

## THE FRAUD RULE IN DOCUMENTARY CREDITS

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### **Keywords:**

The Fraud Rule; Documentary Credits; Autonomy Principle; Illegality; Nullity.

### **Abstract:**

This thesis contributes to research on the application of the fraud rule in documentary credits under English law. The conflict between the fraud rule and the autonomy principle in documentary credits is an essential point in the thesis. Most of the difficulties over the application of the fraud rule in documentary credits are caused by the solid position of the autonomy principle. In the absence of relevant legislation, the thesis focuses on the development of case law. The thesis starts by analysing the historical development of the fraud rule in the United States, where the rule was born, and follows with a comparison of its development and application in United States and English courts. The application of the fraud rule was relaxed, in some respects, in the United Kingdom during the 1990s. This relaxation conflicted, to some extent, with the traditional standard of applying the fraud rule, as established in older cases, such like *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd*.<sup>2</sup> The argument aroused by the new approaches is described at the end of the second chapter. Following on from the arguments, an extensive analysis of the fraud rule was made in the last part of the thesis. The analysis includes a study of two other possible exceptions, the illegality exception and the nullity exception. Those two possible exceptions, which also form the last part of the thesis, bring much new thought into the research of the application of the fraud rule.

### **1 Introduction - the Aim of the Thesis**

Documentary credits have been used as the main means of payment in international trade transactions for about 80 years. Despite the advantages of the system, the

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<sup>2</sup> [1975] Lloyd's Rep. 444.

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separation between the documents and the goods (known as the 'autonomy principle'), which is the fundamental principle of documentary credits, may also cause problems, such as frauds and abuse of the credit. The fraud rule was established to prevent the fraudulent seller from abusing the credit during transactions. It therefore conflicted with the autonomy principle from its inception. The conflict between the fraud rule and the autonomy principle did not stop the application of the fraud rule in the United Kingdom. Nevertheless, the efficiency of the fraud rule was more or less restricted by the rigorous requirements for its application in the United Kingdom. This thesis focuses on research into the development of the fraud rule in the United Kingdom. The author endeavours to explore a proper way to adapt the fraud exception into the documentary credits system in a manner which minimises conflict with the autonomy principle. Ideally, the fraud rule may execute its best function to prevent frauds through international trade transactions.

## **2 The Main Structure of the Thesis**

This thesis is mainly composed of three chapters.

**The first chapter** is generally a background of the establishment and the development of the fraud rule. The original development of the fraud rule is traced and discussed in the United States. Although the root of the fraud rule in the United Kingdom comes from the old American Case *Sztejn v J. Henry Schroder Banking Corporation*,<sup>3</sup> the standard of the application of the fraud rule in the United States was not applied by the English courts. A comparison between the two standards of application is also made in the first chapter.

**The second chapter** begins with research into a new phenomenon, which emerged from the 1990s in English case law. The author summarises the new phenomenon as several new approaches to the application of the fraud rule in the United Kingdom. Each approach is analysed carefully in this chapter. A comparison between the old standard of the application of the fraud rule in the United Kingdom, which is discussed in the first chapter, and the new approach, is made in chapter 2. The conditions for the application of the new approach will also be discussed in this chapter. At the end of the second chapter, questions relating to the arguments caused by the new approach will be pointed out.

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<sup>3</sup> (1941) NYS.2d 631.

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**The third chapter**, which is also the last chapter of the thesis, is an expansive and collected study of the fraud rule. In this chapter, two possible exceptions, other than the fraud rule in documentary credits, will be analyzed, namely the illegality exception and the nullity exception. The analysis of the two possible exceptions also leads to a deeper study of the fraud rule. Finally, the unsolved problems in the first and the second chapters are answered in the last chapter, and the reasonable and efficient way of applying the fraud rule with the least conflict with the autonomy principle is suggested at the end of the thesis.

### **3 The Main Issues of the Thesis**

#### ***The Historical Development of the Fraud Rule***

The fraud rule originated in the United States from the case of *Sztejn v J. Henry Schroder Banking Corporation*.<sup>4</sup> The application of the fraud rule was first supported by Judge Shientag's words in his judgment in this case, which expressed the view that there is a difference between the situation where there is 'a mere breach of the warranty regarding the quality of the merchandise'<sup>5</sup> and where 'the seller has intentionally failed to ship any goods ordered by the buyer';<sup>6</sup> in the later situation, 'where the seller's fraud had 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...'<sup>7</sup> *Sztejn* was the first case which was decided on the basis of an independent rule under the law of letters of credit – the fraud rule. It pointed an independent way to applicants who have been defrauded by dishonest beneficiaries to protect their interests.

*Sztejn* is the landmark case for the application of the fraud rule, not only in the United States, but also in the United Kingdom. The precise circumstances in which the fraud rule would apply was left open in *Sztejn*.<sup>8</sup> However, the standard to be used in applying the fraud rule developed differently as between the United States and the United Kingdom. Where in the United States, although there were arguments for a different standard for

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<sup>4</sup> Ibid.

<sup>5</sup> Ibid, 634.

<sup>6</sup> Ibid.

<sup>7</sup> Ibid, 635.

<sup>8</sup> *Sztejn* is a too typical fraud case, in which the fraudulent conduct was assumed to be so clear and serious. The judgment was all established on the basis of the assumption of the allegation of the fraudulent conducts of shipping worthless rubbish on the part of the seller was true.

the application, such as 'egregious fraud'<sup>9</sup> and 'intentional fraud',<sup>10</sup> Article 5-109 of UCC 1995 regulated the fraud rule as an exception in documentary credits, 'material fraud'<sup>11</sup> being settled as the standard of fraud while applying the fraud rule; in the United Kingdom, the standard was settled more on the basis of intentional, rather than material fraud. It is hard to explain why the two common law countries applied the fraud rule by two different standards, especially when the root of the fraud rule in English law was actually the United States decision in *Sztejn*. It is hard to explain why the United States courts are not convinced by the autonomy arguments, and arguments for security of banks, that impress the English courts; the Uniform Customs and Practice on Documentary Credits (UCP), which encapsulates it, has been adopted as much by American banks as by those in the UK. However, the difference of legal practice between the United Kingdom and the United States may be a possible reason. Revocable credits are common in the United States, or at least were until recently. Perhaps there, the security aspect of the transaction is less important.

There is another issue which impressed the author of thesis, that the 'material fraud' test was not efficient in its application, though it was recognized both by the UCC 1995 and the Official Comment. An 'egregious fraud' was accepted as the explanation of the material fraud in most of the judgments.<sup>12</sup> This extremely high standard left the application of the fraud rule back in the dark again. The low efficiency of the fraud rule in its birth place may be a best reason for the difficulty of the application of the fraud rule in the United Kingdom.

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<sup>9</sup> 'Egregious fraud' is not a term which commonly used by courts in connection with the fraud in documentary credits.' Xiang Gao and Ross P Buckley, (2003) Oxford U Comparative L Forum 3 at [ouclf.iuscomp.org](http://ouclf.iuscomp.org). It was established during the discussion of the application of the fraud rule in cases by judges.

<sup>10</sup> The idea of 'intentional fraud' was raised in the case of *NMC Enterprises v Columbia Broadcasting System, Inc*. It made the intention of the fraudster's as a main requirement for applying the fraud rule.

<sup>11</sup> The material standard made the serious of the fraud been the only line to decide the establishment of the fraud.

<sup>12</sup> See cases: e.g. *Mid-America Tire v PTZ Trading Ltd Import and Export Agent*, 2000 Ohio App. LEXIS 5402; (2000) 43 UCC Rep. Serv 2d (Callaghan) 964. Judgment delivered by Young PJ, Walsh J concurred, Valen J dissented; also *New Orleans Brass v Whitney National Bank* and the *Louisiana Stadium and Exposition District* (2002) La. App. LEXIS 1764.

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***The Main Argument—a Comparison between the Traditional Approaches of Applying the Fraud Rule and the New Phenomenon since 1990s***

The fraud rule was first accepted in the United Kingdom in *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd*.<sup>13</sup> The autonomy principle, although given a very strong position in the UCP, did not prevent the application of the fraud rule in the United Kingdom. Megarry J, in his judgment, admitted the authority of the United States case, *Sztejn v J. Henry Schroder Banking Corporation*.<sup>14</sup> However, the different standard for the application of the fraud rule was also apparent in this case. In this case, it was proved by the plaintiff that a great proportion of the shipment was either rubbish or empty cartons, and the evidence was affirmed by the judge. However, there was still 'no established fraud, but merely an allegation of fraud'.<sup>15</sup> The reason was mainly because 'Promodisc [alleged fraudster] was not a party',<sup>16</sup> and so the matter was not dealt with 'on [that] footing'.<sup>17</sup> The involvement of the beneficiary was seen as the central criterion for the application of the fraud rule. The fraud rule may not be accepted no matter how material the fraud is if there is a lack of the beneficiary's involvement of the fraud.

Although *Discount Records Ltd* applied the fraud rule at a comparatively high standard,<sup>18</sup> it was the well-known case of *United City Merchants (Investments) Ltd. v Royal Bank of Canada (The American Accord)*,<sup>19</sup> that pressed the application of the fraud rule to a very narrow scope in the United Kingdom.

The standard of applying the fraud rule in the United Kingdom after the decision of Lord Diplock in *The American Accord* may be summarized as follows:

First, the fraud has to be clearly established; a mere allegation of fraud is not sufficient;

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<sup>13</sup> [1975] Lloyd's Rep. 444.

<sup>14</sup> (1941) NYS 2d 631.

<sup>15</sup> [1975] Lloyd's Rep. 444. 446-447

<sup>16</sup> *Ibid.*

<sup>17</sup> *Ibid.*

<sup>18</sup> The intention of the fraudster is hard to prove as a subjective issue.

<sup>19</sup> [1983] 1 AC 168.

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Secondly, the fraud has to be known to the bank; it is not the bank's responsibility to examine the fraud in the transaction or then inside genuineness of the documents.<sup>20</sup>

Thirdly, the intention of the beneficiary is also one of the essentials of the application of the fraud rule.

The three conditions for the application of fraud rule in English courts made the application in practice of the fraud rule in documentary credit extremely rare. But it still established the basis of the applying of the fraud rule in English courts. And from the late 1990s, English courts started to consider details of the application, and some of the possible exceptions emerged during the application of the fraud exception. Those exceptions are discussed deeply in this thesis to challenge the traditional standard of the application.

In contrast to the old approach of applying the fraud rule, the new approaches adopted a lower evidential requirement, that of a seriously arguable case of fraud, instead of a clearly established fraud, when applying the fraud rule in documentary credits cases in certain situations, and those situations may be summarized as follows:

**First**, where there the buyer asked for a injunction at the pre-trial stage to restrain the beneficiary from demanding payment before any question of the enforcement of the guarantee or credit, the evidential requirement for granting the injunction to the buyer should be the establishment of a seriously arguable case of fraud on the part of the beneficiary;<sup>21</sup>

**Secondly**, where the bank was involved in the related underlying transaction, a lower requirement may be applied, instead of clearly proven fraud;<sup>22</sup>

**Thirdly**, where a beneficiary was seeking for a summary judgment to force the bank for payment, and the bank had a claim, with a real prospect of success, that there was a misrepresentation by the beneficiary directed at persuading the bank to enter to the letter of credit, a lower standard may be applied.<sup>23</sup>

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<sup>20</sup> This was established in the case of *Gian Singh & Co. Ltd. v Banque de l'Indochine* [1974] 1 WLR 1234, though it may vary while the cause of action is different. It was discussed in the later part of the thesis.

<sup>21</sup> See case *Themehelp Ltd v West* [1996] QB 84.

<sup>22</sup> This was established in the case of *Safa Ltd. v Banque Du Caire* [2000] 2 Lloyd's Rep. 600.

<sup>23</sup> This exception was also established in *Safa*, but also confirmed in the case of *Solo Industries*

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**Fourthly**, a bank may not be forced to pay by a summary judgment if it can establish a claim with a real prospect of success that the demand was fraudulent even if it had no clear evidence of fraud at the time of demand.<sup>24</sup>

Those new approaches brought about much argument as to the application of the fraud rule; however, the thesis explains these new approaches as exceptions rather than conflicts to the traditional application. Despite the difference of the causes of action and parties involved, all the exceptions were applied by the English courts at the pre-trial stage. And the issues around those exceptions were also similar: an application of a lower evidential requirement while applying the fraud rule. Also compared to the other three exceptions, the fourth exception was a most controversial one. There are two meanings within this approach: one is also about the evidential requirement which is being lowered from the clearly established fraud to a real prospect of success (or a powerful evidence); the other is about the knowledge of the bank, which means the fraud knowledge of the bank at the time of the demand, may not be necessary.

The issue of the requirement of the bank's knowledge or notice was always a controversial issue as a standard of applying the fraud rule. The main idea of this requirement came from the old case of *Gian Singh & Co. Ltd. v Banque de l'Indochine*,<sup>25</sup> where the plaintiff sued the bank because of a payment against a forgery document. Mr. Justice Tan Ah Tah, during the appeal, confirmed that the forgery was proved, but decided the bank was not liable because 'the paying bank was in no position to be aware of the forgery'.<sup>26</sup> Also in a recent case *Banque Saudi Fransi v Lear Siegler Services Inc*,<sup>27</sup> where a bank sought to get a summary judgment of reimbursement from the defendant, the defendant refused the reimbursement by claiming there was a fraud of the beneficiary, the summary judgment was granted, and one of the reasons was that there was not a fraud come to the notice of the bank.

The decisions of these two cases look quite different from the fourth exception that was established in the case of *Safa*. The argument on the requirement of the banks'

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*UK Ltd v Canara Bank* [2001] 1 WLR 1800.

<sup>24</sup> Again see *Safa Ltd. v Banque Du Caire* [2000] 2 Lloyd's Rep. 600.

<sup>25</sup> [1974] 2 Lloyd's Rep. 1.

<sup>26</sup> *Ibid*, 3.

<sup>27</sup> [2006] 1 Lloyd's Rep. 27.

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knowledge was one of the main issues in the last part of the thesis.

### ***An Extensive Study—a Collective Study between the Fraud Rule and Other Two Possible Exceptions***

While the fraud rule challenged the autonomy principle in documentary credits under certain conditions in English Law, two other possible exceptions developed during the practice of documentary credits, namely the illegality exception and the nullity exception. The illegality exception, although was not well-developed as the fraud rule, was also admitted by English Law clearly in the case of *Mahonia Ltd v JP Morgan Chase Bank*.<sup>28</sup> Colman J expressed his agreement with the view of Staughton LJ in *Group Josi Re v Walbrook Insurance Co. Ltd*,<sup>29</sup> that it is incredible for a party to an unlawful arms transaction to 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. And Colman J made a conclusion in the end of his judgment that the beneficiary should not 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’.<sup>30</sup> The thesis also analyses the reasonableness of the illegality exception through the Law Commission’s suggestions for reform,<sup>31</sup> but the author of the thesis concentrates more on the rationale of the existence of the nullity exception since it was literally rejected in the case of *Montrod Ltd v Grundkötter Fleischvertriebs GmbH*.<sup>32</sup>

The thesis challenges the idea of a total rejection of the application of the nullity exception, taking the view that the nullity exception might exist and be applied in English Law under certain conditions. Although, in *Montrod*, Potter LJ made a clear expression about the appliance of the nullity exception that ‘there should be no general nullity exception based upon the concept of a document being fraudulent in itself or devoid of commercial

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<sup>28</sup> (No.1) [2003] EWHC 1927 (Comm); [2003] 2 Lloyd’s Rep 911 and (No.2) [2004] EWHC 1938 (Comm). However, the first case in which illegality has been considered as affecting payment under a letter of credit in English Law is not *Mahonia*, but *Group Josi Re v Walbrook Insurance Co. Ltd*. [1996] 1 WLR. 1152.

<sup>29</sup> [1996] 1 WLR. 1152.

<sup>30</sup> [2003] 2 Lloyd’s Rep 911,927

<sup>31</sup> . Most recently Law Commission Consultation Paper No 189, ‘The Illegality Defence: A Consultative Report’ (2009).

<sup>32</sup> [2001] EWCA Civ 1954



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value',<sup>33</sup> he added a idea that there might be a possibility that 'the conduct of a beneficiary in connection with the creation and /or presentation of a document forged by a third party might, though itself nor amounting to fraud, be of such character as not to deserve the protection available to a holder in due course'.<sup>34</sup> To explain this idea, he also cited the decision of the High Court of Singapore in *Lambias (Importers and Exporters) Co Pte Ltd v Hong Kong and Shanghai Banking Corpn*,<sup>35</sup> in which the court held a certificate contained discrepancies entitling the bank to refuse the documents tendered, and the inspection certificate was found to be a nullity in any event.

The author of the thesis considers this idea as a very important point in the analysis of the nullity exception. Although Potter LJ did not admit the nullity exception, he made a concession on the situation that there was a connection between the beneficiary and the creation of a forged document, even though the document was directly made by a third party. In other words, there might be some other exceptions, besides the fraud rule, in which the beneficiary's involvement in the fraud may not be required, as long as there is a connection between the beneficiary and the creation of the forged document. The author of the thesis considered this idea, in the context of the nullity exception, as that a nullity might be seen as a exception for the bank to refuse the payment as long as there was a connection between the beneficiary and the creation of the null document.

If the above is correct, the nullity exception must exit under certain conditions. And the thesis analyses the conditions of its application in different situations, which were classified by the cause of the action. In other words, the application of nullity exception differs while different relationships were involved in. In the end of the study, it was concluded in the thesis that it is reasonable to have a nullity exception but in documentary credits but only in certain circumstances. One possibility is where the bank decided to reject the documents according to his knowledge of the nullity, and the other is where the nullity was noticed by the buyer before the enforcement of the letter of credit arose as between the beneficiary and the bank. However, no matter in what circumstance, the nullity exception does not exist beyond the protective position of the bank in documentary credits. In other words, the buyer is not allowed to reject the reimbursement to the bank

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<sup>33</sup> Ibid. 1992.

<sup>34</sup> Ibid.1992-1993.

<sup>35</sup> [1993] 2 SLR 751.

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under a nullity exception, since the bank has no obligation to examine whether the document is null, as long as he paid reasonable care to examine the apparent conforming of the documents. However, the court would not grant a summary judgment in the favour of a beneficiary to enforce a bank's obligation to pay, while the bank has decided to refuse to pay against a null document either.

Research into the nullity exception also inspired further research into the application of the fraud rule, as well as the illegality exception. The conditions of applying the three exceptions may be discussed in a similar way by the different causes of action. It has to be mentioned here that Potter LJ's idea regarding the connection between the beneficiary and the defect was not made under a nullity exception. Actually, it was a forged document which was referred to by Potter LJ when expressing his idea. Therefore, it may be understood that no matter whether for the fraud rule or for the nullity exception, the involvement of a different party and the cause of action are essential points which should be considered during the application. For the illegality exception, as long as the illegality is not too serious, such as criminal illegality, it may also be considered in this context.

### **The Achievement on the Application of the Fraud Rule in the United Kingdom**

The thesis thus successfully reconciles the other two exceptions with the fraud rule, which is the core issue of the whole thesis. The analysis from the aspect of the cause of action solves many arguments as to the application of the fraud rule, especially the conflicts between the new approaches and the traditional approach of applying the fraud rule in English law.

Generally, the standard of proof in applying the fraud rule is still very high in English law. The fraud still has to be clearly established at the final judgment. However, when the issue raised at pre-trial stage, such as in an action for applying a summary judgment or an injunction, the evidential requirement may be lowered to that of a seriously arguable case of fraud, instead of a clearly established fraud, when the action was taken by a beneficiary against the bank for payment, or was taken by an applicant to prevent the beneficiary from asking for payment before the banks were involved in the action. For the requirement of the knowledge of the bank, it is still a condition of applying the fraud rule for other parties against the bank, when the bank has decided to pay, or has already paid,

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against a facially conforming document. The bank always has the right either to pay or to reject to pay when facing a possible fraud involving documents. Even in a final judgment stage, the bank only has to prove the fraud any time before the final judgment; whether the fraud was proved by the bank at the time of payment was not an issue for the court to consider. Nevertheless, the knowledge of the bank at the time of payment can still be essential in an action between an applicant and the bank on the issue of a reimbursement. The applicant can only sue the bank according to the bank's responsibility to examine the face of the documents before payment under the UCP; the bank has no business to consider the underlying contract between the applicant and the beneficiary. The only way for the applicant to refuse reimbursement to the bank or prevent the bank from making payment is that he has to prove the bank has the knowledge of the fraud before payment, otherwise the applicant will not be able to succeed in an action against the bank's payment, even if he can prove the fraud at the stage of the final judgment.

There is a particularly difficult issue, which is the requirement of the fraudulent intention of the beneficiary, when applying the fraud rule. This requirement was clearly expressed by Lord Diplock in famous case of *The American Accord*. This thesis tried to challenge this view in two ways.

On the one hand, besides the contractual relationship between the bank and the beneficiary, in which the bank is liable to pay against a complying document, the bank also hold security interests in documents. If the bank noticed a forgery or even a nullity in a facially conforming document which may affect his security interests, he should be able to reject the document even only on a defense of the security interests. Of course, the security interests may vary according to different documents. The author of the thesis may consider this as the reason why, in applying a nullity exception, there was no requirement for the beneficiary's fraud or direct involvement to the making of the nullity. Because if the null document is a bill of lading, the bank may lose its title on the document by accepting the null bill of lading. But even in a situation where the security interest was not very serious, the bank should be entitled to reject the payment on a defense of the security interest. Of course, the bank may face a charge of a wrong dishonor by the beneficiary, but it may face a charge from the applicant if the applicant believes the bank has the

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knowledge of the forgery in the documents. It should be under the banks' discretion to decide which way he wants to go.

On the other hand, even if the fraud issue arose without the beneficiary's fraud, it is hard to see why the risk should be allocated to the applicant or the bank but not the beneficiary. Although the beneficiary was not intentionally in making a fraud, and the fraud might be made by a third party, under the letter of credit contract, the beneficiary has an obligation to present a conforming document to the bank, but not a forgery document which is only complying with the credit on the face. The beneficiary should not be seen as in the same position of a holder in due course which was expressed by the Lord Diplock in the case of *American Accord*. Furthermore, when Potter LJ explained his idea on the 'connection point', he was considering the connection between the beneficiary and a forgery made by a third party, when the beneficiary was not actually fraudulent. It is hard to justify the range of the connection in a fraud involved case, however, if according to the decision of *Lambias*, the fact the seller introduced the fraudulent party to the bank was qualified to the 'connection', an arrangement of the transport by hiring a fraudulent carrier should be in no doubt qualified to the 'connection'.<sup>36</sup> In other words, the connection is easy to be established as long as the seller has a relationship with the fraudulent party. Then it may be reasonable to allocate the risk caused by the fraud to the beneficiary rather than other two parties when the connection is established.

Of course, the fraudulent intention is always a main requirement for applying the fraud rule. However, it is questionable whether the intention can only be justified while it comes from the beneficiary. Also if the above analysis was right, why should the beneficiary be protected in a third party's fraud, and why should the risk be allocated to the beneficiary or the bank, who was innocent to the fraud?

## Conclusion

The fraud rule, as an exception of documentary credits system, exists in international trade law for certain reasons. It prevents the fraudulent seller from abusing the credit; it protects the buyer's rights under the sale contract; it also efficiently protects the bank's security interests. The existence of the fraud rule fills, or at least narrows, the gap between

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<sup>36</sup> Actually, a very similar situation happened in the case of *American Accord*, but the decision did not follow the 'connection point'.

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documentary credits and fraudulent conduct. Although the conflict between the fraud rule and the autonomy principle is hard to ignore, a proper method of application of the fraud rule may reduce the collision. The solid position of the autonomy principle in English courts is not necessary to hinder the efficiency of the fraud rule. The new approaches which emerged during the 1990s are a good pattern of the application of the fraud rule in English law. Furthermore, the illegality exception and the nullity exception are both possible exceptions under certain conditions in the documentary credits system. Those exceptions, in addition to the fraud rule, may provide a better environment for the development of the documentary credits system. The payment system may be more functional with the protection of those exceptions. Optimistically, the conflicts between the autonomy principles and those exceptions will be decreased by the development of the exceptions.