Documentary credits and illegality in the underlying transaction.

Mahonia Limited v J P Morgan Chase Bank
English Commercial Court [2003] EWHC1927 (Comm)

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DOCUMENTARY CREDITS AND ILLEGALITY IN THE UNDERLYING TRANSACTION

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Facts
An interlocutory application was made on assumed facts.

In 2001, Mahonia, Chase Bank and a subsidiary of Enron entered into three swap transactions. Under those transactions, Mahonia lent Enron through Chase's intermediation a sum of about US$50 million. The sum was to be repaid with interest in six months after drawdown. Repayment was agreed to be partly secured by the issue of a letter of credit by West LB AG at the application of Enron for the benefit of Mahonia. The overall effect of the three swaps was that Enron was to receive the use of US$350 million for six months. It was contended by West LB that the transaction was purely a cosmetic scheme to provide Enron with a loan of US$350 million at a rate of interest of roughly 3.4 per cent per annum which Enron did not have to record in its accounts as a debt. Enron also paid Chase an arrangement fee of US$1 million.

Enron defaulted on the repayment and Mahonia thus made a demand on West LB on the basis of the letter of credit. The bank refused to pay arguing that the letter of credit was tainted by illegality as the letter of credit was arranged to enable Enron to commit an accounting offence under US securities law and as such, was unenforceable on grounds of public policy. West LB claimed that it was not aware of the illegal nature of the underlying transactions until after the claim for payment under the letter of credit was made. They were therefore not privy to the illegality and was not prevented from relying on the illegality defence.

The question for the court was whether the principle of autonomy required the bank to disregard the illegality under foreign law and pay according to the terms of the credit.

Decision
The court supported the bank's argument that the illegality affected not only the underlying transactions but also the letter of credit. Colman J found that the letter of credit was an essential requirement of Chase in order to set up the cosmetic scheme; it was therefore not divisible from

the underlying transactions. Not only the three swaps but also the letter of credit must be said to have an illegal purpose in as much as both the swaps and the letter of credit were entered into for the purpose of providing the structure on which Enron's misleading accounts were to be founded.

The court went on to hold that it did not matter that the illegality was under a foreign law or that the illegality was known only to one party. As Colman J said:

> It must logically be just as contrary to public policy to enable the claimant to enforce a contract which has been entered into for a foreign illegal purpose known only to himself as to enable him to enforce such a contract the purpose of which is known to both parties.

Comment

This is yet another case in very recent times permitting the derogation from the principle of autonomy in documentary credit. It is on the whole a moral decision but moral decisions often may not always sit well with the paradigms of commercial certainty. Cases on illegality and letters of credit are few, the main one being *Group Josi v Walbrook Insurance Co Ltd & others* [1996] 1 Lloyd's Rep 345. This case is important in offering guidance on the extent to which illegality might be compared to fraud as an exception to the principle of autonomy. It may be recalled that Lord Diplock in *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 took care in stressing that fraud by the beneficiary was only *one* 'established exception' to the principle that the bank's duty was to pay against documents which on their face conformed with the requirements of the letter of credit and without reference to any challenge to those documents arising from disputes between the applicant and the beneficiary. Hence, the first hurdle for the bank in the present case was to show that it was not contrary to principle to rely on the illegal purpose for which the letter of credit was obtained as a defence against a demand for payment. In the present case, Colman J did not consider that plain emphasis of Lord Diplock a rejection of illegality as a defence. The judge reasoned that Lord Diplock's explanation for the fraud exception, by reference to the general maxim that the court should not permit the use of their process by a dishonest person to carry out a fraud strongly indicated that illegality should similarly be admitted as a defence.

There is however an aspect which the court did not quite consider: in fraud cases, the fraud is normally practised on the applicant and/or the bank. In cases where the underlying transaction is said to be illegal, the illegality is likely not practised on either the applicant or the bank. It would appear that, as far as the court was concerned, that was immaterial. So long as an offence (be it under English or foreign law) is to be committed through the use of the letter of credit, it must prevent the beneficiary from benefiting from it as long as the beneficiary was a participant in the offence and the bank had no prior notice of the illegality. It is clear that this reliance on the public policy rule that a dishonest person should not benefit from his crime is to ensure that beneficiaries are suitably deterred. There is however no emphasis on the bank's role in all this – it is not required to make inquiries into the purpose of the application for the letter of credit. Even where the unusual nature of the terms of the letter of credit might have put the bank on enquiry that something may not be entirely right, there is nothing to prevent the bank from refusing to pay. For even where the bank is fully complicit in the illegality, on the basis of *ex turpi causa* the beneficiary need not be paid.

The analogy made with fraud means that before the defence of illegality can be relied on, it must be shown that the beneficiary was privy to the illegality and, secondly, that it is not enough for the bank to claim that it has suspicions that the underlying transaction was illegal. It must be able to show that the bank had more than mere suspicion and that not only was the underlying transaction illegal but the letter of credit was central to achieving the illegal purpose or cannot be separated from the illegal purpose.

In *Group Josi*, J, a reinsurer, agreed with W that the latter would pay over to them certain loss reserves in exchange for a letter of credit under which W would be entitled to draw down against debit notes stating that J was liable for the amounts in question. J brought proceedings to prevent W from drawing down under the letter of credit. It argued that it was not properly authorised under the

Insurance Companies Act 1982 to carry on insurance business in Great Britain and as the contracts were made in the jurisdiction, they and the letter of credit were illegal and unenforceable. Clarke J at first instance held that the letter of credit was not tainted by the illegality (if proved) not only because it represented a contract separate from the underlying reinsurance contracts, it was a mere facility provided subsequently to the entering into of the illegal reinsurance contracts which assisted performance in a manner not specifically rendered illegal. Where, on the other hand, the letter of credit plays from the outset an integral part in the illegal transaction, the letter of credit could not and should not be enforced.

Staughton LJ in *Group Josi* gave the following as an example of when the letter of credit was deemed to be an integral part of the underlying transaction:

> It seems to me that there must be cases when illegality can affect a letter of credit. Take for example a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1,000 kalashnikov rifles to be carried to the port of Basra. I do not suppose that a court would give judgment for the beneficiary against the bank in such a case.

Staughton LJ went on to state, in passing, that if the reinsurance contracts were illegal and if the letter of credit was used as a means of paying sums due under those illegal contracts, the court would restrain the bank from making payment to the beneficiary. That would not be because the letter of credit contract was itself illegal but because it was being used to carry out an illegal transaction. This reversal of Clarke J's finding demonstrates starkly that, in commercial law, it is only in very rare situations that the letter of credit would not be found to play an integral part in the underlying transaction. Payment is, after all, virtually always an integral part of commercial or financial transactions.

It is however open to argument that the reasoning in *Bowmakers Ltd v Barnet Instruments Ltd* [1945] KB 65 may avail the beneficiary in such a position. It might be possible for him to plead his claim for payment not on the illegality but on some other legal interest. Clarke J in *Group Josi*, for example, relied on this as a possible ground to permit the enforcement of the letter of credit; the judge found that the fact that opening the letter of credit amounted to effecting conditional payment under the reinsurances by means of a separate contractual engagement between the bank and the reassureds, and as such a conditional payment was not rendered illegal by the Insurance Companies Acts. The applicability of that reasoning was rejected by Staughton LJ in the Court of Appeal and as far as the present case was concerned, Colman J too thought that the separate nature of the letter of credit could not be used to trump the public policy that the beneficiary should not benefit from his illegality.

The court also confirmed that Waller LJ's guidance in *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd* (1999) 68 Con LR 180 on the issue of the quantum of proof was applicable to the present circumstances. It may be recalled that in that case that the following test was laid down:

(a) When the demand was made under the demand bond [or letter of credit], did the surety or the bank have clear evidence from which the only inference to be drawn was fraud [illegality]? If the answer was no, prima facie the beneficiary was entitled to judgment.
(b) What, on the information available at the time of the application for summary judgment, was the strength of the surety's case that the demand was fraudulent [for an illegal purpose]?
    — If the evidence was now clear, then no judgment would be given in favour of the beneficiary because of the fact that the surety [bank] would be entitled to a judgment of the equivalent sum.
    — If the evidence was powerful but not quite sufficient to enable summary judgment to be entered in favour of the surety on the basis that the demand was fraudulent [or founded on an illegal purpose], then either judgment would be entered with a stay of execution or probably no judgment would be entered at all until what was in effect the counterclaim had been fought out at trial.

— If the evidence was less than powerful, judgment would be entered in favour of the beneficiary and the surety would be left either to pursue his remedy against the applicant or pursue a claim or counterclaim for reimbursement for monies paid if it subsequently transpired that there was indeed fraud [an illegal purpose].

In case it might be thought that the present case makes it easy for banks to plead illegality, it should be noted that these guidelines (which are not entirely free from controversy) mean that the bank will need to show that it has 'clear evidence' of illegality. This is not easily established, especially where the illegality is one under some arcane foreign law.

The judgment is very much grounded on public policy but policy can sometimes be a blunt instrument. For example, how should a court deal with the validity and enforceability of a letter of credit where the underlying transaction is illegal but that illegality is a mere technical misdemeanour? On this issue, Colman J commented:

> There is much to be said for the view that the public policy in superseding the impregnability of letters of credit where there is an unlawful underlying transaction defence may not be engaged where the nature of underlying illegal purpose is relatively trivial, at least where the purpose is to be accomplished in a foreign jurisdiction.

Such a qualitative assessment of what is trivial is difficult – should the triviality be evaluated from English eyes or under foreign law or both? How is such an assessment of gravity to be approached given the principle of international judicial comity?

An addendum. Colman J's judgment does not set out in any detail the respective arguments of counsel. Although it was justified on the need to keep the judgment to "manageable proportions in the time available", it would have been interesting to see how counsel for the beneficiary developed the reasoning in *Bowmakers*.

JC