

# **Towards the recognition of the illegality exception under documentary credits in South Africa**

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## **ABSTRACT**

Letters of credit have two cardinal principles namely Strict compliance and the Independence principle. Strict compliance entails that for a beneficiary to be honoured under a credit, he has to strictly comply with the terms and conditions of the credit. The independence principle treats letters of credit as being autonomous from the underlying contract and their application will not be interfered with on grounds irrelevant to the credit itself. The idea behind the letter of credit transaction is that if the beneficiary makes a conforming presentation, the bank will honour the credit and conversely if the presentation made by the beneficiary is not conforming the bank will not honour the credit. The independence principle is not of absolute application and has exceptions to it. The universally accepted exception being fraud by the beneficiary. This is the only exception recognized in South Africa under letters of credit. This exception however does not extend to situations where there is illegality in the underlying contract. This leaves a lacuna in the legal framework as the banks are mandated to pay against a conforming presentation, notwithstanding the presence of blatant illegality in the underlying contract. The status quo enables banks to honour credits even if they are against certain foreign exchange regulations or if payment is being made to an enemy alien.

South African law does not recognize the illegality exception. The study seeks to argue for the recognition of the illegality exception. The established fraud exception rule is premised on the maxim *ex turpi causa non oritur actio*, which means that the court will not allow its process to aid a bad cause. The bad cause being either fraud or illegality. With this maxim also encompassing illegality, the illegality exception has, however, not been recognized and established. The study argues that the illegality from the underlying contract ought to pierce the impregnable autonomy principle so as to prevent illegalities under the guise of letters of credit. The study seeks to advocate for the recognition and establishment of the illegality exception under letters of credit in South Africa, which is abstract from the fraud exception. The illegality exception, if recognized will furnish banks with autonomy to dishonour a letter of credit tainted by illegality from the underlying contract. This study also seeks to conceptualise the scope of application for the illegality exception.

**Keywords:** Letters of credit, the fraud exception, the illegality exception, international trade, recognition, establishment.

## LIST OF ABBREVIATIONS

Actual Probs Econ & L	Actual Problems of Economics and Law
Acta U Danubius Jur	Acta Universitatis Danubius. Juridica
Afr J Int'l & Comp L	African Journal of International and Comparative Law
All ER	All England Law Reports
Ankara B Rev	Ankara Bar Review
CA	Court of Appeal
Camb L J	Cambridge Law Journal
Ch D	Chancery Division
CLD	Commercial Law Digest
Comp & Int'l L J S Afr	Comparative and International Law Journal of Southern Africa
F Supp	Federal Supplement
F 2d	Federal Reporter, Second Services
Harv L Rev	Harvard Law Review
HL	House of Lords
ICC	International Chamber of Commerce
Int'l Bus L J	International Business Law Journal
Int'l Trade & Bus L Rev	International Trade & Business Law Review
ISBP	International Standard for Banking and Practice for Examination of Documentary Credits
ISP	International Standby Practices
J Bus L	Journal of Business Law
JIBLR	Journal of International Banking Law & Regulation
J S Afr L	Journal of South African Law
Kor U L Rev	Korea University Law Review
LMCLQ	Lloyd's Maritime and Commercial Law Quarterly
M L Rev	Mexican Law Review
QB	Queen's Bench
NYS	New York Supplement

NYS 2d	New York Supplement Second Services
SA	South African Law Reports
SALJ	South African Law Journal
S Afr Merc LJ	South African Mercantile Law Journal
Sing J Legal Stud	Singapore Journal of Legal Studies
UNSWLJ	University of New South Wales Law Journal
UCP 500	Uniform Customs and Practice for Documentary Credits 500 (1993)
UCP 600	Uniform Customs and Practice for Documentary Credits 600 (2007)

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## Chapter 1 - Introduction

### 1.1 Problem Statement

As a great scholar once said, "Trade is a way of people getting to know each other." The global market has grown and the manner in which business and trade were conducted two hundred years ago is different from the manner in which it is carried out today. As is recognised the world over, there are typically three essential requirements to a contract of sale. These are *consensus ad idem*, the *merx* being traded, and the price of the *merx*.<sup>1</sup> In an international contract the basic requirements are more or less the same but include insurance among other things.<sup>2</sup>

There are many differences between domestic transactions and international contracts of sale. In a domestic sale contract, parties usually have a vast knowledge of each other, the relationship is based on trust, and the risk involved is minimal. The goods being traded do not have to travel overseas or across borders. The legal system of the buyer and the seller are the same and in the event of a dispute, any party would fully know how to deal with the legal system of their country. With an international contract, often times parties do not know each other. It is quite common for, there to be mistrust between such parties. The buyer is often afraid that the thing he contracted for may not be delivered on time, or that goods of defective quality may be delivered; or worse yet that the contracted goods may not be delivered at all. This risk was covered before-hand by the practice of asking a trader to give a cash deposit which would provide the other party with money to fall back on.<sup>3</sup> The practice was cumbersome, however, as it tied up a trader's capital. This saw the advent of the involvement of banks in such commercial transactions.<sup>4</sup>

This gave a whole new outlook to the parties who are involved in a standard international contract of sale, as banks are righteous and candid institutions which always hold up their end of the bargain.<sup>5</sup> Instead of payment being done by the buyer

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<sup>1</sup> Fouche *Legal Principles of Contracts and Commercial Law* 132.

<sup>2</sup> Carr *International Trade* 463.

<sup>3</sup> Kelly-Louw *Selective Legal Aspects* 1.

<sup>4</sup> Kelly Louw *Selective Legal Aspects* 1.

<sup>5</sup> Hugo *The Law relating to Documentary Credits* 9.

or rather the buyer forwarding a cash deposit,<sup>6</sup> an independent financial institution would open up a contract known as a letter of credit. The buyer deposits an amount equal to the credit into the bank, upon which the bank issues the letter of credit (as separate contract for the benefit of the seller).<sup>7</sup> Payment will be done upon the delivery of specified commercial documents by the seller to the buyer's bank.<sup>8</sup> This agreement takes the form of a tripartite agreement<sup>9</sup> of which all aspects are independent of each other.<sup>10</sup> The buyer applies to the bank for the issuing of a letter of credit, the credit is issued to the seller on account of the buyer and there is a contract of sale between the buyer and seller.<sup>11</sup>

Letters of credit have two distinct legal characteristics, which are independence and strict compliance.<sup>12</sup> That is to say they are independent of the underlying contract between seller and buyer, the contract between the bank and the account party for the opening up of the letter of credit and the contract between the beneficiary and the issuing bank. When the beneficiary presents conforming and stipulated documents, the bank has to honour the letter of credit.<sup>13</sup> Payment through letter of credit has increased the ease of doing business and the court in *Intraco Ltd v Notis Shipping Corporation - The Bhoja Trader*,<sup>14</sup> likened it to the lifeblood of commerce.<sup>15</sup> However, the autonomy principle is always at the mercy of unscrupulous traders and is subject to abuse as evinced in the *Mahonia Ltd v JP Morgan Chase Bank (No 1)*.<sup>16</sup> The court held that a party which had contracted in an illegal contract under English law could not enforce that contract and claim payment, as doing so would offend public policy and the *ex turpi causa rule*.<sup>17</sup> In the *Group Josi Re v Walbrook*

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<sup>6</sup> Kelly-Louw *Selective Legal Aspects* 1.

<sup>7</sup> McKendrick *Goode on Commercial Law* 1062.

<sup>8</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 3<sup>rd</sup> ed 259.

<sup>9</sup> The contract of sale being the first contract, the contract for the opening of the letter of credit being the second one and the contract for the payment of the purchase price by the bank to the seller being the third contract.

<sup>10</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 3<sup>rd</sup> ed 259.

<sup>11</sup> McKendrick *Goode on Commercial Law* 1060.

<sup>12</sup> Hugo 2014 *J S Afr L* 662.

<sup>13</sup> *Loomcraft Fabrics CC Nedbank Ltd and Another* 1996 1 SA 812 A 815.

<sup>14</sup> [1981] 2 Lloyd's Rep 256 (CA) hereinafter referred to as The Bhoja Trader case.

<sup>15</sup> *Intraco Ltd v Notis Shipping Corporation - The Bhoja Trader* [1981] 2 Lloyd's Rep 256 (CA) 257.

<sup>16</sup> [2003] 2 Lloyd's Rep 911 QB 918.

<sup>17</sup> *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] 2 Lloyd's Rep 911 QB 918.

*Reinsurance Co Ltd*,<sup>18</sup> the court noted *obiter* that it would stop payment under a letter of credit where such documentary credits were used to carry out an illegal transaction.<sup>19</sup> This was piecemeal recognition of the illegality exception.

To help curb abuse, there are certain checks and balances that have been put in place. They are infused with the characteristics of letters of credit to create a robust payment mechanism. To date there is only one internationally recognised exception, namely the fraud exception rule.<sup>20</sup> Fraud, has since 1941,<sup>21</sup> been the most widely accepted exception but it is not captured in the UCP 600.<sup>22</sup> This is because fraud differs in various jurisdictions and the prerogative to define what fraud is has been left to municipal law<sup>23</sup> to decide. With the courts stating that they will not allow their process to be used to further a dishonest cause, as proclaimed in the *ex turpi causa non oritur action* maxim,<sup>24</sup> the fraud exception rule has flourished in different jurisdictions.<sup>25</sup>

In the same vein, the courts will not let their process be used to further an illegality.<sup>26</sup> Since the fraud exception is typically based on the same tenets as the principle of illegality, there has been a discussion about the international recognition of another exception to the autonomy principle, which is the illegality exception.<sup>27</sup> With trade being international, there are a number of exceptions to the autonomy principle apart from the fraud exception, although these are not universally recognised, for example, the nullity exception and unconscionability exception have been recognised in some jurisdictions which are heavily influenced by English Law.<sup>28</sup>

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<sup>18</sup> *Group Josi Re v Walbrook Reinsurance Co Ltd* [1996] 1 Lloyd's Rep 345.

<sup>19</sup> *Group Josi Re v Walbrook Reinsurance Co Ltd* [1996] 1 Lloyd's Rep 345 362.

<sup>20</sup> This is the only recognized exception to the autonomy principle under letters of credit in South Africa. See *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A).

<sup>21</sup> *Sztejn v J Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941).

<sup>22</sup> A set of rules promulgated by the International Chamber of Commerce to cater for the operation of documentary credit.

<sup>23</sup> Municipal law as used in the international law context meaning domestic law.

<sup>24</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168 183.

<sup>25</sup> Meral 2012 5 Ankara B Rev 45.

<sup>26</sup> *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 Lloyd's Rep 345.

<sup>27</sup> Alavi 20 Kor U L Rev 10.

<sup>28</sup> See *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies (The Raffaella)* [1984] 1 Lloyd's Rep 102 (CA); *TTI Team Telecom International Ltd v Hutchinson 3G UK Ltd* [2003] All ER (Comm) 914.

In *United City Merchants v Royal Bank of Canada*,<sup>29</sup> the court, although not explicitly, stated that illegality was a recognised exception but refused to give judgment for the applicant because the contract contravened Peruvian Exchange Control Regulations and was against the Bretton Woods Agreement.<sup>30</sup>

In South Africa, there is no decided case law where the illegality exception was upheld, but a number of English courts have suggested *obiter* that illegality should be a ground which provides for exception to the autonomy principle. Illegality occurs in two circumstances; which are when the letter of credit itself is illegal due to it being outlawed by law, and when the underlying contract is illegal. This thesis seeks to show when and how the illegality exception to the independence principle under documentary credits can be recognised.

This leads to the following questions: If illegality were to be recognised as an exception to the autonomy principle, then what burden of proof is required and at which time should the illegality be proved? Since the English courts have dealt with these questions *obiter* and as South African commercial law is mainly modelled along the lines of English law, the findings of English courts are persuasive, if not binding in this field, and will therefore be extensively analysed in this research.

## **1.2 Research Question**

When and how can the illegality exception to the independence principle under documentary credits be recognised in South Africa.

## **1.3 Research Methodology**

This study will be conducted by way of a literature review of relevant textbooks, international conventions, scholarly journals, case law and other publications relating to the exceptions under the independence rule in documentary credits. The main thrust of the research will focus on international instruments and a comparative analysis will be taken, where necessary to contrast the position in South Africa to the position in Britain where recognition of the illegality exception has gained prominence.

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<sup>29</sup> *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL).

<sup>30</sup> *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) 183.

## **1.4 Framework**

The research will be divided into five chapters. The first chapter introduces the study and discusses the background of the study. It also provides for an outline of the study and the methodology of the research.

The second chapter will focus mainly on a discussion of letters of credit. The chapter will focus on the different types of letters of credit, their purpose in international trade and how payment in a documentary credit occurs. The chapter will provide a cursory glance at the manner in which letters of credit function, also highlighting the different parties involved as well as the different relationships created. The chapter will conclude with a discussion on the legal characteristics of letters of credit.

The third chapter will focus mainly on the exceptions to the autonomy principle. With the fraud exception being the universally recognised exception, the focus will be on its definition, the standard of proof required to sustain an allegation of fraud and when fraud should be established. Third-party fraud will also be looked at in this chapter. The chapter will also touch on the new group of exceptions which are being recognised in other jurisdictions such as the nullity exception and the unconscionability exception. Case law which has dealt with various exceptions will be discussed.

The fourth chapter will focus on the recognition of the illegality exception as a ground on which the issuing bank can refuse to honour a credit. The intention is to look at the manner in which the illegality exception has been dealt with in various jurisdictions such as England and Singapore. The chapter will define illegality, as well as the standard of proof required to sustain the illegality. The chapter will also look at the characteristics, parameters and requirements for the illegality exception to be recognised. The chapter will also ascertain the role of the beneficiary in the illegality to sustain it as an exception.

The fifth chapter will provide a recapitulation of all the chapters in the thesis. The chapter will explore the recognition of the illegality exception under letters of credit and will provide conclusions and recommendations for the possible establishment of the illegality exception.

## Chapter 2- Letters of Credit in International Trade

### 2.1 Introduction

This chapter seeks to introduce letters of credit in international trade. The chapter will give an overview of the different types of letters of credit and how they function. The various contracts which are involved in letters of credit will also be discussed. Lastly the chapter will touch on the characteristics underlying the letters of credit such as the independence principle, the conformity of documents and the doctrine of strict compliance.

### 2.2 Letters of Credit

Letters of credit<sup>31</sup> can be said to be the most useful payment mechanism in modern day trade from the period between the World Wars up until today.<sup>32</sup> This has led to some judges christening documentary credits as the lifeblood of commerce.<sup>33</sup> The definition of a "letter of credit" has evolved over the years, with various authors adding their ideas to it. It seems that up to now, there is no precise definition of a letter of credit. Enonchong<sup>34</sup> defines a letter of credit as a commitment made by a bank at the request of its customer (the applicant or account party) to make payment, of a specified amount of money to a certain person (the beneficiary) upon the presentation of specified documents.<sup>35</sup> On the other hand, Goode<sup>36</sup> defines a documentary credit as a "banker's assurance of payment against the presentment of specified documents." The principal use a of letter of credit is to provide a means of payment for goods supplied by the seller to the buyer.<sup>37</sup> It usually facilitates dealings between traders in different countries, by ensuring that the goods are paid for by the buyer and conversely delivered by the seller.<sup>38</sup> Letters of credit were created as a panacea

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<sup>31</sup> They can be referred to as documentary credits or commercial credits.

<sup>32</sup> Hapgood *Paget's Law of Banking* 618.

<sup>33</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146 155; *Intraco Ltd v Notis Shipping Corporation-The Bhoja Trader* [1981] 2 Lloyd's Rep 256 (CA) 257.

<sup>34</sup> *The Independence of Letters of Credit and Demand Guarantees* 7.

<sup>35</sup> Enonchong *The Independence of Letters of Credit and Demand Guarantees* 7.

<sup>36</sup> McKendrick *Goode on Commercial Law* 1059.

<sup>37</sup> Hugo 1993 5 *S Afr Merc LJ* 47.

<sup>38</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 1.

to the many problems bedevilling international trade.<sup>39</sup> With international trade expanding and new players coming into the arena, trade between parties who had no previous knowledge of each other became a new phenomenon. The standard methods of payment such as open account and payment in advance could not be used between parties which did not have a long standing business relationship.<sup>40</sup> With the lack of knowledge amongst parties comes mistrust and unwillingness to do business. The parties may wish not to be exposed to the inherent risks which come with an international sale. With the use of a letter of credit, the banker lends his name and good standing to overcome the seller's lack of knowledge of or confidence in the buyer, or uncertainty regarding the political situation in the country of the buyer.<sup>41</sup> This mechanism has enjoyed widespread international success due to international consensus on its nature, use and consequences.<sup>42</sup> It should be preserved with sanctity since it is now "a universally acceptable means of payment in international transactions."<sup>43</sup>

Letters of credit are regulated by a set of private rules titled *Uniform Customs and Practice* (UCP) for documentary credits.<sup>44</sup> These rules are formulated by the International Chamber of Commerce (ICC),<sup>45</sup> which is an international business organisation which aims to codify international best practices for world commercial activities. The current set of UCP is the UCP 600 which came into effect in July 2007 and has been widely used across the world for the regulation of documentary credits. The first set of UCP was formulated in 1933. It was developed over the years into the current edition, by incorporating changes. The advent of e-commerce has resulted in the formulation of the *Supplement to UCP 600 for Electronic Presentation*<sup>46</sup> by the ICC, which contains 12 articles which deal with the electronic presentation of documents.<sup>47</sup> The UCP is of special import to documentary credit as it has successfully

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<sup>39</sup> Brindle and Cox (ed) *Law of Bank Payments* 541.

<sup>40</sup> Cranston *Principles of Banking Law* 421.

<sup>41</sup> Hapgood *Paget's Law of Banking* 619; King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 16.

<sup>42</sup> Hugo *The Law relating to Documentary Credits* 1.

<sup>43</sup> *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 1 WLR 1233 (CA) 1240.

<sup>44</sup> Hereinafter referred to as UCP.

<sup>45</sup> Cranston *Principles of Banking Law* 421; McKendrick *Goode on Commercial Law* 1055.

<sup>46</sup> The Supplement to UCP 600 for Electronic Purposes will hereinafter be referred as the eUCP.

<sup>47</sup> Van Niekerk and Schulze *South African Law of International Trade: Selected Topics* 306.



standardised the ideal of documentary credits, and as it has been reviewed and amended several times it has shown development in the law governing documentary credits.<sup>48</sup>

The UCP defines a credit as:

any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation<sup>49</sup>

How the credit is going to be honoured is dependent on what the parties would have agreed to in the contract of sale. There are various ways in which a complying presentation may be honoured. The bank will pay only if the stipulated documents are presented and they conform to the terms and conditions of the credit.

### **2.3 How Letters of Credit Function**

The operation of a letter of credit is firstly commenced by agreement between the seller and the buyer. Often times the seller includes that he requires to be paid by way of a documentary credit in the contract of sale.<sup>50</sup> The contract of sale will be known as the underlying contract. The buyer ( the applicant) will then have to ensure that he applies to the bank for the issuance of a letter of credit for the benefit of the seller (the beneficiary).<sup>51</sup>

The issuing of a letter of credit involves a number of parties. The issuing bank will enter into a contract with the buyer (the applicant/customer). The bank will then issue the letter of credit for the benefit of the seller.<sup>52</sup> The bank may conduct an enquiry into the creditworthiness of the applicant or ask the applicant to deposit funds, which funds will act as security.<sup>53</sup> If the letter of credit is silent as to when a letter of credit has to be opened, the letter of credit has to be opened within a reasonable time. The application for a letter of credit is done by the completion of a lengthy and standard

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<sup>48</sup> Hugo 1993 5 S Afr Merc LJ45.

<sup>49</sup> A 2 of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>50</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 3<sup>rd</sup> ed 257.

<sup>51</sup> Hapgood *Paget's Law of Banking* 633.

<sup>52</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 3<sup>rd</sup> ed 257.

<sup>53</sup> Adodo *Letters of Credit-The Law and Practice of Compliance* 11.

application form which contains the basic terms and conditions of the letter of credit. The application form then forms the bulk of the contract between the issuing bank and the seller.<sup>54</sup>

Usually the issuing bank is in the buyer's country and the seller is situated in a different country. Once the letter of credit is opened, it becomes the prerogative of the issuing bank to inform the seller of the existence of such credit. The issuing bank will then enter into a contract with another bank which is in the seller's jurisdiction.<sup>55</sup> The bank which advises the seller of the existence of the credit is known as the Advising Bank.<sup>56</sup> The Advising Bank's obligation is to inform the seller of the existence of the credit after having satisfied that indeed such a credit exists and is authentic.

Once the seller becomes aware of the credit, he is obliged to go through it and check if it complies with the requirements as set out in the underlying contract. Should the contract be non-compliant, he should inform the buyer that it is not in conformity with the contract of sale and ask him to redress it. In the event that he fails to do so, he cannot rely on the non-conformity of the letter of credit and is deemed to have waived his right to insist on compliance.<sup>57</sup>

Once the seller has acquired the necessary goods, the seller will then proceed to prepare the documents which are required by the letter of credit. At the same time, the seller will in this regard be performing his side of the contract. The issuing bank will not expect the seller to present the commercial documents to the issuing bank in the buyer's country, as such a requirement would be cumbersome. The issuing bank will then nominate a bank in the seller's country which will be responsible for accepting the documents from the seller.<sup>58</sup> This bank will be known as the Nominated Bank.<sup>59</sup> If the documents which are presented are in conformity with the credit, the nominated

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<sup>54</sup> Van Niekerk and Schulze *South African Law of International Trade: Selected Topics* 3<sup>rd</sup> ed 258.

<sup>55</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 87-88.

<sup>56</sup> A 2 of the Uniform Customs and Practice for Documentary Credits 600 (2007) defines the advising bank as "the bank that advises the credit at the request of the issuing bank."

<sup>57</sup> *W J Alan & Co Ltd v El Nasr Export and Import Co* [1972] 2 QB 189 (CA) 217D-E

<sup>58</sup> Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* 25-26.

<sup>59</sup> A 2 of the Uniform Customs and Practice for documentary credits 600 (2007) defines a nominated bank as the bank at which the credit is available or any bank in the case of a credit available with any bank.

bank will honour the credit, as an agent of the issuing bank.<sup>60</sup> However, there is no contractual relationship between the beneficiary and the nominated bank and the honouring of credit by the nominated bank is by virtue of its contract with the issuing bank.<sup>61</sup> The nominated bank has a mandate to examine the documents reasonably to see if they conform on the face of it.<sup>62</sup> There is a time frame for examination and the UCP sets it at five working days.<sup>63</sup> Should the documents not be in conformity, the nominated bank should inform the seller that the documents are non-conforming. Failure to inform the seller that the documents are non-conforming would render the nominated bank bound to honour the credit as if the presentation was compliant.<sup>64</sup> However, the nominated or issuing bank can enquire from the buyer whether to waive the discrepancies and accept the non-conforming documents.<sup>65</sup> Since the banks are servants to the applicant of the credit, if the applicant condones the non-conformity, the credit should be honoured.

The nominated bank will then submit the documents to the issuing bank and the issuing bank will in turn reimburse the nominated bank for the payment which it has made under the credit.<sup>66</sup> The issuing bank will then pass on the documents to the buyer who will go and collect the goods using the documents of title.

#### **2.4 Types of Letters of Credit**

A letter of credit is a very versatile instrument that comes in different types. The determinant factor for which type of documentary credit to use is which type of documentary credit best suits the parties' intentions. Distinctions in the letters of credit are of paramount importance as they determine the basis of a bank's liability and how a bank ought to perform when honouring the credit.

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<sup>60</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 90; Jack *Documentary Credits* 134.

<sup>61</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 216.

<sup>62</sup> A 14 (a) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>63</sup> A 16 (d) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>64</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 146; A 16 (f) of the Uniform Customs and Practice on documentary credits 600 (2007).

<sup>65</sup> *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd* 2002 (3) SA 688 (SCA) para J.

<sup>66</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 3<sup>rd</sup> ed 259.

### 2.4.1 Irrevocable and Revocable Letters of Credit

With the purpose of a letter of credit being to provide security to both the exporter and the importer,<sup>67</sup> there is a type of documentary credit that caters for parties who have a longstanding business relationship. The irrevocability of a letter of credit determines whether it offers the amount of security which fits best into the situation. In theory, there are revocable and irrevocable credits but in practice it seems the revocable credits have died a natural death as their use has declined due to the slight amount of security that they offer.<sup>68</sup> The predecessor to the current edition of the UCP provides for both revocable and irrevocable documentary credits. The definition of a credit by UCP 600 seems to have sounded a death knell to revocable credits.<sup>69</sup> Irrevocability is built into and entrenched in a credit by the UCP 600.<sup>70</sup> With trade involving a lot of autonomy, parties may still desire to use revocable documentary credits in certain circumstances. The use of revocable credits is still permissible in international trade as evinced by UCP 600.

A revocable letter of credit is one such undertaking by the bank to pay a credit which entitles the issuing bank at the instruction of the buyer to revoke it without giving notice to the seller.<sup>71</sup> The giving of notice to cancel or amend a documentary credit is of no legal consequence but is just a matter of courtesy.<sup>72</sup> The issuing bank incurs no real commitment under such a credit except that if any bank had accepted, paid or negotiated the credit prior to the receipt of notice of amendment or revocation, it will be entitled to reimbursement from the issuing bank.<sup>73</sup> It follows that revocable credits are of little value in so far as security is concerned. The use of revocable letters of credit is limited in international trade.<sup>74</sup> Their use is mainly as a convenient payment mechanism where security for payment is not an issue and where parties have a long standing business relationship.<sup>75</sup> A revocable credit represents a buyer who is in a

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<sup>67</sup> Hugo 1993 5 *S Afr Merc LJ* 47.

<sup>68</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 270.

<sup>69</sup> McKendrick *Goode on Commercial Law* 1067, Doise 2007 *Int'l Bus L J* 113.

<sup>70</sup> McKendrick *Goode on Commercial Law* 1067.

<sup>71</sup> A 2 of Uniform Customs and Practice for Documentary Credits 500 (1993).

<sup>72</sup> *Cape Asbestos Co Ltd v Lloyd's Bank Ltd* [1921] WN 274.

<sup>73</sup> A 8 (b) of Uniform Customs and Practice for Documentary Credits 500 (1993).

<sup>74</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 18.

<sup>75</sup> McKendrick *Goode on Commercial Law* 1067.

strong bargaining position.<sup>76</sup> He may revoke it should there be a risk of default of performance by the seller due to political interference or insolvency.<sup>77</sup> A revocable credit has been deemed practically worthless from the perspective of the seller.<sup>78</sup> Even if conforming documents have been presented but before acceptance by the issuing bank, a revocable credit may be cancelled.<sup>79</sup>

On the other hand an irrevocable credit is a credit where the issuing bank gives a binding undertaking to the beneficiary which cannot be revoked once communicated.<sup>80</sup> The only revocation of an irrevocable credit that can take place is with the consent of the beneficiary.<sup>81</sup> The effect of an irrevocable credit is that the beneficiary can effect contractual rights against the issuing bank and the confirming bank as if it were the issuing bank. The payment undertaking is absolute and places an obligation on the bank to accept the documents for as long as they are conforming on their face and have been presented within the stipulated time.<sup>82</sup> The bank has to pay even if there are allegations of the contract not being performed. Therefore, most of the letters of credit that are used in international trade, are irrevocable, as they provide better security for both the buyer and the seller.

#### 2.4.2 *Confirmed and Unconfirmed Letters of Credit*

Another distinction between letters of credit which appears *ex facie* the UCP is the difference between confirmed and unconfirmed letters of credit. The issue in an unconfirmed or confirmed letter of credit is on the undertaking of an intermediary bank.<sup>83</sup> The seller may trade with a party in a country which has stringent exchange control regulations and would want to be safeguarded against any regulations which may affect the buyer's capability to pay the purchase price. In some cases, the seller may not have confidence in the buyer's banking system and may require a bank, normally in the seller's jurisdiction to add its undertaking to pay the purchase price.

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<sup>76</sup> Hugo *The Law relating to Documentary Credits* 39.

<sup>77</sup> McKendrick *Goode on Commercial Law* 1067.

<sup>78</sup> Hugo *The Law relating to Documentary Credits* 39.

<sup>79</sup> Hugo *The Law relating to Documentary Credits* 39.

<sup>80</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 18.

<sup>81</sup> Jack *Documentary Credits* 20.

<sup>82</sup> *Stein v Hambros Bank for Northern Commerce* (1921) 9LI.LR 433 507.

<sup>83</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 18.

The confirming bank will add its confirmation to the letter of credit and assume the risk of payment as a mandate of the issuing bank.<sup>84</sup> This mechanism gives the beneficiary improved security since there are undertakings of both the issuing and confirming banks.<sup>85</sup>

Article 2 of the Uniforms Customs and Practice for Documentary Credits 600 defines a confirmation as:

a definite undertaking of the confirming bank, in addition to that of the issuing bank, to honour a complying presentation

A confirmed credit is defined as one under which the issuing bank's undertaking on an irrevocable credit is buttressed by that of another bank.<sup>86</sup> The bank which reinforces the credit is called the confirming bank. The confirming bank adds the confirmation as a mandate of the issuing bank.<sup>87</sup> The legal effect of a confirmed credit is that the beneficiary enjoys the same contractual rights that it has under its contract of payment with the issuing bank.<sup>88</sup> Under the UCP 600, a confirming bank is mandated to honour the credit if it constitutes a compliant presentation.<sup>89</sup>

Confirmation takes place when the seller requires that the buyer ensure that the credit is confirmed. The buyer (the issuing bank's customer) asks the bank to ensure that the credit is confirmed. The issuing bank then looks for a correspondent in the seller's country which it asks to add its confirmation, for a fee.

On the other hand, an unconfirmed credit is one such credit which is issued by the issuing bank only and advised by the advising bank.<sup>90</sup> The advising bank does not add an undertaking to the credit and its role is merely to advise the seller of the existence of the letter of credit.<sup>91</sup> With an unconfirmed credit there are no rights and obligations

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<sup>84</sup> Hapgood *Paget's law of Banking* 625.

<sup>85</sup> Del Busto *ICC Guide to Documentary Credit Operations, A Stage by Stage Presentation of the Documentary Credit Process, ICC Publication No. 515 44.*

<sup>86</sup> McKendrick *Goode on Commercial Law* 1067.

<sup>87</sup> Hapgood *Paget's Law of Banking* 624.

<sup>88</sup> Brindle and Cox (ed) *Law of Bank Payments* 541.

<sup>89</sup> A 8 of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>90</sup> The role of this bank will be dealt with later in this chapter.

<sup>91</sup> Hapgood *Paget's Law of Banking* 623.

which arise from the relationship between the advising bank and the seller.<sup>92</sup> The advising bank's only duty towards the beneficiary is to satisfy itself that the credit is authentic.<sup>93</sup>

#### *2.4.3 Sight Payment, Acceptance and Deferred Payment Credits.*

The determinant factor in some documentary credits is the point in the transaction where such a credit is payable.<sup>94</sup> Article 2 of the Uniform Customs and Practice for Documentary Credits 600 defines "honour" as meaning:

To pay at sight if the credit is available by sight payment

To incur a deferred payment undertaking and pay at maturity if the credit is available by deferred payment

To accept a bill of exchange (draft) drawn by the beneficiary and pay at maturity if the credit is available by acceptance.

The above provision means that there are three ways in which a credit may be honoured. A sight payment credit is a credit which is honoured on sight when the beneficiary presents the stipulated documents.<sup>95</sup> The beneficiary presents the documents to the nominated bank and after examination and finding that the documents are in conformity with the terms of the credit, the bank pays the beneficiary.<sup>96</sup> A sight payment credit does not require the use of a bill of exchange but should it be used, it will be a sight draft payable on sight.<sup>97</sup>

A deferred payment credit allows the nominated bank or issuing bank to postpone the date of payment to a future date, which is arrived at in accordance with the formula in the credit. The date is often decided from the date of the bill of lading, date of shipment or date of presentation.<sup>98</sup> A deferred payment credit does not make use of a bill of exchange and should a bill of exchange be used it ceases to be a deferred payment credit and is rather an acceptance credit. The seller will present the

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<sup>92</sup> Jack *Documentary Credits* 24 -25.

<sup>93</sup> A 9 (b) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>94</sup> Jack *Documentary Credits* 25.

<sup>95</sup> King *Gutteridge and Megrah's Law of Bankers Commercial Credits* 19.

<sup>96</sup> A 14 of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>97</sup> Brindle and Cox (ed) *Law of Bank Payments* 542.

<sup>98</sup> McKendrick *Goode on Commercial Law* 1068.

documents to the nominated bank which will examine them and inform the seller whether they have been accepted or not. Once they are accepted, the nominated bank incurs a deferred payment undertaking to pay on the agreed date. An intermediary bank which pays to the beneficiary before the deferred payment date does so with the authority of the issuing bank.<sup>99</sup> If before the date of payment is due it transpires that the presented documents are fraudulent, the intermediary bank can still be reimbursed by the issuing bank.<sup>100</sup> This new position was brought about by the UCP 600. Previously the paying of a deferred payment undertaking before the maturity date was at the intermediary bank's own peril.<sup>101</sup>

Acceptance credits are similar to deferred payment credits, but they require a bill of exchange. When the beneficiary presents the documents for payment, he presents them with a bill of exchange, which bill is a term bill.<sup>102</sup> After examination by the issuing bank or nominated bank and if the documents are found to be conforming, the bank will accept the term bill and pay on maturity.<sup>103</sup> The bill will have a period of credit where the price will be paid upon the bill having matured.<sup>104</sup> The seller has an option to wait for maturity, but need not wait, as he can discount it to a third party.<sup>105</sup>

## **2.5 The Purpose and Use of Letters of Credit.**

The letter of credit has been the most successful tool in modern-day international trade.<sup>106</sup> This section will evaluate the purpose and uses of the letter of credit.

Documentary credits provide the seller with security that he is going to be paid the purchase price upon delivery of the commercial documents.<sup>107</sup> Their main use is as a

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<sup>99</sup> A 12 (b) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>100</sup> Takahashi 2009 *JIBLR* 285.

<sup>101</sup> *Banco Santander SA v Bayfern Ltd* [1999] Lloyd's Rep Bank 239; King *Gutteridge and Megrah's Law of Bankers Commercial Credits* 19.

<sup>102</sup> Brindle & Cox (ed) *Law of Bank Payment* 543.

<sup>103</sup> King *Gutteridge and Megrah's Law of Bankers Commercial Credits* 19.

<sup>104</sup> Jack *Documentary Credits* 26.

<sup>105</sup> Hugo 2002 *SALJ* 106.

<sup>106</sup> Hugo 1993 5 *S Afr Merc LJ* 47.

<sup>107</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd* 1978 QB 159 (CA) 169 [1978] 1 All ER 976.



payment mechanism, and the courts have recognised and buttressed this purpose in a number of cases.<sup>108</sup>

There are various risks which are inherent in an international contract of sale. Chief amongst them is the difference in the legal systems between the buyer and the seller. Also, the buyer might become insolvent and not able to afford to pay the purchase price. The buyer may also find a cheaper price for the same product, may wish to repudiate the former contract, and may not take delivery of the goods, which will result in the seller incurring extra expenses. On the other hand, the seller may ship goods of low quality which do not fit the contractual description, delay shipping in a contract where time is of the essence or fail to ship the goods at all. The documentary credit serves the interests of both parties quite handsomely. It strives to create a balance between the requirements of both parties and curtail the risks in international trade.<sup>109</sup>

The seller is guaranteed that he will receive payment for his goods as he acquires the undertaking of a bank that there will be payment against delivery of the stipulated documents.<sup>110</sup> The promise to pay is that of an institution of honour and high standing, and the risk of default of payment is minimised.<sup>111</sup> The opening of a letter of credit does, however, not discharge the buyer's obligation to pay the purchase price, it only suspends it. Should the bank not pay, the seller has a right to claim payment from the buyer.<sup>112</sup>

The letter of credit has an important security function. The interests of the buyer are served and protected in that by opening a letter of credit with the bank he or she stipulates the terms and conditions for proper performance by the seller.<sup>113</sup> The contractual relationship between the issuing bank and the buyer enables the bank to

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<sup>108</sup> Hugo 1993 5 S Afr Merc LJ 5 47; *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A); *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homs Refinery* [1984] 1 Lloyd's Rep 251 (CA)

<sup>109</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 2.

<sup>110</sup> *Sztejn v J Henry Schroder Banking Corporation* (1941) 31 NYS 2d 631 633-634.

<sup>111</sup> Jack *Documentary Credits* 2.

<sup>112</sup> Hugo *The Law relating to Documentary Credits* 19.

<sup>113</sup> Hugo 1993 5 S Afr Merc LJ 48.

ensure that the seller performs properly.<sup>114</sup> Should one of the stipulated documents not be presented then the presentation will not be compliant and the issuing bank will not pay.

A documentary credit transaction resembles a situation where the buyer does not have a good reputation or rather relationship with the seller, which enables him to rely on his goodwill for solvency and honest dealing.<sup>115</sup> It is necessary to finance international trade by way of a letter of credit as it enables a buyer who may not afford to pay the purchase price to rely on the creditworthiness of a financial institution to bankroll the transaction.<sup>116</sup> The buyer in this instance will not have his credit locked up in the goods and have to wait until he receives the goods after shipment and is able to sell them. Similarly, the seller is not inconvenienced by having to lock up capital tied up whilst he waits to receive the goods.<sup>117</sup>

A letter of credit is also used to curtail the continuous fluctuations of exchange rates in different countries.<sup>118</sup> Even if a party is in good financial standing and the parties enjoy a longstanding relationship, it has been found useful to hedge against the devaluation of currencies by using letters of credit, a safe and secure method of payment. Trade financing by way of a letter of credit guards against uncertainties, risks, or political interference. Payment may be easily forthcoming.<sup>119</sup>

## **2.6 The Legal Characteristics of Letters of Credit**

The cornerstone of the prevalent use of letters of credit as a successful payment mechanism is premised on two fundamental principles, which are the doctrine of strict compliance and the doctrine of independence.<sup>120</sup> With various contracts being part of

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<sup>114</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 57; see Jack *Documentary Credits* 69.

<sup>115</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 2.

<sup>116</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 2.

<sup>117</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 2; Jack *Documentary Credits* 3.

<sup>118</sup> McKendrick Goode on Commercial Law 1061.

<sup>119</sup> King *Gutteridge and Megrah's Law of Bankers' Commercial Credits* 2.

<sup>120</sup> Hugo 1993 5 *S Afr Merc LJ* 48.

the letter of credit transaction, the independence principle has ensured the preservation of a letter of credit as a robust payment mechanism.<sup>121</sup>

### *2.6.1 The Independence Principle*

The independence principle has been preserved throughout the different editions of the UCP.<sup>122</sup> In the current edition of the UCP, it is highlighted that the letter of credit is independent from all other contracts. In essence there are typically four contracts in a letter of credit transaction and the letter of credit is independent of all four of them.<sup>123</sup> Independence is a primary characteristic of a letter of credit and extends to the choice of law. In fact, the independence of a letter of credit is distinct to the extent that the choice of law in the underlying contract will not apply to the letter of credit.<sup>124</sup>

Article 4 (a) of UCP 600 states that:

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 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 of the UCP 600 goes on to reinforce the principle laid down by Article 4 of the UCP 600, by differentiating and stating that under letters of credit banks are concerned with documents and not with the goods, services or performances to which the documents relate. In essence this principle entails that the question whether a letter of credit should be honoured is to be decided squarely with reference to the letter of credit itself.<sup>125</sup> The letter of credit must be honoured irrespective of any dispute arising from the contract which has created it or the underlying contract.<sup>126</sup>

Once a beneficiary under a letter of credit has complied with the terms of the letter of credit he is entitled to payment,<sup>127</sup> the only exception being in the event of fraud,

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<sup>121</sup> Hugo 1993 *5 S Afr Merc LJ* 48.

<sup>122</sup> A 3 of Uniform Customs and Practice for documentary credits 500 (1993).

<sup>123</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 68.

<sup>124</sup> Enonchong *The Independence principle of letters of credit and demand guarantees* 68.

<sup>125</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 67.

<sup>126</sup> *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 QB 127 (CA).

<sup>127</sup> Hugo *The Law relating to Documentary Credits* 9.

which will be discussed later on in the next chapter.<sup>128</sup> When asked to honour a letter of credit, the issuing bank cannot raise a defence that it may not be able to recoup its money from its client or raise a dispute under the underlying contract, in trying to evade its obligations under the letter of credit.<sup>129</sup>

The recognition of the independence principle was first established through the *locus classicus* of *Sztejn v J. Henry Schroder Banking Corporation*<sup>130</sup> where the principle was stated as follows:

It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade. One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a most unfortunate interference with business transactions if a bank, before honouring drafts drawn upon it, was obliged or even allowed to go behind the documents at the request of the buyer, and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped. If the buyer and the seller intended the bank to do this, they could have so provided in the letter of credit itself, and in the absence of such provision, the Court will not demand, or even permit, the bank to delay paying drafts which are proper in form.

The recognition of the independence principle has cascaded down from the days of the *Sztejn* case and has found a place in South African law. South African courts have buttressed the independence principle. In *Ex Parte Sapan Trading*,<sup>131</sup> the court held that the attaching of proceeds of a letter of credit was contrary to the purpose for which the credit was created. The Applicant had made an application for an order to attach the proceeds for the purposes of securing jurisdiction. The dispute was for the payment of certain handling fees due to the Applicant. The court found that the Applicant had made a legitimate case for attaching the proceeds of credit, but that such an order would be against the tenets of international trade law.

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<sup>128</sup> *United City Merchants v Royal Bank of Canada* [1983] AC 168.

<sup>129</sup> Hugo 2014 *J S Afr L* 662; A4 of the Uniform Customs and Practice for Documentary Credits 600(2007).

<sup>130</sup> (1941) 31 NYS 2d 631 633-34.

<sup>131</sup> 1995 (1) SA 218 (W).

In *Phillips v Standard Bank of South Africa and Others*,<sup>132</sup> the court was faced with a matter where the Applicant, who was the buyer, wanted to prevent the bank from honouring the letter of credit. The Applicant had contracted with a certain merchant for leather shoes. Upon arrival of the goods, the applicant noticed that the goods were defective and immediately notified the seller of the defects. The Applicant sought to have payment suspended whilst the issue of the defective shoes was dealt with. The seller did not grant the buyer such indulgence and the buyer approached the court on an urgent basis in a bid to stop payment. The court ruled that in the absence of an allegation of fraud on the part of the beneficiary, there was no ground on which payment by the first respondent could be stopped.<sup>133</sup> A letter of credit constitutes an independent contract and the buyer may not go behind it and cause the bank to stop payment on the basis of a breach of contract by the seller.<sup>134</sup>

### 2.6.2 *The Doctrine of Strict compliance*

One of the foundations of the law of letters of credit is the strict compliance doctrine.<sup>135</sup> This doctrine has been accepted the world over and has given rise to strength of letters of credit as a payment mechanism. The doctrine finds its basis in the UCP.<sup>136</sup>

This principle has not received much analysis in South Africa, however, with the law of documentary credits being heavily influenced by English law, English decisions have dealt with this principle. As early as in 1926, the House of Lords ruled that the test for documentary credits is a strict one. In *Equitable Trust Company of New York v Dawson Partners Ltd*,<sup>137</sup> Lord Sumner stated that "there is no room for documents which are almost the same, or which will do almost the same." Even earlier than 1926, in *English, Scottish & Australia Bank Ltd v Bank of South Africa*,<sup>138</sup> the court held that a person

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<sup>132</sup> 1985 (3) SA 301 (W).

<sup>133</sup> *Phillips v Standard Bank of South Africa and Others* 1985 (3) SA 301 (W) 303.

<sup>134</sup> *Phillips v Standard Bank of South Africa and Others* 1985 (3) SA 301 (W) 304.

<sup>135</sup> Hugo 2014 *J S Afr L* 662.

<sup>136</sup> A 14 (a) of the Uniforms Customs and Practice for Documentary Credits 600 (2007).

<sup>137</sup> 1926 27 LI L Rep 49 (HL) 52.

<sup>138</sup> [1922] 13 LI L Rep 21 24.

who ships based on a documentary credit ought to perform as required in conformance with its exact terms.

The doctrine serves the interests of the buyer and the issuing bank in ensuring that the seller strictly conforms to the terms and conditions of the letter of credit before payment is made to the seller.<sup>139</sup> The role of the bank in this instance is ministerial and not investigative.<sup>140</sup> The bank has to examine the documents on the face of it to check whether they conform or not.<sup>141</sup> This obligation not to delve into the underlying contract is buttressed by Article 5 of the UCP 600.<sup>142</sup> The obligation of the issuing bank was clearly articulated in *Midland Bank v Seymour*,<sup>143</sup> wherein the court stated that:

There is of course no doubt that the bank has to comply strictly with the instructions that it is given by its customer. It is not for the bank to reason why. It is not for it to say: "This, that or the other does not seem to us very much to matter." It is not for it to say: "What is on the bill of lading is just as good as what is in the letter of credit and means substantially the same thing." All that is well established by authority. The bank must conform strictly to the instructions which it receives!

The doctrine of strict compliance entails that documents presented should strictly comply with the terms of credit. With the majority of presentations made under documentary credits being non-conforming there has been a paradigm shift in the doctrine of strict compliance.<sup>144</sup> The court in *New Braunfels National Bank v Odiorne*<sup>145</sup> decided that the doctrine ought not to lead to what is termed "oppressive perfectionalism." The doctrine of strict compliance ought not to defeat the purpose for which documentary credits were created.

There is a very thin line between strict compliance and oppressive perfectionalism and the courts have sat on the fence in their interpretation of presentations made under letters of credit. In *Astro Exito Navegicia SA v Chase Manhattan Bank NA*,<sup>146</sup> the court held that the discrepancy in the tonnage described in the survey report was a fraction of one percent and the court held that it was conforming. On the contrary in *J H*

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<sup>139</sup> Alavi 2016 *19 Kor U L Rev* 7.

<sup>140</sup> Adodo *Letters of Credit- the Law and Practice of Compliance* 568.

<sup>141</sup> A 14 (a) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>142</sup> This article states that banks deal with documents and not goods or the underlying contract.

<sup>143</sup> [1955] 2 Lloyd's Rep 147 151.

<sup>144</sup> Manangaro 2011 *14 Int'l Trade & Bus L Rev* 274.

<sup>145</sup> 780 2d 313 1989 para 316-317.

<sup>146</sup> [1986] 1 Lloyd's Rep 455 461.

*Rayner & Co Ltd and Oilseeds Trading Co Ltd*,<sup>147</sup> a different conclusion was reached where the letter of credit described the goods as "coromandel groundnuts." The invoice described them as per the letter of credit as "coromandel groundnuts" but the bill of lading described them as "machine shelled groundnut kernels." Evidence was led before the court which showed that the two were the same thing but the court held that the documents were non-conforming.<sup>148</sup>

The revision of UCP 600 has seemed to soften the rigours of the strict compliance principle and no longer requires strict compliance but rather substantial compliance.<sup>149</sup> The presentation does not have to mirror the terms of the letter of credit to precise perfection but rather should not be in conflict with the credit.<sup>150</sup> The ICC has published a set of rules which complement the UCP, *the International Standard for Banking and Practice for Examination of Documentary Credits*,<sup>151</sup> which are an effort to stem the scourge of most of the presentations being non-conforming. With the UCP being silent on spellings and typing errors, the ISBP caters for misspellings and typing errors.<sup>152</sup> It provides that a typing error that does not alter the meaning of a word or the phrase in which it occurs, does not make the document discrepant. Paragraph 6 of the ISBP lists a series of abbreviations which would render the document discrepant and Paragraph 7 discourages the use of slash marks since they are accorded a different meaning.<sup>153</sup>

The UCP now allows a discrepancy of not more or less than ten percent of the amount on the credit or the unit price.<sup>154</sup> With regards to the quantity of goods, it allows a discrepancy of five percent when quantity is not specified in the credit.<sup>155</sup>

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<sup>147</sup> [1942] 2 All ER 694.

<sup>148</sup> Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* 283.

<sup>149</sup> Alavi 2016 *19 Kor U L Rev* 8.

<sup>150</sup> A 14 (b) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>151</sup> Hereinafter referred to as ISBP.

<sup>152</sup> Alavi 2016 *19 Kor U L Rev*. 13.

<sup>153</sup> Malek, Quest and Jack *Documentary Credits* 188-189.

<sup>154</sup> A 30 (a) of the Uniforms Customs and Practice for Documentary Credits 600 (2007).

<sup>155</sup> A 30 (b) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

## **2.7 Conclusion**

This chapter has introduced the law of documentary credits as they are used as payment tools in international trade. The different types of letters of credit have been explained, as have the rights and obligations arising out of each type of letter of credit. It has also dealt with the date of payment of the different types of credits and the mechanics involved in the honouring of such credits. A brief overview has been given of how the letter of credit functions in a practical sense. The chapter has also touched on the purpose of letters of credit and what their main use is. The chapter has concluded with a description of the legal characteristics of documentary credits and the relevant provisions which underpin the legal characteristics. There has been mention of the fraud exception as being the only universally recognised exception to the independence principle. The fraud exception and other exceptions will be discussed in the next chapter.



## Chapter 3-The Fraud Exception and Other Exceptions in Letters of Credit

### 3.1 Introduction

The efficacy of the system of payment through letters of credit has been preserved through the efficient checks and balances which exist in the system. The cornerstone of the law of documentary credits is the autonomy principle,<sup>156</sup> which states that the letter of credit is totally divorced from the underlying contract.<sup>157</sup> However, as with all general rules, the autonomy principle has exceptions and is not absolute.<sup>158</sup> Its application may be departed from in certain circumstances, so as to perpetuate commercial peace. International sales have been christened "sales of documents" rather than the "sale of goods." A controversial point which has arisen in the last century is the question as to what happens when the beneficiary renders defective performance or does not render performance at all, with regards to the underlying contract but still presents documents which are strictly conforming. Documents may well be forged and still be strictly conforming even though they are only worth the paper that they are written on. Those documents would not be documents of title.

If strict adherence is to be had to the principle of independence, then the bank has to honour the credit. In a bid to strike a balance between two competing principles<sup>159</sup> and to curb the potential hazard of a beneficiary benefiting from its own fraud, exceptions to the independence principle have been agreed upon. Not all jurisdictions have agreed to the exceptions to the independence principle, but general consensus has been founded upon one particular exception, fraud. In that regard it is safe to say that, to date, fraud as an exception is universally recognized.<sup>160</sup>

This chapter will look at the fraud exception principle particularly, asking what fraud is and how the fraud exception has been used to breach the independence principle

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<sup>156</sup> Kelly-Louw *Selective Legal Aspects* 345, Garcia 2009 *ML Rev Vol 3 No 1* 74.

<sup>157</sup> Hugo 2014 *J S Afr L* 662.

<sup>158</sup> Alavi 2016 *Actual Probs Econ & L* 125.

<sup>159</sup> Kelly Louw states that when dealing with an issue of fraud, two conflicting and competing principles need to be taken into account. The independence principle states that the bank should not be allowed to decide whether or not to honour a credit on the basis of the underlying contract. Conversely, it is grossly unreasonable to allow a beneficiary who perpetrates a fraud to be able to claim payment under the credit.

<sup>160</sup> Garcia 2009 *ML Rev Vol 3 No 1* 78.

and to uphold the efficacy of letters of credit in international trade. There will also be a consideration of how different prominent jurisdictions have dealt with the fraud exception, the standard of proof required to sustain the exception and who bears the burden of proof. Lastly there will be a brief overview of the exceptions recognized in Singapore but which have not been universally accepted.

### **3.2 What is Fraud?**

In South Africa, fraud exists both as a delict (a tort) and as a statutory offence with criminal sanctions. The requirements for fraud as a delict were illustrated in *Bayett and Others v Bennett and Another*,<sup>161</sup> as (i) misrepresentation (ii) the misrepresentation being fraudulent with the person making the misrepresentation knowing that it was false (iii) constructive or actual intent to cause loss to the misrepresentee or to benefit the misrepresenter<sup>162</sup> (iv) misrepresentation must be material<sup>163</sup> (v) there must be injury suffered as a result of the fraud. Fraud as a crime is defined as the illegal and purposeful making of a misrepresentation which causes actual or potential prejudice to another.<sup>164</sup> The essential elements for common law fraud are misrepresentation, actual or potential prejudice, illegality and purpose.<sup>165</sup> In England, the essential elements for the delictual claim for damages premised on fraud are false material representation, where the representor is "aware that the representation is false or is recklessly careless as to whether it is true or false", the misrepresentation is made to the claimant, the claimant relies on the representation and the claimant suffers loss as a result of the representation.<sup>166</sup>

The definitions of fraud in various jurisdictions share various similarities but also show a lot of differences. In South Africa, loss can be actual or potential, whereas in England, loss has to be actual and ascertainable. With the fraud exception rule being of universal application in the various jurisdictions which have recognised this

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<sup>161</sup> [2012] ZAGPHJC 9.

<sup>162</sup> *Berkemeyer v Woolf* 1929 CPD 235 242-243.

<sup>163</sup> *Service v Pondart-Dianna* 1964 (3) SA 277 (B) 279A-D.

<sup>164</sup> *Snyman Criminal Law* 523, *Myeza* 1985 4 SA 30 (T) 31-32, *Gardener* 2011 1 SACR 570 (SCA) para 29.

<sup>165</sup> *Snyman Criminal Law* 523.

<sup>166</sup> *Enonchong The Independence Principle of Letters of Credit and Demand Guarantees* 99.

exception, the different definitions in the respective jurisdictions make the fraud exception rule one of the most controversial and confused areas of law.<sup>167</sup> The fraud rule in letters of credit does not lend itself to precise definition. The area is still developing and it is not possible to state the aspects of the law with precision.<sup>168</sup> With the ICC not defining and regulating the use of the fraud exception in the UCP 600, its definition and use is left to the mercy of domestic law within the various jurisdictions.<sup>169</sup> This is because of the difference in the definition of fraud in municipal laws or rather because of the uncertainty of laws in domestic laws.<sup>170</sup> The fraud exception is, thus, a creature of common law and judicial precedent.<sup>171</sup>

The definition of the fraud rule was formulated in the American case of *United City Merchants v Royal Bank of Canada*,<sup>172</sup> wherein Lord Diplock stated that fraud occurs where the beneficiary, for the purpose of benefitting under the credit, fraudulently presents to the bank documents that have material representations of fact that the seller knows to be untrue.<sup>173</sup> With English law requiring actual prejudice to sustain a claim for fraud, it seems that the fraud exception rule is a fusion of the essential elements of fraud in the South African criminal law and the English requirements for the tort of fraud. The fraud exception does not require reliance by the claimant on the misrepresentation and the suffering of actual loss for it to be established.<sup>174</sup>

In South Africa, no case law has defined what fraud is under letters of credit, but with the principles of demand guarantees also applying to letters of credit, the fraud exception was defined under demand guarantees.<sup>175</sup> In *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd*,<sup>176</sup> Theron JA stated that it is settled that where a beneficiary makes a call on a guarantee whilst consciously aware that he is not entitled to make

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<sup>167</sup> Anon 1980 93 *Harv L Rev* 992.

<sup>168</sup> Kelly-Louw *Selective Legal Aspects* 169.

<sup>169</sup> Rule 1.05 ISP 98as.

<sup>170</sup> Jack *Documentary Credits* 208.

<sup>171</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 96.

<sup>172</sup> [1983] AC 168 (HL).

<sup>173</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* 1983 1 AC 168 183.

<sup>174</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 99.

<sup>175</sup> Kelly Louw *Selective Legal Aspects* 244.

<sup>176</sup> [2014] 1 All SA 307 (SCA).

such a call, the courts will intervene to protect the bank and refuse the enforcement of the guarantee in issue.<sup>177</sup>

The fraud exception rule is *sui generis*, as it manages to permeate through the divide created by the autonomy principle, which is between the underlying contract and the letter of credit. The legal basis on which the fraud exception is premised was laid down in *United City Merchants v Royal Bank of Canada*, where Diplock LJ stated that the exception for fraud on a beneficiary who "wishes to avail himself of credit is a clear application of the maxim *ex turpi causa non oritur actio*" (fraud unravels all). The courts will not permit their process to be used by a dishonest person to perpetrate a fraud.<sup>178</sup>

The operation of the fraud exception enables the bank to delve into the provisions of the underlying contract and to stop payment if there is evidence of fraud. It should be noted that not all misrepresentation would amount to fraud. The misrepresentation should have a nexus to the issuing bank honouring the credit in circumstances where it should not.<sup>179</sup> Analysing the definition by Diplock LJ, there needs to be a positive state of mind on the part of the beneficiary who is presenting the documents and knows that the documents being presented contain material which is untrue.<sup>180</sup> The knowledge of the beneficiary does not have to be the actual state of mind. Fraud is applicable where the beneficiary has serious doubt as to the veracity of the documents and where the beneficiary is recklessly careless whether it be true or false.<sup>181</sup> The materiality of the misrepresentation should be material to the bank's duty to pay. If the information contained on the document is false but immaterial, the fraud exception will not apply.<sup>182</sup> *Enochong*<sup>183</sup> illustrates that if the terms of the credit state that shipping should be completed in the month of January and shipping is done on 12 January but for some reason a false date of 10 January is inserted on the bill of lading,

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<sup>177</sup> *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* [2014] 1 All SA 307 (SCA) para 17.

<sup>178</sup> *United City Merchants (Investment) Ltd v The Royal Bank of Canada* [1983] 1 AC 168 183.

<sup>179</sup> *Jack Documentary Credits* 215.

<sup>180</sup> *United City Merchants (Investment) Ltd v The Royal Bank of Canada* [1983] 1 AC 168 183.

<sup>181</sup> *Jack Documentary credits* 215.

<sup>182</sup> *Enochong The Independence Principle of Letters of Credit and Demand Guarantees* 105.

<sup>183</sup> *The Independence Principle of Letters of Credit and Demand Guarantees* 105.

although there is misrepresentation, it is not material, and the fraud exception principle will not apply.<sup>184</sup>

The application of the fraud exception has several consequences upon its application.

### 3.2.1 *The Operation of the Fraud Exception Rule*

The question of fraud can arise in different scenarios but the most common ones are

- (i) The principal raises the defence in proceedings and applies for a prohibitory interdict against the bank stopping it from honouring the credit
- (ii) The principal may apply for an interdict prohibiting the beneficiary from presenting the documents to obtain payment
- (iii) The issuing bank may refuse to pay on the presentation of conforming documents and raise the defence of fraud. The beneficiary might sue the issuing bank for summary judgment to compel the issuing bank to honour the credit.<sup>185</sup>

These applications are made on an urgent basis and often result in interim relief being granted should the applicant prove a *prima facie* case.<sup>186</sup> The interim relief will have a return date where the order granted in the interim will be confirmed or discharged. With the bank refusing to pay on the basis of its having knowledge of fraud on the part of the beneficiary, the beneficiary may resort to suing for breach of contract by summary judgment.<sup>187</sup> Where the bank refuses to pay, a mere allegation of fraud will not suffice and the bank is obliged to show that it has sufficient knowledge of the fraud.<sup>188</sup> The bank has to prove the fraud to the required standard.<sup>189</sup>

The principal can also raise the defence of fraud after payment and when the bank requires reimbursement from the applicant of the letter of credit for the money it has

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<sup>184</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 105

<sup>185</sup> Kelly-Louw *Selective Legal Aspects* 165-166.

<sup>186</sup> Jack *Documentary Credits* 220; Kelly-Louw *Selective Legal Aspects* 166.

<sup>187</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 115; Kelly-Louw *Selective Legal Aspects* 166.

<sup>188</sup> Carr *International Trade Law* 500.

<sup>189</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 116.

paid to the beneficiary of the credit.<sup>190</sup> This defence, however, is not often times resorted to, since the bank has to show it executed its duties diligently.<sup>191</sup> For the principal to succeed under this defence, it has to show that the bank had clear knowledge of fraud at the time of payment.<sup>192</sup> The fraud does not have to be unclear to require the bank to launch an investigation as this flies in the face of the bank's ministerial duty.<sup>193</sup>

When banks are presented with evidence of fraud by the principal, they may generally feel that the evidence is not strong enough for them to refuse to honour the credit.<sup>194</sup> They are generally loth to refuse to pay a credit upon the presentation of conforming documents for fear of losing their greatest asset, their reputation.<sup>195</sup> Often times the banks would advise the account party of the fraud and the principal will apply for an interdict to stop payment by the bank. When an account party has evidence of fraud it applies for an interdict on an urgent basis. The interdict is provisional, however, and it has to be proven or discharged at a later stage. The decision to grant an interdict is premised on the balance of convenience and takes into account that the account party may not have sufficient and concrete evidence to establish a case for fraud.<sup>196</sup>

### **3.3 The Burden and Standard of Proof**

The principles regarding the burden and standard of proof seem to be settled the world over and all jurisdictions use the same standard of proof. It is an established principle of the law that the burden of proof is on the plaintiff or applicant.<sup>197</sup> He who alleges must prove.

The ordinary standard of proof which applies in civil matters is proof on a balance of probabilities.<sup>198</sup> The issue of the onus of proof was settled in *Bolivinter Oil SA v Chase*

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<sup>190</sup> Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* 251.

<sup>191</sup> Kelly Louw *Selective Legal Aspects* 166.

<sup>192</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 114.

<sup>193</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 114.

<sup>194</sup> Jack *Documentary Credits* 218.

<sup>195</sup> Kelly Louw *Selective Legal Aspects* 205.

<sup>196</sup> Jack *Documentary Credits* 218.

<sup>197</sup> This principle is enshrined in this maxim *affirmati non neganti incumbit probatio*; *Hornal v Newberger Products Ltd* [1957] 1 QB 247.

<sup>198</sup> Hugo *Letters of Credit* 278.

*Manhattan Bank*,<sup>199</sup> which established requirements regarding the onus of proof on a party seeking to avoid payment on a documentary credit using the fraud defence. The court held that where a party applies for an injunction to prevent payment, there must be proof that should the payment go ahead it is likely to permit the beneficiary to benefit from his own fraud at the expense of the plaintiff.<sup>200</sup> An interdict to stop payment under a letter of credit would not be granted on mere say-so, but rather where the plaintiff makes a sufficient case of fraud to the satisfaction of the court.<sup>201</sup>

With the English courts being very hesitant to interfere with the autonomy of letters of credit, they have adopted a relatively narrow and inflexible approach towards the application of the fraud rule.<sup>202</sup> The standard of proof is very high to the extent that the fraud exception rule seems to be illusory under English law. The courts have set a high standard of proof which will suffice to safeguard the autonomy principle but which still remains attainable.<sup>203</sup> Under English law the plaintiff has to prove clear or obvious fraud so as to succeed in invoking the fraud rule.<sup>204</sup> In *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd*,<sup>205</sup> the court cited the *Sztejn* case in refusing to grant an injunction stopping the banks from paying. In this case, the plaintiff contracted for the purchase of gramophone records and cassettes. The buyer instructed the defendant to open an irrevocable letter of credit in favour of the seller and the seller shipped the goods purporting to be those ordered and presented apparently conforming documents to the issuing bank in Paris, which the bank accepted. Upon the arrival of the goods, the buyer inspected the goods, together with a representative of the issuing bank and found out that most of the goods shipped were not as contracted for. The buyer sought to stop the issuer from honouring the credit but the issuer stated that since it was an irrevocable letter of credit, it could not

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<sup>199</sup> [1984] 1 Lloyd's Rep 251.

<sup>200</sup> *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251 252.

<sup>201</sup> *Phillips v Standard Bank of South Africa* 1985 3 SA 301 (W).

<sup>202</sup> Enonchong 2007 LMCLQ 85.

<sup>203</sup> McKendrick *Goode on Commercial Law* 1102.

<sup>204</sup> Kelly Louw *Selective Legal Aspects* 184.

<sup>205</sup> [1975] 1 Lloyd's rep 444 (Ch D).

stop payment. Relying on the fraud exception as raised in the *Sztejn* case, the buyer sought to interdict the bank from honouring the credit raising the defence of fraud.<sup>206</sup>

The court dismissed the buyer's claim and ruled that it was different from the *Sztejn* case. In the case of *Sztejn v J Henry Schroder Banking Corporation*,<sup>207</sup> the complainant had alleged fraud and was dealing with a case of established fraud which was not the case in the present instance. The court ruled that there was a mere allegation of fraud and not established fraud.<sup>208</sup> The court also reiterated that it would not hastily "interfere with bankers' irrevocable credits, especially in international banking unless" circumstances warranted interference. If courts were too eager to intervene too frequently, this would affect the credibility of credits.<sup>209</sup> In this case, the buyer had obtained evidence of the fraud in the presence of the issuer, but the court held that this was only an allegation of fraud and not clear or established fraud. This illustrates the high level of proof required by the English courts for one to succeed in using the fraud defence.<sup>210</sup> English courts have held that they will only interfere with the machinery of irrevocable obligations assumed by banks only in extraordinary circumstances.<sup>211</sup> Where the circumstances do not fall within the ambit of fraud, they will leave the parties to pursue alternative dispute resolution remedies.<sup>212</sup>

In South Africa, the standard of proof is modelled along the lines of English law. Although only a few cases have dealt with the fraud exception rule under South African law, these cases have stated with certainty that the standard of proof is high. In *Loomcraft Fabrics CC v Nedbank*,<sup>213</sup> the court ruled that the fraud by the beneficiary had to be clearly established. The Applicant in this case wanted to restrain the bank from honouring a letter of credit, after the goods delivered did not satisfy it. The basis of the interdict was that there was fraudulent misrepresentation on the bill of lading.

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<sup>206</sup> *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd* [1975] 1 Lloyd's rep 444 (Ch D) 444.

<sup>207</sup> 31 NYS 2d 631 (1941).

<sup>208</sup> *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd* [1975] 1 Lloyd's rep 444 (Ch D) 447.

<sup>209</sup> *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd* [1975] 1 Lloyd's rep 444 (Ch D) 448.

<sup>210</sup> Xiang *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* 49-50.

<sup>211</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 CA.

<sup>212</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 CA.

<sup>213</sup> 1996 1 SA 812 (A).



The court ruled that the bank had a duty to honour the credit and could escape the duty only upon proof of fraud by the beneficiary. For the interdict to be granted, fraud must be clearly established. Whilst the burden of proof remained on a balance of probabilities, an allegation of fraud will not lightly be inferred.<sup>214</sup> In dismissing the application, the court ruled that mere error, oversight or misunderstanding, however gross cannot be held to be fraud.<sup>215</sup> In *Z Z Enterprises v Standard Bank*,<sup>216</sup> the court was faced with an application to interdict the defendant from paying the remitting bank under documentary collection on the basis of fraud. The court agreed that fraud was a sufficient ground for stopping payment but ruled that there had to be a "clear established" fraud for the exception to apply.<sup>217</sup> The court ruled that there had not been fraud but a mere breach of contract.

Although the disputes in the cases discussed above are about civil matters, the standard of proof is very high and will not be inferred lightly. The high standard of proof ensures that the fraud exception rule is not resorted to in every case, including where there is breach of contract, but is reserved for circumstances that warrant it.

### **3.4 Third Party Fraud**

Often-times fraud is perpetrated on the issuing bank or on the buyer by the seller. Whether fraud by another person who is not the beneficiary will give rise to the application of the fraud exception rule is a question, the answer to which is dependent on a number of factors. It is an established principle of commercial law that the actions of an agent are attributed to the principal. The same, however, cannot be said under the law relating to the fraud exception rule, as the actions of the agent do not accumulate to the principal. There seems to be a *lacuna* as to whether a beneficiary is liable for the fraud of his agent under the fraud exception rule, or whether his agent's knowledge of the fraud can also be imputed to be knowledge by the beneficiary.<sup>218</sup>

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<sup>214</sup> *Loomcraft CC v Nedbank* 1996 (1) SA 812 A 817G-H.

<sup>215</sup> *Loomcraft CC v Nedbank* 1996 (1) SA 812 A 822G-H.

<sup>216</sup> 1995 CLD 769 (W).

<sup>217</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W) 770, 783.

<sup>218</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 108.

It is settled, however, that where the beneficiary is an intended victim of the fraud by the agent and makes the presentation in good faith oblivious of the fraud, the beneficiary will not be liable for the agent's fraud. What is important in establishing fraud is the knowledge of the beneficiary at the time of the presentation of the documents.<sup>219</sup> In this regard, if the beneficiary colludes with an agent to perpetrate a fraud, the fraud is deemed to have been committed by him.<sup>220</sup> The maxim *commodum ex injuria sua nemo habere debet* applies.<sup>221</sup>

The *locus classicus* for the third party fraud principle is *United City Merchants v Royal Bank of Canada*<sup>222</sup> where a loading broker inserted a different loading date from the actual loading date. The beneficiary presented the bill of lading which contained a materially false representation. The beneficiary had an honest belief that the date stated on the bill of lading was the true date. The Court of Appeal<sup>223</sup> accepted the argument that the presence of a material false representation entitled the bank to decline the document. The knowledge of the beneficiary was irrelevant as the document was a nullity.

The House of Lords in *United City Merchants v Royal Bank of Canada*<sup>224</sup> had a view different from that of the Court of Appeal. Lord Diplock ruled that the approach by the Court of Appeal would sound a death knell for the efficacy of documentary credits. Furthermore, he stated that the absence of the beneficiary's knowledge absolved him from any wrongdoing and made him a victim of the deceit thus entitling him to payment.

The absence of an honest belief with regard to the truthfulness of a document contained in a presentation can suffice as fraud. This also covers the situation if the fraud in the document had been done by a third party. In *Tukan Timbers Ltd v Barclays*

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<sup>219</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 108.

<sup>220</sup> Xiang 2001 *UNSWLJ* 6.

<sup>221</sup> This translates into the dictum that a wrongdoer should not be enabled by law to take any advantage from his actions.

<sup>222</sup> [1983] 1 AC 168.

<sup>223</sup> *United City Merchants v Royal Bank of Canada* [1981] 3 All ER 142.

<sup>224</sup> [1983] 1 AC 168.

*Bank Plc*,<sup>225</sup> the court held that the beneficiary could not have held an honest belief that the document had been created by the required people.

### **3.5 The Nullity Exception**

It is generally agreed that the fraud exception is the only universally accepted exception to the autonomy principle of letters of credit. However, there are other exceptions, whose recognition remains controversial. With the fraud exception rule not extending to cover fraud by a third party unknown to the beneficiary, there have been calls to recognise the nullity exception so as to address that loophole.

The nullity exception is one which does not lend itself to a precise definition. Due to the controversies over its application there has not been much development around it under the letters of credit.<sup>226</sup> The English courts have tried to define what constitutes a nullity. In *Tek Chao v British Traders and Shippers*,<sup>227</sup> the court refused to find that a misdated bill of lading was a nullity, although it held that it was valueless.<sup>228</sup> In *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies*,<sup>229</sup> a bill of lading which contained an additional misstatement was viewed as a sham piece of paper.<sup>230</sup> In *United City Merchants v Royal Bank of Canada*,<sup>231</sup> a bill of lading with a wrong date of loading was described as being far from a sham. This shows the divergent views and uncertainty surrounding the nullity exception. Numerous scholars<sup>232</sup> have tried to give a standard definition as to what a nullity is. Enonchong<sup>233</sup> states that a document is a nullity if due to a defect, the document is void and is not what it purports to be. It may be because it has been forged or that it has been created in error with honest belief. The determinant factor in deciding whether a document is a nullity or not is whether the falsity or defect goes to the root of the document so as to leave it devoid of the purpose it ought to serve.<sup>234</sup> If,

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<sup>225</sup> 1987 Lloyd's Rep 1 171.

<sup>226</sup> Donnelly 2008 4 *J.Bus.L* 317.

<sup>227</sup> 1954 2 QB 459 (QB).

<sup>228</sup> 1954 2 QB 459 (QB) 476.

<sup>229</sup> 1984 1 Lloyd's Rep 102.

<sup>230</sup> 1984 1 Lloyd's Rep 102 (CA) 112.

<sup>231</sup> [1983] 1 AC 168.

<sup>232</sup> Garner Black's Law Dictionary 1173; Alavi 2016 *Actual Probs Econ & L* 129.

<sup>233</sup> *The Independence Principle of Letters of Credit and Demand Guarantees* 145.

<sup>234</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 145.

notwithstanding the defect, the essence of the document is not destroyed, it does not amount to a nullity, and it remains alive in spite of the defect.<sup>235</sup> In the case of *United City Merchants v Royal Bank of Canada*,<sup>236</sup> although the bill of lading had been antedated, it was held not to be a nullity as it still remained a document of title which entitled the possessor to receive goods at the port of destination.<sup>237</sup>

Another school of thought states that the decision whether a document is a nullity or not ought to be determined by having regard to whether the document can be construed as being without legal effect.<sup>238</sup> This principle was not adhered to in the case of *Montrod Ltd v Grundkottter Fleischvertiebs GmbH*,<sup>239</sup> where the inspection certificate was held as not being void despite the fact that it was of no legal force. It is argued by Donnelly,<sup>240</sup> that the conclusion that a certificate which had been signed by the applicant under a mistaken belief had legal force does not accord with sound legal reasoning. It follows that if the "without legal effect" principle were to be followed then *Montrod* was wrongly decided.

The nullity exception comes into play when the beneficiary presents documents which are null and void unbeknown to him. The question arises whether the bank ought to pay against documents that are apparently conforming, but which it knows are null and void.

### 3.5.1 *The Legal Recognition of the Nullity Exception.*

The nullity exception was first recognised under English law in the case of *United City Merchants v Royal Bank of Canada*.<sup>241</sup> The sellers had delivered the cargo for shipment on the 15<sup>th</sup> of December but the cargo was loaded only on the 16<sup>th</sup> of December which was outside the period of shipment which had been prescribed under the letter of credit. The loading broker, E.H Mundy, antedated the date of loading to the 15<sup>th</sup> of December. The appellants presented the documents including the antedated bill of

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<sup>235</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 146.

<sup>236</sup> [1983] 1 AC 168.

<sup>237</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 146.

<sup>238</sup> Neo 2004 *Sing J Legal Stud* 71.

<sup>239</sup> 2002 1 All ER 257.

<sup>240</sup> 2008 4 *J Bus L* 320.

<sup>241</sup> [1981] 3 All ER 142.

lading to the confirming bank's branch in London.<sup>242</sup> The bank refused to honour the credit as it was aware of the forgery that had been perpetrated by the loading broker. The three judges who sat in the Court of Appeal all concurred in recognising the nullity exception. In dismissing the appeal, Stephenson LJ ruled that a forged document is a nullity, that it is not a conforming document entitling the presenter of it to be paid, and if the banker to which the documents are to be presented knows of the forgery he must not pay. Ackner LJ, adding his sentiments in dismissing the appeal from the *court a quo*, ruled that a banker cannot be compelled to pay a credit unless all conditions stated in the credit are complied with. Furthermore, he stated that, a banker should not to be obligated to accept to pay against documents which he knows to be valueless. To do so would be to strip the banker of the security for his advances, which is a cardinal feature of trade financing. Griffiths LJ, also concurring with Ackner LJ and Stephenson LJ ruled that a bank takes documents as security for its payment. It is not obliged to take waste paper. If the bank is aware that the documents are false it must refuse to accept them. He disagreed with the general fraud exception rule which exonerates a beneficiary who is innocent of third party fraud. He stated that even if the presenter is a victim of the forgery and in good faith believes the documents to be genuine, that cannot affect the bank's right to dishonour the credit. Citing *Old Colony Trust v Lawyers Title & Trust Co*,<sup>243</sup> Griffiths LJ said that what is of importance is the character of the document and not the origin or the identity of the forger.

The decision in the Court of Appeal was appealed against to the House of Lords wherein Lord Diplock left the issue of the nullity exception unanswered.<sup>244</sup> He, ruled, however, that they did not see any reason why an innocent beneficiary should be in a worse position than a holder in due course, who had not negotiated the draft. With all the other judges concurring, Lord Diplock ruled that the bank had to pay when presented with conforming documents. In allowing the appeal, he held that there ought to be a difference between a forgery in a document which does not destroy the essence of the document and forgery by a third party which renders the document a nullity, and that he was not persuaded by the Court of Appeal's stance of treating both

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<sup>242</sup> *United City Merchants (Investment) Ltd v The Royal Bank of Canada* [1981] 3 All ER 142 143.

<sup>243</sup> 1924 297 F 152.

<sup>244</sup> *United City Merchants (Investment) Ltd v The Royal Bank of Canada* [1983] 1 AC 168 188.

as the same. With the House of Lords overturning the decision of the Court of Appeal and granting judgment in favour of the applicant, the question regarding the nullity exception was left unanswered.

Twenty years later the English courts were faced with the question of the nullity exception in the *Montrou Ltd v Grundkotter Fleischvertriebs GmbH*.<sup>245</sup> The facts of the *Montrou* case are that there was a contract of sale for meat by GF to Ballaris. The price was to be paid through a deferred payment credit. Montrou was a financial company that was financing the purchase on behalf of Ballaris. One of the documents to be presented, was a certificate of inspection signed by Montrou. Grundkotter did not have any dealings with Montrou and during the course of negotiations it appeared that Grundkotter could sign the certificate of inspection on behalf of Montrou. Montrou sent a stamp by post and the certificate of inspection was created. Grundkotter had acted innocent of fraud.

Documents conforming on their face were presented and accepted by the issuing bank, which in turn presented them to Montrou. Montrou raised the issue of the certificate which had been created without its authority and sought to avoid paying. The issuing bank paid the credit and turned to Fibi Bank for payment.<sup>246</sup> Fibi Bank then sought summary judgment against Montrou if it were to be found liable to the issuing bank. In the court *quo*, Raymond Jack QC found that the set of facts did not warrant for the application of the fraud exception rule as there had been no fraud.<sup>247</sup> As a result, Grundkotter was entitled to payment. The defence of Montrou of the certificate of inspection being a nullity was rejected as not forming part of English law.<sup>248</sup>

The matter was taken on appeal. The Court of Appeal came to the same conclusion that the nullity exception did not form part of English law. The reasoning of the Court of Appeal was premised on three distinct principles. Lord Potter ruled that the

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<sup>245</sup> [2002] 1 All ER 257.

<sup>246</sup> Fibi Bank had applied for the credit acting on instructions of Montrou who was the Applicant in the letter of credit.

<sup>247</sup> *Montrou Ltd v Grundkotter Fleischvertriebs GmbH* [2002] 1 All ER 257 257.

<sup>248</sup> *Montrou Ltd v Grundkotter Fleischvertriebs GmbH* [2002] 1 All ER 257 258; Hooley 2002 61 (2) *Camb L J* 279.

autonomy principle and the rule that banks deal only with documents and goods coupled with the issuing bank's duty to pay against the presentation of documents which conform on their face entitled the beneficiary to payment. Conversely, the issuing bank was to pay against documents complying on their face.

In rejecting the appeal, Lord Potter also cited the provision of the UCP 500 as it was the UCP applicable at that time. He stated that the bank had failed to treat the presentation as non-conforming inside the days which are stated in the UCP. With the bank not rejecting the documents during the *dies induciae*, the bank was precluded from treating the presentation as non-conforming. Lord Potter ruled that upon the proper application of the provisions of the UCP, the liability of the issuing bank to pay on maturity accrued seven days after the presentation of the various documents.<sup>249</sup>

Lord Potter went on to define the meaning of fraud along the principles set out by Lord Diplock in the case of *United City Merchants v Royal Bank of Canada*.<sup>250</sup> He ruled that for fraud under letters of credit to be established, there had to be knowledge of the fraud by the beneficiary and intent to accrue an undue benefit. He sought not to extend or avoid the fraud exception and was of the view that even if the beneficiary had created the certificate of inspection, he was not guilty of fraud as his intentions were devoid of any fraudulent intentions. As such the fraud exception did not apply.

Finally, the nullity exception was rejected based on sound policy. He postulated that the formation of the nullity exception would not accord with the precision of the law relating to letters of credit and would provide a loophole and chink in the armour in the principles of autonomy and negotiability. He saw the recognition of the nullity exception as being burdensome on the banks as it placed a responsibility on them to investigate facts which it was not competent to do. To require banks to investigate facts would fly in the face of the banks' ministerial duty as provided for by the UCP. In conclusion, he sounded a death knell to the recognition of a nullity exception under English law by stating that the recognition of the nullity exception would harm *bona*

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<sup>249</sup> *Montrod Ltd v Grundkötter Fleischvertriebs GmbH* [2002] 3 All E.R. 697 708b.

<sup>250</sup> [1983] 1 AC 168.

*fide* beneficiaries in chain contracts, as it would impact negatively on the efficacy of trade financing via documentary credits.

Although the decision by Potter is criticised for not according with logic, as it obliges a bank to pay against waste paper and leads to tolerance of the circulation of fraudulent documents in international trade,<sup>251</sup> Hugo postulates that *Montrod* was a logical conclusion to the *United City Merchants* case.<sup>252</sup>

### 3.5.2 Lessons from Singapore

With English commercial law having influenced Singapore commercial law, it was expected that the courts in Singapore would closely follow decisions of the English courts.<sup>253</sup> Twenty years after Lord Potter's decision in the case of *Montrod Ltd v Grundkötter Fleischvertriebs GmbH*,<sup>254</sup> the Singapore Court of Appeal deliberated upon the question of the nullity exception. In *Beam Technology (MFG) PTE Ltd v Standard Chartered Bank*,<sup>255</sup> the Singapore Court of Appeal recognised the nullity exception although confining it to strict limits. In this case, a letter of credit was opened for payment of the sale of electronic components. One of the documents to be presented by the beneficiary in order to obtain payment, was a "clean air waybill." When the documents were presented the confirming bank rejected the air waybill on the basis that the freight forwarders which had purported to have issued the air waybill were non-existent. The beneficiary brought a claim for summary judgment for payment under the letter of credit. The question before the court was whether the bank was entitled to refuse to make payment when the air waybill was a forgery known to the bank.<sup>256</sup>

The court did not follow the reasoning in the *United City Merchants v Royal Bank of Canada*<sup>257</sup> and *Montrod Ltd v Grundkötter Fleischvertriebs GmbH*,<sup>258</sup> as it held that the

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<sup>251</sup> Hooley 2002 61 (2) *Cambridge L J* 281.

<sup>252</sup> Hugo and Lambertyn *Documentary Credits and Independent Guarantees* (Annual Banking Law Update 2004) 12.

<sup>253</sup> [1983]1 AC 168.

<sup>254</sup> [2002] 3 All E.R. 697.

<sup>255</sup> [2003] 1 S.L.R. 597.

<sup>256</sup> *Beam Technology (MFG) PTE Ltd v Standard Chartered Bank* [2003] 1 S.L.R. 597 para 5.

<sup>257</sup> [1983]1 AC 168.

<sup>258</sup> [2002] 3 All E.R. 697



two cases were not direct authority on the question before the court. The court differentiated the *Montrod v Grundkotter Fleischvertriebs GmbH*<sup>259</sup> case and viewed the document in issue in the *Montrod v Grundkotter Fleischvertriebs GmbH*<sup>260</sup> case as not being essential but one which dealt with the quality of the goods sold.<sup>261</sup> The Court of Appeal found that a nullity exception under letters of credit existed. The court tried to strike a balance between the interests of the UCP, common law and international trade, ruling that a bank was not obliged to look beyond the faces of the documents, however, that hindrance did not apply to a situation where a material document was forged and was null and void.

The court set out the procedure for having resort to the nullity exception. The court allowed for reliance on the nullity exception subject to certain requirements. The exception must be resorted to within the *dies induciae* set by the UCP. The document, which was the subject of the exception, had to be, a material document, which had been forged so as to render it null and void, and notice had to be given to the beneficiary within the time frame set by the UCP.<sup>262</sup>

The rationale for the recognition of the nullity exception under Singapore law was that a proper document was what was required. Chao Hick Tin J.A buttressed the principle of the nullity exception by saying that if a bank, in the face of a null and void document forged without the knowledge of the beneficiary had still to honour the credit, this would defy logic and common sense.<sup>263</sup> It can therefore be said that the nullity exception as recognised in Singapore has a narrow definition.

### **3.6 The Unconscionability Exception**

Just like any other exception, the unconscionability exception seeks to provide protection to the principal. However, this exception is applicable when there is no fraud or nullity in the documents presented. The unconscionability exception is used when the beneficiary's conduct in claiming payment under the guarantee though not

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<sup>259</sup> [2002] 3 All E.R. 697.

<sup>260</sup> [2002] 3 All E.R. 697.

<sup>261</sup> *Beam Technology (MFG) PTE Ltd v Standard Chartered Bank* [2003] 1 S.L.R. 597 para 31.

<sup>262</sup> *Beam Technology (MFG) PTE Ltd v Standard Chartered Bank* [2003] 1 S.L.R. 597 para 36.

<sup>263</sup> *Beam Technology (MFG) PTE Ltd v Standard Chartered Bank* [2003] 1 S.L.R. 597 para 33.

amounting to fraud is devoid of good faith. This takes the form of the beneficiary taking an unfair advantage in the exercise of his unbridled right to demand payment. This exception enables the court upon application to restrain the beneficiary from demanding payment because doing so under the circumstances would be an abuse of the beneficiary's right. Unconscionability means that a condition in a claim of the beneficiary to draw under the credit or demand guarantee is so maligned with *mala fides* that the court decides to prevent payment in the absence of fraud or forgery.<sup>264</sup> Mere breaches of contract by the party who is claiming payment under the performance guarantee was not held to be covered under the unconscionability exception.<sup>265</sup>

This exception should, however, be distinguished from the fraud exception as it does not require fraud on the part of the beneficiary. It must also be distinguished from the nullity exception as it exists in the absence of a document which is a nullity. A beneficiary's conduct may be unconscionable even in the absence of fraud and nullity.

Where a beneficiary seeks recourse in the courts under the unconscionability exception, the court may restrain the beneficiary from demanding or receiving payment under the instrument, restrain the bank from making payment or grant a freezing injunction against the beneficiary.

### *3.6.1 The Unconscionability Exception under English Law*

There seems to be no settled position under English law regarding this exception, with many English cases pronouncing that fraud is the only exception to the autonomy principle under letters of credit and demand guarantees. Although the issue in question was not expressly referred to as the unconscionability exception, the *Earl of Chesterfield*<sup>266</sup> case ruled that the common law courts may provide relief in situations where the established principles of law would have prevented contracting parties from escaping the consequences of their contracts.<sup>267</sup> This case was not a documentary credit case but left room for the recognition of the unconscionability exception. The

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<sup>264</sup> Ellinger and Neo *The Law and Practice of Documentary Credit* 169.

<sup>265</sup> *GHL Pte Ltd v Uniback Building Construction Pted Ltd* 1999 4 SLR 604.

<sup>266</sup> (1750) 28 ER 82 (Ch).

<sup>267</sup> Woolf *The Doctrine of Unconscionability* 24.

first recognition of unconscionability in letters of credit and demand guarantees was in 1966, where it was held in *Elian and Rabbath v Matsas and Matsas*,<sup>268</sup> that in the system of performance bonds, there might be situations where the bad faith of the party entitled the court to permeate the autonomy principle by granting an injunction so as to avoid an irretrievable injustice.

In *Potton Homes Ltd v Coleman Contractors Ltd*,<sup>269</sup> Eveleigh LJ ruled that it was improper to regard fraud as the only situation where the court would interdict the buyer, and that each case ought to be decided on its own merits. He postulated that where it warrants, the seller should be able to prevent a call on the bond. In this case, a contractor and an employer had contracted for a construction project where the employer agreed to provide funds for the implementation of the project.<sup>270</sup> The employer (the buyer) fell behind on its payments, which resulted in a dispute arising between the employer and contractor regarding defects in the constructed units. The employer made a demand under the performance bond and the contractor sought payment for sums due on the underlying contract and an injunction to stop the employer from obtaining payment under the performance bond. The contractor succeeded in interdicting the employer from calling on the performance bond on the basis of unconscionability.

The unconscionability exception was partially recognised by *TTI Team Telecom International Ltd v Hutchinson 3G UK Ltd*,<sup>271</sup> where the court was of the view that a lack of good faith is an established ground on which a beneficiary may be restrained from demanding or receiving payment under a performance bond. This case involved a contract to supply computer equipment by TTI to H3G. H3G made an advance payment of part of the contract price and TTI acquired an advance payment guarantee issued by its bank in favour of H3G, covering the amount advanced. When a dispute arose over the performance of the contract by TTI, H3G sought to call on the demand guarantee. TTI sought to interdict the calling of the bond on the grounds that the demand was in bad faith.

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<sup>268</sup> [1966] 2 Lloyd's Rep 495.

<sup>269</sup> (1984) 28 Build LR 19.

<sup>270</sup> *Potton Homes Ltd v Coleman Contractors Ltd* (1984) 28 Build LR 19 20-21.

<sup>271</sup> [2003] 1 All ER 914.

Although the court recognized that *mala fides* in the conduct of a beneficiary is a ground to restrain a beneficiary from calling up a bond or demand guarantee,<sup>272</sup> the injunction was not granted for lack of evidence on the allegation of bad faith.<sup>273</sup> The recognition of the unconscionability exception in *TTI Team Telecom International Ltd v Hutchinson 3G UK Ltd*<sup>274</sup> was *obiter* and it cannot be stated as proper recognition of the unconscionability exception.<sup>275</sup> The unconscionability exception under English law has however been criticized as "being uncertain, made *ex tempore*, *obiter* and running contrary to established English authority."<sup>276</sup> This criticism places the unconscionable conduct exception as a nonentity under English law.

### 3.6.2 The Unconscionability Exception under Singaporean Law

With Singapore being a former British colony and having adopted the British common law, it would be expected that their decisions would be influenced by those of the English courts.<sup>277</sup> Until recently, fraud was the only recognized exception to the independence principle under documentary credits and demand guarantees under Singapore law.

The position was that where a beneficiary made a call (in whatever circumstances) in the absence of fraud, then the bank must pay despite the demand seeming unfair to the account party.<sup>278</sup> The increase in the number of abusive calls in Singapore created a mischief which the law had to curb. Learning from *Potton Homes Ltd v Coleman Contractors Ltd*,<sup>279</sup> in *Royal Design Studio Pte Ltd v Chang Development Pte Ltd*,<sup>280</sup> the court granted an injunction to prevent the beneficiary of a performance bond from benefitting from his own wrong. The decision was premised on the enforcement of the underlying contract and did not touch on the demand guarantee itself. In *Kvaener Singapore Ltd v UDL Shipbuilding Pte Ltd*,<sup>281</sup> the court departed from the *Royal*

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<sup>272</sup> *TTI Team Telecom International Ltd v Hutchinson 3G UK Ltd* [2003] 1 All ER 914 para 34.

<sup>273</sup> *TTI Team Telecom International Ltd v Hutchinson 3G UK Ltd* [2003] 1 All ER 914 para 96.

<sup>274</sup> [2003] 1 All ER 914.

<sup>275</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 161.

<sup>276</sup> Enonchong *2007 LMCLQ* 102.

<sup>277</sup> Alavi *2016 Acta U Danubius Jur* 103.

<sup>278</sup> *American Home Assurance Co v Hong Lam Marine Pte Ltd* [1999] 3 SLR 682 para 42.

<sup>279</sup> (1984) 28 Build LR 19.

<sup>280</sup> 1990 1 SLR 1116.

<sup>281</sup> 1993 3 SLR 350.

*Design*<sup>282</sup> case and developed a line of reasoning to include interdicts against issuers of performance guarantees. These were the first steps in the departure from the established English position of recognizing fraud as the only exception to the independence principle.<sup>283</sup>

The *locus classicus* for the unconscionability exception in Singapore is *GHL Pte v Unitrack Construction Ltd*<sup>284</sup> where the court upheld the unconscionability exception. An employer and a contractor had concluded a construction contract. The guarantee to cover the contractor's obligations was ten percent of the contract price. The contract price was reduced, but the bond amount was not. There was a dispute between the contractor and the employer and the employer sought to call on the unrevised performance bond. The court ruled that although fraud was absent, it was unconscionable for the employer to call on the bond, which was ten percent of the original price, when the contract price had been revised downwards. The same line of reasoning was also employed in *Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd*.<sup>285</sup>

The unconscionability exception under Singapore law does not lend itself to easy definition. There have been various attempts to define unconscionability. In *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa*,<sup>286</sup> the Singapore Court of Appeal did not set out the parameters of the unconscionability exception, finding such an exercise to be futile, but left it open ended to include situations where malice was involved. Whether or not a party's conduct is unconscionable is a question which is to be answered by looking at the facts of each case. There is no hard and fast rule or test in regards to what amounts to unconscionability.

In trying to define unconscionability, Lai Kew Chai J suggested in *Raymond Construction Pte Ltd v Low Yang Tag*,<sup>287</sup> that unconscionability involves unfairness as opposed to dishonesty or fraud, or conduct which is so maligned with malice that a

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<sup>282</sup> 1990 1 SLR 1116.

<sup>283</sup> Alavi 2016 *Acta U Danubius Jur* 103.

<sup>284</sup> 1999 4 SLR 604.

<sup>285</sup> 2003 1 SLR 667.

<sup>286</sup> 2000 1 SLR 657.

<sup>287</sup> (Suit 1715/95, 11 July 1996 unreported).

reasonable court would either interdict such a party or refuse to assist the party. Mere breach of contract by the party does not translate to unconscionability. In a bid to bring clarity and certainty to the unconscionability exception, *McConell Dowell Constructors (Aust) Pty Ltd v Sembcorp Engineers and Constructors Pte Ltd*<sup>288</sup> ruled that a case of unconscionability should deal with an element of unfairness. It is now a settled position of the law that unconscionability involves unfairness, but that does not translate unfairness in every situation into being unconscionable.

In summation, it should be noted that under Singapore law the unconscionability exception does not have a precise definition but is centered on curbing unfairness and the abuse of rights. The unconscionability exception, just like the fraud exception, is an abstract exception which is recognized under Singapore law. Although the cases which have been referred to are concerned with performance guarantees, it is submitted that the unconscionability exception is equally of application to letters of credit under Singapore law. Although there is, controversy relating to the unconscionability exception the world over, the application of this exception in Singapore has not hampered international trade.

### **3.7 Conclusion**

This chapter has dealt with the fraud exception rule that is the universally accepted exception to the independence principle under letters of credit. The exception was analysed by looking at the essential elements of the fraud exception under South African and English law. The chapter looked at how the fraud exception rule operates from the perspective of the account party and the issuing bank. From the discussion it is clear that the only recognizable exception that is universally accepted is the fraud exception rule, but, it is not easily attainable. With the burden and standard of proof being very high, to the extent that the fraud exception rule is described as elusive, it is reserved for fitting circumstances only. The fraud exception will apply only where there is clear-cut fraud on the part of the beneficiary. Fraud on the part of the beneficiary also extends to fraud by a third party where the beneficiary was a party to the fraud.

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<sup>288</sup> 2002 1 SLR 199.

The chapter has also looked at the less popular exceptions to the independence principle. The nullity and unconscionability exceptions, although not expressly recognized under English law, have been given partial recognition *obiter* by English law.<sup>289</sup> Full recognition of these exceptions has happened under Singaporean law, which is rooted in English law. The *obiter* commentary in the above-mentioned English cases has heavily influenced the development of these two exceptions in Singapore. The nullity and unconscionability exceptions have a very narrow scope of application so as to preserve the efficacy of the documentary credits under international trade financing. There are very strong policy considerations which advocate the establishment of the two exceptions internationally, and their application has not hampered the development of international trade financing.

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<sup>289</sup> *United City Merchants* (Court of Appeal decision), *Montrod* case for the nullity exception and the *TTI* case for the unconscionability exception.

## Chapter 4-The Illegality Exception

### 4.1 Introduction

The previous chapter has discussed the universally accepted fraud exception rule together with the other controversial exceptions to the independence rule whose recognition is still arguable and is selective, the unconscionability and nullity exceptions. This chapter will look at the illegality exception and ask if illegality in the underlying transaction ought to extend to the letter of credit, contrary to the independence principle. It will analyse the illegality exception as recognised in different jurisdictions and look at ways to advocate its establishment under South African law. It will define illegality under general law, and illegality in letters of credit. There will be an exploration of illegality, which should suffice to trigger the withholding of the payment of a letter of credit, as well as of the standard of proof that would suffice for a bank to withhold payment.

### 4.2 Illegality in a General Context

The law, as defined, is a set of legal principles, which governs human conduct and are enforceable by the state.<sup>290</sup> It is an inherent characteristic of the law of contract that parties have freedom to contract, but, such freedom is not absolute and the contract has to be within the confines of the law.<sup>291</sup> Roman Dutch law also provides that a contract should not be contrary to public morals (*contra bonos mores*).<sup>292</sup> In other words, "if a contract is contrary to the law, good morals or public policy", it is illegal, and illegal contracts do not create any rights and are void.<sup>293</sup> Illegality is defined as an act that is forbidden by the law, or that is unlawful.<sup>294</sup> It follows that a transaction is illegal or tainted with illegality if the law prohibits the transaction or some characteristic of it.<sup>295</sup> Illegality arises in two circumstances namely statutory illegality and common law illegality. For example, a contract for the sale of marijuana would

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<sup>290</sup> Maisel and Greenbaum *Introduction to Law and Legal Skills* 15.

<sup>291</sup> Bradfield *Christie's Law of Contract* 402.

<sup>292</sup> *Botha v Finanscredit (Pty) Ltd* 1989 (3) SA 773 (A) 782.

<sup>293</sup> Bradfield *Christie's Law of Contract* 392.

<sup>294</sup> Garner *Black's Law Dictionary* 815.

<sup>295</sup> Alavi 2016 *20 Kor U L Rev.* 7.



not be valid under South African law. In the event of a dispute, the court would not render any assistance to enforce any rights arising out such a contract.<sup>296</sup> Such a contract is *void ab initio*. The same thing applies to a contract that is *contra bonos mores*.<sup>297</sup> A court in South Africa would not assist parties in a contract entered into for the purposes of furthering prostitution. It should be noted, however, that morals differ from society to society. The rationale behind the court's playing the role of an innocent bystander in illegal contracts is premised in the *in pari delicto* rule as well as the common law position that nothing good comes out of something that is bad.<sup>298</sup> Should there be an illegal contract, the loss would lie where it falls.<sup>299</sup>

### **4.3 Illegality in Letters of Credit**

Illegality in letters of credit exists in two forms, the first being that the underlying contract itself is illegal. The contract may be for the sale of arms or for the sale of minerals by persons who are not authorised under law to be dealing in such. In South Africa, it is illegal to trade minerals with persons without a licence issued by the regulator,<sup>300</sup> so if a party is to contract with such prohibited persons then their contract is an illegal one. A contract could be illegal because of sanctions placed by a country on another country, making it illegal to deal with persons from that particular country. The *Zimbabwe Democracy and Economic Recovery Act*<sup>301</sup> promulgated by the United States Congress had the effect of making certain dealings with the Zimbabwean government and different Zimbabwean state-owned enterprises illegal.<sup>302</sup> The same applied to the sanctions placed on Iraqi companies after the invasion of Kuwait by Iraq. It became illegal for UK companies to honour letters of credit in favour of Iraqi companies.<sup>303</sup> There are also other circumstances wherein the underlying contract is

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<sup>296</sup> Bradfield *Christie's Law of Contract* 455.

<sup>297</sup> Bradfield *Christie's Law of Contract* 455; *Lion Match Co Ltd v Wessels* 1946 CPD 376 381.

<sup>298</sup> *MacFoy v United Africa Co.* 1962 A.C 152 160.

<sup>299</sup> Van Der Merwe *et al Contract General Principles* 173.

<sup>300</sup> S4 of the *Precious Metals Act* 37 of 2005.

<sup>301</sup> *Zimbabwe Democracy and Economic Recovery Act* of 2001.

<sup>302</sup> Chigara 2017 25 *Afr J Int'l & Comp L* 298; S4 of the *Zimbabwe Democracy and Economic Recovery Act* of 2001.

<sup>303</sup> *Itek Corp v First Nat Bank* (1981 D Mass).

illegal because it violates exchange control regulations<sup>304</sup> or infringes lending limits on credits.<sup>305</sup>

The rationale behind the recognition of illegality is the same as that behind the fraud exception rule. The maxim *ex turpi causa non oritur actio* which loosely translates into "No court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act", has certain implications on the legality and enforceability of contracts. There are two consequences of this maxim, the first being that the "court will not enforce a contract which is expressly or impliedly forbidden by statute or that is entered into" for the furtherance of an illegal activity and the second being that the court will not assist a claimant to recover a benefit from his own wrongdoing.<sup>306</sup> Having regard to this rule, if B agrees to kidnap C in exchange for a sum of money paid by A but borrowed from D, the loan agreement between D and A would be illegal if D is aware of the purpose of the loan. The illegality exception also applies where the loan agreement is replaced by a letter of credit in favour of B. Since fraud is the only recognised exception, under this hypothetical situation D, being aware of the purpose of the letter of credit, would not be allowed to withhold payment to B. The question to be asked is whether the illegality of the underlying contract should extend to the letter of credit, notwithstanding the existence of the autonomy principle.

The second form of illegality is illegality in the letter of credit. Letters of credit are often issued by financial institutions, and the government of any respective jurisdiction may cause any financial institution to be placed under curatorship. When a financial institution is under curatorship, any letters of credit issued by it will be illegal for lack of capacity, and no rights and obligations arise out of such an issuance.<sup>307</sup> The position concerning a situation where the letter of credit is illegal is quite settled. The issue of permeating the independence principle does not arise, as the letter of credit itself is unenforceable based on its illegality. These cases of illegality are rare, however, as banks do not issue letters of credit where they are aware of the illegality.<sup>308</sup>

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<sup>304</sup> Mugasha 2004 5 J Bus L 515, *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL).

<sup>305</sup> *Id International Dairy Queen Inc v Bank of Wadley* (1976 MD Ala).

<sup>306</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 186.

<sup>307</sup> Alavi 2016 20 Kor U L Rev 8.

<sup>308</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 186.

Another type of illegality often arises due to supervening impossibility. At the time of issuing the letter of credit, the bank is legally able to honour the credit when a conforming presentation is made, but due to supervening unforeseen circumstances at the time of contracting, payment becomes illegal. The supervening statutory impossibility renders any payment obligations under the letter of credit illegal and unenforceable. A concrete example occurred when the United Kingdom promulgated a number of statutes outlawing the payment of any funds to person in Iraq or Kuwait following the Iraqi invasion of Kuwait. When sanctions are imposed by a country on another country, as happened in the Iraq invasion, they are not extinguished by the lifting of the sanctions but may continue to be in existence for a lengthy period after the embargo has been uplifted.<sup>309</sup>

#### ***4.4 Arguments for the Recognition of the Illegality Exception***

A bank will stop honouring a letter of credit where there is a discovery of illegality before the credit has been honoured. Payment will be withheld even though the presentation conforms to the terms of the letter of credit.<sup>310</sup> There have been many policy considerations concerning reasons for recognising the illegality exception. On the other hand of paramount importance is the need to preserve and perpetuate the sanctity of the letters of credit, on the one hand, and on the other hand, there is the policy against the enforcement of transactions tainted with illegality.<sup>311</sup>

##### *4.4.1 Consideration Being Consistent with the Established Principles.*

It is without doubt that the fraud exception rule is the most universally accepted exception to the independence principle under letters of credit and demand guarantees.<sup>312</sup> The recognition of the illegality exception requires little extension of the recognised fraud exception rule.<sup>313</sup> Under English and South African law, it is clear law that the court will not assist in the enforcement of an illegal contract.<sup>314</sup> The rationale behind this principle is that although the letter of credit is independent and

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<sup>309</sup> *Shanning International Ltd (in liq) v Lloyds TSB Bank plc* [2001] 1 WLR 1462.

<sup>310</sup> Kelly-Louw 2009 *Comp & Int'l L J S Afr* 379.

<sup>311</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyds Rep 911.

<sup>312</sup> Kelly-Louw 2009 *Comp & Int'l L J S Afr* 351.

<sup>313</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 188.

<sup>314</sup> Amaefule *Exceptions to the Principle of Autonomy* 212; Kelly Louw *Selective Legal Aspects* 277.

autonomous from the underlying contract there is a close link between the two so that illegality in the underlying contracts extends to the letter of credit.<sup>315</sup>

The juristic basis of the fraud exception rule is the maxim *ex turpi causa non oritur actio*. This maxim translates into "No court will assist a party who has a cause of action founded in an illegal activity."

#### 4.4.2 *The Same Juristic Basis as the Fraud Exception Rule*

The juristic basis of the recognised fraud exception rule is the maxim *ex turpi causa non oritur actio*.<sup>316</sup> This is also the same basis for the illegality exception. The maxim loosely translated means "No action may arise from an unworthy or base cause."<sup>317</sup> What amounts to an unworthy or base cause has been described as being fraud or illegality.<sup>318</sup> With the fraud exception having the same juristic basis as the illegality exception, and the fraud exception providing a basis for the breach of the independence principle, the same should occur when the illegality exception is applied.<sup>319</sup>

The strongest argument for the recognition of the illegality exception is the public policy basis in favour of the application of the *ex turpi causa non oritur actio*. With the recognised fraud exception seeking to curb mischief against a private interest and the protection of the bank's private interests, there is more reason to recognise illegality as an exception, as it seeks to provide protection for public interest.<sup>320</sup> In *Mahonia Ltd v JP Morgan Chase Bank (No 1)*,<sup>321</sup> the court remarked that if a beneficiary should be stopped from using a letter of credit to benefit from his own fraud, the same should apply in the case of illegality.<sup>322</sup> It defies logic why the same beneficiary should be aided by the courts in enforcing a fraction of an underlying contract which would not

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<sup>315</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 188.

<sup>316</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 189.

<sup>317</sup> Virgo *The Principles of the Law of Restitution* 740.

<sup>318</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 189.

<sup>319</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 189.

<sup>320</sup> Enonchong 2006 *LMCLQ* 412.

<sup>321</sup> [2003] 2 *Lloyd's Rep* 911 QB.

<sup>322</sup> [2003] 2 *Lloyd's Rep* 911 QB para 68.

have been enforceable because of illegality, but for the letter of credit, however serious the material illegality involved.<sup>323</sup>

If the fraud exception is meant to protect the private interests of the bank, the rationale to protect public interests lends more credence to the recognition of the illegality exception.<sup>324</sup>

#### *4.4.3 No Additional Responsibilities on Banks.*

With the UCP 600 regulating the operation of letters of credit and providing that banks are concerned with documents and not the underlying contract,<sup>325</sup> the scope of the illegality exception should be in line with these principles. The duty of the bank is to examine documents presented to it, to check whether they conform to the terms and conditions of the credit.<sup>326</sup> Subsequently, there have been arguments that the recognition of the illegality exception will place an obligation on the banks to investigate the underlying contract and determine illegality in the underlying contract.<sup>327</sup> The application of the illegality exception will follow the same process as the fraud exception. If, upon examination, the bank does not discover any illegality *ex facie* the documents presented, it should honour the credit.<sup>328</sup> The exception will apply only where there is clear evidence of illegality. This approach would not contravene the ministerial duties bestowed on banks in as far as honouring letters of credit is concerned.<sup>329</sup>

### **4.5 The Illegality Exception under English Law**

It is a well-established fact that South African commercial law is heavily influenced by the tenets of English law.<sup>330</sup> To date there is only one recognised exception to the independence rule, which is the fraud exception.<sup>331</sup> Although they have not expressly

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<sup>323</sup> *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] 2 Lloyd's Rep 911 para 68.

<sup>324</sup> Enonchong 2006 *LMCLQ* 412.

<sup>325</sup> A 5 of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>326</sup> A 14 (a) of the Uniform Customs and Practice for Documentary Credits 600 (2007).

<sup>327</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 189.

<sup>328</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 189.

<sup>329</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 189.

<sup>330</sup> Kelly Louw *Selective Legal Aspects* 91.

<sup>331</sup> Alavi 2016 *Actual Probs Econ & L* 125.

recognised other exceptions, there were circumstances when the English courts acknowledged the existence of other exceptions other than the fraud exception rule.<sup>332</sup>

The first major recognition of the illegality exception was in the case of *United City Merchants v Royal Bank of Canada*.<sup>333</sup> Although this case is seen as the *locus classicus* of third party fraud, the judgment was the first to pronounce illegality as an excuse for breaching the autonomy principle under letters of credit.<sup>334</sup> The illegality issue in this case was called the Bretton Woods Point,<sup>335</sup> as it was in contravention of the Bretton Woods Agreement.<sup>336</sup> The contract between the buyer and the seller was that the purchase price for the goods being sold was to be overstated. With the seller having received its purchase price, it would remit the excess to the credit of the buyer's associate in the United States of America. The buyer's associate would receive the excess in United States dollars from the proceeds of the letter of credit paid by the Peruvian bank, which the buyer would have paid in Peruvian currency. Such a scheme was illegal under Peruvian law, which outlawed the maintenance or establishment of foreign currency accounts by Peruvians. Peruvian law also forbade the overvaluation of imports and obligations payable in foreign currency, which were contrary to Peruvian exchange regulations.

During the hearing, after ventilation of the potentially illegal issue under the Bretton Woods Agreements, Lord Diplock held that "payment by the confirming bank to the sellers of half of the invoice price was an essential part of the monetary transaction and therefore unenforceable".<sup>337</sup> Due to the illegality issue, the seller lost half of the instalments. Although illegality was not recognised as a distinct exception to the autonomy principle under documentary credits, it was evident that the court would not give credence to illegal conduct, regardless of its being masked under the system of letters of credit.<sup>338</sup> It is the author's view that this was the first step towards the

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<sup>332</sup> Enonchong 2006 LMCLQ 404; *United City Merchants case*; *Group Josi Re, Mahonia (No 1)*.

<sup>333</sup> [1983] 1 AC 168.

<sup>334</sup> Lu *Exceptions in Documentary Credits* 205.

<sup>335</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168 169.

<sup>336</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168 188.

<sup>337</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168 190.

<sup>338</sup> Lu *Exceptions in Documents Credits* 207.

recognition of the illegality exception under documentary credits distinct from the fraud exception.

The first English decision to have particularly dealt with the question as to whether illegality in the underlying contract could be a ground for the piercing of the autonomy principle on grounds apart from fraud was *Group Josi Re v Walbrook Insurance Co Ltd and Others*.<sup>339</sup>

The case was between reinsurer claimants under different reinsurance contracts and their defendant reinsured companies. Letters of credit were issued in favour of Walbrook Insurance on account of Group Josi Re in return of the payment of certain sums of money which had been detained by Walbrook Insurance as loss reserves. Later claimants required an injunction to interdict insured companies from demanding payment under the letter of credit. Among others, a ground for requesting an injunction by the claimants was the illegality of reinsurance contracts based on section 2 of the English Insurance Companies Act 1982, which banned claimants from performing insurance business in England in the absence of an official authority.<sup>340</sup> Claimants argued that, since illegality in underlying reinsurance contracts will affect the letters of credit, they are unenforceable and the court should enjoin the bank from honouring them. The Court of Appeal was faced with the question of whether illegality in the underlying contract could cause and find a ground for a distinct illegality exception.

In the hearing, in the court a *quo*, Clarke J held that letters of credit were independent of the underlying contract and illegality in the underlying contract could not taint the letters of credit.<sup>341</sup> The matter was taken up on appeal. Saville LJ expressed the opinion that illegality in the underlying contract does not affect the enforceability of the letters of credit.<sup>342</sup> Staughton LJ, in passing a dissenting judgment about why the letters of credit were not to be paid out, stated that:

... in my judgment illegality is a separate ground for non-payment under a letter of credit. That may seem a bold assertion, when Lord Diplock in the *United City*

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<sup>339</sup> [1996] 1 Lloyd's Rep 345/ [1996] 1 W.L.R 1152.

<sup>340</sup> *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 W.L.R 1152 1153A.

<sup>341</sup> [1996] 1 Lloyd's Rep 345 368.

<sup>342</sup> [1996] 1 Lloyd's Rep 345 368.

*Merchants* case said that there was one established exception. In the same case, the House of Lords declined to enforce a letter of credit contract in part for another reason [besides fraud], that is to say the exchange control regulations of Peru as applied by the Bretton Woods Agreement Order in Council 1946. I agree that the Bretton Woods point may well have been of a kind of its own and not an indication that illegality generally is a defence under a letter of credit. But it does perhaps show that established fraud is not necessarily the only exception.<sup>343</sup>

He went on further to add that:

It seems to me that there must be cases when illegality can affect a letter of credit. Take for example a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1000 Kalashnikov rifles to be carried to the port of Basra. I do not suppose that a court would give judgment for the beneficiary against the bank in such a case.<sup>344</sup>

In seemingly emphasizing his indication of the existence of an illegality exception, Staughton LJ also added that before illegality could be viewed as a basis for preventing payment by the bank, it had to be clearly established, and there had to be prior knowledge by the bank.<sup>345</sup> Furthermore, he stated that if the reinsurance contracts were illegal and if the letters of credit were used to pay sums due under illegal contracts, the court would restrain the bank from making payment and the beneficiary from claiming payment, if the illegality had been clearly proved.<sup>346</sup> The rationale for such a stance being that the letters of credit were being used to further an illegal cause rather than their being illegal *per se*.<sup>347</sup> The decision by Staughton LJ in *Group Josi Re*<sup>348</sup> although discussing the illegality exception, left the subject under a cloud of uncertainty as his decision was mainly in *obiter*.<sup>349</sup>

The illegality exception question once again came before the English courts in *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)*.<sup>350</sup> This case involved the collapse of Enron. The facts of the matter are that the beneficiary (Mahonia) was a special purpose vehicle created for the purpose of facilitating Enron's financial transactions. Enron applied to the London branch of West LB AG, a German bank, for the issuing of

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<sup>343</sup> [1996] 1 Lloyd's Rep 345 362.

<sup>344</sup> [1996] 1 Lloyd's Rep 345 362.

<sup>345</sup> [1996] 1 Lloyd's Rep 345 362.

<sup>346</sup> [1996] 1 Lloyd's Rep 345 362.

<sup>347</sup> [1996] 1 Lloyd's Rep 345 362.

<sup>348</sup> [1996] 1 Lloyd's Rep 345.

<sup>349</sup> Enonchong 2006 *LMCLQ* 409; Alavi 2016 *20 Kor U L Rev* 11.

<sup>350</sup> [2003] 2 Lloyd's Rep QB 911.



a standby letter of credit in favour of Mahonia for the amount of USD 165 million. The letter of credit was issued to support a swap transaction between a subsidiary of Enron and Mahonia. After West LB had issued the letters of credit, Enron declared Chapter 11 bankruptcy. Enron's bankruptcy meant default on Enron's part and default by Enron entitled Mahonia to make a demand under the standby letter of credit. JP Morgan Chase Bank, on behalf of its client Mahonia, made a demand. The issuing bank, West LB refused to pay and argued that although the presentation was conforming to the terms and conditions of the letter of credit, it was unenforceable due to illegality. The illegality alleged was that the transaction was masked to provide Enron with a disguised loan to allow it to illegally manipulate its accounts in breach of the *United States General Accepted Accounting Practices (GAAP)*,<sup>351</sup> *Financial Accounting Standards and the United States Securities Law (Securities Exchange Act 1934)*.<sup>352</sup>

As a result, West LB declined to pay on the standby letter of credit. It sought to use the illegality defence by stating the circumstances under which it asserted that the purpose behind the letter of credit was for Enron to disguise a loan agreement which was in violation of U.S criminal and civil law and therefore unenforceable under English law as a result of illegality under public policy grounds.<sup>353</sup> Mahonia applied for the defence to be struck off and for default judgment to be entered in its favour. The court was faced with the legal question whether illegality could amount to a defence.<sup>354</sup> In coming to a decision, Colman J first considered the nature of the illegality contended by the defendant. He came to an interpretation that the procurement of the standby letters of credit was a vital cog for Chase Bank to set up the cosmetic scheme, and as such it was illegal directly or by association or taint.<sup>355</sup> Colman J came to the conclusion that the three swaps as well as the letters of credit had an illegal purpose. With the letters of credit being entered for providing the support system which Enron's misleading accounts were hinged on, the illegality in the underlying contract could taint the letter of credit and provide a defence.<sup>356</sup>

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<sup>351</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's Rep 911 QB para 5.

<sup>352</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 359.

<sup>353</sup> Kelly Louw *Selective Legal Aspects* 263.

<sup>354</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB.

<sup>355</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB 915.

<sup>356</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB para 69.

Without the letters of credit, the basis of the alleged illegality could not have been created.<sup>357</sup> With the alleged purpose being illegal under American law and not English law, the question was whether English courts would refuse to enforce a contract where the purpose was to commit an illegal act in a foreign country.<sup>358</sup> The court dismissed the application for summary judgment referred to *Regazzani v KC Sethia*<sup>359</sup> and stated that a contract which had the common purpose of parties to contravene the law of a foreign country was unenforceable under English law.<sup>360</sup> In the present case, only one party harboured the intention to contravene American law, since West LB was not privy to the alleged illegality. In answering the question as to what would happen if only one of the parties had an unlawful intention, Colman J argued that a party who had contracted for an illegal purpose under English law could not enforce the contract under English law as it was contrary to the *ex turpi causa* principle.<sup>361</sup> He also pointed out that it had to be contrary to the public policy to allow a claimant to enforce a foreign contract entered into for an illegal purpose known only to himself as it would have been if the illegal purpose was known to both parties.<sup>362</sup>

The court was tasked with deciding whether illegality, as opposed to fraud, provided a basis for breaching the autonomy principle. In this regard, Colman J ruled that in the same way that a beneficiary would not be entitled to benefit from his own fraud as a matter of public policy, it also followed that the courts should allow him to "enforce part of an underlying transaction that would have been unenforceable on the grounds of illegality, if no letter of credit had been involved," regardless of the severity of the illegality.<sup>363</sup> Colman J held that there was an arguable case of illegality on the part of the letter of credit which rendered it unenforceable against the defendant.<sup>364</sup> He took the view that the illegality in the underlying contract could breach the

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<sup>357</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB 915.

<sup>358</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB 916.

<sup>359</sup> [1958] AC 301.

<sup>360</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB 916.

<sup>361</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB 916-917.

<sup>362</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's rep 911 QB 919.

<sup>363</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 361.

<sup>364</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's Rep 911 QB 927.

independence principle and taint the letter of credit rendering it unenforceable.<sup>365</sup> He dismissed the application and the matter was referred for a full-scale trial.<sup>366</sup>

The matter went on trial before Cooke J in *Mahonia Ltd v West LB AG (No 2)*<sup>367</sup> and was decided on the merits. The court decided that the issuing bank had to pay against a conforming demand after the bank had failed to sustain an argument that the underlying contract was illegal.<sup>368</sup> Cooke J, came to the conclusion that there was no illegality in the underlying contract as Enron's accounting practices were not contrary to United States Securities law.<sup>369</sup> He also found that Mahonia had not been aware of any unlawful intention and had not been privy to any element of improper accounting.<sup>370</sup> With the court finding that there was no illegality in the manner in which Enron had conducted its dealings, the question of the enforceability of a letter of credit where the underlying credit was illegal was purely academic.<sup>371</sup> Nonetheless, Cooke J commented on this issue and concurred with the decision arrived at in *Group Josi Re* that the independence principle in letters of credit may be breached by illegality in the underlying contract as the illegality extends to the letter of credit.<sup>372</sup>

Cooke J also ruled that whether illegality would affect the enforcement of the letter of credit was to be decided on the facts of each case bearing the illegality involved. He upheld Colman's decision in the court *a quo*<sup>373</sup> and concurred that he would find it illogical for a party to be allowed to enforce a letter of credit upon which the sale of heroin, was hinged which contract would be illegal in both the country of origin and that of destination.<sup>374</sup>

In summation, to date there is no English authority which has expressly recognized an independent illegality exception that would breach the autonomy principle under letter of credit. All the current decisions are *obiter* and as such, not binding.

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<sup>365</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 362.

<sup>366</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)* [2003] 2 Lloyd's Rep 911 QB 928.

<sup>367</sup> [2004] EWHC 1938.

<sup>368</sup> Hugo *Documentary Credits and Independent Guarantees* (Annual Banking Law Updates 2005) 13.

<sup>369</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 363.

<sup>370</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 363.

<sup>371</sup> Amaefule *Exceptions to the Principle of Autonomy* 237.

<sup>372</sup> Kelly-Louw 2009 *Comp & Intl L J S Afr* 363; *Mahonia Ltd v West LB AG (No 2)* [2004] EWHC 1938 para 432.

<sup>373</sup> *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] 2 Lloyd's Rep 911 QB 927.

<sup>374</sup> *Mahonia Ltd v West LB AG (No 2)* [2004] EWHC 1938 para 429.

Consistency in the decisions arrived at by the English courts show that there is a general acceptance and eagerness to recognize the illegality exception under letters of credit. There were also subsequent decisions by the English courts, like *Oliver v Dubai Bank of Kenia*,<sup>375</sup> where the court held that exceptions to the autonomy principle under documentary credits include beneficiary fraud and possible illegality.<sup>376</sup> In *Lancore Services Ltd v Barclays Bank Plc*,<sup>377</sup> the court expressed the opinion that illegality in the underlying contract was a defence for payment in letters of credit.<sup>378</sup>

#### **4.6 The Illegality Exception under Singapore Law**

The Singapore legal system has acclimatized to the recognition of new exceptions to the autonomy principle under letters of credit.<sup>379</sup> The courts in Singapore have recognized the nullity<sup>380</sup> and unconscionability<sup>381</sup> exceptions as new and separate exceptions distinct from the independence principle.<sup>382</sup> It is in this regard that it is relevant to look at the position of the illegality exception under Singapore law.

To date there have not been any reported cases where the Singapore courts have recognized the illegality exception.<sup>383</sup> Contrary to the recognition of the illegality exception, there is judicial opinion against the recognition of the illegality exception.<sup>384</sup> In *American Home Assurance Co v Hong Lam Marine Pte*,<sup>385</sup> performance bonds were dishonoured by the issuing bank because of illegality in the underlying contract. The issuing bank refused to honour the bonds because the underlying contract had been backdated to avoid compliance with certain statutory provisions.<sup>386</sup> The Singapore Court of Appeal rejected the claim that the underlying contract was illegal and unenforceable, holding that the underlying contract for building a ship was enforceable. Furthermore, the court stated that even in the case of illegality in the

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<sup>375</sup> [2007] EWHC 2165.

<sup>376</sup> *Oliver v Dubai Bank of Kenia* [2007] EWHC 2165 para 12.

<sup>377</sup> [2008] EWHC 1264 (Ch).

<sup>378</sup> *Lancore Services Ltd v Barclays Bank Plc* [2008] EWHC 1264 (Ch) para 115.

<sup>379</sup> Amaefule *Exceptions to the Principle of Autonomy* 210.

<sup>380</sup> *Beam Technology (Mfg) Pte Ltd v Standard Chartered* 2003 1 SLR 597.

<sup>381</sup> *GHL Pte v Unitrack Construction Ltd* 1999 3 SLR 862.

<sup>382</sup> Alavi 2016 20 Kor U L Rev 19.

<sup>383</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 205.

<sup>384</sup> Alavi 2016 20 Kor U L Rev 19.

<sup>385</sup> 1999 3 SLR 862.

<sup>386</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 205.

underlying contract, it would not affect the beneficiary's claim on performance bonds as they are independent of the underlying contract. There was no logic in having the illegality in the form of antedating having any effect on the respondent's claim since the purpose of the shipbuilding contract was not to deceive the authorities.<sup>387</sup>

Until such time as the Singapore courts have recognized the illegality exception in Singapore, there is no illegality exception under Singapore law.

#### ***4.7 The Illegality Exception under South African Law.***

Under South African law, a contract, which is against the provisions of a certain statute and contrary to public morals, is void. There are no rights that emanate from such a contract.<sup>388</sup> This is the same when the letter of credit is illegal. The bank is not entitled to pay, due to the doctrine of illegality. This is so because the contract is illegal and nothing arises out of an illegality

The only recognized exception in documentary credits under South African law is the fraud exception rule.<sup>389</sup> There has not been any pronouncement by the South African courts regarding the recognition of the illegality exception.<sup>390</sup> In fact, there has not been any case which has come before the courts which had the question whether illegality could be an exception to the independence principle under letters of credit.

#### ***4.8 Towards the Recognition of the Illegality Exception under South African law.***

It is without doubt that the fraud exception rule is the only exception to the independence rule under letters of credit.<sup>391</sup> The recognized fraud exception rule is a result of decisions by various courts of law in different jurisdictions.<sup>392</sup> The governing set of rules for documentary credits, Uniform Customs and Practice for Documentary

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<sup>387</sup> *American Home Assurance Co v Hong Lam Marine Pte* 1999 3 SLR 862 para 128.

<sup>388</sup> Havenga *et al General Principles of Commercial Law* 91.

<sup>389</sup> *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (SCA).

<sup>390</sup> Kelly Louw 2009 *42 Comp & Int'l L J S Afr* 377.

<sup>391</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 95.

<sup>392</sup> Alavi 2016 *Actual Probs Econ & L* 125.

Credits does not provide for exceptions that are applicable under documentary credits.<sup>393</sup>

With the illegality exception and the fraud exception sharing the same juristic basis, it is argued that the illegality exception should be established as an independent, non-fraud exception to the independence principle under letters of credit. As previously stated, under South African law it is an established principle that the court will not help a party benefit from his own wrong and that an illegal contract is unenforceable.<sup>394</sup> Should the position differ because the contract in issue is a letter of credit, which is said to be independent of the underlying contract? Where there is blatant illegality, should the bank be compelled to pay because the only recognized exception in the fraud exception rule?

The cornerstone of the letter of credit is its independence principle.<sup>395</sup> It is also entrenched in the UCP 600 and it provides that the letter of credit is totally divorced from the underlying contract.<sup>396</sup> Whether or not a credit ought to be honoured is a question which should be responded to with reference to the letter of credit alone.<sup>397</sup>

#### **4.9 Application of the exception**

The fraud exception as a benchmark for the illegality exception has defined parameters for the illegality exception. The illegality exception will be resorted to only in fitting circumstances. In other words, the fraud exception as the benchmark has a narrow application. This leaves the question as to what standards are to be used for the application of the illegality exception.

##### *4.9.1 The Standard of Proof*

The standard of proof used in the fraud exception also ought to be used in the illegality exception.<sup>398</sup> A high standard of proof ensures that the efficacy of the letters of credit is maintained and the autonomy of the independence principle is preserved and kept

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<sup>393</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 96.

<sup>394</sup> Bradfield *Christie's Law of Contract in South Africa* 454.

<sup>395</sup> Kelly Louw *Selective Legal Aspects* 335.

<sup>396</sup> A 5 of Uniform Customs and Practice for Documentary Credits 600 (UCP).

<sup>397</sup> Hugo 2014 *J S Afr L* 662.

<sup>398</sup> *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 Lloyd's Rep 345 362.

intact.<sup>399</sup> The law requires that fraud must be clearly established for one to succeed under the fraud exception rule.<sup>400</sup> For the illegality exception to succeed the party seeking it should show that there is clear and established illegality. The standard of clearly established illegality is not one which is easily attainable and as a result the illegality exception, like the fraud exception, will be successfully established in only a few cases.<sup>401</sup> The high burden of proof will ensure that the illegality exception is reserved for cases of clear illegality only.<sup>402</sup>

When a bank seeks to dishonour a letter of credit on the basis of the illegality exception, the bank must have sufficient proof of illegality and must be able to prove it. If the bank is visited with an application for summary judgment, it must show that it has a plausible defence (being proof of illegality) which has prospects of success at trial.<sup>403</sup> Just as in a defence to a summary judgment under South African law, for a respondent to succeed he has to show that he has a *prima facie* defence with prospects of success at trial.<sup>404</sup> Although the bank may not have sufficient proof of the illegality it may invoke the illegality exception by merely showing a bright prospect of success of proving clear illegality at trial.<sup>405</sup> At the time of trial, the bank should have sufficient knowledge of the illegality.<sup>406</sup> The plausible defence, which had sufficed at the summary judgment application, will not suffice at this stage. The bank ought to have concrete evidence at this stage. With regards to an interdict being sought by the account party, either to interdict the bank from paying, or the beneficiary from making a presentation, the party should have a very strong case and clear established illegality for the interdict to be granted.<sup>407</sup>

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<sup>399</sup> Alavi 2016 *20 Kor U L Rev* 12-13.

<sup>400</sup> *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank* [1985] 2 Lloyd's Rep 554.

<sup>401</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 193.

<sup>402</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 194.

<sup>403</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 194.

<sup>404</sup> Theophilopoulos, van Heerden and Borraine *Fundamental Principles of Civil Procedure* 229.

<sup>405</sup> Alavi 2016 *20 Kor U L Rev* 13.

<sup>406</sup> Alavi 2016 *20 Kor U L Rev* 13.

<sup>407</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 194.

#### 4.9.2 *The Seriousness of the illegality*

For the illegality exception to apply, the alleged illegality in the underlying contract must be severe.<sup>408</sup> This would be a good parameter for restricting the illegality exception.<sup>409</sup> It is settled at law that the law does not concern itself with trivialities.<sup>410</sup> Although the illegality defence is premised on public policy grounds, public policy does not require the courts to refuse to enforce a transaction on the basis of illegality where the illegality is a minor and technical violation.<sup>411</sup> If public policy mandates that the courts can enforce an underlying contract which has a minor illegality, it follows that for the illegality in the underlying contract to taint a letter of credit, which is autonomous from the underlying contract, it has to be sufficiently serious.<sup>412</sup> In *Standard Chartered Bank v Pakistan National Shipping Corporation and Others (No 2)*,<sup>413</sup> the court hinted at the need for the illegality to be serious by noting that even a claim which is tainted by an illegal act will succeed regardless of the illegality except where the illegality is gross.

Severe illegality is a term that does not lend itself to precise definition. In attempting to define it, Cooke J, looked at whether the illegality involved intentional transgressions or not.<sup>414</sup> He held that illegalities were to be divided into two categories, with the contraventions not involving any element of deception and premeditated crime such as breach of S13 (a) or S13 (b) of the US Securities Exchange Act 1934, being found in the first category. The second category of illegalities consisted of intentional and premeditated transgressions, such as breaches of S10 (b) and S20 (e) of the US Securities Exchange Act 1934, and such illegalities would be serious enough to attract the exception and to defeat the beneficiary's claim under the documentary credit, since the illegality would be a planned conduct to intentionally deceive by wrongly accounting on a large scale.<sup>415</sup> Colman J in *Mahonia Ltd v JP Morgan Chase and West*

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<sup>408</sup> Alavi 2016 *Actual Probs Econ & L* 134.

<sup>409</sup> Amaefule *Exceptions to the Principle of Autonomy* 247.

<sup>410</sup> *De minimis non curat lex*.

<sup>411</sup> Enonchong *The Independence Principle in Letters of Credit and Demand Guarantees* 195.

<sup>412</sup> Enonchong *The Independence Principle in Letters of Credit and Demand Guarantees* 195.

<sup>413</sup> [1998] 1 Lloyd's Rep 684.

<sup>414</sup> *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)* (2004) EWHC 1938 (Comm).

<sup>415</sup> *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)* (2004) EWHC 1938 (Comm) para 430.



*LB (No 1)*<sup>416</sup> stated that a beneficiary who was a party to an illegal arms deal would not be allowed to benefit under the letter of credit which was the cog of the transaction, even if the letter of credit itself was not rendered illegal.<sup>417</sup> He further reiterated by stating that a letter of credit to secure payment for the purchasing of heroin would be tainted by the illegality of the underlying contract regardless of the autonomy principle. If this is the standard that is set for the seriousness of the illegality to lead to the exception being upheld, the efficacy of the commercial letter of credit will be kept intact.<sup>418</sup>

#### 4.9.3 *The Involvement of the Beneficiary*

The illegality exception should apply only where the beneficiary colluded in performing the illegality in the underlying contract or was privy to it.<sup>419</sup> This is a very important parameter in limiting the scope of the illegality exception.<sup>420</sup> Such a principle has its roots entrenched in the maxim *commodum ex iniuria sua nemo habere debet*.<sup>421</sup> Under general principles of contract law, where a contract is illegal because it was entered into for the furtherance of illegal purposes yet the beneficiary had no knowledge of the illegal purpose, the illegality defence does not affect the beneficiary's rights.<sup>422</sup> Where a lender lends money to a person who will use it for an illegal purpose, he does not forfeit his rights under that loan agreement.<sup>423</sup> If the same set of facts were to be applied to letters of credit, a beneficiary would still be paid even if the buyer imports goods to South Africa in breach of port regulations without the seller's knowledge. To allow such illegality to affect the beneficiary's claim under the letter of credit, would affect the integrity and efficacy of letters of credit.<sup>424</sup>

This line of reasoning was upheld in *Mahonia (No 2)*.<sup>425</sup> Cooke J, ruled that even if there had been any illegality in the swap transactions and the manner in which Enron

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<sup>416</sup> [2003] 2 Lloyd's rep 911.

<sup>417</sup> *Mahonia Ltd v JP Morgan Chase and West LB (No 1)* [2003] 2 Lloyd's Rep 911 QB para 68.

<sup>418</sup> Alavi 2016 *Actual Probs Econ & L* 134.

<sup>419</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 196.

<sup>420</sup> Amaefule *Exceptions to the Principle of Autonomy* 250.

<sup>421</sup> A wrongdoer should not be enabled by law to take any advantage from his actions.

<sup>422</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 196.

<sup>423</sup> *Bosse v Mastercraft* (1995) 123 DLR (4<sup>th</sup>) 161 (Ont.CA).

<sup>424</sup> Amaefule *Exceptions to the Principle of Autonomy* 250.

<sup>425</sup> [2004] EWHC 1938 (Comm).

had done its accounting practices, the illegality exception would not have been upheld due to Enron being ignorant of the illegal nature of the accounting for the swap transactions in the manner that it did. The manner in which this limitation in the fraud exception rule is designed ensures that the beneficiary's claim is not defeated unless he had knowledge of the fraud prior to the presentation of the documents.

#### 4.9.4 *The Degree of Connection*

Another factor that will limit the scope of the illegality exception is the degree of connection between the letter of credit and the illegal underlying contract.<sup>426</sup> For the illegality exception to apply there has to be a close nexus between the illegality in the underlying contract and the letter of credit.<sup>427</sup> The issue of close connection presents difficulty in application as there is no set criterion which determines whether in a particular case, there is a proper nexus between the letter of credit and the illegality of the underlying contract.<sup>428</sup> The difficulty of ascertaining the required degree of connection was noted in *Fidelity & Deposit Co of Maryland v Grand Nat. Bank*.<sup>429</sup> The courts have come up with two different ways of establishing connection. The two tests, however, have not received much support due to their various shortcomings. These tests are referred to as the Reliance test and the Mahonia test.

The reliance test was formulated in *Bowmakers Ltd v Barnet Instruments Ltd*<sup>430</sup> and received approval in *Tinsley v Milligan*.<sup>431</sup> The test states that the illegality exception will apply only if the claimant relies on his illegality to assist his claim.<sup>432</sup> Under English law, the reliance principle is not the universal rule used to determine whether illegality should affect a civil claim.<sup>433</sup> The court in the *Tinsley* case explained that the rule is the same, whether a plaintiff founds himself on a legal or an equitable title; he is entitled to recover if he is not required to rely on his own illegality.<sup>434</sup> The reliance test

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<sup>426</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 197.

<sup>427</sup> *Mahonia Ltd v JP Morgan Chase Bank and West LB (No. 1)* [2003] EWHC 1927 (Comm) [2003] 2 Lloyd's Rep 911 QB para 69.

<sup>428</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 197.

<sup>429</sup> 2 F Supp 666,668 (E D Mo 1933).

<sup>430</sup> [1945] KB 65.

<sup>431</sup> [1994] 1 AC 340.

<sup>432</sup> Alavi 2016 *20 Kor U L Rev* 16.

<sup>433</sup> Alavi 2016 *20 Kor U L Rev* 16.

<sup>434</sup> *Tinsley v Milligan* [1994] 1 AC 340 376.

has not found favour with many scholars<sup>435</sup> as a satisfactory test for determining the connection between the letter of credit and an illegal underlying contract in the framework of documentary credits.<sup>436</sup>

The test has been rejected for various reasons. Firstly, it has been criticised as unsatisfactory due to its not being based on any policy grounds.<sup>437</sup> Secondly, there is uncertainty about the application of the test. It is unclear whether the test forbids the claimant from relying on his own illegality or on the illegal transaction.<sup>438</sup> In *Group Josi Re v Walbrook Insurance Co. Ltd*,<sup>439</sup> Staughton LJ commented on the reliance rule as prohibiting a party from relying on his own illegality<sup>440</sup> and later shifted to prohibiting a party from relying on the illegal contract.<sup>441</sup> The two scopes are worlds apart, with the former being narrower. It will allow a claimant to succeed, despite the underlying contract being tainted with illegality.<sup>442</sup> Thirdly, the application of this test about documentary credits would lead to undesired results because it would reduce the scope of the exception to make the prospects of success almost illusory.<sup>443</sup> This means that the beneficiary would succeed in enforcing the letter of credit despite there being an illegal conduct because he did not rely on his own illegality.<sup>444</sup>

Cooke J introduced the Mahonia test in *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)*,<sup>445</sup> wherein he took the view that the beneficiary could make out his claim without relying on the alleged illegality. The criterion used by the court to arrive at the decision that the letter of credit would have been sufficiently connected to the illegal purpose is not clear. In his judgment, Cooke J comes up with a plethora of formulations for the Mahonia test. At first he stated that the closeness test determines the connection of the underlying contract to the letter of credit. He went on to hold that since the letter of credit was a crucial part of the scheme, which gave

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<sup>435</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 197.

<sup>436</sup> Alavi 2016 *20 Kor U L Rev* 16.

<sup>437</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 197.

<sup>438</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 197.

<sup>439</sup> [1996]1 W.L.R 1152.

<sup>440</sup> *Group Josi Re v Walbrook Insurance Co. Ltd* [1996]1 W.L.R 1152 1160.

<sup>441</sup> *Group Josi Re v Walbrook Insurance Co. Ltd* [1996]1 W.L.R 1152.

<sup>442</sup> Enonchong *The Independence Principle of Letters of Demand and Demand Guarantees* 198.

<sup>443</sup> Enonchong *The Independence Principle of Letters of Demand and Demand Guarantees* 198.

<sup>444</sup> Alavi 2016 *20 Kor U L Rev* 17.

<sup>445</sup> [2004] EWHC 1938 (Comm).

rise to the unlawful accounting transaction, it was indirectly linked to the accounting itself in the form of the underlying swap transactions.<sup>446</sup>

The Mahonia test has been criticised for being open to doubt because the formulations forwarded are vague. The formulation that the degree of connection between the letter of credit and the underlying contract should be measured by whether the letter of credit was opened in consideration of obligations in the underlying contract, serves little purpose because in almost all cases the letter of credit would be opened in consideration of such obligations.<sup>447</sup> The idea that the letter of credit is strongly connected to the illegal underlying contract because without it the contract would not have come into fruition, has been subjected to criticism.<sup>448</sup> Enonchong,<sup>449</sup> argues that the fact that parties to the illegal contract have decided to carry it out using a letter of credit when they could have gone ahead without the letter of credit is not a strong ground for holding that the letter of credit is not sufficiently connected to the illegality. This test would set a precedent so glaring that every bit of illegality would cause the bank not to pay, thus hampering international trade.

It is suggested that the sole question to be used to determine if the letter of credit is sufficiently connected to the illegality of the underlying transaction should be the beneficiary's participation in it.<sup>450</sup> It is strongly argued that once the beneficiary becomes privy to the illegal purpose in the underlying contract, it should suffice to establish a close connection between the illegality in the underlying contract and the letter of credit in respect of which it is issued. This approach is persuasive and highly commended.<sup>451</sup>

#### **4.10 Conclusion**

This chapter has dealt with the illegality exception. It commenced by defining and discussing illegality in general law and illegality under letters of credit. It is now

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<sup>446</sup> Mahonia test in *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)* [2004] EWHC 1938 (Comm) paras 426-427.

<sup>447</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 200.

<sup>448</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 200.

<sup>449</sup> *The Independence Principle of Letters of Credit and Demand Guarantees* 200.

<sup>450</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 200.

<sup>451</sup> Amaefule *Exceptions to the Autonomy Principle* 254.

apparent that should the illegality be in the letter of credit, the autonomy principle does not come into play as the letter of credit is dishonoured based on its own illegality. Controversy arises when the illegality is in the underlying contract, which is separated from the letter of credit by the independence principle. There are various arguments for the recognition of the illegality exception. It is based on the same tenets as the fraud exception rule and its recognition would not place any extra burden on the ministerial duties of banks. The illegality exception is consistent with the established principles of illegality under general law and its extension to letters of credit would not hamper international trade. The chapter also discussed the illegality exception in various jurisdictions. Under English law, the illegality exception has piecemeal recognition as an independent non-fraud exception. Case law pertaining to the illegality exception has not come out emphatically in pronouncing the exception. Different judges, however, have stated that there exists another exception to the independence rule apart from fraud. Under Singaporean law, the courts have refused to recognise the illegality exception despite having recognised the nullity and unconscionability exceptions. Under South African law, there has not been any decision where the court was asked to determine on the illegality exception.

The thrust of this dissertation is to advocate the recognition of the illegality exception. The idea behind the illegality exception is to preserve public policy by mandating banks to dishonour a letter of credit where the underlying contract is blatantly illegal. The next chapter will deal with conclusions and recommendations on the illegality exception under South African law.

## **Chapter 5 - Conclusions and Recommendations**

### ***5.1 Introduction***

This study set out to explore avenues for the application of the illegality exception in documentary credits under South African law. At present, illegality is a defence under general law only and does not extend to documentary credits.<sup>452</sup> The study was also meant to set out the parameters which would govern the application of the illegality exception. The parameters of the established exception to the independence principle, the fraud exception, could be used as a model for the recognition for other non-fraud exceptions. This study has also looked at other non-fraud exceptions such as unconscionability and nullity in different jurisdictions.

The thrust of the first chapter was to introduce the study and to give a brief background to the topic as well as to explain the research question, the research methodology and the framework of the study.

The second chapter presented an overview of letters of credit as a payment mechanism under international trade. The chapter defined a letter of credit as a banker's undertaking in writing to honour a complying presentation.<sup>453</sup> There was a discussion of the legal framework governing the operation of the letters of credit and a brief background of how letters of credit came into being.

The chapter also dealt with the manner in which letters of credit function, showing the different stages from the opening of the letter of credit to the stage when the beneficiary makes a presentation in exchange for the credit being honoured. The different kinds of letters of credit were analysed and their differences illustrated. The purposes of the letter of credit were discussed and it was shown that the primary purpose of the letter of credit is as a payment mechanism.<sup>454</sup> The chapter was concluded by looking at the legal characteristics of letters of credit, which are the doctrines of strict compliance and the independence rule.<sup>455</sup> The independence principle states that the letter of credit is independent of the underlying contract. The

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<sup>452</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 185.

<sup>453</sup> See the discussion at 2.2 above.

<sup>454</sup> See the discussion at 2.5 above

<sup>455</sup> See the discussion at 2.6 above.

doctrine of strict compliance entails that for a beneficiary to be paid under a letter of credit, he has to strictly comply with the terms and conditions of the letter of credit.<sup>456</sup> Substantial compliance will not suffice. It was demonstrated that the independence rule is not a rule of absolute application, has fraud as a universally accepted exception and that the application of other exceptions such as recklessness, nullity and unconscionability is still controversial.<sup>457</sup>

Chapter Three looked at the exceptions to the independence principle under documentary credits. Fraud, as the universally recognised exception to the independence rule received the most attention. The chapter defined fraud as a delict and as a crime, under South African law. The definition of fraud under letters of credit is thus different from fraud under general law. The leading case of *United City Merchants v Royal Bank of Canada*<sup>458</sup> defined fraud as occurring when the beneficiary for the purpose of drawing on the credit, fraudulently presents to the bank documents that have material representations of fact that the seller knows to be false.<sup>459</sup> The chapter discussed the circumstances under which the bank may withhold payment on the basis of fraud. The standard under the fraud exception rule is high and the burden of proof required to succeed is on the party seeking to use the fraud exception rule. As is settled at law, he who alleges must prove. Although lawsuits where the fraud exception defence is relied upon are civil in nature, the standard of proof is not on a balance of probabilities. The standard of proof has been set very high in an effort to preserve the efficacy of the system of documentary credits. The fraud exception will apply only if the beneficiary relies upon false information which he himself knows to be untrue for the purposes of benefitting under the credit. In that regard, third party fraud will not be captured by the fraud exception rule.<sup>460</sup>

The chapter also provided a brief overview of the nullity and unconscionability exceptions. The two exceptions are recognised in few jurisdictions. The nullity exception applies where a presentation contains documents which are not what they

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<sup>456</sup> See the discussion at 2.6.2 above.

<sup>457</sup> Kelly Louw *Selective Legal Aspects* 162.

<sup>458</sup> [1983] 1 AC 168.

<sup>459</sup> *United City Merchants v Royal Bank of Canada* [1983] AC 168 183.

<sup>460</sup> See the discussion at 3.4 above.

purport to be.<sup>461</sup> The documents presented will be null and of no economic or commercial value, hence the name nullity exception. The nullity exception was first recognised in *United City Merchants v Royal Bank of Canada*<sup>462</sup> but its stay in English law was short-lived as it was overruled by the House of Lords which ruled that there was no nullity exception under English law.<sup>463</sup> To date there is no nullity exception under English law. The nullity exception is recognised in Singapore, however, although it has a very narrow scope of application.<sup>464</sup>

The unconscionability exception has its roots in the principle of good faith (*uberrimae fidei*).<sup>465</sup> The unconscionability exception seeks to provide a safe haven to a party who is a victim of a beneficiary's bad faith on calling up a guarantee. Unconscionability as an exception is controversial and has been vehemently criticised as being uncertain and running contrary to established English authority.<sup>466</sup> Under Singaporean law, the English position has been disregarded. Singapore recognises the unconscionability exception. Unconscionability has been defined as involving unfairness as opposed to dishonesty or fraud, or conduct which is so coloured with malice that a reasonable court would interdict such a party or refuse to lend aid to such a person. The unconscionability exception does not have set parameters but the court is left to use its discretion to suit the justice of the case.<sup>467</sup>

The goal of Chapter Four was to discuss of the illegality exception and to advocate the recognition of the illegality exception under South African law. The chapter commenced by defining illegality under general law and went on to look at illegality under letters of credit. Two conditions of illegality under letters of credit exist. Where the letter of credit itself is illegal, the autonomy principle is not involved. In this case, the letter of credit would be unenforceable because of the doctrine of the illegality of contracts.<sup>468</sup> Where an underlying contract is illegal, this makes the court involve the autonomy principle in deciding to pronounce the letter of credit unenforceable. The

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<sup>461</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 145.

<sup>462</sup> [1981] 3 All ER 142.

<sup>463</sup> *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168.

<sup>464</sup> See the discussion in 3.5.3 above.

<sup>465</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 159.

<sup>466</sup> See the discussion in 3.6.2 above.

<sup>467</sup> See the discussion in 3.6.2 above.

<sup>468</sup> See the discussion in 4.2 above.



chapter showed that illegality, although distinct from the fraud exception, has the same characteristics as the fraud exception.<sup>469</sup> The primary concern of the illegality exception is the preservation of law and order and restraining the bank from honouring a credit where there is blatant illegality. The chapter looked at the status quo of the illegality exception in leading jurisdictions such as Singapore, England and South Africa. Singapore is an important yardstick as it has been quick to recognise other non-fraud exceptions as evinced by its recognition of the nullity exception.<sup>470</sup>

Under English law there has not been an explicit recognition of the illegality exception but rather piecemeal recognition. The courts have stated in *obiter* that a bank may be within its rights to refuse to honour a credit when there is blatant illegality.<sup>471</sup> Singapore has not recognised the illegality exception and the judicial opinion seems at present to be against the recognition of the exception.<sup>472</sup> The illegality exception pertaining to letters of credit under South African law was looked at and it was found that there has not been any case where the illegality exception was recognised.<sup>473</sup> The chapter went on to look at ways under which the illegality exception could be established under letters of credit in South Africa.

## **5.2 Final Conclusions and Recommendations**

Many scholars have advocated the establishment of the illegality exception under letters of credit. Van Niekerk and Schulze<sup>474</sup> have added their voice to the call for the recognition of the illegality exception in South Africa. The yardstick to be used for the illegality exception is the fraud exception as it is universally recognised and is based on the same policy considerations as the illegality exception. The principle of autonomy in letter of credit transactions has the purpose of protecting the rights of the seller by separating the letter of credit from the underlying contract.<sup>475</sup> Absolute application of the autonomy principle would have undesired effects and leave the buyer without protection. The recognition of the fraud exception does not take into

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<sup>469</sup> See discussion in 4.3.2 above.

<sup>470</sup> See discussion in 3.5.3 above.

<sup>471</sup> *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA) 362.

<sup>472</sup> Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* 205.

<sup>473</sup> Kelly Louw *Selective Legal Aspects* 280.

<sup>474</sup> *South African Law of International Trade: Selected Topics* 250.

<sup>475</sup> Alavi 2016 *Actual Probs Econ & L* 135.

account all the improprieties that may be perpetrated in international contracts. It is argued that there ought to be more exceptions to the independence principle in addition to fraud.<sup>476</sup> Illegality on the part of the beneficiary is as likely to result in a breach of the impregnable autonomy principle.<sup>477</sup> The fraud exception seeks to protect private interests whereas illegality seeks to preserve public interests and this adds weight to the argument for the recognition of the illegality exception.<sup>478</sup>

Fraud on its own does not encompass illegality. This leaves a situation where in the absence of fraud, the bank is mandated to pay and thus to aid in the performance of illegal activities. In the absence of an illegality exception, a South African bank is obliged to honour a letter of credit which is paying for an illegal arms deal or which is in contravention of certain foreign exchange regulations. The non-recognition of the illegality exception under South African law sets a very glaring precedent. It is the recommendation of this dissertation that illegality ought to be recognised as an exception to the independence principle, independent from the fraud exception. The illegality exception is an important part of the development of documentary credits.<sup>479</sup> As the basis for the illegality and fraud exceptions is the same, the recognition of the illegality exception (due to its narrow scope) poses no threat to the efficacy of documentary credits.<sup>480</sup> It also does not place an extra burden on the banks, as they are not asked to delve into the merits of the underlying contract. They will still be limited to their ministerial duties.<sup>481</sup> As the independence principle is a cardinal principle of letters of credit, any means of penetrating it must be closely defined. If the illegality exception is left open-ended it would not achieve the desired effect but would instead destroy the efficacy of letters of credit under international trade.<sup>482</sup> If clearly conceptualised, the illegality exception would provide a safe and stable environment for documentary credits.<sup>483</sup> A narrow but efficient application of the

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<sup>476</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 380.

<sup>477</sup> Kelly Louw *Selective Legal Aspects* 280.

<sup>478</sup> Lu *Exceptions in Documentary Credits* 235.

<sup>479</sup> Lu *Exceptions in Documentary Credits* 235.

<sup>480</sup> Lu *Exceptions in Documentary Credits* 235; Alavi 2016 *Actual Probs Econ & L* 134.

<sup>481</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 379.

<sup>482</sup> Kelly Louw 2009 *Comp & Intl L J S Afr* 380.

<sup>483</sup> Lu *Exceptions in Documentary Credits* 235.

illegality exception subject to banks' independent responsibility would relieve some of the current disputes bedevilling the documentary credit system.<sup>484</sup>

The illegality exception should be used as a defence only when the alleged illegality has been clearly established. The illegality exception should not apply in cases of trivial illegality. The standard of proof for the illegality must be as high as that used under the fraud exception. The illegality exception should cover circumstances where the illegality is sufficiently serious. The courts will not concern itself with trivialities and it should be reserved for circumstances such as an illegal arms sale as illustrated in *Mahonia Ltd v JP Morgan Chase Bank and Another (No 1)*.<sup>485</sup> The beneficiary also has to be involved in the illegality for the illegality exception to apply. There must be a nexus between the underlying contract and the illegality.

Kelly Louw<sup>486</sup> also argues that the seriousness of illegality must be determined by the criminal element. If the illegality carries with it an outright criminal element and relates to the commission of a criminal offence, the illegality exception should apply. In the event that there is no clear criminal element, the illegality should be deemed not serious and should not form an exception to the independence principle. The bank is mandated to honour the credit in such a situation. Where the contract is tainted by illegality, the account party should be able to apply for an injunction to stop the bank from making payment.

Van Niekerk and Schulze<sup>487</sup> have provided an illustration of how the illegality exception would function. If the bank is aware of the illegality of the underlying contract after conducting a meticulous examination of the information supplied, they suggest that the bank should not honour the credit. Where the bank is not aware of the illegality and after exercising reasonable care is still not able to find any illegality in the underlying contract, it can honour the credit and be reimbursed by the applicant. These suggestions accord with the established principles on the application of the fraud exception and cannot be faulted.<sup>488</sup> They do not place any additional duties on

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<sup>484</sup> Lu *Exceptions in Documentary Credits* 284.

<sup>485</sup> [2003] 2 Lloyd's Rep 911 QB.

<sup>486</sup> 2009 *Comp & Int'l L J S Afr* 385.

<sup>487</sup> Van Niekerk and Schulze *South African Law of International Trade: Selected Topics* 2<sup>nd</sup> Ed 312.

<sup>488</sup> Kelly Louw 2009 *Comp & Int'l L J S Afr* 379.

banks. If the bank fails to execute its duties diligently, then it should not be allowed to be reimbursed. With the above suggestions, the recognition and application of the illegality exception is a possibility. South African courts would have a guide on how to deal with such an issue, should it arise.

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