

# **DOCUMENTARY CREDIT FRAUDS: NEED FOR REGULATION OF BANKING SECTOR IN INDIA**

## **Abstract**

In the recent past, several frauds involving banks were witnessed in India which posed challenges for the smooth functioning of banking sector. One of the major elements of banker-customer relationship is trust which is essential for the future of existence of banking institutions. There is a threat to this principle of trust which is implied in banking transactions by the parties involved in it because of the frauds committed by some of the unscrupulous customers in connivance with the banking officials. Often, it can be witnessed that the legal enforcement agencies are facing a tough time to bring the culprits under the ambit of law, when they escape abroad after committing economic frauds. This is high time for the law makers as well as reformers to give serious thought on this type of economic crimes. Documentary credit fraud is one among the tools for such frauds committed by the unscrupulous persons who use the banking stream for the same. Though, the documentary credit, otherwise widely known as letters of credit in India, which aims, to facilitate the process of international trade, at times can be used as means to commit banking fraud due to its specific characteristics of autonomy principle.

In this type of credit mechanism which are extended by the banking institution to its customers especially businessmen, financial commitment is ensured by the banks on behalf of its customer relying solely on the documents alone presented by the other party, generally the seller of goods. Many a times, geographical distance, absence of efficient prosecution and the diversity of legal system at the global level strengthen and encourage the reasons for commission of fraud involving documentary credit mechanism of banking institutions. This area remains unexplored generally, and the existing research, especially in India focuses on the using of this instrument as a method of mitigating the fraud risk management by the banks as well as the measures implemented by the banking community as an internal measure. Its legal implications and the need for legislative framework to regulate the banking sector remains nebulous. This paper examines the concept of documentary credit and its regulatory mechanism in banking sector. It will explore the nuances in the principle of fraud rule developed by the developed countries and its application by the courts in India. The need to adopt preventive measures to manage the risk of fraud in documentary credit transactions with a proper legislation to address the issues posed will also be examined in this paper.

## **I Introduction**

DOCUMENTARY CREDIT are the financial instruments relied upon by the traders involved in the business transactions especially in international trade. In the present economic order promoted by liberalization of international trade, they are relied upon by industries as debt supporting instruments such as commercial

paper or industrial revenue bonds.<sup>1</sup> Generally, these instruments are based on commercial policy and efficiency considerations that demand the prompt honour of the instrument by banks. In this type of transaction huge amount of money is involved based on documents by the banks, hence, banking institutions play a pivotal role to facilitate the payment transactions between the parties involved. In case of delay in making payment by bank, reputation of country may be at stake and on the other hand, it may also result in increasing instances of international commercial fraud.<sup>2</sup> It is done either by practice of fraud in collusion with banks or shipping agents. Its rampant growth will threaten the financial security of a nation. However, government intervention and control in this area are very limited.<sup>3</sup> The peculiar feature of this instrument is that banks make payment to the seller merely based on the documents presented to them by the party mentioned in the credit. The bank which issues documentary credit (also known as letters of credit) is under an obligation to make the payment to the parties irrespective of any factual discrepancy raised by the parties in the basic sale transaction. Since the banker is not party to the basic underlying contract between the parties for the sale of goods, there is no obligation on the banks to check the factual authenticity of the documents presented to them by the seller.<sup>4</sup> They are bound to check only the veracity of the documents mentioned in the credit instrument.<sup>5</sup> The theory behind the use of documentary credit is often referred to as “pay now, litigate later”.<sup>6</sup> It upholds the principle of prompt payment by the banking institutions to the seller irrespective of any fraudulent transactions committed by the parties in the basic underlying contract of sale. In the present scenario prevailing in the banking sector in our country, it can be reframed as “fly now, pay later” for the fraudsters who escape abroad after committing default in making payment to the banks on the credit advanced to them. Hence, the banking institutions are faced with major difficult situations when it creates a vast avenue for fraudsters to indulge in fraudulent activities including money laundering only on the basis of documents.<sup>7</sup>

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1 See for discussion on industrial revenue bonds, Read H. Rayan and Charlers W. Mooney (Eds), *Letters of Credit Supporting Debt Instruments* (Practicing Law Institute, U.S.1986).

2 Catty Gunn, “Financial Fraud”, *Banking World* 21 (1984).

3 Susmitha P Mallaya, “Documentary Credits in International Trade Law”, 33 *Cochin University Law Review* 20 (2009).

4 Van Houtee, H, *The Law of International Trade*, (Sweet & Maxwell, London, 2002); Richard Schaffer et.al., *International Business Law and its Environment*, (West Educational Publishing Co., U.S.A. 1999).

5 Susmitha P Mallaya, “Doctrine of Strict Compliance in Letters of Credit: Need for Reforms in India”, 37 *Cochin University Law Review* 242 (2012).

6 Jacqueline D Lipton, “Documentary Credit Law and Practice in the Global Information Age”, 22 *Fordham Int’l L. J* 1972 (1999).

7 Susmitha P Mallaya, “Documentary Credit and Money Laundering: An Overview”, 48 *Chartered Secretary* 72 (2018).

### Functioning of documentary credit

Documentary credit transactions are primarily based on a chain of transactions involving four parties each having separate contractual relationships. The basic underlying contract is between the buyer and the seller, then between issuing banker and the seller as well as paying bank and seller. The parties involved are the buyer (applicant for the credit), the seller (the beneficiary under the credit), the bank issuing the credit (the issuing bank) as well as the bank which makes payment (the intermediary bank or paying bank). The obligations of the bank will be determined based on the particular situation. The seller, presenting the documents specified in the letter is known as the beneficiary who will export the goods to the buyer's country. Banker in the beneficiary's country known as the advising bank will intimate the beneficiary of the credit received. The paying bank will make payment to the seller beneficiary after verification of the terms and conditions mentioned on the documents presented by him.

In this type of transactions, generally, the documents presented by the seller includes an invoice for the goods shipped, an insurance certificate in respect of the goods, a bill of lading or other evidence of shipment of goods by the seller for transportation. The seller will receive payment for the goods from the banker before the buyer makes actual delivery of goods. This liberty can be misused by the unscrupulous buyer without shipping any physical goods and create a forged document of shipment. Both the buyer and seller in connivance with some of the employees of the bank can also create such a situation and the money can be transferred which will make the banking institution to suffer the loss. Unless the forgery is obvious, the bank is entitled to pay because documents usually indicate dispatch of the cargo. In other words, it signifies the fact that documents may be presented for a non-existent cargo by the parties involved.<sup>8</sup> By the time the buyer comes to know about this, 'he' would have lost his money. When it comes to the question of claim for loss from the insurance company, they will deny compensation because generally, insurers do not pay for a non-existing cargo.

### Doctrine of trust *viz a viz* fraud

Trust is the basis of all transactions in commercial world including banking institutions. It is the glue that binds corporate relationships. No matter how strong the legal rules requiring fiduciary loyalty are, no matter how successfully the market aligns a fiduciary's self-interest with corporate interest, trust is essential for corporate survival. In the absence of some measure of trust between those who invest their money and those who manage it, the corporation cannot succeed as an efficient business

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8 Carole Murray, David Holloway (Eds.), *Schmitthoff's Export Trade*, (Sweet and Maxwell, London, 2012).

entity.<sup>9</sup> Moreover, it is a known fact that fraud is one of the oldest and the best known phenomena in the business world. As pointed out “as long as there have been commercial systems in place, there have been those who tried to manipulate these systems”.<sup>10</sup> However, there is lack of serious attitude to deal with the fraud issues both by the banks and the persons or companies involved in international trade. Sometimes, fraudsters victimize companies which do not employ proper control measures and protect themselves from law enforcement bodies by finding legal loopholes in particular jurisdictions. As observed the essential elements in a company which result in vulnerability to fraud risk are weak controls, dishonest employees, lack of clarity regarding company resources and negligent managers.<sup>11</sup> As far as commercial institutions are concerned, trust and their integrity is very fundamental for effective functioning in particular and any economic system in general. Unfortunately, the importance of this point is sometimes overlooked. This shows how fraud can be a basis to create distrust in commercial transactions which in long run can exploit the working of commercial institutions especially banking sector of a country, backbone of economic progress.

#### **Jurisprudential perspective of trust and its application in documentary credit transactions**

In order to view the application of concept of trust in the documentary credit transactions from the law and economic perspective, one can view the study made by Francis Fukuyama,<sup>12</sup> where he refers to trust as a massive, densely-argued and illustrated study in economic and social history. Fukuyama argues that economic prosperity and business success cannot be adequately explained by abundance of natural resources, brilliance of intellect, or the presence of good laws and institutions. Rather, he emphasizes that success in business and economic prosperity require a culture of trust and a capacity for what Fukuyama calls “spontaneous sociability.” This is where the future of banking institutions in our country needs to be viewed today. If the trust of public is lost in these institutions, the future of these institutions will be at stake. Reports of banking frauds will create a scenario of distrust among people in the banking system. This, in turn, will put our nation in the category of “low trust” society.

Banker-customer relationship is one in which trust and confidence arise when confidential information comes to the knowledge of banker in peculiar circumstances.<sup>13</sup> In this scenario even if there is some suspicion in the nature of transaction by the

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9 Lawrence E Mitchell, “Fairness and trust in Corporate Law”, 43 *Duke Law Journal* 425 (1993).

10 ICC International Maritime Bureau, 2002 as cited in Hamed Alavi, *infra* 11.

11 Hamed Alavi, “Mitigating the Risk of Fraud in Documentary Letters of Credit”, *Baltic Journal of European Studies* 139 (2016).

12 Francis Fukuyama, *Trust : The Social Virtues and the Creation of Prosperity* (New York Free Press, 1995).

customer, the banker need to take extra care not to divulge the information of the customer with the authorities. Moreover, the letters of credit are based on the principle of autonomy<sup>14</sup> which imposes obligation on banker to honour the documents presented in conformity of credit irrespective of the sale agreement between the parties. This exclusiveness on the other hand, provides an opportunity for unscrupulous person to indulge in transaction which results in the commission of financial fraud. Of course, fraud has been recognized as an exception to the absolute principle of autonomy in letters of credit transaction based on which banks can deny paying to the parties if it comes to their knowledge that the tendered document is false. However, mere suspicion is not sufficient to deny the payment based on fraud, it should be beyond reasonable doubt.<sup>15</sup> It has been recognized by the common law as part of commercial practice that banks are expected to act in a reasonable manner in case of allegation of fraud in relation to the commercial documents. Thus, a mere allegation of fraud by the trader does not affect the obligation of the banker to make payment to the seller on his presentation of required documents.<sup>16</sup> It has been recognized universally by the courts including common law as well as by codified practice of merchants that there must be clear evidence both as to the fact of fraud as well as to the bank's knowledge of such fraud in order to refuse making of payment by the banks.<sup>17</sup>

However, there is no clarity with regard to the degree of evidence of fraud required to be proved by the alleged party. Similarly, it is not clear whether the knowledge of such fraud to the seller beneficiary and the bank is necessary to invoke the rule of fraud exception. In this context, it is essential to analyse the fraud rule to minimize the risk undertaken by the concerned parties and also to examine whether there is a provision to cover this risk by the insurance policies by banks, even if, how much it can cover in situation of fraud by the parties is not certain.

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13 Gareth Jones, "Breach of Confidence after Spy-catcher", 42 *Current Legal Problems* 49-50 (1989). See also Susmitha P Mallaya, "Banker's duty of Confidentiality : Modern Trends", 28 *Cochin University Law Review* 305 (2004).

14 Uniform Customs and Practice of Documentary Credits (UCP 500), art.3 (a). The principle of autonomy is codified under this provision.

15 *Gian Singh Ltd. v. Banque de l'Indochine* [1974] 2 All E.R.754.

16 Hans Van Houtee, *The Law of International Trade*, (Sweet and Maxwell, London, 2002).

17 *United City Merchants (Investments) Ltd v. Royal Bank of Canada Glencore International AG v. Bank of China*, 1996 (1) Lloyd's Rep 135; *Fortis Bank SA/NV v. Indian Overseas Bank*, 2011 (2) Lloyd's LR 33; *United Commercial Bank v. Bank of India*, AIR 1981 SC 1426; *Himadri Chemicals Industries Limited v. Coal Tar Refining Co* (2007) 8 SCC 110.

## II Meaning and concept of fraud rule

It has been universally recognized as a customary practice by traders as well as codified in Uniform Customs and Practice of Documentary Credits (UCP) that the cornerstone of the documentary credit transactions is the principle of autonomy which emphasis on the obligation of banks to deal with documents only and not to get concerned with the underlying sales transactions between the buyer and seller.<sup>18</sup> This principle sometimes, paves way for the commission of fraud by using this instrument by unscrupulous persons, since it is not designed to prevent fraud which will in turn affect the integrity of the business transactions. Common law recognized the importance of fraud rule in *United City Merchants (Investments) Ltd v. Royal Bank of Canada*.<sup>19</sup>

In order to perpetuate fraud, different means are adopted in documentary credit transactions. Sometimes, the beneficiary perpetrates a fraud against the bank by making the documents appear as genuine but the issuing bank will come to know about this fraud only after a lapse of time. Similarly, the fraud exception remains too narrow and the banker is liable to pay irrespective of fraud. Thus in *Discount Records Ltd v. Barclays Bank Ltd*,<sup>20</sup> Megarry J., refused to grant injunction on an allegation of fraud. He observed:<sup>21</sup>

I would be slow to interfere with banker's irrevocable credits, and not lease in the sphere of international banking, unless a sufficiently good cause is shown; for interventions by the court that are too ready or too frequent might gravely impair the reliance which, quite properly, is placed on such credits.

In this case, the buyers failed to establish the evidence of the alleged fraud. When they opened the cartons they found that it contained only a small quantity of goods ordered. Some of the cartons were empty and contained goods which were not ordered. But the bank accepted the draft which was in order. The facts of this case showed that the buyer communicated to the bank that fraud had occurred. But on enquiry, the bank found that the alleged discrepancies were insignificant and the beneficiary was not a party to such fraud.

Similarly, in an earlier case, U.S. Court refused to invoke the fraud exception.<sup>22</sup> They believed that issuing bank's liability relates only to the verification of documents

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18 *Supra* note 11. Also see Ross Cranston, *Principles of Banking Law* (Oxford University Press, New York, 2002).

19 (1982) 2 W.L.R 1039. This case is also known as *American Accord* case.

20 [1975] 1 All E R 1071 (C.D.).

21 *Id.* at 1075.

22 *Supra* note 1.

and checking whether they are on the face complies with credit. A mere doubt regarding the quality of goods will not amount to fraud. Hence, banks cannot refuse payment. However, Cardozo J dissented and took a different version for fraud.<sup>23</sup> He held that fraud means misrepresentation. This view can be ascertained from the following:

We have to bear in mind that this controversy...arises between the bank and a seller who has misrepresented the security upon which advances are demanded... I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face.

According to Cardozo's observation, in order to invoke the fraud rule, a misrepresentation should amount to complete non-performance of the contract. Therefore a clear understanding of the meaning of fraud is required in order to apply them in cases of documentary credit.

### Meaning of Fraud

The meaning of 'fraud' can be inferred from various judicial interpretations of both common law principles and equity principles which were later recognized in India in the legislation of Contract Act.<sup>24</sup> British courts tried to interpret and give meaning to the fraud under letters of credit through various decisions. The term 'fraud' was given a meaning of dishonesty or deceit in *Beauman v. A.R.T.S. Ltd.*<sup>25</sup> In another instance, the court observed that fraudulent misrepresentation or deceit will be the basis of many types of fraud. In *Derry v. Peek*,<sup>26</sup> Lord Herschel tried to define fraud exhaustively by stating that in order to sustain an action of deceit, there must be proof of fraud and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, (2) without belief in its truth, or (3) recklessly, careless whether it is true or false. However, this is only a general classification of the fraud.

This meaning of fraud will be of little use as far as letter of credit is concerned because in these transactions, fraud can be committed by both buyer and seller through the use of documents as well as goods. Though, fraud in relation to documents can be proved, it is difficult to establish the fraud in relation to goods. In case of fraud

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23 *Supra* note 1.

24 The Indian Contract Act, 1872 (Act 9 of 1872), s.17.

25 [1949]1 KB 550.

26 (1889) 14 App. Cas. 337 at 376.

committed through goods by seller, mere allegation or suspicion before the payment by the bank is not sufficient and the banker cannot withhold the payment unless there is proof that the seller has committed the fraud.<sup>27</sup>

It can be observed that generally courts have given a very narrow meaning to the term 'fraud'. The courts recognized fraud only in cases relating to the outrageous conduct of the parties which shocks the conscience of the courts.<sup>28</sup> This narrow interpretation is justified on the ground that a broader rule would defeat the certainty of letter of credit transaction. However, there are two wider interpretations of the term 'fraud'. One is breach of standard contract, the other is intentional fraud standard.<sup>29</sup> The customer would be entitled to get an injunction against payment only by showing that there is a standard breach of contract with the underlying contract.<sup>30</sup> It can be seen that the traditional "egregious fraud" standard is followed in the intentional fraud standard. According to that a beneficiary who presents confirming documents under a letter of credit should be prevented from receiving payment only when his own wrongdoing has led to the creation of these documents.<sup>31</sup> Later, broader definition of "wrong doing" was adopted to include a false representation.<sup>32</sup> However, courts insist narrow definition and are reluctant to broaden the definition. For instance, in *Roman Ceramics Corporation v. Peoples National Bank*,<sup>33</sup> the district court enjoined payment by finding that the beneficiary knew that the invoices covered by letter of credit had been paid. But the issuing bank attempted to get payment by misrepresenting this fact. While applying the definitions of fraud in the transaction, the court observed that the circumstances that justify the injunction are limited narrowly to the fraud committed by the beneficiary.<sup>34</sup> Therefore, traditionally, it can be seen that 'egregious fraud' was followed in letter of credit transactions in foreign countries.

The most important case law universally accepted and followed in case of documentary credit is *Sztejn v. J. Henry Schroder Banking Corporation*,<sup>35</sup> of United States.

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27 *Supra* note 18.

28 Harfield, "Enjoining Letter of Credit Transactions", 95 *Banking Law Journal* 596 (1978).

29 Michael Stern, "The Independence Rule in Standby Letters of Credit", 52 *University of Chicago Law Review* 218 (1985).

30 Note, "Fraud in the Transaction Enjoining Letter of Credit during the Iranian Revolution", 93 *Harr. L. Rev.* 992 (1980).

31 Stephen H. Van Houten, "Letters of Credit and Fraud: A Revisionist View", 62 *Canadian Bar Review* 371 (1984).

32 Agasha Mugasha, "Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee", *Journal of Business Laws* 515 (2004).

33 714 F. 2d.1207 (3d Cir.1983) cited in Mark S. Blodgett and Donald O Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud", *American Business Law Journal* 443 (1998).

34 *Ibid.*



In this case, the seller shipped rubbish materials under a contract of sale. He obtained a bill of lading from the carrier fraudulently, stating that the goods shipped in the container are in good condition. However, the buyer refused to accept the documents on suspecting fraud. Injunction suit was filed by him to restrain the issuing bank from accepting the documents from the seller and making him payment. The court held that the principle of autonomy is the important element of documentary credit and fraud is an exception to this. Sheintag J., said,<sup>36</sup>

[W]here the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.

This case enunciates major elements of the fraud rule. It declared three principles of paramount importance. First, payment under a letter of credit may only be interrupted in a case of fraud; mere allegation of breach of warranty cannot be an excuse for such an interruption. Second, payment under a letter of credit can only be interrupted when fraud is proven or established; mere allegation of fraud should not be an excuse for such an interruption. Third, payment should be made in accordance with the terms of the credit, notwithstanding the existence of the proven fraud, if a holder in due course or a presenter with similar status makes demand for payment.<sup>37</sup>

Nonetheless, certain questions relating justification of the degree of knowledge of fraud for refusal of payment by the issuing bank and the payment made without knowledge of fraud is protected or not, also the position of negotiating banker is left unanswered.

Apart from this, it is to be noted that although in case of *Maurice O'Meara Co v. National Park Bank*,<sup>38</sup> the question of breach of warranty was involved when the seller shipped inferior quality of newsprint paper, in *Sztejn* case<sup>39</sup> the seller shipped the bales of worthless rubbish material and presented the documents before the bank covering the goods ordered by the buyer and committed the fraud. According to Richard Shaffer, *Maurice O'Meara, Sztejn* case presents a clear distinction between a mere breach of warranty and fraud.<sup>40</sup>

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35 31 N.Y.S.2d 631 (1941).

36 *Ibid.*

37 Ross P. Buckley & Xiang Gao, "The development of the fraud rule in Letter of Credit Law: The Journey so far and the road ahead", U. Pa. J. Int'l Econ. L 663 (2002).

38 (1924) 239 N. Y. 386.

39 *Supra* note 33.

40 Richard Schaffer et.al., *International Law and its Environment* (West Educational Publishing Co., U.S.A., 1999).

However, whenever the question of fraud comes, the courts look into the *Sztejn* rule. This rule has been expressly adopted in English decisions. In *American Accord* case<sup>41</sup>, the sellers were unaware of the fraud committed by the shipping agent by fraudulently dating the bill of lading in order to convey the impression that the goods had been shipped before the expiry of the period specified in the documentary credit. Macatta J, by referring to *Sztejn*'s case observed that the banker is not expected to pay under the letters of credit if he knows that the documents are forged and the request is made by the seller fraudulently.<sup>42</sup>

Similarly, in *Establissement Esezka International Anstalt v. Central Bank of Nigeria*,<sup>43</sup> the bank paid against a set of documents which included a bill of lading and a certificate of origin. It was found that the bill of lading was forged and certificate of origin contained fraudulent misstatements. Hence, the bank refused to make payment. The seller sued the bank for not complying with the letters of credit agreement. The court justified the bank's action and Lord Denning M.R. J observed that in case if the forged and fraudulent documents are presented by the seller in the letters of credit, the banker is justified to refuse payment as a defense.<sup>44</sup>

Therefore, it can be seen that fraud rule of *Sztejn* case has influenced and shaped the fraud exception in all jurisdictions across the world. Even today, the same principle is followed universally. It even got statutorily recognized. Thus, fraud exception was made part of statute in United States.<sup>45</sup> Accordingly, if the letter of credit is fraudulent

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41 *Supra* note 17.

42 *Ibid.*

43 [1979] 1 Lloyd's Rep. 445.

44 *Ibid.*

45 Uniform Commercial Code 1995, article 5- s.109 Fraud and Forgery ;(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and (2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:(1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;(2) a beneficiary, issuer, or nominated person

or forged, the banker is justified to refuse the payment as well as if it was found that there is an existence of fraud in the transactions of underlying sales contract between the buyer and seller, the buyer can restrain banker from making payment. The Uniform Commercial Code article 5 section 9 of the US statute specifies certain factors which the court must consider in order to determine the applicability of fraud exception. These factors include the effect of injunction on the beneficiary, the prohibition of injunction by another law and the availability of a remedy for fraud or forgery against the responsible party.<sup>46</sup>

### III Categories of documentary credit fraud

The peculiar feature of this financial instrument is the guarantee assured by the banker to the seller beneficiary by relying solely on the presentation of complying documents in letters of credit by him. This financial deal between the parties naturally shifts the payment risk from the applicant buyer to the banker and the absolute application of the principle of independence will make them vulnerable to the risk of fraud. Article 5 of the UCP 600 provides that “bank deal with documents not goods or services” which signifies the fact that the banker need not be concerned about the factual position of the sales contract between the buyer and seller for goods. Hence, the seller is not bound to prove the banker that he fulfilled his obligation under the contract in question. He needs to present the bank only the complying documents mentioned in the credit to receive the payment from the bank. Therefore, fraud is considered as the “most controversial and confused area”<sup>47</sup> as it goes to the very heart of documentary credit by obliging the bank to look at the facts being complying presentation and stop payment in cases of fraud in transaction.<sup>48</sup>

#### Fraud to the buyer and fraud to the banker: Distinction

In this type of financial transaction, fraud can take place in different forms. Several times buyers are victims of fraud as well as bankers. In connivance with the seller, buyer can use the channel of bank for the transfer of money without actual sale

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who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;(3) all of the conditions to entitle a person to the relief under the law of this State have been met; and(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1) available at <https://www.law.cornell.edu/ucc/5>(last visited on May 4, 2018).

46 *Ibid.*

47 H.P. Kee, “Fraud in the Transaction: Enjoining Letters of Credit during the Iranian Revolution” *Harvard Law Review* 992 (1980).

48 Buckley, R.P & Gao, X, “The development of the fraud rule in letter of credit law: the journey so far and the road ahead”, *University of Pennsylvania Journal of International Law* 663 (2002).

transactions. This will result in huge loss to the banker. A report published by United Nations' Conference on Trade and Development considers buyers as victims of fraud in letters of credit transactions.<sup>49</sup> Apart from this, it examined the four popular methods of defrauding account parties in international trade. They are falsification of documents by the beneficiary in order to obtain the payment from the issuing bank when no cargo exists in practice, another is when the goods delivered by the beneficiary do not comply with the contract of sales in terms of quantity or quality, selling the same cargo to more than one person and the fourth type is issuing a document of title i.e. bill of lading twice for the same cargo. These are the situations where buyers are becoming victims of fraud.

In another situation, bankers are made victims of fraud in letters of credit transactions. At the initial stage, the fraudsters fabricate patterns of international trade by heavy investments during a few years and precipitate trust relationship with the banker. Later, they will swindle bankers who will focus only on documents and cause to ignore any suspicious transactions. In this situation sometimes, the employees of banks will also support the fraudsters.<sup>50</sup> Each year the fraudsters always try to explore more and more sophisticated new schemes. They are directly responsible either to the buyers or the banks in transactions losing huge amounts of money.<sup>51</sup> The interest of banking institution will get affected because of a loss of defrauded applicant who will go bankrupt, being not able to reimburse the bank. In some cases the applicant and the beneficiary collude together in order to defraud the bank.<sup>52</sup> In both the situations, the banks interest will get threatened. Though, banks can resort to insurance mechanism, they will not get fully reimbursed if the element of fraud and negligence by the banker is proved.

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49 World Investment Report : Transnational Corporations, Agricultural Production and Development, United Nations Conference on Trade and Development, (United Nations, Geneva, 2009) available on [http://www.unctad.org/en/docs/wir2009\\_en.pdf](http://www.unctad.org/en/docs/wir2009_en.pdf) (last visited on May 1, 2018) as cited in *supra* note 11.

50 Ibid. In India for instance the fraud happened in Punjab National Bank by Nirav Modi, "*Nirav Modi Scam: Sebi raps PNB for disclosure lapses in quarterly results*", *Business Standard*, May 18, 2018. available at [http://www.business-standard.com/article/finance/nirav-modi-scam-sebi-raps-pnb-for-disclosure-lapses-in-quarterly-results-118051700632\\_1.html](http://www.business-standard.com/article/finance/nirav-modi-scam-sebi-raps-pnb-for-disclosure-lapses-in-quarterly-results-118051700632_1.html)(last visited on May 18, 2018).

51 Mukundan, Pottengal, "Trade Finance Frauds", speech and material in the 3rd Annual Conference on Letters of Credit, organized by ICC Austria, Vienna, 14 May, 2009 available at <http://www.os.x-pdf.ru/20raznoe/529236-1-publications-the-university-eastern-finland-dissertations-social.php> (last visited on May 3, 2018).

52 Todd P, "Can banks protect themselves against buyers' frauds?", *Documentary Credits Insight* ICC, 15 (1996).

### Frauds through bill of lading

In international trade, bill of lading is the most relied document in letters of credit by the parties involved. It may provide both title to the goods as well as rights to sue under the contract of carriage for the breach.<sup>53</sup> This document is used by fraudsters to commit fraud by non-shipment of goods. A bill of lading will be issued by a known shipping company to the party concerned without actually shipping the goods or by using imaginary names for the carrier and ship. In such cases, the carrying vessel named in the bill may not even exist. Thus for instance, in *Hindley & Co. v. East Indian Produce Co. Ltd.*,<sup>54</sup> the seller in connivance with the shipping company committed the fraud with the help of bill of lading document. The bank after verifying the authenticity of document made payment to the seller. Though the court, remarked over the obligation of the seller, buyer became the victim of fraud. Kerr J., remarked that “If no goods had in fact been shipped, the sellers had not performed their obligation”,<sup>55</sup> the sellers argued that they were not party to the non-shipment of the goods as it is the duty of the shipping company to verify it. However, the court held that the seller cannot avoid his liability to the buyer. The seller has to ship goods of the contractual description. He should tender proper sales, insurance and shipping documents to the buyer and should not indulge in fraudulent activities. In earlier case it was observed that the seller is not concerned with the safe arrival of goods and their subsequent delivery to the buyer. But during initial stage, he should be vigilant.<sup>56</sup>

Another fraud committed through the use of document of bill of lading is the short shipment of goods i.e. by shipping lesser quantity of goods than actually contracted. Though, bill of lading is prima facie evidence of shipment of goods, the onus of proof is on the carrier to show that the goods have not been shipped or goods are shipped in lesser quantity than the order placed with it.<sup>57</sup> Although, it is the subjective satisfaction of shipper, a proof of extreme probability and satisfactory evidence is required in this type of shipment.<sup>58</sup> In this situation also the banker cannot deny payment to the seller beneficiary since the bill of lading presented will be in terms with those mentioned in letters of credit. In this type of fraud also buyer will be the victim when he receives lesser quantity of goods.

Bill of lading fraud is also made by falsification. This is done generally, when goods are shipped late. In such case, the date is often altered to show that shipment had been made in time. Thus, in *Kwei Tek Chao v. British Traders and Shippers Ltd.*,<sup>59</sup> it was proved that

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53 For a discussion, see T.K. Thommen, *Bills of Lading in International Law and Practice*, (Eastern Book Company, Lucknow 1986).

54 [1973] 2 Lloyd's Rep. 515.

55 *Ibid.*, at 518.

56 *Biddle Bros. v. Clemens Horst Co.*, [1911] 1 K.B. 214.

57 *Smith v. Bedouin S.N.Co.*, [1896] A.C. 70

58 *Hain S.S. Co. v. Herdman & Mac Dougall* (1922) 11 Ll.L. Rep. 58.

59 [1954] 2 Q.B. 459.

the bill of lading showed the goods in question was loaded in the ship not within the actual time mentioned in the document but at a later stage. The court held that the bill of lading was forged. Nonetheless, the provision under UCP frees banks from liability or responsibility for the falsification or legal effect of documents.<sup>60</sup> However, this relief may not be enough to avoid all the consequences of fraud.

### **Miscellaneous fraud**

Apart from this, acceptance of time drafts instead of sight drafts will also pave way for commission of documentary credit fraud. On presentation of sight draft, inspection of goods by the buyer is impossible since the bank will make the payment immediately to the beneficiary. Similarly, in some cases the carrier provides the shipper, the agent of beneficiary with a blank copy of the bill of lading long before the shipment is to take place. In such a condition, the risk of fraud will be very high as the beneficiary has access to a blank document of title and without any problem he can fill it up and sign in the name of the carrier's agent.

### **IV Comparative perspective of documentary credit fraud**

In case of documentary credit transactions internationally there is no accepted legal regime to combat fraud risk. Letters of credit transactions are generally, covered under the set of rules developed by International Commercial Practice known as UCP 600. However, it is silent with regard to documentary fraud. Generally, fraud is covered under national rules. Fraud as an exception to the principle of autonomy was first created as a judicial practice in United States<sup>61</sup> Later, it was made part of statutory provision in article 5 of Uniform Commercial Code to prevent the commission of frauds while dealing with this financial instrument. This legislative provision is very significant to deal with the problem in the US as well as valuable for other countries which need to develop provisions for tackling such a problem. The codification of fraud rule in the UCC was far more significant in several respects than the decision in *Sztyjn* would have been by itself. The UCC in a statute clearly told victims of letter of credit fraud that they could effectively protect their interest by using the weapon of the fraud rule. They no longer had to structure their cases using other principles, such as the law of contracts or by saying that the documents were non-conforming. However, neither the code nor its comments gave any hint as to what type of fraud gave the bank an option to pay. This resulted in formulation of a number of standard frauds. Some courts took a strict and restrictive approach and adopted an egregious standard of fraud,<sup>62</sup> while other courts adopted a

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60 The U.C.P. 600, art 34.

61 *Supra* note 35.

62 *International Industries v. Girard Trust Bank*, 336 A.2d 316 (Pa.1975) available at [http://www.leagle.com/decision/1975804461Pa343\\_1748.xml/INTRAWORLD%20IND,%20INC.%20v.%20GIRARD%20TRUST%20BK](http://www.leagle.com/decision/1975804461Pa343_1748.xml/INTRAWORLD%20IND,%20INC.%20v.%20GIRARD%20TRUST%20BK). (last visited on May 6, 2018).

constructive standard of fraud. There is no certainty in fraud standard even though it is recognized statutorily. A task force was setup to study the case laws and make recommendation for the revision. They made several observations regarding the issues of fraud and recommended for the adoption of 'material fraud' as the standard of fraud. Thus the legislation was revised to include this proposition suggested and recommended by the task force. The objectives of the drafting effort to revise present article 5 in UCC were to harmonise the US law with international rules and practices and also to keep flexible enough to accommodate the evolving changes in technology and practices, so that the usefulness and competitiveness of the letters of credit can be maintained and facilitated.

England was a leading commercial and banking center during past centuries which necessitated it to develop internationally affluent letters of credit and the exception of fraud rule has been recognized in a variety of court decisions in England. However, the courts adopted a very rigorous approach to deal with documentary credit frauds. Thus, *R.D. Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd*,<sup>63</sup> is perhaps the first decision which discusses the fraud rule. Though this case was not a case of established fraud, a restrictive view was taken to enable the circumstances in issuing bank to justify refusal to pay. They considered the proof of 'Material misrepresentation' as the standard of fraud in the law governing letters of credit.<sup>64</sup> This shows that they have adopted the position close to that of the United States. However, in United States, the courts give more severity to the effect of the fraud on the transaction rather than the state of fraud of the beneficiary, while in the U.K. the courts require proof of the state of mind of the fraudster. Therefore, it can be seen that in England, four main types of documentary fraud disputes have been identified, where fraud is suspected and alleged. Firstly, the paying bank has not paid; and the letters of credit applicant for injunction order attempting to prohibit the paying bank from paying out under the letters of credit, on the grounds of fraud of the beneficiary.<sup>65</sup> Secondly, the beneficiary has tendered compliant documents, but the paying bank has refused to make payment on the basis of the beneficiary's fraud; the beneficiary sues the paying bank. Thirdly, the paying bank has paid, and sought recovery of payment from the beneficiary because the presented documents are fraudulent. Fourthly, the paying bank has paid, but the issuing bank refused to reimburse on the grounds of fraud; the paying bank sues the issuing bank to seek reimbursement. In

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63 [1977] 2 All.E.R. 862.

64 *United City Merchants (Investments) Ltd v. Royal Bank of Canada*, [1983] 1 A.C. 168.

65 Raymond Jack (1993) *Documentary Credits – The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees*, (Butterworths, London, 1993), see also Connerty Anthony, 'Fraud and Documentary Credits: The Approach of the English Courts', available at <http://www.wwserv.co.uk/anthonyweb/FRAUD%20AND%20DOCUMENTARY%20CREDITS.pdf> (last visited on May 6, 2018).

general, English case law adopted a consistent and strict approach to letters of credit fraud exception rules. Clear principles concerning the fraud exception in letters of credit were established in the late 1970s and these principles guided England in the way of their development.<sup>66</sup>

In Canada, the courts focused on the standard of proof rather than standard of fraud in applying the fraud rule with regard to the documentary credit transactions.<sup>67</sup> They considered whether the rule is confined to cases of forged or fraudulent documents or can it be extended to fraud in the underlying transaction.<sup>68</sup> They addressed this issue in a very simple way. Fraud in Canada means something of 'dishonesty or deceit or clearly untrue or false'. Being a country of English tradition, the Canadian courts traditionally follow the approach of their English counterparts and hence they adopted the standard of common law fraud. Therefore, it can be seen that the position in Canada on the standard of fraud is somewhat confusing or contradictory.<sup>69</sup>

In Australia the fraud rule was considered only in a small number of cases. They recognized two kinds of standard fraud. One is the intentional fraud and the other is the gross equitable fraud. However, it can be seen that while applying the fraud rule by the courts only intentional fraud was accepted and the application of gross equitable fraud was rejected. For instance, in *Olex Focas Pty Ltd. v. Skoda Export Co.*,<sup>70</sup> Bhatt J of the Supreme Court of Victoria observed that only when it is proved that the banker was aware of the fraud at the time of making payment and also in situations where forged document was presented by the seller-beneficiary the fraud rule will be applied. This could have been developed as a major rule for fraud exception and might have adopted universally because of the clarity.

China, after becoming a member of World Trade Organization started to play an important role in international trade. This resulted in the wide use of letters of credit in trading as a payment mechanism at international trade. However, the practice of using the letters of credit in China has not been long. More seriously, most often the trading parties in China have been victims of fraud concerning the letter of credit.<sup>71</sup> The

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66 *Infra* note 70.

67 Stephen Van Houten, "Letters of Credit and Fraud: A Revisionist View", 62 *Canadian Bar Review* 371 (1984).

68 Jeffrey J Browne, "The Fraud Exception to Standby Letters of Credit in Australia", 11 *Bond Law Review* 98 (1999).

69 *Ibid.*

70 (1996) 13 4 F.L.R.331.

71 Yanan Zhang, "Approaches to Resolving International Documentary Letters of Credit Fraud Issue", *University of Eastern Finland* 29 (2011).

72 Presently it is UCP 600.



banking industry in China accepted the UCP principles as international banking practice after the Bank of China adopted the UCP 400 on 1 August 1987.<sup>72</sup> Later, the Supreme Court of China (SPC) issued the Judicial Provisions on some issues in the adjudication of the letter of credit-related cases in 2005, which came into effect in 2006. However, the judicial practice of the provisions and its effective implementations remain an interesting area for research. In China, there is no specific law governing letter of credit. Generally, the principles of contract law is followed and contracting parties are expected to have a general duty of goodfaith in conducting and performing contracts. However, there are no specific provisions concerning the letters of credit in Contract Law 1999. The problem is that in letters of credit transactions, several parties are involved and legal relationships are complicated, which makes the General Principles of the Civil law and Contract law insufficient for handling the letters of credit fraud issue. In China, most provisions in laws are not specific and not ready to be applied in individual cases. The imperfect quality of legislation in general leads the SPC to issue judicial interpretations of statutes, rules, memoranda and specific instructions to local courts. The legitimacy and legal basis of these various documents are doubtful.<sup>73</sup> Thus it can be seen that fraud exceptions in letters of credit are developed mainly through the courts.<sup>74</sup> However, the courts dealt with letters of credit fraud disputes without specific rules and proper legal procedural instruments. The letters of credit fraud exception rules involve and combine three essential rules, they are degree of fraud, the locus of the fraud, and procedural limits on injunctive relief.

Another comparative approach can be taken from the UNCITRAL Convention which is intended to facilitate the use of independent guarantees and stand-by letters of credit.<sup>75</sup> This Convention is the first document which presents details of the fraud rule in letter of credit transactions at an international level. Although this Convention limits its scope to independent undertakings, such as standbys and demand guarantees, it can also apply to international documentary credits. This Convention takes effect between contracting States,<sup>76</sup> and contains several articles dealing with the fraud issue and prevention of fraudulent or unjustified calling of standby letters of credit or independent guarantees. The UCP does not include such rules; and thus the Convention provides positive support to the UCP.<sup>77</sup> Generally speaking, these provisions in this

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73 *Supra* note 71.

74 *Ibid.*

75 Bergsten, Eric E., "A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters", 27 *Int'l Law* 859 (1993).

76 UNCITRAL, art.26.

77 Goode, Roy, *Transnational Commercial Law - International Instruments and Commentary*, (Oxford University Press, Oxford, 2004).

Convention are successful, as this Convention condensed most of the aspects of the fraud rules that have been developed in commercial practice by national courts and/or legislators. More importantly, detailed and useful guidance is given. In particular, there is a list of about what kinds of misconduct could lead to an application of the fraud rule,<sup>78</sup> and there is also a provision indicating that either fraud in the documents or fraud in the underlying transaction could apply to the fraud rule.<sup>79</sup> It is also apparent as to what actions the victims of fraud can take when fraud is clearly taking place. Therefore, it can be viewed that these provisions relating to the fraud rule in this Convention indicate a vital and positive development, and will offer guidance for national courts to exercise the fraud rule. However, these provisions can be criticised as being vague due to the various difficulties of the independent undertaking practice and a better policy might be to leave it to the commercial markets to incorporate existing rules. In brief, the Convention demonstrates a constructive development on letters of credit fraud exception rules at the international level, although the application of such rules may be varied before national courts.

European Union (EU) which seems to have a good record concerning legal assistance over criminal matters assists national authorities in investigating and prosecuting serious cross-border criminal cases which includes documentary frauds. The European Judicial Network which was established in 1998 coordinates the activities of national authorities taking care of a particular case and facilitates collection of evidence under the EU and other international mutual legal assistance agreements.<sup>80</sup> However, mutual legal assistance in the EU in the real world is not without problems, and it was criticised as being time consuming and inefficient, because the mutual relations of the various European criminal agencies, bodies, and institutions are governed only by soft law. The development of mutual legal assistance does not seem to be promising at the international level. It is suggested that in case of documentary credit fraud, international cooperation should go beyond the negotiation of treaties and conventions. There is a need for governments to develop and establish routes for reciprocal assistance from law enforcement agencies, security departments of the banking and financial industries. Apart from this, forensic accounting firms, and law firms should also develop their networks to combat fraud.<sup>81</sup>

### V Documentary credit fraud: Indian perspective

There is no specific law governing letters of credit transactions in India. Generally, they are based on law governing contract and the banks are not regulated by any policy

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78 *Supra* note 74, art. 19, para.1(a)-(c).

79 *Ibid.*

80 *Supra* note 70.

81 *Ibid.*

decisions by the government. The UCP which is universally accepted soft law is followed by the banks in India as a practice and the Reserve Bank of India issues instructions to regulate this credit transactions. Many of the instructions are in conformity with the practice recommended by the International Chamber of Commerce i.e. UCP principles. These principles are made part of the terms of contract with its customer. Moreover, the practice found in India is that every major bank participant has its own training manuals and guidelines to deal with the letters of credit cases. These internal practices will result in creating massive fraud which goes undetected. There is staggering potential for committing massive fraud on the banking system in the form of discounting of letters of credit bill and through accounting systems. This shows the absence of clear supervision over banking related financial scam.<sup>82</sup>

As far as judiciary in India is concerned, no creative role was enacted in this regard. They are hesitant to interfere in cases relating to documentary credit and generally follow the established principles from foreign countries especially the common law. May be they are trying to refrain from interfering with the commercial disputes involving letters of credit considering the commercial utility of the instrument and also because of the banking institutions involved in these transactions.<sup>83</sup> However, the courts have observed that these principles need not be treated as sacrosanct, therefore while deciding the cases involving letters of credit, they have recognized fraud as an exception to the principle of autonomy of the letters of credit again based on English case laws.<sup>84</sup>

Thus in the cases where there is serious dispute between the parties involved and a good prima facie fraud is established the courts interfere,<sup>85</sup> though they blindly follow the English precedents. For instance, Mukherjee J,<sup>86</sup> while deciding the cases involving letters of credit observed as follows:

[A]n irrevocable commitment either in the form of confirmed bank guarantee or irrevocable letter of credit cannot be interfered with except in case of fraud or in case of question of apprehension of irretrievable injustice has been made out. This is well-settled principle of the law in England. This is also a well settled principle of law in India...

The courts in India insist for proof of fraud and a mere allegation of fraud is not sufficient to invoke the fraud exception.<sup>87</sup> They also try to adopt the meaning for “fraud” in

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82 Susmitha P Mallaya, “Banking Practice in Letter of Credit: Need for Regulating Accounting Standards in India”, *Cochin University Law Revive* 33 (2013). Also see an article by the same author *infra* 88.

83 *United Commercial Bank v. Bank of India* (1981) 2 SCC 766.

84 *Hindustan Steelworks Construction Ltd. v. Tarapore & Co.* (1996) 5 SCC 34.

85 *U.P. Co-op Federation Ltd v. Singh Consultants and Engineers (P) Ltd.* (1988) 1 SCC 34.

86 *Ibid.*

87 *General Electric Technical Services Company Inc. v. Punj Sons (P) Ltd.*, AIR 1991 SC 1994.

documentary credit by referring to the definition of fraud in the Indian Contract Act, 1872.<sup>88</sup> The courts make it clear that fraud should be established against the beneficiary which is of an egregious nature and must be established beyond reasonable doubt.<sup>89</sup> A finding as to the commission of fraud cannot be based on mere suspicion. Also, it cannot be based on the basis of mere non supply of goods.<sup>90</sup> Moreover, the courts are inclined to add any additional grounds to the fraud exception. Thus, in *BSES Ltd. v. Fenner India Ltd.*,<sup>91</sup> the court declined to accept the averment that “lack of good faith” or “enforcing with an oblique purpose” as the additional grounds to constitute the fraud rule exception. Hence, the court would examine each case in order to find out whether the case falls within any of the classes relating to fraud rule or not. It can be seen that major hurdle faced in India is regarding the difficulty to produce solid proof of fraud in documentary credit transactions. This paves way for the court to adopt rigid approach to decide the cases dealing with issues relating to documentary credit.

## VI Conclusion

In international trade, though documentary credit can be considered as most reliable financial instrument, its trustworthiness will get eroded in the business community if the fraud transactions are not regulated. Its fair use is beneficial for the economy of a country in general and banking sector in particular. However, the law governing documentary credit, especially, fraud rule is a very confusing area. The soft law regulations in this area make it a tool for fraudsters to indulge in fraudulent activities. On the part of the Government, there is lack of proper regulation and effective policy decisions to address these issues and safeguard the interests of the banks as well as buyers. The UCP guidelines which are followed universally shall be seen as an attempt to restore the balance of equities between the buyer and seller.<sup>92</sup> As per the American Institute of Certified Public Accountants (AICPA), a sound anti-fraud policy needs to be adopted which contains four main measures like prevention, detection, deterrence and response. In tune with this, in India also similar measures can be adopted with the help of Institute of Chartered Accountant, Institute of Cost and Works Accountant of India. There is a need to adopt a strong regulatory mechanism specifically to address these issues of fraud involving documentary credit in banking sector. This can be based on strong policy measures on the part of government for the time being. Later, a

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88 *State Trading Corporation of India Ltd. v. Jainsons Clothing Corporation* (1994) 6 SCC 597; *Ram Chandra Singh v. Savitri Devi* (2003) 8 SCC 319, also see, Susmitha P Mallaya, “An Appraisal of Fraud Rule Exception in Documentary Credit Law with special Emphasis on India”, *KULR* 83 (2016).

89 *Himadri Chemicals Industries Ltd. v. Coal Tar Refining Company*, AIR 2007 SC 2798.

90 *I.T.C. Limited v. Debts Recovery Appellate Tribunal* (1998) 2 SCC 70.

91 A.I.R. 2006 SC1148.

92 Razeen Sapideeen, “International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency”, [2006] *Journal of Business Laws* 133.

special statutory framework needs to be brought in tune with the international law governing these practices. Apart from this, there is a need to organize various workshops and special training programmes for the employees of banks as well as customers who rely on this instrument as part of their business transactions.

Electronic form of this instrument needs to be encouraged with proper cyber safety attached to it. At international level, a new legal framework for the use of electronic transport documents have been made by the international communities which aims to develop methods for claiming transferability of rights and liabilities electronically.<sup>93</sup> In India also there is a need to reform the banking practices and provide special legal framework to meet the technological challenges used to commit documentary fraud by electronic means. The existing provisions in the domestic law which are based on contract law and criminal law are not adequate to address the electronic documentary frauds.

It can be observed from the decisions relating to this area that the courts in India are hesitant to invoke the fraud rule in the documentary credit transactions, mainly because of the sensitivity of this document in the area of financing both national and international trade. However, if proactive role is not adopted, it will result in the growth of fraudulent transactions involved in this area. Therefore, judiciary can take appropriate measures to curb the menace of documentary credit fraud by upholding the reliability of the traders in this instrument for commercial transactions till the time legislative framework gets developed in India.

The recent incidences of bank frauds in India show that the internal practices of the banks result in creation of massive fraud which goes undetected. There is staggering potential for committing massive fraud on the banking system in the form of discounting of letters of credit bill and through accounting systems due to the lack of proper supervision over banking related financial scam. Hence, there is a need for a controlling mechanism in accounting standards of the banking institutions to monitor the misuse of documentary credit which can prevent financial frauds. If ignored, it may, in future, result in insolvency of banking institutions in India as well.

*Susmitha P Mallaya\**

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93 Caslav Pejovic, "Documents of title in Carriage of goods by Sea: Present Status and Possible future directions", [2001] *Journal of Business Law* 461.

\* Assistant Professor, Faculty of Law, University of Delhi. This paper is the extension of the research work undertaken by the author for the award of Ph.D in law by the Cochin University of Science and Technology. The author gratefully acknowledges the review comments received from Upendra Baxi, Professor of Emeritus, University of Delhi and University of Warwick.