

New York Standby and
Guarantee Forum 2018
Recurring Topics:
Abusive Use of Rights to Demand

Basic Rules: UCC 5-109 - Fraud and forgery – Issuer's rights

(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:

...

(2) **The issuer, acting in good faith**, may honor or dishonor the presentation in any other case.

Basic Rules: What is “Good Faith”?

UCC 1-201(20): "Good faith" means **honesty in fact** in the transaction or conduct concerned.

Basic Rules: UCC 5-109 - Fraud and forgery – Applicant's rights

(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 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 paragraph (1) of subsection (a) of this section.

Basic Rules: Clean Letters of Credit and Fraud

“Whether a beneficiary can commit fraud by presenting a draft under a clean letter of credit (one calling only for a draft and no other documents) has been much debated. Under the current formulation it would be **possible but difficult** for there to be fraud in such a presentation. If the applicant were able to show that the beneficiary were committing material fraud on the applicant in the underlying transaction, then payment would facilitate a material fraud by the beneficiary on the applicant and honor could be enjoined. The courts should be **skeptical** of claims of fraud by one who has signed a “suicide” or clean credit and thus granted a beneficiary the right to draw by mere presentation of a draft.”

- N.Y. U.C.C. § 5-109, Official Comment 3.

Basic Rules: 5-109 Exception to Independence Principle

“[C]ourts **must** examine the underlying transaction when there is an allegation of material fraud, for only by examining that transaction can one determine whether a document is fraudulent or the beneficiary has committed fraud and, if so, whether the fraud was material.”

“Material fraud by the beneficiary occurs only when the beneficiary has **no colorable right to expect honor and where there is no basis in fact to support such a right to honor.**”

- N.Y. U.C.C. § 5-109, Official Comment 1.

Case: 3M Co. v. HSBC Bank USA, N.A. (SDNY 4/18)

Clean LC – but Court considered fraud claim anyway

Possible fraud by beneficiary Turkish Post Office not sufficient because:

- (1) Turkish Post Office not the beneficiary of the HSBC LC, but that of a Turkish LC twice removed from HSBC's LC

- (2) Evidence disclosed a possible legitimate basis for draw

Note – TRO remained in effect for 21 months. Judge said he was giving 3M a chance to produce evidence of fraud.

Case: SNC-Lavalin Group, Inc. v. BNP Paribas Canada
2017 Q.C.C.S. 3694 [Canada – Quebec Superior Court]

To obtain interlocutory injunction, applicant needs to establish a
“strong prima facie case of fraud”

“Disagreeing on the interpretation of the underlying agreement is not proof of serious prima facie case of fraud”.

Applicant claimed that the payment demands made by Beneficiary were tantamount to fraud because no default under the contract.

Held: Dispute over the interpretation of underlying contract did not amount to fraud. Interlocutory injunction denied.

Case: Societe Anonyme Marocain de l'Industrie du Raffinage v. Bank of America N.A., 2016 NY Slip Op 50127(U) (Sup. Ct., N.Y. Co.)

Possible example of “good faith” dishonor due to internal knowledge of fraud. Bank had already paid \$37 million invoice for oil in lieu of draw on LC at customer’s direction; payment was supposed to reduce \$45 million LC, but bank did not expressly refer to the LC when it paid Petraco. Petraco later came back with the same invoice and presented it against the LC. Bank had internal knowledge that the invoice had been paid and therefore was able to say from its own knowledge that the draw, which had to certify that the invoice was unpaid, was false.

Had the bank paid anyway, would that have been in good faith?

Case: American Express Bank Ltd. v. Banco Espanol de Credito, S.A., 597 F. Supp. 2d 394 (S.D.N.Y. 2009)

LC (“demand guarantee”) issued in Pakistan, counterguarantee by Banesto. Draw in Pakistan; demand on Banesto for reimbursement, but no one paid anyone. Arbitral panel ruled that Pakistan beneficiary should withdraw its call on Pakistan LC but Pakistan beneficiary did not and instead sued to overturn award and sued Pakistan issuer for dishonor.

Held: Bad faith for issuer to demand reimbursement because issuer had no duty to pay beneficiary due to arbitration award, even though it was literally true that a demand had been made on issuer, triggering right to demand reimbursement. Conversely, presumably, good faith for Banesto to refuse to pay.

Is this the same good faith standard that would apply under 1-201(20)? Does bad faith draw constitute fraud?