

## **Interpretation of 3rd Party's Fraud Exception Rule Under Law of Letters of Credit**

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### **I. Introduction**

Principle of Independence is one of major principles in interpretation of Letter of Credit. The essence of this principle can be summarized that the letter of credit is independent both of the underlying contract between the seller and the buyer and of the contract between the applicant and the issuer. Thus, the bank does not get involved in any dispute arising between the seller and the buyer.

There are two exceptions to the principle of independence in case of illegality and the fraud. As for the fraud rule this is considered most controversial and confused area of the law governing letters of credits. The fraud rule in the law governing letters of credit plays a vital role in situations where the documents presented by the party demanding

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payment under a letter of credit strictly comply on their face with the terms and conditions of the letter of credit, but are in fact forged or fraudulent. According to the rule, payment under the letter of credit can be dishonoured by the issuer or enjoined by a court if fraud is found in the transaction, provided that the party seeking payment does not belong to a specified class of protected persons.

In most cases, fraud in a letter of credit transaction is practiced by the beneficiary, in which case the fraud rule clearly applies. Even if the fraud is not perpetrated by the beneficiary itself, the fraud rule will still apply if the beneficiary knows of, or has participated in, the fraud.<sup>1)</sup> However, fraud in a letter of credit transaction can occasionally be perpetrated by somebody other than the beneficiary and without the knowledge of the beneficiary. The perpetrator may be the applicant or a third party.

This paper addresses the question of whether the fraud rule can be applied in such situation where a third party is involved whilst the beneficiary is innocent, employing decision of the House of Lords in *United City Merchants v Royal Bank of Canada*. At this case the House of Lords founded principle of independence, which has been widely upheld internationally, is not applicable to innocent beneficiary.

## II. 3rd Party Fraud Exception Rule

### 1. Characteristics of Letters of Credit

Letter of credit can be defined in two ways. Firstly the Uniform Customs and Practice for Documentary Credits <sup>2)</sup> (U.C.P.) which is largely

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1) *Contronic Distributors Pty Ltd v Bank of New South Wales* [1984] 3 NSWLR 110, in which the beneficiary and applicant colluded in fraudulently obtaining a letter of credit and the fraud rule was applied.

2) Int'l Chamber of Commerce, ICC Uniform Customs and Practice for Documentary Credits Publication No. 600 (rev. 2007) [hereinafter U.C.P.].

used around the world. Letter of credit is an Issuing bank's undertaking of payment against presentation of complying documents. The issuing bank's obligation is well described in Article 7 as follows.

**Article 7 Issuing Bank Undertaking**

- a. Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, the issuing bank must honour if the credit is available by:
  - i. sight payment, deferred payment or acceptance with the issuing bank;
  - ii. sight payment with a nominated bank and that nominated bank does not pay;
  - iii. deferred payment with a nominated bank and that nominated bank does not incur its deferred payment undertaking or, having incurred its deferred payment undertaking, does not pay at maturity;
  - iv. acceptance with a nominated bank and that nominated bank does not accept a draft drawn on it or, having accepted a draft drawn on it, does not pay at maturity;
  - v. negotiation with a nominated bank and that nominated bank does not negotiate..

Secondly, article 5 of the Uniform Commercial Code (U.C.C.)<sup>3)</sup> which is established in USA for the use of letter of Credit. U.C.C describe the letter of credit in the same way of U.C.P. 5-102 define Letter of Credit as follows.

"Letter of credit" means a definite undertaking that satisfies the requirements of Section 5-104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution,

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3) The American Law Institute and the National Conference of Commissioners on Uniform State Laws, Uniform Commercial Code (rev 2001) [ hereinafter U.C.C.];

to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.

### 1.1. Principle of Independence

The principle of independence has long been recognized by cases in many countries and is expressed in Articles 4 and 5 of the U.C.P. Article 4 is about the separateness of the letter of credit from the other transactions. Article 5 mentions about the paper driven or documentary nature of the letter of credit<sup>4)</sup>. Therefore, in a letter of credit transaction, the issuer's only concern is whether the documents tendered by the beneficiary on their face conform to the terms and conditions stipulated in the letter of credit. The issuer is entitled to make payment with full reimbursement to the applicant, even if the documents turn out to be forgeries or include fraudulent statements, as long as it pays in good faith against the documents which are regular on their face. <sup>5)</sup>

Document checkers are competent to determine the visible conformity of documents, but they are not in a position to determine the in fact compliance of the documents, and the law excuses them from having to do so. If the bank is required to go behind the documents, the letter of credit scheme will collapse.<sup>6)</sup>

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4) Article 5 - Documents v. Goods, Services or Performance

Banks deal with documents and not with goods, services or performance to which the documents may relate.

5) *Sztejn v. J. Henry Schroder Banking Corp.*, (It is true that even though the documents are forged or fraudulent, if the issuing bank has already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment).

6) This has been recognized by many cases and commentators. E.g., *Old Colony Trust Co. v. Lawyers' Title and Trust Co.*, 297 F. 152, 155-56 (2d. Cir. 1924).

It would be dangerous if bankers or banking institutions who issue letters of credit were confronted with the problem of deciding anything more than whether or not the documents presented were the documents required under the letter of credit and whether the conditions in the letter of credit set forth were complied with... The banker is always in a position of sharp responsibility, and, if he honours a letter of credit contrary to its terms, he

## 1.2 Principle of Strict Compliance

The principle of strict compliance is another basic doctrine of the law of letters of credit. Under this principle, every party to a letter of credit transaction wishing to receive payment has to tender complying documents.

If the documents tendered are not in strict compliance with the terms of the letter of credit, the party tendering the documents may not get paid even though it has fully performed the underlying contract. For instance, if the issuer pays the beneficiary against documents that do not strictly comply with the requirements of the credit, it does so at its peril and may not be reimbursed by the applicant. The doctrine of strict compliance also means that the bank must stick to the instructions of the applicant.<sup>7)</sup>

The strict compliance doctrine is not detailed in the UCP<sup>8)</sup>, but has long been endorsed by consistent judicial view. In *Equitable Trust Co. of*

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may invite troublesome litigation. Thus, it is to the interest of the merchant as well as the bank that it should not be made difficult to obtain letters of credit because of technical reasons, and hence that the issuance of such letters shall not be embarrassed by placing upon the issuing bank any responsibility to look beyond the documents required under the letter and the conditions, if any, with which under the letter there must be compliance.

7) However, discrepancies in the documents may be cured or waived. In 1987, a survey in the United States revealed that 90% of documents initially tendered contained discrepancies, but no more than 1% were incurable. See Boris Kozolchyk, *Strict Compliance and the Reasonable Document Checker*, 56 *Brook. L. Rev.* 45, 48 (1990). Other studies point to a discrepancy rate of between 49% and 51.4% in surveys done in 1983 and 1986 in England and substantially higher rates in earlier surveys in Hong Kong and Australia. Clive E. Schmitthoff, *Discrepancy of Documents in Letter of Credit Transactions*, in Clive M. Schmitthoff's *Select Essays on International Trade Law* 432, (Chi-Jui Cheng, ed., 1998).

8) Article 14 - Standard for Examination of Documents (a)

A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation

New York v. Dawson Partners,<sup>9)</sup> Lord Sumner put the principle proverbially: "there is no room for documents which are almost the same, or which will do just as well."<sup>10)</sup> However, this principle is clearly provided in UCC Article 5. Section 5-108(a), provides that "an issuer shall honor a presentation that appears on its face strictly to comply with the terms and conditions of the letter of credit. Unless otherwise agreed with the applicant, an issuer shall dishonor a presentation that does not appear so to apply"<sup>11)</sup>

## 2. Meaning of Fraud Exception Rule

"The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour the draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued."<sup>12)</sup>

Under the principle of independence as emphasized by Article 5 of the UCP 600 all parties concerned in the credit operation deal with documents, and not with goods, services and/or other performances to which the documents may relate. The seller simply has to provide documents facially conforming to the terms of the credit. This separation of the documents

9) *Equitable Trust Co. of New York v. Dawson Partners*, 27 Lloyd's L. Rep. 49 (1927) [hereinafter *Equitable Trust*]. *Equitable Trust* is a case in which the dispute was between the banker and the applicant.

10) *Equitable Trust*, supra note 127, at 52. See also, e.g., *Old Colony Trust Co. v. Lawyers' Title and Trust Co.*, 297 F. 152, 155 (1924) ("the transaction is one to purchase documents and not goods and that, in our view, the documents referred to in a letter of credit must conform in every respect with the requirements of that letter of credit." Id.).

11) Cf. U.R.D.G. art. 9; UNCITRAL Convention art. 16(1); I.S.P.98 R.4.01, 8.01(a).

12) J.F. Dolan, *Documentary Credit Fundamentals: Comparative Aspects*, 3 Bank. & Fin.L.R 121 (1988)

from the actual performance "creates ... a loophole for those unscrupulous beneficiaries (third parties, or sometimes applicants) to abuse the system."<sup>13)</sup> If the documents tendered appear on their face to be in compliance with the terms and conditions of the credit, the issuer will effect payment regardless of any dispute between the buyer and the seller.<sup>14)</sup>

It is common knowledge that fraud is wrong, immoral and should not be allowed in any circumstances. It attacks public policy and poses "an equally serious threat to the commercial utility of the letter of credit."<sup>15)</sup>

Banks involving as a mere financier is accepted that this is the "only practical way for the documentary credit system to work"<sup>16)</sup> Permitting the buyer to stop the payment mechanism simply alleging that the goods do not conform to the underlying contract would destroy the utility of letters of credit. On the other hand, allowing the seller to receive payment from the bank upon presentation of false or forged documents would be equally unjustifiable..

Schmitthoff refers to the fraud rule as the one that "permits a court to consider evidence other than the actual terms and conditions of the credit and is founded on the maxim *ex turpi causa non oritur actio*"<sup>17)</sup>, which means that the plaintiff cannot found an action based on its own wrongdoing.

In essence the fraud rule entitles the bank to refuse payment in case it alleges fraud and provides a defence should the bank be sued by the applicant or the presenter of the documents.

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13) Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002) The Hague, p. 30

14) See Article 14 of the UCP 600

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

16) *Trade Finance Fraud – Understanding the Threats and Reducing the Risk*, A Special Report prepared by the ICC International Maritime Bureau (2002) ICC Publication No. 643, p. 28

17) Schmitthoff's *Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London, p. 210

### **3. Fraud by 3<sup>rd</sup> party other than beneficiary**

A typical letter of credit arrangement involves three parties; the applicant, the beneficiary and the issuer. However, in most letter of credit cases further parties are involved; they can be classified into two groups. The first comprises those parties who are directly involved in the letter of credit payment process, for example, banks, such as the negotiating bank, the confirming bank or the advising. The second group comprises those parties who are not directly involved in the letter of credit transaction, but participate in other transactions or activities related to it. So, in a commercial letter of credit transaction, parties such as insurers, carriers and loading brokers are not directly involved, but may participate in preparing documents for the presentation or demand for payment on the letter of credit. In the following discussion the parties in the second group will be treated as third parties, and fraud perpetrated by them will be regarded as 'third party fraud'.

### **4. Law Cases**

As third party fraud in letter of credit transactions occurs only in a minority of cases there are just several cases at this moment. I employ two cases as below.

#### **4.1 The United City Merchants Ltd v. Royal Bank of Canada <sup>18)</sup>**

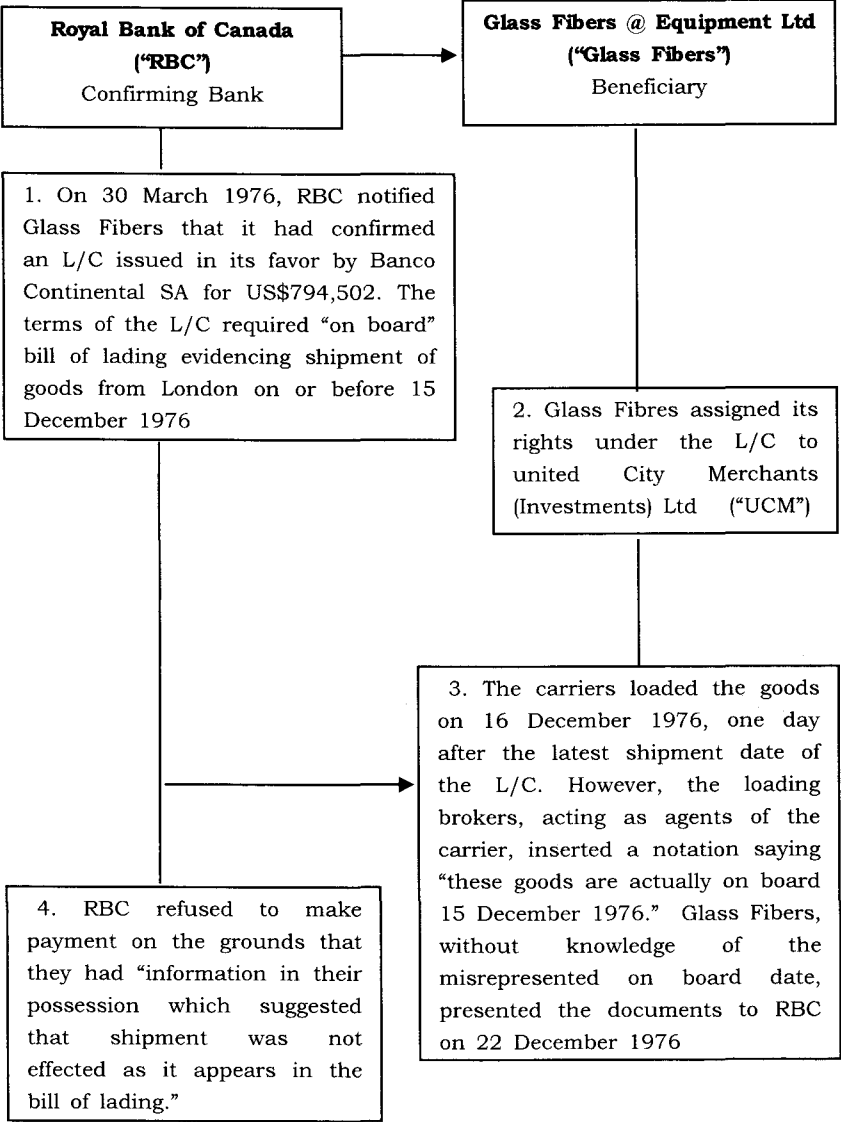
An issue was raised and tested in the English case of United City Merchants. Because of its significance, United City Merchants warrants detailed treatment.

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18) [1979] 1 Lloyd's Rep. 267, [1981] 1 Lloyd's Rep 604, [1983] AC 168



**Facts summary in diagram**  
**United City Merchants Ltd vs. Royal Bank of Canada**



### (1) Background

In October 1975, Glass Fibres and Equipment Ltd ('GFE'), an English company, entered into a contract to sell glass fibre making equipment to a Peruvian company named Vitrorefuerzos SA ('Vitro'). Payment was to be made by an irrevocable letter of credit issued by the Banco Continental SA of Peru and confirmed by the Royal Bank of Canada ('RBC'). GFE assigned their rights, entitlements and benefits under the letter of credit to United City Merchants ('UCM'), and notice of the assignment was given to the banks. Shipment, after some amendments, was to be from London to Callao on or before 15 December 1976.

GFE sent goods for temporary storage to their forwarding agents telling forwarding agents, who in turn told a Mr Baker, an employee of E H Mundy & Co (Freight Agencies) Ltd, the details of the requirements for the bills of lading, including the latest shipment date. However, the goods were not shipped until 16 December (not 15 December, as required in the contract). But Baker, not acting for, and without the knowledge of the sellers or the consignees of the letter of credit, fraudulently entered 15 December as the date of shipment on a notation stamped on the bill of lading. When documents were presented for payment by UCM, RBC refused to pay on the basis that it had information suggesting that shipment had not in fact been effected as indicated in the bill of lading. The plaintiffs then brought the action against the defendants for wrongful dishonour. In its defence, RBC contended, inter alia, that the presentation was fraudulent in that the goods were loaded on board the American Accord<sup>19)</sup> on 16 December and not on 15 December as agreed.

### (2) The Judgments

Justice Mocatta of the Queen's Bench Division, after citing a series of

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19) This case is often cited as The American Accord because of the name of the ship involved.

authorities including *Sztejn v J Henry Schroder Banking Corp* ('*Sztejn*'), accepted that, although the issuing of a letter of credit constitutes a bargain between the issuer and the beneficiary which imposes an absolute obligation on the issuer to pay the amount of the letter of credit upon the presentation of conforming documents irrespective of any dispute between the parties about the underlying transaction, there was 'an exception to the strict rule: the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment'.<sup>20)</sup>

But because Mocatta J found that 'Mr Baker was not the plaintiffs' agent for making out the bills of lading and that there was no fraud on the part of the plaintiffs in presenting them', relying on the principle of *ex turpi causa non oritur actio*, his Honour held that the case was vitally different from the situation in *Sztejn*, and therefore rejected the defendants' arguments, concluding:

Where there has been personal fraud or unscrupulous conduct by the seller presenting documents under the letter of credit, it is right that a bank should be entitled to refuse payment against apparently conforming documents on the principle *ex turpi causa non oritur actio*. But here I have held that there was no fraud on the part of the plaintiffs, nor can I, as a matter of fact, find that they knew the date on the bills of lading to be false when they presented the documents. ... Accordingly, I take the view ... that the plaintiffs are ... entitled to succeed.

### Court of Appeal

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Justice Mocatta's decision was reversed by the Court of Appeal, which construed the applicant's mandate to the bank was only to pay against the presentation of genuine documents; therefore the bank was justified

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<sup>20)</sup> *United City Merchants v Royal Bank of Canada* [1979] 1 Lloyd's Rep 267, 276 (emphasis added), quoting Lord Denning in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976, 982.

in refusing to pay against forged documents. The Court held that the fact that the fraud had been committed by a third party could not prevent the bank from raising the defence of fraud against the beneficiary

The Court of Appeal also considered the issue of risk allocation between innocent parties. The bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the documents are forgeries it must refuse to accept them. It may be that the party presenting the documents has himself been duped by the forger and believes the documents to be genuine but that surely cannot affect the bank's right to refuse to accept the forgeries.

The Court of Appeal concluded that the decision of Mocatta J had put the bank in a curious position:

The latest date for shipment of the machinery was [December] 15, 1976. The machinery was in fact shipped on [December] 16, 1976, and if the bill of lading had shown that date the bank would have refused to pay upon presentation of the documents because of the strict rule that the documents must comply in every respect with the terms of the letter of credit... [I]t would be a strange rule that required a bank to refuse payment if the document correctly showed the date of shipment as [December] 16, yet obliged the bank to make payment if it knew that the document falsely showed the date of shipment as [December] 15 and that the true date was [December] 16.

#### House of Lords

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However, on appeal, the House of Lords unanimously overruled the decision of the Court of Appeal and restored that of Mocatta J on this issue.

The House of Lords held that the legal effect of the forgery in the bill of lading was not such as to make the bill a 'nullity';<sup>21)</sup> therefore

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21) In Lord Diplock's view, a forged document would be a 'nullity' if it were so

neither its validity nor the bank's security interest would be affected by the forgery. Although the issuing date on the bill of lading was false, the goods had been shipped and the bill of lading gave the right of possession to the holder.

According to Lord Diplock:

The bill of lading with the wrong date of loading placed on it by the carrier's agent was far from being a nullity. It was a valid transferable receipt for the goods giving the holder a right to claim them at their destination, Callao, and was evidence of the terms of the contract under which they were being carried.

[T]he realisable value on arrival at Callao of a glass fibre manufacturing plant made to the specification of the buyers could not be in any way affected by its having been loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976.<sup>22)</sup>

#### **4.2 Montrod Ltd v. Grundkötter Fleischvertriebs GmbH** <sup>23)</sup>

The same reasoning was followed in the Montrod Ltd v. Grundkötter Fleischvertriebs GmbH case,

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forged as to deprive it of all legal effect: *ibid.* His Lordship also stated that he 'would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case'

22) It has been unfortunately suggested that '[t]o the shipping industry, this case, by contrast with *Sztejn*, might be analogous to an inconsequential "white lie" specifically designed to rectify the unduly burdensome formalities inherent in maritime venture financing': Joseph A Walsh II, 'Documentary Maritime Fraud: Redefining the Standard' (1989) 6 *Arizona Journal of International and Comparative Law* 223, 250.

23) [2001] EWCA Civ 1954,

(1) The facts of the case

A German seller, Grundkötter Fleischvertriebs GmbH, and a Russian buyer, Ballaris, entered into a contract for the sales of frozen pork meat. The buyer engaged Montrod, a finance and investment company, to facilitate the purchase by being the applicant for a credit. Montrod applied for the credit through its bank, Fibi Bank who arranged for the opening of the credit by Standard Chartered Bank in favour of the seller. The credit, which was advised to the seller by a German bank, was payable 45 days after sight on presentation of specified documents, including inspection certificates signed by Montrod.

This was a device ensuring that the credit would only be operable if Montrod had been put in funds to cover its liabilities by the buyer. This was important for Montrod because although the credit named him as the applicant, he was not the buyer in the underlying contract and had no contractual relationship with the seller.

In the course of negotiations the buyer informed the seller that one of its employees should sign the inspection certificates on behalf of Montrod. The seller, believing that he had authority to sign on behalf of Montrod, presented certificates so signed to the bank. The goods were delivered to the buyer in Moscow. Between the date of presentation and the date of payment, Montrod informed the issuing bank that the certificates of inspection presented were forgeries and also applied for injunction restraining the bank from making payment under the credit.

(2) The judgements

The trial court held that the seller was entitled to payment under the credit, since the seller had not acted fraudulently. In the light of the judgment, the bank made payment to the seller. Montrod appealed but the Court of Appeal upheld the trial Court's decision and Lord Justice Potter stated, that:

"The fraud exception to the autonomy principle recognised in English law has hitherto been restricted to, and it is in my view desirable that it should remain based upon, the fraud or knowledge of fraud on the part of the beneficiary or other party seeking payment under and in accordance with the terms of the letter of credit. It should not be avoided or extended by the argument that a document presented, which conforms on its face with the terms of the letter of the credit, is nonetheless of a character which disentitles the person making the demand to payment because it is fraudulent in itself, independently of the knowledge and bona fides of the demanding party. In my view, that is the clear import of Lord Diplock's observations in *Gian Singh* and in the *United City Merchants* case, in which all their Lordships concurred."

#### **IV. Conclusion**

In respect of fraud where the principle of independence is not applied, the case law has been developed to prevent beneficiary fraud and that cases in which the fraud is perpetrated by parties other than the beneficiary are very rare. As most letter of credit fraud cases involve beneficiary fraud, it is common to find in them expressions or paragraphs which indicate that the fraud rule should be applied because of the fraud by the beneficiary.

However, the cases discussed in this paper have taken a different view. The *United City Merchant* case demonstrates that the identity of the fraudulent party raises a real issue in cases where the beneficiary is not the perpetrator of the fraud. The decisions analysed indicate that the courts (with the exception of the English Court of Appeal) have accepted the argument put forward by the beneficiaries in each case and have held that the fraud rule should not apply when the fraudulent party is not the beneficiary who is innocent. The House of Lords finding was based on "

nullity exception” where the applicant actually got no damage in receiving the goods in order without hurting function of Bill of Lading.

This view can be justified on the basis that in terms of UCC Article 5, forgery cannot be invoked as an exception against a person who has proved himself to be a holder in due course and who had no knowledge of the forgery. The Court could not see any justification for distinguishing between such a holder in due course and a beneficiary. It is averred that such a distinction does in fact exist, and moreover that it should exist. A holder in due course is a completely innocent party, who has given value in exchange for the document which he possesses

If the goods and the Bill of Lading were discrepant to some extent, the House of Lord would have not held such decision in favour of the beneficiary. This means that If the 3rd party fraud/fraudulent document is of significant damage to the applicant<sup>24)</sup>, the nature of the documents should be the relevant and determining factor in the application of the fraud rule, not the identity of the fraudulent party..

From practical view point - the issuing bank eventually accepts the discrepancy (ie, though apparent ante dated Bill of Lading) when there is waiver request of the applicant. This is because the applicant in most cases wants to take out the goods which are confirming to its order, as early as possible, by paying to the issuing bank. If the issuing bank, nonetheless, does not pay the Letter of Credit insisting the discrepancy in spite of the applicant’s waiver request, the court might hold in favour of the beneficiary when it comes to the suit case

UCP independence rule is surely first source of letter of credit law but in case of innocent beneficiary where the applicant does not get damage/loss on the goods resulting from documents required, I believe that the nullity exception can be employed if the dispute is brought into the court. Also the issuing bank need to treat this exceptionally along with close contact with applicant at the same time

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24) ie, the date of shipment is recorded some days later



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## ABSTRACT

### **Interpretation of 3rd Party's Fraud Exception Rule Under Law of Letters of Credit**

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The fraud exception rule allows for the issuing bank to dishonor the claim if it the documents and transactions bear fraud though the documents presented are complied with the terms and conditions of the letter of credit.

A question arises whether the fraud exception rule can apply to innocent beneficiary when fraud is made by 3rd party.

United City Merchants v. Royal Bank of Canada showed a good example how to handle in case of innocent beneficiary. At this case House of Lord found that innocent beneficiary deserves payment applying nullity exception rule.

I believe that the nullity exception rule is employed for the benefit of innocent beneficiary as far as the issuer and applicant get no actual damage by the 3rd party's fraudulent action which is shown on documents.

Key Words : Independence Principle, Strict Compliance Principle, Fraud Exception Rule, 3rd Party Fraud, Back Dated Bill of Lading, Nullity Exception Rule, United City Merchants v. Royal Bank of Canada