



Research article

The fraud exception in letters of credit – the Chinese approach

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Abstract

In 2005, the Supreme People's Court (SPC) introduced new provisions relating to letter of credit (L/C) transactions in the People's Republic of China (PRC). This paper will examine the effectiveness of the new provisions concerning the L/C fraud exception rules. The issue is whether the Chinese view of the fraud exception, which was introduced by the Uniform Customs and Practice Model Law for Documentary Credits (UCP), is effective and in line with accepted international views. To that end, this paper will explain the provisions and then employ a comparative approach. It will briefly compare Chinese fraud regulation with English and U.S. jurisprudence and measure effectiveness by noting the prevailing English and U.S. views.

This analysis is timely because China is gaining momentum in its economic development; hence, the attitude of Chinese courts concerning the issue of trade financing with L/Cs is important. The conclusion is that, in general, Chinese regulations are in line with international jurisprudence, and therefore, the reforms are working overall. However, some gaps or questions give rise to uncertainty. This paper suggests that the gaps need to be resolved either by courts or through further regulation by the Supreme People's Court.

Keywords: Letters of credit, UCP 600, Chinese Provisions of 2005, Fraud exception

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استثناء الاحتيايل في خطابات الاعتماد - المنهجية الصينية

ملخص

أدخلت المحكمة الشعبية العليا (SPC) في عام 2005 أحكامًا جديدة تتعلق بمعاملات خطابات الاعتماد (L/C) في جمهورية الصين الشعبية (PRC). تتناول هذه الورقة البحثية مدى فعالية الأحكام الجديدة المتعلقة بقواعد استثناء مبدأ الاحتيايل لخطابات الاعتماد. والمسألة هي ما إذا كانت المنهجية الصينية الخاصة بمبدأ استثناء الاحتيايل، وهي القواعد الموضوعية في إطار القانون النموذجي للاعتراف والممارسات الموحدة للاعتمادات المستندية (UCP)، فعالة وتتماشى مع المنهجيات الدولية المقبولة والمعترف بها. وتحققًا لهذه الغاية، تستعرض هذه الورقة البحثية الأحكام، ثم تستخدم نهجًا مقارنة. وسوف تستعرض هذه الورقة البحثية لوائح مكافحة الاحتيايل الصينية بإيجاز مقارنة مع الأحكام القضائية للولايات المتحدة، وقياس مدى الفعالية من خلال استعراض وجهات النظر السائدة في المملكة المتحدة والولايات المتحدة الأمريكية.

ولقد جاء هذا التحليل في الوقت المناسب حيث إن الصين تكتسب زخمًا في مجال التنمية الاقتصادية؛ وبالتالي، فإن موقف المحاكم الصينية فيما يتعلق بمسألة التمويل التجاري باستخدام خطابات الاعتماد أمر بالغ الأهمية. وبالخلاصة أن اللوائح الصينية بوجه عام تتماشى مع الفقه القضائي الدولي، وبالتالي، فإن الإصلاحات سوف تنطبق بشكل شامل على جميع الأنظمة. بيد أن بعض الثغرات أو التساؤلات تثير الشكوك. وتشير هذه الورقة إلى أن هذه الثغرات تحتاج إلى حل إما من خلال المحاكم أو من خلال المزيد من اللوائح التي تضعها المحكمة الشعبية العليا.

I. Introduction

Documentary letters of credit (L/Cs) are a significant payment method in international trade; in 2004 they accounted for approximately 15% of all international transactions.¹ They are governed by rules established by the International Chamber of Commerce (ICC) which, in 2006, approved a revision of the rules governing L/Cs in the Uniform Customs and Practice Model Law for Documentary Credits (UCP 600) that went into effect on July 1, 2007.²

The main feature of the UCP 600 is the autonomy (or independence) principle, namely, that a credit is separate from the underlying contract between the seller and the buyer.³ This feature is noted in article 4 of the UCP 600:

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

¹See Edward E. Lehman & John Lee, *Adjudicating letter of credit-related cases: the Provisions on Several Issues Concerning the Trial of Letter of Credit Disputes, China's first letter of credit-related law, has attracted widespread attention in the banking sector and judicial circles*, 20 CHINA L. & PRAC. 23 (Sept. 2006), <http://ezfind.technion.ac.il/vufind/EdsRecord/edsqgo.edsqcl.153186283>

²United States Council for International Business, *Uniform Customs and Practice for Documentary Credits* (Mar. 7, 2013), <http://www.uscib.org/ucp-600-ud-4465/>.

³John Ren, *The Scope of the Fraud Exception in Letter of Credit Law*, 26 J. CONTRACT L. 289, 291 (2010).

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.⁴

Article 14(a) clarifies the autonomy principle by stating that: “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.”⁵

Under the autonomy principle, the bank is obligated to pay the beneficiary as long as the documents presented conform to the descriptions of the credit, as noted in article 7. It states: “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 honor if the credit is available.”⁶

The only exception to the autonomy principle is the fraud exception, which allows the aggrieved party to ask for an injunction against payment even when the documents are strictly in compliance with the L/C contract. The UCP 600 does not contain any articles providing guidelines for examining fraudulent behavior or documents. The reason given by the ICC is that, although the UCP 600 recognizes the fraud issue, the scope of exceptions can vary across jurisdictions and hence, domestic law and domestic courts acting in good faith should be the ones to protect the interests of the trading parties.⁷ In other words, the UCP 600 is the uniform standard for best banking practices but not a regulator on issues such as fraud. The very nature of a model law—developed in “bottom-up” fashion by non-judicial bodies—means that it cannot be as fully developed as a code. Consequently, it requires an overlay by legislatures and courts. The result of leaving the fraud issue to domestic courts, unfortunately, is a lack of uniformity for all facets of documentary credits and results that are not uniform in all jurisdictions.

At the outset, it must be noted that this paper will describe the nature, evolution, and technical movement of L/C fraud law narrowly, specifically examining the fraud exception as it relates to the People’s Republic of China (PRC). The reason: the PRC is currently one of the largest users of L/Cs in the world. It is estimated that nearly 30 percent of Chinese exports and imports are settled with L/Cs, which represented a dollar value of close to U.S.\$600 billion in 2006.⁸ As of January 1 in that year, “The Provisions . . . on Some Issues Concerning the Trial of Cases of Disputes over Letter of Credit,” announced by the Chinese Supreme People’s Court (SPC) on November 14, 2005, went into effect. The goal of the provisions was to standardize L/C practices in China.⁹ There are five specific articles in the 2005 SPC provisions that relate to the fraud exception.

Overall, the L/C fraud exception rules in China need to be considered in two stages, substantive and procedural. The first stage is to determine the existence of L/C fraud, which is an issue dealt with under the substantive law. The second stage is to consider the feasibility of a stop payment order in cases where fraud exists, which is a procedural issue. This paper will only discuss the substantive issue.

⁴The text of the UCP 600 can be found at: http://www.fd.unl.pt/docentes_docs/ma/mhb_MA_24705.pdf.

⁵*Id.* art. 14(a).

⁶*Id.* art. 7.

⁷Yanan Zhang, *Documentary letters of credit fraud exception rules: A comparative study of English law and Chinese law*, 30 J. INT’L BANKING L. & REG. 210, 211 (2015) [hereinafter Zhang, *Documentary*].

⁸Xiang Gao, *The Fraud Rule in Law of Letters of Credit in the P.R.C.*, 41 THE INT’L LAWYER 1067, 1068 (2007).

⁹Lehman, *supra* note 1.

To that end, two questions are of importance. First, were the 2005 SPC Provisions and their subsequent implementation by courts in line with international best practices? Second, were the reforms effective?

II. The historical development of L/C fraud in China

Before the 1970s, the PRC had a highly centralized and planned economy. It was not until 1978 that China opened up its economy to the world. It took six years after that for the first court case in China to address an L/C dispute, the 1986 *Yuegang Agricultural Resources Development Co. v. Japanese Technology of Science Co.* case.¹⁰ The plaintiff, a Chinese buyer, sued the Japanese seller, maintaining that machines delivered pursuant to a contract were not up to the quality specified in the contract. The plaintiff sought to freeze a payment owed of ¥216 million, and the court, despite the L/C aspect, froze the payment through a stop-payment order.

This ruling was disappointing because the decision did not follow international jurisprudence dealing with the fraud exception. The decision simply relied on PRC Civil Procedure Law and failed to take the fraud principle of L/Cs into consideration. Simply put, the courts in China were not familiar with L/Cs. Not surprisingly, the Japanese seller and paying bank, referencing the autonomy principle, strongly criticized the improper freezing of the payment.

Gradually, the numerous stop-payment orders issued by Chinese courts drew criticism from Chinese banks because the frequent court interference with payments not only harmed the healthy operation of L/C transactions, but also seriously damaged the reputation of China's emerging banking industry.¹¹ The problem was that, at the time, the only general principles dealing with L/C fraud were in the General Principles of the Civil Law (GPCL) of the PRC and Contract Law.¹² The scope of the problem led to the Higher People's Courts approaching the SPC to develop much-needed instructions and guidelines on L/C-related cases.

On June 12, 1989, the SPC issued the "Summary of the National Forum on the Adjudication of Economic Cases relating to Foreigners and People from Hong Kong and Macao in the Coastal Region."¹³ The announcement included the establishment of fraud rules in Paragraph (4)(ii), "Regarding the Freezing of Payment of a Letter of Credit,"¹⁴ which states:

A letter of credit is a documentary transaction independent from the underlying sales contract, under which the issuing bank is obliged to pay the seller within the prescribed time as long as the seller presents the required documents conforming on their face with the terms of the letter of credit ... The letter of credit and the sales contract belong to two different legal relationships.

¹⁰*Yuegang Agric. Res. Dev. Co. v. Japanese Tech. of Science Co.*, Zhu Zhong Fa Jin Shen Zi Di 23-3, Hao Case No. 23-3 (Econ. Div., Zuhai Interm. People's Ct. 1986).

¹¹Lehman, *supra* note 1.

¹²Yanan Zhang, *Evaluation of documentary letter of credit fraud exception rules in China*, 29 J. INT'L BANKING L. & REG. 103, 103 (2014) [hereinafter Zhang, *Evaluation*].

¹³See 最高人民法院关于印发《全国沿海地区涉外涉港澳经济审判工作座谈会纪要》的通知 (法(经)发[1989]12号. [Announcement from the Supreme People's Court concerning the National Forum on the Adjudication of Economic Cases Relating to Foreigners and People from Hong Kong and Macao in the Coastal Region, Fa (Jing) Fa No.12 (Sup. People's Ct. 1989)], <http://law.lawtime.cn/d556800561894.html> [hereinafter, *Announcement*].

¹⁴Zhang Ruiqiao, *A Comparative Study of the Fraud Exception Rule of Letters of Credit: Proposed Amendments to the Chinese Credit System* 86-87 (LL.M. Thesis, McGill University, ProQuest Dissertations Pub., Nov. 2009).

Generally payment of a letter of credit should not be frozen without serious consideration merely because there is a dispute over the foreign-related sales contract; otherwise the reputation of the Chinese bank can be jeopardized. In view of the practice at home and abroad, if sufficient evidence shows that the seller is using the underlying contract to defraud the buyer, and the Chinese bank has not paid within a reasonable time, a people's court may freeze the payment of the letter of credit upon the request of the buyer. However, a people's court should not freeze the payment of an acceptance credit when a time draft presented hereunder has already been accepted by the Chinese bank, as the obligation of the Chinese bank in such a situation has become unconditional under the law of negotiable instruments. Hence a people's court taking such measures must proceed with caution, should first contact the Chinese bank, and seek advice from higher courts when necessary. A people's court should follow the same steps mentioned when it receives an application from a Chinese foreign arbitration agency for the freezing of the payment of a letter of credit.¹⁵

These guidelines, though drafted in 1989, were largely in line with the principles that would be contained in the 2006 UCP 600 and thus reflected established international jurisprudence. The guidelines were not a judicial interpretation, however, but only a conference announcement. As a result, they could not be directly quoted in judgments or rulings, so their legal effect was extremely weak.

In the guidelines, two basic rules were laid out: first, that a court can only interfere with a payment if sufficient evidence of fraud is shown, and second, that a court cannot interfere with the payment if the bank has already accepted the draft.¹⁶ Despite the clear advice, these policy rules were not well applied in the subsequent 15 years because of their lack of binding effect. However, it was the first set of Chinese instructions that could be used as a guideline in the L/C fraud cases, and it also has had a great influence on the provisions that were finally introduced in 2005.

From 2001 until the announcement of the 2005 SPC Provisions, drafters proceeded cautiously, taking into account international customary rules and, undoubtedly, international jurisprudence concerning L/C. As noted above, the SPC directed special attention toward examining the fundamental principles that had been widely adopted by many other jurisdictions. These rules were adapted to suit the Chinese legal system and augmented with suggestions from local banks and courts.¹⁷

III. 2005 SPC provisions addressing the trial of disputes over letters of credit

This section will highlight the provisions that play the most significant role with regard to the L/C fraud exception. But it will start with Article 5, which sets out the basic principles governing L/Cs, independence and strict compliance.

After the issuing bank makes a commitment on the payment or acceptance of a letter of credit or performance of other obligations under the letter of credit, the issuing bank shall perform the payment obligation within the time limit as specified in the letter of credit as long as the

¹⁵See *Announcement*, *supra* note 13, ¶ (4)(ii).

¹⁶Xiang, *supra* note 8, at 1074.

¹⁷中国法院网, 最高人民法院《关于审理信用证纠纷案件若干问题的规定》的说明(2005年12月9号) [China Court, *Review of the Provisions of the SPC on Some Issues in the Adjudication of L/C Cases* (09 Dec. 2005)], <http://www.chinacourt.org/article/detail/2005/12/id/189405.shtml>, [hereinafter, China Court, *Review*].

documents conform to the clauses of the letter of credit and the documents conform to each other on the surface. If a party concerned initiates a protest for the reason of the basic transaction between the applicant and the beneficiary, the people's court shall not support it, except under the circumstances as prescribed in Article 8 of these Provisions.

The specific 2005 SPC Provisions dealing with fraud were divided into four parts, namely: 1) the establishment of fraud, 2) immunization of the fraud exception, 3) the conditions for a stop-payment order, and 4) the remedy as to the stop-payment order. Five articles particularly relate to the L/C exception rules: articles 8, 9, 10, 11, and 15.¹⁸

A. The establishment of fraud: Articles 8 and 9

Article 8 lists the circumstances which constitute the fraud exception.

Any of the following circumstances shall be considered to constitute L/C fraud:

- (I) the beneficiary has forged or incorporated false contents in any of the presented documents;
- (II) the beneficiary, in bad faith, delivers no goods or delivers goods of no value;
- (III) the beneficiary, in conspiracy with the applicant or any third party (parties), presents documents while no real underlying transactions exist;
- (IV) other circumstances where fraud under a L/C may be found.

Simply put, this article avoids defining L/C fraud but instead lists all the circumstances where fraud exists, focusing primarily on the beneficiary. This approach has led to discussion amongst Chinese scholars. Ren has argued that “a fraud is a fraud and it should not matter who commits the fraud” and that it is hard for banks to distinguish who committed the fraud.¹⁹

Additionally, Huang has argued that sub-section (I) of the article explicitly includes innocent beneficiary fraud because the unknowing presentation of false documents by the beneficiary is regarded as fraud under that sub-section, despite the fact that the beneficiary did not commit the fraud.²⁰ This issue is commonly connected to antedating of bills of lading, and early cases proved to supply contrasting answers.²¹

Zhang, however, has pointed out that it is not clear how to establish fraud if the beneficiary is unaware of the third-party fraud.²² In essence the beneficiary must be aware of the fraud, and hence the bank must be notified before honouring the L/C. Zhang has also suggested that third-party fraud should not result in application of the fraud rules if the third party was not the holder of the credit;²³ this approach is consistent with most foreign laws and international instruments.

¹⁸最高人民法院关于审理信用证纠纷案件若干问题的规定. 法释[2005] 13 号. [*Provisions of the Supreme People's Court on Some Issues Concerning the Trial of Cases of Disputes over Letter of Credit*, Fa Shi No. 13 (Sup. People's Ct. 2005)], http://www.gov.cn/ziliao/flfg/2005-12/09/content_122712.htm. The SPC adopted the provisions as a judicial interpretation rather than as legislation, which plays a significant role in judicial practices.

¹⁹Ren, *supra* note 3, at 294.

²⁰See 黄亚英, 中国法院网, 信用证欺诈例外中的第三方欺诈 (2004 年 10 月 13 日) [Huang Yaying, CHINA COURT, *Discussion on L/C Fraud Exception and Third Party Fraud*, (13 Oct. 2004)], <http://www.chinacourt.org/article/detail/2004/10/id/135509.shtml>.

²¹See, e.g., The 3rd Civil Court, Higher People's Court of Jiangsu Province, *Whether Anti-dated BL Constitutes L/C Fraud*, 4 PEOPLE JUSTICE 67 (2004).

²²Zhang, *Evaluation*, *supra* note 12, at 105.

²³*Id.* at 127.

Another issue that might arise is that sub-section (IV) of the article introduces the catch-all language “other circumstances.” It allows courts some discretion to consider circumstances that are not related to the beneficiary committing fraud. This leeway might open the door to injunctions outside established international principles.²⁴

Sub-section (II) of the article does apply a strict condition that if the beneficiary consciously delivers no goods, or goods with no value, fraud is committed. However, this creates a lacuna because the section does not clearly state what constitutes goods with no value. Is it completely different goods or substantially different goods? Might any goods—even sand instead of machinery—have a value? This issue has been resolved by article 9, which states:

If the applicant, issuing bank or any other interested party finds any of the circumstances as prescribed in Article 8 of these Provisions, and believes that irremediable losses will be caused to it, it may file an application with the competent people’s court for suspending the payment under the letter of credit.

Arguably, courts would approach the granting of a stop payment order through the eyes of the buyer and thereby determine that goods not corresponding to the contract have no value to the buyer.

As can be seen, the Chinese courts employ a very strict approach in the examination of the fraud issue.

B. The immunization of the fraud exception: Article 10

The key issue in article 10 is whether the issuing bank, the confirming bank, or the presenting bank has acted in good faith. The article states:

Upon determining that L/C fraud exists, the People’s Court shall render an order to suspend or judgment to terminate payment under the L/C, except in any of the following circumstances:

- (I) A party nominated or authorized by the issuing bank has made payment in good faith according to the issuing bank’s instructions;
- (II) The issuing bank or a party nominated or authorized by it has accepted the draft under the L/C in good faith;
- (III) The confirming bank has paid in good faith;
- (IV) The negotiating bank has negotiated in good faith.

Under this article, if banks act in good faith and the payment has already been accepted or paid, the stop-payment order cannot be obtained. At first glance, this approach appears consistent with the English rule that notice of the fraud must come to the bank’s attention before the draft is presented for collection of payment. But a problem exists in interpreting sub-section II of the article, which is whether “accepted” means presented to the bank but payment has not been effected, or payment has been made as noted in sub-section (I). The suggestion can be made that accepted means accepted; otherwise, sub-section (I) would cover the issue and sub-section (II) would not be needed.

In addition, the principle of good faith has not yet been embraced by English law and is hence not a principle governing commercial contracts, unlike in the United States and Australia.

²⁴See King Tak Fung, *Chinese Guidelines for L/C Disputes*, 12 DC INSIGHT (Apr.–June 2006).

C. *Conditions for the stop-payment order: Article 11*

Article 11 notes:

Application for suspension of L/C payment filed by a party prior to initiating a suit shall be accepted by the People's Court, provided that the following conditions are met:

- (I) The court which accepts the application has jurisdiction over the dispute on which the application is based;
- (II) The evidence provided by the applying party demonstrates the existence of any of the circumstances stipulated in Article 8;
- (III) The applying party's legal rights and interests would be irreparably damaged if payment under the L/C were not suspended;
- (IV) The applying party has provided reliable and sufficient security;
- (V) No circumstances stipulated in Article 10 exist. Application for suspension of payment under a L/C during the course of litigation shall comply with conditions (II), (III), (IV) and (V) of the preceding paragraph.

Article 11, in essence, lists the conditions that must be met in order to suspend payment. Of particular interest are sub-sections (II) & (III).

Sub-section (II) requires the applicant to provide evidence to prove the beneficiary's fraud. This provision has been criticized because it does not clearly state what the standards of proof should be. Should the evidence be "sufficient" or any other standard, such as irreparable damage?

The answer to this question has been partially supplied in an appeal court case.²⁵ The judge established the criterion that "the fraud has to be substantial enough." The view therefore is that the applicant should provide evidence of substantial fraud. Substantial fraud can be demonstrated when the fraud seriously affects parties' interests and jeopardizes the purpose of the underlying contract.²⁶

Gao has commented that the evidence must consist of written documents, such as the evaluation letter from an independent party, because oral allegations are not likely to be accepted.²⁷ This comment suggests a very high threshold because the time before and during litigation, particularly when L/Cs are issued, is so limited that it may not be easy for the plaintiff to find adequate evidence.

Sub-section (III) resolves the issue to some extent because it sets out irreparable damage as a condition to stop payment. It does not, however, provide a detailed answer as to what amounts to irreparable damage, leaving this issue to the discretion of the courts. Considering that a stop-payment order should be the last resort, the principle of irreparable damage should only be used when the evidence proves fraud beyond doubt. After all, the 2005 SPC Provisions indicate enough reasons to stop payment without having to resort to the use of discretionary methods.

The recommendation is that courts – specifically the SPC – should issue regulations or announcements clarifying the lacunae in order to improve certainty and uniformity of the fraud rules in China.

²⁵*Woori Bank, South Korea v. Xuanlian Co., Ltd., Beijing*, Higher Civ. Final No. 516 (Higher Ct., Beijing 2008).

²⁶Zhang, *Evaluation*, *supra* note 12, at 120.

²⁷Xiang, *supra* note 8, at 1086.

D. *The stop-payment order remedy: Article 15*

Article 8, addressed above, and article 15 together provide remedy for an innocent party to stop payment. Article 15 provides:

In case the people's court, through substantial trial, determines that a letter of credit fraud is constituted and that none of the circumstances as prescribed in Article 10 of these Provisions exists, it shall make a judgment on terminating the payment under the letter of credit.

Article 15 thus simply notes that if fraud is detected, as defined in article 8, payment is permanently suspended.

In sum, the 2005 SPC Provisions concerning the L/C fraud issue constituted a significant legal development in China. They serve as a gap-filler for the previous unofficial policy statements, and they established a new legal instrument (the stop-payment order). Such rules will standardize the approach and prevent the applicants from improperly relying on judicial intervention in the L/C system.²⁸ The provisions suggest a strict approach to dealing with the L/C fraud rules and appear to follow the English model.

IV. Chinese jurisprudence²⁹

Since the SPC 2005 Provisions were implemented, several cases have been decided. Of these, four decisions are significant. The necessary facts are summarized and the decisions where relevant are discussed.

In the first, a 2009 case,³⁰ a Chinese buyer and a Hong Kong seller entered into a contract concerning clear PET washed bottle flakes (a form of plastic used for making packaging). As specified in the contract, the goods were to contain less than 0.03% PVC and 0.8% water. In the L/C, the required documentation included, amongst other items, invoices, bills of lading, an SGS test report, and a sample.

However, upon receipt of the documents and goods, the buyer required the goods to be examined. The test results showed that the products consisted of 20.7% PVC and 4% water, the product didn't match the sample, and the boxes were full of plastic waste. Based on these facts, the buyer/plaintiff sought an injunction against the payment by claiming fraud by the seller.

The court decided to apply the UCP 600, as contractually agreed upon by both parties. As the court noted, the UCP 600 does not provide a clear guideline to solve the L/C fraud issue. Because the case was venued in China, the Chinese SPC provisions on the L/C were effective in order to fill the gap.

Based on several test reports, the court agreed with the plaintiff that the seller had delivered worthless garbage instead of the contracted-for goods because the delivered products were actually scrap materials that failed significantly to conform to the contract requirements. Therefore, the court held, the goods should be regarded as being of no value. This constituted L/C fraud as defined in article 8(II): the beneficiary delivered goods that were of no value. However, taking article 10(I) into consideration, the plaintiff could not succeed in obtaining the stop-payment order because the issuing bank had made or honored the payment in good faith.

²⁸Zhang, *Evaluation*, *supra* note 12, at 106.

²⁹For general information and updates on Chinese law, see *China Foreign-Related Commercial and Maritime Trial*, <http://library.law.yale.edu/research/guides/resources/chinese-foreign-related-commercial-and-maritime-trial>.

³⁰江阳玛蒂公司诉香港新威公司交付无价值货物信用证欺诈案. (2009) 锡民三初字第 191 号 [Jiangyin Madi Difference Chem. Fiber Co., Ltd. v. Sun Rider Indus. Co., Xi Civil 3 First-Instance No. 0191 (Intermed. Ct., Wuxi City, Jiangsu Province 2009)].

The second, a 2011 case,³¹ dealt with the sale of cathode copper. The UCP 600 again applied. The buyer signed a commission contract with a trading company. The company would, on behalf of the buyer, enter into a sales contract with the seller and open a letter of credit as an issuer. The buyer agreed to deposit 15% of the total sales value. The seller was actually a subsidiary of the buyer.

As was later shown, the buyer and the seller colluded to collect the L/C payment. The seller/beneficiary transferred the actual goods to a logistics company in Singapore and presented the bills of lading to collect the L/C payment. Once the trading company received the documents, it was supposed to pass the documents to the buyer only when the remaining payment was made. However, the buyer manipulated fictitious bills of lading for the same amount of goods in exchange for the actual documents from the trading company, which left the trading company in possession of a forged bill of lading. The trading company never received the residual payment and decided to collect the goods which were never supplied. The trading company commenced an action against the seller, the buyer, and the negotiation bank.

The Higher Court in Zhejiang Province held that the beneficiary/seller had no subjective intention to deliver the goods, which constituted fraud under article 8(II). In addition, the negotiation bank was involved in the design of the fraudulent financing conduct, which fell under article 8(III) because the documents were presented while no underlying transactions took place. The stop-payment order therefore could be obtained under article 15 because no conditions could be satisfied under article 10.

The negotiation bank appealed³² and tried to argue that, pursuant to the autonomy principle under UCP 600, the documents presented were consistent with the L/C contract, and thus it acted in good faith and with due care. After all, article 4 states that a credit is separate from the underlying contract between the seller and the buyer.³³

On appeal, therefore, the question whether the fraud was established or committed was not at issue. The question was simply whether the negotiation bank acted in good faith, and consequently, whether the payment injunction should be reconsidered. The SPC decided to affirm the original decision and pointed out that the negotiation bank didn't take reasonable care in the examination of the repeated L/C documents which were presented. Although related party transactions are not prohibited in China, the L/C should be used as a payment method, not an illegal financing method. The bank, as an expert, should have been aware of such unusual transactions: the bills of lading had been transferred very frequently in a short period of time. Thus, the negotiable payment by the negotiation bank was in bad faith. The SPC held that it was reasonable to stop the payment.

It was not a surprise that the court incorporated Article 8(III) into its decision and put weight on the requirements of good faith. Arguably neither the U.S., nor certainly the English courts, would have argued the case in a similar fashion because in relation to L/Cs, good faith in essence is not a deciding factor in either country.

Regarding the two cases above, it is noteworthy that the Chinese courts strictly followed the new provisions, resulting in more just decisions. Two more cases, decided in 2014, confirm that Chinese courts

³¹宁波海田国际贸易有限公司诉好运国际企业集团有限公司、澳大利亚和新西兰银行（中国）有限公司上海分行等信用证欺诈纠纷案（2011）浙商外终字第 31 号 [Ningbo Haitian Int'l Trade Co., Ltd. v. Fine Faith Int'l Enter. Grp. Ltd., Zhe Commercial Foreign Final No. 31 (Appeal Case, Higher Ct., Zhejiang Province 2011)].

³²澳大利亚和新西兰银行（中国）有限公司上海分行与宁波海田国际贸易有限公司信用证欺诈纠纷案，(2013)民申字第 1385 号 [Shanghai Branch, Australia & New Zealand Banking Grp. (China) Ltd. v. Ningbo Haitian Int'l Trade Co., Ltd., Min Shen Zi No. 1395 (Sup. People's Ct. 2013)].

³³Ren, *supra* note 3, at 291.

are applying and following the new provisions. The first of the 2014 cases was an appeal case.³⁴ A Hong Kong seller and a Chinese buyer had agreed to a contract concerning the sale of natural rubber and compounded rubber. The buyer opened a letter of credit and the payment date was October 31, 2013. Upon receiving the documents, the buyer took the required documents to collect the goods from the carrier. It turned out to be a non-delivery of goods. There were no goods from the carrier matching the description in the bills of lading and the invoices. The buyer requested a stop payment order to reduce the loss due to this established L/C fraud.

The lower court determined that the issuing bank had not made the payment, and thus decided to terminate the payment based on the establishment of fraud under articles 8(II) and 10. The decision was appealed by the seller, with the additional fact that the confirming bank had already negotiated the payment on August 26, 2013. The issuing bank accordingly accepted the draft because of the conforming documents. Therefore, the court of appeal concluded that article 10(II) was satisfied and the payment could not be terminated.

As in the first 2014 case, fraud was the issue in the second 2014 case.³⁵ Therefore, the court focused on whether the injunction on payment issued by the initial court was reasonable. The facts – somewhat complicated – were as follows. The Hong Kong Company A (seller/beneficiary) instructed Trading Company B, as an import agent, to buy coal. The coal was subsequently sold to Chinese Company C (buyer). Companies A and C belonged to the same legal person, which indicated that the L/C in question was used as a financing method by Company A to collect its money while Company C deferred its payment to Trading Company B in bad faith. This constituted an L/C fraud under article 8(IV). Trading Company B initially instituted the proceedings, against Company A. The initial court determined the existence of fraud and prohibited the payment.

Company A and the issuing bank (appellants) appealed this decision, with Trading Company B as respondent. The appellants argued that the stop-payment order should be voided because the negotiation bank in Hong Kong had negotiated payment with the beneficiary in April 4, 2014, and the issuing bank had then accepted the draft in May 9, 2014. The appellate court agreed with the appellants and eventually, based on articles 10(II) and 10(IV), decided to override the initial court's decision. Consequently, the payment was not suspended.

As demonstrated by the foregoing cases, the Chinese courts have recognized the significance of article 10 in protecting the innocent third party—the bank—from the consequences of L/C frauds. Under article 10, banks are protected if they acted in good faith to negotiate and accepted the draft no matter how serious the fraud was. Undoubtedly, court judgments in China before the announcement of the 2005 SPC Provisions were not in line with worldwide best practices and hence were at odds with the UCP.³⁶ The new provisions, in contrast, set out clear guidance for the judges endeavoring to understand in what situations banks are immunized from L/C fraud, and thus, when stop-payment orders cannot be obtained.

³⁴ *中石化化工销售(香港)有限公司与广东物骏贸易有限公司民事裁定书* (2014) 粤高法民四保复字第 1 号 [Sinopec Int'l (Hong Kong) Co., Ltd. v Guangdong Wujun Trading Co., Ltd., Min Si Bao Fu Zi No.1 (Appeal Case, Higher Ct., Guangdong Province 2014)].

³⁵ *中国能源集团(香港)有限公司、中信银行股份有限公司太原分行二审民事裁定书* (2014) 晋民复字第 10 号 [China Energy Holdings (H.K.) Ltd., China Citic Bank (Taiyuan Branch) v. Shanxi Jiaotan Grp. Int'l Trading Co., Ltd., Jin Min Fu Zi No.10 (Appeal Case, Higher Ct., Shanxi Province 2014)].

³⁶ Zhang, *Evaluation*, *supra* note 12, at 106.

V. Comparison

This part of the article is by no means comprehensive, but highlighting comparative features can help promote understanding both of the Chinese regulations and of the prevailing international approaches. Among these international approaches, there is no uniform application of the fraud exception as several different standards are used.

In general, English court cases apply the fraud exception for L/C transactions narrowly.³⁷ U.K. courts are very reluctant to grant injunctions,³⁸ based on a determination not to compromise the Autonomy Principle. As an example, in *Czarnikow-Rionda Sugar Trading, Inc. v Standard Bank London, Ltd.*,³⁹ Rix J. rejected the claim of the plaintiff. His Honor was not in favor of granting an injunction because the advising banks were not made aware of the fraud prior to the payment.

Under English law, there are two kinds of fraud and thus two possible exceptions that stop the banks' obligation to pay. As explained in *United City Merchants (Investments) Ltd v Royal Bank of Canada*, "Firstly, if the documents were forged and were nullities, then, the condition of the credit that there is a conforming document is not fulfilled; and secondly, if the beneficiary was himself dishonest or fraudulent."⁴⁰

On the other hand, the United States approach is more flexible. The exception rule based on intentional fraud was first recognized in *Sztejn v J. Henry Schroder Banking Corporation*.⁴¹ However, *Asbury Park & Ocean Grove Bank v National City Bank of New York*⁴² did not follow exactly the decision in *Sztejn* and reverted to the application of egregious fraud. This standard sets a very high threshold to prove fraud, requiring clear establishment of fraud and not just the allegation of fraud.⁴³ In addition, notice must be given to the paying bank of the fraud before the documents are presented for payment. Arguably, the U.S. and English courts are not as far apart as it appears at first glance, but they are not *ad idem* either.

It is important to note that there are strong connections between the fraud exception in English law and the Chinese provisions, namely article 8(I) and 8(III). Zhang⁴⁴ supported the court decision in *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)*⁴⁵ as an outstanding explanation of the English position on the L/C fraud exception.⁴⁶ Despite the fact that this decision has been criticized,⁴⁷ Zhang still agreed that determining whether the alleged third-party fraud constituted L/C fraud in *United City Merchants* required consideration of commercial and practical reasonable arguments. Hence, it is necessary to consider two issues: first, the beneficiary's awareness of fraud, and secondly, the consequences of the fraud (i.e. is the fraud substantial).⁴⁸

³⁷Zhang, *Documentary*, *supra* note 7, at 213.

³⁸Nevin Meral, *The Fraud Exception in Documentary Credit: A Global Analysis*, 2 ANKARA B. REV. 45, 59 (2012).

³⁹[1999] 1 All ER 890 (QB, Comm.).

⁴⁰[1983] 1 AC 168, 172 (Ct. App., Civ. Div.).

⁴¹*Sztejn v J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

⁴²35 N.Y.S.2d 985 (Sup. Ct. 1942), *aff'd*, 52 N.Y.S.2d 583 (App. Div. 1944) (Mem. Op.).

⁴³See *Discount Records Ltd. v Barclays Bank Ltd.* [1975] 1 WLR 315, 319 (Ch), where this view was confirmed.

⁴⁴Zhang, *Evaluation*, *supra* note 12, at 105.

⁴⁵*United City Merchants*, [1983] 1 AC 168.

⁴⁶Zhang, *Evaluation*, *supra* note 12, at 104.

⁴⁷See, e.g., Roy Goode, *Chapter 9: Abstract Payment Undertakings*, in *Essays for Patrick Atiyah* 229-31 (Peter Cane & Jane Stapleton eds., 1991).

⁴⁸Zhang, *Evaluation*, *supra* note 12, at 105.

These two issues have been covered in the Chinese provisions. Article 8(III) captures the situation where the beneficiary submits false documents with the collusion of a third party. And further, article 11(III) and article 9 allow the issuance of an injunction against payment when severe loss will be caused by the fraud. Arguably, a suspension of the payment is always an option in these cases.

In sum, it can be argued that the same conclusion can be reached by applying either English jurisprudence or the Chinese provisions. It is clear that both court systems tend to favor a high threshold, and therefore a stop payment order cannot be easily obtained. However, one must be cautious in reaching conclusions about Chinese jurisprudence because courts do have some discretion based on article 8(IV).

VI. Conclusion

Most countries have no specific legislation on the L/C fraud issue but have developed a detailed and relatively consistent approach through interpretation by courts. However, the PRC, a civil law (socialist-based) country, does not rely on case law, unlike common law countries. The Chinese courts initially dealt with L/C disputes without unified and detailed codes, resulting in improper procedural instruments and inconsistent practice.⁴⁹ Therefore, it was necessary for the SPC to develop a uniform and detailed rule on L/C issues in light of other country practices and world best practices.

The 2005 SPC Provisions that resulted, and the leading jurisprudence that followed, have demonstrated that dealing with L/C exception rules is not significantly different in China from the way it is done in England. A high threshold, or strict approach, is favored by both countries due to their economic interest in maintaining the stable functioning of the L/C and promoting the healthy operation of international trade.

The Chinese approach was developed on the basis of a study of international practice. Because of the special nature of the Chinese civil law system, the new provisions were necessary, and they have been effective as a binding rule and a standardized guideline. However, as suggested by Zhang, the SPC still needs to provide more guidance on particular problems concerning L/C fraud, such as third party fraud, the standard of proof, and irreparable damage:

In general, obtaining a stop-payment order does become more difficult, and the judicial intervention to the L/C system in China is now highly restricted. But several problems such as third-party fraud, standard of proof of L/C fraud, evaluation of “irreparable damage” when determining whether to issue a stop-payment order still remain both in legal provisions and in judicial practice. Thus, the SPC are recommended to provide clear guidance on such issues in future provisions or through typical court cases.⁵⁰

Even with these caveats, the 2005 reform has achieved a level of certainty that can be favorably benchmarked against the U.S. and English approaches.

In sum, in all three countries examined, the primary function of the L/C system is to facilitate payment. Setting a high threshold for L/C fraud helps maintain the stability and certainty of L/C transactions.⁵¹ The strict approach is therefore reasonable in order to sustain a reliable L/C system and achieve the smooth operation of international trade financing.

⁴⁹China Court, *Review*, *supra* note 17.

⁵⁰Zhang, *Documentary*, *supra* note 7, at 108.

⁵¹Zhang, *Evaluation*, *supra* note 12, at 120.