Shipping & International Trade

Court Rejects Bank's Claim for the Recovery of Monies Paid Under a Letter of Credit on the Basis of Fraud

Introduction

The recent collapse of major oil traders in Singapore has resulted in a slew of litigation proceedings commenced by banks seeking to recover monies paid to beneficiaries under letters of credit. In *Credit Agricole Corporate & Investment Bank, Singapore Branch v PPT Energy Trading Co Ltd* [2022] SGHC(I) 1 ("***Credit Agricole***"), the Singapore International Commercial Court ("**SICC**") upheld the independence principle in respect of letters of credit, applying a strict formulation of the fraud exception expounded in *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168, i.e. that a bank is only entitled to refuse payment out under letters of credit where the beneficiary acts dishonestly, as opposed to recklessly, in the presentation of documents for payment.

Material Facts

The litigation arose in connection with a letter of credit ("**LC**") issued on 3 April 2020 by the plaintiff bank ("**Bank**") on the application of the Bank's customer ("**Zenrock**"), in favour of the defendant beneficiary ("**PPT**"), for the purchase of crude oil ("**Cargo**") by Zenrock from PPT.

To support its application, Zenrock provided the Bank with its contract with PPT ("**PPT Contract**") and a fabricated copy of its on-sale contract ("**Fabricated TOTSA Contract**") with Total Oil Trading SA ("**TOTSA**"). Zenrock purported to assign the receivables under the Fabricated TOTSA Contract to the Bank. The Fabricated TOTSA Contract reflected an inflated on-sale price to TOTSA, as compared to the price under the true terms of the TOTSA sale ("**True TOTSA Contract**"). This gave the impression that the receivables under the Fabricated TOTSA Contract would cover the PPT Contract purchase price to be paid out under the LC.

Unbeknownst to the Bank at the time:

(a) The PPT Contract was part of a round-tripping transaction under which Zenrock sold to Shandong Energy International (Singapore) Pte Ltd ("**Shandong**"), which sold to PPT, before Zenrock purchased the Cargo back from PPT and "on-sold" the Cargo under the Fabricated TOTSA Contract. Expert evidence showed that the prices under the round-tripping contract were about US$10 per barrel higher than the market price at the material time.

(b) The round-tripping transaction was built upon an underlying transaction where Zenrock purchased the Cargo from SOCAR Trading SA ("**SOCAR**") and on-sold the Cargo to TOTSA under the True TOTSA Contract. The receivables under the True TOTSA Contract had been assigned to ING Bank, which had financed the purchase from SOCAR.

The LC required presentation of *inter alia* original bills of lading and other shipping documents relating to the Cargo. However, as is not uncommon, the LC allowed the presentation of a letter of indemnity ("**LOI**") addressed to the Bank "*for account of*" Zenrock in lieu of shipping documents where original bills were unavailable. The relevant terms of the LOI (which was governed by English law) are as follows:

> "*To date we are unable to provide you with the requisite shipping documents… which consist of… [original bills of lading endorsed to the Bank].*
>
> *In consideration of your making payment of the full invoiced price of USD23,662,732.50… for the shipment at the due date for payment under the terms of the above contract without having been provided with the above documents, we hereby expressly warrant that at the time property passed under the contract we had marketable title to such shipment, free and clear of any lien or encumbrance, and that we had full right and authority to transfer such title to you, and that we are entitled to receive these documents from our supplier and transfer them to you.*
>
> *We further agree to protect, indemnify and save you harmless from and against any and all damages, costs and expenses (including reasonable legal fees) which you may suffer or incur by reason of the original bills of lading and other documents remaining outstanding or breach of warranties given above …*"

PPT presented its signed commercial invoice and LOI under the LC on 16 April 2020. Around the same time, the Bank became aware of the double-assignment of receivables by Zenrock and its fabrication of the TOTSA sale terms. The Bank did not reject PPT's presentation as non-compliant within the five-banking day period (i.e. by 23 April 2020) stipulated under Article 14(a) of the UCP 600 (incorporated by reference into the LC). However, the Bank subsequently refused to make payment under the LC, having obtained an *ex parte* interim injunction from the High Court on 28 May 2020, prior to the due date for payment on 5 June 2020.

The Bank commenced proceedings against PPT seeking a declaration *inter alia* that (i) PPT was not entitled to receive any sums under the LC, and/or that (ii) PPT was in breach of the terms of the LOI and liable to pay damages equivalent to the sums payable by the Bank under the LC.

Decision of the Singapore International Commercial Court

Ambit of fraud exception in relation to letters of credit

On the ambit of the fraud exception in relation to letters of credit, the Court held that:

(a) In the absence of fraud, letters of credit must be honoured by the issuing bank if the terms of the letter of credit are satisfied on the basis of the documents presented for payment, without regard to anything else; the fraud in question must relate to the documents presented under the letter of credit rather than the underlying sale contract.

(b) Proof of dishonesty is the key to relying on the fraud exception in relation to letters of credit. A beneficiary acts dishonestly if it presents otherwise facially compliant documents either with the knowledge that what is contained therein is false, or without belief that what is contained therein is true.

(c) A reckless failure on the part of the beneficiary to ascertain the truth of the representations contained in the presented documents, which are made in the honest belief that they are true, will not amount to fraud sufficient to vitiate a demand for payment under a letter of credit.

Therefore, to succeed on its claim, the Bank would have to establish that PPT had acted dishonestly and intended to participate in the fraud which Zenrock perpetrated on the Bank, by showing that PPT knew that the purpose of the round-tripping transactions was to effect a fraud on the Bank and/or that Zenrock intended to defraud the Bank; it would not be enough to simply show that PPT was reckless in not enquiring into the purpose of the round-tripping transactions. In this regard, it is critical to bear in mind the basis of the fraud alleged by the Bank: (i) the double-assignment of the proceeds of the sale to TOTSA (both to ING and the Bank); and (ii) the deliberately inflated price of the Cargo stated under the PPT Contract and the Fabricated TOTSA Contract (to make the Bank disburse greater sums than it would have otherwise done if the prices had been correctly stated).

PPT's knowledge of the round-tripping transactions

Although PPT was hardly an "innocent bystander", the Court nevertheless found that PPT was not dishonest. While the Court found that PPT knew that Zenrock was engaged in round-tripping transactions, this did not mean that PPT was a participant in Zenrock's fraud nor could it be said that PPT had actual knowledge of, or was wilfully blind to, the fact that the round-tripping transactions were part of a fraudulent scheme. Critically, the Court found that PPT had no knowledge of either the double-assignment or the deliberate price-inflation, both of which were central elements of the fraud as alleged by the Bank.

The Court also rejected the Bank's argument that PPT ought to have made enquiries in light of its knowledge of the round-tripping nature of the transactions, citing *DBS Bank Ltd v Carrier Singapore (Pte) Ltd* [2008] 3 SLR(R) 261 for the proposition that a beneficiary under a letter of credit owes no duty of care to the issuing bank in presenting documents for payment. In light of this, the Court reasoned that the absence of any enquiry to ascertain what lay behind the round-tripping and other unusual features in the transaction, could not amount to dishonesty. Similarly, dishonesty could not be inferred simply from PPT's knowledge of the foregoing features.

The round-tripping transactions were not sham transactions

The Bank had also argued that the transactions were sham transactions because there was no intention that property in the Cargo should ever pass under PPT and that they were financing transactions only, of which PPT was well aware. The Court disagreed and held that the transactions were genuine sale and purchase transactions, notwithstanding the fact that they were round-tripping transactions:

(a) In order for a transaction to be a "sham", it is necessary for all parties to that transaction to have a common subjective intention that the transaction documents are not intended to create the legal rights and obligations which they give the appearance of creating. What is required for a sham is a finding that the parties to the sham were dishonest in creating a pretence of a transaction in order to deceive others when there was in reality no such transaction.

(b) On the facts of the case, the transaction documents, particularly the deal recaps and sale contracts, showed that the parties in the series of transactions intended to enter into real sale and purchase transactions.

(c) The motive and/or purpose for the transaction is not in itself determinative of whether or not the transaction is a sham; accordingly, whether or not the round tripping transactions were concluded for the purpose of securing funds for Zenrock did not change the fact that they were genuine sales and purchases.

Accordingly, as the round-tripping transactions (including the PPT Contract) were genuine sale and purchase transactions, and there was no evidence that any of the traders in the chain did not intend property to pass in the Cargo, the Court found that the transactions were not shams.

Nature of the LOI

The Court also held that since the Bank failed to make payment to PPT on the due date (5 June 2020), the warranties contained in the LOI did not apply. The Court also rejected the application of the indemnity

for the same reason. In any event, the Court held that PPT had not breached the warranties in the LOI and that the Bank would not have suffered any losses covered by the indemnity in the LOI.

Commentary

As can be seen, the SICC's decision above sets a high watermark for the burden which banks have to bear in seeking to refuse payment where a facially compliant presentation is made under an LC. That having been said, a bank which is constrained to pay under an LC is not necessarily without other remedies. For instance, the bank may, after paying under the LC, potentially seek to recover such payment from the beneficiary, i.e. to "pay first, sue later". In *Bank of China Ltd, Singapore Branch v BP Singapore Pte Ltd* [2021] SGHC 120 – which was not referred to in the SICC Judgment – the General Division of the High Court held that there was arguably a distinction in the applicability of negligent misrepresentation (as a cause of action) in actions concerning refusal of payment under an LC and actions concerning recovery of payment already made under an LC. In the latter, it remains an open question whether a duty of care can be imposed on an LC beneficiary, in actions by the issuing bank to recover payment made. It is also worth noting that much will also depend on the precise nature of the fraud being alleged against the applicant and beneficiary.

This case therefore highlights the difficulty which banks, who have been defrauded by their customers, face in attempting to recoup their losses from parties in the underlying sale transactions. It is therefore important for banks to conduct proper due diligence on their customers. This decision also underscores the importance of banks acting promptly and serving notices of assignments as soon as possible, which might buy sufficient time for a bank to uncover the fraudulent scheme and to consider its courses of action.

Finally, the decision brings to light the potential pitfalls in refusing to make payment under the letter of credit against the beneficiary's LOI when a bank suspects foul play. The consequence of being unable to rely on the warranties and/or indemnities contained in the LOI can be severe, as demonstrated in this case. It is therefore important for banks to carefully scrutinize the wording of the LOI before agreeing to issue a letter of credit allowing for the presentation of LOIs in lieu of original bills of lading.

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