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STANDBY LETTERS OF CREDIT AND THE FRAUD EXCEPTION: AN UPDATE

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1. Introduction

In my 1999 article on standby letters of credit¹, I noted that the use of standby credits in Canada was very recent, and the case law accordingly somewhat undeveloped². It is therefore appropriate to review, on a periodic basis, the progress of the development of the law with respect to standby credits.

The standby credit continues to be put to a wide range of uses, and the number of cases over the last three years that refer to the words “letter of credit” is huge. Most of these cases simply refer to a particular use of a letter of credit (eg. as security for costs in litigation or as a method of “bonding off” construction liens). But there have been numerous cases concerning the law of letters of credit, both standby and documentary. The issue that is raised in most cases concerning letters of credit, and the issue on which I will concentrate in this article, is the fraud exception to the obligation of the issuer to pay under a letter of credit on demand by the beneficiary. In this article, I propose to review some of the recent cases, with a view to seeing how the law is developing and how some overriding themes are being dealt with by the courts.

2. Overview

I do not propose here to review again the law respecting the principle of autonomy of letters of credit and the fraud exception thereto – I refer you to my previous article. To summarize some of the material law in Canada, in *Angelica-Whitewear*, the Supreme Court of Canada settled the following with respect to the fraud exception:

- (1) the exception applies to both cases of fraud in the tendered documents and “fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one”;
- (2) the fraud exception should not extend to fraud by a third party of which the beneficiary is innocent;³
- (3) on an application for an interlocutory injunction to restrain payment under a letter of credit because of alleged fraud, the standard to be met by the applicant is a strong

prima facie case of fraud; and

- (4) in an action for damages brought against an issuer for paying or not paying on a letter of credit after fraud was brought to the issuer's attention, the standard to be met by the issuer is whether fraud "was so established to the knowledge of the [issuer] before payment of the draft as to make the fraud clear or obvious to the [issuer]."

In this article, I will review recent cases on the following issues:

- (1) what is the standard to be met when an issuer or an applicant sues the beneficiary for the return of monies paid under a letter of credit, when the issuer or the applicant alleges after the payment is made that fraud existed?
- (2) the meaning of "fraud" for purposes of these cases;
- (3) the review by the issuer of fraud alleged by the applicant before payment to the beneficiary; and
- (4) the standard on an injunction.

While reviewing these cases, three over-riding themes will be developed:

- (1) what is and should be the approach of the courts to letter of credit cases?
- (2) are we seeing the development of standby credit law that is different from documentary credit law?⁴
- (3) is the fraud exception becoming too broad?

3. Recent Cases

- (1) *Lac du Bonnet (Rural Municipality) v. Lee River Estates Ltd.*⁵

The first case I want to look at is a very simple one, but it serves to illustrate how important the approach to a letter of credit case is to a correct decision.

Facts

The parties to this action entered into a development agreement relating to the development of a cottage lot subdivision by Lee River Estates Ltd. ("Lee River") within the municipality. Pursuant to the development agreement, Lee River provided a letter of credit to secure its obligations under the agreement.

The letter of credit was two paragraphs long. The second paragraph stated as follows:

"The municipality may call upon it in whole or in part by written demand signed by the secretary-treasure [sic]. The letter of credit is renewed from year to year unless the Credit Union gives 30 days advance notice of its intention not to renew. The expiry date will be September 1, 1993."

The municipality demanded payment on the letter of credit and, subsequently, the applicant (Lee River) indicated it was contesting the calling of the credit. The issuer (Astra Credit Union) refused to pay. The municipality commenced these proceedings against Lee River for a declaration that it was entitled to payment under the letter of credit.

Decision and Discussion

Lee River argued that it was not in default under the development agreement and, therefore, the municipality was not entitled to call the letter of credit. The court noted in some detail⁶ the principle of autonomy of letters of credit and stated that "[i]f Lee River takes the position that the [municipality] is not entitled to retain the funds payable under the letter of credit, then its proper recourse is to commence proceedings against the [municipality] for damages for breach of contract, not to attempt to stop payment under the letter of credit"⁷. The court also stated that "while the right to call the letter of credit arises on Lee River failing to comply with the contract, payment under the letter of credit is not dependent on the [municipality] proving that non-compliance"⁸. The court accordingly concluded that "all of the arguments raised by Lee River that relate to the performance and/or default under the development agreement are irrelevant to the issue of Astra's obligation to pay under the letter of credit"⁹ and declared that the municipality had the authority to call the letter of credit.

Note the approach of the court in this case. The full text of the credit is set out. The court examines in some detail the law relating to letters of credit and the autonomy principle. The court

does not dwell on the circumstances that existed between the applicant and the beneficiary. In particular, it does not spend any time examining whether, in fact, there was any default under the development agreement that would entitle the municipality to call under the letter of credit. Given the terms of the credit and the principle of autonomy, any such examination is not fruitful. The action was brought simply on the letter of credit, and not under the development agreement. The wording of the letter of credit was very clear - it was payable simply on demand, with no other requirements. In the circumstances, absent any evidence of fraud (which does not appear to have been alleged), the court had a very simple question to answer: did the demand meet the documentary requirements set out in the letter of credit? Since it did, then the beneficiary was entitled to be paid.

(2) *Royal Bank v. Genra Canada Investments Inc.*¹⁰

This case involved questions that Canadian courts have not yet definitively answered: can the issuer sue for repayment of monies paid by it under a letter of credit on the basis that the demand on the credit was fraudulent (of which fraud the issuer learns only after payment) and, if it can, what is the standard of proof of fraud to be met by the issuer?

Facts

The issuer, Royal Bank, sought recovery from the beneficiary of over \$2 million paid out pursuant to a letter of credit in favour of Genra Canada Investments Inc. ("Genra"). The letter of credit was issued at the request of Landawn Shopping Centres Limited ("Landawn").

Landawn, a real estate developer, had obtained construction financing for a retail shopping plaza project in Oakville from Royal Bank in 1988. Genra (then Royal Trust Corporation of Canada) agreed with Landawn to take out Royal Bank's construction financing with a term loan. The initial advance under the term loan was \$24,350,000, and Royal Bank subordinated its security on the Oakville property to Genra's security. In addition to a first mortgage on the land, Genra required Landawn to deliver a letter of credit in the initial amount of \$8,700,000. The letter of credit was stated in the commitment letter between Landawn and Genra, "in addition to protecting the lender against interest rate fluctuations and the remaining costs to complete the Project, [to] also serve as security for 10% holdbacks as provided in the *Construction Lien Act*".¹¹

The letter of credit was to be reduced/released in two stages. There was to be a \$1,700,000 reduction upon the borrower selecting a fixed interest rate for a minimum term of 5 years, attaining a debt service coverage ratio of no less than 115% and attaining release of all 10% holdbacks for deficiencies in the finishings provided under the *Construction Lien Act*. A further reduction of \$7,000,000 (that is, the balance of the letter of credit), or such reduced amount as was based on a cost to complete report from the lender's cost consultant, was to be granted at the expiry of 45 days after the date on which a copy of the certificate by the project architect of substantial completion for the project was published in accordance with the *Construction Lien Act*. Partial releases based on the then remaining cost to complete were to be permitted based on architect's certificate of completion, verified by the cost consultant.

Under the mortgage that secured the Gentra loan, upon the occurrence of a default, the mortgagee (Gentra) was entitled to accelerate the loan and exercise any and all of its rights under the mortgage, the other security and the commitment or any other rights available to it, including demand for payment of the letter of credit.

Gentra later confirmed that, as the interest rate for the loan had been fixed, the letter of credit would not be required to serve as security against rate fluctuations, although it would serve to protect Gentra against debt servicing risk.

The letter of credit was originally issued by Royal Bank on November 30, 1988 in the amount of \$7,917,880 (a sum less than originally agreed upon because of construction progress up to that date). The letter of credit provided as follows:

“Provided, however, that you [Gentra] are to deliver to the Royal Bank... as at such time as a written demand for payment is made upon us, a letter confirming that monies drawn pursuant to this Letter of Credit are due and payable in accordance with the terms of a Loan Commitment dated October 21, 1988 made between our said customer [Landawn] and Royal Trust Corporation of Canada [Gentra].”¹².

The court did not set out the entire letter of credit in its reasons, and did not state whether the letter of credit referred to the Uniform Customs and Practice for Documentary Credits (the “UCP”).

From time to time after its issuance, the letter of credit was renewed to extend the expiry date and

was reduced in amount as construction progressed, down to the amount of \$2,160,907 as at November 10, 1989. Construction of the project was substantially completed by the end of 1989 and all construction lien holdbacks were released by April 1990.

In 1991, Landawn and Gentra entered into a cross-collateralization agreement whereby Landawn agreed that the security that it had given for the Oakville project would also secure another project in Etobicoke known as the Queen's Plate project, with respect to which Gentra had also lent money to Landawn.

By early 1993, Landawn was in default under both the Oakville and Queen's Plate project loans with Gentra. By letter dated July 27, 1993, Gentra made demand on Royal Bank under the letter of credit for payment of \$2,160,907. The demand contained the required sentence by Gentra, whereby Gentra confirmed that the monies to be drawn were due and payable in accordance with the loan commitment relating to the Oakville project.

Royal Bank paid the demanded amount to Gentra, but later determined that, as at the date of demand, no amounts were due or payable by Landawn to Gentra on account of interest rate fluctuations, cost to complete the Oakville project or construction lien holdbacks for the Oakville project. In fact, Gentra applied the payment paid by Royal Bank under the letter of credit to Landawn's indebtedness to Gentra on the Queen's Plate project. Royal Bank objected to the call on the letter of credit by correspondence dated August 6, 1993 to Gentra.

On September 15, 1993, Landawn filed for protection under the provisions of the *Companies' Creditors Arrangement Act* (Canada).¹³ The CCAA plan was approved by Landawn's creditors on March 10, 1994 and sanctioned by the court on March 31, 1994. As part of the CCAA plan, title to both the Oakville property and the Queen's Plate property was vested in Gentra in partial satisfaction of Landawn's debt to Gentra. Royal Bank recovered nothing on the Oakville project and it alleged that, if Gentra had applied the proceeds of the drawdown under the letter of credit to its loan secured by the Oakville property, the value of the Oakville property may have been enough to repay the balance of the Gentra debt and there may have been surplus to which Royal Bank may have been entitled. The bank alleged that the cross-collateralization agreement amounted to an amendment to the letter of credit to which the bank did not consent and that the call on the letter of credit by Gentra for purposes entirely different than that set out in the commitment constituted

fraud.¹⁴

Trial Decision and Discussion

As stated above, the primary issues in this case were:

1. Is the issuer entitled to sue the beneficiary for the repayment of the money?
2. What is the standard to be met by the issuer in proving fraud by the beneficiary in an action for repayment of monies drawn under a credit?
3. Had the issuer met this standard and proven fraud by the beneficiary?

The court did not set out the issues that it thought needed to be resolved in this case. After disposing of a *res judicata* argument by the beneficiary, the court began its analysis where most courts do in a case involving an allegation of fraud on a letter of credit: with a discussion of the principle of autonomy of letters of credit. The court quoted from *Angelica-Whitewear*. It noted that the letter of credit itself set out the principle, when it stated that the bank would pay “without enquiring whether you have a right as between yourself and our said customer to make such demand”.

The court continued by noting that “the only exception to the independent nature of an issuing bank’s obligation to the beneficiary of a letter of credit is fraud.” The court again quoted from *Angelica-Whitewear*.

The court then stated:

“What is usually contemplated within the fraud exception is fraud perpetrated by a beneficiary upon the customer of the issuing bank, whereas the fraud that is alleged in the instant case is said to be that of the beneficiary and the customer against the issuer of the letter of credit.”¹⁵

This statement by the court apparently stemmed from an argument of the beneficiary, that “there can be no such fraud [by the beneficiary against the issuer] in theory and that there has been no such fraud in fact”. However, there does not appear to be any distinction made in the case law between fraud on the applicant and fraud on the issuer. Just before this statement by the court, the court had cited *Angelica-Whitewear* to the effect that there is no distinction between fraud in the tendered documents and fraud in the underlying transaction.¹⁶ Fraud in the tendered documents could be construed as fraud on the issuer, while fraud in the underlying transaction presumably would be

fraud perpetrated on the applicant. In any event, it is difficult to think of why such a distinction is useful. If the beneficiary is fraudulently attempting to drawdown on the letter of credit, does it matter who it is attempting to defraud? Given that:

1. the fraud is usually perpetrated by a presentation of false documents to the issuer of the credit, which false documents (especially in the case of standby credits) often contain (false) representations by the beneficiary to the issuer¹⁷ to the effect that the beneficiary is entitled to make demand; and

2. a definition of “fraud” cited by the Supreme Court of Canada¹⁸ is “a false representation of fact, made with a knowledge of its falsehood, or recklessly, without belief in its truth, with the intention that it be acted upon by the complaining party, and actually inducing him to act upon it”,

it would seem that most fraud in these cases is being perpetrated against the issuer.¹⁹

The bank responded to this argument by alleging that *Gentra*, the beneficiary under the letter of credit, had committed fraud by demanding under the letter of credit when there was no amount due and owing under the Oakville loan. The bank’s position was that it did not matter, and did not weaken the principle of autonomy, if the fraud was perpetrated on the issuer or the applicant. In support of this position, the bank cited the English case of *Bank Russo-Iran v. Gordon Woodruffe & Co.*,²⁰ where the court stated that a bank is entitled to refuse payment if it learns of fraud before making the payment and can sue the beneficiary for the money back if it learns of the fraud after payment.

This passage is really answering the first issue raised above, is the bank entitled to sue the beneficiary for the money back? The *Bank Russo-Iran* case apparently says yes and, as the court pointed out in the *Gentra* case, this passage from the *Bank Russo-Iran* case was quoted by the Supreme Court of Canada in *Angelica-Whitewear*.²¹ Further, as stated in my previous article,²² the courts in Ontario have already agreed with the principle that the issuer can recover monies from the beneficiary that are paid as a result of a demand wrongly made by the beneficiary.²³ Although the court quotes the *Bank Russo-Iran* case on this issue, it does not state whether it agrees with it or not. Further, the court at this point does not decide whether or not there can be fraud by the beneficiary on the issuer.

Rather, the court then moves on to examine whether there was fraud. At this point, the second

issue raised above becomes pertinent, what standard must the issuer meet to prove fraud? As outlined above, in *Angelica-Whitewear*, the Supreme Court of Canada distinguished between two types of cases, first, an application for an interlocutory injunction and, second, an action for damages in a case where the issuer has paid or not paid after having the fraud issue raised to it. These guidelines do not assist in this case, where the issuer has paid before learning of any fraud. This case is really an ordinary case of fraud: the person defrauded is suing the fraudster to get their money back. It therefore appears that the ordinary civil fraud standard applies: the onus is on the plaintiff to prove fraud on a balance of probabilities, and fraud must be clearly and distinctly proved.²⁴

The court does not address this standard issue. It moves directly into an examination of the parties' respective positions on whether fraud existed in this case. As stated above, the bank's position was that fraud had taken place "because there were, in fact, no monies due and payable in accordance with the terms of the Commitment letter dated October 21, 1988 to the knowledge of the beneficiary".²⁵ This tracks the wording of the letter of credit. The bank's position appears to be factually correct. Although the court does not analyze the wording of the letter of credit in any great detail, some care does appear to have been taken in drafting that wording. To repeat, the letter of credit stated that monies could be drawn thereunder "[p]rovided... that you [Gentra] ... deliver to the Royal Bank... a letter confirming that monies drawn pursuant to this Letter of Credit are due and payable in accordance with the terms of [the] Loan Commitment". The commitment provided that the letter of credit secured certain obligations, not all obligations of the borrower. Therefore, the phrase "are due and payable *in accordance with*" the commitment appears to be an attempt to specify that the monies drawn down must be payable in accordance with the provisions of the commitment, that is for the specific reasons set out in the commitment. At the time of demand under the letter of credit, it appears that no amounts were outstanding with respect to interest rate fluctuations, costs to complete the project or construction holdbacks. Gentra had confirmed that interest fluctuations were no longer a concern, and that the letter of credit instead would also secure "debt servicing". This would usually mean interest payable on the loan, so assuming that Gentra's "confirmation" of this change in the commitment was binding on the borrower/applicant, Gentra could argue that some debt servicing was unpaid. However, as counsel for the bank pointed out, all of this was irrelevant anyway, since in making demand under the letter of credit, Gentra intended to apply the proceeds to the Queen's Plate loan and not the Oakville loan.

The court began its analysis of the application of the law to these facts and allegations with the

following statement:

“The exception for fraud to the autonomy of letters of credit must be narrowly construed lest it risk depriving the letter of credit of its autonomous nature. Thus, a demand for payment is only fraudulent if the claim to the funds is not even colourable as being valid or has absolutely no basis in fact.”²⁶

The court then quoted the description of fraud given by Blair J. in *Cineplex Odeon Corp. v. 100 Bloor West General Partner Inc.*²⁷, most of which is quoted in my previous article²⁸, and which quote ends:

“Cases where the demand on the letter of credit can be said to be “clearly untrue or false”, or “utterly without justification”, or where it is apparent there is “no right to payment”, all fall within the foregoing principles and must be read in the context of those “fraud” principles”.

The court then examined the basis for the call on the credit made by Gentra. It found that “the Letter of Credit was not intended to stand as general security for Landawn’s obligations to Gentra under the mortgage”.²⁹ Further, “Gentra never considered that there was a basis for making the call on the Letter of Credit in respect of the specific purposes set out in the Commitment in respect of the Oakville property. Rather, Gentra’s purpose and intent in making the call on the Letter of Credit was to obtain the money and apply it against the Queen’s Plate debt”.³⁰

The court also found that the bank never consented to an amendment adding the letter of credit to the security package for the Queen’s Plate project, ie. to the cross-collateralization agreement.³¹ The court found that there were valid, though technical, reasons for Gentra to drawdown on the letter of credit, namely that the debt service coverage ratio was never met and the certificate of substantial completion for the Oakville project was never published in accordance with the *Construction Lien Act*. Further, the commitment was silent on how or for what amount a draw under the letter of credit could be made on these bases, thus implying that a call for the entire amount of the credit was not prohibited. In addition, the court noted that the beneficiary had obtained a legal opinion prior to draw down, that it was proper to demand under the credit. The court concluded that “because a call could be made for these purposes, quite apart from the Cross-Collateralization Agreement, it cannot be said that there has been any fraud on the issuing bank”.³²

The court then went further and said that “whatever the intention of Gentra and Landawn may have been [in entering into the Cross-Collateralization Agreement and applying the monies to the Queen’s Plate project] the call on the Letter of Credit was proper from a documentary point of view and the application of the funds by Gentra is immaterial”.³³ The next paragraph in the decision of the court is troublesome. The court states:

“The Letter of Credit did not require the beneficiary to verify or attest to the accuracy of the call documents. It simply required Gentra to present the call documents in accord with the Letter of Credit and that was done. It was not a condition precedent that the content of the call documents be true and RBC specifically agreed not to enquire into the underlying transaction.”³⁴

After citing an American case and the UCP relating to the relationship between the commitment and the letter of credit the court continued:

“If the issuer wishes to qualify its letter of credit and tie its obligation to make payment to the occurrence of specific events or performance of certain contracts, it must do so by express language. In the instant case, the Letter of Credit does not require as a condition precedent to payment that monies actually be due and payable in accordance with the Commitment dated October 21, 1988. Rather, all the Letter of Credit calls for is a mere statement to this effect.”³⁵

This would appear to be carrying the autonomy principle too far. In reviewing the call documents under a letter of credit (ie. the demand under the letter of credit by the beneficiary), the issuer of the letter of credit is entitled to rely on the truth of the statements made in those documents.³⁶ If the beneficiary must only provide a document that says “I am entitled to the monies as they are due and owing under a commitment”, but such statement need not be true, then the beneficiary is essentially being invited to defraud the issuer and the applicant without any consequences insofar as the issuer is concerned. Is this the law? The court stated that “[i]t was not a condition precedent [to the obligation of the issuer to pay under the letter of credit] that the content of the call documents be true and [the issuer] specifically agreed not to enquire into the underlying transaction”.³⁷ However, there is a distinction between the underlying transaction and the truth of the call documents. Although the issuer may have agreed not to enquire into the underlying transaction, it was certainly

entitled to rely on the content of the call documents being true. In fact, if the issuer receives notice prior to payment that the call documents are not true, then the issuer may be entitled to refuse to pay if the false statements constitute fraud.³⁸ So it is a condition precedent to the obligation of the issuer to pay on demand under a credit that it have no knowledge that the call documents are fraudulent (that is, false). Further, the fact that the issuer agreed in the credit not to enquire into the underlying transaction does not mean that the issuer must pay even if it has knowledge of fraud.³⁹

The court concluded, in short, that “there has been no fraud on the customer; and although it would be inimical to the nature of documentary credits to speak of fraud on the issuer, no such fraud, in any event, has been established here.”⁴⁰

The court also stated that the bank could not recover the monies paid on the basis of mistake, as “[r]elief for monies paid under mistake of fact is not provided for in equity where the party paying has waived all enquiry into the fact in issue”.⁴¹ Further, the bank could not claim unjust enrichment, as there had been no deprivation to the bank, which should reasonably have expected when it issued the letter of credit that a call on the credit could be made.⁴²

Court of Appeal Decision and Discussion

The bank appealed. The Court of Appeal dismissed the appeal. On the fraud issue, the Court of Appeal had three problems with the bank’s submission. First, the court stated that “[a]n allegation of fraud is a very serious matter. A party making such a serious allegation faces a very high hurdle”.⁴³ The bank submitted that the trial judge’s definition of a claim being fraudulent only if it is “not even colourable as being valid or has absolutely no basis in fact” was too high and that the correct definition was that found in *Derry v. Peek*⁴⁴. That case required, in the context of a representation, that for such representation to be fraudulent, it must be made knowingly, without an honest belief in its truth, or recklessly or carelessly whether it be true or false. The Court of Appeal, taking into specific consideration that Gentra had consulted two law firms to confirm that it could draw down on the letter of credit,⁴⁵ found that “it is simply unrealistic and unfair to seriously consider that its conduct was deserving of the labels ‘dishonest’ or ‘reckless’.”⁴⁶

The court did not disagree with the trial judge’s formulation of the definition of fraud. The court cited the words of Blair J. in *Cineplex Odeon*⁴⁷ to the effect that fraud imports “some aspect of impropriety, dishonesty or deceit”.

Second, the Court of Appeal found that the wording of the letter of credit was against the bank. The court agreed with the trial judge that the demand was proper from a documentary point of view, the application of the funds by Gentra was immaterial and the letter of credit did not require that Gentra verify or attest to the accuracy of the call documents. None of this can be argued with, as we have discussed above. The Court of Appeal did not mention the finding of the trial judge that it was not a condition precedent to the obligation of the issuer to pay that the call documents be true.

Third, the Court of Appeal agreed with the trial judge that there were technical reasons that justified Gentra's call on the letter of credit.

The bank conceded before the Court of Appeal that the grounds of mistake and unjust enrichment were "inextricably linked to the fraud issue [and] that if RBC's appeal on the fraud issue was unsuccessful, the appeal on grounds of fact and unjust enrichment should also fail".⁴⁸

On the facts, the decision in the *Gentra* case appears to be correct: it would be difficult to characterize Gentra's conduct as fraudulent. The trial judge adds to the definition of "fraud" found in the *Cineplex Odeon* case by endorsing the view set out in the *Ward Petroleum* case⁴⁹ that fraud is action that is not even colourable as being valid or has absolutely no basis in fact.⁵⁰ Although the trial judge did not address the issue of whether intent to defraud is a necessary component of fraud in these cases, the Court of Appeal specifically endorsed the statements made in the *Cineplex Odeon* case that fraud imports "impropriety, dishonesty or deceit", and the courts did not allow the bank's claim for mistake. The case therefore appears to stand for the proposition that there must be fraudulent intent to find fraud.

However, the decision is somewhat unsatisfactory in the following respects:

1. the courts never directly addresses the issue of whether the issuer is entitled to sue the beneficiary for the repayment of the money. Since the court did not find fraud, it did not need to answer this question, but overall it appears to agree that the issuer is so entitled;
2. the courts never directly addresses the issue of what is the standard to be met by the issuer in proving fraud by the beneficiary in an action for repayment of monies drawn under a credit. The Court of Appeal did say that a party alleging fraud "faces a high hurdle". Since the courts apparently

dealt with this as it would any case in which fraud was alleged, it could perhaps be said that the case stands for the proposition that fraud in the circumstances of this case must be proven as in any other civil fraud case: on the balance of probabilities, and must be clearly and distinctly proved;

4. the trial court's approach to the issues raised did not include a detailed examination of the meaning of the wording of the letter of credit itself;

5. the trial court gives no reason for its finding that "it would be inimical to the nature of a documentary credit to speak of fraud on the issuer", and the Court of Appeal did not comment on this. The relationship between the issuer and the beneficiary is essentially a contractual relationship,⁵¹ and one feature of that relationship is that the issuer need only pay to the beneficiary upon receipt of the proper documents called for under the credit and subject to there being no fraud by the beneficiary. When the beneficiary knowingly presents false documents to the issuer in an attempt to induce the issuer to pay out under the letter of credit when the beneficiary has no legal entitlement to the monies, this would appear to constitute fraud perpetrated by the beneficiary on the issuer. Even if one does not agree with that statement, in the larger scheme of things, whether the fraud is characterized as fraud upon the issuer or the applicant does not appear to be relevant; the courts do not want, in the famous phrase from the *Sztejn* case, to allow "the principle of the independence of the bank's obligation under the letter of credit [to] be extended to protect the unscrupulous seller"; and

6. most unsatisfactorily, the trial court suggested that it is not a condition precedent to payment under the letter of credit by the issuer that "the contents of the call documents be true", ie. that the issuer, having before it a demand from the beneficiary stating that the amount demanded is due and payable by the applicant, which demand complies with the documentary requirement of the letter of credit, must pay whether or not the statement made in the demand is true. Although this finding of the court is technically correct, it is only correct when (as was the case here) the issuer has no knowledge that the demand before it is false. If the issuer knows that the demand is false, then it may not have to pay if the demand is fraudulent. Thus, this finding of the trial court is potentially misleading. It is better to say that it is not a condition precedent to payment under the credit that the beneficiary prove that the statements made by it in the demand are true. However, it is an underlying basis of any call on a credit that the statements made therein are true; if they are not, the issuer may be entitled not to pay.⁵²

(3) *Re Yorkwood Homes (Georgetown) Inc. v. Law Development Group Georgetown (No. 2) Ltd.*⁵³

In this case, the applicant (instead of, as in the *Gentra* case, the issuer) sued the beneficiary for repayment of monies paid under a letter of credit, on the basis that the request for payment was wrongful.

Facts

Law Development Group Georgetown (No. 2) Ltd. (“Law”) entered into an agreement of purchase and sale to sell lots in a subdivision developed by Law to Yorkwood Homes (Georgetown) Inc. (“Yorkwood”) and to other corporations. The agreement provided that the vendor or the purchaser would have the right to terminate the agreement if draft plan approval in final and binding form for the plan of subdivision for the lots in question was not obtained by a certain date. Either party was entitled to extend the date. The date was extended, but at the end of the extension period neither party terminated the agreement.

The vendor held a letter of credit obtained by the purchaser as a deposit or partial payment of the purchase price. The day before the extended time period referred to above was to expire, the vendor drew down on the letter of credit. Under the agreement, it was entitled to do so only on the date that the plan of subdivision received draft plan approval in final and binding form. This had not yet happened on the date that the vendor drew down on the letter of credit.

The purchaser took the position that the agreement had automatically terminated and requested that the monies drawn down on the letter of credit be repaid. The vendor took the position that the agreement continued. The trial judge found that the agreement had terminated and ordered the repayment of the monies to the purchaser.

Court of Appeal Decision and Discussion

The decision of the Court of Appeal deals primarily with the issue of whether the agreement terminated. In the circumstances, the court allowed the appeal and found that the agreement had not terminated.

With respect to the drawdown on the letter of credit, the Court of Appeal agreed with the trial judge that the money must be returned to the purchaser, for two reasons: first, the condition precedent to

its drawdown in the agreement of purchase and sale had not been met, and, second, in its documentation to the issuer of the letter of credit supporting the drawdown, the vendor did not certify that the plan of subdivision had received draft plan approval in final and binding form, which certification was required by clause 2(a) of the letter of credit.

With respect to the first basis given by the court for ordering the return of the money, it can be seen that this case, an action by the applicant for monies wrongly paid under a credit, is much different than the *Gentra*-type case, where the issuer is suing. When the applicant is suing, the issue is between the parties to the underlying contract (in this case, the agreement of purchase and sale between Law and Yorkwood), and is to be decided under the terms of that contract. There is no need to prove fraud (which does not appear to have been alleged in this case);⁵⁴ if the beneficiary breached the underlying contract by demanding under the credit when it had no contractual entitlement to do so, then the applicant will have its remedy in contract.

With respect to the second basis for the court's decision, the court is incorrect in holding that documentary non-compliance means the beneficiary must return the monies. Actually, if the issuer paid under the letter of credit without there being strict documentary compliance, then the issuer will not be entitled to reimbursement or indemnification from the applicant for such payment.⁵⁵ The effect of the documentary non-compliance as between the applicant and the beneficiary depends on the provisions of the underlying contract.

(4) *Standard Trust Co. (In Liquidation) v. Bank of Nova Scotia*⁵⁶

This was an action by a beneficiary for payment under a letter of credit, in circumstances where the issuer did not pay on demand by the beneficiary because of allegations of breach of contract by the applicant.

Facts

Regatta Plaza Limited ("Regatta") obtained construction financing from the Standard Trust Company ("Standard"). As part of the security required by Standard for such loan, on May 25, 1990, Regatta obtained an irrevocable letter of guarantee from The Bank of Nova Scotia (the "bank") in the amount of \$300,000 in favour of Standard. The letter of guarantee stated that it was issued in connection with the "financing of Phase I, II and III of Regatta Plaza Limited as referred

to a Letter of Offer dated May 17, 1990 from Standard Trust". Payment under the letter of guarantee would be made upon presentation to the bank of a written demand, which was to certify (a) that the amount demanded is due and payable to the beneficiary by Regatta and (b) that the beneficiary has requested payment of the said amount from Regatta and has not received payment. The letter of guarantee did not refer to the UCP.

Between July 9 and October 29, 1990, written statements were sent by Standard to Regatta indicating the amounts of principal and interest owing at the date of each statement and requesting payment of the amount of interest then owing. Regatta paid the interest owing upon receipt of each such statement. Subsequent to October 29, 1990, until January 30, 1991, although Standard continued to send these statements, Regatta did not make any payment.

The letter of guarantee stated that it expired on May 25, 1991. On April 1, 1991, Standard wrote to the bank requesting a renewal or extension of the letter of guarantee for another year, which letter was copied to Regatta. On May 2, 1991, Standard went into liquidation. On May 15, 1991, Regatta wrote to the bank advising that Standard was in breach of the financing agreement between Regatta and Standard and that the bank was not to payout on the letter of guarantee.

On May 24, 1991, Standard, through its provisional liquidator, demanded payment from the bank of \$300,000. At that time, Regatta's indebtedness to Standard exceeded \$300,000. The demand included the following sentence:

"The undersigned certify that the \$300,000 is due and payable by Regatta Plaza Limited and further certify that payment has been requested from Regatta Plaza Limited and that payment has not been received".

The bank did not make the payment demanded. Rather, on May 29, 1991, the bank wrote to the solicitors for Standard advising that, due to the letter that it had received from Regatta, it was holding on paying under the demand. The bank advised that it understood that a deal had been struck between Standard and Regatta regarding refinancing of the loan and that a demand would not be made. The bank further advised that it had reason to believe that no demand for the \$300,000 was issued to Regatta as one of the conditions of the letter of guarantee being issued. Subsequently, the bank made a number of requests of Standard and its solicitors for a copy of the demand for payment made by Standard to Regatta. These requests were not responded to.

Due, no doubt, to the liquidation of Standard, an action was not commenced by Standard, through its liquidator, until May 15, 1996 claiming the \$300,000. The bank defended on the basis that Standard had not complied with the conditions of the letter of guarantee in its demand for payment from the bank, in that its “certification was false as no demand was made of Regatta”.

The bank also added Regatta to the action as a third party. Regatta supported the position taken by the bank and alleged that the certification by Standard was false and amounted to a perpetration of fraud on the bank. Regatta denied that the monthly statements from Standard were requests for payment of the amount demanded by Standard pursuant to the letter of guarantee. The bank and Standard brought cross-motions for summary judgment.

Trial Decision

The decision of the trial judge is set out in some detail in the Court of Appeal’s decision. The trial judge held that the principle of strict documentary compliance would not prevent Standard from succeeding in its motion - in other words, Standard had complied with the strict documentary requirements of the letter of guarantee. After citing the principle of autonomy of letters of credit, the trial judge noted that the one exception was fraud.

The trial judge then reviewed the degree of proof necessary to establish fraud. He noted that, in *Angelica-Whitewear*, the Supreme Court of Canada distinguished between cases where an interlocutory injunction was brought against an issuing bank to restrain it from payment under the letter of credit and an action being brought after a decision by the issuing bank to pay or not to pay, on the basis that the bank had received notice of alleged fraud by the beneficiary. In the former case, a strong *prima facie* case of fraud is the test, whereas in the latter case the fraud must be so established to the knowledge of the issuing bank before payment of the draft as to make the fraud clear or obvious to the bank.

After reviewing the circumstances of this case, the trial judge concluded that the bank had acted reasonably in withholding immediate payment. The trial judge stated:

“Considering the liquidation of Standard and the probability of new people being involved on the file, it was reasonable for the bank to wonder whether the condition requiring that a request for payment be made had been overlooked by Standard. ...When no copy of the

demand had been produced by Standard, despite further requests from the Bank,... the Bank was entitled to draw the adverse influence that Standard had not made a demand for \$300,000.00 on Regatta and that the demand letter stating the opposite was false.”⁵⁷

The trial judge discussed whether the certification by Standard that payment had been requested from Regatta was fraudulent. He noted that in the circumstances of this case, fraud was not the only explanation; he noted that it was possible that Standard officials had made an honest mistake as to the effect of earlier requests for payment contained in the periodic statements referred to above. The question was then whether it was necessary for Standard to have a “fraudulent intention”. The trial judge quoted the court in *Old Colony Trust Co. v. Lawyers Title and Trust Co.*,⁵⁸ where the court stated:

“Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit.”

The trial judge concluded that:

“Once an issuing bank has knowledge a demand letter falsely certifies that a condition of the letter of guarantee has been met, this is all the bank needs in order to withhold payment. The bank need not establish the intention or state of mind of the certifier. ...The clause in the letter of guarantee, requiring the Bank to pay without enquiring whether Standard had a right to the amount as between it and Regatta, does not cover the present situation, where the Bank has sufficient information prior to the demand, without inquiring, to raise concerns about the correctness of what Standard certified.”⁵⁹

The trial judge therefore dismissed Standard’s application for summary judgment. Standard appealed.

Decision of Court of Appeal and Discussion

The issues, as stated by the Court of Appeal, included the following:

“1. was the written demand by Standard to the Bank on the Letter of Guarantee regular on its face, and should the Bank have honoured that demand?”

2. did the Bank have sufficient knowledge of fraud by Standard to justify the Bank's refusal to honor the demand made on the Letter of Guarantee?

3. what is the degree of fraud required to permit a Bank to avoid paying a demand on a Letter of Guarantee?"⁶⁰

The Court of Appeal's summary of the issues is succinct and well considered. In its examination of the first question posed by it, the Court of Appeal noted that the letter of guarantee did not require that the request for payment made by the beneficiary to the applicant for payment be in writing, nor that it be made within any specific time period prior to the demand being made on the issuer under the credit, and that the beneficiary need only certify that it had "requested" payment from the customer and had not received payment. The court therefore found that the regular monthly statements sent by Standard to Regatta constituted requests for payment as contemplated by the letter of guarantee. The court agreed with the trial judge that the failure to certify the exact amount for which a request for a payment had been made in Standard's demand on the bank did not constitute a breach of the principle of strict documentary compliance for letters of credit.

With respect to whether, in fact, a request had been made by Standard on Regatta for payment, the Court of Appeal stated:

"Nothing in the Letter of Guarantee would give the right to the bank to demand a copy of the request made by Standard for payment by Regatta Plaza nor did the failure of Standard to supply the Bank with a copy of any such request entitle the Bank to draw the "adverse inference" that Standard had not made a request for the funds."⁶¹

This is yet another way to say what we have already reviewed above: the beneficiary does not have to prove that the statements it has made in its demand under the credit are true, unless of course the credit provides otherwise. The difficulty with this statement is: what is the issuer to do when the applicant has advised that the issuer should not pay, and then the issuer receives a demand from the beneficiary? In the case of *Royal Bank v. Darlington*⁶² the court stated that "there was no duty on the part of the [issuer] to embark upon enquiries beyond a careful examination of the ... materials provided [by the applicant], acting honestly and in good faith in their capacity as bankers in doing so".⁶³ In other words, the applicant must provide sufficient material to the issuer to show clear or obvious fraud by the beneficiary. In this case, the applicant had merely written to the issuer advising

it not to pay, and had alleged breach of contract, but not fraud. This is not sufficient proof of fraud.

The court noted that, contrary to statements made by the trial judge, there was no need for Standard to give notice to Regatta that, if it did not pay the amounts owing, it would drawdown on the letter of credit. In the view of the Court of Appeal, there was nothing in the letter of guarantee which justified the position taken by the bank in refusing to make payment when presented with the demand. This raised the question of whether there was fraud which would so justify the bank in taking this position, and the court began its examination of the second and third questions posed by it above.

The Court of Appeal had already noted that the trial judge quoted *Angelica-Whitewear* on the standard to which the bank's decision not to pay was to be measured. The court also quoted Lord Denning, M.R. in *Edward Owen*⁶⁴, where the Master of the Rolls indicated that there must be clear fraud of which the bank has notice, otherwise the bank must pay after a demand under the letter of credit. The court then stated: "In my view, in the absence of fraud "clear or obvious to the bank", the trial judge was not entitled to consider the contractual arrangements... between Standard and Regatta...". The "clear or obvious" wording is from *Angelica-Whitewear*. In discussing whether fraud existed in this case, the Court of Appeal quoted the off-quoted words of Blair, J. in the *Cineplex Odeon* case⁶⁵ as to the meaning of "fraud". The court also reviewed the case of *Fuji Bank Canada v. 1440 Ste. Catherine Street Developments Inc.*⁶⁶ where the Ontario Court of Appeal stated:

"The appellant bank received the documentation required by the Letter of Guarantee, namely a certificate signed by the appropriate officer of the respondent stating that there had been a default and specifying the amount payable. Any right of the appellant bank to then examine the underlying contract before addressing its obligation to pay would have to flow from the Letter of Guarantee itself."

The evidence of the representative of the bank was that he was aware of negotiations between Standard and Regatta relating to refinancing and to the possible renewal of the letter of guarantee as part of that potential refinancing. When he received the demand for payment from Standard, he suspected that no demand for payment had been made by Standard on Regatta for payment, and therefore that the certification in the demand for payment was false. On the facts, as the Court of Appeal noted, it appears that the bank was confused between the need for a "demand" to have been

made and the requirements of the letter of guarantee, which required only that Standard certify that a “request” for payment had been made. This confusion obviously increased the Bank’s suspicions that the certification by Standard was false, for it indeed appears to have been true on the facts that no written demand for payment was made by Standard on Regatta for all of Regatta’s indebtedness to Standard. However, it does appear to have been true on the facts that requests for payment were made in the form of the monthly statements, and there is also reference in the case to possible oral requests for payment being made on Regatta.

The Court of Appeal noted that the bank had not actually alleged fraud on the part of Standard, and that the trial judge had in fact not made a finding of fraud on the part of Standard. These conclusions of the Court of Appeal were sufficient to dispose of the case, but the court also noted that there was no suggestion that the amount demanded by Standard under the letter of guarantee was not owing by Regatta to Standard. The bank was aware that Regatta was indebted to Standard. In the circumstances of the case, the bank had no justification to believe that Standard was attempting to perpetrate a fraud.

As to whether something less than fraud on the part of Standard would justify the bank’s refusal to pay under the letter of guarantee, the Court of Appeal quickly concluded that there was “nothing in the authorities to indicate that anything less than fraud can have the same effect as would fraud so as to justify the refusal of the Bank to pay...”.⁶⁷

The court then came to the next issue raised by the trial judge: was “fraudulent intention” a necessary part of finding fraud? This issue was raised as well in *Gentra*, described above. It is a very important issue, as fraud without intent is basically just mistake or negligence. The *Gentra* case apparently did not revise the law on this which, at present, would appear to be as set out in the *Cineplex Odeon* case, where the court stated that fraud is “something dishonest and morally wrong” and that “fraud is not mistake”. In *Standard Trust*, the Court of Appeal examined the *Old Colony Trust* case that was cited by the trial judge. The court in that case apparently ordered that a bank was not required to make payment under a letter of credit where the documents tendered on the bank were false. One of the documents required was a negotiable warehouse receipt. It appears that a warehouse receipt was issued when the goods in question were not actually received by the warehouse. This made the receipt, which no doubt was sufficient on its face, insufficient for the purposes of the letter of credit. The Court of Appeal stated:

“I cannot see how *Old Colony* is helpful to the position taken by the [bank]. There were documents to be presented with the demand for payment under the letter of credit and the documents were to be legal and valid documents. Where the documentation, as there, was “false or illegal”, the issuer cannot be called upon to recognize them as complying with the terms of the letter of credit.”⁶⁸

There are problems with this statement of the Court of Appeal. First of all, the court appears to be agreeing that, if the documentation presented to the bank is “false”, then the issuer cannot be compelled to recognize it as complying with the terms of the letter of credit. This, in fact, does appear to be helpful to the position taken by the bank in this case - the bank’s position was that the certification by Standard was false. If that were, in fact, true, then the bank would indeed appear to be justified in not paying, on the basis of the *Old Colony Trust* case. Secondly, in making this statement, the court does not really get to the issue. The court says, basically, that only legal and valid documents are effective when presented under a letter of credit. But if the documents are regular on their face, how is the issuer to know whether they are legal and valid? If is, of course, only when the issuer has been advised that the documents are “illegal” or “false” that these issues arise. And if the documents are not legal and valid, does it matter whether or not they are presented by the beneficiary with fraudulent intent? To put it another way, what if the documents are false due to a mistake that is a negligent or innocent mistake? Why should the issuer have to pay if the beneficiary mistakenly says “I am entitled to payment” but does not have to pay if the beneficiary fraudulently says the same thing? In both cases, the underlying basis for the call on the letter of credit does not exist.

This is a difficult issue. If the courts begin to interfere with payments under letters of credit on the basis of mistake, then the principle of autonomy would be compromised, and so would the commercial efficacy of the document. The number of cases that the courts would have to examine would probably rise. If the courts do not interfere on the basis of mistake, then some injustices will result, and the courts could be accused of being arbitrary in deciding where to draw the line in interfering with payments under letters of credit. On the basis of past practice and precedent, and the possible greater certainty that results when the exception to the autonomy principle is narrowed to fraud, I would submit that it is preferable to have only the fraud exception to the autonomy principle.⁶⁹

However, in the view of the court, the certification by Standard was not, in fact, false, and the court allowed Standard's appeal and ordered the bank to pay.

This case accordingly demonstrates the following:

1. an issuer who suspects that a statement made in a demand for payment under a letter of credit is false will have to be more than suspicious in order to justify not paying. In the view of the Court of Appeal in this case, any fraud had to be "clear and obvious" to the bank, and the suspicions that the bank had were not sufficient to meet this test;

2. this case again demonstrates the danger of getting too involved in the relationship between the applicant and the beneficiary. The trial judge could have taken a simpler approach to the case, starting with, was there documentary compliance? If there was, payment should follow unless fraud was alleged. Since fraud was alleged, and the bank had not paid because of it (ignoring for the moment that fraud was not actually alleged until the applicant was added as a third party to this action), was fraud "clear or obvious" to the bank? If the trial judge had asked himself this question, instead of apparently getting tangled up in the questions of whether the certification by Standard was false and whether fraudulent intent was required, he may have come to a different conclusion from the one he did come to; in the circumstances of this case,⁷⁰ it seems difficult to find fraud on the part of Standard;

3. although the Court of Appeal does not specifically say so, it does not appear to agree with the trial judge's assertion that fraudulent intent is not required. The Court of Appeal did affirm that nothing less than fraud would justify non-payment by the issuer; and

4. in order to determine whether fraud alleged by the applicant exists, the issuer is not entitled to examine the underlying contract or any other documents unless the letter of credit itself requires this. There is another circumstance which would lead to the issuer being obliged to examine such contract, and that is if the applicant or other person alleging fraud provides the contract to the issuer as part of its evidence of the fraud: recall the discussion above of *Royal Bank v. Darlington*.

(5) *Century Property and Casualty Insurance Corp. v. London Guarantee Insurance Co.*⁷¹

This case involved an injunction brought by the applicant to enjoin payment under a letter of credit. In its decision, the court equated having no right to payment with fraud.

Facts

Royal Bank of Canada had issued a standby letter of credit in favour of London Guarantee Insurance Co. ("London Guarantee") in the amount of \$2,250,000 (U.S.) at the request of Coscan Development Corporation ("Coscan"). The plaintiff, a re-insurer, had arranged the letter of credit⁷² which was to stand as security for the obligations of Coscan under a performance bond facility provided to Coscan by London Guarantee.

On November 18, 1999, London Guarantee sought to drawdown the complete amount of the letter of credit. On November 22, 1999, the plaintiff obtained an *ex parte* order enjoining the payment on the letter of credit. In this case, the plaintiff was seeking to continue the injunction pending the trial of the action.

In the initial *ex parte* proceeding, the material before the judge had made reference to the fact that the letter of credit stood as security for a performance bond on only one project, and that only \$70,000 (U.S.) remained outstanding on that bond. The judge found that to allow London Guarantee to drawdown the whole \$2,250,000 (U.S.) without any justification would allow the plaintiff to be a victim of fraud.

Decision and Discussion

On this application to continue the injunction, the material before the court indicated that the plaintiff had significantly misstated the issue in the initial hearing regarding the amount of the bonds. In fact, the bonds outstanding were in excess of \$30,000,000, and the plaintiff was mistaken in stating that the letter of credit secured only \$70,000 (U.S.) in bonds. It was also made clear that the letter of credit was to expire on December 1, 1999, and London Guarantee was therefore demanding under the letter of credit on the eve of its expiry, presumably in the belief that the letter of credit was not going to be renewed, as it had been a number of times in the past. The plaintiff confirmed that it would agree to renew the letter of credit for another year. The court was of the view that the misrepresentations by the plaintiff on the original injunction application were material and normally would have been fatal to the continuation of the injunction. However, the court was further of the view that a strong *prima facie* case of fraud had been made out, in that the plaintiff was demanding under the letter of credit even though there have been no default on any bond nor any demand for payment by a bond holder. The court cited *Rosen v. Pullen*⁷³ as authority for the

proposition that “calling upon a letter of credit in circumstances where there is no entitlement to do so establishes a *prima facie* case of fraud”.

The defendant put forward the position that, as the letter of credit was about to expire and the plaintiff had not agreed to renew it (the court did not state whether the defendant had asked for a renewal and the plaintiff had refused), it was entitled to demand under the letter of credit in order to avoid losing its security. The defendant claimed to be simply replacing one form of security (the letter of credit) with another (cash), which new form of security would continue to be held by the defendant as security for the obligations under the bonds. The defendant was prepared to consent to an order to this effect. However, the court concluded that the defendant “has failed to answer satisfactorily the complaint that it had no underlying right to claim the funds under the letter of credit without default or demand under the bond”. The court ordered the continuation of the injunction.

In my view, this case is dealt with in a very unsatisfactory way by the court. First of all, the terms of the letter of credit are not set out by the court. It is therefore impossible to tell what form a demand by the beneficiary had to take. Secondly, it is very common for letters of credit to be issued for periods of time that are less than the term of the underlying contract. In these circumstances, the understanding between the applicant and the beneficiary often is that, if the letter of credit is not renewed from time to time, then the beneficiary will be entitled to drawdown on the letter of credit if it is about to expire, in order that the beneficiary not lose its security. The reason that letters of credit are issued for terms less than that of the underlying contract has usually more to do with the requirements of the issuing bank than any agreement between the beneficiary and the applicant.

Normally, this ability of the beneficiary to drawdown on the letter of credit if it is about to expire would be set out in the underlying contract. This was apparently not the case here, otherwise the defendant would have produced the contract. People drafting contracts calling for letters of credit as security should note that this wording should appear in the contract, if a letter of credit with a term less than the term of the underlying contract is offered as security.

Finally, is it fair for the court to conclude that the defendant “had no underlying right to claim the funds under the letter of credit without a default or demand under the bonds”? Referring to the well known quote of Blair, J. in the *Cineplex Odeon* case, fraud implies some aspect of impropriety,

dishonesty or deceit or that the statements are “clearly untrue or false” or “utterly without justification” or there is “no right to payment”. It is questionable whether any of these terms apply to the fact situation in this case.

It would appear to be more accurate in this case to say that the beneficiary, facing the loss of its security, made demand with the intention of holding the cash that was received as substitute security for the expiring letter of credit. Such a case would appear to be more properly dealt with by the applicant through an action against the beneficiary, enjoining it not to dissipate the funds, rather than an *ex parte* application for an injunction enjoining any claim to payment by the beneficiary. Although civil fraud may not be as serious as criminal fraud, it is still a serious matter and the courts should not be eager to find fraud, lest the fraud exception be broadened on a case by case basis into a mistake exception. It should always be borne in mind that the seminal fraud exception case, *Sztejn*⁷⁴, was a case where, firstly, fraud was assumed by the court for the purposes of the proceedings before it and, secondly, the fraud was, on the facts, exceedingly clear (being a case where it was alleged that the beneficiary had shipped, instead of the goods that were ordered, a container of worthless rubbish). This is the kind of “clear and obvious” fraud or “strong *prima facie* case of fraud” that must exist before a court enjoins payment under a letter of credit.

(6) *IMC Canada Ltd. v. Enron Canada Corp.*⁷⁵

Finally, I want to close my review of the recent case law with a case that demonstrates the continuous assault by ingenious counsel on the principle of autonomy.

Facts

In this case, the applicant under a letter of credit brought an application to the Alberta Court of Queen's Bench for an injunction restraining the beneficiary, Enron Canada Corp. ("Enron Canada"), from demanding payment under a letter of credit issued by Chase Manhattan Bank U.S.A. (N.A.) at any time during the currency of an event of default under the agreement between the parties triggered by the bankruptcy of Enron Corp.

IMC and Enron Canada had entered into an ISDA master agreement to govern future natural gas swap transactions between them. Under the terms of that agreement, each of the parties provided standby letters of credit to the other to secure their potential indebtedness under the agreement. The letter of credit provided by IMC was in the amount of \$8,000,000.

Thereafter, Enron Corp., which was a credit support provider (ie. a guarantor) for Enron Canada under the agreement, filed for chapter 11 protection under the U.S. Bankruptcy Code. Shortly thereafter, IMC became indebted to Enron Canada in the amount of \$2,300,000 and Enron Canada demanded payment from IMC of such amount. IMC's response was that Enron Canada had committed an act of default under the ISDA agreement by virtue of the bankruptcy proceedings commenced by its credit support provider. IMC wrote to the issuer, advising it not to pay under the letter of credit, as Enron Canada, being in default under the ISDA agreement, had no basis on which to drawdown on the credit.

Decision and Discussion

Essentially, IMC was attempting to get the court to protect IMC against a possible future bankruptcy of Enron Canada. Under an ISDA master agreement, the bankruptcy of the credit support provider of one party is an event of default which would allow the other party to unwind the contract. However, IMC had advised the issuer that it did not wish to unwind the contract at that time (presumably because doing so at that time would not have been in IMC's favour). Accordingly, it brought this application, claiming that it would suffer irreparable harm if forced to

pay, as it may in the future be entitled to money from Enron Canada and, if Enron Canada were to go bankrupt, it would not be able to collect. The court found that irreparable harm had not been shown:

“What the applicant alleges is at best a risk based on a double contingency; if the market turns [Enron Canada] may end up owing me money and, if [Enron Canada] becomes insolvent, I may not be able to collect my money. Surely that is no proper basis for granting injunctive relief.”⁷⁶

This decision is interesting for two reasons:

- (i) as stated above, it demonstrates one of the infinite number of ways that parties will challenge the autonomy of letters of credit. That the courts so consistently refuse to bite is to their credit; and
- (ii) the court makes what appears to be the correct decision without any reference to letter of credit law. Although the court disposes of the application relatively quickly on the basis of the law of injunction,⁷⁷ it could have disposed of the case very quickly if it had applied the law of letters of credit: this was an application for an injunction; accordingly, a strong *prima facie* case of fraud had to be shown; the applicant, not even alleging fraud, therefore failed in its case and the application would have been dismissed.

4. Conclusion

(1) The Meaning of “Fraud” in Letter of Credit Cases

In *Angelica-Whitewear*, the Supreme Court of Canada did not set out a definition of fraud for the purposes of these letter of credit cases. The court did refer to the latin maxims *fraus omnia corrumpit* and *ex turpi causa non oritur actio*, which perhaps imply that, as Blair J. put it in the *Cineplex Odeon* case, there must be something dishonest or morally wrong about the act in question before it will be called “fraud”. I submit that, in using the word “fraud”, the Supreme Court had in mind a definition that included knowledge on the part of the fraudster of the falseness of her representation (which is what I mean when I refer to “fraudulent intent”), or recklessness towards whether it was true or not.

In many of the cases, the courts have found fact situations that involved demands that were “clearly untrue or false” or that were made when there was “no right to payment” to constitute fraud,

without specific reference to a finding of fraudulent intent⁷⁸. But fraudulent intent, being a subjective frame of mind, will always be difficult to prove. I submit that these cases are essentially cases where the courts have inferred fraudulent intent from the fact that, in the circumstances of each case, there was no other explanation why the beneficiary, which had no right to payment, made a demand under the credit. The need to find (or infer) fraudulent intent remains; otherwise, the courts would be interfering with payment under letters of credit on the basis of mere mistake.

The Supreme Court of Canada did say in *Angelica-Whitewear* that the “potential scope of the fraud exception must not be a means of creating serious uncertainty and lack of confidence in the operation of letter of credit transactions”⁷⁹ and, it is submitted, allowing injunctions to be issued against issuers on the basis of mistake would create such uncertainty. As the court said in the *Lee River* case, if the applicant believes that the beneficiary is mistaken in demanding under the credit, or is breaching the underlying contract by doing so, then the applicant should be suing the beneficiary, not the issuer. This is what was done in the *Yorkwood Homes* case, and there would seem to be no reason to doubt that the order of the court there to the beneficiary to return the monies received by it was obeyed. It is only in the case of fraud that suing the issuer to restrain payment is necessary – the fraudster will not return the monies received by him just because a court orders him to after the fact, so it is necessary to prevent the issuer from paying him at all.

The recent cases canvassed in this article have illuminated somewhat the meaning of “fraud”. In *Gentra*, the court viewed fraud as an act “not even colourable as being valid” or having “absolutely no basis in fact”. These expressions are not materially different from “clearly untrue or false” or “no right to payment”, but the examination by the court of the facts in that case was a useful one on this point. The fact that there was some basis for a demand in the case (even if the beneficiary did not have that basis in mind when making the demand on the credit), plus the fact that the beneficiary had first sought a legal opinion as to its entitlement to demand and that the applicant owed the beneficiary more than the amount of the credit, would tend to negate any finding of fraud. I would add that the identity of the beneficiary in that case also tended to negate fraudulent intent: the beneficiary was a financial institution or entity which, if the court had held the opposite way, would have been good for the money.

The Ontario Court of Appeal in the *Gentra* case and, apparently, the Newfoundland Court of Appeal in the *Standard Trust* case were of the view that fraudulent intent is part of fraud in these cases. The

decision in the *Century Property* case is a step backward in this regard. There, the court, even though it now had the true facts before it (unlike the judge at first instance), which facts showed that the applicant had materially misled the judge at first instance, equated having no right to payment with fraud.⁸⁰ Yet, there was some colour of right to what the beneficiary was doing, in that if it did not demand under the credit, the credit would have expired and been lost to the beneficiary (which may have been a breach of the underlying contract by the applicant), and the beneficiary was an institution which, if ordered to repay the monies, presumably would have been able to do so.

(2) The Standard on an Action for Return of Monies Paid

In *Gentra*, on an action by the issuer against the beneficiary for the return of monies paid, allegedly as a result of fraud by the beneficiary, the court did not expressly set out the standard of proof of fraud in the circumstances. But the court appeared to treat the case as “an ordinary case of fraud”; that is, the court appeared to use the normal standard for proof of fraud, on a balance of probabilities, but to be proved clearly and distinctly. Even if it is going too far to say that the court’s decision is precedent for this statement, I submit that this is the appropriate standard.

In a case where the applicant is suing the beneficiary for return of monies wrongly paid, fraud is not an issue (although, if fraud exists, the applicant is entitled to the return of the monies by the beneficiary). As seen in the *Yorkwood Homes* case, if the beneficiary has breached the underlying contract by demanding on the letter of credit when it has no entitlement to do so, then normal contract law will determine whether the remedy is the return or repayment of the monies received by the beneficiary.

(3) Review by the Issuer of Allegations of Fraud

If the applicant or another person alleges fraud to the issuer prior to payment under the letter of credit, the *Standard Trust* case stands for the proposition that the issuer is not then entitled to request copies of the underlying contract or other documents referred to in the demand for payment, unless the letter of credit entitles the issuer to so ask. Further, the issuer cannot draw an adverse inference from any failure of the beneficiary to provide the documents requested by the issuer.

As set out in the *Royal Bank v. Darlington* case, it is up to the applicant or other person alleging fraud to provide the issuer with evidence that will show the issuer that fraud is clear or obvious. The letter

that the applicant sent in the *Standard Trust* case, alleging a breach of contract by the beneficiary, failed to meet this standard.

(4) Standard on Injunction

Although the correctness of the decision could be debated, the *Century Property* case is a good example of what the courts are quite often asked to decide quickly, and on an *ex parte* basis: is a case where the beneficiary under the underlying contract apparently may not have a right to payment a sufficient proof of fraud? The courts would do well to approach these cases in a consistent and principled manner, and not in the manner demonstrated by the court in this case.

(5) Approach of Courts to Letter of Credit Cases

In any case where the applicant or some other involved entity is alleging fraud in order to obtain an injunction restraining the issuer from paying, or enjoining a beneficiary from demanding or receiving payment, under a letter of credit, or in order to defend an action by the issuer for indemnification with respect to monies paid under a letter of credit, or in order to sue the issuer for wrongly paying under the letter of credit, the court must resist the temptation to embark upon an examination of the underlying transaction. The person alleging fraud will no doubt place before the court an affidavit or other evidence which will describe in detail the relationship between the applicant and the beneficiary and the underlying transaction. The court must recall that, in any letter of credit scenario, there are three sets of relationships: applicant/beneficiary, applicant/issuer and beneficiary/issuer. In an injunction case, it is the beneficiary/issuer relationship, which is represented by the letter of credit (issued by the issuer to the beneficiary) itself, that the applicant seeks to interfere with by having the court restrain payment under the credit. In a case where the issuer is suing for indemnification, the right to indemnification, while contractual to a certain extent, also depends on the letter of credit.⁸¹

Accordingly, what the court should be focussing on initially is the letter of credit itself. What does it say? What are the requirements for drawing under the credit? Is the UCP referred to?⁸² Next, the court should examine the demand under the credit: does it meet the documentary compliance test? If it does, then the principle of autonomy of letters of credit compels the court to order the issuer to pay, without any examination of the underlying transaction, unless the applicant for the injunction has alleged the only exception to the autonomy principle, fraud.

If fraud has been alleged, then in an injunction case, the court must ask itself whether a strong *prima facie* case of fraud has been proven by the applicant for the injunction. In a case where the issuer is suing the applicant for reimbursement or is being sued by the beneficiary for payment because it did not pay on demand, the court must ask itself whether the issuer had before it clear or obvious proof of fraud. In examining the evidence before it, the court must remind itself that fraud includes dishonesty, moral turpitude, knowledge of falseness or recklessness. Simple proof of breach of contract is not fraud. Even an apparent absence of entitlement to demand payment should be examined closely: the court in the *Gentra* case gives the useful test of, is there any colour of right in the demand? The court should also examine the circumstances of the beneficiary (what kind of entity is it? what are the chances of getting the money back from it if it is allowed to receive payment under the letter of credit?), the reasons the beneficiary has for making demand in the alleged circumstances and whether the beneficiary sought legal advice on its entitlement to make demand before it did so.

The courts do not want to make themselves the dupes of unscrupulous beneficiaries of letters of credit. But, on the other hand, fraud is a serious allegation, and the courts should not easily find that fraud exists. Although it may seem easy on an application for an injunction to find that a strong *prima facie* case of fraud exists, on the theory that the trial of the issue will in due course sort out the actual truth, it may be preferable, in the interest of preserving the commercial utility of letters of credit, that the court be scrupulous in reaching its determination of whether the standard has been met.

(6) Standby Credit Law vs. Documentary Credit Law

Graham and Geva raised this issue in 1984, recognizing that the differences between documentary and standby letters of credit may give rise to differences in the law respecting each of them. Interestingly, there is still no evidence on the cases reviewed here that any such difference has arisen. A case such as the *Lee River* case would have been the exact kind of case that may have created different law: the letter of credit in that case was a simple, two paragraph letter issued by a local trust company at the instance of a real estate developer, and it did not appear that the parties had any great knowledge of letter of credit law. The applicant apparently thought that the municipality could not draw on the letter of credit unless entitled to do so under the underlying contract, yet this requirement was omitted from the credit itself, thus enabling the municipality to demand payment

under the credit at any time. Notwithstanding this, the court resisted the temptation to interfere with the principle of autonomy to protect the perhaps naïve applicant.

(7) Is the Fraud Exception Becoming too Broad?

Although there are quite a number of letter of credit cases in which fraud is alleged, it does not appear that the courts are making this exception unduly easy to prove. As discussed above, the courts have, for the most part, resisted attempts to equate fraud with mistake or simple falseness of demand. This will be an area where the courts will continue to be challenged: why, the courts will be asked, should there be a difference between a demand under a credit that is fraudulent and a demand that is negligently or innocently false or mistaken? In either case, the beneficiary has no entitlement to payment under the underlying transaction. In response, the courts must remind themselves that letters of credit are instruments that, due to their legal qualities, have a certain commercial usefulness. One of those qualities is the principle that the underlying transaction is irrelevant in determining whether payment is to be made under the credit. Fraud, being a serious matter involving moral turpitude, has been made an exception to this principle, as the courts do not wish to assist or condone fraud. But mistake or breach of contract is not such a serious matter. It can be dealt with between the parties to the underlying transaction (in a way that fraud, obviously, cannot). The fraud exception should not be broadened into a mistake exception.

¹ (1999), 14 B.F.L.R. 505.

² Only one of the cases cited in my article was a Supreme Court of Canada case (*Angelica-Whitewear Ltd. v. Bank of Nova Scotia*, [1987] 1 S.C.R. 59 (hereinafter “*Angelica-Whitewear*”)), and only two had reached the level of the Ontario Court of Appeal (*Gan General Insurance Co. v. National Bank of Canada*, [1999] O.J. No. 206 and *Dunlop Construction Products Inc. (Receiver of) v. Flavelle Holdings Inc.* (1996), 31 O.R. (3d) 58). There were also two that reached the Alberta Court of Appeal (*366604 Alberta Ltd. (Trustee of) v. Pensionfund Properties Ltd.*, [1998] A.J. No. 980 and *Morguard Trust Co. v. Royal Bank* (1989), 70 Alta. L. R. (2d) 242, [1990] 2 W.W.R. 85, 101 A.R. 254) and one the British Columbia Court of Appeal (*Platinum Communications Systems Inc. v. Imax Corp.* (1989), 41 B.C.L.R. (2d) 175).

³ See *Global Steel Ltd. v. Bank of Montreal* (1999), 50 B.L.R. (2d) 219 (Alta. C.A.) for a recent case applying this principle. This aspect of the fraud exception will bear close watching in the future, as the court in *Angelica-Whitewear* did not seem 100% sure of its view on this point, and the variety of ways that a third party’s fraud could affect payment under a credit is probably infinite – and the question of whether the beneficiary had anything to do with the actions of the third party will always be difficult to answer.

⁴ This theme was first put forward by G. B. Graham and B. Geva in their article “Standby Credits in Canada” (1984), 9 C.B.L.J. 180 (herein referred to as “Graham and Geva”).

⁵ [1999] M.J. 324 (Q.B.).

⁶ The court quoted passages from the Canadian Encyclopedic Digest, L. Sarna “Letters of Credit - The Law and Current Practice” (3rd ed.) (Toronto: Thomson Canada Limited, 1992), and Crawford and Falconbridge on Banking and Bills of Exchange (8th ed.) (Aurora: Canada Law Book Inc., 1986).

⁷ *Supra*, note 5, para. 22.

⁸ *Ibid*, para. 23.

⁹ *Ibid*, para. 25.

¹⁰ (2000), 1 B.L.R. (3d) 170 (Ont. S.C. [Commercial List]); additional reasons at (2000), 2000 Carswell Ont 2837; affd. (2001) 15 B.L.R. (3d) 25, 147 O.A.R. 96 (Ont. C. A.). This case was recently reviewed by Hilary Clarke at (2002), 17 B.F.L.R. 423.

¹¹ *Ibid*, 1 B.L.R. (3d), p. 172.

¹² *Ibid*, p. 175.

¹³ R.S.C. 1985, c. C-36, as amended (the “CCAA”).

¹⁴ *Supra*, note 10, 1 B.L.R. (3d), p. 177.

¹⁵ *Ibid*, p. 180.

¹⁶ *Angelica-Whitewear*, p. 83.

¹⁷ See *Robinson v. Ontario New Home Warranty Program* (1994), 18 O.R. (3d) 269 (Ont. Gen. Div.) at p. 284, where the court, in examining the demand by the beneficiary on the issuer, found that the statements made therein were representations by the beneficiary to the issuer, and not to a guarantor of the applicant.

¹⁸ In *Parna v. G. & S. Properties Ltd.*, [1971] S.C.R. 306, at 316, taken from Anson on Contract, and quoted in *930154 Ontario Inc. v. Onofri*, [1994] O.J. No. 2095 (Ont. Gen. Div.)

¹⁹ See Sarna, *supra*, note 6, Chap. 5, §3(c)(vi), pp. 5-26 ff., where the author, after referring to the statement of the trial judge in *Genra* that it would be “inimical to the nature of documentary credits to speak in terms of fraud on the issuer”, *infra*, note 40, states: “[t]his is difficult to grasp where one of the parties to the credit transaction has committed a fraud....The courts would be reluctant in the extreme to permit a beneficiary, who fraudulently conspired with a customer, to defraud an issuer.”

²⁰ (1972), 116 Sol. Jo. 921 (Eng. Q.B.).

²¹ *Angelica-Whitewear*, p. 79. The quote from the *Bank Russo-Iran* case was part of a larger quote from Lord Denning's judgment in *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*, [1978] 1 All E.R. 976 (C.A.) (hereinafter "*Edward Owen*"), dealing with the issue of the appropriate standard to be met in proving fraud exists.

²² *Supra*, note 1, at p. 521.

²³ See *Royal Bank v. Ontario New Home Warranty Program*, [1996] O.J. No. 735 (Ont. Gen. Div.); and see Sarna, *supra*, note 5, at p. 3-28.

²⁴ See 13 C.E.D. (Ont. 3^d ed.), Title 65, § 192 (and see §1.1, which states that proof of fraudulent misrepresentation "requires a higher degree of probability commensurate with the severity of the accusation").

²⁵ *Supra*, note 10, 1 B.L.R. (3d), p. 181.

²⁶ *Ibid*, p. 182, citing *Ward Petroleum Corp. v. Federal Deposit Insurance Corp.*, 903 F. 2d 1297 (U.S. 10th Cir. Okl. 1990) at page 1301. See also *Intraworld Industries Inc. v. Girard Trust Bank* (1975), 336 A. (2d) 316 (S. C. Penn.) where the court said, at pp. 324-5, that if the call documents "are genuine in the sense of having some basis in fact", then no injunction would be warranted, an injunction being warranted only if the beneficiary "has no *bona fide* claim to payment" (quoted in McGuinness, *infra*, note 31, p. 825, footnote 190).

²⁷ [1993] O.J. No. 112 (Ont. Gen. Div.).

²⁸ At 14 B.F.L.R., p. 529

²⁹ *Supra*, note 10, 1 B.L.R. (3d), p. 184. Note that this finding was made, notwithstanding that the mortgage in this case specifically provided otherwise (see text above after footnote 11). The court found that, since the commitment did not provide for it, the credit could not stand as general security. The court apparently held, therefore, that the commitment's failure to state this prevailed over the provision of the mortgage that did state this.

The court did not say whether the commitment or the mortgage contained a provision, which is common in these loan documents, stating which of the two documents prevailed in the event of a conflict or inconsistency between them.

³⁰ *Ibid*, pp. 184-5.

³¹ But why would the bank even have been asked to consent to this? On first principles, the letter of credit and the underlying transactions are separate transactions. Kevin McGuinness in his book “The Law of Guarantee” (2nd ed.) (Toronto: Carswell, Thomson Professional Publishing, 1996) at p. 817 quotes from *Re Carley Capital Group* (1990), 119 B.R. 646 (W. D. Wisc.), where the court noted that the principle of autonomy “relieves parties to a letter of credit transaction from the burden of ascertaining and policing contractual relationships in which they are not involved....[T]he issuer of a letter of credit acts as a mere lender relying upon the strength of its contract with its customer rather than being required to monitor the underlying transaction.” Accordingly, the parties to the underlying transaction are free to amend their contract as they see fit, without reference to the issuer of the letter of credit. In the *Gentra* case, by entering into the cross-collateralization agreement, the applicant and the beneficiary in effect amended the commitment letter relating to the Oakville transaction, allowing the beneficiary to draw down on the credit for other purposes. As the beneficiary had pointed out to the court earlier in the decision, it is up to the issuer, upon the issuance of the credit, to get whatever security it wants from the applicant. If the issuer wants to consent to any amendments to the commitment, then it must extract that covenant from the applicant at that time (and it could, if it wished, insist on getting the same covenant from the beneficiary).

Although the point was apparently not raised in this case, when the letter of credit stated that the beneficiary had to provide a letter confirming that monies drawn pursuant to the credit were due and payable in accordance with the terms of “the commitment”, do the words in quotation marks mean “the commitment as amended from time to time” or “the original commitment, not including any amendment”? Without answering the question, it could fairly be said that, if the issuer had wanted these words to be interpreted in the latter way, then it would have been better off saying that directly in the credit.

³² *Supra*, note 10, 1 B.L.R. (3d), p. 185.

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ *Ibid.*, p. 186.

³⁶ Henry Harfield in his book “Bank Credits and Acceptances” (5th ed.) (New York: John Wiley & Sons, Inc., 1974) at p. 69 states that, in connection with “clean” credits, “banks deal in written representations, and not in facts”. In other words, issuers deal with the representations made to them (to the extent such representations are required under the credit to be made) in paying under a standby credit, and do not concern themselves with the underlying transaction and its facts. In dealing with these representations, the issuer is entitled to rely on their truth, just as it is entitled to rely on the truth of the bills of lading and other documents that are presented under documentary letters of credit.

³⁷ Perhaps what the court meant is what was said by the court in the *Lee River* case: payment under the credit is not dependent on the beneficiary proving the truth of the statement made in the demand for payment. Two sentences before this quoted sentence, the court stated: “The Letter of Credit did not require the beneficiary to verify or attest to the accuracy of the call documents.” In other words, the beneficiary need not prove the truth of its statements. But this is different from saying that the statements need not be true.

³⁸ This is the fraud exception to the principle of autonomy, which was affirmed in *Angelica-Whitewear*.

³⁹ This would negate the fraud exception to the autonomy principle. The statement in the letter of credit (which appears in many, if not most, letters of credit) that the issuer will not enquire into the underlying transaction is simply a statement of the autonomy principle, and is not a waiver by the issuer of the fraud exception. In *Canadian Pioneer Petroleums Inc. v. Federal Deposit Insurance Corp.*, [1984] 2 W.W.R. 563 (Sask. Q.B.), the court held that the issuer had waived any review of possible fraud in the underlying transaction, as the wording of the letter of credit stated that the issuer would pay “notwithstanding ... any fraud in the underlying transaction”.

⁴⁰ *Supra*, note 10, 1 B.L.R. (3d), p. 186.

⁴¹ *Ibid.* This appears to conflict with the passage quoted by the court (as part of the bank's submissions) from the *Bank Russo-Iran* case, where the court stated that, in a case of fraud, the issuer is entitled to recover money paid under a credit "as paid under a mistake of fact". See Sarna, *supra*, note 6, p. 8-3, §2.1. However, in a case of fraud, there is no need to allege mistake of fact in order to obtain the remedy of recovery of monies paid; the defrauded party will have an action on the basis of the fraud for the return of the monies paid: see C.E.D. (Ont. 3^d ed.), Title 65. By lowering the standard to mistake, the results might be actions by issuers to recover monies paid out under a mistake of fact where no fraud exists.

⁴² Sarna, *supra*, note 6, p. 83, §2.1, states that the issuer may have recourse for recovery against the beneficiary on the basis of unjust enrichment; however, the case cited in support of this statement – *West Shore Ventures Ltd. v. K.P.N. Holdings Ltd.*, [1999] B.C.J. No. 1227 (B.C.S.C.), affd. with cross-appeal allowed [2001] B.C.J. No. 713 (B.C.C.A.), appl. for leave to appeal dismissed [2001] S.C.C.A. No. 302 – was actually a case of an applicant who was not a party to the underlying contract suing the beneficiary.

⁴³ *Supra*, note 10, 15 B.L.R. (3d), p. 28.

⁴⁴ (1889), 14 App. Cas. 337 (Eng. H. L.). This definition is virtually identical to the definition approved by the Supreme Court of Canada in the *Parna* case, *supra*, note 18.

⁴⁵ Hilary Clarke, in her review of the *Gentra* case, *supra*, note 10, also notes the Court of Appeal's reference to the legal opinions obtained by Gentra, and concludes that the *Gentra* case stands for the proposition that "[a]s long as the beneficiary has received legal advice that a call on the letter of credit is appropriate, it appears that it cannot thereafter be accused of acting fraudulently in making the call" (page 428) and that "[a]ccording to *RBC v. Gentra*, the test for fraud is not met where the call on the letter of credit has been made with legal advice" (page 429). However, I submit that this is putting it too strongly. Neither the trial judge nor the Court of Appeal explicitly makes these findings; rather, they refer to the fact that Gentra went and obtained legal opinions as part of the overall fact situation in determining whether Gentra acted fraudulently. It could certainly be safely said that the courts

found that getting a legal opinion is evidence that one is not acting fraudulently, but since it would obviously be relatively easy for a fraudster to feed a law firm a fact situation that would result in a favourable opinion being elicited from the firm, which fact situation would not be true, I submit that obtaining a legal opinion before demanding on a letter of credit cannot be a complete answer to an allegation of fraud (ie. is only rebuttable evidence that fraud does not exist).

⁴⁶ *Supra*, note 10, 15 B.L.R. (3d), p. 28.

⁴⁷ *Supra*, note 27.

⁴⁸ *Supra*, note 10, 15 B.L.R. (3d), p. 29.

⁴⁹ *Supra*, note 26.

⁵⁰ Ms. Clarke, in her review of the *Gentra* case, *supra*, note 10, suggests that this standard narrows the fraud exception, the breadth of which, after *Angelica-Whitewear*, “was open to interpretation”. I would suggest that this standard is not much different from the “clearly untrue or false”, “utterly without justification” or “no right to payment” standards enunciated in *Cineplex Odeon*, which standards came from cases such as *Rosen v. Pullen* (1981), 126 D.L.R. (3d) 62 (Ont. H. C.) and *Henderson v. Canadian Imperial Bank of Commerce* (1982), 40 B.C.L.R. 318 (S.C. in Chambers). Indeed, in suggesting the “utterly without justification” standard in the *Henderson* case, Berger J. considered himself to be “broadening” the fraud exception.

⁵¹ See the cases cited at footnote 53 of my previous article, *supra*, note 1, and the reference in *Angelica-Whitewear*, at page 82, to the obligation of the issuer to the beneficiary as “of a *sui generis* contractual nature”.

⁵² Ms. Clarke, in her review of the *Gentra* case, *supra*, note 10, states: “According to *RBC v. Gentra*, the test for fraud is not met...where the statements made in the call documents are untrue, unless it is a specific requirement of the letter of credit that statements made in the call documents be true. Issuers of letters of credit have been warned [apparently as a result of the decision in *Gentra*] that if they are not prepared to honour a call unless statements contained in the call documents are true, they must take care to provide so expressly in the letter of

credit.” But how is this to be done? If a letter of credit already requires that the beneficiary, as a requirement of a drawdown, say “I am entitled to this money” (as the beneficiary had to say in *Gentra*), what does it add to have the credit say “and such statement shall be true” or what use is it to also require in the credit that the beneficiary also say “and what I am saying is true”? If the beneficiary is acting fraudulently, he won’t care about adding the last quoted words to the first quoted ones. Surely, it was always the case that the issuer was entitled to rely on the truth of the statements made by the beneficiary in its demand. Or will standby letters of credit now require proof from independent third parties or other sources that what the beneficiary is saying is true? If this happens, I would submit that the commercial utility of standby credits will be damaged.

⁵³ (1999), 45 O.R. (3d) 257 (C.A.).

⁵⁴ Although, as McGuinness, *supra*, note 31, states at p. 822, footnote 181, “there is no doubt that the customer [applicant] may recover any amount paid to the beneficiary as a result of its fraud from that beneficiary”.

⁵⁵ See Sarna, *supra*, note 6, p. 3-7 ff., §1(c); Crawford and Falconbridge, *supra*, note 6, §3701.4(c), p. 856; Harfield, *supra*, note 36, pp. 70, 105.

⁵⁶ [2001] N.J. No. 147 (Newf. C.A.), application for leave to appeal dismissed [2001] S.C.C.A. No. 411.

⁵⁷ *Ibid*, para. 28.

⁵⁸ (1924), 297 F. 152, at page 158.

⁵⁹ *Supra*, note 56, para. 34.

⁶⁰ *Ibid*, para. 39.

⁶¹ *Ibid*, para. 51.

⁶² [1995] O.J. No. 1044 (Ont. Gen. Div.) (reviewed in my previous article, *supra*, note 1, commencing at p. 534).

⁶³ *Ibid*, para. 198.

⁶⁴ *Supra*, note 21.

⁶⁵ *Supra*, note 27.

⁶⁶ [1997] O.J. No. 1906 (Ont. C.A.).

⁶⁷ *Supra*, note 56, para. 72.

⁶⁸ *Ibid*, para. 76.

⁶⁹ This issue is, of course, the subject of much commentary. Most observers seem to be in favour of a narrow fraud exception: see Crawford and Falconbridge, *supra*, note 6, p. 867, where the author quotes Henry Harfield as stating that “[i]t is to be hoped that injunctions will be dealt out subject to the same law of probability that governs the filling of inside straight”; and McGuinness, *supra*, note 31, para. 12.87, pp. 830-1. But also see Van Houten, *infra*, note 80, and Sarna, *supra*, note 6, who states, at p. 5-17, that “liberal use of the *Sztejn* exception may be seen as strengthening, at least at the interlocutory injunction stage, the customer’s protection against fraud, even at the risk of disrupting the delicate mechanism of the credit operation”.

⁷⁰ The circumstances being that the letter of credit required certification that the beneficiary had “requested payment” from the applicant, that requests had apparently been made, that the applicant owed more than the amount of the credit to the beneficiary at the time demand was made, and that the demand complied with the credit.

⁷¹ [1999] O.J. No. 4549 (Ont. S.C.).

⁷² The meaning of this is somewhat unclear, but presumably by “arranging” the issuance of the letter of credit, the plaintiff had become liable to indemnify the bank upon any drawdown under the letter of credit.

⁷³ (1981), 126 D.L.R. (3d) 62, 16 B.L.R. 28 (Ont. H.C.)

⁷⁴ *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S. 2d 631 (N.Y. Sup., 1941).

⁷⁵ [2001] A.J. No. 1660 (Q.B.).

⁷⁶ *Ibid*, para. 32.

⁷⁷ Crawford and Falconbridge, *supra*, note 6, comment on the interaction of the law of injunction and the law of letters of credit at pp. 866-7.

⁷⁸ See the *Iran* case, the *Iraq* case, *Rosen v. Pullen* and *Henderson v. CIBC*, all cited at footnote 8 of my previous article, *supra*, note 1.

⁷⁹ *Angelica-Whitewear*, p. 72.

⁸⁰ See S. H. Van Houten “Letters of Credit and Fraud: A Revisionist View” (1984), 62 C.B.R. 371, where the author, in discussing the fraud standard in letters of credit cases, notes at p. 380 that the United States Supreme Court has held that “fraud had a wider meaning in equity than at law and that it could be found to exist without proof of an intention to defraud or misrepresent [footnote omitted]”.

⁸¹ See the discussion of this in my previous article, *supra*, note 1, at pp. 517-9.

⁸² Although the circumstances of each case have to be examined, reference to the UCP in the letter of credit may reflect a greater knowledge than usual by the parties with the law of letters of credit, and in particular with the principle of autonomy.