Financial Crime Review: Fraud & Sanctions

ATFCP – January 28, 2025

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|Agenda

1. Fraud Prevention / Sanction Risk Management

2. Recent Sanction & Fraud Cases: Lessons to be learned

   a. *Celestial Aviation v UniCredit [2024] EWCA*

   b. *Banque De Commerce Et De Placements S.A. v. China Aviation Oil* [2024] SGHC

   c. *Winson Oil Trading v. Oversea-Chinese Banking Corp. & Standard Chartered Bank (SCB)* [2023] SGHC 220, and SGCA [2024]

   d. *R vs Balli Steel plc. 2023.*

3. Historical Fraud Cases: Have we learned any Lessons?

   a. British Seafood (2010)

   b. Solo Industries (2001)

4. Red Flags, Triggering Events & Managing the Financial Crime Risk

5. US Presidential Executive Orders - Drug Cartels as FTO's

Fraud Prevention / Sanction Risk Management: "Prevention is 9/10th's of the cure"

- **Know your customer**
  - Understanding the customer's business and asking the right questions. Never assume a business or structure is too complex to understand.
  - Knowing your customer's customer.
  - An awareness of social engineering. Are you too close to the customer?
- **Understand your product design, policies, and credit risk**
  - Periodic review of customers in low credit risk products. Fraudsters prefer products that require minimal internal review.
- **Understand your legal documentation and ensure its robust / up to date**
  - Do you understand what documents you're requesting from customers? When's the last time they've been reviewed?
- **If red flags arise?**
  - Know the escalation procedures for suspected fraud, sanction impact, or financial crime.
  - Developing relationships with credit approvers, legal and compliance. Fraud prevention is a team sport.

Celestial Aviation v Unicredit (London Branch) – EWHC, EWCA, 2024

The facts:

- Between 2017 and 2020, Sberbank issued twelve USD denominated Standby Letters of Credit (SBLCs) to guarantee obligations of two Russian airlines who had leased airplanes from Celestia. UniCredit was the confirming bank for all twelve SBLCs.

- In March 2022 (following Russia's invasion of Ukraine and the imposition of sanctions by the EU and UK), Celestial demanded payment under the SBLC for termination of the leases by default.

- Demands were compliant but UniCredit refused to pay, alleging that it was prohibited from making the payments by the sanctions on Russia imposed by UK, EU and the USA. Celestial sued in the English High Court and judgment issued in March 2023.

- On April 6, 2023, Sberbank was designated and it became prohibited to deal in any funds or economic resources owned, held or controlled by Sberbank or making funds available to Sberbank.

Celestial Aviation v Unicredit (London Branch) – EWHC, 2024

The English High Court decision:

- Payment by UniCredit could not be regarded as the provision of financial services in connection with the prohibited supply of aircraft. UK Regulations operate prospectively and not retrospectively. The financial services took place *when the SBLCs were issued or confirmed*, (before the sanctions came into effect). So not in violation of UK regulations.

- The claims were independent of the underlying transaction between Celestial and Sberbank. The applicable laws were therefore those of the place of performance - Irish law (Celestial was based in Ireland) and the law of England & Wales.

- In relation to US sanctions, UniCredit must show (which it did not) that it was illegal to make payment in the place of performance—here, England and Ireland.

- Following the English case of *Libyan Arab Foreign Bank v Bankers Trust [1989] 1 QB 728*, the Court held that where a contract requires payment in US dollars, the *beneficiary is entitled to demand payment in cash.* So even if a transfer through a US correspondent bank was unlawful, UniCredit had not established that US sanctions prevented the transaction.

Celestial Aviation v Unicredit (London Branch) – EWCA, 2024

The issues on appeal:

- Whether UK Regulations prohibited UniCredit from making payment under the SBLCs as it prohibited provision of financial services and funds in connection with the direct or indirect supply of "*restricted goods*" to a person connected with Russia.

- If not, whether Unicredit had a defence under the *UK Sanctions & Money Laundering Act (SAMLA)* on the basis that its belief that it was complying with the *Act* was reasonable.

  - Section 44 of SAMLA (Protection for acts done for the purpose of compliance) provides that the section applies to acts done in the reasonable belief that the act was in compliance with SAMLA section 1 regulations and states that a person is not liable to any civil proceedings to which in the absence of the act they would have been liable.

- Was the question of illegality under US sanctions engaged under the Ralli Bros v Compania Naviera [1920] principle on the basis that the payment required involving a correspondent US bank?

- If the US sanctions regime was engaged, whether payment under the demands would have been illegal under the US regime.

Celestial Aviation v Unicredit (London Branch) – EWCA, 2024

Court of Appeal Decision

- The restriction on the provision of financial and other ancillary services in relation to Russia-related activities may apply not just to current activities, but those that occurred before the relevant sanctions were imposed.

- The Court of Appeal confirmed that the UK's general defence to claims of liability for actions taken in the "reasonable belief" that they were necessary to comply with UK sanctions is broad and allows a party to take a conservative interpretation of UK sanctions. Unicredit was protected from civil action against it under SAMLA as it had acted in the reasonable belief that it was complying with the regulations. The payment of the SBLC's was factually connected with prohibited activities.

- In circumstances in which foreign sanctions may have impact on the parties or the transactions, this can be used as a basis to argue that the contract has become illegal to perform. However, in this instance, the US regulations could not be relied upon. - The Appeal court found Unicredit could not rely on US sanctions because it did not make reasonable efforts to obtain a US license.

Celestial Aviation v Unicredit (London Branch) – EWCA, 2024

Court of Appeal Decision & Overall Results

- The Court of Appeal provided a strong defence of the independence principle in terms of the ability ot the parties to rely only upon the compliant demand. However, the Court clarified that this does not extend to ignoring that the letters of credit, the demand and the payment were all factually "in connection" with the leases as contemplated by the SAMLA regulations. The LC's were issued only because of the leases and the payment was triggered only by an alleged default.

  - There is more certainty for banks in making or refusing to make payment where UK sanctions may have impact. The protection against liability is broadly stated.

  - Banks can raise issues with inability to complete a transaction due to foreign sanctions, but the impact of the same will be treated narrowly.

  - While the independence principle was upheld, allowing parties to look only at the SBLC to determine requirement for payment (and not other extenuating circumstances), under SAMLA, the overall transaction and the various connected strands must be considered.

Banque De Commerce et De Placements S.A. (BCP) v. China Aviation Oil (Singapore) Corp (CAO) - Singapore High Court, 2024

Facts

- Zenrock purchased approx. 260,000 barrels of Gasoil from CAO. The sale contract between Zenrock and CAO was part of a number of "**circular trade transactions**" as CAO had already purchased the same Gasoil from an intermediate Seller "Shandong" on materially back-to-back terms.

- To support the purchase from Gasoil, Zenrock asked BCP to issue an LC for USD20.5 million to the benefit of CAO. The LC was confirmed by UBS Switzerland AG.

- Zenrock's represented to BCP that the Gasoil would be sold onward to PetroChina (as the ultimate Buyer) and the **proceeds of that sale would be assigned by PetroChina to BCP to reimburse CAO for the drawing**.

- The LC required CAO to present the commercial invoice and original B/Ls. In the event original B/Ls and other documents were unavailable at the time of presentation, CAO could replace the originals B/Ls with a letter of indemnity (LOI) in the form required by the LC.

- The LOI was addressed to Zenrock (following typical practice) and **included reps and warranties from CAO to Zenrock.**

Banque De Commerce Et De Placements S.A. (BCP) v. China Aviation Oil (Singapore) Corp (CAO) - Singapore High Court

Facts & Claim

- CAO drew on the LC by presenting an LOI (letter of indemnity) and the relevant commercial invoice to UBS (confirming Bank). UBS forwarded the documents to BCP who paid UBS and UBS paid CAO's drawing.

- As BCP had been informed by Zenrock that they were to be paid from the proceeds of the sale to PetroChina (the ultimate buyer of the Gasoil), BCP requested payment from PetroChina but was informed that **the sale contract between Zenrock and Petrochina had been cancelled**.

- As BCP could not recover the amount from PetroChina, it pursued Zenrock. **But Zenrock had become insolvent.** So BCP claimed against CAO.

- BCP alleged: (1) CAO's contract with ZenRock was a sham/fraudulent transaction that did not involve a true sale of physical gasoil or transfer of title; (2) CAO had breached the reps and warranties in the LOI; and therefore (3) on the basis of the fraud exception, they were entitled to withhold or recover payment from CAO.

Banque De Commerce Et De Placements S.A. (BCP) v. China Aviation Oil (Singapore) Corp (CAO) - Singapore High Court

High Court Decision

- The contract between Zenrock and CAO was not fraudulent because:
  - The circular trade transactions which the CAO-Zenrock contract was part of, are not inherently fraudulent. They can be justified by economic and commercial reasons.
  - BCP treated the expected receivables from PetroChina as the main security for the LC, rather than the original bills of lading.
  - There was no evidence of CAO's participation in any alleged Zenrock fraudulent action.
  - China Aviation Oil's staff treated the deal as a genuine transaction, for example by applying normal risk management procedures and appointing an independent inspector to verify the loading of the oil onto a vessel.
- The fraud exception to the LC independence principle could not be invoked as the LOI and the invoice were addressed to Zenrock, not BCP and furthermore were presented to UBS, not BCP.

Winson Oil Trading v. Oversea-Chinese Banking Corp.(OCBC) & Standard Chartered Bank (SCB) [2023] SGHC 220, and SGCA 31 [2024]

Facts

- Winson (oil traders) sold Gasoil to Hin Leong (oil traders) on 27 March 2020 which was the final leg of circular trades that took place on the same afternoon.

  1. Hin Leong sold a quantity of Gasoil in two shipments to Trafigura Pte Ltd ("Trafigura");
  2. Trafigura sold the same quantity of Gasoil to Winson; and
  3. Winson sold the same quantity of Gasoil back to Hin Leong.

- To support Hin Leong's purchase of the oil from Winson, Hin Leong instructed Overseas Chinese Banking Corporation (OCBC) to issue an LC to Winson. Standard Chartered Bank (SCB) was the second issuing bank.

Winson Oil Trading v. Oversea-Chinese Banking Corp. (OCBC) & Standard Chartered Bank (SCB) [2023] SGHC 220, and SGCA 31 [2024]

Facts & Allegations

- Winson made demands under the LC's on OCBC and SCB presenting Letters of Indemnity from Winson addressed one to each bank and the relevant Bills of Lading (B/L's) as required by the LC's.

- Around this time, Hin Leong became insolvent and was alleged to have committed a number of other frauds.   Realising they might never recover for any payment made, the banks examined the transaction and the demand and refused to pay, asserting the fraud exception.

- Winson sued the banks, but the banks alleged that the transaction was fictitious (there was no oil purchased as represented in the LOI's and the B/L's presented and relied upon in the LOI were forgeries.

- It became evident that the Bills of Lading (B/L's) that had been used in a previous transaction and that the entire transaction was done to obtain financing despite no trade having occurred (this may be called a synthetic trade).

- So, while there may not have been an intention to defraud, the use of the B/L's represented a trade that was fictitious.

Winson Oil Trading v. Oversea-Chinese Banking Corp. (OCBC) & Standard Chartered Bank (SCB) [2023] SGHC 220, and SGCA 31 [2024]

Banks defence to the Claim

- The fraud exception is satisfied if in presenting documents for payment, a beneficiary makes a false representation of material fact knowingly, or without belief in its truth (which *includes* the beneficiary being reckless, in the sense of being indifferent to the truth).

- The banks alleged that the LOIs which Winson presented to them contain various representations of material fact, which were false.

- The LOI's contained the following representations (summary) which were alleged to be false:

  - There was cargo shipped, pursuant to valid BLs, onboard the named vessels

  - Winson had good title to that cargo

  - Winson had passed good title to Hin Leong.

Winson Oil Trading v. Oversea-Chinese Banking Corp. (OCBC) & Standard Chartered Bank (SCB) [2023] SGHC 220, and SGCA 31 [2024]

High Court Decision

- The Court found that the representations in the LOI's were false – there was no cargo shipped, the B/Ls were invalid, the cargo was not shipped as stated, Winson did not have good title to any cargo and so the title was not transferred.

- The judge concluded that the banks had established the fraud exception in relation to Winson's presentations and so that payment can be withheld.

- Winson's claim is dismissed. Winson appeals

Court of Appeal Decision

- The Appeal Court dismissed the appeal on the basis that the High Court had not erred in finding the fraud exception had been met.

- This case was good news to issuing banks and particularly the Court of Appeal decision can be relied upon in Singapore and is also of influence in other (especially common-law) jurisdictions.

Balli Steel plc.
False invoicing and statements to gain finance.

- Balli Steel collapsed in 2023 owing more than GBP328 million to creditors in UK, Europe, Asia and the Middle East.

- After decades of profitable trading, in 2012 the company faced a growing deficit and resorted to concocting fake trades.

- In order to obtain continued financing from their banks they fabricated evidence of a healthy business.

- The company presented falsified transaction and shipping documents as well as falsified accounts to their banks. Shipping documents issued by a Caymen island shipping company owned by Balli Steel and transactions verified by them via faxes emanating from a UK number at Balli's offices in the UK.

- When, after a year they were unable to keep up the pretence, the lenders withdrew the credit lines.

- The Serious Fraud Office investigated the collapse, and the three directors were charged with fraud, and using the proceeds to fund criminal lifestyles. All three directors were found guilty and sentenced to prison terms and asset confiscation orders.

British Seafoods (2010)

- British Seafood, which was reputed to be the UK's biggest importer of fish from Asia, distributing frozen seafood to the retail trade in the UK.
- Financers invested or lent funds based on mis-representations that inflated the value or the trades or represented trades having occurred that didn't exist.
- Investors / Lenders lost money as they didn't realise the extent of the multiple financing on the same transactions.
- Duplicate Trades & Multiple Lenders.
- Settled out of court.

Solo Industries UK Ltd. 1999

- Over five years, Solo Industries built up an almost totally fictitious business of exporting metals from India (via Dubai) persuading multiple global banks to lend funds.

- Financial statements were audited by one of the big five accounting firms with no concerns raised.

- In reality...
  - There were only a few real deals to satisfy the curious;
  - The fraud had been built up over a number of years;
  - There were multiple bank financings, all of which were drawn;
  - 80% of transactions were fraudulent.

- The fraud was exposed only when the Indian internal revenue service investigated tax irregularities.

- Settled out of court - USD300-500 million in losses much of which was written off by the banks.

Red Flags, Triggering Events & Managing the Financial Crime Risk

- Customer attributes and behaviour
- Cash flow and turnover
  - Sudden or dramatic increase in sales / profits / cash flow
- Unusual transactions
  - Transactions that don't fit with the description of the business or with past transactions
- Intelligence monitoring – what systems can you rely on?
- Media – anything in the news?
- Third party proceedings (court orders, complaints, compliance investigations)
- Key Counter parties – Anything new? Any insolvencies?

US Presidential Executive Order – Drug Cartels as FTO's

- A long list of US Presidential executive orders was introduced last week including the decision to designate drug cartels as *Foreign Terrorist Organizations*, or FTOs. The Secretary of State can designate any criminal organisation or cartel as an FTO.

- The repercussions of the order include

  - Prohibiting people or companies subject to U.S. jurisdiction from providing material support, including finances, to the FTOs;

  - Freezing the assets of cartels housed in U.S. institutions and blocking transactions involving FTO assets.

  - Any violation by a US person or US based person may result in fines or the implementation of sanctions.

  - The designation will encourage other countries to follow suit, as doing business with an FTO could result in sanctions being applied to the foreign entity or country.

- Question – what happens with a cartel or criminal organisation has an interest in/ control of a legitimate US business?