Illegality in the Underlying Transaction: A Defence to Dishonouring Letters of Credit?

By Dr Zhixiong Liao*

This paper raises doubts over the seemingly prevailing view that illegality in the underlying contract for international trade should be accepted as an exception to the autonomy principle of documentary letters of credit. Contrary to the seemingly prevailing view, this paper argues that there are logical flaws in the "illegality exception" arguments. It suggests that where commercial documentary letters of credit for international trade are involved, the "illegality exception" would be much less likely than expected to be accepted, especially in most common law jurisdictions. It also submits that the public policy concerns over letters of credit being used to facilitate illegal transactions could be better addressed by public law, such as specific statutory provisions, rather than by an ill-founded and loosely formulated "illegality in the underlying contract defence" in private law.

I. Introduction

The principle of autonomy is fundamental for the operation of documentary letters of credit which are widely used in the context of international sale and finance. This principle provides a separation of letters of credit from the underlying contract, which renders letters of credit popular as a prompt and certain tool of payment and security in international trade. However, public policy requires this principle not to operate in certain circumstances. In addition to the fraud exception (and possibly the nullity exception), illegality in the underlying contract has been proposed and argued by some academics to be another exception to the principle of autonomy for documentary letters of credit, which seems to be the prevailing view. This paper is to reconsider the issue whether illegality in the underlying contracts for international sale should be an exception to the autonomy principle where commercial letters of credit used in international trade as a means of payment of the price are involved.

After a brief overview of the autonomy principle and the development of exceptions, this paper will firstly discuss international documents/practice, international law and the current positions of some common law jurisdictions that may be relevant to the issue. Critiques will then be made on the arguments for an "illegality exception"; followed by discussions on practical difficulties for the proposed "illegality exception".

Finally, conclusions and submissions are to be made accordingly.

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II. The Independence/Autonomy Principle and Developing Exceptions

Documentary letters of credit are widely used in international trade and finance. A documentary letter is a banker's promise to pay against the presentation of specified documents. "The fundamental principle governing letters of credit … is that the obligation of the issuing bank … is independent of the performance of the underlying contract for which the credit was issued".[1] The doctrine of strict compliance and the doctrine of autonomy are fundamental to the operation of letters of credit.[2] As a combined effect of these doctrines, the bank, when it examines the documents, unless required or allowed otherwise by the letter of credit, has to focus on the documents alone, examine them on their face, and ignore any extraneous circumstances including the underlying transactions. This presents a risk that a fraudulent beneficiary might try to claim payment by presenting documents which appear conforming on their face when the beneficiary in fact has no right to receive payment. The bank may also be liable if it makes a payment where the law prohibits it to pay in the circumstance. The law, therefore, has to identify and carve out circumstances where the bank is entitled to look beyond the presented documents and look at extraneous circumstances when making the payment decision. The development of law in this regard is to establish exception(s) to the general principle. An exception "may sometimes act to destroy the independence of the letter of credit and to relieve the issuer of the letter of credit from its obligation to pay the beneficiary", with the effect as a defence to the non-payment under the letter of credit.[3]

Fraud seems to be a well-recognised exception to the principle of autonomy.[4] It has been argued that some other grounds, such as unconscionable conduct, termination or completion of the underlying contract, nullity or non-existence of the underlying contract, and illegality or violation of the public policy have emerged as real or potential exceptions to the autonomy principle.[5]

Regarding the issue whether illegality in the underlying contract should be an exception, it seems that most academics in this area are in favour of the adoption of such an illegality exception, that is, illegality in the underlying transaction or contract should be a defence to non-payment under the letter of credit.[6] It may be worthwhile to discuss the current positions in this regard in the relevant international law or documents and in some common law jurisdictions, and to summarise the suggested "justifications" for the "illegality exception" argument, before making analyses and critiques on such an arguments.

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1 *Bank of Nova Scotia v Angelica-Whitewear* [1987] 1 SCR 59 at 81 per Le Dain J.

2 See International Chamber of Commerce [ICC] Uniform Customs and Practice for Documentary Credits [UCP] 500, arts 2, 13, 14 and 15; and UCP 600, arts 5, 7, 8, 14 and 15.

3 Gerald T McLaughlin "Letters of Credit and Illegal Contracts: The Limits of the Independence Principle" (1989) 49 Ohio St LJ 1197 at 1197.

4 See *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) at 183. See also the United States Revised Uniform Commercial Code [Revised UCC] art 5-109.

5 See, for example, Agasha Mugasha "Enjoining the beneficiary's claim on a letter of credit or bank guarantee" (2004) JBL 515 at 515. See also D Warne and N Elliot *Banking Litigation* (2nd ed, Sweet & Maxwell, London, 2005) at 259.

6 See, for example, McLaughlin, above n 3, Mugasha, above n 5 and N Enonchong "The Autonomy Principle of Letter of Credit: An Illegality Exception?" (2006) LMCLQ 404. See also Michelle Kelly-Louw "Illegality as an exception to the autonomy principle of bank demand guarantees" (2009) 42 Comp. & Int'l LJ S Afr 339; Roger J Johns and Mark S Blodgett "Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independent Principle of Letters of Credit and Bank Guarantees" (2011) 31 N Ill ULR 297.

III. Current Positions in Relevant International Law or Documents and Some Common Law Jurisdictions

A. The UCP

The Uniform Customs and Practice for Commercial Documentary Credits (UCP) is a publication by the International Chamber of Commerce (ICC). ICC published the first version of UCP in 1933 and issued the current version "UCP 600" in 2007. UCP 600 contains rules relating to the application, issuing, advising, confirming, negotiating, reimbursement, and standard requirements on related documents. It also contains rules concerning the relationship between letters of credit and the underlying contracts,[7] and between documents and the related goods/services/performance.[8]

Although the purpose of the UCP is to provide "universally used rules on documentary credits",[9] UCP is not binding unless it is incorporated into the domestic law of a particular jurisdiction or incorporated into the contracts by the parties.[10] It is noted that to date no jurisdiction has clearly incorporated UCP into its domestic law.[11] Therefore, UCP itself is not "law", but model terms of contract for the parties to adopt.

UCP offers no help in answering the question whether illegality of the underlying contract is a defence to payment demands under letters of credit. UCP 600 (as with UCP 500) says nothing as to whether there are any exceptions to the autonomy principle,[12] nor is there any guidance as to the formulation of an exception. It is open for each jurisdiction to develop their respective exceptions. Different jurisdictions may recognise different exceptions, and they may also formulate the "same" exception in different ways. The effect of this problem is amplified by the absence of provisions in the UCP concerning governing law and jurisdiction. A party is very likely to engage in "forum shopping", seeking to take advantage of the jurisdiction with the most favourable exceptions to its particular claim, which consequently decreases certainty in commercial relationships and allows a plaintiff to dictate where a dispute will be resolved to the detriment of the defendant.[13] As different jurisdictions are very likely to have different or even completely conflicting conclusions on whether a particular transaction is illegal, the uncertainty problem will be even more significant if an "illegality exception" is to be adopted.

B. The UNCITRAL Convention

Unlike UCP, The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (UNCITRAL Convention) is an international treaty and thus an international "law". Notably,

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7 UCP 600, art 4.

8 UCP 600, art 5.

9 ICC "Revised ICC rules on documentary credits make progress" (26 October 2005), <www.iccwbo.org/News/Articles/2005/Revised-ICC-rules-on-documentary-credits-make-progress/l>.

10 Article 1 of the UCP 600 provides that the rules contained apply "when the text of the credit expressly indicates that it is subject to these rules" and the parties can expressly modify or exclude those rules.

11 See Ricky J Lee "Strict Compliance and the Fraud Exception: Balancing the Interests of Mercantile Traders in the Modern Law of Documentary Credits" (2009) 5 Macquarie J Bus L 137 at 145–146.

12 Whereas the principle is well enshrined by the UCP provisions, namely, arts 3, 4 and 9 of UCP 500 and arts 4, 5 and 7 of UCP 600.

13 See EP Ellinger "The UCP-500: considering a new revision" (2004) LMCLQ 30 at 43–44.

it specifically provides for an illegality exception. Article 19 of the Convention, "Exception to Payment Obligation", provides that in certain circumstances, including the circumstance where the payment demand "has no conceivable basis",[14] the guarantor/issuer has a right to withhold the payment. Article 19(2) lists "types of situations in which a demand has no conceivable basis", including the situations where "the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal".[15] Further in art 20, the Convention provides that the court may on application and "on the basis of immediately available strong evidence" issue a "provisional order" to withhold or block the payments under the guarantee or stand-by letter of credit if "there is a high probability"[16] that a situation listed in art 19(1) presents or if the letter of credit was used "for a criminal purpose".[17]

It is therefore arguable that the UNCITRAL Convention as international law adopts an illegality exception because the court may issue an injunctive order to withhold the payment if the "the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal".[18] It has been pointed out that this is a "narrow" exception as it only applies *after* the underlying obligation has been declared invalid by a court or tribunal.[19]

Two points must be noted in this regard. Firstly, the scope of the UNCITRAL Convention is limited to Independent Guarantees and Stand-by Letters of Credit, not applicable to commercial documentary letters of credit that are commonly used in international trade as a means of payment of the price. Even though, arguably, the Convention has adopted an "illegality exception" to the autonomy principle, it does not flow logically that such an "illegality exception" also applies to circumstances where traditional commercial documentary letters of credits used in international trade are involved. Arguably, the title of the Convention suggests the contrary, that is, illegality in the underlying contract should not be a defence to non-payment under the credit where classic commercial documentary letters of credit are involved. Otherwise, the title and arts 19 and 20 of the Convention should have been different.

Secondly, there is also an obvious practical difficulty for the application of the UNCITRAL Convention even if we leave aside the above point and assume that the illegality exception provided in the Convention can be extended to commercial letters of credit. Since the Convention came into existence in 1995, to date, more than 20 years after, there have been only nine countries that have signed the Convention so far and the United States, being a signatory, has not ratified it yet. The other eight signatory countries are Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia,[20] all of which have shares in the international trade pie that are extremely limited or even negligible. None of the major international trade players, such as the United States, China,

14 United Nations Convention on Independent Guarantees and Stand-by Letters of Credit [UNCITRAL Convention], art 19(1)(c).

15 Article 19(2)(b).

16 Article 20(1).

17 Article 20(3).

18 Article 19(2)(b).

19 Michelle Kelly-Louw "Selective Legal Aspects of Bank Demand Guarantees" (Doctoral thesis, University of South Africa, 2008) at 282.

20 United Nations Commission on International Trade Law "Status 1995-United Nations Convention on Independent Guarantees and Stand-by Letters of Credit" <www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html>.

Japan, the United Kingdom, Germany, Australia, among others, are members of the Convention. Such a situation renders the Convention not really "international" law in a practical sense.

The above shows that no "international law" has adopted illegality in the underlying transaction as a defence to payment demands under commercial documentary letters of credit used in international trade as a means of payment of the price.

C. The English Position

It seems that the United Kingdom is the jurisdiction most prepared to adopt the illegality exception, which is illustrated by a number of cases. *Group Josi Re v Walbrook Insurance Co Ltd*[21] was, prior to 2003, "the only English case in which illegality (of the underlying contract) has been considered as affecting payment under a letter of credit".[22] In that case:[23]

> … an underwriting agency, Weavers, wrote primary risks on the London market for a pool of overseas insurers. Weavers also arranged and managed reinsurance of its pool members by outside reinsurers. The plaintiffs, Group Josi, one of the reinsurers, agreed with Weavers that the latter would pay over to them loss reserves held in respect of the reinsures in exchange for a letter of credit under which Weavers would be entitled to draw down against debit notes stating that Group Josi were liable for the amounts claimed under the reinsurances. Group Josi brought proceedings against Weavers and the reassured companies to restrain them from drawing down under the letters of credit.

One of the grounds for this claim, as Group Josi argued, was that the letters of credit and the underlying reinsurance contracts were "illegal and unenforceable" because "Group Josi was not authorized to carry on insurance business in Great Britain under the Insurance Companies Acts 1974–82".[24]

The argument was rejected at first instance. Group Josi appealed. The Court of Appeal found on the facts that the reinsurance contract was not illegal. Despite this finding, Staughton LJ alone went on to consider whether illegality of the underlying contract is a defence under a letter of credit. He said:[25]

> [I]n my judgment illegality is a separate ground for non-payment under a letter of credit. That may seem a bold assertion, when Lord Diplock in the *United City Merchants* case said that there was "*one* established exception" [i.e. fraud]. But in that very case the House of Lords declined to enforce a letter of credit contract in part for another reason [besides fraud], that is to say the exchange control regulations of Peru as applied by the Bretton Woods Agreements Order in Council 1946. I agree that the Bretton Woods point may well have been a kind of its own, and *not an indication that illegality generally is a defence under a letter of credit*. But it does perhaps show that established fraud is not necessarily the only exception.

It seems to me that there must be cases when illegality can affect a letter of credit. Take for example a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1000 Kalashnikov

21 *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 (CA).

22 *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911 at [48] per Colman J.

23 At [48].

24 At [48].

25 *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 (CA) at 362 (emphasis added).

rifles to be carried to the port of Basra. I do not suppose that a Court would give judgment for the beneficiary against the bank in such a case.

He continued:[26]

> Turning to the present case, if the reinsurance contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the Court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the Court would do so.

From these statements, it seems that Staughton LJ is prepared to accept the possibility that illegality in the underlying contract may be a defence to non-payment under a letter of credit. However, it should be noted that such statements were made on hypothetical circumstances rather than on the facts of the case, hence being only obiter dicta, but not law. On the facts, the underlying reinsurance contracts were held not illegal. Furthermore, the letter of credit involved in the case was essentially a stand-by letter of credit, but the statements talked about a traditional commercial letter of credit used in international trade as a means of payment of the price. The underlying contracts in the case were reinsurance contracts, but the underlying contract referred to in the hypothetical case (selling for 1000 Kalashnikov rifles) is a contract for the sale of goods in international trade, a totally different type of contract. With all due respect, the learned judge did not talk about any of those differences at all. Therefore, such statements should be treated with caution.

Mahonia Ltd v JP Morgan Chase Bank (No 1) is another case where the "illegality exception" was discussed.[27] In this case, each of the three parties: Mahonia, JP Morgan Chase Bank (first defendant) and a subsidiary of Enron (ENAC), entered into a swap agreement with the other parties. According to the swap agreement between Mahonia and ENAC, Enron applied to the WestLB AG (second defendant) for a letter of credit as a security in favour of Mahonia. Shortly after the letter of credit was issued, Enron and its 13 subsidiaries, including ENAC, went into bankruptcy. Under the letter of credit, the bankruptcy was an event of default entitling Mahonia to demand for the payment under the letter of credit. JP Morgan presented conforming documents to WestLB AG on behalf of Mahonia. WestLB AG refused to pay and argued that the purpose of the swaps transactions was to provide Enron with a loan disguised as income on a derivative transaction without the disclosure of Enron's deficient accounts to the Securities and Exchange Commission, which was illegal under the United States' law and thus contrary to the English public policy. Mahonia applied to the Queen's Bench Division (Commercial Court) for a summary judgment that the illegality defence be struck out.

The issue was whether illegality in the underlying transactions could be a defence to the non-payment under the letter. Colman J noticed the conflict between two public policy considerations – the special function of letters of credit and the need to insulate them from the underlying transactions on one hand, and the public policy principle of ex turpi causa on the other.[28] He discussed *Group Josi Re v Walbrook Insurance* and referred to Staughton LJ's "unlawful arms transaction" example. He found "it almost incredible that a party to an unlawful arms transaction

26 At 362.

27 *Mahonia Ltd v JP Morgan Chase Bank (No1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911.

28 At [68].

would be permitted to enforce a letter of credit which was an integral part of that transaction" even if the letter of credit itself is not illegal.[29] He then gave "an even more extreme example" and stated:[30]

> I cannot believe that any Court would enforce a letter of credit so secure payment for the sale and purchase of heroin between foreign locations in which such underlying contracts were illegal.

Colman J came to the conclusion that "there is at least a strongly arguable case" that the letter of credit could not be enforced against the bank on the basis that in certain circumstances the illegality of the underlying contract can taint the letter of credit and thereby render it unenforceable.[31] He based his reasoning on Lord Diplock's approach in *United City Merchants v Royal Bank of Canada*[32] and stated:[33]

> If a beneficiary should as a matter of public policy (ex turpi causa) be precluded from utilizing a letter of credit to benefit from his own fraud, it is hard to see why he should be permitted to use the courts to enforce part of an underlying transaction which would have been unenforceable on grounds of its illegality if no letter of credit had been involved, however serious the material illegality involved. To prevent him doing so in an appropriately serious case such as one involving international crime could hardly be seen as a threat to the lifeblood of international commerce.

He therefore dismissed Mahonia's application that the Court should strike out the bank's defence of illegality in the underlying transactions.

Mahonia, after failure in the summary application, brought the case to the English Commercial Court for a full trial.[34] Cooke J found that there was no illegality in the underlying contract, and the beneficiary was not privy to any unlawful purpose. The Court thus on the facts held that West LB AG as the issuer of the letter of credit was obligated to pay an apparently conforming demand.[35]

If only for the judgment of the case itself, it was unnecessary for the Court to decide whether in law illegality of the underlying contract would render the letter of credit unenforceable. However, Cooke J went on to consider this issue and largely agreed with Colman J's view that letters of credit could be tainted by the illegality of the underlying contracts and thus unenforceable despite the autonomy principle,[36] although he had different views regarding the elements for such an "illegality exception".

It should be noted again, however, such statements were still obiter dicta. The underlying contracts were held not illegal; they were swap agreements rather than contracts for the sale of goods in international trade; the letters of credits were essentially stand-by letters of credit rather than the traditional documentary letters of credits used in international trade as a method of payment of the price. Colman J's statements (and the heroin example) were made in the lower court and in a summary proceeding. Notwithstanding such statements suggest an inclination of the English courts to recognise illegality in the underlying contracts as a defence to non-payment under letters

29 At [68].

30 At [68].

31 At [69].

32 *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL) at 183–184.

33 *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911 at [68].

34 *Mahonia Ltd v JP Morgan Chase Bank (No 2)* [2004] EWHC 1938 (Comm).

35 At [223].

36 See Kelly-Louw, above n 19, at 267.

of credit, they are not law. Even the "illegality exception" advocators acknowledge that English law has not yet accepted such an "illegality exception" to date.[37]

D. The United States

The Revised United States Uniform Commercial Code (Revised UCC), art 5, specifically provides that fraud and forgery are the exceptions to the autonomy principle of letter of credit,[38] but there is no explicit provision for a separate illegality exception in the Revised UCC,[39] which has caused controversy. Some argue that since there are provisions recognising fraud and forgery as exceptions in the Revised UCC, the absence of provision for an illegality exception implies that illegality in the underlying contract, in the absence of fraud or forgery, is not a recognised defence to payment demands under the letters of credit.[40] Others disagree with this. For instance, Professor McLaughlin argues that although there was no explicit provision for an illegality exception, it was still left open to accept an illegality exception, because the UCC did not exclude it as an exception either.[41] He based this argument on UCC s 5–103(b) as authority, which provides that "the statement of a rule in this article does not by itself require, imply, or negate application of the same or a different rule to a situation not provided for, or to a person not specified in the article". McCullough also stated that fraud in the transaction may not be the only ground in the United States for an exception to the autonomy principle; if the underlying contract was illegal, it was perhaps appropriate to suspend the autonomy principle and enjoin payment on that ground.[42]

This divergence raises a question: whether or not illegality in the underlying contract, under the United States law, could be a separate defence to non-payment under letters of credit. A brief discussion of the revision history and the nature of the Revised UCC art 5 might be helpful to answer this question.

The original UCC art 5 was revised in 1995. Before the drafting committee was appointed, a special Task Force, consisting of eminent letter of credit specialists, was appointed to study the relevant case law, evolving technologies, and changes in customs and practices.[43] The Task Force identified significant issues, discussed them and made recommendations for the revision of art 5. They also substantially participated in the amendment of art 5. During the course of the recodification of art 5, the Task Force spelt out the exception to the autonomy principle of Letters of Credit so that the exception applied only where a required document is forged or materially fraudulent or honour of the presentation would facilitate a material fraud by the beneficiary on

37 See Enonchong, above n 6, at 410.

38 Revised UCC, art 5, s 5–109.

39 See Enonchong, above n 6, at 408.

40 See Enonchong, above n 6, at 408. See also PS Turner "Mahonia v J.P. Morgan Chase Bank: The Enron L/C and the Issuing Bank's Defence of Illegality" (2006) 8 JPSL 733.

41 See Gerald T McLaughlin 'Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit law' (2002) 119 BLJ 501 at 527–528; see also McLaughlin, above n 3, at 1217–1235.

42 See BV McCullough *Banking Law* (Vol No 12: International Banking – Letters of Credit) (looseleaf ed, 1981–) at 234.04[3][g]; and BV McCullough *Letters of Credit* (looseleaf ed, 1987–) at 5.04[3][g]; both cited in Kelly-Louw, above n 19, at 274–275.

43 See "Prefatory Note" to Revised UCC art 5; see also Jim Barnes "The UCP in Court 'Illegality' as Excusing Dishonour of L/C Obligations" (2005) 11 ICC's DCInsight 7 at 7.

the issuer or the applicant.[44] Barnes, a leading member of the Task Force, indicated that they did consider but they "did not enlarge the exception to include 'illegality'".[45] They limited an issuer's extraordinary defences (and applicant's injunction actions) to drawings that would unduly exploit the autonomy principle.[46] They focused on letter of credit policy and not on the existence of other public policy grounds.[47] In determining the scope of defences to payment obligation under a letter of credit, they "gave zero attention to the law applicable to *guaranty, suretyship, or other security arrangements*".[48] In Barnes's view, letters of credit policy requires illegality in the underlying contract should *not* be a defence, but other public policy might require this problem to be redressed; he thus suggests that "relief based on illegality must be sought *after* the bank pays".[49]

As to the nature of the Revised UCC art 5, as part of a statutory code, those provisions can be a codification or modification of existing common law rules. Generally, unless being substituted or modified by the code, the relevant existing common law rules on the subject matter would not be precluded. But if we look at the title of UCC, the words "uniform" and "code" might indicate that such a code is trying to cover as wide range as possible of recognised rules on the related subject matter in the particular area. If this is so, the absence of an illegality defence in the Revised UCC more likely than not implies that as a rule illegality has not been recognised as a separate defence in the United States. Turner, an eminent specialist in the area, also argues that there should be no general defence based on illegality in the underlying contract; and even if such a defence were to be acknowledged it should be narrowly construed and be available only in the case of criminal or other serious illegality and, analogously to the defence of fraud, be available only when payment to the beneficiary would be obviously pointless or unjust.[50] In relation to McLaughlin's argument for an illegality defence, Professor Kenneth found himself "more persuaded of the merits of his general approach than of his specific conclusions".[51]

The above observation is consistent with the prevailing view in the United States that because illegality is not included in s 5–109, it means that the bank must pay despite the illegality of the underlying contract.[52] Even before the Revised UCC art 5 came into effect, when the prior UCC art 5 s 5–144(2) was still in operation, there had been case authorities refusing to accept illegality in the underlying contract as a defence to payment under a letter of credit. In *KMW International v*

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44 Barnes, above n 43, at 7.

45 At 7.

46 At 7.

47 At 7.

48 At 7 (emphasis added).

49 At 8.

50 Turner, above n 40, at 733.

51 E Scott Kenneth "Introduction: Scholarship in Banking Law: An introduction to the Symposium" 49 Ohio St LJ 1183 at 1183–1184.

52 See Barnes above n 43; J Barnes comments on *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm) in JE Byrne and CS Byrne (eds) *2005 Annual Survey of Letter of Credit Law and Practice* (Institute of International Banking and Law Practice, Montgomery Village, 2005) at 331; B Wunnicke, DB Wunnicke and PS Turner *Standby and Commercial Letter of Credit* (3rd looseleaf ed, Aspen Publishers) where the authors discuss the fraud exception, but mention nothing of the existence of an illegality exception; RD Aicher, DL Cotton and TK Khan "Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)" in JE Byrne and CS Byrne (eds) *2005 Annual Survey of Letter of Credit Law and Practice* (Institute of International Banking and Law Practice, Montgomery Village, 2005) at 19–21. See also Enonchong, above n 6, at 408.

Chase Manhattan Bank NA, the Court opined that "there is nothing in the U.C.C … which excuses an issuing bank from paying a letter of credit because of supervening illegality".[53] Some other cases also pointed to the same direction. For instance, in *New York Life Assurance Company v Hartford National Bank and Trust Company* the Court held that a bank that has issued a standby letter of credit may not refuse to pay on the ground that the credit was issued to secure an illegal penalty clause in the underlying contract.[54] In *Prudential Insurance Company of American v Marquette National Bank of Minneapolis*, the Court arrived at a similar conclusion.[55] It is also observed that generally the United States courts have refused to allow illegality in the underlying transaction to be a defence to payment under the letter of credit.[56]

There have been attempts to put illegality in the underlying contract into the fraud exception category and to use it as a defence to payment under the credit, but those attempts failed. In *Western Security Bank NA v Superior Court* the California Court viewed presumed illegality in the underlying transaction as constituting fraud.[57] The Court in the appellate decision sought to promote the California public policy and to support California legislation prohibiting the collection of deficiencies in real estate foreclosures. The beneficiary's draw under the letter of credit would have allowed the beneficiary to collect the deficiency. The Court viewed the deficiency as "illegal" under the anti-deficiency statute and thus held that the beneficiary's presentation was fraudulent and that the issuer was entitled to dishonour by reason of the fraud. The decision was reversed by the California Supreme Court,[58] and it brought about clarifying legislation by the California legislature. Arguably, the attempts to squeeze illegality in the underlying contract into the category of fraud (the United States' "fraud in the underlying transaction") in order to use it as a defence under UCC demonstrate that the United States' courts feel they are bound to apply the UCC and no provisions in the UCC for an illegality defence means that illegality in the underlying contract has not been recognised as a separate defence in the United States.

Barnes pointed out that declarations by courts that the underlying obligation is illegal and unenforceable will not prevent payment under the letters of credit; and in such instances, relief based on illegality could only be sought after the payment.[59]

After the English judgments of *Mahonia*, another question arises: will it affect the United States' position in this regard? Barnes observed that banks and lawyers in the United States are inclined to think that *Mahonia* "got it backwards" because there are vital differences between the law applicable to (classic) commercial letters of credit used in international trade as a means of payment of the price and surety bonds.[60] He points out that after *Mahonia* efforts to enjoin letter

53 *KMW International v Chase Manhattan Bank NA* 606 F 2d 10 (2nd Cir 1979) at 16; see also *Centrifugal Casting Mach Co Inc v American Bank and Trust Co* 966 F 2d 1348 (10th Cir 1992) at 1352; both cited in Enonchong, above n 6, at 408.

54 *New York Life Insurance Company v Hartford National Bank & Trust Co* 378 A 2d 562 (SC Conn 1977).

55 *Prudential Insurance Company of American v Marquette National Bank of Minneapolis* 419 F Supp 734 (3d Cir 1976).

56 AN Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (Interlegal CC, Pretoria, 1997) at 419.

57 *Western Security Bank NA v Superior Court* 269 Cal App (Cal Ct App 1993), remanded with directions to vacate, 888 P 2d 243 (Cal 1995).

58 See *Western Security Bank v Superior Court* 933 P2d 597 (Cal 1997); See also Turner, above n 40.

59 See Barnes, above n 43, at 7.

60 At 7.

of credit payments based on claims that the underlying obligations are illegal seem to be much more promising and for new transactions *Mahonia* presents a challenge,[61] however, after a brief discussion, he ultimately concluded:[62]

> *Mahonia*'s treatment of illegality is very unlikely to have any effect on US courts enforcing US law-governed L/Cs, and non-US courts enforcing L/C obligations governed by US law may well be persuaded to apply that law, including the uniform statutory provisions on L/C independence and the limited fraud exception to independence.

Therefore, it could be concluded that in the United States, illegality in the underlying contract is not a defence to payment under commercial documentary letters of credit, and this position is very unlikely to be affected by the English judgments of *Mahonia*.

E. Australia

In respect of the Australian position, Mugasha listed "illegality or violation of public policy" as a separate heading when he discussed grounds enjoining payments under letters of credit and bank guarantees in Australia.[63] Dixon is also of a similar view.[64] It is submitted that their point of view in this regard is under-argued and not convincing.

In addition to the fraud exception, some Australian courts seem to have recognised other exceptions to the autonomy principle in the way of taking into account the situations of the underlying transactions. Almost all of the cases, however, were concerned about bank guarantees (performance bonds) used in the construction industry rather than letters of credit in international trade. Despite this, an observation of them might still help to figure out what the possible position of the "illegality defence" to payment under letters of credit might be in Australia, as it has been suggested that the autonomy principle is equally fundamental for both letters of credit and bank guarantees to operate and thus the same principles govern both of them although no convincing arguments or justifications were given.[65]

Some Australian cases created an "underlying contract" exception,[66] namely, the terms or situations of the underlying contracts were held to be able to affect the bank guarantees and render them unenforceable. In *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd,* the applicant sought to restrain the beneficiary from demanding payment under a performance bond, which emphatically declared that it was payable unconditionally on demand by the beneficiary but also provided that the "contract is by reference made a part hereof".[67] The Court held that the applicant could rely on the wording of the underlying contract to restrain the beneficiary from demanding payment.[68] In *ADI Ltd v State Electricity Commission of Victoria,* the Court by an interlocutory order restrained the beneficiary from demanding payments of performance bonds relying upon a stipulation in the underlying contract which prevents the beneficiary from calling

61 At 7.

62 At 8.

63 See Mugasha, above n 5, at 523–524.

64 See Bill Dixon "As Good As Cash? The Diminution of Autonomy Principle" (2004) 32 ABLR 391.

65 See Mugasha, above n 5, at 516.

66 See Dixon, above n 64, at 402.

67 *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451 (NSWSC).

68 See Mugasha, above n 5, at 529.

upon the issuer to meet its obligation under the performance bond.[69] Byran J's stated "if the contract is *avoided* or if there is a *failure of consideration*" the payment demand could be restrained.[70]

Such cases should be read with caution. Even Mugasha, a promoter of the "illegality exception", suggested that these cases are "exceptional",[71] and in these cases, the autonomy principle was "misapplied".[72] He also suggested that these cases were so decided because the incorporation of the terms of the underlying contract turned the bank guarantee from unconditional to conditional, and in the particular context (domestic construction industry).[73] He also noted that in some other cases the Australian courts are reluctant to interfere with commercial letters of credit because of their function in international trade.[74] Therefore, this line of cases do not support a general "illegality defence" to non-payment under the classic letter of credit used in international trade as a means of payment of price.

Some other cases seem to create a so-called "statutory unconscionability exception" in Australia.[75] In *Olex Focas Pty Ltd v Skodaexport Co Ltd*, the Court held that unconscionable conduct under general law is *not* a ground for issuing an injunction prohibiting payment of a bank guarantee, but that statutory unconscionability is.[76] The Court held that an injunction could be issued because of an infringement of s 51AA of the Trade Practices Act 1974 (Cth), which provides that a corporation must not engage in conduct that is unconscionable within the meaning of the unwritten law.[77]

Some might argue that the "statutory unconscionability exception" is in essence an "illegality exception", but it should be noted that it was accepted as a defence simply because the conduct in the underlying transactions were contrary to the particular provisions of a statute (for example, s 51AA of the Trade Practice Act 1974 (Cth) as discussed above). Had there been no such a specific statutory prohibition, the outcome of the judgments would have been substantially different.

Another might-be relevant case is *Sirius International Insurance Co (Pub) v FAI General Insurance Ltd.*[78] In this case, an irrevocable stand-by letter of credit was issued by Westpac Ban, an Australian bank, on the application of FAI, an Australian insurance company, in favour of Sirius, a Swedish reinsurance company, as security required by Sirius, who agreed to act as fronting reinsurer and hence assumed the risk, in the event of the insolvency or default of FAI, Sirius have nonetheless to pay Agnew, the insured. A side letter negotiated and agreed between Sirius and FAI provided that Sirius would not draw down under the letter of credit unless one of the two conditions was satisfied. As Lord Steyn indicated in the House of Lords' decision, the House of Lords in this case had been expecting to deal with important issues regarding the autonomy principle applicable to letters of credit.[79] In this case, however, the Court of Appeal and House of Lords had no issues

69 *ADI Ltd v State Electricity Commission of Victoria* (1997) 13 BCL 337 (VSC).

70 At 340.

71 See Mugasha, above n 5, at 529.

72 At 531.

73 At 531.

74 At 531.

75 Dixon, above n 64, at 403.

76 *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380, (1996) 134 FLR 331 (VSC).

77 See Mugasha, above n 5, at 518–519.

78 *Sirius International Insurance Co (Pub) v FAI General Insurance Ltd* [2004] UKHL 54, (2004) WLR 3251.

79 At [3].

as to whether the side letter had effect on Sirius' entitlement to draw down the stand-by letter of credit. The issue was whether one of the two conditions set out in the side letter had to be satisfied so that payment could be made out under the letter of credit. This case shows how the payment under a stand-by letter of credit could be closely connected to or even dependent on an underlying document.

It should also be noted that none of those cases was directly related to illegality in the underlying contract. Furthermore, none of them concerned classic documentary letters of credit, but performance bonds or bank guarantees instead. Even if the "statutory unconscionability exception" might be argued in essence as an "illegality exception", it is too far-fetched to infer that an "illegality defence" has been or should be recognised by Australian courts where classic documentary letters of credit commonly used in international trade are involved. These cases do suggest that Australian courts are open-minded as to new exceptions to the autonomy principle. However, it seems that Australian courts are vigilant about the differences between documentary letters of credit used in international trade, and bank guarantees and performance bonds, and are reluctant to recognise a general "illegality exception" where the classic documentary letters of credit are involved.

F. New Zealand

In New Zealand, there is a current statute, the Illegal Contracts Act 1970, dealing with illegal contracts. Section 6 of the Act provides that illegal contracts are to be of no effect, but subject to provisions of this Act and of any other enactment.[80] Section 7 of the Act provides that "notwithstanding the provisions of section 6, but subject to the express provisions of any other enactment", the court may grant "such relief by way of … variation of the contract, validation of the contract in whole or part or for any particular purpose, or otherwise howsoever as the court in its discretion thinks just". The combined effect of ss 6 and 7 is that an illegal contract is unnecessarily declared ineffective although "of no effect" being a default rule, but rather the court has a wide discretion to decide the effect of an illegal contract including validation of an illegal contract. The restriction on such discretionary power of the court is "express provisions of any other enactment".

If this is so, even if in circumstances where a letter of credit itself is illegal (under New Zealand law), it is still possible that the court may grant a relief of "validation of the contract" under s 7 of the Illegal Contracts Act unless this is prohibited by express provisions of any other enactment. This means even if the letter of credit itself is illegal, the illegality is unnecessarily a defence of non-payment under the letter of credit. A logical inference is that where the illegality is found in the underlying contract, it is even less likely that the illegality becomes a defence to the violation of a bank's mandate to pay under the legitimate letter of credit, unless otherwise provided by any provisions of an enactment.

To date there have been neither cases nor legislation in New Zealand that have directly addressed whether illegality in the underlying contract can be a defence to payment under a letter of credit. The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 might be relevant and the recent Supreme Court's decision in *Westpac NZ Ltd v Map* may be an indication of the preference of New Zealand courts.[81]

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80 Illegal Contracts Act 1970, s 6(1).

81 *Westpac NZ Ltd v Map & Associates Ltd* [2011] NZSC 89, [2011] 3 NZLR 751.

The Anti-Money Laundering and Countering Financing of Terrorism Act, among others, sets up an example of under what circumstances (for instance, where the payment itself or the underlying activity is an activity of money laundering or financing of terrorism – an illegal activity) a court may grant an injunction to stop the payment, notwithstanding such a payment is a contractual obligation. Under the Act, there is an overriding duty for the banks and any other relevant persons to comply with the Act and non-compliance is not excused by contractual obligations. The High Court may, on application of the relevant Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) supervisor, grant, rescind or vary an injunction requiring a person to do an act or thing if the statutory requirements are met.[82] The High Court may also, on the application of the relevant AML/CFT supervisor, grant an injunction restraining a person from engaging in conduct that constitutes or would constitute a contravention of a provision of the Act, if the statutory requirements are met.[83] It is conceivable that without this Act and any other enactment, a bank cannot easily breach its mandate to make out a payment under a contract, simply by alleging possible illegality in the underlying transaction. This legislation suggests that a general conception of illegality may not be a defence to non-payment under letters of credit, but rather specific legislation is required, as otherwise most of this legislation would be largely redundant.

The recent Supreme Court's decision in *Westpac NZ Ltd v Map & Associate Ltd* is not a case directly related to non-payment under letters of credit because of the illegality in the underlying contract, but rather a case where the bank refuses to follow the client's instructions to make out the payment under the letter of credit for fear of liability that may arise from breach of trust for aiding fraud.[84] This case, however, shows how high the bar could be for a defence to failure to honour customers' instructions. In this case, MAP, a New Zealand chartered accountants firm, had agreed in 2006 to act as a deposit agent for parties involved in the sale of approximately 94 per cent of the shareholdings in Prodem, a private Bolivian Bank.[85] BIV, a Venezuelan State Bank, entered into an agreement to purchase the shareholdings and agreed to deposit the purchase price with MAP pending completion of the due diligence and settlement of the sale. MAP opened in its own name a foreign currency account with Westpac. In December 2012, MAP provided Westpac with a sealed envelope containing instructions for the transfer of the funds, but Westpac was directed not to open the envelope until MAP authorised it to do so. Then, over USD 49,000,000 was received and deposited into MAP's account with Westpac. During this time, Westpac did not receive instructions to disburse the money, but an alert that a large amount of payments from Bolivia should be treated with caution and also that BIV had assigned its rights in the Prodem shares to Bandes, another Venezuelan Bank. In February 2008, MAP instructed Westpac to act on those instructions, but Westpac declined, arguing that some of the parties to be paid did not appear to be shareholders. Westpac continued to decline payment of the funds after making enquiries and advised MAP to apply to the High Court for an order.

The High Court ordered that Westpac was to act on the instructions and held that Westpac had no defence to MAP's claims for breach of mandate and was, therefore, liable for interest and

82 Anti-Money Laundering and Countering Financing of Terrorism Act 2009, ss 85 and 86.

83 Sections 87 and 88.

84 *Westpac NZ Ltd v Map & Associate Ltd* [2011] NZSC 89, [2011] 3 NZLR 751.

85 The facts are set out in details in the New Zealand Court of Appeal decision *Westpac Banking Corp Ltd v MAP & Associates Ltd* [2010] NZCA 404, [2011] 2 NZLR 90.

costs.[86] Both the Court of Appeal and the Supreme Court substantially upheld the High Court's decision.[87] Tipping J in the Supreme Court observed that as a general principle liability to perform contracts is generally strict, and a defence to breach of contract should not be easily available, especially for banks, which are better able to bear the loss and manage the risks than customers.[88] The Court of Appeal and the Supreme Court reaffirmed that a bank's principal duty is to act in accordance with its customers' wishes; and the long-standing principle that banks should honour their customers' instruction should not be easily undermined.

Although this is not a case directly on point regarding whether illegality in the underlying contracts could be a defence to non-payment under letters of credit, it suggests that New Zealand courts take a conservative position in accepting breach of bank's mandate. It seems that this case poured cold water on the argument that New Zealand should adopt illegality in the underlying contract as an exception to the autonomy principle of letters of credit.

From the above discussion, it can be seen that none of the selected common law jurisdictions have actually adopted an "illegality exception" to the autonomy principle. The most likely jurisdiction that might adopt the illegality exception is the United Kingdom, but as analyses below show, there are still significant barriers to overcome for the adoption of illegality in the underlying contract as a defence to non-payment under classic documentary letters of credit used in international trade as a means of payment of the price.

IV. Critiques on the Arguments for the "Illegality Defence"

Arguments for the "illegality in the underlying contract defence" to non-payments under documentary letters of credit can be summarised as the followings: a) the English case of *Group Josi* and the two *Mahonia* cases suggest that illegality in the underlying transactions should be an exception to the autonomy principle of letters of credit; b) "no reason why" or "hard to see why"[89] the principle of ex turpi causa which justifies the fraud exception should not "equally apply" to illegality in the underlying contract; c) regarding the autonomy principle and its exceptions, "same principles should equally" apply to bank guarantees, stand-by letters of credit and documentary letters of credit. It is submitted such arguments are not as strong as they appear to be, for a number of reasons, inter alia, the existence of logical flaws in the arguments.

Firstly, almost all the arguments for the "illegality exception" are based on the Judges' opinions in the English case of *Group Josi* and the two *Mahonia* cases. It is true that those statements suggested an "illegality exception" is now more likely to be accepted in the United Kingdom than before, as pointed out in part III; however, none of those statements, pointing in favour of an "illegality exception", were ratio decidendi; they were merely obiter dicta. None of the letters of credits involved in those cases were a traditional commercial documentary letter of credit used in international trade as a means of paying the price. No illegality in the underlying transactions was found by the courts based on the facts. Such opinions have not yet been cited with approval by the English Court of Appeal or the House of Lords. The hypothetical examples given by the Judges

86 *MAP & Associates Ltd V Westpac Banking Corp Ltd (No 2)* HC Auckland CIV–2008–404–1373, 10 March 2009.

87 *Westpac Banking Corp Ltd v MAP & Associates Ltd* [2010] NZCA 404, [2011] 2 NZLR 90 (CA); *Westpac NZ Ltd v Map & Associate Ltd* [2011] NZSC 89, [2011] 3 NZLR 751 (SC).

88 At [14] per Tipping J.

89 *Mahonia Ltd v JP Morgan Chase Bank* (No 1) [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911 at [68].

in those cases are extremely exceptional, that is, where the underlying transactions are a sale of Kalashnikov rifles to Iraq,[90] or a sale of heroin.[91] All of these factors suggest that such opinions should be treated with caution.

Secondly, the arguments for the "illegality exception" either intentionally or inadvertently ignore the undeniable distinctions between bank guarantees and stand-by letters as a category, and classic commercial documentary letters of credit used in international sale as another. Almost all of the arguments for a general "illegality exception" are mainly based on the obiter dicta in the English case of *Group Josi* and the two *Mahonia* cases, but they fail to recognise or place sufficient weight on the fact that none of these cases involved a classic commercial documentary letter of credit used in international trade (but rather stand-by letters of credit were in issue). They also fail to justify why classic commercial documentary letters of credit used in international trade should be subject to the same rule regarding the "illegality exception" as stand-by letters of credit. The two categories of bank instruments have substantially different functions and contexts of use, although the autonomy principle applies to both (but unnecessarily *equally* applies to both). For traditional commercial documentary letters of credit, payment under the credit is a *primary* obligation of the underlying contract, that is, the payment of the price of the goods or services; whereas for stand-by letters of credit or bank guarantees or performance bonds, the payment obligation is *secondary* or *collateral* to the underlying contract, functioning only as a surety or security (collateral to the main contract). The purpose of performance bonds and bank guarantees (and stand-by letters of credit) is "not to act as a conduit for the payment of the price [which is the purpose of commercial letters of credit] … but to cajole the seller into performance, particularly performance of his physical obligations under the contract of sale, and the bond is consequently closely linked to that contract".[92] Therefore, performance bonds (and bank guarantees and stand-by letters of credit) are "less independent" from the underlying contracts then classic commercial letters of credit used as a means of payment of the contractual price.[93] Although Lord Denning, in *Edward Owen v Barclays Bank International*, stated, in obiter dictum, that "[a]ll this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit",[94] Eveleign LJ made such comments in *Potton Homes Ltd v Coleman Contractors Ltd*:[95]

> In attributing to the bond many similarities to a letter of credit, I do not regard Lord Denning as saying that one should approach every case upon the basis that the bond is a letter of credit and to have no regard to the circumstances which brought it into existence.

Such fundamental differences justify the different treatments where different categories of bank instruments are involved. As the United States United Commercial Code § 5–103 comment 1 (2009) points out, only staunch recognition of [the independence] principle by the issuers and the courts will give letters of credit the continuing vitality that arises from the certainty and speed of payment under letters of credit. To that end, it is important that the law does not carry into letter of credit transactions rules that properly apply only to secondary guarantees or to other

90 *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 (CA) at 362.

91 *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911 at [68].

92 Charles Debattista "Performance bonds and letters of credit: a cracked mirror image" (1997) JBL 289 at 303.

93 At 301.

94 *Edward Owen Engineering Ltd v Barclays Bank International* [1978] QB 159, [1978] 1 All ER 976 per Lord Denning at 171–172.

95 *Potton Homes Ltd v Coleman Contractors Ltd* [1984] 28 BLR 19 (CA) at 27.

forms of engagement.[96] It is not convincing to argue that "illegality exception/defence" should be adopted merely based on discussions about bank guarantees, performance bonds or stand-by letters of credit, without justifications why such a fundamental distinction should be ignored. It is also inappropriate using those concepts interchangeably or in a vague or slippery way when the "illegality exception" is argued for.

Thirdly, the arguments for the "illegality exception" fail to recognise the distinction between fraud and illegality in the underlying contract. Almost all of the arguments for an "illegality exception" heavily rely upon the ex turpi causa principle, which justifies the fraud exception, but fail to provide plausible reasons why the same principle should be *equally* applicable to both.[97] The Latin maxim *ex turpi causa non oritur actio* means "from a dishonourable cause an action does not arise." Based on this principle, a person will be unable to pursue a cause of action if such action arises as a result of his/her own wilful, illegal act. Dishonesty or the knowledge of the illegality is required. The principle may not be *equally* applicable to both fraud and the "illegality in the underlying transaction", since there are significant differences between them. There must be dishonesty for a fraud to be established; whereas parties to a transaction may not be aware of the illegality in the transaction. In an international sale scenario, for fraud, *the seller* (beneficiary of the letter of credit) is more likely to defraud the issuing bank and the applicant of the letter of credit, that is, the seller commits fraud and the innocent buyer bears the risk; whereas for an "illegal underlying transaction", it is more likely that *the buyer* knows about the illegality and voluntarily assumes the risk of the illegal goods being confiscated by the government. In an illegal underlying transaction, although there could be circumstances where neither of the parties are aware of the illegality, the more common situation is that both the seller and buyer are aware of the illegality (conspiracy) and voluntarily assume the risk; whereas in a fraud case, the seller and buyer are more likely to have conflicting interest and fraud is only unilaterally committed by the seller (beneficiary). Furthermore, the "illegality exception" will cause much more serious harm to the autonomy principle than the fraud exception. It is arguable that the presentation of documents fraudulently made to the issuing bank is a breach of an implied contractual obligation under the letter of credit contract itself, that is, documents required by the letter of credit and presented for payment must be genuine, and a breach of such an essential term of the letter of credit contract gives rise to the bank the right to dishonour its obligation to pay under the letter of credit contract. This means the independence or separation of the letter of credit from the underlying contract has not been fundamentally undermined. For the "illegality in the underlying contract defence", however, the bank's dishonouring of its obligation under the letter of credit contract must rely on a situation in the underlying contract rather than the letter of credit contract itself, which significantly violates the independence of the letter of credit.

They are also differences regarding what kind of interests are being harmed. For fraud, the beneficiary seller will get unjust enrichment at the cost of the buyer. What is protected from the fraud exception is a private interest based on fairness. Whereas for an illegal underlying transaction exception the aim is to protect public interest, in most circumstances both parties to the illegal underlying transaction obtain a benefit at the cost of society. Public, rather than private, interest being harmed does not mean the justification for an illegality exception in private law is stronger

96 UCC § 5–103 cmt 1 (2009).

97 If illegality in the underlying contract is to be recognised as a defence, the rationale of the recognition would be the same as fraud, namely, the maxim ex turpi causa. See *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911at [68] per Colman J.

than that for a fraud exception. Public interest could and should be better protected by public law. Deviation from the autonomy principle will not work better than a statute declaring what kinds of payments are prohibited by law.

The ways of counteracting are also different. For fraud, the recognition of a fraud exception, or payment in cash in advance will be an effective way to eliminate the possibility of fraud; whereas for illegality, a payment in cash in advance or in arrears will not do anything to the illegality of the underlying transaction. Therefore, an illegality exception will not effectively prevent the illegal transaction, although the parties to an illegal transaction may get more difficulties regarding the time and method of payment. There must be statutes preventing the illegal transaction itself, and/or the payment for illegal transactions, regardless of the methods of payment. For example, if selling or buying heroin is illegal, the legislation may make this clear and prohibit the illegal transaction itself, and the financing, including any payment for such a transaction, whether the financing or payment is made in a form of cash or a letter of credit.[98] Circumstances where illegality in the underlying transaction entitles the court to grant injunctions should be carved out by express provisions of an enactment (as found under ss 86–88 of the Anti-Money Laudering and Countering Financing of Terrorism Act New Zealand). In this circumstance, the court may grant an injunction on the request of the relevant public body, relying on a particular statute, rather than a general, poorly defined and highly problematic "illegal underlying contract exception".

V. Practical Difficulties for the "Illegality Defence"

In addition to the logical flaws in the arguments for an "illegality exception", there are also practical difficulties for the proposed "illegality exception". Firstly, different jurisdictions very likely have significantly different conclusions as to whether a particular transaction is illegal. For example, trading of Compound Pseudoephedrine HCl Sustained Release Capsules (CONTACÒNT) under Chinese law is totally legal but would be illegal under New Zealand law.[99] Much greater differences can be found with "illegality" than "fraud" in different jurisdictions. Most jurisdictions have similar ideas as to what constitutes a "fraud", but whether a particular transaction is "illegal" could be fundamentally different in different jurisdictions as the "illegality" must be determined against the law of a particular jurisdiction, which may be considerably different from one jurisdiction to another. Uniformity of law, although difficult, is highly desirable for the promotion of international trade. Adoption of a highly controversial "illegality exception", which inevitably closely connects to different results of determining the existence of illegality in a particular transaction by different jurisdictions, will not only harm the efforts for the uniformity of international business law, but will also significantly encroach the autonomy principle of documentary letters of credit and subsequently harm international trade. Where the major international trade players (for example, the United States) do not accept an "illegality exception", a jurisdiction adopting such an exception will make it an "exception" to, and hence the risk of being alienated from, the international market. As discussed above, the UNCITRAL Convention arguably adopts a very narrow "illegality defence" regarding non-payments under independent guarantees and stand-by letters of credit (not commercial documentary letters of credit), but none of the major international trade players has ratified this Convention, which renders it not really "international" law in a practical sense.

98 The Anti-Money Laundering and Countering Financing of Terrorism Act is a good example of this.

99 See Misuse of Drugs Act 1975, ss 6 and 7. See also discussions below on the hypothetical case of Compound Pseudoephedrine HCl Sustained Release Capsules.

A logical inference from the unwelcomeness of the Convention is that it is already difficult for the "major jurisdictions" to adopt an "illegality exception" where only independent guarantees and stand-by letters of credit are involved, it will be even more difficult if classic commercial letters of credit are included, taking into account the "lifeblood" function of the latter.

Secondly, it is highly difficult to formulate the "illegality exception". If an "illegality exception" is to be adopted, the elements of it must be made clear. What qualifications should the illegality defence be subject to? The *obiter dicta* in the English case of *Group Josi* and the *Mahonia* cases suggest an "illegality exception" but none of them, however, clearly set out the elements of the "illegality defence". There are also differences in this regard between the two Mahonia cases. Colman J in *Mahonia (No 1)* put in place a series of factors that a court should consider and weigh up in determining whether the illegality defence applies, namely, the gravity of the illegality, connection between the letter of credit and the underlying contract, and whether the parties are privy to the illegality, among others.[100] Whereas Cooke J in *Mahonia (No 2)* emphasised as an overriding factor the close degree of connection between the letter of credit and the illegality of the underlying transaction.

Thirdly, there are also other practical issues regarding the proposed "illegality exception". For example, standard and time of proof of the alleged illegality, the gravity of illegality required, and what the issuing/corresponding bank's duties are. Such issues/concerns also point against the adoption of a general "illegality exception".

In relation to standard of proof of the alleged illegality, Staughton J in *Group Jos* stated that the illegality of the underlying contract must be "clearly established". It has been pointed out this is a very high standard of proof, and consequently, the illegality defence will succeed only in very rare cases.[101] This may suggest the "illegality defence" has little significance in practice. The time of evidence is "even more of a problem".[102] Colman J stated:[103]

> … the fact that the bank did not have clear evidence of such illegality at the date when payment had to be made would not prevent it having a good defence on that basis if such clear evidence were to hand when the Court was called upon to decide the issue.

It would be too harsh and impractical in most circumstances to require the bank to clearly establish the illegality in the underlying contract at the time of dishonouring the letter of credit. Under UCP 600, the bank has "a maximum of five banking days following the day of presentation" to determine if a presentation is complying and once the documents presented are complying on the face of them the bank must pay.[104] This implies that the bank has little time to investigate and collect sufficient evidence to meet the high standard of proof, that is, "clearly establish". Another factor is the accessibility of relevant documents (for example, the underlying contract). When the documents are presented for payment, the underlying contract is not included. The bank has no right or obligation to go beyond the documents presented unless otherwise agreed. On the other hand, making evidence, obtained after the dishonouring, admissible at trial does not alleviate the bank's concern in practice as the bank must make the decision to pay or not on the basis of the very limited evidence available at hand and within the short time frame.

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100 *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911at [64]–[69].

101 See Enonchong, above 6, at 413–414.

102 *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 (CA) at 1164.

103 *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911 at [69].

104 UCP 600 2007, art 14(b).

The gravity of the illegality in the underlying contract is also in issue. Colman J in *Mahonia (No 1)* stated that the illegality must be of a sufficiently serious nature to trigger the ex turpi causa principle.[105] What amounts to "sufficiently serious illegality"? Cooke J in *Mahonia (No 2)* stated that the illegality would be "sufficiently serious" if the contravention involves "any elements of deceit or intentional wrongdoing".[106] Enonchong argued that this "deliberate wrongdoing" test is not the only basis on which trivial and serious illegality could be distinguished and the test may not provide the right answer in every case.[107] Kelly-Louw suggested that if the illegality is not linked to a criminal element, it should not be deemed to be sufficiently serious, but of a mere technical nature.[108] Similarly, Mugasha suggested if the illegality is of a technical nature, for example, contrary to import or export regulations or failure by the applicant to comply with the licensing requirements in the applicant's country, it could not be a defence to non-payment under the letter of credit.[109]

These tests suggested are not without problems. Firstly, it is not always easy to determine whether a provision of a statute or regulation is of "technical nature", and sometimes a breach of "licensing requirements" may be a criminal offence.[110] Secondly, it is not clear which jurisdiction's law is to be relied on in determining whether the prima facie criminal offence presents. Mugasha further proposed:[111]

> Perhaps the test should be whether the underlying contract is manifestly illegal under the law that governs such a contract *and* if the law governing the letter of credit or bank guarantee considers the transaction manifestly illegal as measured by *international standards*.

This test is still problematic. It would be difficult to find "international standards" as to what amounts to a "manifestly illegal" contract. As pointed out in the above discussions, different jurisdictions may have completely different laws and/or standards as to whether a particular transaction is illegal. Where there is no consensus on whether a particular transaction is illegal or not, how can there be commonly recognised "international standards" as to the seriousness of an illegality?

Another problem with the proposed "illegality exception" is the bank's duty in relation to the illegality suspected/discovered in the underlying transaction. The English cases of *Group Josi* and *Mahonia* did not make clear what the duties and obligations of the banks are in relation to illegality in the underlying contract. In the United States the conception is that if the illegality defence is recognised, banks would be compelled to determine whether payment under the letter of credit will be used for an illegal purpose and this will place them in additional difficulties in examining the documents.[112] If, however, the banks are not obliged but only entitled to invoke the "illegality defence", no bank will be willing to take the risk of breaching its mandate even if it has clear evidence of illegality in the underlying contract. There is no point for a bank to do an investigation

105 *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] EWHC 1927 (Comm), [2003] 2 Lloyd's Rep 911 at [65].

106 *Mahonia Ltd v JP Morgan Chase Bank (No 2)* [2004] EWHC 1938 (Comm) at [430].

107 See also Enonchong, above n 6, at 417.

108 See Kelly-Louw, above n 19, at 281.

109 See Agasha Mugasha *The Law of Letters of Credit and Bank Guarantees* (Federation Press, NSW, 2003) at 189–190.

110 For example, importing controlled drugs into New Zealand without a licence: see Misuse of Drugs Act, s 6.

111 Mugasha, above n 111, at 190 (emphasis added).

112 See Enonchong, above 6, at 412.

on its own cost and to take the risk of being sued for something that it is not obliged to do under the law.

Finally, a general, loosely defined “illegality exception” is open to abuse and may produce unfair situations in practice and harm international trade. For instance, as a hypothetical scenario, a contract for sale of CONTACÒNT was concluded between a Chinese seller and a New Zealand buyer, with a choice of law clause that the contract of sale was exclusively governed by China law. On the application of the New Zealand buyer, a New Zealand bank issued a letter of credit in favour of the Chinese seller. The sale and purchase of the CONTACÒNT, which is commonly used as an anti-flu drug in China, is absolutely legal under Chinese law. However, it is a criminal offence to import this drug into New Zealand without a license.[113] If the New Zealand buyer failed to obtain such a license, can the buyer apply to a New Zealand court to restrain the bank from paying the seller (beneficiary) against the confirming documents presented? The underlying contract of sale is lawful under the governing law (Chinese law), but unlawful under New Zealand law in certain circumstances (the failure of obtaining an import license). Is the statutory provision requiring the import license of a “technical nature”? If an “illegality in the underlying contract defense” is allowed and an injunction is granted to restrain the bank from paying against the apparently confirming documents, it will be totally unfair and unjust. As indicated in the New Zealand mussel case, it is the New Zealand buyer’s duty to make clear the import restrictions and to obtain the license.[114] Its failure to obtain the license results in the transaction being “criminally illegal” under the New Zealand law, although it is absolutely legal under the governing law of the contract. The Chinese seller might be totally ignorant about the New Zealand drug control system and have done nothing wrong, however, by not being paid by the issuing bank relying on a “illegality exception” it has to put up with the problem and bear the loss caused by the culpable New Zealand buyer.

The existence of the huge logical flaw, the ignorance of the reality of international trade, and other problems as mentioned above substantially impair the plausibility of the arguments for the “illegality exception” to the autonomy principle of documentary letters of credit.

VI. Conclusion

As to whether illegality in the underlying contract should be a defence to payment under documentary letters of credit, the UCP 500 and UCP 600 are totally silent. None of the common law jurisdictions discussed has actually adopted such an “illegality exception”, whether the bank instruments involved are bank guarantees, stand-by letters of credit, or classic commercial documentary letters of credit. The strongest pieces of “evidence” pointing in favour of an “illegality exception” are: a) the opinions made by some judges in the English case of *Group Josi* and the *Mahonia* cases; and b) art 19 of the UNCITRAL Convention provides for an “illegality exception” to the autonomy principle. Most of the arguments for an “illegality exception” are based on these two points, in addition to the point that the principle of ex turpi causa on which the fraud exception is based should be equally applicable to illegality in the underlying contract.

The opinions made by some judges in the English case of *Group Josi* and the two *Mahonia* cases are obiter dicta only. Therefore, the UNCITRAL Convention is the only law to date that

113 Misuse of Drugs Act, ss 6 and 7.

114 Case 123: CISG 35 (2); 49 Germany: Bundesgerichtshof; VIII ZR 159/94 8 March 1995, Published in German: Entscheidungen des Bundesgerichtshofs in Zivilsachen (BGHZ) 129, 75.

recognises the "illegality exception", although none of the major players in the world have ratified this Convention. It must be noted, however, neither any of the above English cases (and cases in other jurisdictions discussed) nor the UNCITRAL Convention is directly about classic commercial documentary letters of credit used in international trade as a means of payment of the price. It is not logical to extend the "illegality exception" (assuming it is adopted) from bank guarantees and stand-by letters of credit to commercial documentary letters of credit, looking at the undeniable fundamental differences between them. Taking into account the "lifeblood" function of commercial letters of credit in international trade, it is even more difficult to argue for an "illegality exception" where commercial letters of credit rather than bank guarantees or stand-by letters of credit are concerned.

Similarly, it is not convincing to justify the "illegality exception" by simply arguing that there is "no reason why the principle of ex turpi causa should not be equally applicable to illegality in the underlying contracts", ignoring the substantial differences between the fraud exception and the proposed "illegality in the underlying contract defence".

There are also many practical difficulties to overcome before the proposed "illegality exception" is accepted by law. Different jurisdictions are very likely differing in determining whether a particular transaction is illegal or not. It is extremely difficult to formulate the "illegality exception", with significant uncertainties regarding, inter alia, elements of the exception, the gravity of the illegality required, standard and time of proof of the illegality and whether the bank is obliged to refuse payment where illegality is discovered. A general, loosely defined illegality exception is easily exposed to abuse, resulting in unfairness and injustice and hence damaging to international trade. For all of the above reasons, the "illegality exception" to the autonomy principle is much less likely to be accepted than expected by the advocators in most common jurisdictions, especially, where classic commercial documentary letters of credit used in international trade as a means of payment of the price are involved.

There are, of course, public policy concerns about illegal transactions in international trade. Such concerns, however, should not be addressed by the introduction of an ill-founded, loosely defined, highly controversial and problematic "illegality exception" to the autonomy principle of payments under documentary letters of credit. Specific enactments, such as the New Zealand's Anti-Money Laundering and Countering Financing of Terrorism Act (especially, ss 85 and 86) is a much better way to address the public policy concern for the protection of public interest.