The Uniform Customs and Practice for Documentary Credits (UCP) is universally accepted rules governing letters of credit, has been recently revised. The latest version of the rules, entitled UCP 600, came into effect on 1 July 2007.

But rules require interpretation. The present volume, UCP 600 - Legal Analysis and Case Studies, examines 93 highly controversial issues that will impact on UCP 600 and international trade. Using Q & A techniques, the author has analyzed 55 comment cases to illustrate the legal principles and the possible pitfalls related to the new UCP. Key sections are devoted to amendments and confirmation, document examination and refusal, insurance documents, intransferable and standby LCs, trade finance risks, fraud and injunction. Special emphasis is given to the latest letter of credit law and practice in the People's Republic of China (PRC).

UCP 600 - Legal Analysis and Case Studies is a comprehensive guide for trade finance practitioners, bankers, lawyers, shippers, managers and anyone involved in letters of credit and international trade.

The author, King Tak FUNG, is a Banking Partner at CLA Piper, the world's largest law firm in terms of the number of lawyers. He was a member of the ICC Consulting Group on the UCP 600 revision, a former Vice-President and Head of Trade Finance at Bank of America N.A., an accredited mediator of the Hong Kong International Arbitration Centre and has acted as a banking and trade finance expert in Hong Kong courts. Mr. FUNG is a frequent speaker and writer on international trade law and practice and is the author of Leading Court Cases on Letters of Credit, published in December 2006 by P.E.E.R. Publishing SA. Since 1988, more than 30,000 judges, lawyers, bankers and business executives have attended Mr. FUNG is innovative, legal and banking workshops.
UCP 600
Legal Analysis and Case Studies

by King Tak FUNG

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PREFACE

By Gary COLLYER
Technical Adviser, ICC Commission on Banking Technique and Practice

The process of drafting UCP 600 took some three-and-a-half years followed by some eight months before their final implementation on 1 July 2007. During that time and in the year since the implementation date, a number of books, other publications and brochures have been issued on the rules by various authors and organizations. Whilst each has served its own purpose and target audience, it is unusual to find a publication written by someone who is not only well-known as a lawyer, but who, earlier in his career, experienced documentary credit transactions from a banker’s perspective as a trade finance expert.

King-Tak Fung, or K.T., as he is more commonly known, has experienced both sides of the “fence”, so to speak, and is ideally placed to write a book that looks at the day-to-day UCP issues, not purely from a legalistic perspective, but also from a practical one, offering advice to bankers, corporates, shipping and logistic organizations and, not least, other lawyers.

When reviewing a number of other publications, I have found they contain a great deal of theory and practical advice, but most authors have shied away from giving pure examples in the shape of case studies. This is probably because practice under UCP 600 had not truly developed at the time they wrote. K.T. has gone against this trend. In addition to taking into account the views expressed in the few UCP 600 Opinions reviewed by the ICC, he has looked at the Opinions given under UCP 500, particularly those that would equally apply under UCP 600.

Having listened to the concerns of practitioners from around the world, K.T. has addressed the more common pitfalls in documentary credit practice, using court cases and case studies as the backbone of his analysis and conclusions, and taking into account various scenarios. He has also tackled issues that have been raised by bankers on a number of occasions, but that were never before the ICC in the form of a request for an Opinion, e.g., in the context of a documentary credit requiring shipment from China, whether China and Hong Kong are considered to be separate banks in the context of article 3 of UCP 600.

Any publication that offers practical advice to users of documentary credits with the aim of resolving persistent problems, enabling banks to have more straight through processing, having importers receive the documents (and goods) in the form they require and allowing exporters to obtain settlement when they expect it should be applauded. This is one of those publications. As K.T. says in his introduction, he is open to receive more comments and updated cases, so we can surely expect further volumes containing this invaluable advice.

June 2008
FOREWORD

By King Tak FUNG

Hong Kong

It is well recognized that UCP 600, a universally accepted set of governing rules on letters of credit, plays an essential role in international trade.

As a member of the ICC Consulting Group on UCP 500 revision, I had the honour and privilege to work with a number of leading L/C experts and to participate in the entire UCP revision process from 2003 to its conclusion in 2007. I believe that sharing this invaluable experience with readers will help them better understand the background and interpretation of the new UCP.

I deliberately set the publication date of this book in July 2008 for two reasons:

1. To celebrate the first anniversary of UCP 600 implementation; and

2. To ensure that I have collected most of the major concerns and queries about UCP 600 from trade finance practitioners in different parts of the world.

Based on my experience in writing the first book, "Leading Court Cases on Letters of Credit", I organized this book around the following principles:

1. Q & A - Most readers prefer concise, precise and to-the-point presentations. I therefore used the Q & A technique to examine 99 highly controversial UCP 600 and trade finance issues commonly raised by L/C practitioners. Readers can therefore obtain answers quickly without substantial research.

2. Cases - In my view, the best way to interpret and explain rules, legal principles and the application of UCP 600 is through the use of case studies. Accordingly, I have selected 55 classic cases to illustrate proper banking practice and the pitfalls of international trade. Unlike my first book that focuses mainly on court cases, a majority of the cases cited in this book involve real banking practice. In recent years, I have been involved with many of these as a legal practitioner and mediator.

3. Topics - There are a total of 12 chapters in the book, covering all of the major topics in UCP 600. To cater for the business sector, I have addressed various issues from a commercial perspective, including "proper usage of Incoterms 2000", "essential terms of a sales contract", "prevention of forged document presentation", etc. Special emphasis has been placed on practical issues such as "control over goods", "comparison between UCP 600 and ISP98 on standby L/Cs", "pitfalls of transferable L/Cs that UCP 600 does not address", "trade finance risks analysis" and "the latest L/C law and practice in the PRC". Hopefully, combining theory and practice in one single volume will provide practical guidance to trade finance practitioners on risk management and will lead to the enhancement of international trade practice.

My hope is that this new book, together with the "Leading Court Cases on Letters of Credit", will provide the reader with a comprehensive and rounded view of letter of credit operations from legal, banking and business points of view.
I look forward to receiving your comments and updated cases from your countries. My e-mail is kingtak.fung@dlapiper.com / fkt@sunitec.com

June 2008
Chapter 11

Fraud and Injunctions

INTRODUCTION

Fraud and injunctions are areas of L/C law that have caused concern to many bankers and trade finance practitioners. The UCP is silent on them. The requirements to prove fraud or obtain an injunction from local courts vary from one country to another. This chapter summarizes some of the legal principles by reference to selected cases decided in several common law jurisdictions.

1. Under what circumstances can the fraud exception apply?

2. What are the essential elements of a common law fraud that must be satisfied for a court to grant an injunction?

3. What kinds of injunctions can be sought?

4. Does the fraud exception apply if the fraud was committed by a third party and the beneficiary had no knowledge of it?

5. Are built-in discrepancies effective?

6. Does the fraud exception apply if the relevant fraud is committed in a foreign jurisdiction?
1. Under what circumstances can the fraud exception apply?

Under the L/C autonomy principle, an issuing bank is obliged to honour compliant drawings unless the fraud exception applies. In *UniCredito Italiano S.p.A. v Alan Chung Wah Tang* 34, the Hong Kong court held:

“It is well-established law that the test is whether, standing in the shoes of the paying bank at the time of payment, the fraud was clear and obvious to it ... If fraud was clear and obvious, then the bank pays the beneficiary at its own peril and it is not entitled to reimbursement. But if fraud is not clear and obvious, then it is not for a banker to question why the businessmen involved in the underlying transaction had chosen to conduct their business in any particular way.”

The judge further said:

“It is clear that fraud must only be alleged when there is sufficient evidence and then it must be alleged specifically with full particulars. It is established principle that it is not fair and just to permit a party to raise a vague unparticularised case in the hope of making it good after discovery.”

A case of fraud can be made out if the court considers that on the material before it the only realistic inference to draw is that of fraud. The more serious the allegation, the more compelling the evidence must be. Mere allegation of fraud will not be accepted by the court, so the applicant must produce cogent evidence to support its charge. In addition to the proof of fraud, the court will also examine other factors to see whether the balance of convenience is in favour of stopping payment by an injunction.

34. [2002] 339 HKCU 1 (Hong Kong).
For example, the court will consider the position of the applicant and the beneficiary, as well as the position of the bank, since an injunction restraining L/C payment can undermine the reputation and integrity of the bank. Moreover, if monetary compensation is an adequate remedy, the courts will probably refuse to grant an injunction. This is because if it is likely that the applicant will subsequently be able to recover the money from the defendant, there is no need for a court to grant an injunction restraining the issuing bank from effecting payment before trial.

In the *United Trading Corporation S.A. v Allied Arab Bank Limited*\(^{35}\), the English court found that there were a number of genuine disputes between the parties on the evidence before it, and it was not possible to draw the conclusion that the only realistic inference was that of fraud. Accordingly, the court discharged the interlocutory injunction previously granted.

**2. What are the essential elements of a common law fraud that must be satisfied for a court to grant an injunction?**

In *Hyosung America, Inc. v Sumagh Textile Co., Ltd*\(^{36}\), the New York court held that the essential elements of a common law fraud claim include:

a. a material false representation by the person who perpetrated the fraud;
b. an intention to defraud;
c. reasonable reliance by the applicant on the representation; and
d. damages caused to the applicant.

In this case, the beneficiary admitted that it had known that the fibre content (i.e., 70 per cent rayon/30 per cent wool) of the goods shipped did not match the description of the goods stated in the presented documents (i.e. 65 per cent rayon/35 per cent wool). The beneficiary also knew that the applicant would be liable to pay


under the L/C if documents that appeared on their face to comply with L/C terms were presented. The court held that there was an intention to defraud and that a five per cent discrepancy in fabric content was material to the underlying sales transaction.

It is clear that if the beneficiary had not falsified the documents, the bank would not have paid out under the L/C. The court, therefore, held that the beneficiary had made a material false representation on which the bank relied, resulting in payment under the L/C. Accordingly, an injunction prohibiting the issuing bank from effecting payment was granted.

3. **What kinds of injunctions can be sought?**

a. An injunction that prohibits the issuing bank from effecting payment under an L/C

   The relevant principles and requirements are set out in Questions 1 and 2 above.

b. An injunction that restrains the beneficiary from dealing with the L/C proceeds

   This is similar to a mareva injunction (i.e. an injunction prohibiting the disposal of assets by the beneficiary). The applicant for this kind of injunction must show there is a risk that the beneficiary will dissipate the proceeds and thereby thwart any judgment that the applicant may obtain against him. It is important to note that such an injunction is not dependent on fraud being shown (or even alleged). Like all mareva injunctions, all that is required is a good arguable case, usually a breach of contract (or any other cause of action), a risk of asset dissipation and the balance of convenience.
Where the beneficiary and issuing bank were well-known companies, as in the case of *Prime Deal (HK) Enterprises Ltd v The Hong Kong and Shanghai Banking Corporation Ltd* [37], the risk of dissipation of assets was held to be minimal. The court therefore did not grant the injunction to restrain the beneficiary from dealing with the L/C proceeds, since damages would have been an adequate remedy, as explained in Question 1 above.

c. An injunction that prohibits the beneficiary from drawing on an L/C and from serving the relevant order on the issuing bank

In these circumstances, the issuing bank will not be named as one of the defendants in the litigation proceedings between the applicant and the beneficiary. Accordingly, the issuing bank will not have to assume substantial legal costs and can withhold payment until the court order is discharged or set aside.

In many jurisdictions, courts may require the applicant to put up security for the purposes of indemnifying the defendant’s damages if it is later proved that the injunction was improperly obtained and had caused damage to the defendant.

4. **Does the fraud exception apply if the fraud was committed by a third party and the beneficiary had no knowledge of it?**

Not all fraud is perpetrated by the parties to an L/C. Therefore, a key question follows: is an issuing bank entitled to reject documents which contain fraudulent misrepresentation made by a third party and if the beneficiary had no knowledge of the misrepresentation when it presented the documents?

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37. [2002] 831 HKCU 1 (Hong Kong).
In the landmark case of *United City Merchants (Investments) Ltd v Royal Bank of Canada*\(^{38}\), the carrier’s agent antedated the shipment date and the beneficiary had no knowledge of it. The House of Lords ruled that the confirming bank was obliged to honour a compliant drawing (at least on the face of the documents), since the fraud exception only applied if the beneficiary knew of the impropriety of the drawing and was deemed by the courts to be privy (i.e. a party) to the fraud.

However, if the fraudulent third party is an agent of the beneficiary, the beneficiary would be deemed to have imputed notice of the fraud and would not be immune from the fraud exception.

In the *United City Merchants* case, the court left open the question raised by cases in which the document presented was a nullity, e.g. the issuer of the document did not exist or the issuer’s signature was forged.

In *Monrod Limited v Grundkotter Fleishvertriebs GmbH and Others*\(^{39}\), the Court of Appeal held:

“If a general nullity exception were to be introduced as part of English law it would place banks in a further dilemma as to the necessity to investigate facts, which they are not competent to do and from which UCP 500 is plainly concerned to exempt them. Further, such an exception would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question. Such a development would thus undermine the system of financing international trade by means of documentary credits.”

The *Monrod* case clarifies the position in English law that the L/C issuing bank may not refuse payment on the ground that the presented document is a nullity unless the beneficiary has notice of the fraud.

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5. Are built-in discrepancies effective?

Some applicants insist on requesting that their bankers issue L/Cs that contain “built-in” discrepancies, hoping they can thereby negotiate a price reduction or even refuse to make payment if the price of the goods drops. One common example is to require a document issued by the applicant or countersigned by the applicant whose signature(s) must be in conformity with the issuing bank’s records. The applicant then refuses to issue the required document or deliberately signs the document not in accordance with the issuing bank’s records, or deliberately fills in inconsistent data for the purpose of rendering the document discrepant under the L/C.

Although such a “built-in” discrepancy may entitle an issuing bank to refuse payment under the L/C, this usually does not discharge the buyer’s payment obligation under the sales contract. The court in *Arma Far East Ltd v Uni Fit Garment Factory Ltd*[^40^] ordered the buyer to effect payment under the sales contract even though the presented documents were discrepant under the L/C contract. This was based on the ground that the discrepancies created by the buyer were intended to prevent the seller from obtaining payment from the bank. This again demonstrates the L/C autonomy principle that the L/C contract is separate from and independent of other contracts, including the sales contract.

6. Does the fraud exception apply if the relevant fraud is committed in a foreign jurisdiction?

In *Mahonia Limited v JP Morgan Chase Bank*[^41^], the issuing bank refused to pay on the ground that the L/Cs issued had an illegal purpose, namely, to provide a structure upon which Enron's misleading accounts were to be founded. The ultimate purpose was alleged to be illegal under the securities law of the US.

[^40^]: [2002] HKEC 1038 (Hong Kong).
The English court held that if the alleged fraudulent purpose could be established, the English court would refuse to enforce the L/C contract, because enforcement of such contracts would be contrary to public policy, even though the relevant fraudulent purpose was to commit an illegal act in a foreign jurisdiction. Under the “fraud unravels all” principle, any process used by a dishonest person to carry out a fraud will be unenforceable on the grounds of its illegality. The principle still stands even if L/Cs are involved; it has been held that the L/C autonomy principle should not be extended to protect the unscrupulous seller. The court stated that in an appropriately serious case, such as one involving an international crime with clear evidence of fraud, it was a threat to the life blood of international commerce; therefore, it would be justified not to enforce the contracts.

SUMMARY

The current reasoning on fraud and injunctions involving L/Cs appears to be that there must be knowledge of the fraud on the part of the beneficiary before the fraud exception will be applied by the courts.

No matter who perpetrated the fraud, all fraud cases must be properly prepared; it is an improper and unacceptable practice to raise a vague and imprecise allegation of fraud in the hope of finding further evidence through the court discovery process.

The applicant has to make full and frank disclosure to the court when it makes the application. In the majority of cases, banks are not in a position to judge whether there is clear evidence of fraud. Accordingly, issuing banks may ask the applicant alleging fraud to obtain a court order prohibiting the issuing bank from effecting payment under the L/C. If such a court order is granted, the bank could justify the temporary suspension of its payment obligations under the relevant L/C.
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by King Tak FUNG

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