAS) and the bank therefore should not have any regard for disputes arising in that contract. The court found, inter alia, that the demand was neither fraudulent nor reckless.

In *Power Curber International Ltd v National Bank of Kuwait*,²⁰ the autonomy principle was also reinforced. Lord Denning MR stated:

...it is vital that every bank which issues a letter of credit should honor its obligations. The bank is in no way concerned with any dispute that the buyer may have with the seller. The buyer may say that the goods are not up to contract. Nevertheless, the bank must honor its obligations. The buyer may say that he has a cross-claim in a large amount. Still, the bank must honor its obligations. No set-off or counter-claim is allowed to detract from it...a letter of credit is given by a bank to the seller with the very intention of avoiding anything in the nature of a set-off or counter claim.

Similarly, in *Westpack Banking Corporation v. South Carolina National Bank*,²¹ the Privy Council stated that;

It is well settled that a bank which issues a letter of credit is concerned with the form of the documents presented to it, and not with the underlying facts. It forms no part of the bank's function, when considering whether to pay against the documents presented to it, to speculate about the underlying facts.²²

In *Discount Records Ltd. V Barclays Bank Ltd*²³ examination of cargo delivered revealed that some of the boxes which should have contained records were empty. Others contained cassettes instead of records. The buyers sought court injunction to stop the bank from paying the seller under the letter of credit. The court declined the application. According to Megarry J., the banker's obligation under the letter of credit is separate from the underlying contract of sale. He reiterated that the court will only intervene if sufficient grave cause was shown. The learned Judge's reason was that if the courts were to intervene in such instances, certainty of payments normally associated with commercial credits will be seriously affected and the integrity of international trade will be undermined.

²⁰ [1981]1WLR 1233. See also *Petrosaudi Oil Services (Venezuela) Ltd v Novo Banco S.A. & Others* [2017] EWCA Civ 9; *UAP Insurance Uganda Ltd v National Housing Construction Co. Ltd.* (MISC APPLICATION NO. 684 of 2013) [2013] UGCOMM 196.

²¹ [1986] 1 Lloyd's Rep 311

²² *Ibid* at 315

²³ [1975]1 Lloyds Rep 444.

The autonomy principle as seen is benched on the 'separateness' of the credit from the contract of sale.²⁴ The consequence of this principle therefore simply means that the bank's obligation to pay arises once a complying set off documents are tendered irrespective of the fact that the underlying contract may not have been performed. Therein lies the appeal of these credits and the reason why it is widely regarded as 'the lifeblood of international commerce.'²⁵ It also gives credence to the court's reluctance to meddle in international commerce. According to Donaldson J. in *The Bhoja Trader*,²⁶ a thrombosis would occur were courts to disturb the merchantile practice of treating rights under a letter of credit as being equivalent of cash in hand.

How Absolute or Sacrosanct is the Autonomy Principle?

Merriam Webster Dictionary define the word 'absolute' as 'having no restriction, exception or qualification; an absolute requirement; absolute freedom.'²⁷ On the other hand, 'sacrosanct has been defined as '(especially of a principle, place or routine) regarded as too important or valuable to be interfered with.'²⁸ The autonomy principle of documentary credits is without a doubt an important principle that ensures the efficacy of letters of credit and the lubrication of the wheels of international commerce but is this principle applied in all cases? Are there instances where the courts would deviate from this principle, i.e. are there exceptions or limits to this rule?

The answer to this question is in the affirmative. The basis of this response is found in what is called the fraud²⁹ exception. As is the case with any general rule or principle that paints human conduct with a broad brush, a strict and unadulterated application is bound to occasion injustice and eventually do more harm than good thus running against the original purpose of that rule [in this case the autonomy rule of documentary credits]. It is common knowledge that fraud is wrong, immoral and against public policy. It poses "an equally serious threat to the commercial utility of the letter of credit"³⁰ and has been referred to as the "cancer in international trade."³¹

²⁴ Articles 4 and 5 UCP 600.

²⁵ *United City Merchants (Investment) Ltd. v Royal Bank of Canada* [The American Accord] op. cit. n 11 . See also *Harbottle v National West Minster Bank* op. cit.n11; *Intraco Ltd v Notis Shipping Corporation of Liberia: The Bhoja Trader* op. cit. n 11.

²⁶ *Intraco Ltd v Notis Shipping Corporation of Liberia: The Bhoja Trader* op. cit. n 11.

²⁷ Merriam Webster Dictionary, 'Absolute' < <https://www.merriam-webster.com> > accessed 11 July 2020.

²⁸ 'Sacrosanct', < www.googlelanguages.com > accessed 11 July 2020. Cambridge Dictionary also defines sacrosanct as 'thought to be too important or too special to be changed.' < www.dictionary.cambridge.org > accessed 11 July 2020.

²⁹ Fraud here deals with a situation in which the documents tendered for payment appear on their face to be in order but is in fact tainted by fraud. It may be that the documents are forged or untrue in relation to the goods to which they relate. It could also be an alteration of information on the documents to misrepresent facts. The aim is to deceive, to defraud and to pass-off such documents as correct so as to obtain payment.

³⁰ G. W. Smith, *Irrevocable Letters of Credit and Third-Party Fraud: The American Accord* (1983) 24 Va J Int'l L 55, p. 96.

³¹ *Standard Chartered Bank v Pakistan National Shipping* [1998] 1 Lloyds Rep 684, 686.

Interestingly, the UCP 600 and the earlier versions, despite the threat, are silent on the issue of fraud.

The fraud rule goes to the very heart of the autonomy of documentary credit principle because it allows the courts or the issuer of the credit to look beyond the credit to the underlying contracts to either grant an injunction or decline payment under the credit in cases of fraud.³² It could be in the form of the beneficiary being the fraudulent party or a third party with or without the privity of the beneficiary. The fraud may also be in the nature of the documents presented or in the non-performance of the underlying contract.

In analysing the fraud rule in *Ulster Bank v Synnott*³³ wherein Synnott a merchant instructed the plaintiff, his bank, to accept a draft of one L., provided a bill of lading was attached. The bank accepted the draft and made payment on presentation of the bill of lading, which subsequently turned out to be forged. The defendant refused to reimburse the bank. Chatterton V.C. held that:

The plaintiff's only duty was to ascertain that the bill of lading was regular on its face. ... The defendant was the person who introduced the drawer of the draft to the plaintiff. The latter agreed to deal with the drawer solely on the authority of the defendant. Once the plaintiff was satisfied that the bill of lading was regular on its face, the defendant bore the risk of its being a forgery.

In other words, the courts strictly followed the autonomy principle in this case and concluded that the risk of fraud on the seller's part must be borne by the buyer. In *Edward Owen Engineering Ltd. v Barclays International Bank Ltd and Umma Bank*,³⁴ the court, per Denning MR, in its decision on performance guarantee, which operates in a similar way as a letter of credit explained thus:

The bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulent in circumstances where there is no right to payment. ...
... the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligations or not; nor with the question whether the supplier is in

³² Hamed Alavi, 'Mitigating the Risk of Fraud in Documentary Letters of Credit' [2016] (6) (1) 141 *Baltic Journal of European Studies Tallin University of Technology*.

³³ [1871] 5 Ir. R. Eq. 595

³⁴ [1978] 1 Lloyd's Rep. 166

default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or condition. The only exception is when there is a clear fraud of which the bank has notice.³⁵

Lord Geoffrey Lane further clarified:

The only circumstances which would justify the bank not complying with a demand would be those which would exonerate them under similar circumstances if they had entered into a letter of credit, and that is this, if it had been clear and obvious to the bank that the buyers had been guilty of fraud.³⁶

In *Etablissement Esefka International Anstalt v. Central Bank of Nigeria*,³⁷ the Ministry of Defence of Nigeria ordered 240,000 tonnes of cement from the plaintiffs, a company in Liechtenstein which operated in London. Payment was by an irrevocable letter of credit issued by the Central Bank of Nigeria and advised to the seller by Midland Bank. The letter of credit called inter alia for, a commercial invoice, a full set of four bills of lading and an insurance policy. On presentation of the documents the bank paid out a substantial part of the amount of the credit. However, there was strong evidence that the bills of lading were forged and there was a suspicion that part of the shipment has not been made at all. The bills of lading stated the port of shipment Volos, Greece but the Greek harbourmaster knew nothing about the vessels named in the bills of lading, or about any cement loaded on board in the port of Volos. Thus, the bank refused further payment. The plaintiffs brought an action against the bank, the bank counterclaimed and applied for security of costs. Lord Denning recognized the overriding effect of a clearly established fraud which is brought to the bank's knowledge. He held that:

The documents ought to be correct and valid in respect of each parcel. If that condition is broken by forged or fraudulent documents being presented – in respect of any one parcel – the defendants have a defence in point of law against being liable in respect of that parcel. And they have a claim, not only as to any outstanding claim but also they have a counterclaim for the money which they have overpaid and which they paid on false documents.³⁸

³⁵ Ibid at 171-172

³⁶ Ibid at 174

³⁷ [1979] 1 Lloyd's Rep. 445

³⁸ Ibid. at 447. See also *Sztejn v. Henry Schroeder Banking Corporation* [1941] 31 N.Y.S. 2d 631; *United City Merchants (Investment) Ltd. v Royal Bank of Canada* [The American Accord] op. cit. n 13.

There is a plethora of case law which underscore the limiting effect of established fraud in the law of documentary credits. The time for the application of the rule is generally agreed to be before payment is made on the credit. Another critical question then is whether the bank can decline payment based on mere suspicion or allegation of fraud, or only where fraud perpetrated by the beneficiary or with his privity or by an independent third party without the knowledge of the beneficiary. In addition is the fraud only connected to the documents tendered?

Where there is a mere allegation of fraud communicated by the buyer/applicant of the credit, the bank's obligation to pay is not affected. The bank in the absence of established fraud is entitled and obligated to make payment. The bank may take shelter under article 34 of the UCP 600 which provides that 'banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents.' The applicant on the other hand may have recourse to the courts for damages.

Where there is positive proof that the fraud has been committed by the beneficiary or with his privity, the banks must not honor its obligation under the credit. This scenario may arise where the seller/beneficiary tenders the documents himself which to his knowledge are false. The fact of the fraud must be clearly pleaded and established. In *United Trading Corp. S.A. v Allied Arab Bank Ltd.*³⁹ the court per Ackner J. reiterated the court's requirement of a strong corroborative evidence of the fraud in the form of contemporary documents from the buyer. If these documents are cogent enough, then a sufficient case of fraud would have been made and the court will so hold.

In a scenario where the fraud was committed by a third party without the knowledge of the beneficiary, the bank is required to effect payment.⁴⁰ Article 34 UCP avails it, where the credit is operated under the UCP. In *United City Merchants (Investment) Ltd. v Royal Bank of Canada*⁴¹ the shipment date on the bill of lading was falsely and fraudulently altered by the shipping agent. The defendant bank having discovered the fact refused to make payment under the credit. The House of Lords, per Lord Diplock in analysing what was referred to as the 'nullity exception' stated that 'the exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio*, or if plain English is to be preferred, "fraud unravels all". The courts will not allow their process to be used by a dishonest person to carry out a fraud.'⁴² The House of Lords found the beneficiaries

³⁹ (1985) 2 Lloyds Rep 554

⁴⁰ See *Montrod Ltd. v Grundkötter Fleischvertriebs GmbH* [2002] 1 All E.R. (Comm.) 257. See also Richard Hooley, 'Fraud and Letters of Credit: Is there a Nullity Exception?' [2002] (61) (2) *The Cambridge Law Journal* <<http://www.jstor.com/stable/4508887>> accessed 17 July 2020.

⁴¹ Op. cit. n 13

⁴² Ibid at 301

innocent as they were not aware of the fact that the agent had not stated the actual truth about the shipment date as required by the credit. Therefore the case was held not to fall within the ambit of the fraud exception.⁴³

Another exception to the principle of autonomy of letters of credit is illegality. The scope of illegality as an exception to the autonomy principle remain controversial.⁴⁴ Where the transaction is tinged with an illegal element, of course the beneficiary will not be able to enforce on the credit.⁴⁵ Thus where a buyer furnishes an irrevocable credit for an amount higher than the amount stated in the underlying sales contract for the purpose of obtaining extra funds overseas in breach of the exchange control legislation prevailing in his country, the letter of credit will not be enforceable.⁴⁶ Other instances of illegality could be as a result of a supervening prohibition, whereby at the time of issuance of the credit it was lawful but by the time of payment, it became illegal by virtue of a government order.⁴⁷

In *United City Merchants (Investment) Ltd. v Royal Bank of Canada [The American Accord]*⁴⁸ a Peruvian company- Vitrorefuerzos SA (Vitro), in 1975 concluded a sale and purchase contract with Glass Fibres, an English company, under which Vitro agreed to buy plant and equipment for manufacturing glass fibre. The purchase was to be financed by an irrevocable, transferable letter of credit. Upon the buyer's request, in March 1976 the credit was opened by Banco Continental SA, a Peruvian Bank and was confirmed by the defendant, the Royal Bank of Canada. The sellers quoted double the genuine purchase price, at the request of the buyer with the intention that the sellers, on obtaining payment would transfer the excess amount to a bank account in the United States. The intention was thus, to exchange Peruvian currency for the US Dollar using the sale contract and the credit, contrary to the exchange regulations of Peru Article VIII, 2(b) of the Bretton Woods Agreement. The House of Lords held that was an 'exchange contract' which was unenforceable since it contravened the Bretton Woods Agreement.

⁴³ Ibid. It has however be argued that this decision opens up the bank to unnecessary risk. The main function of the documents tendered under a letter of credit is to provide security. If the forged documents constitute a worthless security, the bank should be under no obligation to pay. Furthermore, it is the seller who prepares the documents or obtains them from third parties, thus there is a contractual relationship between the seller and the third party. It is against the principles of contract law to "punish" the bank for fraud deriving from a contractual relationship to which the bank is not a party, and which is beyond the control of the bank. See Zsuzsanna Tóth, op. cit. n 12.

⁴⁴ Michelle Kelly-Louw, ' Illegality As An Exception To The Autonomy Principle of Bank Demand Guarantees' < [2009] (42) (3) *The Comparative and International Law Journal of Southern Africa* < <https://www.jstor.org/stable/23253107> > accessed 18 July 2020

⁴⁵ Ibid at 88

⁴⁶ Ibid. See also E.P. Ellinger, Letters of Credit in Norbert Horn, Clive M. Schmitthoff (ed.), *The Transnational Law of International Commercial Transactions*, Vol.2 (1982), The Netherlands, p. 264. In *International Dairy Queen Inc. v Bank of Wadley* 407 F Supp. 1270 (MD Ala 1976), the issuance of a demand guarantee was prohibited.

⁴⁷ Michelle Kelly-Louw, op. cit. n 44

⁴⁸ Op. cit. n 13

A case of illegality may also arise where the credit is governed by the law of one country but a court of another country, which is not the place of performance of the credit issues an order for non-payment. In this scenario, the English Courts tend not to recognise the order made by that other court and will ignore the illegality resulting from the foreign court order.⁴⁹ This was actually the case in *Power Curber International Ltd. v National Bank of Kuwait*⁵⁰ where the English court enforced a letter of credit that was governed by the law of North Carolina and also payable there, despite a Kuwaiti court order prohibiting payment.⁵¹ Also in *J Zeevi and Sons Ltd v Grindlays Bank (Uganda) Ltd*⁵² the Court of Appeal of New York refused to give effect to the order of the Ugandan Government prohibiting the issuing bank from making payment under the letters of credit issued for the benefit of Isrealis. The court held that the place of payment was New York and the applicable law was New York Law. The payment was therefore ordered.

What about an illegality in the underlying contract? Despite the assertion of Lord Diplock in the *United City Merchants case* that there is one established exception to the autonomy principle, i.e. the fraud exception, the courts have given credence to illegality in the underlying contract as a distinct and separate exception to the autonomy of letters of credit principle.⁵³ In *Mahonia Ltd v JP Morgan Chase Bank and Another*,⁵⁴ the claimant, Mahonia, was a special purpose vehicle created to take part in Enron financial transactions. Enron requested the London branch of West LB AG (Westdeutsche Landsbank Girozentrale), a German bank, to issue a standby letter of credit for US\$165 million, in favour of Mahonia. The credit was issued to support a swap transaction between a subsidiary of Enron, Enron North American Corporation [ENAC] and Mahonia. Soon after the credit was opened, Enron went into financial difficulties and subsequently went into bankruptcy. Under the letter of credit, Enron's bankruptcy was an event of default which entitled Mahonia to make a demand and it made a demand for the amount due under the credit on the 5th of December 2001. West LB AG refused to pay and argued that although the documents presented for payment conformed to the credit, the credit was unenforceable because it was illegal. The illegality alleged was that in fact and unknown at the time, the purpose of the underlying swap transaction was to provide Enron with a disguised loan so as to enable it improperly to manipulate its account in breach of the United States General Accepted Accounting Practices (GAAP), Financial Accounting Standards, and the United States securities law, i.e. the Securities Exchange Act 1934.

⁴⁹ Michelle Kelly-Louw, op. cit. n 353

⁵⁰ Op. cit. n 20

⁵² 37 NY 2d 220 (1975)

⁵³ Michelle Kelly-Louw, op. cit. (n 353)358

⁵⁴ [2003]2 Lloyd's Rep 911

The English Commercial Court recognized, obiter, illegality in the underlying contract to a letter of credit as a defence to non-payment.⁵⁵

Conclusion:

Letters of credit are indeed the life blood of international commerce without which international trade would be greatly hampered. It provides better security than the other forms of payment and when the conditions under the credit are complied with, addresses the concerns of the parties involved. The court are also quite reluctant to interfere with the workings of these credits, as they staunchly recognize that the credits are separate and distinct agreements from the underlying contract of sale. Even the harmonized guidelines on documentary credits- the UCP- stipulate same. But the separateness or the independence or autonomy of documentary credits is a general rule. It is trite that general rules have exceptions. Specific scenarios present a valid deviation from the application of a general rule. The exceptions to the autonomy of letters of credit, therefore are fraud and illegality. Thus this principle is not absolute after all. The autonomy principle is without a doubt a critical appeal-enhancer of letters of credit but will not apply where there is an incidence of fraud or illegality.

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⁵⁵ It is noteworthy that the decision in the Mahonia case is *strict sensu*, obiter. However, the writer reasons that the courts would not allow its processes to be employed in the perpetration of an illegal act even where the illegal act is an infringement of a foreign law as it would be against public policy and good conscience. The illegality must of course be clearly established and known to the bank.

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