Case No: 2002 Folio 1400

**IN THE HIGH COURT OF JUSTICE**
**QUEENS BENCH DIVISION**
**COMMERCIAL COURT**
**[2003] EWHC 1927 (Comm)**

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 30 July 2003

**Before** :

**THE HONOURABLE MR JUSTICE COLMAN**

- - - - - - - - - - - - - - - - - - - - -

**Between:**

| | |
|---|---|
| **Mahonia Limited** | **Claimant/ Part 20 Defendant** |
| **- and –** | |
| **JPMorgan Chase Bank** | **Part 20 Defendant** |
| **- and –** | |
| **WestLB AG** | **Defendant/ Part 20 Claimant** |

- - - - - - - - - - - - - - - - - - - - -
- - - - - - - - - - - - - - - - - - - - -

**Mr Laurence Rabinowitz QC and Mr Steven Elliott** (instructed by **Slaughter and May**) for the Claimants
**Mr Michael Brindle QC and Mr Derrick Dale** (instructed by **Berwin Leighton Paisner**) for the Defendants

Hearing dates : 23-25 June 2003

- - - - - - - - - - - - - - - - - - - - -

Judgment

**Mr Justice Colman :**

Introduction

1. These applications raise an important point as to the law relating to the enforceability of documentary credits. Whereas there is strong authority that an issuing bank is entitled to refuse payment under a documentary credit if at the time when it ought to pay, following presentation of conforming documents, the bank has knowledge of established or obvious fraud, there is no conclusive authority as to whether and, if so, in what circumstances the bank can rely on illegality affecting the letter of credit as an excuse for failure to pay.

2. There are before the court two applications by the claimants:

   (i) under CPR 3.4(2)(a) to strike out those paragraphs of the defence and counterclaim of the issuing bank, West LB AG, to which I refer as "the Bank", which rely on illegality as a defence to the claimant beneficiary's claim for payment under a documentary credit;

   (ii) under CPR 24.2(a)(i) for summary judgment against the Bank on those same paragraphs of the defence and counterclaim.

3. The claim in this action arises out of the collapse of the giant Enron Corporation, which was incorporated in Oregon. It filed for voluntary Chapter 11 bankruptcy protection in the United States on 2 December 2001. So also did 13 of its direct and indirect subsidiaries, including Enron North America Corporation, to which I refer as "ENAC". The letter of credit which has given rise to this claim was issued by the Bank pursuant to a Facility Agreement dated 10 September 2001 under which the Bank agreed with Enron that, upon request by Enron, the Bank would issue instruments, including letters of credit, subject to the terms of the Facility Agreement. The letter of credit was issued for the account of Enron on behalf of ENAC. On 5 December 2001 J P Morgan Chase Bank ("Chase") which is a Part 20 defendant to a claim by the Bank in these proceedings, acting on behalf of the claimant, presented a conforming document to the Bank and demanded payment of the amount due under the letter of credit, namely US $165 million. Under the terms of the letter of credit the Bank was obliged to pay within five banking days. It declined to do so. If the Bank had paid, its ability to recover reimbursement from Enron would obviously be extremely doubtful due to the Chapter 11 proceedings.

4. In order to understand the Bank's illegality defence in this case, it is necessary to consider the background against which Enron procured the letter of credit. On the face of it, the detail of this background is complicated but its substance is quite simple. It may be summarised as follows:

   (i) The claimant, Mahonia, is a company incorporated in Jersey. Its shareholders are trustees. It is a special purpose vehicle, one of the functions of which has been to take part in financial transactions involving Chase and Enron.

   (ii) On 28 September 2001 three swaps transactions were entered into :

      (a) between Chase and Mahonia ("the Chase/Mahonia Swap") US $350 million was paid by Chase to Mahonia at the outset and an amount calculated by reference to the future price of natural gas futures on 25 March 2002 was to be paid by Mahonia to Chase on 26 March 2002;

      (b) between Mahonia and ENAC ("the ENAC/Mahonia Swap") under which US $350 million was to be paid by Mahonia to ENAC at the outset and

an amount calculated in an identical manner (by reference to the price of natural gas futures on 25 March 2002) to the calculation under the Chase/Mahonia Swap was to be paid by ENAC to Mahonia on 26 March 2002;

(c) between ENAC and Chase ("the ENAC/Chase Swap") under which ENAC was on 26 March 2002 to pay to Chase a fixed sum which, as calculated, amounted to US$355,961,258.40 and Chase was to pay ENAC, in effect, the same amount as was to be paid by ENAC to Mahonia on the same date.

(iii) The overall effect of the circularity of these three swaps was that ENAC was to receive the use of US $350 million from 28 September 2001 to 26 March 2002 and that Chase was to be paid by ENAC an additional US$5,961,258.40. It is said by the defendant Bank that this transaction was a cosmetic device 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.

(iv) As a condition of entering into this three-swap transaction Chase required Enron to provide security in the amount of US$315 million. It was a term of the ENAC/Mahonia Swap that ENAC should provide this security by letter of credit in favour of Mahonia as beneficiary. In the event, ENAC provided the Bank's letter of credit the subject of these proceedings in the sum of US$165 million together with a second letter of credit for US $150 million provided by a syndicate of banks led by Chase. The provision of the security in respect of a substantial proportion of the variable payment to be made by ENAC to Mahonia under the ENAC/Mahonia Swap was thus an integral part of the circular transaction.

5. The substance of the defendant Bank's case on illegality is summarised in the following way.

(i) Enron's purpose in entering into the three-swaps transaction was to obtain a loan without showing it as such in its accounts.

(ii) Omission so to show the loan was contrary to United States GAAP and Financial Accounting Standards Board statement 133.

(iii) It would therefore have been in breach of United States Securities Laws for Enron to have filed such deficient accounts with the SEC. That conduct with intent to defraud could lead to criminal and civil liability under United States law.

(iv) Section (22) of the Bank's defence and counterclaim states:

"22 The Letter of Credit is tainted by Illegality and/or is unenforceable on grounds of Public Policy.

The purpose and/or performance of the Three Swaps involved illegality

155 It was known and intended by Enron and Chase (on its own and on behalf of Mahonia) that the disguised loan would be treated in Enron's accounts as income on a derivative transaction rather than as a loan which was not in accordance with US GAAP and in breach of US securities laws (15 USC 78m(1)-(2) and 17 CFR 240.13b2-2). That was the primary purpose behind structuring the transaction as the Three Swaps instead of as a loan.

156 Accordingly, the accounting treatment, or proposed accounting treatment, of the Three Swaps was not in accordance with US GAAP and involved a breach of US GAAP and would have involved a violation of US securities laws.

157 By reason of the matters aforesaid, the purpose behind the Three Swaps was an illegal one and/or it was intended by Enron and Chase and Mahonia that the Three Swaps would be utilised illegally.

158 In the premises, the Letter of Credit is rendered illegal (whether directly or by way of taint) and/or is unenforceable on grounds of public policy.

162 Further, or alternatively, Enron and Chase (on its own behalf and on behalf of Mahonia) in disguising the $350 million loan to Enron as the Three Swaps acted in concert to falsely treat and improperly report the $350 million loan in public filings required by US federal statutes. Such improper reporting amounts to the commission of a criminal offence in the USA (15 USC 78m, 15 USC 78ff and 17 CFR 240.13b2-2). In addition, the false treatment and improper reporting of the $350 million loan constituted a securities fraud on shareholders of Enron and/or lenders to Enron and/or creditors of and/or potential investors in Enron (15 USC 78j and 18 USC 2) or a mail or wire fraud (18 USC 1341 and 1343).

163 In the premises, the Letter of Credit is rendered illegal (whether directly or by way of taint) and/or is unenforceable on grounds of public policy."

6. For the purposes of the present applications only, the parties are agreed that the facts which I have set out as constituting the relevant illegality or unenforceability should be assumed to be true. One further relevant fact is to be assumed, namely that neither at the time when the document was presented to the Bank under the letter of credit (5 December 2001) nor at the last date for making payment under it (10 December 2001) was the Bank aware of the details of the three swaps transaction or had obtained information amounting to clear evidence that the transaction was illegal under United States law.

7. The remaining material facts are that the letter of credit provided as follows:

> "Effective 9 October 2001, we hereby establish our Irrevocable Transferable Standby Letter of Credit No. 2170300IC140450 in your favour for the account of Enron Corp. 1400 Smith Street, Houston TX 77002, USA on behalf of Enron North America Corp (the "Account Party"), for the aggregate amount not exceeding USD 165,000,000.00 (United States Dollars One Hundred and Sixty Five Million), available to you at sight upon demand at our counters at Woolgate Exchange, 25 Basinghall Street, London EC2V 5HA, on or before the expiration hereof against presentation to us of one of more of the following statements, dated and signed by a representative of Mahonia Limited or the transferee:
>
> 1. 'An Event of Default (as defined in the ISDA Agreement as referenced in the Swap Transaction Confirmation dated September 28th, 2001 between Mahonia Limited and Enron North America Corp, as the same may have been amended (the 'Agreement')) has occurred and is continuing with respect to Enron North America Corp under the Agreement. Wherefore, the undersigned does hereby demand payment of USD _____';

or

2. 'An Early Termination Date (as defined in the Agreement) has occurred as a result of a Termination Event (as defined in the Agreement) and Enron North American Corp has failed to make all payments in an aggregate amount of USD _____ due and owing to Mahonia Limited in accordance with the terms of the Agreement. Wherefore, the undersigned does hereby demand payment of USD _____'

The amount which may be drawn by you under this Letter of Credit shall be automatically reduced by the amount of any drawings paid through ourselves referencing this Letter of Credit No. 2180300IC140450.

We hereby agree with you that documents drawn under and in compliance with the terms of this Letter of Credit shall be duly honoured upon presentation as specified.

This Letter of Credit shall be governed by the Uniform Customs and Practice for Documentary Credits, 1993 Revision, International Chamber of Commerce Publication No. 500 (The "UCP"), except to the extent that the terms hereof are inconsistent with the provisions of the UCP, including but not limited to Articles 13(b) and 17 of the UCP, in which case the terms of this Letter of Credit shall govern.

With respect to Article 13(b) of the UCP, the Issuing bank shall have a reasonable account of time, not to exceed three (3) banking days following the date of its receipt of documents from the beneficiary, to examine the documents and determine whether to take up or refuse the documents and to inform the beneficiary accordingly."

8. The demand for payment presented to the Bank on 5 December 2001 was in appropriate terms as follows:

"Demand on Letter of Credit 2170300IC140450

To: Westdeutsche Landesbank Girozentrale, London Branch

An Event of Default (as defined in the ISDA Agreement as referenced in the Swap Transaction Confirmation dated September 28th, 2001 between Mahonia Limited and Enron North America Corp, as the same may have been amended (the "Agreement")) has occurred and is continuing with respect to Enron North America Corp under the Agreement. Wherefore, the undersigned does hereby demand payment of USD 165,000,000.00."

9. The Swap transaction confirmation referred to is the ENAC/Mahonia Swap. It is common ground that the filing of voluntary petitions for bankruptcy by Enron and its subsidiary, ENAC, constituted an Event of Default under the ENAC/Mahonia Swap.

10. The underlying issue on these applications is whether the principle that a letter of credit gives rise to an autonomous contract insulated from the underlying transaction in connection with which it is issued precludes the Bank from declining to pay against presentation of a conforming document on the facts assumed as the basis of this application.

11. However, in order to resolve this issue, there are the following specific issues.

(i) Is the fact that the underlying transaction in connection with which the letter of credit was issued was illegal or, by reason of illegality under the law of a foreign

state, unenforceable in the English courts as a matter of public policy, relevant to the Bank's duty to pay under the letter of credit, analogously to fraud?

(ii) If so, is a defence based on such illegality or unenforceability conditional upon there being clear evidence of such at the time when the Bank comes under an obligation to pay, again analogously to the fraud exception?

(iii) To what extent is it necessary, in this context, to distinguish between a letter of credit being a contract intrinsically illegal and a letter of credit which, because of its connection with a wider transaction having an illegal purpose, is infected or tainted by that purpose? In particular, how if, at all, does the principle in Bowmakers Ltd v. Barnet Instruments Ltd [1945] KB 65 apply in this connection?

The Nature of the Illegality alleged

12. Before considering the law specifically applicable to letters of credit it is necessary to identify precisely what is said to involve illegality in the present case. Whereas the claimant pursues these applications on the assumption, for present purposes only, that the factual allegations in paragraphs 155 to 157 and 162 of the defence are true, it challenges the assertion in paragraphs 158 and 163 that "in the premises, the Letter of Credit is rendered illegal (whether directly or by way of taint) and/or is unenforceable on grounds of public policy". Paragraphs 158 to 163 clearly have to be read in the context not only of paragraphs 155 to 157 and 162 respectively, but also the other pertinent paragraphs in the pleading, including, in particular, paragraphs 59 to 61 and 79 to 80. Reading these allegations together, it is obvious that the pleading is asserting that, given that the procurement by Enron of the letter of credit was an essential requirement of Chase in order to set up the cosmetic scheme, it is said to be illegal directly or by way of taint or unenforceable. I therefore understand the substance of what the defendant Bank alleges to be that not only the three swaps but also the letter of credit had an illegal purpose in as much as both the swaps and the letters of credit were entered into for the purpose of providing the structure upon which Enron's misleading accounts were to be founded. While it is true that the swaps were intended to provide the visible basis of these accounts and so were closer to the ultimate intended illegality, without the letters of credit this basis could not have been created.

13. The ultimate purpose was, however, rendered illegal by the securities law of the United States and not by English law. Similarly, as the claimant accepts the existence of that purpose was such as to render illegal the utilisation of the swaps. The net result is that the letters of credit were created for the purpose of forming part of the basis of a transaction (the swaps) which were illegal under United States law because they had an illegal purpose.

14. In these circumstances, it is necessary to investigate the criteria which determine whether the English courts will refuse to enforce contracts the purpose of which is to commit an act illegal in a foreign country.

15. In Regazzoni v. KC Sethia (1944) Ltd [1958] AC 301 there was a claim by the buyers for wrongful repudiation by the sellers of a contract for the sale of jute bags CIF Genoa. The purpose of the contract, known to both parties was that buyer should subsequently re-sell the goods for shipment to South Africa. The facts were such that both parties were aware of this purpose and, also, importantly, of the fact that such a large quantity of jute bags could not be obtained from anywhere except India and further that Indian law prohibited the export of goods to South Africa. It was held that, although on the face of it the contract provided neither for the shipment of goods

from India nor their delivery into or sale to South Africa, the action must fail because the enforcement of the contract would be contrary to public policy. Viscount Simmonds, having referred to Foster v. Driscoll [1920] 2 KB 287, concluded his speech at page 322-323 by the observation that:

> "The distinctive feature of (Foster v Driscoll) was that Scrutton L.J. thought that the contract there in question could be carried out legally, and for that reason, differing from Lawrence and Sankey L.JJ., held that it was not invalid. The principle of the decision in Ralli Brothers [1920] 2 K.B. 287 was emphatically reasserted and the apparent innocence of the documents was disregarded, the guilty intention being proved ab extra. So, here, it has been conclusively found that the common intention of the parties was to violate the law of India, and it is of no consequence that the documents did not disclose their intention."

16. Similarly, Lord Reid at pages 323 – 324 observed:

> "The real question is one of public policy in English law: but in considering this question we must have in mind the background of international law and international relationships often referred to as the comity of nations. This is not a case of a contract being made in good faith but one party finding thereafter that he cannot perform his part of the contract without committing a breach of foreign law in the territory of the foreign country. If this contract is held to be unenforceable, it should, in my opinion, be because from the beginning the contract was tainted so that the courts of this country will not assist either party to enforce it.
>
> I do not wish to express any opinion about a case where parties agree to deal with goods which they both know have already been smuggled out of a foreign country. Such cases may raise difficult questions. The crucial fact in this case appears to me to be that both parties knew that the contract could not be performed without the respondents procuring a breach of the law of India within the territory of that country."

17. And at page 325:

> "This contract does not require the seller to obtain the goods from India: it is only after investigation of the facts that it appears that he could not have got them anywhere else, and this contract does not disclose the buyer's intention to send the goods to South Africa. On the face of it this contract could be performed without a breach of the laws of any country. I shall quote from what Lawrence L.J. said in Foster's case [1929] 1 K.B. 470, 510 : "On principle, however, I am clearly of opinion that a partnership for the main purpose of deriving profit from the commission of a criminal offence in a foreign and friendly country is illegal, even although the parties have not succeeded in carrying out their enterprise, and no such criminal offence has in fact been committed; and none the less so because the parties may have contemplated that if they could not successfully arrange to commit the offence themselves they would instigate or aid and abet some other person to commit it." These passages cover the present case, and I agree with them."

18. Lord Somerwell, having at page 329, identified the problem in that case as:

> "Will our courts enforce a contract if its performance involves a breach of foreign criminal or "public" law? If the answer is "No," one has to consider the degree of involvement that will produce unenforceability."

observed at the conclusion of his speech at pages 330-331:

> "In conclusion, I would like to say a word as to the scope of the word "involves" in my statement of the question raised in the present appeal. One has, at one end of the scale, a contract which on its face necessitates a breach of the foreign law: a contract to deliver prohibited goods in the territory. At the other end one may have a contract of sale legal on its face at a normal market price, the vendor suspecting or knowing that the buyer intends to use the goods for an illegal purpose in a foreign country. The same problem arises when a contract is said to be unenforceable as immoral or illegal under our own law: Pearce v. Brooks (1886) L.R. 1 Ex. 213. In Foster v. Driscoll the majority found that the evidence established a joint enterprise to import whisky into the United States. 'It is not the case,' said Sankey L.J., where one or other of them merely knew that the whisky was going to the States. I am never very clear as to the effect of 'mere' and 'merely', though I may have used one or other myself. If the question is one of illegality under our law, the contract is unenforceable if the defendant knew that the goods or money or other consideration were to be used for a purpose immoral or illegal under our law."

19. Ragazzoni v. Sethia, supra, thus differs in one respect from the present case because the contract sought to be enforced could not be performed for the intended purpose without the commission of a breach of the law of India, namely the shipment of the goods from India combined with the common purpose that the buyer could resell them to South Africa. Both features of the case rendered the enforcement of the contact contrary to public policy. However, the common purpose of the parties in entering into the contract was unquestionably that it should be performed and that its performance would bring about a breach of Indian law. That was the substance of the affront to public policy. The entering into of the contract was, however, but a part of the common purpose of the parties to it, and that common purpose was to procure a breach of Indian law. If one has regard to the fact that the contract itself did not on the face of it require the commission of a breach of Indian law because the buyer could in theory have re-sold the goods elsewhere, but that it was a necessary part of the fulfilment of a common purpose which did involve such a breach, there is, with one exception, no material distinction from the position of the contract between Enron and the Bank for the provision of the letter of credit. The purpose of Enron in procuring the letter of credit was to effect a breach of United States law. It was, however, a purpose of which the Bank was entirely ignorant. Had that not been so, I have no doubt that the enforcement of that contract at the suit either of Enron or the Bank would have been contrary to public policy in the English Courts. It is to be observed that it was unnecessary to refer to the unlawful purpose of the transaction in order to formulate a claim for breach of the contract which formed a part of it.

20. What, then, is the position where only one of the two parties to the contract has an unlawful purpose?

21. If the relevant contract were entered into by the Claimant for an unlawful purpose and the unlawfulness contemplated was English, rather than foreign, there is strong authority that the Claimant could not enforce the contract. In Alexander v. Rayson [1936] 1 K.B. 169 the claimant claimed rent allegedly due to him as lessor from a tenant under two instruments. One was a lease, and the other a service agreement, but the services to be provided by the lessor under the service agreement were, except for a minor matter, the same as those to be provided under the lease. The issue before the court was whether the plaintiff was entitled to recover any of the amounts outstanding

in circumstances where his purpose in creating the two documents was to represent to the local authority that the only rent receivable was that under the lease in order that the rateable value of the flat should be reduced. By the time that the matter came before the court this plan had failed because, although the lessor at first achieved a reduction in the rateable value, the local authority subsequently discovered the bogus nature of the lease and consequently increased the rateable value. It was held in the Court of Appeal that the claimant's claim failed. The statement of underlying principle expressed by Scott L.J. at page 182 was as follows:

> "It is settled law that an agreement to do an act that is illegal or immoral or contrary to public policy, or to do any act for a consideration that is illegal, immoral or contrary to public policy, is unlawful and therefore void. But it often happens that an agreement which in itself is not unlawful is made with the intention of one or both parties to make use of the subject matter for an unlawful purpose, that is to say a purpose that is illegal, immoral or contrary to public policy. The most common instance of this is an agreement for the sale or letting of an object, where the agreement is unobjectionable on the face of it, but where the intention of both or one of the parties is that the object shall be used by the purchaser or hirer for an unlawful purpose. In such a case any party to the agreement who had an unlawful intention is precluded from suing upon it. Ex turpi causa non oritur actio. The action does not lie because the Court will not lend its help to such a plaintiff. Many instances of this are to be found in the books."

22. Then, having reviewed the relevant authorities, such as Pearce v. Brooks (1866) L.R. 1 Ex. 213, Scott L.J. summarised their effect as follows:

> "It will be observed that in all these cases the plaintiff was endeavouring to enforce by action an agreement, or a clause in an agreement, which was tainted by the unlawful intention of the plaintiff, or the unlawful intention of the defendant known to the plaintiff, as to the purpose for which the subject matter of the agreement was to be used. To such an action, the maxim, ex turpi causa non oritur actio applies."

23. The Court of Appeal was concerned in that case with contractual documentation created for the purpose of misleading a third party and not with a contract of which the subject-matter was illegal or immoral. However, there is also in point the decision also of the Court of Appeal in Scott v. Brown, Doering, McNab & Co [1892] 2 QB 724. A plaintiff claimed to recover money paid to the defendant stockbrokers through whom he had purchased shares in a company on the grounds that the contract should be rescinded on the grounds that the brokers had used their own shares to satisfy his instructions and had not purchased shares on the open market. However, the court rejected the claim on the grounds that the contract was entered into and the money under it paid to the defendant for the unlawful purpose of rigging the market in those shares. Lindley J. observed at page 729:

> "The plaintiffs purchase was an actual purchase, not a sham purchase; that is true, but it is also true that the sole object of purchase was to cheat and mislead the public. Under these circumstances, the plaintiff must look elsewhere than to a court of justice for such assistance as he may require against the persons he employed to assist him in his fraud, if the claim to such assistance is based on his illegal contract."

As Scott LJ said of that case in Alexander v. Rayson, supra, at page 188:

> "It will be observed that there was no intention on the part of the plaintiff in that case to use the shares in an unlawful way. The intention was merely to make use of the existence of the share contract in order to defraud the public by inducing them to believe that it recorded a genuine transaction."

24. Thus, if a claimant enters into a contract lawful on its face for the purpose of using the subject-matter to be derived from the contract or the very existence of the contract or the consequence of its being performed for an unlawful purpose he will not be permitted to enforce it. To permit him to do so would be contrary to public policy as offending against the ex turpi causa principle. That the defendant was ignorant of the purpose when the contract was entered into is irrelevant.

25. In this connection it is necessary to refer to Tinsley v. Milligan [1994] 1 AC 340. There the issue was whether the defendant was entitled to enforce a resulting trust over a house which had been purchased in the name of the plaintiff alone as part of an unlawful scheme to defraud the Department of Social Security. The House of Lords held by a 3-2 majority that once the beneficial interest had been created when legal title to the house passed to the plaintiff, the defendant did not need to rely on the unlawful underlying agreement in order to prove the beneficial interest upon which he relied. On the authority of Bowmakers Ltd v. Barnet Instruments Ltd [1945] KB 65 the defendant could therefore make good her beneficial interest by circumventing the illegal purpose. As Lord Browne-Wilkinson concluded at page 326:

> "In my judgment the time has come to decide clearly that the rule is the same whether a plaintiff founds himself on a legal or equitable title: he is entitled to recover if he is not forced to plead or rely on the illegality, even if it emerges that the title on which he relied was acquired in the course of carrying through an illegal transaction."

26. At the conclusion of his judgment Lord Browne-Wilkinson considered an argument that if the underlying transaction were illegal collateral rights acquired under it could not be enforced even if the underlying legal transaction did not have to be pleaded: as in Scott v. Brown, Doering, McNab & Co supra, He put the position thus:

> "It is said that once the illegality of the transaction emerges, the court must refuse to enforce the transaction and all claims under it whether pleaded or not: see Scott v. Brown, Doering, McNab & Co [1892] 2 QB 724. Therefore, it is said, it does not matter whether a plaintiff relies on or gives evidence of the illegality: the court will not enforce the plaintiff's rights. In my judgment, this submission is plainly ill founded. There are many cases where a plaintiff has succeeded, notwithstanding that the illegality of the transaction under which she acquired the property has emerged: see, for example, Bowmakers Ltd v. Barnet Instruments Ltd [1945] KB 65 and Singh v. Ali [1960] AC 167. In my judgment the court is only entitled and bound to dismiss a claim on the basis that it is founded on an illegality in those cases where the illegality is of a kind which would have provided a good defence if raised by the defendant. In a case where the plaintiff is not seeking to enforce an unlawful contract but founds his case on collateral rights acquired under the contract (such as a right of property) the court is neither bound nor entitled to reject the claim unless the illegality of necessity forms part of the plaintiff's case."

27. Although the Bowmakers v. Barnet Instruments approach may sometimes be relevant in cases not involving claims of title to goods or real property: see Pye Ltd v. BG Transport Services Ltd [1966] 2 Lloyd's Rep 3000, I do not consider that Tinsley v. Milligan has abolished illegality or unenforceability due to considerations of public

policy as a defence in all cases except those where the claimant can only recover if he pleads and proves a transaction which is on its face intrinsically unlawful or unenforceable as a matter of public policy. In my judgment, that case is concerned with enforcement of collateral rights, legal or equitable, acquired under an illegal contract or one having an illegal purpose but leaves untouched the principle that the English courts will not enforce a contract lawful on its face which is entered into for an unlawful purpose. A collateral right in this context normally refers to a proprietary right and does not include a right of action on a contract itself. Cases such as Fisher v. Bridges (1854) 3 E&B 642, Alexander v. Rayson, supra, Regazzoni v. Sethia, supra, and Spector v. Ageda [1973] Ch 30 remain good law.

28. Does it make any difference that the purpose was unlawful, not under English law, but under the law of a foreign friendly state?

29. In my judgment, it does not. 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 to it.

30. It follows inexorably that if Enron had sought in the English courts to enforce the letter of credit contract against the Bank, for example because the Bank had omitted to give effect to a properly formulated request from Enron to open the letter of credit, the claim would have failed on the assumed facts. Enron's purpose in procuring the opening of the letter of credit, being to enable it to provide to Chase the security necessary to create by means of the three swaps a device for deceiving the SEC and the public, the court would have held that to enforce the contract would be contrary to public policy.

31. Consequently, the position at which one arrives on this application on the assumed facts is that the claimant seeks the court's assistance in enforcing the letter of credit which has been opened pursuant to a contract which would be unenforceable on the grounds of public policy due to its unlawful purpose, that purpose being known to the claimant, but not to the Bank until long after the demand for payment had been presented to the Bank.

32. On the face of it, the enforcement of the letter of credit would appear to conflict with the public policy principle of ex turpi causa, in as much as the court is being invited to enforce a contract valid on its face which was with the claimant's knowledge created to support the unlawful purpose of the wider three swaps transaction.

33. It is therefore necessary to investigate whether, as Mr Rabinowitz, on behalf of the claimant, contends the principle of autonomy of letters of credit makes all the difference.

The Nature of the Autonomy Principle and the Fraud Exception

34. There can be no doubt that the concept of the separation of letters of credit from the contracts in respect of the performance of which they provide security is a principle well-established in English law. Article 3a of the Uniform Customs and Practice for Documentary Credits (1993 Revision) which was expressly incorporated in this case states:

> "Credits, by their nature, are separate transactions from the sales or other contract(s) on which they are based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit."

35. The starting point for analysis of the autonomy principle is the decision of the House of Lords in United City Merchants (Investments) Ltd v. Royal Bank of Canada [1983] 1 AC 168. The letter of credit there was opened to effect payment of monies due under a contract for the sale of manufacturing equipment. The sellers and the buyers agreed that the amount payable and covered by the letter of credit should be double the true price. This was for the purpose of enabling the Peruvian Buyers to exchange Peruvian currency into hard currency under the cloak of a sale contract. Further, the goods were shipped one day later than the shipment period and the loading brokers, without the knowledge of the claimants or the defendant bank, fraudulently entered on the bills of lading the last day in the shipment period. The defendant bank refused to pay under the letter of credit on two distinct grounds:

    (i) the forged bills of lading;

    (ii) the letter of credit was unenforceable under the Order in Council giving effect in England to the Bretton Woods Agreements because the sale contract was an exchange contract and both it and the letter of credit were therefore within Article VIII section 2(b) of the Order in Council.

36. As to the first defence Lord Diplock, with whose speech all four other members agreed in rejecting the submission that, even without the knowledge of the beneficiary or the bank at the time of presentation, the fact that the bills of lading were forged, entitled the bank to refuse payment, stated the relevant principles relating to the contract in the letter of credit between the beneficiary and the bank thus (at pages 183 to 184).

    "the parties to it, the seller and the confirming bank, 'deal in documents and not in goods,' as article 8 of the Uniform Customs puts it. If, on their face, the documents presented to the confirming bank by the seller conform with the requirements of the credit as notified to him by the confirming bank, that bank is under a contractual obligation to the seller to honour the credit, notwithstanding that the bank has knowledge that the seller at the time of presentation of the conforming documents is alleged by the buyer to have, and in fact has already, committed a breach of his contract with the buyer for the sale of the goods to which the documents appear on their face to relate, that would have entitled the buyer to treat the contract of sale as rescinded and to reject the goods and refuse to pay the seller the purchase price. The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment.

    To this general statement of principle as to the contractual obligations of the confirming bank to the seller, there is one established exception: that is, where the seller, for the purpose of drawing on the credit, expressly or by implication, (makes) material representations of fact that to his knowledge are untrue. Although there does not appear among the English authorities any case in which this exception has been applied, it is well established in the American cases of which the leading or 'landmark' case is Sztejn v. J Henry Schroder Banking Corporation (1941) 31 NYS 2d 631. This judgment of the New York Court of Appeals was referred to with approval by the English Court of Appeal in Edward Owen Engineering Ltd v Barclays Bank

> International Ltd [1978] QB 159, though this was actually a case about a performance bond under which a bank assumes obligations to a buyer analogous to those assumed by a confirming bank to the seller under a documentary credit. The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim ex turpi causa non oritur action or, if plain English is to be preferred, 'fraud unravels all'. The courts will not allow their process to be used by a dishonest person to carry out a fraud."

37. It is to be observed that Lord Diplock was in that passage at pains to emphasise that there was only one "established exception" (emphasis added) to the principle set out in that passage that the confirming 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 buyer and seller, that exception being where the beneficiary attempted to procure payment by presenting documents which he knew to contain material misrepresentations pertinent to the terms of the credit. Lord Diplock's reference to the decision in the New York Supreme Court in Sztejn v. J Henry Schroder Banking Corporation (1941) 31 NYS 2d 631 shows that at this stage of his speech he is dealing with the circumstances in which on the information before the issuing bank at the time of presentation of documents it is then entitled to reject the documents. In Sztejn the plaintiff seller sought to restrain the payment or presentment for payment of drafts under the letter of credit for the reason that the documents were fraudulent in that the boxes shipped by the seller were not packed with the goods but with rubbish. Having observed that the application of the doctrine of autonomy presupposed that the documents were genuine and conforming, Shientag J. continued at page 634:

> "However, I believe that a different situation is presented in the instant action. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. It is true that even though the documents are forged or fraudulent, if the issuing bank has already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment:
>
> Bank of New York & Trust Co v. Atterbury Bros, Inc 226 App Div 117, 234 NYS 442, affirmed 253 NY 569, 171 NE 786; Brown v. C Rosenstein Co 120 Misc, 787, 200 NYS 491, affirmed 208 App Div 799, 203 NYS 922. However, in the instant action Schroder has received notice of Transea's active fraud before it accepted or paid the draft."

38. For these reasons it was held that the seller was entitled to restrain presentation of the documents and payment by the bank.

39. Lord Diplock's explanation for the fraud exception, by reference to his citation with obvious approval of Sztejn, that it was "a clear application" of ex turpi causa and his further reference to the English courts not permitting the use of their process by a dishonest person to carry out a fraud strongly indicates that he had in mind that as a matter of public policy a claimant would not be entitled to use the autonomy doctrine

to derive a benefit from his own fraud. What he is saying is that the fraudulent claimant will not be entitled to a remedy if the Bank, having clear evidence of fraud, declines to pay at the time when the documents are presented. What he is not saying is that the claimant who, at trial, is proved to be fraudulent will nevertheless be entitled to recover from the bank if it did not have clear proof of fraud at the time of the presentation of documents. Not only does Lord Diplock not support this latter proposition, but his speech is completely inconsistent with it. If the bank is protected by the doctrine of ex turpi causa when it has clear evidence of fraud at the time of presentation it must, inescapably, also be protected if, at trial, it is demonstrated that the beneficiary is attempting to use the court's process to benefit from his own fraud. It is true that later in his judgment (page 185 B-C) Lord Diplock refers to the bank's "contractual right to refuse to honour the documentary credit" which at first sight suggests an analysis which involves the qualification of the absolute nature of the bank's obligation. However, his judgment should be read as a whole and with regard to his very explicit reference to the ex turpi causa principle as the true foundation for the bank's not being liable for a refusal to pay in the face of clear evidence of fraud. That explanation accords more comfortably with principle and is therefore to be preferred to Lord Diplock's subsequent apparently inconsistent reference to a "contractual right" to refuse to pay.

40. In this connection, it is important to distinguish between the contractual duty assumed by the bank under the letter of credit and the availability to a beneficiary of a remedy for breach of that duty. As to the bank's contractual duty, there is very clear authority that, upon presentation of conforming documents, the bank must pay unless it can at the time of presentation or when it ought to pay establish on the evidence in its possession that the beneficiary is perpetrating a fraud in presenting the documents and demanding payment: see Edward Owen Engineering Ltd v. Barclays Bank International Ltd [1978] QB 159, per Lord Denning MR at 171, Browne LJ. at 172-173 and Geoffrey Lane LJ. at 175, and United Trading Corporation SA v. Allied Arab Bank Ltd [1985] 2 Lloyd's Rep 544, per Ackner LJ. at 560-561. Both these cases relate to performance bonds, but it is well established that the same principles apply as to letters of credit. By setting at a high level the evidential threshold of fraud on the information available to the bank at the time of presentation of the documents – "on the material before it the only realistic inference to draw is that of fraud", per Ackner LJ in the United Trading Corporation Case, supra – there is preserved the almost impregnable financial integrity of a letter of credit or performance bond as "the life-blood of international commerce" as per Kerr J. in R D Harbottle v. National Westminster Bank Ltd [1978] QB 146 at 155. Thus, neither the bank nor the party on behalf of whom the letter of credit or bond has been opened can obtain from the court any order interfering with payment against conforming documents unless they can satisfy this very high evidential threshold.

41. It is however to be observed that in the United City Merchants case, supra, at page 184 in the passage cited above Lord Diplock did not define the contractual obligation of the bank to pay upon presentation of conforming documents as limited to cases where it did not have clear evidence of fraud. He explained the fraud exception as to recovery bar based on the ex turpi causa principle prohibiting the beneficiary from enforcing its rights against the bank by relying on the bank's failure to pay as a breach of contract. The bank's "entitlement" to decline to pay in those circumstances is thus that it has instantly available to it, on the evidence in its possession at the relevant time, a good defence to a claim for breach of contract, that of ex turpi causa.

42. It then becomes necessary to explore the position that arises when a bank fails to pay against presentation of conforming documents yet does not have sufficiently compelling evidence of fraud at that time. It has no more than a suspicion. On the face of it, the beneficiary is at once entitled to summary judgment on the basis of a breach of contract by the bank and the bank can obtain no order from the court. But what happens if, in the meantime and, before the application for summary judgment is heard, the bank acquires clear evidence of fraud? Is the beneficiary still entitled to judgment? Has the bank lost the ex turpi causa defence which would have been available to it if it had acquired that clear evidence at the time when it was called upon to pay?

43. This problem was discussed by the Court of Appeal in Balfour Beatty Civil Engineering v. Technical & General Guarantee Co Ltd (1999) 68 Con LR 180. That was an appeal from a summary judgment on a performance bond, the defence being that the beneficiary had no honest belief that there had been a default under the underlying agreement, when demand for payment was made. Waller LJ, with whom Swinton Thomas LJ and Jonathan Parker J. agreed, said this:

> "Mr Bartlett submits that where the bank or surety is itself refusing to pay and the question is whether judgment should be given under Order 14 the position is different. In that context it would, he submits, be very odd if the court had concluded on the evidence available at the Order 14 hearing that the demand was fraudulent, but then proceeded to give judgment in favour of the fraudster because the evidence of the fraud was not available to the bank when the demand was made. He submits there simply is no authority that compels the court to reach such a conclusion. He thus submits at the very least the question must be tested at the time of the Order 14 summons. He further submits that if at that stage the bank puts up simply an arguable case there is no reason why the bank should not have leave to defend.
>
> There is obviously force in at least part of Mr Bartlett's submission. If at the Order 14 stage the bank can show that the only proper inference is fraud it would be absurd to think that the bank would have judgment entered against it. It would not seem right to hold that since the bank can recover from its customer, it is legitimate to give judgment in favour of the fraudster allowing recovery from the fraudster only at the suit of the customer.
>
> However, as it seems to me, whatever the context in which the Edward Owen case was decided, it is authority for the proposition that the bank or surety is only entitled to refuse to pay on a bond where it has clear evidence of fraud. The liability of the surety or bank cannot, as it seems to me, alter depending on the context. How then can the absurdity be avoided?
>
> The answer, as it seems to me, is that on analysis if a bank or surety has a clear case at the Order 14 stage which it did not have at the demand stage, that the demand was fraudulent, the bank has a counterclaim against the fraudster which it is capable of establishing for the return of the money. Just to expand on that theme a little. It is clear that simply because after demand on a bond it turns out that no sum was due from the customer to his contractor, that does not lead to the bank or surety having any remedy against the beneficiary of the bond. The customer who of course must indemnify the bank or surety may have a right as against the beneficiary under their contract but that is all. If, however, the beneficiary has made a fraudulent representation to the bank in order to obtain money under the bond, I cannot see why in addition to any

remedy that the bank's customer may have (if the customer has been forced to indemnify the bank), the bank does not have its own remedy directly against the beneficiary. That may be very important in the context of a case such as the present in which the customer of the surety or the bank has gone into liquidation.

Now, coming back to the order 14 application, and seeing where the above analysis would lead. A bond is treated as the equivalent of a bill of exchange or a letter of credit, so that it follows that normally a set-off or counterclaim will not be enough to prevent judgment being given. That does not prevent the defendant continuing to pursue the counterclaim, and may in some rare cases lead to a stay of execution while that counterclaim is being fought out. Of course if a defendant is in a position to bring its own Order 14 on a counterclaim, then if judgment were obtained one would simply cancel out the other.

If the above is a correct analysis, it seems to me to lead to a sensible solution which fits with the Edward Owen case but also produces a just result. The questions to be asked are:

1. When the demand was made did the surety or the bank have clear evidence from which the only inference to be drawn is fraud? If the answer is 'No' then prima facie the beneficiary is entitled to judgment.

2. What, on the information now available, is the strength of the surety's case that the demand was fraudulent?

(a) If the evidence is now clear, then no judgment will be given in favour of the beneficiary because of the fact that the surety would be entitled to a judgment for the equivalent sum.

(b) If the evidence is powerful but not quite sufficient to enable Order 14 judgment to be entered in favour of the surety on the basis that the demand was fraudulent, then either judgment would be entered with a stay of execution or probably no judgment would be entered at all until what is in effect the counterclaim had been fought out.

(c) If the evidence is less than powerful, judgment will be entered in favour of the beneficiary, and the surety will be left either to pursue his remedy against the customer or pursue a claim or counterclaim for reimbursement if so advised.

The above analysis produces solutions which fit with the philosophy of performance bonds as exemplified by Edward Owen. It places on the surety or the bank who refuses to meet a demand the onus of showing that it had clear evidence of fraud at the date of the demand so as to allow it not to pay if the beneficiary is not prima facie to be entitled to judgment. If it fails in that task, it still has the opportunity where again the onus is on it, to establish that it now has clear evidence of the fraud which will again lead to the beneficiary being refused judgment. If it fails in that task, it still has an opportunity where again the onus is on it, to establish that the case of fraud is a powerful one which should allow the counterclaim to be fought out before any judgment in favour of the beneficiary is enforced. If it fails to show even a powerful case judgment will be entered but that does not preclude the surety continuing with a claim to return of the money based on an allegation of fraud if it can persuade counsel that the evidence is such that it is proper to plead it."

44. The Court of Appeal decided that the surety's evidence did not amount to an arguable case that the beneficiary had been fraudulent and the summary judgment was therefore upheld.

45. The nature of the fraud considered in that case was such as to amount to a fraudulent misrepresentation made to the surety, which could form the basis of an action for damages for deceit by way of counterclaim. The discussion, in the passage which I have cited, as to the remedies available to the surety at the summary judgment stage based on evidence of fraud has to be read against that background. However, although the point was never taken or considered in that case, it is, in my view, unnecessary to confine the surety's position to one founded on a counterclaim for damages or circuity or potential circuity of action. As long as there is before the court evidence which establishes fraud by the beneficiary there is evidence sufficient to establish a straight defence based on ex turpi causa. For this purpose, I agree with Waller LJ. that the strength of the fraud case has to be tested on the evidence available at the hearing of the summary judgment application, as distinct from the time of demand.

46. Just as the surety's entitlement to withhold payment is based, according to United City Merchants, supra, on clear evidence of fraud and therefore of an ex turpi causa defence at the time when demand is made and payment would otherwise become due, so also the surety should have a direct defence on the basis of ex turpi causa at whatever stage in the proceedings prior to the hearing of the summary judgment application he can adduce the evidence necessary to establish fraud. The availability of that defence cannot, in my judgment, depend on whether evidence of fraud becomes available before or after demand is made and payment would otherwise become due.

47. This analysis of the remedies available to the beneficiary cannot be said to damage the integrity of the letter of credit as a virtually impregnable security any more than the analysis of Waller LJ. in the Balfour Beatty Case. Nor does it affect the circumstances in which the court will restrain a beneficiary from making demand under a letter of credit or a bank from paying against such demand which are helpfully and comprehensively considered by Rix J. in Czarnikov-Rionda Sugar Trading v. Standard Bank London Ltd [1999] 2 Lloyd's Rep 187, particularly at 202-203.

Illegality and Letters of Credit

48. The only English case in which illegality has been considered as affecting payment under a letter of credit is Group Josi Re v. Walbrook Insurance Co Ltd and Others [1996] 1 Lloyd's Rep 345. In that case an underwriting agency, Weavers, wrote primary risks on the London market for a pool of overseas insurers. Weavers also arranged and managed reinsurance of its pool members by outside reinsurers. The plaintiffs, Group Josi, one of the reinsurers, agreed with Weavers that the latter would pay over to them loss reserves held in respect of the reinsurers in exchange for a letter of credit under which Weavers would be entitled to draw down against debit notes stating that Group Josi were liable for the amounts claimed under the reinsurances. Group Josi brought proceedings against Weavers and the reassured companies to restrain them from drawing down under the letters of credit. Amongst the grounds for this claim were:

> (i) Group Josi was not authorised to carry on insurance business in Great Britain under the Insurance Companies Acts 1974-82 and as the contracts of

reinsurance were made in London, they and the letter of credit were illegal and unenforceable;

(ii) the chairman, deputy chairman and managing director of Weavers were party to a fraud to divert from Weavers and the reassured pool members commissions which should have been credited to them and Group Josi were induced to enter into the contracts of reinsurance by false and fraudulent representations that the commissions would be duly paid or credited to those to whom they were due and that there was a failure to disclose the fraudulent purpose when the reinsurances were placed, that Group Josi had to Weaver's knowledge validly avoided the reinsurances for that reason and that there would therefore be a fraud if Weavers presented the debit notes against the letter of credit.

49. I had granted an interlocutory injunction restraining the reinsured and Weavers from presenting a claim for payment under the letters of credit. Clarke J held that the reinsurance contracts were illegal but that the letters of credit were not thereby rendered illegal or tainted with illegality and Phillips J. held that the reinsurance contracts had not been avoided for non-disclosure. On appeal it was held that there was no evidence that either Weavers or the reassured companies knew of the alleged representation or relied on them and that there was therefore no basis for the argument that it would be dishonest for Weavers to present debit notes to obtain payment under the letters of credit. It was also held that the effect of section 132(6) of the Financial Services Act 1986 on Section 2 of the Insurance Companies Act 1982 was retrospectively to render contracts of reinsurance illegally entered into on the grounds of lack of authorisation unenforceable only at the suit of the reinsurers and not by the reassured. Accordingly, operation of the letter of credit by or on behalf of the reassured would involve no illegality.

50. The question of the effect of any illegality under the Insurance Companies Acts on the letters of credit was considered by Clarke J. at first instance and in the Court of Appeal by Staughton LJ. Before Clark J. exactly the same issue was raised in relation to another reinsurer, Deutsche Ruck. He held that the authorities going back to Hamzeh Malas & Sons v. British Imex Industries Ltd [1958] 2 AB 127 supported the proposition that the contract between the reassureds and the bank was quite separate from that between the reassureds and the reinsurers. He observed at page 351:

> "It is the separate or independent nature of the relationships between the parties to the commercial contract on the one hand and the beneficiary and the issuing or confirming bank on the other which is one of the underlying bases for the decisions to which I have referred."

51. Further, basing his reasoning on the principle that the provision of a confirmed letter of credit was conditional payment of the amount due under the reinsurance contracts as identified by the Court of Appeal in W J Alan & Co v. El Nasr Export & Import Co [1972] 2 QB 189 per Lord Denning MR at 210-211, Clarke J. continued at page 352:

> "Thus when the letters of credit were issued in 1983 they amounted to payment under them by the reinsurers unless Citibank failed to pay when conforming documents were presented, in which case the reinsurers' obligations would revive. But until then the reinsurers had done everything which was required of them under the relevant contracts of reinsurance. They were under no obligation to do any more. When the letters of credit were issued and confirmed by Citibank new rights and obligations came into

existence as between the defendants as beneficiaries and Citibank as confirming bank.

In these circumstances the letters of credit are not in my judgment void because the contracts of reinsurance are void. Mr Bartlett correctly accepts that the plaintiffs would not be entitled to recover cash paid in settlement of claims. Equally, in my opinion, they are not entitled to the delivery up of the letters of credit on the ground that they are void. Subject to the possibility of revival referred to above, in the inconceivable event that Citibank did not pay, the provision of the letters of credit amounted to payment under the contracts of reinsurance just as payment of cash would have done.

It follows from the above analysis, in my judgment, that the letters of credit are not void and that the defendants are entitled to present documents under the letters of credit and to be paid in cash in accordance with their terms. Moreover neither the defendants in presenting the documents nor the bank in paying against them would be carrying on of the business of insurance by the plaintiffs."

52. It will be noted that the route by which Clarke J. arrived at his conclusion that the letters of credit were not void and unenforceable was:

(i) the letter of credit represented a contract separate from the underlying reinsurance contract;

(ii) the opening of the letter of credit was conditional payment under the reinsurance contract;

(iii) in presenting the documents to the bank the reassured would not be carrying on the business of insurance prohibited by the Insurance Companies Acts and nor would the bank in paying under the letters of credit.

(iv) nor would either of the reassured and the bank be aiding and abetting the carrying on by the insurers of unauthorised insurance business.

53. He then went on to consider the alternative argument, based on United City Merchants, that the letters of credit were rendered illegal by the illegality of the underlying transactions, that is the reinsurance contract. Having referred to Lord Diplock's speech in that case, he continued:

"Thus it can be seen that one of the purposes of the whole transaction including the letter of credit was to convert Peruvian currency into United States dollars in breach of the exchange control regulations. The House of Lords held that the task of the court in deciding whether the contract was unenforceable under the Order in Council was to consider the substance of the transaction and to penetrate any disguise presented by the actual words the parties used, to identify any monetary transaction which the words were intended to conceal and to refuse to enforce the contract to the extent that to do so would give effect to the monetary transaction. The House held that there was no difficulty in identifying that part of the transaction which fell foul of the exchange control regulations, namely the sum of US $331,043 which was half the price shown in the contract and provided for in the letter of credit.

The contract including the letter of credit was held to be unenforceable to that extent. In my judgment however that decision does not assist the plaintiffs in the present case. There the House of Lords held that the role of the court was to examine the substance of the whole transaction in order to see to what

> extent it fell foul of the regulations. That included an examination of the letter of credit which was part of the whole transaction so that the prohibition directly attacked the enforceability of the letter of credit. See also Mansouri v. Singh 1 WLR 1393, especially per Lord Justice Neill at p1403.
>
> The prohibition in the Insurance Companies Acts does not seem to me to attack the enforceability of the letters of credit. The question here is whether the letters of credit given in payment under the reinsurance contracts are void and unenforceable in circumstances where it is accepted that cash payments made under the contracts would not be. In my judgment they are not void or unenforceable."

54. Clark J. then considered whether, if the collateral contract between the reinsurers and the bank for the opening of letters of credit was void because tainted by illegality or as amounting to the carrying out by the reinsurers of unauthorised insurance business, the letters of credit themselves were also illegal. He concluded that they were not. He observed at page 354.

> "As soon as the letters of credit were opened and confirmed they had an independent existence. There is no suggestion that Citibank (or indeed Chase Manhattan) knew the relevant facts. Thus I see no reason why the defendants should not present the documents to the bank. For all the reasons which I have already discussed, the relationship created by the letters of credit is separate from and independent of the underlying contracts, including the collateral contract pursuant to which they were opened. Thus, in my judgment, whether or not the collateral contract was void because it was tainted with the illegality of the reinsurance contracts or because it amounted to the carrying on of unauthorised insurance business, the letters of credit themselves are not void."

55. Accordingly, the reinsurers were not entitled to the declarations claimed that the letters of credit were illegal, void and unenforceable.

56. In the Court of Appeal Staughton LJ. considered the position under the letters of credit on the assumption, which he held to be wrong, that the contracts of reinsurance were illegal. He held that, although Lord Diplock had referred in the United City Merchants Case to fraud as the one established exception to the bank's duty to pay against conforming documents under a letter of credit, illegality was "a separate ground of defence under a letter of credit" (page 362). He relied for this proposition on the analogous position in United City Merchants where the Bretton Woods Agreement Order in council had rendered unenforceable in the English courts exchange contracts which were in breach of the exchange control regulations of states parties to the Agreement. I interpose that Lord Diplock clearly stated at page 189 of his judgment that an exchange contract contrary to the exchange control regulations of a party to the Agreement other than the UK would not be illegal under English law and acts in this country in performance of such an exchange contract would not be illegal. It was merely unenforceable. However, although as a matter of construction the contract constituted by the letter of credit in that case was not an exchange contract, not being a contract to exchange one currency for another currency but a contract to pay currency in exchange for documents, nonetheless the court could "penetrate any disguise presented by the actual words the parties have used to identify any monetary transaction ……. which those words were intended to conceal and to refuse to enforce the contract …." (page 190).

57. Staughton LJ. then considered the following example:

> "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 1000 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."

58. His conclusion may have been influenced by the approach to unenforceability in United City Merchants.

59. Having tentatively expressed the view that, before the bank could rely on the illegality of the underlying transaction as a defence to a claim for non-payment, the illegality would have to be clearly established and known to the bank and having expressly left open the question whether the bank would have a defence if illegality were clearly proved at trial but in doubt when the documents were presented for payment (page 362) Staughton LJ. continued:

> "Turning to the present case, if the reinsurance contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the Court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the Court would do so. That would not be because the letter of credit contracts were themselves illegal, but because they were being used to carry out an illegal transaction."

60. He then went on the justify that conclusion by holding that because the required debit notes to be presented to the bank had to assert that outstanding losses were due to the reassureds under the reinsurance contracts, the reassureds and Weavers would, when inviting the court to enforce the letters of credit, be founding their claim on the underlying illegal contracts of reinsurance and would thus be within the principle in Bowmakers Ltd v. Barnet Instruments Ltd [1945] KB 65. This reasoning clearly assumes that the reassureds and Weavers were knowing participants in the assumed illegality of the reinsurance contracts. Staughton LJ. expressly rejected the argument, upon which Clark J. had relied, that the fact that opening a 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 that such conditional payment was not rendered illegal by the Insurance Companies Acts (page 363). He concluded that part of his judgment with this passage:

> "But that does nothing whatever to convince me that the obligation of the bank to pay under the letters of credit is altogether free from taint from any obligation of the reinsurers which it superseded."

61. Of the other two members of the court Rose LJ. confined his short judgment to holding that the subsequent legislation had retrospectively removed the illegality from performance of the reinsurance contracts and Saville LJ. having reached the same conclusion, observed, without reasons, that he did not accept the argument that the postulated illegality applied to or tainted the letters of credit (page 368).

62. Finally, it is necessary to refer to the decision of Power J. in the Queen's Bench Court of Alberta in Morguard Bank of Canada v. Reigate Resources (Canada) Ltd and Canada Trust Company (1985) 40 Alta LR (2d) 77 in which there is a clear indication that if a letter of credit were set up to give effect to an underlying contract which was illegal, the letter of credit would, in principle, remain enforceable as a separate and

distinct contract from the contract under which it was procured to be opened. Since illegality was not established, the decision is obiter.

Discussion

63. In order to investigate the enforceability of the letter of credit it is first necessary to identify what function it had in relation to the assumed illegal purpose of the three swaps. That function was to provide security to Chase in case the planned circulation of funds was interrupted by the failure of ENAC to pay Mahonia, the beneficiary under the letter of credit. If ENAC failed to pay Mahonia, then the money would not get back to Chase and the circularity which was an essential feature of the structure of the overall transaction would be broken, with the source of the funding (Chase) remaining out of its money.

64. The transaction is therefore similar in many ways to one in which the underlying contract is illegal to the knowledge of both parties and therefore unenforceable by either and where one of the parties to it procures an innocent third party to provide to the other a bond which pays against a certificate that the underlying contract has not been performed. Leaving aside the additional feature of a letter of credit, the authorities discussed in paragraphs (21 to 27) above support the proposition that the innocent third party could rely by way of defence on the underlying illegality. The position would be no different if the underlying contract were legal on its face but entered into for an illegal purpose or if the underlying contract were illegal because it required the carrying out of an act in the United States which was unlawful there or was for the purpose of the carrying out of such an act. Does it make any difference that the security was provided by means of a documentary letter of credit confirmed by a bank innocent of the illegality of the underlying transaction, but which has clear evidence of that illegality at the time when it ought otherwise to pay?

65. As appears from the authorities discussed earlier in this judgment, the impregnability of letters of credit is a consequence of the need to insulate them from the transaction in relation to which they have been utilised as security. That is because they have a special function in international trade which requires that their integrity and irrevocability should not be interfered with unless an ex turpi causa defence can be clearly proved by the bank, as for example in a case of fraud such as to be found in Sztejn v. J Henry Schroder Banking Corporation, supra. As a matter of public policy the courts will not permit their process to be used to obtain the benefit of an unlawful act. In such a case the policy of the law in withholding its process from the enforcement of benefits derived from an unlawful act displaces the otherwise impregnable nature of the letter of credit. Does that policy extend to a case like the present where the unlawfulness consists not in a fraud on the bank but in the purpose for which the letter of credit has been procured?

66. I am bound to say that I have found the reasoning of Clark J. in the Group Josi case discussed at paragraph (52) above, strongly persuasive resting, as it does, on the insulation of the opening and negotiation of the letter of credit from the unlawful carrying on of insurance business. He was able to distinguish between conduct prohibited by the legislation and conduct collateral to that unlawful conduct. Only the latter would have to be relied upon in order to enforce the letters of credit. In that case however the letters of credit were not an integral part of the unlawful conduct. They were simply a facility provided subsequently to the entering into of the illegal contracts which assisted performance in a manner not specifically rendered illegal. Where, however, the letter of credit plays from the outset an integral part in the illegal transaction, there is, as I see it, a very different situation, when its comes to

enforcement for the court's process is then deployed for the purpose of giving effect to an essential part of the illegal scheme.

67. Although in United City Merchants, supra, Lord Diplock expressly stated that the underlying sale contract and letters of credit were not rendered illegal by the Bretton Woods Order in Council, the underlying sale contract was certainly prohibited and thereby rendered unenforceable. However, the conclusion that the letter of credit was also rendered unenforceable was derived from the proper construction of the Order in Council which required the court to go behind contracts which on their proper construction, when taken in isolation, were not exchange contracts but which were a disguise for a prohibited monetary transaction. Accordingly, that case is an example of a letter of credit which because of its cosmetic purpose was directly rendered unenforceable by legislation. Unlike Straughton LJ. I therefore am unable to derive from that case any very significant assistance on this point.

68. However, there is a real conflict between on the one hand the well-established principle that contracts lawful on their face which are entered into in furtherance of an illegal purpose will be unenforceable at the suit of the party having knowledge of that purpose at the time of contracting and on the other hand the policy of the law reflected in all the letter of credit cases of preserving the impregnability of the letter of credit save where the bank has clear evidence of an ex turpi causa defence such as fraud. This conflict is not, in my judgment, a matter which can be resolved simply by postulating the separate nature of the letter of credit and applying reasoning similar to that in the Bowmakers case. Thus, like Staughton LJ. in Group Josi, supra, at page 362 I find it almost incredible that a party to an unlawful arms transaction would be permitted to enforce a letter of credit which was an integral part of that transaction even if the relevant legislation did not on its proper construction render ancillary contracts illegal. To take an even more extreme example, I cannot believe that any court would enforce a letter of credit to secure payment for the sale and purchase of heroin between foreign locations in which such underlying contracts were illegal. On the other hand, 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 the underlying illegal purpose is relatively trivial, at least where the purpose is to be accomplished in a foreign jurisdiction. The problems which arise from attempting to reconcile conflicting considerations of public policy may well give rise to uncertain consequences, as illustrated in relation to the finality of New York Convention arbitration awards in Westacre Investments Inc v. Jugoimport – SDPR Holding Co [1999] QB 740. It would, however, be wrong in principle to invest letters of credit with a rigid inflexibility in the face of strong countervailing public policy considerations. If a beneficiary should as a matter of public policy (ex turpi causa) be precluded from utilising a letter of credit to benefit from his own fraud, it is hard to see why he should be permitted to use the courts to enforce part of an underlying transaction which would have been unenforceable on grounds of its illegality if no letter of credit had been involved, however serious the material illegality involved. To prevent him doing so in an appropriately serious case such as one involving international crime could hardly be seen as a threat to the lifeblood of international commerce.

69. In the present case, I have therefore come to the conclusion that on the assumed facts there is at least a strongly arguable case that the letter of credit cannot be permitted to be enforced against the defendant bank. That represents at the very least a realistic prospect of success for the Bank's defence based on this point. Furthermore, the

conclusion as to whether enforcement is permissible at least arguably depends on the gravity of the illegality alleged. Although on the pleaded case that appears to be considerable, the uncertainty of this area of law is such that this is an issue which ought to be determined by reference to the evidence before the court at trial and not merely on assumptions derived from the pleaded defence. Moreover, I have also concluded, as I have sought to explain, that the fact that the Bank did not have clear evidence of such illegality at the date when payment had to be made would not prevent it having a good defence on that basis if such clear evidence were to hand when the court was called upon to decide the issue. For this purpose I proceed on the basis that it now has sufficiently clear evidence as expressed in the pleading.

70. Accordingly, the claimant's application to strike out the illegality defence and for summary judgment in respect of that defence will be dismissed.

71. Unusually, I have not set out in this judgment in extenso the respective arguments of counsel. It is a consequence of the need to keep this judgment to manageable proportions in the time available. This is in no way an indication that those submissions were unhelpful. On the contrary, they could not have been more comprehensive or of greater assistance. Should this matter go further those arguments will appear with admirable clarity in their respective outline submissions before me.