Client Alert | Commercial Litigation

Letters of Credit: Autonomy Principle is Re-confirmed

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Overview

- The Court of Appeal has confirmed the "autonomy principle" of letters of credit under English law, holding that PetroSaudi Oil Services (Venezuela) Ltd ("**PetroSaudi**") and its director and General Counsel had made a valid demand under a standby letter of credit. They had not acted fraudulently "*in any sense*" in making a demand to the issuing bank, Novo Banco.
- The Court of Appeal's decision confirms the narrow application of the fraud exception to the principle of the autonomy of credit. The decision gives comfort and reassurance to parties engaging in international trade who wish to rely on letters of credit as a means of guaranteeing payment, where invoices under the underlying contract are unpaid or disputed.

The Autonomy of Letters of Credit and the Fraud Exception

In large commercial transactions, sellers are exposed to significant risk that the buyer will fail to pay on time, negatively impacting their cash flow. To protect against this risk, sellers frequently require buyers to procure letters of credit.

Letters of credit are standalone contracts between the seller and the buyer's issuing bank which are separate to the performance of the underlying contract. They provide a payment obligation from a third party to the underlying contract (the issuing bank), and create standalone rights and obligations.

In this way, performance under the underlying contract has no direct impact upon performance under the letter of credit: demands made under the letter of credit are to be assessed for compliance with the documentary and other requirements stipulated under the letter of credit. If these are satisfied, the demand must be paid by the issuing bank, without examination of liability under the underlying contract. This transfers the risk of non-payment from seller to buyer.

Exceptionally, though, if the beneficiary to the credit makes a fraudulent demand, the bank is entitled to refuse to pay: payment is not required in respect of demand documents that contain material representations of fact that, to the knowledge of the maker of the statement, are untrue.

Background to the PetroSaudi case

PetroSaudi entered into a drilling contract with the Venezuelan state oil company PDVSA (the "**Drilling Contract**"). The Drilling Contract was governed by Venezuelan law and provided for disputes to be submitted to arbitration in Paris. Novo Banco S.A. had entered into a standby letter of credit facility as issuing bank with PetroSaudi (the "**SBLC**") for payment of invoices issued by PetroSaudi to PDVSA under the Drilling Contract. The SBLC was governed by English law and subject to the jurisdiction of the English courts.

A dispute arose under the Drilling Contract in respect of certain of these invoices and was referred to arbitration.

Clause 803 (3) of the Drilling Contract provided that PDVSA would be deemed irrevocably to have accepted an invoice if PDVSA failed to dispute its validity within 15 days. Clause 803(4) also obliged PDVSA to pay the invoice upfront even if it was disputed pending resolution of the dispute (a "*pay now, argue later*" clause). PDVSA successfully argued before the arbitral tribunal that these two provisions of the Drilling Contract were incompatible with Venezuelan statute, namely Article 141 of the Venezuelan Public Contracting Law of 19 November 2014 ("**LCP**"), which provides:

> *The principal shall pay the obligations assumed under the agreement in compliance with the following:*
>
> *1. Verification of the compliance and the supply of the good, rendering of the services, performance of the work or any part thereof.*
>
> *2. Receipt and review of the invoices presented by the contractor […]*

The arbitral tribunal had held that Article 141 "*mandatorily requires a state entity to ascertain that invoices for services rendered are correct before paying them […]*".

The arbitral tribunal was yet to determine the substantive dispute as to the validity of the invoices. It had struck down PDVSA's payment obligations only to the extent that the tribunal held these contradicted Article 141 by compelling PDVSA to pay invoices before these were accepted by PDVSA or determined to be due in arbitration.

The English proceedings

On 16 September 2016, the arbitral tribunal lifted its prior injunction precluding PetroSaudi from issuing demands in relation to disputed invoices, recognising that it was for the English court to decide whether any demand complied with the SBLC. Three days later, PetroSaudi presented a demand for over US$ 129 million to Novo Banco under the SBLC. As the SBLC required, the demand contained a declaration, signed by PetroSaudi's General Counsel, which included the following wording:

> *We certify that the Applicant [i.e. PDVSA] is obligated to the Beneficiary [PetroSaudi] to pay the amount demanded under the Drilling Contract executed among the Beneficiary and PDVSA Servicios S.A.*

PDVSA applied to the English High Court for an injunction restraining Novo Banco from making payment. PDVSA argued that, given the decision of the arbitral tribunal in respect of Article 141 of the LCP, PDVSA could not be said to be "*obligated*" to make payments under the invoices.

At first instance, HHJ Waksman QC agreed with PDVSA and held that the General Counsel had made the declaration to Novo Banco S.A. fraudulently on the basis of a "*lawyer's construct*".

The Court of Appeal's Decision

Christopher Clarke LJ, giving the judgment of the Court of Appeal, overturned the findings of the High Court judge. He found that PetroSaudi's General Counsel was correct to conclude that the sums were due and payable in the sense required under the SBLC: PDVSA was obliged to pay PetroSaudi, even though PDVSA could not presently be compelled to do so by virtue of Article 141 of the LCP. Article 141 simply gave PDVSA *"a form of legal excuse for non-fulfillment of its existing obligation to pay*". In particular:

- Article 141 of the LPC did not mean that no obligation to pay could in any sense arise unless and until Article 141 had been satisfied. Indeed, the introductory language of Article 141 made it clear that prior obligations were to be "*assumed*".
- There is "*nothing legally contrived in recognising different types of debt obligation*", including an obligation that is due and payable even where there is some restriction on the discharge of that obligation by the debtor.
- Given the background to the SBLC, including its importance to PetroSaudi in light of "*Venezuela's dilatory payment history*" as well as the "*well-known purpose of such instruments*", it made most commercial sense to interpret the SBLC so as to enable PetroSaudi to make demands pending the outcome of arbitration.

Christopher Clarke LJ stressed that, even if, contrary to his own conclusion, the High Court judge had been correct to conclude that PDVSA was not obliged to make the payments, this was not enough to engage the fraud exception, adding:

> *I wish […] to express some disquiet at the finding of the judge that, on the view that he took of the legal position, [PetroSaudi's General Counsel] was fraudulent in signing the certificate. Whilst there is only one true construction of an instrument such as the certificate, different legal minds may obviously take different views on such a question."*

He would, had it been necessary for him to do so, have wished:

> *"to have given anxious consideration to the question whether, despite the well-recognised advantages of a trial judge and the inhibition rightly felt by [the Court of Appeal] in overturning findings of fact, the judge was entitled to conclude that the General Counsel was fraudulent (i.e. conscious of the falsity of what he was saying or with no honest belief in, or a reckless indifference to, its truth)".*

Comment

The Court of Appeal's decision confirms that an obligation to pay under an English law letter of credit will not easily be avoided by reference to provisions of the governing law of the underlying contract which may raise technical barriers to payment. The Court of Appeal's decision effectively preserves the commercial purpose of the credit.

Christopher Clarke LJ's final comments on the application of the fraud exception will also be reassuring to individuals invited to sign any declaration of legal entitlement. Of course, such individuals must have an honest belief in the truth of their declaration. But, in overturning the surprising first instance decision in this case, the Court of Appeal gave clear guidance that the courts will be slow to find fraud simply on the basis that a judge has reached a different conclusion as to the correct legal position.

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