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**DOCUMENTARY CREDITS IN INTERNATIONAL  
COMMERCIAL TRANSACTIONS  
WITH SPECIAL FOCUS ON THE FRAUD RULE**

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## ***PREFACE***

*“Stylus mercatorum et consuetudo  
praevalere debet jure communi”  
/Casaregis/*

International commercial transactions require efficient risk management. Where transport of goods reaches over frontiers and delivery and payment are separated in time and space both seller and buyer have to face certain risks.

The seller faces the risk of change in the buyer’s financial status after shipment of goods has taken place, which may lead to delay in receiving the purchase price or to non-payment.

On the other hand, effecting payment to the seller upon shipment without being able to find out whether the goods are as per contract carries significant risk for the buyer.

In order to eliminate or at least to minimise the risk of non-delivery and non-payment, as well as the difficulties arising from the conflicting legislations, currency and culture, merchants have created different methods and various instruments to finance international trade.

One of the most widely used methods of payment is the letter of credit. It has been developed to reconcile the various economic interests of the parties.

By agreeing to payment by a letter of credit the seller and the buyer invite a third trustworthy party – usually a bank - into their relationship. Upon the buyer’s request the bank opens a letter of credit in favour of the seller. By issuing the letter of credit the bank undertakes a primary and independent obligation to effect payment to the seller provided that complying documents specified in the letter of credit are tendered.

The transaction may involve the service of other banks, acting as agents of the issuing bank, or simply advising the letter of credit to the seller or undertaking a separate obligation to pay to the seller.

Letters of credit play a significant role in financing international trade, and have gained great importance. They have been described as “the life blood of international commerce”<sup>1</sup> and have been referred to as “quintessential international instruments”<sup>2</sup>.

The law of letters of credit has emerged mainly from the customs of bankers dealing with importers, exporters, freight forwarders, shipping and insurance companies.

Today, these customs are embodied in a Code drafted by the International Chamber of Commerce titled “Uniform Customs and Practice for Documentary Credits” (UCP).

The provisions of the UCP are incorporated globally into standard letters of credit agreements in an attempt to provide a measure of uniformity in cross-border transactions. The latest revision of UCP, referred to as UCP 500, entered into effect more than a decade ago, on the 1<sup>st</sup> of January, 1994. Since then, international business transactions have gone through rapid changes, especially in the field of maritime transport, insurance, trade law, and other sophisticated technologies, to which letter of credit law has had to adapt.

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<sup>1</sup> R.D.Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd [1978] Q.B. 146 at 155

<sup>2</sup> Report of the Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5 (Letters of Credit)*, presented to the Letter of Credit Subcommittee of the Uniform Commercial Code Committee of the American Bar Association’s Business Law Section and the U.S. Council on International Banking, Inc., reprinted in [1990] 45 Bus. Law 1521 at 1532

In the Hungarian legal literature little has been written about letters of credit. Although banks issue letters of credit and effect payment upon them legal scholars have given little attention to this financial instrument.

The aim to fill in this gap has been the original driving forces behind researching the subject area and writing this thesis.

Furthermore, the UCP 500 is currently under revision. No revision can be successfully carried out without understanding the existing provisions governing the operation of letters of credit. This has given an excellent opportunity to provide a concise account of the law of letters of credit

The thesis is divided into nine chapters. Its subject is the international letter of credit, thus the domestic use of letters of credit is not contemplated.

**Chapter I.** gives a short introduction to the history of letters of credit. The chapter is structured with the consideration that looking into the commercial background of the letter of credit and conducting a brief survey on its historical origins is the starting point to understand the operation of this legal instrument.

**Chapter II.** examines the sources of letter of credit law. Although the UCP is considered to be the primary source of law, its development has been highly influenced by other regulations. Therefore, besides discussing the drafting and revision of the UCP the chapter introduces other rules published by the International Chamber of Commerce and relevant for the subject area, such as the eUCP, ISBP, URR 525 and the ISP98. It also summarizes the provisions of the United Nations Convention on Independent Guarantees and Standby Letters of Credit drafted by the UNCITRAL in an effort to harmonise the rules of guarantees and standby letters of credit.

Due to its highly international character, few countries have attempted to codify letter of credit law on a national level. One exception is the United States, which devoted a separate chapter in the Uniform Commercial Code to letters of credit and which has gained the well-desired attention of researchers.

Case law undoubtedly forms a prominent part of letter of credit law. The conclusions deriving from the cases are far-reaching and they require careful consideration. Consequently cases and court decisions from different jurisdictions are given and analysed in all chapters of the thesis.

Letters of credit come in various forms and types. While **Chapter III.** primarily focuses on documentary credits, for the sake of completeness, it also discusses the other basic form: the standby letter of credit.

A summary of the different types of letters of credit is given as well, highlighting their commercial purpose and usage.

The letter of credit transaction involves four independent, but interdependent relationships: usually a sales contract between the seller and the buyer, a contract between the buyer and the issuing bank, the actual letter of credit relationship between the issuing bank and the seller and a separate contract between the issuing bank and the corresponding banks. Understanding the operation of letters of credit require thorough analysis of these relationships, as well as the role of the parties. This is provided in **Chapter IV.**, alongside with the rights and obligations of the parties to the transaction.

Documentary credits received their name based on the understanding that banks deal with documents not with goods. The seller obtains payment upon the condition that he provides the bank with the documents required. The documents to be tendered are defined by the buyer in its application for the issuance of the letter of credit, and they form the core of the credit provisions.

**Chapter V.** gives a detailed description of the various documents accompanying the documentary sale.

The law of letters of credit is founded on two cardinal principles: the Principle of Strict Compliance and the Principle of Independence. As described in **Chapter VI.**, the Principle of Strict Compliance allows the bank to reject payment to the seller if the documents tendered do not strictly comply with the terms and conditions of the letter of credit.

On the other hand the Principle of Independence requires the bank to honour its obligations to the seller regardless of any disputes between the seller and the buyer concerning the underlying contract. This principle is incorporated into the UCP and has long been recognised by case law.

However, “as is the case with any rule that paints human conduct with a broad brush”<sup>3</sup>, a rigid application of the principle may produce harsh results, running against the original purpose of the letter of credit. This is the case when fraud is involved in the transaction. To avoid injustice an exception has been created to the Principle of Independence; the so called “fraud exception”.

The “fraud exception” is discussed in **Chapter VII.** This chapter addresses the “fraud exception” through the analysis of selected common law and civil law jurisdictions and the United Nations Convention on Independent Guarantees and Standby Letters of Credit. Although fraud in the letter of credit transaction is an everyday reality the UCP is silent on this matter. The thesis discloses the basic reasoning why drafters of the UCP have been unwilling to tackle this problem and offers possible solutions with the non-disguised aim of supporting the inclusion of the fraud rule into the Code.

**Chapter VIII.** focuses on the future of the UCP. It is divided into two sections. Section One is devoted to the analysis of the eUCP, a set of supplementary regulations allowing letters of credit to enter the electronic age. Section Two brings the attention to the current revision of the UCP 500, pointing out the most critical points of the discussion on the future Code.

**Chapter IX.** provides a general summary .

This thesis compiles the results of several years of research. The collection of data started in the United States while being a visiting student in the Emory School of Law, Atlanta (GA). Returning to Hungary the author continued the collection but soon encountered the problem of lack of relevant Hungarian legal material on the subject matter. In order to broaden my knowledge, I contacted professors of law of foreign universities, and lawyers and bankers of foreign jurisdictions. I also received access to DC-PRO Focus, the most comprehensive store of on-line letter of credit information, including rules, cases, articles, official opinions of the International Chamber of Commerce and a discussion forum.

Additionally, to understand the operation of letters of credit I visited two commercial banks in Hungary, and later an additional in Greece, where I explored the day-to-day operation of this financial instrument from the perspective of a banker.

In 2004-2005 the research was further extended in the National and Kapodistrian University of Athens, Greece within the framework of a scholarship received from the State Scholarship Foundation of the Republic of Greece.

In October 2005 I participated in the Paris meeting of the Banking Commission of the International Chamber of Commerce authorised to carry out the revision of the UCP. This

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<sup>3</sup> GETZ, H.A., *Enjoining the International Standby letter of Credit: The Iranian Letter of Credit Cases*, (1980) 21 Harvard International Law Journal, p. 189 at 204

allowed me to receive first hand information on the opinion of lawyers, bankers and trade professionals from several countries and compare the differing views on the most debated provisions of the UCP 500.

The thesis is written from the perspective of a lawyer as opposed to that of a banker, thus it focuses more on the legal framework than on the practical operation of the letter of credit.

### ***ACKNOWLEDGEMENT***

During the course of studying this segment of international banking law and collecting material for the doctoral thesis I received enormous help and support from many people, as well as from institutions.

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Athens, 10 March, 2005

Zsuzsanna Tóth, dr.

## TABLE OF CONTENTS

|  |           |
|--|-----------|
| <b>PREFACE</b>   | <b>I</b>  |
| <b>ACKNOWLEDGMENT</b>  | <b>IV</b> |
| <b>I. THE HISTORY OF LETTERS OF CREDIT</b>   | <b>1</b>  |
| <b>II. THE SOURCES OF LETTER OF CREDIT LAW</b>   | <b>5</b>  |
| 2.1. ICC Rules   | 5         |
| 2.1.1. The Uniform Customs and Practice for Documentary Credits                        | 5         |
| <i>The development of the UCP</i>  | 5         |
| <i>The nature and application of the UCP</i>   | 8         |
| 2.1.2. eUCP  | 9         |
| 2.1.3. International Standard Banking Practice   | 10        |
| 2.1.4. Uniform Rules on Bank-to-Bank Reimbursements under Documentary Credits          | 11        |
| 2.1.5. The International Standby Practices   | 12        |
| 2.2. United Nations Convention on Independent Guarantees and Standby Letters of Credit | 13        |
| 2.3. Uniform Commercial Code   | 14        |
| 2.4. National law  | 16        |
| <b>III. WHAT IS A LETTER OF CREDIT? THE NATURE OF LETTERS OF CREDIT</b>                | <b>17</b> |
| 3.1. What is a letter of credit?   | 17        |
| 3.2. Classification of letters of credit   | 18        |
| 3.2.1. Documentary Credit  | 18        |
| 3.2.2. Standby Letters of Credit   | 19        |
| 3.3. Types of letters of credit  | 21        |
| 3.3.1. Payment at sight, deferred payment, acceptance and negotiation credits          | 21        |
| 3.3.2. Revocable and Irrevocable credits   | 22        |
| 3.3.3. Confirmed and unconfirmed credits   | 23        |
| <i>Confirmed credits</i>   | 23        |
| <i>Unconfirmed credits</i>   | 25        |
| 3.3.4. Revolving Documentary Credits   | 26        |
| 3.3.5. Red Clause Documentary Credits and Green Clause Documentary Credits             | 26        |
| 3.3.6. Transferable Documentary Credits  | 27        |
| <i>Transfer of the credit</i>  | 28        |
| <i>Assignment of the proceeds of the credit</i>  | 30        |
| 3.3.7. Back-to-Back Documentary Credits  | 30        |
| <b>IV. THE STAGES OF A LETTER OF CREDIT TRANSACTION</b>                                | <b>32</b> |
| 4.1. Relationship between the parties  | 33        |
| 4.1.1. The relationship between the Buyer and the Seller                               | 34        |

|           |   |           |
|-----------|---|-----------|
| 4.1.2.    | The relationship between the Buyer(Applicant) and the Issuing Bank                    | 34        |
| 4.1.3.    | The relationship between the Seller(Beneficiary) and the Issuing Bank/Confirming Bank | 35        |
| 4.1.4.    | The relationship between the Issuing Bank and the Correspondent Bank                  | 35        |
| 4.2.      | The rights and obligations of the parties   | 36        |
| 4.2.1.    | The rights and obligations of the Buyer   | 36        |
|           | <i>The underlying contract</i>  | 36        |
|           | <i>Time of opening the credit</i>   | 38        |
|           | <i>Instructions given to the bank</i>   | 40        |
|           | <i>Reimbursing the Issuing Bank</i>   | 42        |
| 4.2.2.    | The rights and obligations of the Seller  | 42        |
|           | <i>Amendment of the irrevocable credit</i>  | 43        |
|           | <i>Amendment of the revocable credit</i>  | 44        |
|           | <i>The Seller is proceeding as if the non-conforming credit was conforming</i>        | 45        |
|           | <i>Presentation of documents</i>  | 46        |
|           | <i>No short circuit of the credit</i>   | 47        |
| 4.2.3.    | The rights and obligations of the Bank  | 49        |
|           | The Issuing Bank  | 49        |
|           | <i>Accepting the Instructions of the Applicant</i>                                    | 49        |
|           | <i>Issuance of the credit</i>   | 51        |
|           | <i>Form of the credit</i>   | 51        |
|           | <i>Examination of documents</i>   | 52        |
|           | <i>Waiver of discrepancies</i>  | 53        |
|           | <i>Genuineness of the documents</i>   | 58        |
|           | <i>Force majeure</i>  | 59        |
|           | <i>The Issuing Bank's duty to pay</i>   | 59        |
|           | The Correspondent Bank  | 59        |
|           | <i>The Advising Bank</i>  | 60        |
|           | <i>The Confirming Bank</i>  | 61        |
|           | <i>The Nominated Bank</i>   | 62        |
|           | <i>Reimbursement of the Correspondent Bank</i>  | 62        |
| <b>V.</b> | <b>ACCOMPANYING DOCUMENTS</b>   | <b>63</b> |
| 5.1.      | General requirements  | 63        |
|           | <i>Strict compliance</i>  | 64        |
|           | <i>Consistency</i>  | 64        |
|           | <i>Original documents</i>   | 66        |
|           | <i>Issuer of the document</i>   | 69        |
|           | <i>Issuance date</i>  | 69        |
|           | <i>Date terminology</i>   | 70        |
| 5.2.      | Transport documents   | 70        |
| 5.2.1.    | Marine/ocean bill of lading   | 71        |
| 5.2.2.    | Non-negotiable sea waybills   | 73        |
| 5.2.3.    | Charter Part Bill of Lading   | 74        |
| 5.2.4.    | Multimodal transport documents  | 75        |
| 5.2.5.    | Air transport documents   | 78        |

|        |   |    |
|--------|---|----|
| 5.2.6. | Road, rail or inland waterway transport documents | 78 |
| 5.2.7. | Courier and post receipts                         | 79 |
| 5.2.8. | Transport documents issued by freights forwarders | 79 |
| 5.2.9. | Regulations common to all transport documents     | 80 |
|        | “Clean” or “claused” transport documents          | 80 |
|        | <i>Payment of freight</i>                         | 81 |
| 5.3.   | The Commercial Invoice                            | 81 |
|        | <i>Name and address of the buyer</i>              | 82 |
|        | <i>Description of the goods</i>                   | 82 |
|        | <i>Quantity of the goods</i>                      | 84 |
|        | <i>Amount</i>                                     | 85 |
|        | <i>Signature</i>                                  | 85 |
| 5.4.   | Insurance Documents                               | 85 |
| 5.5.   | Other Documents                                   | 87 |

## **VI. GOVERNING PRINCIPLES OF THE LETTER OF CREDIT TRANSACTION**

|      |   |           |
|------|---|-----------|
|      |   | <b>88</b> |
| 6.1. | Principle of Independence                                 | 88        |
|      | 6.1.1. General overview                                   | 88        |
|      | 6.1.2. The Principle of Independence in the case law      | 89        |
| 6.2. | Principle of Strict Compliance                            | 91        |
|      | 6.2.1. General overview                                   | 91        |
|      | 6.2.2. The Principle of Strict Compliance in the case law | 92        |
|      | 6.2.3. The bank’s duty in the examination of documents    | 95        |
|      | “On their face”   | 95        |
|      | <i>Reasonable care</i>                                    | 96        |
|      | <i>Non-documentary requirements</i>                       | 97        |
|      | <i>Duration of the examination</i>                        | 97        |
|      | <i>Discrepancies</i>                                      | 98        |

## **VII. THE FRAUD EXCEPTION**

|      |  |            |
|------|--|------------|
|      |  | <b>100</b> |
| 7.1. | The meaning of the fraud rule  | 101        |
| 7.2. | Historical background of the fraud rule  | 102        |
|      | 7.2.1. The fraud exception in the early English case law                             | 102        |
|      | <i>Pillans v. Van Mierop</i>   | 103        |
|      | <i>Ulster Bank v. Synnott</i>  | 103        |
|      | <i>Societe Metallurgique v. British Bank for Foreign Trade</i>                       | 103        |
|      | <i>Bank Russo-Iran v. Gordon Woodroffe &amp; Co Ltd</i>                              | 104        |
|      | <i>Edward Owen Engineering Ltd v. Barclays Bank International Ltd. and Umma Bank</i> | 105        |
|      | <i>Etablissement Esefka International Anstalt v. Central Bank of Nigeria</i>         | 106        |
|      | <i>United City Merchants (Investments) Ltd v. Royal Bank of Canada</i>               | 106        |
|      | 7.2.2. Important early cases in the United States                                    | 112        |
|      | <i>Higgins v. Steinhardter</i>   | 112        |
|      | <i>Old Colony Trust Co v. Lawyer’s Title &amp; Trust</i>                             | 113        |
|      | <i>Maurice O’Meara Co v. National Park Bank</i>                                      | 113        |
|      | <i>The Szejn case</i>  | 115        |

|        |   |     |
|--------|---|-----|
| 7.3.   | The regulation of fraud in documentary credits in selected jurisdictions                                    | 117 |
| 7.3.1. | The position of the United States of America  | 118 |
|        | <i>The first draft of Article 5 of the UCC</i>  | 118 |
|        | <i>The Iranian Cases</i>  | 123 |
|        | <i>Revised UCC Article 5</i>  | 125 |
| 7.3.2. | The position of the United Kingdom  | 136 |
|        | <i>Requirements in order to evoke the fraud rule</i>  | 137 |
|        | <i>The nullity exception</i>  | 141 |
| 7.3.3. | The position of Hungary   | 143 |
| 7.3.4. | The position of Greece  | 146 |
| 7.4.   | The position taken by the United Nations Convention on Independent Guarantees and Standby Letters of Credit | 149 |
| 7.5.   | The UCP   | 150 |

## **VIII. THE FUTURE OF THE UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS**

|        |   |            |
|--------|---|------------|
|        | <b>DOCUMENTARY CREDITS</b>  | <b>153</b> |
| 8.1.   | eUCP  | 153        |
| 8.1.1. | Structure of the eUCP   | 154        |
| 8.1.2. | Scope of the eUCP   | 154        |
| 8.1.3. | Principles  | 155        |
|        | <i>Document</i>   | 156        |
|        | <i>Electronic record</i>  | 156        |
|        | <i>Sign and Electronic signature</i>  | 157        |
|        | <i>Format</i>   | 158        |
|        | <i>The Independence Principle</i>   | 158        |
| 8.1.4. | Electronic presentation   | 158        |
|        | <i>Place of presentation</i>  | 158        |
|        | <i>Time of presentation</i>   | 159        |
|        | <i>Notice of completeness</i>   | 159        |
|        | <i>Other issues related to presentation</i>   | 159        |
| 8.1.5. | The obligation of the bank to examine the electronic record and the notice of refusal | 160        |
|        | <i>Corruption of an electronic record after presentation</i>                          | 160        |
| 8.1.6. | Disclaimer of bank's liability  | 161        |
| 8.1.7. | Fraud   | 161        |
| 8.1.8. | Summary   | 161        |
| 8.2.   | The revision of the UCP: UCP 600 is on its way  | 162        |
| 8.2.1. | The revision of the UCP 500   | 163        |
| 8.2.2. | Selected issues   | 165        |
|        | <i>Title of the COde</i>  | 165        |
|        | <i>Scope of the UCP</i>   | 165        |
|        | <i>Definitions and Interpretations</i>  | 166        |
|        | <i>Revocability of a credit</i>   | 166        |
|        | <i>Deferred payment credit</i>  | 167        |
|        | <i>Amendment of the credit</i>  | 167        |
|        | <i>"On their face"</i>  | 167        |
|        | <i>Reasonable time</i>  | 168        |
|        | <i>Notice of rejection – waiver and release of documents</i>                          | 168        |
|        | <i>Force majeure</i>  | 169        |

|                               |            |   |
|-------------------------------|------------|---|
| <i>Transport documents</i>    | 169        | x |
| 8.2.3. Summary                | 169        |   |
| <b>IX. CONCLUDING REMARKS</b> | <b>171</b> |   |
| <b>TABLE OF CASES</b>         | <b>173</b> |   |
| <b>BIBLIOGRAPHY</b>           | <b>176</b> |   |

## I.

### THE HISTORY OF LETTERS OF CREDIT

Understanding the nature of letters of credit as an international financial device and the reason why they have become widely used by merchants all over the world requires us to find out its historical origins.

Some scholars believe that the origins of letters of credit go back to ancient Egypt and Babylon, which had an adequate system of banking. Rufus Trimble mentions a clay promissory note of Babylon dating from 3000 B.C., exhibited in the University Museum of Philadelphia, USA, which provided for repayment of an amount and the interest on a specific date.<sup>4</sup> Wigmore refers to an evidence of an obligation made in 248 B.C. in Egypt “for the repayment, in wheat, or upon default double its value, of a loan of money from one Zenon, which ends with: ‘and the right of execution shall rest with Zenon and the person bearing the note on behalf of Zenon’”.<sup>5</sup> It is also verified that banks of ancient Greece prepared letters of credit “on correspondents with the view to obviating the actual transport of specie in payment of accounts”<sup>6</sup>.

With the collapse of the Roman Empire the role of the banks as well as the great extent of commerce between trading nations diminished. It was not until the 12<sup>th</sup> and early 13<sup>th</sup> century that banks in Genoa, Venice, Florence and other European cities were re-established. At this time merchants had to face two major problems: (a) travelling with gold was very dangerous; and (b) commerce generated currency that was not sufficient to satisfy the needs of traders.

The earliest devices with which merchants tried to solve these problems were with the bills of exchange<sup>7</sup> and letters of credit. In their early history these payment instruments operated in a very similar way, and letters of credit were used to supplement the bills of exchange.

There are commentators who believe that their development in Europe was inspired by the discoveries made by Marco Polo in the 13<sup>th</sup> century who reported the use of currency and other negotiable documents in China, concluding that such a measure was one of the reasons for “the

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<sup>4</sup> Rufus James Trimble, *The Law Merchant and the Letters of Credit*, In 61 Harvard Law Review, 1948, p. 981 at 982

<sup>5</sup> J.H. Wigmore, *A Panorama of the World's Legal Systems* (ed. 1936) Saint Paul, p.69

<sup>6</sup> Rufus James Trimble, *The Law Merchant and the Letters of Credit*, In 61 Harvard Law Review, 1948 p. 984, See also Alan Davidson, *The Evolution of Letters of Credit Transactions*, In Butterworths Journal of International Banking and Financial Law, Vol 10. No. 3, March 1995, p. 128

<sup>7</sup> According to the British Bill of Exchange Act of 1882 the bill of exchange (or draft) is an “unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to the bearer”. The law of bills of exchange in most common law countries is governed by this Act, whereas the majority of the civil law countries adopted the Geneva Convention on the Unification of the Law relating to the Bills of Exchange of 1930.

Aiming to reconcile these two systems the UNCITRAL in 1988 drafted a Convention on International Bills of Exchange and International Promissory Notes. So far, only five states have adopted it. For more information visit: [www.uncitral.org](http://www.uncitral.org).

ways and means by which the Great Chan can have and indeed does have more treasures than all the kings in the world”<sup>8</sup>.

In any case, it was impossible to conduct commerce via caravan without some sorts of documentary letters. To explain their early operation Professor Dolan gives the following example:

“... a Florentine merchant who bought wool from an Amsterdam merchant could issue a bill of exchange to the Dutch merchant’s agent in Florence directing a third party (the drawee) to pay the sum due for the wool. The agent, having taken the bill in payment for the wool, could travel across Europe or by sea to a commercial center, where he would meet the drawee and ask the drawee for payment.

The drawee would pay the draft either (1) in gold (though such payment would be rare); (2) by “clearing”, that is, by setting the draft off against sums due from the Dutch merchant on other drafts; or (3) by accepting the draft and returning it to the agent. In the third case, the holder had a readily marketable instrument, which he could use to trade or which he could take with him to other commercial centers. He could do so armed with the knowledge that such “currency”, while valuable to merchants, was of little value to the brigands who stalked the highways and the pirates who sailed the seas.

[...]

It ... did not take long for some enterprising merchant, whose paper was suspect, and, therefore, subject to heavy discount or to outright rejection in the trade, to strengthen his bills by obtaining the drawee’s announcement that he, the drawee, would pay or accept the bills. The announcement was a letter of credit.”<sup>9</sup>

De Roover<sup>10</sup> also refers to letters of credit used by the Medici Bank in Bruges and in Italy between 1385 and 1401. The various provisions of the letters are strikingly similar to those of the modern letters of credit. They stated for example that (a) payments are to be made as requested by a named beneficiary; (b) the payments could not exceed a specific sum; (c) the payor shall obtain receipts from the beneficiary; (d) the payment shall be charged to the account of the issuer with the payor; or (e) upon receipt of a written notice from the payor that the amount has been paid, the issuer shall credit the payor’s account accordingly.<sup>11</sup>

By the 17<sup>th</sup> century letters of credits were common financial instruments both in the European continent and in England. At this time they functioned more like a traveller’s cheque.

By the 19<sup>th</sup> century British banks had a virtual monopoly on the issuance of letters of credits. This was due to the fact that in world trade the Pound Sterling was the most accepted currency and the bankers of London gained a pre-eminent position in the field of international finance.

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<sup>8</sup> FD de Rooy, *Documentary Credits* (1984) The Netherlands p. 6, explained also by Alan Davidson, *The Evolution of Letters of Credit Transactions*, In Butterworths Journal of International Banking and Financial Law, Vol 10. No. 3, March 1995, p. 129

<sup>9</sup> J.F.Dolan, *The Law of Letters of Credit* (1983) Boston, p. 3-3

<sup>10</sup> Raymond de Roover, *Money, Banking and Credit in Medieval Bruges*, In 2 Journal of Economic History (Suppl. Issue), 1942, p.52.

<sup>11</sup> See also Rufus James Trimble, *The Law Merchant and the Letters of Credit*, In 61 Harvard Law Review, 1948, p. 985.

In the United States letters of credit emerged from the “competition of factorage houses for business, which led to the issuance of promises to accept drafts against shipments”<sup>12</sup>. The growing number of manufacturers and their relationships with foreign traders, the specialization of banking activities and the technological development such as the more frequent use of telegraph for communicating the terms of the contracts facilitated the increasing use of letters of credit<sup>13</sup>.

On the other hand, letters of credit were not used exclusively by merchants. Thomas Jefferson, third president of the US, wrote the following letter to Captain Meriwether Lewis in 1803 on the occasion of leading an expedition to explore the wild western territory:

*“Dear Sir,*

*In the journey which you are about to undertake for the discovery of the course and source of the Mississippi, and of the most convenient water communication from thence to the Pacific ocean [sic], your party being small, it is to be expected that you will encounter considerable dangers from the Indian inhabitants. Should you escape those dangers and reach the Pacific Ocean, you may find it imprudent to hazard a return the same way, and be forced to seek a passage round by sea in such vessels as you may find on the Western coast. But you will be without money, without clothes and other necessities, as a sufficient supply cannot be carried with you from hence. Your resource in that case can only be in the credit of the US, for which purpose I hereby authorize you to draw on the Secretaries of State, of the Treasury, of War and of the Navy of the US, as you may find your drafts will be most negotiable for the purpose of obtaining money or necessities for yourself and your men. I solemnly pledge the faith of the United States that these drafts shall be paid punctually at the date they are made payable. I also ask of the Consuls, agents, merchants and citizens of any nation with which we have intercourse or amity to furnish you with those supplies which your necessities may call for, assuring them of honorable and prompt [unreadable]. And our own Consuls in foreign parts where you may happen to be, are hereby instructed and required to be aiding and assisting to you in more entire satisfaction and confidence to those who may be disposed to aid you, I, Thomas Jefferson, President of the United States of America, have written this letter of general credit for you with my own hand, and signed with my name.”<sup>14</sup>*

The outbreak of World War I. broke the well-established and trusted trading links that had existed between the merchants worldwide. In order to keep on trading merchants were forced to create new links with firms often unknown or not trusted. These circumstances were favourable for the extensive use of letters of credit which invited a trustworthy paymaster, a bank, into the merchants’ relationship. By the 1950’s letters of credit had earned a predominant position in domestic commerce of the United States and were also widely used in international transactions.

Since World War II. the use of letters of credit in world trade remains steadfast. Although from time to time the emergence of alternative means of trade finance overshadows the use of the letter of credit, it has “proven to be a flexible instrument, which can be readily attempted to the needs

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<sup>12</sup> Boris Kozolchyk, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, In 14 American Journal of Comparative Law, 1965, p.395 at 398

<sup>13</sup> Kozolchyk also points out that ‘testimonies in the *Vietor v. National City Bank* case (200 App.Div.557 at 572, 193 NYS 868 at 878-879, 1922) indicated that a leading United States inland bank had issued more than \$ 100 million worth of commercial and travelers’ letters of credit during the period 1870-1913. (ibid)

<sup>14</sup> *Trader’s Corner*, In Documentary Credit Insight Vol 2, No. 3 Summer, 1996

of changing conditions in international trade”<sup>15</sup>. As Kozolchyk points out “in a world of shrinking distances and increasing trade there will be a continuing need for such a highly reliable, ... , and flexible means of payment and financing”<sup>16</sup>.

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<sup>15</sup> Rolf Eberth, E.P.Ellinger, *Deferred Payment Credits: A Comparative Analysis of Their Special Problem*, In *Journal of Maritime Law and Commerce*, Vol 14. No.3, July 1983, p.387 at 388

<sup>16</sup> Boris Kozolchyk, *Letters of Credit* In Jacob S. Ziegel (ed), *International Encyclopedia of Comparative Law*, Vol 9. Ch 5. (1980) Hamburg, p. 146

## II.

### THE SOURCES OF LETTER OF CREDIT LAW

The law of documentary credits has developed mainly through customs. As Kozolchyk explains: “Many of its operative rules, regardless of geography or legal system, have emerged from the customs of the bankers dealing with importers and exporters, and with shipping and insurance companies”<sup>17</sup>.

Today, these customs are embodied in a Code drafted by the International Chamber of Commerce under the title “Uniform Customs and Practice for Documentary Credits” (UCP).

Since banks worldwide in most cases subject their letter of credit to the UCP, this forms the primary, but not the sole, source of letter of credit law. The development of the letter of credit law has also been highly influenced by other regulations created by the ICC, the United Nations Commission on International Trade Law (UNCITRAL), and by national legislation and case law.

This chapter focuses on the most important sources of letter of credit law. It summarizes the international regulations drafted by the International Chamber of Commerce, including the UCP, eUCP, ISBP, URR 525 and the ISP98.

It introduces the UNCITRAL convention which attempted to harmonise the rules in the field of guarantees and standby letters of credit.

It also reviews the UCC as “the most comprehensive and detailed statutory coverage”<sup>18</sup> of letters of credit worldwide.

Court decisions that undoubtedly play a significant role in the development of letter of credit law are dealt with in later chapters, wherever relevant.

#### 2.1 ICC Rules

##### 2.1.1 The Uniform Customs and Practice for Documentary Credits

###### The development of the UCP

In order to facilitate international trade and to try to reduce the conflicts arising there have been many attempts to achieve a greater uniformity in the differing legal systems.

The first attempts to harmonise the law of letters of credit - primarily on a national basis - date back to the 1920's. After the end of World War I. the New American Commercial Credit Conference drafted a set of regulations in relation to letters of credit aiming to be used by the banks in the United States.

The same path was followed by Germany<sup>19</sup> and Greece in 1923, France and Norway in 1924, Czechoslovakia, Italy and Sweden in 1925, Argentine in 1926, Denmark in 1928 and the Netherlands in 1930.<sup>20</sup>

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<sup>17</sup> Boris Kozolchyk, *Letters of Credit* In Jacob S. Ziegel (ed), *International Encyclopedia of Comparative Law*, Vol 9. Ch 5. (1980) Hamburg, p. 146

<sup>18</sup> Rolf A.Schütze, Gabriele Fontane, *Documentary Credit Law Throughout the World – Annotated legislation from more than 35 countries*, ICC No. 633, (2003), Paris, p. 120

From the aspect of international harmonization the International Chamber of Commerce (hereinafter referred to as the ICC), founded in 1919, has undertaken a leading role in establishing uniform rules, such as the INCOTERMS and the Uniform Customs and Practice for Documentary Credits, “which have gained worldwide application and have over many years proved a stabilizing element in international trade”<sup>21</sup>.

In its 1929 congress held in Amsterdam, the ICC initiated the first international standardization on letters of credit. Unfortunately, the proposed unified law was not widely accepted, in fact it was only adopted by banks in France and Belgium.

After a thorough revision, the Uniform Customs and Practice for Documentary Credits (hereinafter referred to as the UCP) was adopted by the ICC at the Vienna Conference in 1933<sup>22</sup>. This version was adhered to by a number of European banks and also some banks in the United States, however, the financial institutes of one of the leading trading countries, the United Kingdom, along with most of the Commonwealth countries refused to adopt it.

The next revision did not happen until after World War II. In 1951 the ICC adopted a new version<sup>23</sup> of the UCP at its Lisbon Conference in order to keep up with the changes that occurred in international trade. As Harfield stated:

“When the dynamics of finance require conduct that is not foreseen or is inconsistent with recorded custom, appropriate changes can be made, as over the years they have been made. As was said in the resolution adopting the 1951 revision, “[T]he purpose ... is to codify the custom and practice as they now exist.”<sup>24</sup>

This version was adopted at a more worldwide scale, not only in Europe and the United States, but also by several banks in Africa and Asia<sup>25</sup>. The United Kingdom again declined to adopt it.<sup>26</sup>

The UCP was revised again in 1962.<sup>27</sup> One of the main objects of the revision process was to “evolve a system that would be of world-wide application. To this end, it was necessary to adapt it to the needs of Britain and the Commonwealth. The 1962 Revision achieved this breakthrough.”<sup>28</sup>

The progress made in technology, especially the revolution in trading methods evoked the necessity of adjusting the rules governing documentary credits to the changing circumstances in international trade. This time the ICC was assisted by the United Nations Commission on

<sup>19</sup> The Association of Berlin Banks and Bankers drafted a regulation, named *Regulativ des Akkreditivgeschäfts der Berliner Stempelvereinigung*, which was adopted by the majority of the German banks.

<sup>20</sup> E.P.Ellinger, *Letters of Credit* In Norbert Horn, Clive M.Schmitthoff (ed.), *The transnational law of international commercial transactions*, Vol.2 (1982), The Netherlands, p. 248.

<sup>21</sup> Rolf Eberth, *The Uniform Customs and Practice for Documentary Credits* In C.M.Chinkin, P.J.Davidson, W.J.M.Ricquier (ed.), *Current Problems of International Trade Financing* (1983), Singapore, p.21

<sup>22</sup> ICC Brochure No. 82

<sup>23</sup> ICC Brochure No. 151

<sup>24</sup> Henry Harfield, *Letters of Credit* (1979), Philadelphia, p. 4

<sup>25</sup> For a list of countries the banks of which adopted the 1951 Revision of the UCP, see Grader van der Maas, *Handbuch der Dokumentenakkreditive*, German translation (1963), p.12

<sup>26</sup> For a detailed reasoning that led the United Kingdom to refuse to adopt the 1951 Revision, see E.P.Ellinger, *Letters of Credit* In Norbert Horn, Clive M. Schmitthoff (ed.), *The transnational law of international commercial transactions*, Vol.2 (1982), The Netherlands, p. 248.

<sup>27</sup> ICC Brochure No. 222

<sup>28</sup> E.P.Ellinger, *Documentary Letters of Credit – A Comparative Study* (1970), Singapore, p. 580

International Trade Law (UNCITRAL), as well as by banking organizations in socialist countries, which were not members of the ICC. The new Revision of 1974<sup>29</sup> has deservedly attained worldwide applause<sup>30</sup> and had been adhered to by banks in 162 countries and territories<sup>31</sup>.

As Kozolchik points it out:

“The draftsmen of the UCP had a realistic and modest goal. The intent was not to codify all the relevant rules of law, customary or otherwise, but rather to compile international banking customs and other rules that facilitate banking functions.”<sup>32</sup>

In 1983 the UCP was revised again. The 1983 Revision, which was effective from the 1<sup>st</sup> of October, 1984<sup>33</sup> widened its application and introduced further changes which were necessary due to the rapidly improving communication facilities and fast-changing technology. In particular, this version addressed the following issues: (1) the negotiations of the documents under the letter of credit; (2) the application of the UCP to standby letters of credit and deferred payment letters of credit; (3) the transmission of letters of credit and documents through SWIFT.<sup>34</sup>

In 1989, the Commission on Banking Technique and Practice of the ICC authorised the new revision of the UCP. This revision intended “to address new developments in the transport industry and new technological applications”<sup>35</sup> as well as “to improve the functioning of the UCP”<sup>36</sup>. The imperfect operation of the UCP was well underlined by the fact that an estimated fifty per cent of the documents presented under the documentary credit had been rejected because of discrepancies found in the documents. This did not only weaken the effectiveness of this financial instrument but also caused serious losses to the actors of international trade.

To tackle these problems the Commission on Banking Technique and Practice established a Working Group whose mandate was “to (1) simplify the UCP 400 Rules; (2) incorporate international banking practices, as well as to facilitate and standardise developing practices; (3) enhance the integrity and reliability of the Documentary Credit undertaking, through the presumption of irrevocability and clarification of the primary liability, not only of the issuing bank, but also of the confirming bank; (4) address the problems of non-documentary conditions and (5) list, in detail, the elements of acceptability for each category of transport document”<sup>37</sup>.

The new Revision was adopted at the ICC’s Mexico Conference in 1993 and came into force on the 1<sup>st</sup> of January 1994. This latest version of the UCP was published as ICC Publication No. 500 and represents a further contribution to the facilitation of international trade and an improvement in the functioning of the rules.

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<sup>29</sup> ICC Brochure No. 290.

<sup>30</sup> E.P.Ellinger, *Letters of Credit* In Norbert Horn, Clive M.Schmitthoff (ed.), *The transnational law of international commercial transactions*, Vol.2 (1982), The Netherlands, p. 249.

<sup>31</sup> See ICC Document No. 470/383 of June 1,1981. Referred by Rolf Ebert, *The Uniform Customs and Practice for Documentary Credits* In C.M.Chinkin, P.J.Davidson,W.J.M.Ricquier (ed.), *Current Problems of International Trade Financing* (1983), Singapore, p.23

<sup>32</sup> Boris Kozolchik, *Letters of Credit*, In Jacob S. Ziegel (ed), *International Encyclopedia of Comparative Law*, Vol 9, Ch 5. (1980) Hamburg, p. 146

<sup>33</sup> ICC Brochure No. 400.

<sup>34</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 16-17

<sup>35</sup> Preface to the UCP 500 by Charles del Busto, ICC Brochure No. 500

<sup>36</sup> Ibid.

<sup>37</sup> Ibid.

The 49 articles of the Code are included in the following seven main parts:

- A. General provisions and definitions
- B. Form and notification of credits
- C. Liabilities and responsibilities
- D. Documents
- E. Miscellaneous provisions
- F. Transferable credit
- G. Assignment of proceeds

Reference to the current version of UCP throughout the thesis will be as UCP 500 or simply UCP unless otherwise noted.

### The nature and application of the UCP

The UCP is neither an international convention, nor it is a law.<sup>38</sup> It is not an international convention as it does not create a formal agreement between states nor it is law, as the ICC, being a non-governmental organization, does not possess legislative authority.

The UCP is a “compilation of internationally accepted banking customs and practice regarding the letter of credit. It is the most successful harmonizing measure in the history of international commerce, which has removed a plethora of technical problems that would have undermined the smooth operation of letter and credit.”<sup>39</sup>

Although the UCP is not a law, we cannot deny that it is forceful since it has been incorporated by reference in the majority of letters of credit used worldwide.

As Lord Mustill pointed out in *Royal Bank of Scotland Plc v. Cassa di Risparmio delle Provincie Lombarde*<sup>40</sup>:

“Undeniably the UCP have an important role in the conduct of international trade. They expound technical terms; they promote consistency; and they enable the parties to express their intention briefly, without the need to negotiate and set out all the terms of the relationship at length. Nevertheless, whilst not belittling the utility of the UCP, it must be recognized that their terms do not constitute a statutory code, as their title makes clear they contain a formulation of customs and practice, which the parties to a letter of credit can incorporate into their contract by reference”.

Article 1 of the UCP states that its applicability is subject to the parties’ agreement. It emphasizes, that:

*“The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication N0. 500, shall apply to all Documentary Credits (including to the extent to which they may be applicable, Standby Letter(s) of Credit) where they are incorporated*

<sup>38</sup> See dr. Halustyik Anna, *Közjogi és magánjogi elemek keveredése a nemzetközi pénzügyekben* In Magyar Közigazgatás, 2001, augusztus, LI évfolyam 8.szám, p. 479 at 481

<sup>39</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 18

Bernard Wheble expressed the same opinion when stated that ‘...UCP is neither an international convention nor is it law by legislation. It is a code of practice, recognized by the courts in many countries as forming part of the payment contract created when a bank issues its documentary credit subject to UCP 500, or when another bank adds its confirmation to that credit’. (See *Bernard S. Wheble on the reasoning behind the UCP Transport Articles* In DC Insight, Winter (1995))

<sup>40</sup> Court of Appeal 21 January 1992, reported by Roger Fayers in *Legal inroads on the autonomy of the letter of credit* In DC Insight Vol 10. No.2 Spring 2004

*into the text of the Credit. They are binding on all parties thereto, unless otherwise expressly stipulated in the Credit.”*

Since its introduction in 1933 a practice has developed amongst banks issuing letters of credit as to express their adherence to the UCP.

Traditionally, the following methods of adherence have developed:

- Banks may, on an individual basis, adhere to the UCP;
- A national banking association may collectively adhere to the text<sup>41</sup>; or
- A legislature may direct its application as a primary or a subsidiary source of letter of credit law.<sup>42</sup>

### **2.1.2. eUCP**

Realising the growing need for setting standards for electronic presentation of documents in May 2000 the Banking Commission of the International Chamber of Commerce authorized the creation of a Working Group “to formulate rules for the evolution from paper-based credits to electronic credits”<sup>43</sup>.

The main goal of the Working Group was to set up a technology independent solution, which allows for future practice to emerge free from most technological constraints.

The so called Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation, or as it is usually referred to, the eUCP was approved at the ICC Banking Commission meeting in Frankfurt in November 2001 and came into force on the 1<sup>st</sup> of April 2002.

The greatest achievement of eUCP is that it brings the documentary credit into the electronic age and revolutionizes its use. By introducing the concept of “mixed presentation” that permits electronic or part-electronic (using both paper documents and electronic records) presentation of documents, it represents an important step towards the era of paperless commerce where the vast majority of the presentation of the documents will be made electronically.

A brief summary of the provisions of the eUCP is given in Chapter VIII.<sup>44</sup>

### **2.1.3 International Standard Banking Practice**

Article 13(a) of UCP 500 states that “Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice”.

“International standard banking practice” is a new notion introduced to the UCP by its 1993 revision. However, upon the publication of the UCP 500 only a little guidance was provided by the ICC on what constitutes the international standard banking practice<sup>45</sup>.

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<sup>41</sup> For a list of countries collectively or banks individually adhered to the UCP 500 see the Adherence List of the ICC at <http://www.iccwbo.org/home/banking/778rev9.asp>, date visited 23 August, 2005

<sup>42</sup> Boris Kozolchik, *Letters of Credit*, In Jacob S. Ziegel (ed), *International Encyclopedia of Comparative Law*, Vol 9, Ch 5. (1980) Hamburg, p. 146

<sup>43</sup> Prof. James E. Byrne, Dan Taylor, *ICC Guide to the eUCP*, ICC Publication No. 639 (2002), p.12.

<sup>44</sup> See Chapter VIII, 8.1

<sup>45</sup> See Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.39

The first initiative to document standard banking practice goes back to 1920 when the New York Bankers Commercial Credit Conference adopted a checklist, called the “Regulations Affecting Export Commercial Credits”.

In 1996 the US Council on International Banking (now called International Financial Services Association, IFSA) published a paper, titled “Standard Banking Practice for the Examination of Letter of Credit Documents” which provided a checklist for banks on what should be considered when examining the documents. This has resulted in the “levelling of widely varying practices”<sup>46</sup>, however, although mostly amongst American banks as the paper was reflecting the point of view of the IFSA member banks.

Reflecting on the urgent need for giving a more detailed explanation on the meaning of “international standard banking practice” the ICC Banking Commission established a Task Force in May 2000. The Task Force was assigned to collect and record standard banking practice worldwide for the examination of documents presented under documentary credits issued subject to the UCP 500<sup>47</sup>. The aim was to try to reduce the number of presentations rejected by the banks<sup>48</sup> by providing a standard for documentary checkers.

After spending months in collecting and reviewing the different practice followed by banks worldwide, the Task Force submitted its final draft to the Commission. The International Standard Banking Practice for the Examination of Documents under Documentary Letters of Credit, or as it is more commonly called the ISBP<sup>49</sup>, was approved by the Commission at its meeting in Rome in October 2002.<sup>50</sup>

The ISBP – as the foreword explains - is a “practical complement to UCP 500”<sup>51</sup>. It gives a detailed explanation on how the rules of the UCP 500 on the examination of documents are to be applied on a day-to-day basis. “As such, it fills a needed gap between the general principles announced in the rules and the daily work of the documentary credit practitioner. ... By using the ISBP, document checkers can bring their practices in line with those followed by their colleagues worldwide.”<sup>52</sup>

It is important to note, that the ISBP does not amend the UCP 500 at any rate.

The ISBP consisting of 200 paragraphs explains, among others:

- The terms that are not defined by the UCP 500 (such as “shipping documents”, or “third party documents”)

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<sup>46</sup> Donald Smith explains the ICC project on international standard banking practices In DC Insight Vol.6. No.3. Summer 2000

<sup>47</sup> See Introduction to the ISBP

<sup>48</sup> Independent surveys have indicated that 60-70% of documentary presentations under letters of credit have been rejected due to discrepancies. These rejections have been slowing trade and have led to costly disputes and court cases. (See David Meynell reflects on why credit fails In DC Insight Vol.4 No. 2 Spring, 1998; Martin Shaw claims there are better ways to reduce discrepancies and that ICC should take advantage of them In DC Insight Vol.5 No.2 Spring, 1999, also SITPRO Report on the Use of Export Letters of Credit 2001/2002 at <http://www.sitpro.org.uk/reports/lettcredr>, date visited: 15 September, 2005.

<sup>49</sup> ICC Publication No. 645.

<sup>50</sup> For a detailed article on the drafting process see Ole Malmqvist, *How ICC is approaching standard banking practice* In DC Insight Vol 7. No.4, Autumn, 2001; Donald R. Smith, *Standard banking practice approved* In DC Insight Vol.8, No.4, Autumn, 2002

<sup>51</sup> See Foreword to the ISBP by Maria Livanos Cattau

<sup>52</sup> Ibid

- How should documents be signed if the credit does not have explicit provisions on the issue
- How should certain typing errors on documents be handled
- What is the "face" of a transport document
- What is a full set of insurance documents
- The significance of a copy as opposed to an original.

The banking practice has welcomed the ISBP. Many believe that it is not only beneficiary for the users of the UCP 500 but will also have a positive influence on the next revision of the UCP.<sup>53</sup>

#### **2.1.4 Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits**

The Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits (URR 525) came into effect on the 1<sup>st</sup> of July 1996. The need to draft these provisions was explained by Jean-Charles Roucher, then Secretary-General of the ICC, in the foreword to the URR 525:

“The 1974 revision of the UCP, updating the 1962 version, reflected the increasing importance of currency markets in international trade and first made specific reference to the involvement of a “third bank” in processing the claims for reimbursement of payments made under documentary credits. ... It had become clear that, while the UCP was the international standard for documentary credit operations, the huge growth in the volume of inter-bank currency reimbursements remained largely subject to local accepted practice in the major financial centres, with the one exception of the United States of America, where banks had formulated their own operating rules.”

In order to create international standards the ICC Banking Commission established a Working Group in 1993. The aim of the Working Group was “to document current practice, weigh differing views and, occasionally, choose the best practice”<sup>54</sup>.

After a 2,5-year drafting process the Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits were accepted by the ICC on the 26<sup>th</sup> of September, 1995, and were first published as ICC publication N°525 in November 1995.

The seventeen articles of the URR 525 deal with the situation covered by Article 19 of the UCP 500, where three banks (an issuing bank, a claiming bank and a reimbursing bank) are involved. It does not amend the provisions of the UCP but sets out a detailed code for the reimbursing process.

The URR 525 has received general approval by practitioners and some believe that it may become part of the UCP with the next revision.<sup>55</sup>

#### **2.1.5. The International Standby Practices**

The International Standby Practices (ISP 98) is a set of rules addressing specifically the operation of standby letters of credit.<sup>56</sup>

<sup>53</sup> See the opinions of bankers given on the ISBP in ‘Three bankers judge the document on standard banking practice’ In DC Insight, Vol. 9 No.1 Winter 2003

<sup>54</sup> Preface to the URR 525 by Dan Taylor

<sup>55</sup> See Dan Taylor on the new ICC bank-to-bank reimbursement rules In DC Insight Vol. 1 No.3 Summer, 1995

<sup>56</sup> The development of standby letters of credit is explained in Chapter III., 3.2.2

Standby letters of credit were developed in the United States in the 1950s where banks were prohibited from issuing guarantees. In order to overcome this difficulty the banking practice created the standby letter of credit as a substitute to guarantees. Since then, the use of standby letters of credit has been wide spread not only amongst the American companies but throughout the world.

In the past, standby letters of credit have been issued subject to the UCP. Article 1 of the UCP 500 makes a specific reference to standby credits and states that its provisions are applicable to documentary credits, and to the extent to which they may be applicable, to standby credits as well. However, several provisions of the UCP 500 are inappropriate for standbys and some issues that are important in standby practice are not addressed at all.<sup>57</sup>

The idea of creating special rules for standby operations was born during the drafting process of the UN Convention on Independent Guarantees and Standby Letters of Credit. The ISP 98, created by the Institute of International Banking Law and Practice, Inc. was revised and adopted by the ICC and came into effect on the 1<sup>st</sup> of January 1999.

As Professor James E. Byrne explains:

“The ISP, like the UCP for commercial letters of credit, simplifies, standardizes, and streamlines the drafting of standbys, and provides clear and widely accepted answers to common problems. There are basic similarities with the UCP because standby and commercial practices are fundamentally the same. Even where the rules overlap, however, the ISP is more precise, stating the intent implied in the UCP rule, in order to make the standby more dependable when a drawing or honor is questioned.”<sup>58</sup>

ISP 98 reflects generally accepted practice. It is compatible with the UCP and with the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit. It also intends to give guidance to lawyers and judges in the interpretation of standby practice by containing several issues generally not addressed by local law.

ISP 98 is applicable if the credit is expressly subjected to it.<sup>59</sup> In case a credit is governed both by the UCP and the ISP 98 the latter prevails in case of conflicting provisions.<sup>60</sup>

## **2.2 United Nations Convention on Independent Guarantees and Standby Letters of Credit**

At its 22<sup>nd</sup> session in 1989 the UNCITRAL<sup>61</sup> decided to prepare a draft convention in order to respond to “an urgent need for uniform legislation in the field of guarantees and standby letters of credit.”<sup>62</sup>

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<sup>57</sup> For an analysis of the necessity of separate rules for standby credits, see *The views of Professor James E. Byrne on why new draft rules for standbys are necessary* In DC Insight Vol.3. No.2. Spring 1997; Georges Affaki, *How do the ISP standby rules fit in with other uniform rules?* In DC Insight Vol.5. No.1. Winter 1999

<sup>58</sup> See Preface to the ISP98

<sup>59</sup> See Article 1.01 (b) of the ISP 98.

<sup>60</sup> See Article 1.02 (b) of the ISP 98.

<sup>61</sup> The UNCITRAL, established by the General Assembly in 1966, is an intergovernmental body with the general mandate to work on the progressive harmonization and unification of the law of international trade. It has prepared a

The preparatory works of the draft convention by the Working Group took place between 1990 and 1995. The convention was adopted and was opened for signature by the General Assembly at its 87<sup>th</sup> plenary meeting on the 11<sup>th</sup> of December 1995.<sup>63</sup>

According to Article 1 the convention applies to an international undertaking, such as an independent guarantee or a standby letter of credit, “if the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State, or if the rules of private international law lead to the application of the law of a Contracting State, unless the undertaking excludes the application of the Convention”. The Convention may also apply to an international letter of credit if the parties expressly state that their credit is subject to it.<sup>64</sup>

The Convention is not only consistent with the rules of the UCP but supplements the operation of letters of credit by dealing with issues not specifically addressed by the UCP.

A particular example is the question of “fraudulent or abusive demands for payment and judicial remedies in such instances”<sup>65</sup>, in which case the guarantor/issuer is entitled to withhold payment if “it is manifest and clear that (a) any document is not genuine or has been falsified; (b) no payment is due on the basis asserted in the demand and the supporting documents; or (c) judging by the type and purpose of the undertaking, the demand has no conceivable basis”<sup>66</sup>.

At the same time, as underlined in Article 20 of the Convention, it is the role of the courts to investigate the facts of the underlying transaction, thus the convention entitles the courts to block payment “on the basis of immediately strong evidence” of a high probability of a fraudulent action.

In 1999 the Commission on Banking Technique and Practice of the ICC endorsed the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit.<sup>67</sup> The Banking Commission appreciated “that the Convention was drafted in full recognition of the role of the various ICC rules in the field [of guarantees and letters of credit], that the UNCITRAL Working Group was directly and indirectly influenced by, and in turn influenced, the revision of the UCP, ICC’s Uniform Rules for Demand Guarantees (URDG) and its recently adopted rules on International Standby Practices (ISP 98).”<sup>68</sup>

The Banking Commission also noted “that the UN Convention expressly defers to international banking practice as represented by ICC rules.”<sup>69</sup>

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wide range of conventions, model laws and other legal instruments dealing with the substantive law that governs international trade.

For further information about UNCITRAL visit [http://uncitral.org/uncitral/en/about\\_us.html](http://uncitral.org/uncitral/en/about_us.html)

<sup>62</sup> Yearbook of the United Nations Commission on International Trade Law, 1989, Vol. XX., p.26

<sup>63</sup> General Assembly Resolution 50/48

<sup>64</sup> Article 1(2) of the Convention

<sup>65</sup> Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Standby Letters of Credit, note 5.

at [http://uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention-guarantees\\_credit.html](http://uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention-guarantees_credit.html)

<sup>66</sup> Article 19 of the Convention

<sup>67</sup> It must be noted that UNCITRAL has also endorsed several instruments adopted by the ICC, such as the UCP 500 (and the previous Revisions of 1962, 1974, 1983), the ISP 98 or the Incoterms 2000. By these endorsements UNCITRAL has largely contributed to the international acceptance of the aforementioned rules. Moreover, due to the strong cooperation between UNCITRAL and ICC in the course of drafting these rules, the observations of countries, not represented in the ICC, could be taken into account.

<sup>68</sup> Policy Statement of the Commission on Banking Technique and Practice of the ICC, 21 June 1999, at [http://www.iccwbo.org/home/statements\\_rules/statements/1999/un\\_letters\\_of\\_credit\\_and\\_independant\\_guarentees\\_eendorsement.asp](http://www.iccwbo.org/home/statements_rules/statements/1999/un_letters_of_credit_and_independant_guarentees_eendorsement.asp), date visited: 22 August, 2005

<sup>69</sup> Ibid.

Up until today eight countries<sup>70</sup> have ratified the convention, in six of which the convention has already entered into force. The United States has signed the convention in 1997 but the ratification has not yet occurred.

### 2.3 Uniform Commercial Code

In the United States of America both the federal government and the individual states have the power to pass statutes or laws. The Constitution gives limitation to both legislations and lists the subjects that fall under federal legislation, exclusively under state legislation, or may be regulated both by state and federal law.

As the economy matured, interstate business and individual movement became more important which increased the need for a greater uniformity of law. There were two responses to this need: (a) the enactment of a federal law on the subject, which in some areas was limited by the constitution; and (b) the drafting of the so called “Uniform State Laws”.

The uniform law movement began in the late 19th century. In 1892 upon the recommendation of the American Bar Association and with the aim of promoting uniformity in state laws in selected areas where such uniformity was desirable, a non-governmental body, the National Conference of Commissioners on Uniform State Laws (NCCUSL)<sup>71</sup> was established.

The members of the National Conference are lawyers chosen by the states, who oversee the preparation of the “Uniform Laws”<sup>72</sup> which the states are encouraged to adopt.<sup>73</sup>

Since its organization, the Conference has drafted more than 200 uniform laws, the most significant and the greatest success of which was the “uniform law” in the field of commercial law, co-sponsored by the American Law Institute. Different parts of commercial law had been codified as early as 1896 but by the 1930 there was a growing interest in “large scale commercial law reform”<sup>74</sup>. The idea of a comprehensive commercial code with the purpose of modernizing and replacing the earlier uniform acts was initiated by William A. Schnader in 1940. By 1944 a drafting group was established under the chairmanship of Karl. N. Llewellyn.

The first Official Text of the Uniform Commercial Code was published in 1952.<sup>75</sup> Since its first appearance, the Official Text has been reviewed and amended several times. The UCC contains 11 different articles, covering the most important parts of commercial law including “Official Comments” on each section.

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<sup>70</sup> The eight countries are: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, Tunisia. For further information visit [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention\\_guarantees\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html), date visited: 27 December, 2005

<sup>71</sup> For the history and the role of the NCCUSL, visit its homepage at <http://nccusl.org>

<sup>72</sup> The phrase ‘uniform law’ can be misleading. We must remember that ‘uniform law’ does not mean that by the approval of the NCCUSL it becomes law throughout the USA. It is simply a model, a legislative proposal addressed to all states, which the states are free to adopt entirely or with modifications or not to adopt at all.

<sup>73</sup> For further information visit <http://www.law.cornell.edu/uniform/uniform.html>, date visited: 22 August, 2005

<sup>74</sup> James J. White, Robert S. Summers, *Uniform Commercial Code* (5<sup>th</sup> ed., 2000) St. Paul, Minnesota, p. 3

<sup>75</sup> The first state adopting the UCC was Pennsylvania in 1953. By 1968 the Code was effective in 49 states.

Article 5 of the UCC governs the letter of credit transaction. When Article 5 was first drafted in the 1950s it was intended to set up an “independent theoretical framework for the further development of letters of credit”.<sup>76</sup>

Innovations in technology and communications, the development of standby letters of credit have affected the law on letters of credit, thus a revision of Article 5 became inevitable in order to cure the “weaknesses, gaps, and errors in the original statute which compromise its relevance”<sup>77</sup>.

In 1986 a Task Force composed of lawyers from the American Bar Association and the representatives of the USCIB was formed to study the previous case law and to analyze the inadequacies of the 1962 version of the UCC Article 5.

The main aims of the drafters of Article 5 were to:

- Conform Article 5 rules to current customs and practices;
- Accommodate new forms of letters of credit, changes in customs and practices, and evolving technology, particularly the use of electronic media;
- Maintain letters of credit as an inexpensive and efficient instrument facilitating trade; and
- Resolve existing conflicts among reported decisions.

The process of review extended over years and produced a vigorous and public debate among interested parties. Between 1991 and 1995 several drafts were concluded. Finally, a Revised UCC Article 5, brought in conformity with the UCP 500 as well, was adopted in 1995.

## 2.4 National law

In the majority of the cases the letter of credit is subject to the UCP by the express agreement of the parties. Furthermore, the parties often agree that the UCP will not only be applicable to their contractual relationship but will also prevail – to the extent it is possible – over national law.

Nevertheless, we cannot ignore the fact that the UCP does not provide a complete set of rules for every aspect of a letter of credit transaction. Questions not addressed by the UCP have to be dealt with as well.<sup>78</sup>

The source of law for these questions can be found in the parties’ specific agreement (if any) and in the regulations of national laws. Some countries adopted specific regulations considering letters of credit<sup>79</sup>. In other legislations the general civil and commercial law is applicable. Nonetheless, may these provisions be general or specifically modelled to letters of credit; they have to be taken into consideration.

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<sup>76</sup> Official Comment on UCC Revised Article 5-101 In Douglas G. Baird, Theodore Eisenberg, Thomas H. Jackson (ed.) *Commercial and Debtor-Creditor Law – Selected Statutes* (2002) New York, p. 527

<sup>77</sup> Report of the Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5 (Letters of Credit)*, presented to the Letter of Credit Subcommittee of the Uniform Commercial Code Committee of the American Bar Association’s Business Law Section and the U.S. Council on International Banking, Inc., reprinted in [1990] 45 Bus. Law 1521 at 1532

<sup>78</sup> An illustrative example may be the fraudulent use of a letter of credit. The UCP itself does not have any provisions on the fraud exception, thus the issue has to be decided upon the rules of the applicable national law.

<sup>79</sup> See for example Article 5 of the Uniform Commercial Code.



### III.

## WHAT IS A LETTER OF CREDIT? THE NATURE OF LETTERS OF CREDIT

Banking practice has developed different types of letters of credits. They vary, among other things, in function, mechanism, payment obligation of the bank or the document requirements. This chapter aims to give a description of the different types of credits used in international commercial transactions.

### 3.1 What is a letter of credit?

Letters of credit are the most common method of payment for international sales of goods. They have been described in numerous ways.

English judges, amongst them Sir John Robert Kerr named the letter of credit “the life blood of international commerce”<sup>80</sup>.

As provided for in Article 2 of the UCP 500 a letter of credit means

*“any arrangement, however named or described, whereby a bank (the “Issuing Bank”) acting at the request and on the instruction of a customer (the “Applicant”) or on its own behalf,*

- I. is to make a payment to or to the order of a third party (the “Beneficiary”), or is to accept and pay bills of exchange (Draft(s)) drawn by the Beneficiary, or*
  - II. authorises another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s)), or*
  - III. authorises another bank to negotiate,*
- against stipulated document(s), provided that the terms and conditions of the Credit are complied with.”*

According to the revised Article 5 of the Uniform Commercial Code, a letter of credit is a

*“definite undertaking ... by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honour a documentary presentation by payment or delivery of an item of value.”<sup>81</sup>*

### 3.2 Classification of letters of credit

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<sup>80</sup> R.D.Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd [1978] Q.B. 146 at 155

<sup>81</sup> Revised Article 5-102(a)(10). The former Article 5 of the UCC defined the letter of credit as ‘an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.’

Before classifying the various types of letters of credit it is important to clarify the different names used in relation to this instrument. The general and most commonly used term is “letter of credit”<sup>82</sup>. Letters of credit are divided into two main groups: commercial letters of credit and standby letters of credit.

In common law countries commercial letters of credits are often referred to as “documentary credits”<sup>83</sup>, or “bankers’ commercial credits”.

The UCP 500 uses the term “documentary credit” in the first articles thereafter simply “credit”. In the thesis when terms “letters of credits” or simply “credits” are used they refer to “documentary credits”.

### 3.2.1 Documentary Credit

The documentary credit is the “traditional form of letter of credit created as a payment and financing mechanism for international sale of goods”.<sup>84</sup>

A typical documentary credit operates in the following way.

Suppose a seller in Greece wishes to sell some goods (e.g.: Ouzo, the well-known Greek liqueur) to a buyer in Hungary. Suppose further that the parties have not previously entered into any business relationship, thus they do not know each other. Although both parties are willing to enter into a relationship, they are very concerned about the other party’s financial reliability.

The seller wishes to get paid as soon as he has shipped the goods. He is afraid that, after shipping the goods the buyer may refuse to pay the purchase price, or even become insolvent. In both cases, the seller may have to engage himself into lengthy negotiations, or sue the buyer to seek enforcement of payment by the court, which will certainly incur great expenses. Not to mention the costs of shipping back the goods or storing them in the original country of destination until further actions.

On the other hand, the buyer is concerned that he may not get the goods in the agreed quality and/or quantity, thus he is not willing to pay unless he inspects the goods.

In a situation like this, where the buyer and the seller are distant from each other and transportation of goods is inevitable, it is impossible to have the seller paid upon shipment and at the same time allow the buyer to pay only upon inspection of the goods.

When difficulties such as distance, different currency (fluctuation of currencies), culture and foreign laws have to be dealt with, the parties are most likely willing to fall back on legal instruments, which reduce the risks both seller and buyer have to face in an international sale of goods.

One of these instruments created by the international trading community is the commercial letter of credit. By agreeing to a commercial letter of credit the parties invite a third, trustworthy party – a bank – into their relationship. Upon the buyer’s request, the bank will open a letter of credit in favour of the seller, agreeing “to assume the primary, direct and independent obligation to honour the seller’s draft presented under the letter of credit provided that complying documents specified in the letter of credit are tendered”.<sup>85</sup>

This way the seller is assured that he will receive payment from an individual “paymaster” regardless of the financial situation of the buyer.

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<sup>82</sup> It is often referred to as L/C.

<sup>83</sup> The term ‘documentary credit’ refers to the fact that the bank decides to honour the presentation strictly upon documents.

<sup>84</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 3

<sup>85</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 3

On the other hand the buyer is also assured that payment will only be effected if the conditions, set by the buyer and appearing in the credit, are completely fulfilled.

In a basic letter of credit transaction three parties are involved: the buyer (usually referred to as the “Applicant”), the bank and the seller (usually the “Beneficiary”). The rights and obligation of the parties and their legal relationship is described in Chapter IV.<sup>86</sup>

### 3.2.2. Standby Letters of Credit

Traditionally, the main purpose of letters of credit has been to effect payment upon presentation of documents that evidence the performance of the seller and also enable the buyer to receive the goods. But – as practice has shown - letters of credit can be used in different ways as well.

Standby letters of credit, although they share a name, function in a totally different way from commercial letters of credit.

A standby letter of credit is

*“an arrangement ... which represents an obligation to the Beneficiary on the part of the Issuing Bank to:*

1. *repay money borrowed by the Applicant, or advanced to or for the account of the Applicant;*
2. *make payment on account of any indebtedness undertaken by the Applicant; or*
3. *make payment on account of any default by the Applicant in the performance of an obligation.”<sup>87</sup>*

In other words, standby letters of credit intend to protect the beneficiary in the event of a non-performance or not proper performance of the other party to the underlying contract.

The difference between a documentary and a standby credit was well pointed out by Harfield in the early 1970s:

*“One of the most ubiquitous of the new breed of letters of credit is the so-called “standby”. As a matter of law and operations, these are indistinguishable from the classic commercial documentary credits. But they are psychological opposites. The classic credit contemplates payment upon performance. The standby credit contemplates payment upon failure to perform. This distinction makes no difference in law, but it looms large in what is laughingly called the “thinking” of lending officers.”<sup>88</sup>*

The applicant to the standby credit does not expect the bank to make payment as it indicates that something has gone wrong in the parties’ relationship. On the other hand, the applicant to the commercial credit usually wishes the seller to be paid, unless there is fraud in the transaction.

Standby letters of credit were developed in the United States in the 1950s. According to federal law the issuance of guarantees by national banks was prohibited. As a solution to the growing need from the business side to ensure payment or performance the American banks created the standby letter of credit, as a substitute to guarantees.

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<sup>86</sup> See Chapter IV. 4.2.

<sup>87</sup> Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p.50

<sup>88</sup> Henry Harfield, *The increasing domestic use of the letter of credit* (1972), 4 U.C.C.L.J., p.258

There is a wide range of transactions where standby letters of credits are used. As Xiang Gao points it out, the “potential breadth of use of standby letters of credit is perhaps the most strikingly demonstrated by the Canadian case of *Rosen v. Pullen*<sup>89</sup>, where a standby letter of credit was used to guarantee performance of a marriage promise”.<sup>90</sup> Standby credits have been used in relation to the payment of salary promised to a football player<sup>91</sup>, booking made by a travel agency<sup>92</sup>, or return of hostages<sup>93</sup>.

However, standby letters of credit are the most commonly used in the field of real estate business, in the construction industry, in the financial industry and in international sale of goods<sup>94</sup>.

In the well know case of *American Bell Int’l. Inc. v. Islamic Republic of Iran*<sup>95</sup>, the plaintiff (a wholly-owned subsidiary of American Telephone & Telegraph Co.) entered into a contract with the Imperial Government of Iran to provide consulting services and equipments as part of a program launched in order to improve Iran’s international communication system. The contract price payable to Bell was \$ 280,000,000 including a down payment of \$ 38,800,000. The Imperial Government had the right to demand return of the down payment at any time. In order to secure the return of the down payment the Imperial Government requested Bell to establish an unconditional and irrevocable letter of guarantee. The letter of guarantee was issued by the Iranshahr Bank. In turn, the bank requested a standby letter of credit to secure reimbursement if the Iranshahr Bank was required to pay to the Imperial Government under the letter of guarantee. The standby letter of credit at the amount of \$ 38,800,000 was issued by the Manufacturers Hanover Trust Company.

Bell commenced performance. However, in late 1978 the Iranian Government was overturned by the Islamic Republic due to a revolution. As a substantial part of the invoices issued by Bell remained unpaid, the company ceased its performance in January 1979. The Islamic Republic requested payment from the Iranshahr Bank, which then turned to the Manufacturers Hanover Trust Company for reimbursement under the standby credit. In order to stop this payment by the Manufacturers Hanover Trust Company Bell turned to court for preliminary injunction.

Denying the injunction the Court held that

“Bell, a sophisticated multinational enterprise well advised by competent counsel, entered into these arrangements with its corporate eyes open. It knowingly and voluntarily signed a contract allowing the Iranian Government to recoup its down payment on demand, without regard to cause. It caused Manufacturers to enter into an arrangement whereby Manufacturers became obligated to pay Bank Iranshahr the unamortized down payment balance upon receipt of conforming documents, again without regard to cause.... One who reaps the rewards of commercial arrangements must also accept their burdens. One such burden in this case, voluntarily accepted by Bell, was the risk that demand might be made without cause on the funds constituting the down payment.”<sup>96</sup>

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<sup>89</sup> [1981] 126 DLR 3rd 62

<sup>90</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 6

<sup>91</sup> See *Beathard v. Chicago Football Club, Inc.*, 419 F. Supp. 1133 (DC. III. 1976)

<sup>92</sup> See *Flagship Cruises Ltd v. New England Merchants Nat’l Bank*, 569 F. 2d. 699 (1<sup>st</sup> Cir. 1978)

<sup>93</sup> See Wiley, “*How to Use Letters of Credit in Financing the Sale of Goods*” 20 Bus.Law (1965) pp.495, 496

<sup>94</sup> For further examples and a detailed explanation of the use of standby credits see E.P. Ellinger, *Standby Letters of Credit* In 6 International Business Lawyer (1978) p.612.

<sup>95</sup> [1979] 474 F. Supp 420, case is also reported by R.H.Folsom, M.W.Gordon, J.A.Spanogle, *International Business Transactions – A problem oriented coursebook* (5<sup>th</sup> ed., 2002), St.Paul, p.329

<sup>96</sup> *Ibid* at 334

### 3.3 Types of letters of credits

#### 3.3.1 Payment at sight, deferred payment, acceptance and negotiation credits

It is important for the beneficiary to know in what manner he will be able to obtain payment. The UCP allows for the following options: the credit may be available by:

- a) sight payment;
- b) deferred payment;
- c) acceptance; or
- d) negotiation.

The parties to the underlying agreement should agree on which of the above mentioned method they wish to use and the applicant should open the letter of credit accordingly. Moreover, the UCP 500 requires that the credit itself indicates whether it is available by sight payment, by deferred payment, by acceptance or by negotiation.<sup>97</sup>

*Sight payment* means payment against documents. The authorized bank shall pay the beneficiary upon presentation of documents, provided that the terms and conditions of the credit are fully complied with. For checking the documents the banks are given a specific period of time.<sup>98</sup>

By deferred payment the beneficiary shall receive payment at some future date (maturity date), specified by the credit.

A deferred payment credit may, for example, provide for payment 90 days after the date of shipment (date of issuance of the bill of lading) or 15 days after presentation of documents. On submission of the documents that meet the conditions of the credit, the beneficiary is given a written statement by the authorized bank that payment will be made on the due date. If the beneficiary wishes to receive payment before this maturity date, he can resort to negotiating the letter of credit, normally at a discount.

Under an *acceptance* credit “the issuing bank undertakes to pay a non-documentary bill drawn by the beneficiary”<sup>99</sup>. It is a “bipartite transaction in which the letter of credit is opened by the issuing bank at the account party’s request and in that very party’s favour”<sup>100</sup>. Article 9(a) (iii) clarifies the liabilities of the issuing bank under an acceptance credit. It states that the issuing bank is obliged to accept drafts drawn by the beneficiary on the issuing bank and to pay them at maturity. If the nominated bank refuses to accept the draft or accepts the draft but does not pay at maturity, the beneficiary is entitled to require payment from the issuing bank.<sup>101</sup>

The credit may also be a *negotiation* credit. The UCP 500 defines negotiation as “giving of value for Draft(s) and/or document(s) by the bank authorized to negotiate”<sup>102</sup>. This bank is called the negotiating bank, which will endorse and negotiate the draft or documents, with certain deductions of discount or interest and commission.

<sup>97</sup> See Article 10 (a) of the UCP 500

<sup>98</sup> The specific period of time may not exceed seven banking days under the UCP 500 and seven business days under the UCC.

<sup>99</sup> E.P. Ellinger, *Letters of Credit* In Norbert Horn, Clive M. Schmitthoff (ed.), *The Transnational Law of International Commercial Transactions*, Vol.2 (1982), The Netherlands, p. 242 at 246

<sup>100</sup> Ibid

<sup>101</sup> See Charles del Busto (ed), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.23

<sup>102</sup> Article 10 (b) (ii) of the UCP 500

Under the UCP 500 there are two kinds of negotiation credits. A credit may restrict the negotiation to a certain bank nominated in the credit, or it can be freely negotiable, which means that any bank can become a negotiating bank by undertaking the negotiation<sup>103</sup>.

However, it is important to note that the term “negotiable credit” is misleading, since the credit itself is not negotiable. It is the draft under the credit that may be freely negotiable.

### 3.3.2. Revocable and irrevocable credits

A distinction has to be drawn between revocable and irrevocable credits. The feature of “revocability” or “irrevocability” of a credit refers to the undertaking of the issuing bank.

A revocable letter of credit gives the applicant maximum flexibility, whereas it gives less security to the beneficiary. It can be amended, revoked or cancelled without the beneficiary’s consent and even without prior notice to the beneficiary.<sup>104</sup>

An irrevocable letter of credit, on the other hand, constitutes a definite undertaking of the issuing bank to pay and accept drafts and/or documents, provided that the stipulated documents are presented and that the terms and conditions are complied with.<sup>105</sup>

Consequently, an irrevocable credit gives greater assurance to the beneficiary as to the payment by the bank, since it cannot be modified or cancelled without the express consent of the beneficiary.

The UCP 500 requires the issuing bank to clearly state in the credit whether it is revocable or irrevocable. In the absence of such indication the credit is presumed to be irrevocable.<sup>106</sup> The majority of the legal systems with statutory provisions on documentary credits address the issue of revocability and irrevocability.<sup>107</sup> Most statutes treat documentary credits irrevocable if the credit does not specifically indicate it.<sup>108</sup> There are however countries, where the presumption of revocability prevails.<sup>109</sup>

In practice, revocable credits are not often accepted as method of payment. The more widely used form is the irrevocable credit, which may be confirmed or unconfirmed.

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<sup>103</sup> Article 10 (b) of the UCP 500 provides that ‘unless the Credit stipulates that it is available only with the Issuing Bank, all Credits must nominate the bank (the “Nominated Bank”) which is authorized to pay, to incur a deferred payment undertaking, to accept Draft(s) or to negotiate. In a freely negotiable Credit, any bank is a Nominated Bank’.

<sup>104</sup> For further explanation see Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p36.

Article 8 of the UCP 500 declares that ‘a revocable credit may be amended or cancelled by the Issuing Bank at any moment and without prior notice to the Beneficiary’.

<sup>105</sup> See Article 9 of the UCP 500

<sup>106</sup> See Article 6 of the UCP 500

The presumption of irrevocability has first appeared in the current version of the UCP. The former version, the UCP 400 presumed the credit to be revocable in the absence of a clear indication to its nature. This presumption of revocability was a ‘long-standing, although unpopular presumption’, which ‘impaired the reliability of the Credit’. See Charles del Busto (ed), *UCP 500 and 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.14

<sup>107</sup> For a detailed analysis of the different statutory provisions see Rolf A.Schütze, Gabriele Fontane, *Documentary Credit Law Throughout the World – Annotated legislation from more than 35 countries* (2003), Paris

<sup>108</sup> For example Bulgaria, Egypt, Greece, Honduras, Slovakia, Tunisia, United Arab Emirates, United States of America.

<sup>109</sup> For example Bahrain, Bolivia, Columbia, Iraq, Kuwait, Oman, Russia, Yemen.

### 3.3.3. Confirmed and unconfirmed credits

Whereas “irrevocability” or “revocability” refers to the obligation of the issuing bank towards the beneficiary, the feature of a credit as “confirmed” or “unconfirmed” is related to the undertaking of an other bank invited into the transaction by the issuing bank.

In many transactions the issuing bank communicates the letter of credit through an other bank that may act as an advising or a confirming bank.

#### Confirmed credits

Upon the authorization or request of the issuing bank, a bank may confirm a letter of credit, which constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, towards the beneficiary to pay, accept draft or to negotiate<sup>110</sup>. Needless to say, that in conformity with the principles of a letter of credit transaction, the obligation of the confirming bank can be evoked upon presentation of documents stipulated by and being in full compliance with the terms and conditions of the credit, on or before the expiry date.

An irrevocable, confirmed letter of credit “gives the beneficiary a double assurance of payment, since it represents both the undertaking of the issuing bank and the undertaking of the confirming bank”<sup>111</sup>.

The *Hamzeh Malas & Sons v. British Imex Industries Ltd.*<sup>112</sup> case gives a good illustration of the nature of a confirmed credit. In this case the Jordanian plaintiffs entered into a contract to purchase a larger quantity of reinforced steel rods by the defendant, a British firm. The payment was to be effected through two letters of credit (as the shipment was to be made in two instalments). The plaintiffs opened the letters of credit in favour of the defendants, confirmed by the Midland Bank Ltd., in London. The first letter of credit was duly realized on shipment of the first instalment. However, later some dispute arose in respect to the first instalment, which the buyer complained not to meet the contracted quality. Thus, he applied for a court injunction in order to restrain the seller from recovering any money under the second letter of credit. The court refused to grant the injunction and observed that:

“... it seems to be plain enough that the opening of a confirmed Letter of Credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers’ confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice.

There is this to be remembered, too. A vendor of goods selling against a confirmed letter of credit is selling under the assurance that nothing will prevent him from receiving the price.”<sup>113</sup>

A confirmed letter of credit usually includes the following – or similar - text:

*“As requested by the Issuing Bank, we hereby add our confirmation to the Credit in accordance with the stipulations under UCP 500 Article 9.”*<sup>114</sup>

<sup>110</sup> See Article 9 (b) of the UCP 500

<sup>111</sup> Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p. 44

<sup>112</sup> [1958] 2 Q.B. 127

<sup>113</sup> *Ibid* at 129

<sup>114</sup> Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p. 42

The confirmation of the confirming bank may be “silent”<sup>115</sup> or may be a so called “seller’s confirmation”. A silent confirmation is the undertaking of the confirming bank without the express authorization of the issuing bank. This undertaking does not represent a “confirmation” within the meaning of the UCP, it is rather a separate agreement between the beneficiary and the “confirming” bank under which the said bank is obliged to purchase or discount the draft. “The confirming bank will have no rights against the issuing bank arising from its [silent] confirmation. Thus, unless it is entitled to be reimbursed because it is nominated by the credit as the paying bank, if its confirmation leads it to have to pay on the credit, it will not have a right of reimbursement.”<sup>116</sup>

The *Mees Pierson NV v. Bay Pacific (S) Pte Ltd*<sup>117</sup>. case from 2000 is a good example of the silent confirmation. The case involved a sale and purchase of 1,870 metric tons of Indian wheat flour. Payment was to be effected by a letter of credit, issued by the Industrial and Commercial Bank of Vietnam. The issuing bank requested the plaintiff to advise the letter of credit to the respondent beneficiary, which the plaintiff did adding also its confirmation without authorization (thus the plaintiff bank became a “silent” confirmer).

The “silent” confirming bank effected payment upon presentation of documents, which later turned out to be forged. When he forwarded the documents to the issuing bank, the issuing bank rejected them.

First the “silent” confirming bank sued the issuing bank for wrongful dishonour<sup>118</sup>, but the claim was dismissed. Then the “silent” confirming bank sued the beneficiary alleging that the beneficiary had knowingly presented forged documents. This claim was also dismissed because the plaintiff could not prove that the beneficiary had been involved or had been aware of the fraudulent act.

In case of a “seller’s confirmation” the seller requests the confirmation of the credit in order to obtain an additional security that it will receive payment. Although this issue is not covered by the UCP 500 it seems to be a common practice.<sup>119</sup> Since the confirmation is not requested and authorized by the issuing bank the confirmer acts at its own risk.

### Unconfirmed credits

A letter of credit is unconfirmed, if the bank merely acts as an agent of the issuing bank without assuming any responsibility towards the beneficiary, thus acting as an advising bank. An advising bank does not confirm the credit; its obligation is to take reasonable care to check the apparent authenticity of the credit.

An unconfirmed letter of credit usually states the following or words of similar intent:

*“This notification and the enclosed advice are sent to you without any engagement on our part.”*<sup>120</sup>

<sup>115</sup> For an analysis of the silent confirmation see *Eric Caprioli on the nuances of silent confirmation* In DC Insight Summer (1996)

<sup>116</sup> Raymond Jack, *Documentary Credits* (1991) London, p. 117. The same opinion can be read in *Fung King-tak on the legality of silent confirmation* In DC Insight Vol.7.No.1 Winter 2001

<sup>117</sup> [2000] 4 SLR 393 (Singapore)

<sup>118</sup> *Meespierson NV v. Industrial and Commercial Bank of Vietnam*, [1998] 2 SLR 632 (Singapore)

<sup>119</sup> See *In which our independent observer notes the differences between “silent”, “soft”, and “clausured” confirmation* In DC Insight Winter (1996)

<sup>120</sup> Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p. 41

As Schmitthoff points it out, although unconfirmed letters of credit are cheaper they do not “localise the performance of the contract of sale in the seller’s country”<sup>121</sup>.

The nature of an unconfirmed letter of credit may be well illustrated by the *Cape Asbestos Co v. Lloyd’s Bank*<sup>122</sup> case, in which importers in Warsaw entered into a contract with the Asbestos Company for the sale of asbestos sheets. As the sales contract provided by payment through a letter of credit, the buyer opened a credit at the Lloyd’s Bank in favour of the seller. The defendant bank advised the credit to the plaintiff adding a clause that stated, “this is merely an advice of opening of the above mentioned credit and is not a confirmation of the same”. The shipment happened in instalments. Upon sending the first instalment the plaintiff presented the draft which was duly accepted by the bank. After shipping the second instalment the plaintiff presented a draft again, which, at this time, was refused by the bank, due to the fact that in the meantime the credit had been cancelled by the importer. Although the bank did not notify the plaintiff about the cancellation of the credit, it was held that “the bank was entitled to refuse the acceptance of the draft for the remainder”.<sup>123</sup>

Based on the above mentioned, in case when the parties are dealing with unconfirmed credits it is wise to insert at least a “notice clause” into the credit, which obliges the bank to notify the beneficiary about the cancellation of the credit.

### 3.3.4. Revolving Documentary Credits

Revolving credits are used in transactions where there is a continuous relationship between the exporter and the importer and the amount is renewed periodically without renewing the terms and conditions of the credit.

In *Nordskog & Co. v. National Bank*<sup>124</sup> the joint general manager of Lloyd’s Bank explained the operation of the revolving credit as follows:

“A revolving credit technically means a credit for a certain sum at any one time outstanding, which is automatically renewed by putting on at the bottom what has been taken off the top. If you have a revolving credit for £50,000 open for three months, to be operated on by drafts at 30 days sight as drafts are drawn, they temporarily reduce the amount of the credit below the £50,000. As these drafts run off and are presented and paid they are added again to the top of the credit and restore it again to the £50,000.”<sup>125</sup>

A revolving credit can be revocable or irrevocable and cumulative or non-cumulative. The meaning of the terms “revocable” or “irrevocable” has been already explained above. The term “cumulative” in relation to a revolving credit means that “any sum not utilized during the first period carries over and may be utilized during a subsequent period”<sup>126</sup>. In more practical words, if a revolving credit is opened for a fixed period of 6 months with an amount up to \$10,000 per months and the beneficiary draws only \$5,000 in the first month, than the remaining \$5,000 will be available for him during the next month along with the \$10,000, that is to say \$15,000 all together.

<sup>121</sup> Schmitthoff’s *Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London p.196

<sup>122</sup> [1921] W.N. 274

<sup>123</sup> Schmitthoff’s *Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London p.196

<sup>124</sup> [1922] 10 Lloyd’s Rep. 652

<sup>125</sup> Ibid at 656

<sup>126</sup> Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p. 48

If the revolving credit is non-cumulative, than any amount not drawn in a specific period of time ceases to be available. In our hypothesis, if the beneficiary draws only \$5,000 in the first month, the remaining \$5,000 will not be available for him during the next month, when he will be able to drawn up to \$10,000 again.

The credit may be revolving not only in relation to time, but in relation to value as well. This latter means, that the letter of credit is automatically reinstated when the value of the credit is exhausted.

Although revolving credits are mentioned in all textbooks, in practice they appear to be rare<sup>127</sup>.

### 3.3.5 Red Clause Documentary Credits and Green Clause Documentary Credits

The Red Clause Documentary Credit received its name from a special condition inserted into the text of the credit, which was originally written by red ink. Under this special condition the confirming bank or any other nominated banks are authorized by the applicant to make advances to the beneficiary before presentation of documents<sup>128</sup>. The amount of the advances is specified in the credit.

Harfield explains it as follows:

“The Red Clause is a device which originated in the China trade, where the seller was most frequently an agent of the buyer...In the fur trade, for example, the persons in China who dealt with American buyers were, in the main, either buyers’ representatives or traders who went into the hinterland and bought raw furs, a little here and a little there, assembled them...They dealt, too, with persons who wanted cash on the barrelhead before they parted with the furs. Accordingly, opening banks began to practice of endorsing on their credits in red ink (whence the name) a clause authorizing the confirming or negotiating bank to pay the beneficiary against the drafts alone, coupled with his simple promise to provide the documents in the future.”<sup>129</sup>

Thus, the Red Clause Documentary Credit is used where the buyer is willing to finance the transaction before the actual shipping of goods.

In practice, for instance a wool importer in England may agree with a wool shipper in Australia to purchase wool. However, the wool shipper may not have the necessary fund to pay the actual suppliers. Thus, the English importer may be willing to pre-finance the transaction by enabling the Australian shipper to obtain funds in advance. In this case the bank would honour the shipper’s drafts to a certain amount, specified by the wool importer, upon presentation of the stipulated documents. When the wool is shipped the shipper would deliver the transport documents to the bank and receive the purchase price less the amount obtained by way of advance.

However, if the shipper fails to ship the wool the bank has the right to demand reimbursement from the applicant for the advances made and all the related costs – such as interest.<sup>130</sup>

<sup>127</sup> Paul Todd, *Bills of Lading and Bankers’ Documentary Credits* (1990), London, p.33

<sup>128</sup> This of course does not mean that the Applicant authorises the Bank to pay the Beneficiary in advance without presentation of any kind of documents. The advances are made upon presentation of documents other than transport documents, eg. a warehouse receipt, evidencing that the goods exist.

<sup>129</sup> Wilbert War, Henry Harfield, *Bank Credits and Acceptances* (3rd ed., 1948) New York, p.133

<sup>130</sup> Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p. 49.

A typical wording of the red clause may be as follows:

*“This red clause documentary credit allows a pre-payment of USD 100,000 against presentation of:*

- beneficiary’s simple receipt and*
- beneficiary’s written undertaking to present the shipping documents within the credit validity.”<sup>131</sup>*

The Green Clause Documentary Credit is a “refinement”<sup>132</sup> of the Red Clause Credit. This also entitles the seller to receive advances before shipment but only on the condition that the goods are warehoused in the name of the nominated bank. The advance payment is made against presentation of the warehouse receipt.

### 3.3.6 Transferable Documentary Credits

Letter of credits are usually opened in favour of the beneficiary named in the credit. It means that only the named person can tender the documents and can require payment from the bank.

However, in today’s complex business relationships it is not exceptional that the beneficiary seeks to transfer its rights under the credit to a third party. This can happen in two ways: by transfer and by assignment.

#### Transfer of the credit

Often the seller is not the manufacturer of the goods being subject of the sales contract. He may only act as a middleman obtaining goods from a third party and selling them to the buyer at a higher price. In this case the seller may use a transferable credit to pay the third party (usually referred to as the Second Beneficiary) selling to him.

By making a credit transferable the seller assigns his right to perform under the documentary credit to a third person. This third person “steps into the credit and in advanced is assured payment out of funds made available by the ultimate buyer, provided that the conditions of the original credit are complied with”<sup>133</sup>.

It is also possible that the seller who is buying from more than one supplier transfers only a certain part of the credit to each supplier.

In the course of the operation of the transferable credit the supplier presents the required documents, including his invoice, to the bank and request payment. The seller also presents his invoice and receives the difference in price between his invoice and what has already been paid to the supplier. Thus, the seller can obtain his profit on the transaction. The bank then sends the invoice presented by the seller to the buyer. This way the buyer will have no knowledge of who the supplier is unless it is revealed by other documents such as the transport documents that may indicate the supplier as the shipper.<sup>134</sup> As Professor Jack explains, the “importance of the first beneficiary’s [Seller] ability to conceal the name of the party selling to him lies in the fact that otherwise the buyer might cut him out on future transactions dealing directly and more cheaply with the third party seller”<sup>135</sup>.

<sup>131</sup>[http://www.ubs.com/1/e/ubs\\_ch/bb\\_ch/finance/trade\\_exportfinance/akkreditiv/arten/besondere\\_arten/red\\_clause\\_akkreditiv.html](http://www.ubs.com/1/e/ubs_ch/bb_ch/finance/trade_exportfinance/akkreditiv/arten/besondere_arten/red_clause_akkreditiv.html), date visited: 15 August, 2005

<sup>132</sup> Raymond Jack, *Documentary Credits* (1991) London, p.30

<sup>133</sup> *Schmitthoff’s Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London p.204

<sup>134</sup> Under Article 31 of the UCP 500 ‘banks will accept a transport document which indicates as the consignor of the goods a party other than the Beneficiary of the Credit.’

<sup>135</sup> Raymond Jack, *Documentary Credits* (1991) London, p.215

This can be well illustrated by the recent case of *Jackson v. Royal Bank of Scotland*<sup>136</sup>. Samson, a partnership formed by Jackson and Davis, imported different goods from the Far East and sold them to British companies. From 1993 Samson entered into several sales contracts of dog chew with a British company, Economy Bag. Payments were effected by transferable letters of credit opened by the defendant bank. The transactions proceeded normally until 1993 when the parties' relationship took an unexpected turn. The bank in error sent a set of documents submitted by the Thai supplier, including its invoice, to Economy Bag instead of Samson, which revealed the substantial profit Samson was making on the transactions. As a result, Economy Bag cut Samson out of the import chain and bought the goods directly from the Thai supplier. Samson suffered a serious loss of business and the partnership was dissolved. Jackson turned to court claiming damages. The court found the defendant bank liable for breach of contract and pointed out that the purpose of using a transferable credit is to enable the first beneficiary to keep confidential from the buyer the profit he was making.<sup>137</sup>

The transfer of credits is a well-established practice and regulated also by the UCP 500. Article 48(a) defines the Transferable Credit as follows:

*“A transferable Credit is a Credit under which the Beneficiary (the First Beneficiary) may request the bank authorised to pay, incur a deferred payment undertaking, accept or negotiate (the „Transferring Bank”), or in the case of a freely negotiable Credit, the bank specifically authorised in the Credit as a Transferring Bank, to make the Credit available in whole or in part to one or more other Beneficiary(ies) (Second Beneficiary(ies)).”*

However, the bank is not authorized to make the credit available for any third person named by the beneficiary. In order to transfer the credit certain conditions have to be met.

According to Article 48(b) of the UCP 500 a credit can be transferred only if it is expressly designated “transferable” by the issuing bank. Besides the issuing bank, the applicant has to give its express consent to the transfer as well. Unless the credit states otherwise, only one transfer can be made.

In case partial shipments are allowed, fractions of a transferable credit can be transferred separately.<sup>138</sup>

In *Bank Negara Indonesia 1946 v. Lariza (Singapore) Pte Ltd*<sup>139</sup> the defendant Lariza, a dealer in commodities entered into a sales contract of palm oil with Bakrie. Payment was made through a transferable letter of credit issued by Bank Negara. In order to fulfil its contractual obligations Lariza contracted with Ban Lee to obtain the palm oil. As a result, Lariza requested the Bank to transfer the credit to Ban Lee but the Bank refused. Ban Lee sued Lariza for breach of contract. In the meantime Bakrie went bankrupt.

The question for the court was whether a bank issuing a transferable credit under the UCP can refuse to effect the transfer at the request of the first beneficiary. The Court of Appeal of Singapore held that if a credit is designated transferable, the issuing bank's consent to effect the transfer is self-evident. “It would make no commercial sense for a bank to have designated a

<sup>136</sup> [2005] 1 Lloyd's Rep. 366

<sup>137</sup> The interesting aspect of the case is that the supplier's identity had been disclosed to the buyer well before the erroneous act of the bank, and only the mark-up applied by Samsung in the various transactions was kept secret. Nevertheless, the court found that it was the bank's duty towards the first beneficiary to protect the confidentiality of the mark-up, and this duty was not lessened by the fact that the buyer could have found out the amount of the mark-up as it knew the supplier's identity and contact details.

<sup>138</sup> Article 48 (e) of the UCP 500

<sup>139</sup> [1988] AC 583. For a detailed analysis of the case see William Godwin, *Transferable Letters of Credit – The effect of Lariza* In The Journal of Business Law, January (1990), p.48

credit issued by it transferable and then to refuse when requested to do so to effect a transfer of it in accordance with its terms.”<sup>140</sup>

It is questionable whether the right of the bank to refuse the request for transfer of a transferable credit is acceptable. In *Benjamin's Sale of Goods* it is argued that an issuing bank is not entitled to refuse to effect a transfer, except on a reasonable ground.<sup>141</sup>

Raymond Jack on the other hand, emphasizes that since the arrangements resulting from the transfer are usually not simple, “it is understandable that banks ... wish to keep the right to say no where they anticipate that a transfer may lead to difficulties for them and the parties with whom they deal. If they are to have that right [of refusal], it is probably correct that they should have an unfettered right leaving it to their good sense in each case ... to determine whether there are objections to a transfer, rather than attempting to impose limitations which might lead to uncertainties and disputes”<sup>142</sup>.

It is important to note that under the UCP 500 the bank is not obliged to accept the request of the first beneficiary for the transfer.

As Article 48(c) states:

*“The Transferring Bank shall be under no obligation to effect such transfer except to the extent and in the manner expressly consented to by such bank.”*

If the credit is not designated as transferable the seller may arrange for a back-to back credit.

#### Assignment of the proceeds of the credit

Assignment has a totally different function as to the transfer of the credit.

Article 49 of the UCP 500 allows the beneficiary to “assign any proceeds to which he may be ... entitled under such Credit, in accordance with the provisions of the applicable law” even if the credit is not stated as transferable. However, this “relates only to the assignment of proceeds and not to the assignment of the right to perform under the Credit itself”<sup>143</sup>.

In practical terms it means the assignment of money which will be payable under the credit following the future presentation of the required documents. Assignment can be made before or after the presentation of documents by the beneficiary.

In case of assignment the beneficiary has to give an irrevocable, written notification to the bank, instructing it to assign the proceeds of the credit to a named assignee. If the bank agrees to the instructions, it must acknowledge and notify the assignee. When presenting the documents the beneficiary will receive any funds not assigned. The assigned part of the credit shall be payable directly to the assignee.

#### **3.3.7 Back-to-Back Documentary Credits**

A Back-to-Back Documentary Credit is used in transactions where a seller, who entered into a contract of sale of certain goods has to purchase those goods from his supplier and no transferable credit is used in the transaction.

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<sup>140</sup> Ibid at 378

<sup>141</sup> *Benjamin's Sale of Goods*, (1981) London, p.2158

<sup>142</sup> Raymond Jack, *Documentary Credits* (1991) London, p.217

<sup>143</sup> See Article 49 of the UCP 500

In this case two separate documentary credits are involved: a documentary credit opened by the buyer in favour of the seller and an other documentary credit opened by the seller in favour of the supplier on the security of the first credit. “The original credit, and the second opened in favour of the supplier, will be in identical terms apart from the price.”<sup>144</sup>

The operation of a Back-to-Back Credit was explained by Judge Devlin in the case of *Ian Stach Ltd v. Baker Bosley Ltd*<sup>145</sup>:

“Where, as in the present case, there is a string of merchants’ contracts between the manufacturer ... and the ultimate user, the normal mechanism for carrying out the various contracts is the familiar one which was intended to be used in this case: the ultimate user, under the terms of his contract of sale, opens a transferable, divisible credit in favour of his seller for his purchase price: his seller in turn transfers so much of the credit as corresponds to his own purchase price to his seller or, more probably, if his own contract with another merchant [the Supplier] also calls for a transferable, divisible credit, procures his own banker to issue a back-to-back credit – that is to say, he lodges the credit in his favour with his own banker, who in his turn issues a transferable, divisible credit for the amount of the purchase to his own seller; and so on, through the string of merchants, until the banker of the last merchant in the string issues the credit in favour of the actual manufacturer. ... The reason why they issue fresh credits is that in banking practice a transferable credit is regarded as transferable once only, and, also as is obvious in this sort of trade, it is desired, naturally enough, by any merchant in the string to conceal from his buyer and his seller who his own customer is.”<sup>146</sup>

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<sup>144</sup> Paul Todd, *Bills of Lading and Bankers’ Documentary Credits* (1990), London, p.32

<sup>145</sup> [1958] 2 QB 130

<sup>146</sup> *Ibid* at 138.

## IV.

### THE STAGES OF A LETTER OF CREDIT TRANSACTION

The purpose of this Chapter is to introduce the basic form of financing international sale of goods, known as a documentary sale.

This chapter intends to give a comprehensive analysis of the main issues concerning the operation of letters of credit, without aiming to include all minor details appearing in the day-to-day banking practice, something which has been done by well-known scholars and which would certainly take volumes.<sup>147</sup>

Before entering into a description of some of the legal difficulties that arise, it is essential to have a general understanding of the transaction itself.

In our hypothesis of the sale of goods between the Greek seller and the Hungarian buyer, described in Chapter III.<sup>148</sup>, in the course of the documentary credit transaction the following stages can be distinguished:

- a) The seller and the buyer conclude a sales contract in which they agree that payment shall be made by a letter of credit.
- b) The buyer (acting as the Applicant) applies to a bank at his place of business (the issuing bank) for the opening of a letter of credit in favour of the seller (known as the beneficiary). In his application the buyer specifies the terms and conditions under which the letter of credit shall be issued.
- c) The issuing bank issues the letter of credit, thus undertaking the definite obligation of effecting payment to the beneficiary upon presentation of documents, strictly complying with the terms and conditions of the credit. The manner in which the bank will effect payment is described in the credit.
- d) The issuing bank may invite an other bank into the transaction, usually with a seat in the country of the seller. This second bank (called the correspondent bank) may act as an advising bank, if it merely informs the seller of the letter of credit without any obligation on its part; or may be a confirming bank, if it confirms the letter of credit issued by the issuing bank, thus undertakes primarily obligation to effect payment to the beneficiary. It may also be a nominated bank, if the credit calls for negotiation.
- e) As soon as the seller receives the letter of credit – supposing that the terms of the credit meet the terms of the underlying sales contract - he is in the position to effect shipment.

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<sup>147</sup> For a detailed analysis see E.P.Ellinger, *Documentary Letters of Credit - A Comprehensive Study*, (1970); H.Harfield, *Bank Credits and Acceptances*, (5<sup>th</sup> ed., 1974); H.C Gutteridge, Maurice Megrah, *The Law of Bankers' Commercial Credits* (7<sup>th</sup> ed., 1983); J.F.Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* (rev. ed., 1996); R. Jack, *Documentary Credits* (3<sup>rd</sup> ed., 2001); Paul Todd, *Bills of Lading and Bankers' Documentary Credits* (1990)

<sup>148</sup> See Chapter III., 3.2.1.

- f) Seller then presents the documents stipulated by the credit to the correspondent bank, which is authorized to take up the documents. The correspondent bank will examine the documents whether they strictly comply with the terms and conditions of the credit. If the documents meet the requirements, the correspondent bank will effect payment to the seller in the manner stipulated by the credit.
- g) The correspondent bank then sends the documents to the issuing bank, which will examine the documents and if it finds that the documents comply with the credit, it will reimburse the correspondent bank that has effected payment to the seller.
- h) Then the issuing bank sends the documents to the buyer and obtains reimbursement in the manner agreed when he opened the letter of credit.
- i) By receiving the documents, the buyer is in the position to take over the goods.

It must be emphasized that the above described is a basic scenario of a letter of credit transaction. The legal difficulties that may arise are detailed in the followings.

#### 4.1 Relationships between the parties

A letter of credit transaction generally involves four independent<sup>149</sup>, however interdependent relationships. These are the relationship between:

- a) the Buyer and the Seller
- b) the Buyer (Applicant) and the Issuing Bank
- c) the Seller (Beneficiary) and the Issuing Bank/Confirming Bank
- d) the Issuing Bank and the Correspondent Bank

The often cited example for the description of these four relationships in case of an irrevocable letter of credit is that given by Lord Diplock in *United City Merchants (Investments) Ltd v. Royal Bank of Canada*<sup>150</sup>:

“It is trite law that there are four autonomous though interconnected contractual relationships involved: (1) the underlying contract for the sale of goods, to which the only parties are the buyer and the seller; (2) the contract between the buyer and the issuing bank under which the latter agrees to issue the credit and either itself or through a confirming bank to notify the credit to the seller and to make payments to or to the order of the seller (or to pay, accept or negotiate bills of exchange drawn by the seller) against presentation of stipulated documents; and the buyer agrees to reimburse the issuing bank for payments made under the credit. For such reimbursement the stipulated documents, if they include a document of title such as a bill of lading, constitute a security available to the issuing bank; (3) if payment is to be made through a confirming bank, the contract between the issuing bank and the confirming bank authorizing and requiring the latter to make such payments and to remit the stipulated documents to the issuing bank when they are received, the issuing bank in turn agreeing to reimburse the confirming bank for payments made under the credit; (4) the contract between the confirming bank and the seller under which the confirming bank undertakes to pay to the seller (or to accept or

<sup>149</sup> The Principle of Independence is explained in Chapter VI. 6.1

<sup>150</sup> [1983] A.C. 168 at 182-183

negotiate without recourse to drawer bills of exchange drawn by him) up to the amount of the credit against presentation of the stipulated documents.”

#### **4.1.1. The relationship between the Buyer and the Seller**

The letter of credit transaction is usually based on an underlying (sales) contract between the seller and the buyer. In this contract the parties provide for payment by a letter of credit, which obliges the buyer to open a credit in favour of the seller.<sup>151</sup> It also obliges the seller to obtain payment from the bank upon the letter of credit and refrain from demanding payment directly from the buyer.

If the letter of credit expires without payment to the seller, the seller is entitled to claim the purchase price from the buyer upon the underlying contract, although, the buyer may deduct any losses suffered due to the failure of the seller to use the letter of credit.

Any disputes arising from the underlying contract will have no effect on the letter of credit due to its autonomous nature.

#### **4.1.2. The relationship between the Buyer (Applicant) and the Issuing Bank**

In order to fulfil its contractual obligations the buyer (acting as the applicant) has to open a letter of credit at the issuing bank in favour of the seller (the beneficiary of the letter of credit). Thus, the buyer gives instructions to the issuing bank in his application, clarifying the terms and conditions under which the bank shall effect payment.

By accepting the terms and conditions submitted in the application form the issuing bank enters into a contractual relationship with the buyer. Under this contract the bank undertakes to issue the letter of credit and to effect payment to the beneficiary upon presentation of documents strictly in compliance with the terms and conditions of the credit.

The bank has to perform his duties to the best of his ability and has to exercise good faith towards the applicant. The applicant on the other hand must indemnify the bank after carrying out the instructions. In practice the bank usually demands the applicant to deposit the amount in an account with the bank, enabling the latter to withdraw the amount paid under the credit adding the commission fee and additional charges directly from the applicant's account after honouring the credit.

This contract is independent from the contract between the seller and the buyer and “the bank must strictly adhere to the buyer's instructions as set out in the application form. This applies both as regards the nature of the documents against the tender of which the bank undertakes to pay the irrevocable credit and as regards any specific instruction defining the nature of the letter of credit to be effected”.<sup>152</sup>

#### **4.1.3. The relationship between the Seller (Beneficiary) and the Issuing Bank/Confirming Bank**

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<sup>151</sup> In case of standby letters of credit it is the seller's obligation to open the credit in order to guarantee that the transaction will be fulfilled.

<sup>152</sup> E.P. Ellinger, Letters of Credit In Norbert Horn, Clive M.Schmitthoff (ed.), *The transnational law of international commercial transactions*, Vol.2 (1982), The Netherlands, p. 255.

By issuing the letter of credit the bank enters into a relationship with the beneficiary the ground of which is a definite undertaking of the bank to effect payment on presentation of documents strictly complying with the terms and conditions of the credit.

Article 9 of the UCP 500 indicates how and when the payment has to be effected by the issuing bank<sup>153</sup>.

By confirming a letter of credit a legal relationship is formed between the confirming bank and the beneficiary. The confirming bank commits itself that upon presentation of documents strictly complying with the terms of the credit, it will either pay, accept draft(s) or negotiate. Thus, the confirming bank “assumes a primary obligation the same as that of the issuing bank to honour its undertaking under the credit”<sup>154</sup>. It is understood that the obligation and liability of the confirming bank is separate from that of the issuing bank.

#### **4.1.4. The relationship between the Issuing Bank and the Correspondent Bank**

Several letter of credit transactions involve banks other than the issuing bank. If correspondent banks<sup>155</sup> are invited into the transaction, a contractual relationship is established between the issuing bank and the correspondent bank.

Their agreement governs the rights and liabilities of the parties, the terms and conditions of the correspondent’s reimbursement for payment made under the credit, as well as all the instructions of the issuing bank.

Gutteridge refers to this relationship as “unless otherwise agreed, that of principal and agent”<sup>156</sup>. If the correspondent bank effects payment to the beneficiary according to its mandate, it is entitled to reimbursement by the issuing bank.

## **4.2 The rights and obligations of the parties**

### **4.2.1 The rights and obligations of the Buyer**

Under a contract of international sale of goods the main obligations of the buyer are (a) to pay the price for the goods, and (b) to take delivery of them.<sup>157</sup>

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<sup>153</sup> For a detailed explanation of the method of payment and other obligations of the issuing bank see Chapter III.3.3.1 and Chapter IV. 4.2.3.

<sup>154</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.24

<sup>155</sup> The term ‘Correspondent Bank’ here refers to other banks, which are instructed by the issuing bank to act on its behalf.

<sup>156</sup> H.C.Gutteridge, Maurice Megrah, *The Law of Bankers’ Commercial Credits* (1955) London, p.43

<sup>157</sup> See United Nations Convention on Contracts for the International Sale of Goods (1980, Vienna), Chapter III., Obligations of the buyer

This thesis does not intend to give a detailed analysis of the buyer's right under the sales contract thus, in the followings only the buyer's rights and obligations regarding the credit transaction will be discussed.

### The underlying contract

The underlying sales contract should spell out with "sufficient particularity what the credit should be"<sup>158</sup>.

It should state the

- type of the credit,
- whether it shall be confirmed or unconfirmed
- whether it should be revocable or irrevocable,
- if it is transferable
- amount of the credit and the currency<sup>159</sup>
- the documents against which payment will be made
- when should the credit be opened
- the expiry date of the credit
- any special condition

Case law has shown that often the underlying contract is rather laconic about the terms of the credit. In *Ficom SA v. Sociedad Cadex Limitada*<sup>160</sup> the underlying contract for the sale of Bolivian coffee contained the following short payment provision: "Payment: by immediate irrevocable letter of credit to be opened in favour of sellers with Banco Mercantil, La Paz, Bolivia".

The underlying contract and the payment terms of the credit differed from each other: the underlying contract did not allow the buyer to cancel the contract for a difference of quality of the goods, while according to the payment terms, no payment was to be made if the goods did not meet the required quality; the contract also entitled the buyer to lower the price in certain circumstances, while the credit did not.

The credit was opened and the sellers did not raise any objection. Later the seller presented documents, among which there was a quality certificate, which did not meet the terms of the credit, so the bank, after consulting the buyer, refused payment. The seller claimed that under the sale contract the buyer had no right to reject the shipment.

The Court held that the parties had a binding agreement as to the form of the credit, and the bank rightly refused to accept the quality certificate that did not comply with the terms of the credit. Justice Robert Goff stated, that:

"In the present case, I am concerned with a contract of sale in which the terms of the letter of credit – and in particular of the documents to be presented under the letter of credit – were undefined in the sale contract. Now, in such a case, it is a commonplace that a letter of credit will be opened thereafter – sometimes preceded by a pre-advice by the buyer of the terms of the proposed credit followed by detailed negotiations of the terms so proposed – resulting in a letter of credit being issued in precise terms acceptable to both parties. Often the letter of credit so agreed will take the form which is usually employed in the particular trade. Now, although it is impossible to formulate any general rule, in such a case the terms of the letter of credit so agreed may well become binding contractually upon the parties. If so, and if they depart in any respect from the terms

<sup>158</sup> Raymond Jack, *Documentary Credits* (1991) London, p.33

<sup>159</sup> The amount and the currency will usually follow from the contract price, but if for any reason it cannot be determined, the contract should specifically state the amount and currency of the credit.

<sup>160</sup> [1980] 2 Lloyd's Rep 118

(express or implied) of the original sale contract, they will constitute a binding variation of that contract: if they simply fill a gap in the original sale contract, then they will operate to supplement the contract. It is of importance to the parties that the terms of the letter of credit, if so agreed by them, should become binding, because on that basis the buyer will enter into a binding agreement with his own bank, which in turn will enter into a binding agreement with the issuing bank instructed to issue a letter of credit to the seller, the terms of which will in their turn become binding as between the issuing bank and the seller.

[...]

Now what happened in the present case? First of all, we have a sale contract which was silent on the terms upon which the letter of credit was to be opened. ... This is not a case where, on the documents before me, there was a pre-advice of the letter of credit terms, followed by negotiation, leading up to an agreement on those terms; it appears that the buyers simply opened a letter of credit in certain terms. But it is plain that the sellers agreed to the letter of credit so opened as being acceptable to them.

[...]

Next, I am satisfied that that agreement was a binding agreement upon the parties. It is true that it is difficult to reconcile the letter of credit, as opened, with the provision of the sale contract ... But such an inconsistency does from time to time occur where there is a contract of sale under which payment is to be made by letter of credit ... and the mere fact that inconsistency of this kind does occur does not of itself detract from the binding effect of the letter of credit. ... It follows that the seller could only draw on the letter of credit if they tendered a quality certificate in accordance with the requirements of the letter of credit so established.”<sup>161</sup>

This case is one example in a long line of unfortunate transactions, where the parties first concluded a sales contract and then agreed on the terms of the letter of credit, which might contain contradicting terms as to the contract.<sup>162</sup>

It also shows that in case the beneficiary fails to raise objection to the contradicting terms of the credit and effects performance, it loses its right to object later, as the terms of the credit become binding on the parties.<sup>163</sup>

### Time of opening the credit

Under the sales contract the buyer is required to open a letter of credit in time in order to enable the seller to fulfil its contractual obligations, for instance, to ship the goods.

The duty of opening the credit in time is understood as a condition presiding the seller's duty to make shipment. The contract may stipulate a period of time within which the credit has to be opened, or may declare the shipment date. Sometimes the opening of the credit depends on an act of the seller, which may be the sending of a performance guarantee or a provisional invoice to the buyer.

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<sup>161</sup> Ibid at 131-132

<sup>162</sup> For further analysis of the case see F.M. Ventris, *Bankers' Documentary Credit* (2<sup>nd</sup> ed., 1983) p. 286

<sup>163</sup> The same was concluded in *Panoutsos v. Raymond Hadley Corporation of New York* ([1917] 2 KB 473); *Enrico Furst & Co. v. W.E. Fischer Ltd* ([1960] 2 Lloyd's Rep. 340); *Soproma SPA v. marine & Animal By-Products Corporation* ([1966] 1 Lloyd's Rep 367); *W.J.Alan & Co.Ltd. v. El Nasr Export and Import Co* ([1972] 1 Lloyd's Rep. 313)

In *Garcia v. Page & Co. Ltd*<sup>164</sup> the sales contract concluded in May required the buyer to open immediately a confirmed credit in London in favour of the seller. The shipment was due in September, however the buyer did not arrange for the credit until the beginning of September. The court held that “under the original contract there was a contract by which a confirmed credit in the terms specified was a condition precedent and it had to be opened immediately. That means that the buyer must have such time as is needed by a person of reasonable diligence to get that credit established”<sup>165</sup>. The buyer’s failure to open the credit in time constituted a breach of contract allowing the seller to terminate the sales contract.

Where the period of time for opening the letter of credit is not stipulated by the contract and the seller is given a certain period of time for shipment, for example, shipment in January, February, the credit must be available to the seller by the beginning of the shipment period. As Lord Denning observed in the *Pavia & Co. SPA v. Thurmann-Nielsen*<sup>166</sup> case:

“The Seller is entitled, before he ships the goods, to be assured that, on shipment, he will get paid. The seller is not bound to tell the buyer the precise date when he is going to ship; and whenever he does ship the goods, he must be able to draw on the credit. He may ship on the very first day of the shipment period. If the buyer is to fulfil his obligations, he must therefore make the credit available to the seller at the very first date when the goods may be lawfully shipped in compliance with the contract.”<sup>167</sup>

Lord Somervell further explained in the same case:

“When a seller is given a right to ship over a period and there is a machinery for payment, that machinery must be available over the whole of that period. If the buyer is anxious, as he might be if the period of shipment is a long one, not to have to put the credit machinery in motion until shortly before the seller is likely to want to ship, then he must put in some provision by which the credit shall be provided, e.g. 14 days after a cable is received from the seller, or some provision of that kind.”<sup>168</sup>

If the credit stipulates for a shipment date instead of a shipment period, the opening of the credit has to happen a reasonable time before that date, as it was stated in the *Plasticmoda SpA v. Davidsons (Manchester) Ltd*<sup>169</sup> case. This reasonable time has to be calculated back from the first date of shipment and not from the date of concluding the contract.

As Schmitthoff explains “taking the first date of shipment as the starting point, the buyer has ... to open the credit a sufficient time in advance of that event to enable the seller to know before he sends the goods to the docks that his payment will be secured by the credit for which it is stipulated”<sup>170</sup>.

The main requirements of opening a letter of credit are summarized in the recent case of *Glencore Grain Rotterdam BV v. Lebanese Organisation for International Commerce*.<sup>171</sup> The case involved the sale and purchase of a cargo of wheat. Under the FOB sales contract the

<sup>164</sup> [1936] 55 Lloyd’s Rep. 391

<sup>165</sup> Ibid at 392

<sup>166</sup> [1952] 1 Lloyd’s Rep. 153

<sup>167</sup> Ibid at 157

<sup>168</sup> Ibid at 156

<sup>169</sup> [1952] 1 Lloyd’s Rep. 527

<sup>170</sup> *Schmitthoff’s Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London, p. 186

<sup>171</sup> [1997] 4 All E.R., the case is also available on the website of the British and Irish Legal Information Institute at <http://www.bailii.org>

plaintiff was obliged to ship the goods on board the vessel provided by the defendant buyer. The buyers had to open a letter of credit in accordance with the contract requirements before the shipment period began. The buyers' bank notified the seller of the proposed terms of the letter of credit which were contradicting the FOB contract, as the sellers could only obtain payment under the letter of credit if they presented bills of lading endorsed "freight prepaid". The sellers objected, but it was not followed by any other communication between the parties as to the terms of the letter of credit. The sellers later refused to ship the goods and the buyers turned to court.

Justice Longmore held that:

"The first issue, therefore, is whether the buyers under a sale contract on what are described as normal f.o.b. terms are entitled to open a letter of credit which requires the sellers to present "freight pre-paid" bills of lading if they are to receive payment from the buyers' bank. Absent any special agreement, the sellers are entitled to see a conforming letter of credit in place before they begin shipment of the goods, and then their obligation is to ship the contract goods on board the vessel provided by the buyers, for carriage on whatever terms as to freight and otherwise the buyers have agreed with the ship-owner. The sellers are expressly free of any obligation to pay freight (special terms apart, f.o.b. is the antithesis of c and f - cost and freight) and in the normal course they cannot be sure before shipment that the ship-owner will issue freight pre-paid bills of lading, unless they are prepared if necessary to pay the amount of freight themselves, or unless some other guaranteed payment mechanism is already in place.

[...]

The freight pre-paid requirement ... was introduced by the buyers and immediately rejected by the sellers. The buyers maintained their requirement on 29 March and it is of the essence of their case that the sellers made no further reference to it before the contract came to an end. The sellers thereafter did not act inconsistently with their previous refusal, and their silence on this matter cannot be regarded as an acceptance of the buyer's demand."<sup>172</sup>

Justice Evans further stated that:

"For these reasons, as well as those given more succinctly by Longmore J., in my judgment the buyers were not entitled to require the sellers to procure and produce freight pre-paid bills of lading in order to receive payment under the letter of credit opened by them. It follows that the buyers failed to open a letter of credit conforming with the sale contract and, subject to the question of waiver considered below, they were thereby in breach of contract."<sup>173</sup>

Thus, it is clear that if the buyer fails to open the letter of credit, it constitutes a breach of contract, for which the seller is entitled to claim damages.

In *Ian Stach Ltd v. Baker Bosley Ltd*<sup>174</sup> the plaintiff undertook to sell steel plate to the defendant. Although the seller requested buyer several times to open a letter of credit, no reply was received. The court held that it was the duty of the buyer to open the letter of credit, and failing to do so entitled the seller to claim damages. The measure of damages equalled to the loss of profit.

### Instructions given to the bank

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<sup>172</sup> Ibid

<sup>173</sup> Ibid

<sup>174</sup> [1958] 1 Lloyd's Rep. 127

In his application submitted to the bank, the buyer has to specify all relevant conditions under which the bank shall effect payment to the beneficiary. Article 5 of the UCP 500 provides that:

*“Instructions for the issuance of a Credit, the Credit itself, instructions for an amendment thereto, and the amendment itself, must be complete and precise.”*

The buyer’s instructions are of utmost importance. The bank is obliged to open the credit according to the instructions accepted. Where the buyer’s instructions are ambiguous or not consistent with other terms of the credit, the bank should try to clear these ambiguities.<sup>175</sup> However, in any case, the buyer shall bear the risk of ambiguities of his instructions.<sup>176</sup>

The ICC has developed a Standard Documentary Credit Application Form in order to:

- aid and guide all applicants in the issuance of the Documentary credit
- ensure that the instructions of the applicant to the issuing bank are given in clear, professional wording, consistent with the language in the UCP 500; and
- provide further standardization both in banking and commercial business procedures.<sup>177</sup>

The Application, among other data, should contain the followings:

- a) the name and address of the Applicant
- b) the name and address of the Beneficiary
- c) the name of the Issuing Bank
- d) the date of Application
- e) the expiry date of the credit and the place of presentation of documents
- f) the amount of the credit
- g) the type of documentary credit
- h) how the documentary credit is to be available, e.g. by payment, deferred payment, acceptance or negotiation
- i) a description of the goods
- j) the list of documents to be stipulated
- k) whether transshipment or par shipment is prohibited or not

In the followings some of the above listed elements, bearing significant relevance from the point of understanding the general operation of a letter of credit, will be discussed.

#### *The amount of the credit*

The amount of the credit should be expressed in numbers and in words as well. The currency of the credit is usually given according to the ISO Currency Code<sup>178</sup>.

Article 39(a) of the UCP 500 allows the credit to be issued containing the terms “about”, or “approximately”, or “circa” or similar expressions in connection with the amount of the credit. This means that a difference of 10 % more or 10 % less is allowed.

<sup>175</sup> For further explanation of the duty of banks to clarify the ambiguities see Chapter IV. 4.2.3.

<sup>176</sup> See Paragraph 2 of the ISBP.

<sup>177</sup> Charles del Busto (ed.), *The New Standard Documentary Credit Forms for the UCP 500* (1993), ICC Publication No. 516, p. 12

<sup>178</sup> The ISO Currency Code is the internationally standardized abbreviation for a country’s currency. The abbreviation contains three letters, eg. USD, EUR, HUF. The first two letters of the code are the two letters of the country’s internet domain name, the third is usually the initial of the currency itself.

*The goods description*

The description of the goods should be brief, not including excessive details. As Article 5(a) of the UCP 500 provides for “in order to guard against confusion and misunderstanding, banks should discourage any attempt to include excessive detail in the Credit or in any amendment thereto”.

The goods description has an important role as to the commercial invoice. Under the UCP 500 the description of the goods in the commercial invoice must correspond with the description in the credit.<sup>179</sup>

*The list of documents to be stipulated*

The determination of the documents to be presented by the seller is essential in a documentary credit transaction. It assures the buyer that payment will only be effected to the seller if the correct documents are tendered.

According to Article 5(b) of the UCP 500

*“All instructions for the issuance of a Credit and the Credit itself and, where applicable, all instructions for an amendment thereto and the amendment itself, must state precisely the document(s) against which payment, acceptance or negotiation is to be made.”*

Besides the required documents the application should state the number of documents and whether originals have to be tendered or copies are accepted as well.

The applicant should also make it sure that the seller is willing and able to provide the required documents.  
describe

*Place for presentation of the documents*

Under Article 42(a) a place for presentation of documents also has to be stated in the credit. Usually this is the city where the documentary credit is available. In case of a freely negotiable credit the seller may present the documents in:

- any place
- a specific place if it is expressly stated in the credit.

*The expiry date of the credit*

The requirement of stipulating the expiry date in the credit is stated by Article 42(a) of the UCP 500<sup>180</sup>.

Although the ICC is discouraging this manner, credits have been issued without stating an exact date of expiry. Instead, they state that the credit is available for a certain period of time, e.g. “one months”, “one year”, without stating the date from which this period is running. In order to avoid conflicts between the bank and the beneficiary, the UCP 500 now states that “the date of issuance

<sup>179</sup> Article 37 (c) of the UCP 500. This provision is further illustrated in Chapter V. 5.3.

<sup>180</sup> ‘All Credits must stipulate an expiry date and a place for presentation of documents for payment, acceptance, or with the exception of freely negotiable Credits, a place for presentation of documents for negotiation. An expiry date stipulated for payment, acceptance or negotiation will be construed to express an expiry date for presentation of documents.’

of the credit by the Issuing Bank will be deemed to be the first day from which such time is running<sup>181</sup>.

### Reimbursing the Issuing Bank

If the issuing bank effects payment under the letter of credit the applicant is obliged to reimburse the bank. This obligation is dependent upon the condition that the bank paid against strictly confirming documents.

The obligation to reimburse the issuing bank, as all other issues between the applicant and the issuing bank, are not governed by the letter of credit. It is usually governed by a separate written agreement

## **4.2.2 The rights and obligations of the Seller**

Under a contract of international sale of goods the main obligations of the seller are (a) the delivery of goods, (b) the handing over of the documents relating to the goods and (c) the transfer of property.<sup>182</sup>

The seller must deliver goods which are of the quantity, quality and description required by the contract.<sup>183</sup>

Before delivering the goods the seller receives the letter of credit, which assures payment for him. The ICC Guide to Documentary Credit Operations gives the following useful list as to the most important steps that the seller (beneficiary) should take when receiving the letter of credit.

The beneficiary should review the letter of credit to see if:

- the credit appears to be a valid credit,
- the type of the credit and its terms and conditions are in accordance with the sales contract,
- the credit does not contain any conditions which are unacceptable or impossible to comply with,
- the documents required by the credit are obtainable and presentable under the credit,
- the goods description or unit prices, if any, are as stated in the sales contract,
- there are no conditions indicated in the credit requiring payment of interest, charges, or expenses not contracted for in the sales contract,
- the shipping and expiry dates indicated in the credit and the period of presentation of the documents are sufficient to enable the beneficiary to comply with them in order to obtain payment there under,
- the port of loading, taking in charge, or place of dispatch and the port of discharge or delivery correspond to the sales contract,
- the insurance requirement (whether is to be covered by the buyer or the seller) is declared in the credit,
- the bank's obligation under the credit is conditioned on total compliance with its terms and conditions and subject to the UCP 500.<sup>184</sup>

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<sup>181</sup> Article 42(c) of the UCP 500

<sup>182</sup> See United Nations Convention on Contracts for the International Sale of Goods (1980, Vienna), Chapter II., Obligations of the seller

<sup>183</sup> Article 35 of the United Nations Convention on Contracts for the International Sale of Goods

As it was stated above, the opening of the credit by the buyer is a precondition to the seller's obligation to ship the goods. The consequences of the buyer failing to open the credit have been discussed above.<sup>185</sup>

Often the buyer does not fail to arrange for the opening of the credit, however the credit communicated to the seller does not conform to the underlying contract. This latter case involves the following possibilities: (a) the seller may object to the terms of the credit and request amendment. The proposed amendment may be discussed by the parties resulting in the issuance of a letter of credit acceptable for both parties; or (b) the seller's objection may not evoke the response of the buyer and the credit will not be amended. It has been pointed out earlier that the silence of the seller on this matter cannot be regarded as an acceptance of the non-conforming terms of the credit, thus in the lack of a properly opened credit, the seller is entitled to terminate the underlying contract and claim damages; or (c) a third possibility is that the seller proceeds as if the non-conforming terms of the credit were conforming.

#### Amendment of the irrevocable credit

The letter of credit issued by the bank should be in conformity with the underlying contract. However, there have been cases where the instructions given to the bank by the applicant resulted in the issuance of a credit, differing from the payment terms of the underlying contract between the seller and the buyer.

The issuance of the credit constitutes a binding contract between the bank and the beneficiary, thus amendment to the credit may only be carried out if all parties concerned agree. As Article 9 (d) of the UCP 500 states:

- (i) *“Except as otherwise provided by Article 48, an irrevocable Credit can neither be amended nor cancelled without the agreement of the Issuing Bank, the Confirming Bank, if any, and the Beneficiary.*
- (iii) *The terms of the original Credit (or a Credit incorporating previously accepted amendment(s)) will remain in force for the Beneficiary until the Beneficiary communicates his acceptance of the amendment to the bank that advised such amendment. The Beneficiary should give notification of acceptance or rejection of amendment(s). If the Beneficiary fails to give such notification, the tender of documents to the Nominated Bank or Issuing Bank, that conform to the Credit and to not yet accepted amendment(s), will be deemed to be notification of acceptance by the Beneficiary of such amendment(s) and as of that moment the Credit will be amended*
- (iv) *Partial acceptance of amendments contained in one and the same advice of amendment is not allowed and consequently will not be given any effect.”*

In practice the issuing bank receives instructions from the applicant to amend the credit. The issuing bank shall review the proposed amendment if it is possible to execute it. Provided that the issuing bank has no objection to the amendment, it will notify the beneficiary of the proposed amendment. In case there is an advising bank in the transaction, the issuing bank shall instruct the advising bank to communicate the amendment to the beneficiary.

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<sup>184</sup> Charles del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p.32

<sup>185</sup> See Chapter IV. 4.2.1.

If the credit is a confirmed one, the confirming bank may choose to communicate the amendment to the beneficiary without extending its confirmation to the amendment. In this case the confirming bank's obligation is still valid regarding the original credit.

The amendment constitute an offer towards the beneficiary, who – in order to effect the amendment – has to accept it. The beneficiary may accept the amendment explicitly or by tendering documents complying with the modified terms of the credit. Silence on the part of the beneficiary shall not be interpreted as acceptance of the amendment.

If the beneficiary does not wish to accept the amendment he shall inform the bank of his rejection.

The ICC has advised a standard form as to the amendment of the irrevocable credit. Carefully examining the Amendment Form it cannot go unnoticed that the Form contains a provision, stating that the “amendment is to be considered as part of the above-mentioned Credit and must be attached thereto”. However, the Form does not contain any reference to the fact, that under the UCP 500 the amendment will only be effective if the beneficiary accepts it, as explained above.

In order to assist the beneficiary in exercising his rights I believe the Amendment Forms should expressly state that for the amendment to become effective the beneficiary is requested to inform the bank of his acceptance.

#### Amendment of the revocable credit

As Article 8 of the UCP 500 provides for, a revocable credit can be amended (or even cancelled) by the issuing bank at any time, without prior notice to the beneficiary.

#### The Seller is proceeding as if the non-conforming credit was conforming

It often happens in international trade that although the letter of credit opened by the buyer does not fully conform to the agreement of the parties regarding the payment terms in the underlying contract, the seller instead of cancelling the contract, proceeds in the hope that the buyer will fulfil its obligations.

This may result in the following outcomes. The buyer may fulfil its contractual obligations and the transaction may end with the satisfaction of all parties involved. On the other hand, the buyer may fail to act according to the underlying contract or may find that the seller's performance was not in full compliance with the terms and conditions of the contract, in which case he may turn to court alleging that the seller breached its contractual obligations.

Often, as a response, the seller may claim that since the letter of credit did not conform to the underlying contract, he was not obliged to effect performance. In this scenario the court may hold that by proceeding the seller has waived the irregularity or may find that he was estopped from complaining of it. It may also be concluded that the conduct of the parties modified the underlying contract “to provide that the credit shall be in the form in which it has in fact been opened”<sup>186</sup>.

The leading case in the British case law considering the first possible court response is the *Panoutsos v. Raymond Hadley Corporation of New York*<sup>187</sup>, in which the contract provided for a confirmed bankers' credit. The credit opened, however was not a confirmed one but the seller took no objection to the letter of credit on that issue. On the contrary, he asked for the letter of

<sup>186</sup> Raymond Jack, *Documentary Credits* (1991), London p.47

<sup>187</sup> [1917] 1 KB 473, [1916-17] All ER Rep 448

credit to be extended; and it was extended. The seller made some shipment but later he cancelled the contract on the ground the letter of credit was not in conformity with the contract. The Court of Appeal held that “the seller, by waiving for a time the condition as to a confirmed credit, was not thereby bound to act upon that credit up to the end of the contract, but that he was not entitled to cancel the contract without giving the buyer reasonable notice of his intention to cancel so as to give the buyer the opportunity of complying with the conditions”<sup>188</sup>.

Lord Denning expressed the same view in the later case of *Plasticmoda Societa per Azioni v. Davidsons (Manchester) Ltd.*<sup>189</sup>, when he said that “if one party, by his conduct, leads another to believe that the strict rights arising under the contract will not be insisted upon, intending that the other should act on that belief, and he does act on it, then the first party will not afterwards be allowed to insist on the strict rights when it would be inequitable for him so to do”<sup>190</sup>. The case involved a sale of 100 tons of cable stripping by the defendant, an English company, to the plaintiff, an Italian company. The goods were to be delivered in two equal instalments. Fearing that the seller may not be able to perform, the buyer requested the bank to open a letter of credit covering only 30 tons of the goods. The buyer also made it clear to the seller several times that he is ready to open a new credit as soon as the seller sends notification that the goods are ready for shipment in a few weeks. The defendant seller never sent such notification, and the plaintiff started court proceedings for breach of contract. The defendant alleged that the breach was on the part of the plaintiff for not arranging for the proper letter of credit covering the full amount of goods. The court held that since the seller never answered to the buyer’s continuous questions as when the goods would be ready, he led the buyer to think that the full credit would be required only if the requested notice was given. This way the seller waived its right to hold the buyer liable for breach of contract.

The second type of court response, when the conduct of the parties leads to the modification of the underlying contract, may be illustrated by the case of *WJ Alan & Co Ltd v. El Nasr Export*<sup>191</sup>. The case involved two sales contracts of coffee between a seller in Kenya and a buyer in Egypt. The payment was to be effected by a confirmed, irrevocable letter of credit. However, the credit opened did not conform to the contracts of sale in several aspects. In particular, the credit was for payment in sterling, not Kenya shillings. The sellers did not complain about the letter of credit, instead, they drew on the credit in respect of the shipments and received payment in sterling. In the meantime the sterling was devalued and the seller made a claim against the buyers to be paid an extra 165,530.45 Kenya shillings in order to recover the difference in the currency. The buyer refused to pay and the seller turned to court.

The court rejected the seller’s claim. As Lord Megaw explained:

“The buyers, through the confirming bank, had opened a letter of credit which did not conform, because it provided sterling as the money of account. The sellers accepted that offer by making use of the credit to receive payment for a part of the contractual goods. By that acceptance, as the sellers must be deemed to have known, not only did the confirming bank become irrevocably bound by the terms of the offer (and by no other terms), but so also did the buyers become bound. ...

The contract had been varied in that respect.”<sup>192</sup>

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<sup>188</sup> Ibid

<sup>189</sup> [1952] 1 Lloyd’s Rep 527

<sup>190</sup> Ibid at 539

<sup>191</sup> [1972] 1 Lloyd’s Rep 313

<sup>192</sup> Ibid at 327.

### Presentation of documents

In order to receive payment, the beneficiary must tender documents strictly complying with the terms and conditions of the credit. Thus, the beneficiary should

- present the documents to the bank within the validity of the credit, and within the banking hours;
- make sure that all documents tendered are “in accordance with the terms and conditions of the credit, and not, on their face, inconsistent with one another”<sup>193</sup>.

It is an obvious requirement that the letter of credit should stipulate its expiry date. Under Article 42 of the UCP 500:

*“All Credits must stipulate an expiry date and a place for presentation of documents for payment, acceptance, or with the exception of freely negotiable Credits, a place for presentation of documents for negotiation. An expiry date stipulated for payment, acceptance or negotiation will be construed to express an expiry date for presentation of documents.”*<sup>194</sup>

The expiry date of a credit is the latest day on which documents can be presented. If the expiry date falls on a day when the bank is not open, the UCP 500 extends the time for presentation to the next following business day, when the bank is open.<sup>195</sup>

If a credit calls for transport documents to be presented by the beneficiary, the UCP 500 requires the credit to contain a provision stipulating a specific time after the shipment, during which period the presentation of the transport documents must be made.

If the applicant fails to specify the time for the presentation of the transport documents the UCP 500 presumes a period of 21 days.<sup>196</sup>

The other condition, as to the documents presented must strictly comply with the terms and conditions of the credit, is discussed in Chapter VI.<sup>197</sup>

### No short circuit of the credit

When the parties to the underlying contract agree that payment shall be effected through a letter of credit, and the credit is opened, the seller cannot short circuit the credit, that is to say, the seller has no right to avoid the bank and tender the documents directly to the buyer and request payment from him.

<sup>193</sup> Charles del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p.33

<sup>194</sup> The former version of the UCP only requested that the credit shall stipulate the expiry date but there was no provision regarding the place of presentation.

<sup>195</sup> See Article 44, which read as follows: ‘(a) If the expiry date of the Credit and/or the last day of the period of time for presentation of documents stipulated by the Credit ... falls on a day on which the bank to which presentation has to be made is closed ... the stipulated expiry date and/or the last day of the period of time after the date of shipment for presentation of documents, as the case may be, shall be extended to the first following day on which such bank is open.’ It further requires that the bank ‘to which presentation is made on such first following business day must provide a statement that the documents were presented within the time limits extended in accordance with sub-Article 44 (a) of the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500.’

<sup>196</sup> See Article 43 of the UCP 500

<sup>197</sup> See Chapter VI., 6.2

This general rule was expressed in the *Soproma SpA v. Marine & Animal By-products Corporation*<sup>198</sup> case which involved the sale and purchase of fishmeal. The seller made two tenders. First, he tendered the documents to the bank, which rightfully rejected them on the ground that the documents did not comply with the terms of the credit. Following the rejection, the seller made an other tender of documents, this time directly to the buyer. Justice McNair explained as follows:

“...the express terms of the contract “Payment: against letter of credit confirmed irrevocable with the Marine Midland Trust Co. of New York...” defines the contractual method of payment by buyers and the contractual method of performance by the sellers by which initially payment is to be obtained. ... under this form of contract the tender of documents has to be made to the bank by whom the credit has been opened or, in the case of a confirmed credit, to the bank by whom the credit has been confirmed, and that such tender of documents is the only manner in which the sellers can obtain payment. Such a conclusion, as it seems to me, is of mutual advantage to both parties – of advantage to the seller in that by the terms of the contract he is given what has been called in the authorities a “reliable paymaster” generally in his own country whom he can sue, and of advantage to the buyer in that he can make arrangements with his bankers for the provision of the necessary funds...

Under this form of contract, as it seems to me, the buyer performs his obligation as to payment if he provides for the sellers a reliable and solvent paymaster from whom he can obtain payment ...

It seems to me to be quite inconsistent with the express terms of a contract such as this to hold that the sellers have an alternative right to obtain payment from the buyers by presenting the documents directly to the buyers.”<sup>199</sup>

The position is of course different when the buyer does not provide a “reliable paymaster”, or other words, when the bank does not pay due to insolvency or any other reason, assuming of course, that the seller has tendered complying documents.

There is a general presumption that credits constitute a conditional and not an absolute payment.<sup>200</sup> It means that if the seller fulfils all his obligations under the credit but the bank nonetheless refuses to pay, then the seller is entitled to claim payment from the buyer.

In *WJ Alan & Co Ltd v. El Nasr Export*<sup>201</sup> Lord Denning held that:

“In my opinion a letter of credit is not to be regarded as absolute payment, unless the seller stipulates, expressly or impliedly, that it should be so. ... If the letter of credit is conditional payment of the price, the consequences are these: the seller looks in the first instance to the banker for payment: but, if the banker does not meet his obligations when the time comes for him to do so, the seller can have recourse to the buyer. The seller must present the documents to the banker. One of two things may then happen: (1) the banker may fail or refuse to pay or accept drafts in exchange for the documents. The seller then, of course, does not hand over the documents. He retains dominion over the goods. He can resell them and claim damages from the buyer. He can also sue the banker for not honouring the credit. ... (2) The bank may accept time drafts in exchange for the documents, but may fail to honour the drafts when the time comes. In that case the banker will have the documents and will usually have passed them on to the buyer, who

<sup>198</sup> [1966] 1 Lloyd's Rep 367. For the summary of the case, see Chapter V., 5.1

<sup>199</sup> Ibid at 385-386

<sup>200</sup> See Raymond Jack, *Documentary Credits* (1991) London, Ch. 3, Part G., Paul Todd, *Bills of Lading and Bankers' Documentary Credits* (1990) London, Section 3.2.3

<sup>201</sup> [1972] 1 Lloyd's Rep 313, For the summary of the case see Chapter IV. 4.2.2

will have paid the bank for them. The seller can then sue the banker on the drafts: or if the banker fails or is insolvent, the seller can sue the buyer. The banker's drafts are like any ordinary payment for goods by a bill of exchange. They are conditional payment, but not absolute payment. It may mean that the buyer (if he has already paid the bank) will have to pay twice over. So be it. He ought to have made sure that he employed a "reliable and solvent paymaster".<sup>202</sup>

In case the confirming bank does not or cannot pay, the seller can first turn to the issuing bank to recover payment, and in case the bank fails to effect payment he may turn to the buyer.

The buyer is liable to pay to the seller, even if he had already paid the bank. This was emphasized in the *E.D & F. Man Ltd. v. Nigerian Sweets & Confectionery Co. Ltd.*<sup>203</sup> case, where the Nigerian buyer arranged for the opening of an irrevocable letter of credit covering the purchase of crystal sugar from the plaintiff. The bank issuing the credit was partially owned by the buyer and payment was to be made by 90 days draft. The buyer received the goods and paid the bank. However, before making payment to the seller the bank became insolvent. Holding the buyer liable the court stated that the buyer's primary liability to pay the purchase price to the seller was not discharged by paying the bank.

### 4.2.3. The rights and obligations of the Bank

#### A. The Issuing Bank

##### Accepting the Instructions of the Applicant

The applicant in order to arrange for the issuance of the letter of credit submits an application to his bank. By accepting the application (the instructions of the applicant) a contractual relationship is established between the bank and the applicant.

In the *United City Merchants (Investments) Ltd v. Royal Bank of Canada*<sup>204</sup> case Lord Diplock described this relationship as follows:

"the contract between the buyer and the issuing bank under which the latter agrees to issue the credit and either itself or through a confirming bank to notify the credit to the seller and to make payments to or to the order of the seller (or to pay, accept or negotiate bills of exchange drawn by the seller) against presentation of stipulated documents; and the buyer agrees to reimburse the issuing bank for payments made under the credit. For such reimbursement the stipulated documents, if they include a document of title such as the bill of lading, constitute a security available to the issuing bank".

The content of the Application Form and the importance of the precise information given by the applicant to the bank have already been discussed above.<sup>205</sup>

The UCP 500 requires the applicant to give precise instructions.<sup>206</sup> However, often these instructions are not clear enough or contain contradicting conditions or may be against the bank's policy or the legal regulations of the country where the bank has its seat.

<sup>202</sup> Ibid at 321-322. The same was held in *Maran Road Saw Mill v. Austin Taylor & Co Ltd* ([1975] 1 Lloyd's rep. 156).

<sup>203</sup> [1977] 2 Lloyd's Rep. 50

<sup>204</sup> [1983] 1 AC 168 at 182-183

<sup>205</sup> See Chapter IV. 4.2.1.

In order to avoid this banks are requested to discourage any attempt on the applicant's side:

- to include excessive detail in the Credit or in any amendment thereto;
- to give instructions to issue, advise or confirm a Credit by reference to a Credit previously issued (similar Credit) where such previous Credit has been subject to accepted amendment(s), and/or unaccepted amendment(s).<sup>207</sup>

It is also advisable for the issuing bank to review the conditions of the credit so that it does not contain non-documentary conditions.

Article 13 (c) of the UCP 500 obliges the banks to disregard any non-documentary requirement.

It is also not without precedent in the practice that the bank notices the unclear or contradicting terms only after the issuance of the letter of credit. It is important to remember that by issuing a credit the bank enters into a contractual relationship with the beneficiary, thus any amendment to the credit can only be effected upon the beneficiary's consent (unless the credit is revocable).<sup>208</sup>

English courts approach this question enabling the bank, acting as the agent of the applicant, to interpret the ambiguous conditions at a reasonable way and to accept documents which "accord with the true construction of the credit"<sup>209</sup>.

As it was expressed in the *Midland Bank v. Seymour*<sup>210</sup> case, which involved the sale of feathers by a Hong Kong company to a British company:

"no principle is better established than that when a banker ... is given instructions..., they must be given to him with reasonable clearness. The banker is obliged to act upon them precisely. ... There is a corresponding duty cast on the giver of instructions to see that he puts them in a clear form. [Thus] when [the banker] acts upon ambiguous instructions he is not in default if he can show that he adopted what was a reasonable meaning."<sup>211</sup>

According to the facts of the case, the defendant Seymour entered into a sale contract of duck feathers with Taiyo Trading Company. Payment was to be effected by letters of credit opened by the plaintiff bank, available "by drafts at 90 days" sight against delivery of [certain] documents". The bank made payment to the Hong Kong company upon the documents tendered. The British importer later found out that the feathers were worthless goods and refused to reimburse the bank alleging that the bills of lading accepted by the bank did not comply with the terms of the credit as they did not contain a full description of the goods, their quality, price and weight.

The bank claimed that it was not necessary that the bills of lading contain the description, price and weight of goods as these data were included in other documents tendered, such as the commercial invoice and weight notes.

The court ruled for the plaintiff and held that since the letter of credit listed the documents to be tendered without specifying their exact content the bank acted within its authority and in a reasonable manner when accepted the bills of lading. It was emphasized that it is the applicant's duty to give clear instructions as to the adequacy of the documents.

In *Commercial Banking Co. of Sydney Ltd v. Jalsard Pty. Ltd.*<sup>212</sup> this view was further explained. The case involved a purchase of goods from a Thai seller. The issued letter of credit called for the

<sup>206</sup> Article 5 (a) of the UCP 500 states that 'instructions for the issuance of a Credit, the Credit itself, instructions for an amendment thereto, and the amendment itself, must be complete and precise.'

<sup>207</sup> See Article 5 (a) of the UCP 500

<sup>208</sup> See Article 9 of the UCP 500

<sup>209</sup> Raymond Jack, *Documentary Credits* (1991), p. 62

<sup>210</sup> [1955] 2 Lloyd's Rep 147

<sup>211</sup> *Ibid* at 153.

<sup>212</sup> [1972] 2 Lloyd's Rep 529

presentation of a “certificate of inspection”. The seller tendered a certificate issued by surveyors who had been supervising the packaging of the goods. The bank accepted the certificate and payment was made to the seller. Later the goods were found to be defective and it was stated that the defects would have been apparent by electrical testing instead of a visual inspection.

The court rejected the buyer’s claim for damages holding that the term “certificate of inspection” meant a certificate issued by a person who had at any rate inspected the goods. If the buyer wished to use a particular method of inspection, it should have explicitly stated it in the credit.

The court emphasized that:

“Both the issuing banker and his correspondent bank have to make quick decisions as to whether a document which has been tendered by the seller complies with the requirements of the credit at the risk of incurring liability to one or other of the parties to the transaction if the decision is wrong. Delay in deciding may in itself result in a breach of his contractual obligations to the buyer or to the seller. This is the reason for the rule that where the banker’s instructions from his customer are ambiguous or unclear he commits no breach of his contract with the buyer if he has construed them in a reasonable sense, even though upon the closer consideration which can be given to questions of construction in an action in a court of law, it is possible to say that some other meaning is to be preferred.”<sup>213</sup>

The notion of the act of a “reasonable man” is often used by common law judges. However, considering the bank’s duty to try to avoid every ambiguity in the credit from a continental legal point, one may find this interpretation too broad and flexible. An act of a “reasonable man” can only be decided on a case-by-case basis, thus cannot serve as a guideline for the bank when issuing the credit.

#### Issuance of the credit

Once the bank accepts the instructions of the applicant it becomes its duty to open the credit according to the instructions.

It is understood that the credit is regarded “opened” when it is communicated to the beneficiary by the bank.

Failing to comply with the accepted instructions of the applicant may result in the following two events: (a) the bank may be liable towards the applicant for breach of contract, or (b) if the bank had already accepted the tender of documents it may be left with these documents without being able to request reimbursement from the buyer.

In *Equitable Trust Company of New York v. Dawson Partners Ltd.*<sup>214</sup>, it was emphasized that a bank not complying strictly with the instructions of the applicant cannot request reimbursement from the applicant. Lord Atkin stated that:

“...letters of credit, like other commercial contracts, have to be carried out in strict accordance with their terms.”<sup>215</sup>

#### Form of the credit

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<sup>213</sup> Ibid at 285-286

<sup>214</sup> [1926] 25 Lloyd’s Rep. 90, the facts of the case are summarized in Chapter VI., 6.2.2.

<sup>215</sup> Ibid at 97

The UCP 500 does not require the letter of credit to be issued in a specific form. The term “text” used in Article 1<sup>216</sup> however implies that the credit should be in writing. Moreover, many of the national laws explicitly call for the credit to be in a written form.<sup>217</sup>

The ICC has developed standard forms for issuing documentary credits<sup>218</sup>, which are used worldwide with little or no modifications.

### Examination of documents

When documents are presented to the bank under the letter of credit it is the bank’s duty to examine them with “reasonable care to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the credit”<sup>219</sup>.

In case of a confirmed credit the bank examining the documents first will be the confirming bank. If it finds that the documents are strictly complying, it will effect payment to the beneficiary and will forward the documents to the issuing bank. If the documents do not comply, the confirming bank may either

- a) reject the document and send them back to the beneficiary or hold them at his disposal, or
- b) seek the instructions of the issuing bank (who will turn to the applicant for instructions) whether the documents can be accepted regardless of the discrepancies.

If the confirming bank accepts the tender, it will forward the documents to the issuing bank. The issuing bank will also examine the documents and if satisfied that the documents are conforming, it will take up the documents and reimburse the confirming bank. In case the issuing bank finds that the documents are non-complying, it has to inform the confirming bank without delay stating all the discrepancies.<sup>220</sup>

The banking Commission of the ICC clarified that when the bank rejects the documents it must provide a single notice of rejection which states all discrepancies. It is not acceptable that the bank sends several notices of rejection as it proceeds with the examination of the documents. In such a case, only the first notice is valid<sup>221</sup>.

On the other hand, if the bank sends a rejection notice without stating any discrepancies (which may be due to an administrative mistake), it is bound to honour the presentation even if valid discrepancies exist.<sup>222</sup>

Under the UCP 500 the bank has a reasonable time, not exceeding seven banking days to examine the documents and to determine whether to accept them or to reject them.<sup>223</sup> Failing to act in accordance with these provisions the bank loses its right to claim that the documents are not complying.<sup>224</sup>

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<sup>216</sup> Article 1 of the UCP 500 reads as follows: ‘The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500, shall apply to all Documentary Credits (including to the extent to which they may be applicable, Standby Letter(s) of Credit) where they are incorporated into the text of the Credit.’

<sup>217</sup> For example: Bulgaria, Czech Republic, Greece, Mexico, Slovakia

<sup>218</sup> See Charles del Busto (ed.), *The New Standard Documentary Credit Forms for the UCP 500* (1993) ICC Publication No. 516

<sup>219</sup> See Articles 13(a) and 14(b) of the UCP 500

<sup>220</sup> See Article 14(d) of the UCP 500

<sup>221</sup> Opinion of the ICC Banking Commission R271 - 1997

<sup>222</sup> Opinion of the ICC Banking Commission R329 – 1998-1999

<sup>223</sup> See Article 13(b) of the UCP 500

<sup>224</sup> See Article 14(e) of the UCP 500

Documents not stipulated by the credit will not be examined by the bank.<sup>225</sup>

Summarizing the above stated rules, if the issuing bank fails to give a timely, complete and properly communicated notice of rejection, the bank is precluded from claiming that the presented documents were not conforming and must make payment to the beneficiary.

#### Waiver of discrepancies

Article 14 of the UCP 500 allows the bank to approach the applicant for a waiver of discrepancy(ies) if it determines the documents appear on their face not to be in compliance with the terms and conditions of the credit.

The waiver of discrepancies and the notice of rejection are dealt with in the following subsections of Article 14 of the UCP 500.

- (b) *“Upon receipt of the documents the Issuing Bank and/or Confirming Bank, if any, or a Nominated Bank acting on their behalf, must determine on the basis of the documents alone whether or not they appear on their face to be in compliance with the terms and conditions of the Credit. If the documents appear on their face not to be in compliance with the terms and conditions of the Credit, such banks may refuse to take up the documents.*
- (c) *If the Issuing Bank determines that the documents appear on their face not to be in compliance with the terms and conditions of the Credit, it may in its sole judgment approach the Applicant for a waiver of the discrepancy(ies). This does not, however, extend the period mentioned in sub-Article 13 (b).*
- (d) (i) *If the Issuing Bank and/or Confirming Bank, if any, or a Nominated Bank acting on their behalf, decides to refuse the documents, it must give notice to that effect by telecommunication or, if that is not possible, by other expeditious means, without delay but no later than the close of the seventh banking day following the day of receipt of the documents. Such notice shall be given to the bank from which it received the documents, or to the Beneficiary, if it received the documents directly from him*  
 (ii) *Such notice must state all discrepancies in respect of which the bank refuses the documents and must also state whether it is holding the documents at the disposal of, or is returning them to, the presenter.*
- (e) *If the Issuing Bank and/or Confirming bank, if any, fails to act in accordance with the provisions of this Article and/or fails to hold the documents at the disposal of, or return them to, the presenter, the Issuing Bank and/or confirming bank, if any, shall be precluded from claiming that the documents are not in compliance with the terms and conditions of the Credit.”*

The referred provisions have been greatly debated among banking practitioners and legal scholars. The debates have been circulating around the following three topics:

- Whether it is acceptable to seek the applicant’s waiver for discrepancies
- If the bank turns to the applicant it cannot give notice of rejection “without delay”
- If the bank allows the applicant to review the documents in order to decide whether it will waive the discrepancies, the bank is not holding the documents at the presenter’s disposal.

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<sup>225</sup> See Article 13(a) of the UCP 500

In the following I will analyze all three possibilities based on the supposed scenario where discrepancies are found by the bank and the beneficiary does not wish to withdraw the documents tendered.

#### *Seeking the Applicant's instructions*

There has been a debate among commentators whether Article 14(c) places the beneficiary “at the mercy of the applicant” when allowing the bank to turn to the applicant for a waiver of discrepancies found in the documents. Michael Doyle argues that by allowing the buyer - and not an “impartial paymaster” - to be the “arbiter” of the documents, it may cause the letter of credit mechanism collapse.<sup>226</sup>

Bernard Wheble took the opposite view. He concluded that by authorizing the bank to approach the applicant, in its sole judgment, for a waiver of discrepancies, the true nature of the documentary credit – which is to be an instrument of payment, rather than of non-payment - is supported.<sup>227</sup>

Paul Todd also emphasizes that “banks are entitled to consult with the applicant, and are allowed time to do so, but only where they have found discrepancies entitling them to reject, and their purpose is to see if the applicants are prepared to waive the discrepancies”.<sup>228</sup>

#### *Giving notice of rejection “without delay”*

Article 14 (d)(i) commands the bank to “give notice of rejection “by telecommunication or, if that is not possible, by other expeditious means, without delay but no later than the close of the seventh banking day following the day of receipt of the documents”.

Article 14(e) further states that if the bank fails to provide timely notice it “shall be precluded from claiming that the documents are not in compliance with the terms and conditions of the Credit”.

Commentators argue that if the notice of rejection has to be communicated to the presenter “without delay”, there is “no time to inquire the applicant whether it will accept the documents”<sup>229</sup> or not.

In April 2002 the ICC Banking Commission issued a paper on discrepant documents and the right process to send a notice of rejection.<sup>230</sup> The paper envisages the following steps for banks to follow when receiving the documents. The first step is to review the documents. The second step is to decide whether the documents presented appear on their face to comply with the terms and conditions of the credit. If the documents are found to be not complying, the bank may – as a third step - approach the applicant for a waiver of discrepancies or decide to refuse the documents. It must be emphasized here, that although the bank is not obliged to turn to the applicant and seek his instructions, in the majority of the cases this is the general banking practice.

<sup>226</sup> *Does UCP 500 sub-Article 14(c) place the beneficiary-exporter “at the mercy of the buyer”?* Michael Doyle and Bernard Wheble debate In DC Insight Vol.2. No.1 Winter, 1996

<sup>227</sup> Ibid

<sup>228</sup> Paul Todd continues his article from the last DCI on the decline of strict compliance In DC Insight Vol. 6, No. 3 Summer 2000

<sup>229</sup> John F. Dolan, *Discrepant documents – to hold or not to hold* In DC Insight Vol 9. No. 4 Autumn, 2003

<sup>230</sup> See An ICC Banking Commission Recommendation, *Discrepant Documents, Waiver and Notice* at <http://www.iccwbo.org/home/banking/952rev2%20Intranet-Internet%20version%20of%20Examination%20and%20Waiver.pdf>, date visited: 1 September, 2005

If the applicant gives waiver the bank can decide to accept the waiver or not. If the bank accepts the waiver, it shall effect payment, accept or incur a deferred payment undertaking. If the bank disregards the applicant's waiver it shall send notice of rejection.

On the other hand, if the applicant's waiver is not received within the period set by the bank or the applicant does not waive the discrepancies, the bank may either decide to take up the documents nevertheless<sup>231</sup> or may send a notice of rejection to the presenter.

This paper seems to provide a clear procedure and to incur "no risk for the bank under UCP providing that it conforms specifically to the steps outlined"<sup>232</sup>. However, how can the bank, following this procedure, meet the requirement of giving notice to the presenter "without delay" whether to take up or reject the documents if – in the meantime – he turns to the applicant for instructions?

The answer may be given if we have a closer look at Step No. 3, where – according to the ICC Banking Commission - the bank may decide to refuse or seek waiver from the applicant right after it comes to the conclusion that the documents are discrepant.

Does the wording of the UCP 500 suggest this? In my understanding it does not. If we read Article 14 carefully, we may conclude the following - and in my view the right – sequence of events.

Under Article 14(b) the bank is obliged to decide whether the documents are discrepant or not. The second sentence of the article allows the bank to refuse to take up the documents if they do not comply. However, this article does not oblige the bank to decide "without delay" whether it will accept or reject the documents.

Realizing the discrepancies the bank may not be able to decide at this point whether to take up the documents or not, thus it may seek the applicant's instructions as provided for in Article 14(c). Therefore, when the bank turns to the applicant he has not yet made a decision on the faith of the documents, all he knows is that they do not strictly comply with the terms and conditions of the credit.

In order to meet the seven banking day requirement imposed upon the bank by the UCP 500, banks usually set a certain period of time within which the applicant has to give instructions whether to waive the documents or not.

The expiration of this period may result in the following scenarios:

- The applicant gives waiver to the discrepancies
- The applicant rejects the discrepancies
- The applicant does not give any instructions to the bank.

After the expiration of the period of time given to the applicant the bank finally has to make up its mind whether to accept or reject the documents. UCP 500 does not oblige the bank to follow the applicant's waiver and accept the documents. The Banking Commission's above referred paper explicitly states that the "issuing bank is not bound by an applicant's decision to waive the discrepancies"<sup>233</sup>.

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<sup>231</sup> In certain cases the bank may decide to take up the documents despite the discrepancies and despite not receiving a waiver from the applicant. This act of the bank is totally in compliance with the provisions of the UCP 500, however the bank has to give due consideration to the reimbursement agreement with the applicant.

<sup>232</sup> An ICC Banking Commission Recommendation, *Discrepant Documents, Waiver and Notice* at <http://www.iccwbo.org/home/banking/952rev2%20Intranet-Internet%20version%20of%20Examination%20and%20Waiver.pdf>, date visited: 1 September, 2005, p.7

<sup>233</sup> Ibid at p.6

When the bank makes up his mind on the faith of the discrepant documents it has to notify the presenter “without delay”, as requested by Article 14(d)(i). Thus, the “without delay” requirement is related to the communication of the decision to the presenter, not to the bank’s decision making process itself.

On the other hand, commentators emphasize that the bank is invited into the payment process as an impartial and trusted paymaster, in order to assure that if the beneficiary fulfils the requirements of the contract he will be paid. By turning to the applicant for waiver, the applicant himself and not the bank becomes the arbiter of the documents and documents may be rejected upon the non-willingness or non-ability of the buyer to pay.<sup>234</sup>

Considering the question of waiver from this aspect, one must not forget the commercial purpose of the letter of credit. Banking practice has shown that in the majority of the cases banks indeed seek the applicant’s waiver, and based on the positive answer the case is settled to the satisfaction of both beneficiary and applicant. This way the letter of credit fulfils its true purpose, to provide payment, rather than prevent it.

It was stated above that under the UCP 500 the bank is not bound by an applicant’s decision to accept the discrepancies and take up the documents.

Courts on the other hand may be of different opinion. In *Bombay Industries Inc. v. Bank of New York*<sup>235</sup>, the plaintiff entered into a contract with Collection Clothing Corp. for a sale of clothes. Payment was to be made by an irrevocable letter of credit, issued by the Bank of New York. Upon presentation of documents the bank found discrepancies and informed the plaintiff. The plaintiff authorized the bank to seek the applicant’s waiver. The applicant granted waiver, nonetheless the bank refused to accept the documents.

The Court concluded that it was a common banking practice that issuing banks would seek waivers from the applicant “because of the large percentage of presentation documents that contain discrepancies” and that “it was in the interest of all parties that such discrepancies be waived”.<sup>236</sup> The court further emphasized that a “bank which ignores, without justification, its applicant’s waiver violates the seller–beneficiary’s reliance on the bank’s neutrality”.<sup>237</sup>

Kozolchik argues that the Court’s absolutist standard is not acceptable. The UCP grants the bank a “discretionary power, but subjects it to the limits of due diligence, good faith, unconscionability and fraud”<sup>238</sup>.

#### *Holding the documents at the presenter’s disposal*

Article 14(d)(ii) requires the notice of rejection, besides stating all discrepancies, to state that the bank is holding the documents at the disposal of, or is returning them to, the presenter.

Banks have developed different responses to this requirement, which may seem practical, but may not always be upheld by courts.

Some banks insert the following text into their notice of rejection: “we are holding the documents at your disposal but if we do not receive your instructions for returning the documents when the

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<sup>234</sup> Does UCP 500 sub-Article 14(c) place the beneficiary-exporter “at the mercy of the buyer”? Michael Doyle and Bernard Wheble debate In DC Insight Vol.2.No.1 Winter ,1996

<sup>235</sup> Case reported by Boris Kozolchik in *A recent US court case interprets the “sole judgment” language of UCP sub-Article 14(c)* In DC Insight Vol. 2 No.1, Winter 1996

<sup>236</sup> Ibid

<sup>237</sup> Ibid

<sup>238</sup> Ibid

applicant waives the discrepancies listed above, we shall release the documents to the applicant without further notice to you.”<sup>239</sup>

Others try to override the relevant provisions of the UCP by inserting into the credit a clause that “the issuer retains the prerogative of securing the applicant’s waiver of the defects and delivering the documents to him after giving the notice of refusal”<sup>240</sup>.

In *Crédit Industriel et Commercial v China Merchants Bank*<sup>241</sup> the parties entered into a sales contract on 10,000 cbm. of logs. The seller presented documents under the letter of credit which were rejected by the bank. The notice of rejection stated: “Please be advised that the following discrepancies were found ... We refuse the documents according to Art 14 UCP no 500. Should the discrepancies be accepted by the Applicants, we shall release the documents to them without further notice to you unless your instructions to the contrary received prior to our payment. Documents held at your risk and for your disposal.”<sup>242</sup>

The court concluded that this notice of refusal was not in accordance with UCP 500 Article 14(d) therefore the bank could not rely on any discrepancies, since it stated that the documents were not to be returned to the presenter or held to his order. They were to be released to the applicant, within some indefinite period, in the event of the applicant accepting the discrepancies, without any notice to the presenter. Thus the notice of rejection was conditional and was in breach of the requirements of Article 14(d).

*Voest-Alpine Trading USA Corp. v. Bank of China*<sup>243</sup> is an other good illustration of the courts’ negative approach to these solutions.

In 1995 Voest-Alpine, a New York corporation entered into a sales contract with Jiangyin Foreign Trade Corporation, under which Voest-Alpine agreed to sell 1,000 metric tons of styrene monomer to the buyer. Payment was to be made by an irrevocable letter of credit issued by the Bank of China. The letter of credit stated that it is governed by the UCP 500.

The seller presented the documents through its bank to the Bank of China on 9 August. On 11 August, the Bank of China sent a telex identifying the discrepancies. However, the telex did not state that the bank was refusing the documents, instead it stated that “we are contracting the applicant for acceptance of the relative discrepancy. Holding documents at your risk and disposal”<sup>244</sup>. On 19 August, after the seven banking day period had expired, the bank finally rejected the documents stating that “now the discrepant documents may have us refuse to take up the documents according to Article 14(b) of the UCP 500”<sup>245</sup>.

Voest-Alpine filed an instant action for payment. The court, finding the bank liable for payment to the beneficiary held that the Bank of China’s refusal was “clearly deficient” and “created ambiguity by offering to contact [the Applicant] about waiver, thus leaving open the possibility that the allegedly discrepant documents might have been accepted at a future date”<sup>246</sup>.

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<sup>239</sup> *Fung King-tak on problems encountered in sending a notice of dishonour* In DC Insight Vol. 6 No. 2 Spring, 2000

<sup>240</sup> The proposal of James Barnes and Jeremy Smith is summarized by John F. Dolan, *Discrepant documents – to hold or not to hold* In DC Insight Vol 9. No. 4 Autumn, 2003

<sup>241</sup> [2002] EWHC 973, reported also in Legal cases 2002-2003, Case summaries provided by the Institute of International Banking Law and Practice

<sup>242</sup> *Ibid*

<sup>243</sup> [2002] US App, 5<sup>th</sup> Cir. see at [http://www.dhlaw.de/eng/elt/Voest-Alpine\\_v\\_Bank\\_of\\_China-condensed.pdf](http://www.dhlaw.de/eng/elt/Voest-Alpine_v_Bank_of_China-condensed.pdf), date visited: 1 September, 2005

<sup>244</sup> *Ibid*

<sup>245</sup> *Ibid*

<sup>246</sup> *Ibid* at 5

### *Proposed solution*

It can be concluded from the above analysis of Article 14 of the UCP 500 that a great percentage of the notice of refusal given by banks contains an inherent contradiction. This contradiction could be overcome if the proper meaning of Article 14 was considered.

It is emphasized again, that Article 14 does not require the bank to decide “without delay” whether to take up or reject the discrepant documents. If the bank wishes to consult the applicant, it should do so before sending the notice of rejection.

On the other hand, as suggested by commentators the banks should include a provision in the letter of credit, similar to the following: “Documents with discrepancies will be rejected. However, notwithstanding any prior notice of rejection by us, we reserve the right to accept a waiver of discrepancies from the applicant, and subject to our concurrence with such waiver, we reserve the right to release documents against such waiver without notice to the presenter, provided that no written instructions to the contrary have been received by us from the presenter before such release.”<sup>247</sup>

By including this wording into the text of the letter of credit, the consent of the beneficiary is deemed to be given by presenting document under the credit.

### Genuineness of the documents

Under the UCP 500 banks are only obliged to check if the document tendered appears on its face to comply with the terms and conditions of the credit, but they are not obliged to investigate whether the document itself is legal or a result of forgery.

In the event of fraudulent documents being presented, it is for the applicant to prove via the legal system in his country that a certain document is not genuine.<sup>248</sup>

Article 15 emphasizes, that:

*“Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s), or for the general and/or particular conditions stipulated in the document(s) or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any document(s), or for the good faith or acts and/or omissions, solvency, performance or standing of the consignors, the carriers, the forwarders, the consignees or the insurers of the goods, or any other person whomsoever.”*

Addressing the matter of original documents the ICC Banking Commission made it clear that “if a document appears to be original or to have been marked as original but is in fact not original, then its presentation may give rise to exceptional defences, rights, or obligations under the law applicable to forged or fraudulent presentations, and is beyond the scope of UCP 500”<sup>249</sup>.

As a result, banks are obliged to honour complying documents, unless legally enjoined from honour or already notified by a court.

<sup>247</sup> See Paul S. Turner, *Notices of discrepancy and requests for waiver under UCP 500 - what's the problem?* In DC Insight Vol. 10, No. 3, Summer 2004

<sup>248</sup> See Opinion of the ICC Banking Commission R341 - 1998/99

<sup>249</sup> Policy statement of the ICC Banking Commission on “Original” document in the context of UCP 500 sub-Article 20(b) issued on 12 July 1999. See at <http://www.iccwbo.org/id415/index.html>, date visited: 5 September, 2005

Force majeure

Article 17 addresses the risk of force majeure. It reads:

*“Banks assume no liability or responsibility for the consequences arising out of the interruption of their business by Acts of God, riots, civil commotions, insurrections, wars or any other causes beyond their control, or by any strikes or lockouts. Unless specifically authorised, banks will not, upon resumption of their business, pay, incur a deferred payment undertaking, accept Draft(s) or negotiate under Credits which expired during such interruption of their business.”*

Under this provision the bank is discharged from its undertaking only if the presentation of documents is not possible due to an event beyond the bank’s control.

On the other hand, if presentation of complying documents has happened in due time (before the interruption of the bank’s business activities), the bank cannot refuse payment on the ground of force majeure.

The Issuing Bank’s duty to pay

In case the issuing bank receives documents that strictly comply with the terms and conditions of the credit, it is obliged to effect payment.

As defined by Article 9 of the UCP this as an exact, reliable and foreseeable obligation, and a primary liability towards the beneficiary.

The amount defined by the credit must be available on the due date and at the place stipulated by the credit. If the due date is a non-banking day, payment has to be effected on the first banking day following the due date.<sup>250</sup>

**B. The Correspondent Bank**

In the most simple letter of credit transactions the issuing bank deals directly with the beneficiary. However, in practice, it is more usual that the issuing bank invites an other bank into the transaction, usually a bank in the beneficiary’s country. This bank is referred to as the “Correspondent Bank” and may assume the following functions:

- it may simply advise the credit, thus becoming an advising bank,
- it may ad its confirmation to the credit, thus becoming a confirming bank, or
- it may act as a nominated bank authorized to pay, accept drafts or negotiate the credit.

The Advising Bank

If the issuing bank does not authorize or request the second bank to ad its confirmation to the credit, or the issuing bank does requests confirmation but the second bank refuses to do so, it simply becomes an advising bank.

Usually, the advising bank does not have any responsibilities towards the beneficiary to effect payment, this duty remains with the issuing bank. The main role of the advising bank is to authenticate the credit and forward it to the beneficiary.

Article 7 of the UCP 500 states that:

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<sup>250</sup> See Paragraph 50 of the ISBP

- a) *“A Credit may be advised to a Beneficiary through another bank (the “Advising Bank”) without engagement on the part of the Advising Bank, but that bank, if it elects to advise the Credit, shall take reasonable care to check the apparent authenticity of the Credit which it advises. If the bank elects not to advise the Credit, it must so inform the Issuing Bank without delay.*
- b) *If the Advising Bank cannot establish such apparent authenticity it must inform, without delay, the bank from which the instructions appear to have been received that it has been unable to establish the authenticity of the Credit and if it elects nonetheless to advise the Credit it must inform the Beneficiary that it has not been able to establish the authenticity of the Credit.”*

The Credit may stipulate that documents have to be presented to the advising bank. The advising bank in this case may act simply as a forwarder of the documents to the issuing bank without assuming any liability to pay.

The credit may expressly state that the advising bank is a nominated bank, thus it will not only take up and examine the documents, but will effect payment as well. In this latter case, if the letter of credit is:

- a sight credit, the advising bank will effect payment to the beneficiary upon examination of documents
- a deferred payment credit and the draft is drawn on the advising bank, it will effect payment on a later date. If the draft is not drawn on the advising bank, it simply acts as a forwarder of documents to the issuing bank, without the duty of examining the documents.
- a negotiable credit, the advising bank will make an immediate payment to the beneficiary at a discount price.

The advising bank may also act as a so called “collecting bank”. In this case it acts as the agent of the beneficiary and collects and forwards the documents to the issuing bank. The beneficiary may also request the collecting bank to check the documents for compliance with the credit before forwarding them to the issuing bank. As Jack Raymond explains it, the reasoning behind this may be that “if there are discrepancies, a bank may be in a better position to request their waiver than the beneficiary itself. Second, the beneficiary may have been financed by the bank to obtain the goods which are the object of the transaction underlying the credit, either by way of a general overdraft arrangement or by a specific advance. In either case the bank may well require that the documents be presented through it, so that it has control of the documents in the event that the transaction goes wrong.”<sup>251</sup>

### The Confirming Bank

If a credit is confirmed a separate contractual relationship is formed between the confirming bank and the beneficiary.

As Article 9(b) of the UCP 500 provides for:

*“A confirmation of an irrevocable Credit by another bank (the “Confirming Bank”) upon the authorisation or request of the Issuing Bank, constitutes a definite undertaking of the Confirming Bank, in addition to that of the Issuing Bank, provided that the stipulated documents are presented to the Confirming Bank or to any other Nominated Bank and that the terms and conditions of the Credit are complied with:*

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<sup>251</sup> Raymond Jack, *Documentary Credits* (1991) London, p. 128

- (i) *if the Credit provides for sight payment - to pay at sight;*
- (ii) *if the Credit provides for deferred payment - to pay on the maturity date(s) determinable in accordance with the stipulations of the Credit;*
- (iii) *if the Credit provides for acceptance:*
  - a. *by the Confirming Bank - to accept Draft(s) drawn by the Beneficiary on the Confirming Bank and pay them at maturity,*
  - or
  - b. *by another drawee bank - to accept and pay at maturity Draft(s) drawn by the Beneficiary on the Confirming Bank, in the event the drawee bank stipulated in the Credit does not accept Draft(s) drawn on it, or to pay Draft(s) accepted but not paid by such drawee bank at maturity;*
- (iv) *if the Credit provides for negotiation - to negotiate without recourse to drawers and/or bona fide holders, Draft(s) drawn by the Beneficiary and/or document(s) presented under the Credit. A Credit should not be issued available by Draft(s) on the Applicant. If the Credit nevertheless calls for Draft(s) on the Applicant, banks will consider such Draft(s) as an additional document(s)."*

Under the UCP the confirming bank is obliged to the beneficiary in the same way as the issuing bank, provided that the terms and conditions of the credit are strictly complied with. Thus, the confirming bank "stands in the same position as the issuer, as the paymaster under the law of letters of credit"<sup>252</sup>.

It is understood, that the obligation of the confirming bank to honour its undertaking under the credit is "separate and independent"<sup>253</sup> from the undertaking of the issuing bank.

Often the confirming or the nominated bank is asked to pay against non-conforming documents. In such a case, if the bank decides not to reject the presentation, it may pay "under reserve" or "against an indemnity".

Payment "under reserve" allows the confirming bank to exercise recourse against the beneficiary in case the issuing bank refuses reimbursing the confirming bank based on the non-conforming documents.

If payment is made "against an indemnity" given by the beneficiary or its bank, any payment made to the beneficiary will be refunded together with interest and related charges if the issuing bank refuses to take up the documents.

### The Nominated Bank

Article 10 of the UCP 500 clarifies that "unless the Credit stipulates that it is available only with the issuing bank or if the Credit is freely negotiable, all Credits must nominate the bank authorized to pay, incur a deferred payment undertaking, accept or negotiate".

This nominated bank may be the issuing bank or an other specific bank, or any bank if the credit is freely negotiable.

A nominated bank must expressly agree on its nomination. By consenting to the nomination it becomes liable towards the beneficiary to pay, accept, or negotiate against complying documents.<sup>254</sup>

<sup>252</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 143

<sup>253</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.24

<sup>254</sup> Article 10(c) of the UCP 500

### Reimbursement of the Correspondent Bank

The issuing bank's duty to reimburse the correspondent bank, which has paid, incurred a deferred payment undertaking, accepted drafts or negotiated, is governed by Article 14(a) and Article 19 of the UCP 500.<sup>255</sup>

Article 14(a) imposes upon the issuing bank to reimburse the correspondent bank and to take up the documents if they were accepted by the correspondent bank as complying and payment has been effected to the beneficiary.

Article 19 allows the issuing bank to effect the reimbursement by instructing an other bank or branch (the "Reimbursing Bank") to reimburse the correspondent bank.

In this latter case, the reimbursing bank does not receive the documents, as they are sent directly to the issuing bank, however has to effect payment to the correspondent bank upon the instructions of the issuing bank.

Under Article 19(a) the issuing bank "shall provide such Reimbursing Bank in good time with the proper instructions or authorisation to honour such reimbursement claims".

If the reimbursing bank fails to effect payment, the issuing bank is liable to the correspondent bank not only for the amount demanded, but for any loss of interest incurred.<sup>256</sup>

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<sup>255</sup> For a discussion on this topic see *'All Credits must clearly indicate whether they are available by sight payment, by deferred payment, by acceptance or by negotiation.'* Practice clearly indicates that things are not clear, according to Vincent O'Brien In Expert View DC Insight

<sup>256</sup> See Article 19(d) of the UCP 500

## V.

### ACCOMPANYING DOCUMENTS

In international sales transactions where the transportation of goods through borders is necessary, both the seller and the buyer wish to minimize the risk they have to face due to factors like distance, difference in currency and culture, or like foreign laws and regulations. The seller wants to make sure that he receives the purchase price upon shipment of the goods. The buyer, in contrast, is not willing to pay unless he is assured that the goods are of the contracted quality and quantity and all other requirements set out in the sales contract are fulfilled.

These conflicting interests of the parties become reconcilable with the adequate listing of the documentary requirements of the letter of credit.

The documentary requirements set out in the credit form the cornerstone of the documentary credit transaction.

The type and number of documents that the beneficiary has to present to the bank in order to receive payment are specified by the applicant. This enables the applicant-buyer to set the highest level of security that he deems necessary in the particular transaction to ensure that the seller will fulfil its contractual obligations.

On the other hand, the beneficiary-seller is assured that in case he tenders the proper documents with the required content and in the correct number he will receive payment from the bank.

Banks are obliged to examine the documents tendered whether they appear on their face to be in compliance with the terms and conditions of the credit. The instructions as to the formal and contextual acceptability of the documents are given to the bank by the applicant.

Documents tendered under the UCP 500 are subject to specific requirements detailed below, unless the applicant explicitly departs from them.

Compared to the previous versions the UCP 500 has expanded the provisions concerning documents, especially those relating to the transport documents, and distinguishes between the followings:

- Transport Documents
- Insurance Documents
- Commercial Invoice
- Other Documents

#### 5.1 General requirements

Before examining the different types of documents let us summarize the general requirements applicable to all documents under the UCP 500.

##### Strict compliance<sup>257</sup>

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<sup>257</sup> For a detailed analysis of the strict compliance rule, see Chapter VI., 6.2

The most important requirement as to all kinds of documents presented under the letter of credit is that they have to comply strictly with the terms and conditions of the credit.

As Judge Bailhache stated in the case of *English, Scottish and Australian Bank Ltd v. Bank of South Africa*<sup>258</sup>:

“it is elementary to say that a person who ships in reliance on the letter of credit must do so in exact compliance with its terms. It is also elementary to say that a bank is not bound or indeed entitled to honour drafts presented to it under a letter of credit unless those drafts with the accompanying documents are in strict accord with the credit as opened”.<sup>259</sup>

It is also worth reminding ourselves of the famous sentence of Lord Sumner in the *Equitable Trust Co of New York v. Dawson Partners*<sup>260</sup>:

“it is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorized to accept are in the matter of the accompanying documents strictly observed. *There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines.*”<sup>261</sup>

Although a discrepancy in the document may not affect the value or the condition of the goods, and may appear a mere technical question, banks are obliged to consider the discrepancy and reject the document unless otherwise instructed by the applicant.<sup>262</sup>

### Consistency

As the second sentence of Article 13 of the UCP 500 provides for:

*“Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.”*

Simply stating it means, that documents that are contradicting to each other will be rejected by the bank. This may be well illustrated by the *Soproma S.p.A v. Marine & Animal BY-Products Corporation*<sup>263</sup> case, in which the contract between an American seller and an Italian buyer required the delivery of “Chilean fish full meal, steam dried, minimum 70 % protein...”. The documents tendered by the seller stated the followings:

Commercial Invoice: “Chilean fish full meal, 70 % protein”

Bill of Lading: “Chilean Fishmeal”

Analysis Certificate: “Fishmeal protein 69,7%”

Quality Certificate: “Steam-dried fish meal, Protein 67% minimum”

Health Certificate: “Fishmeal”<sup>264</sup>

Justice McNair pointed out “the documents so tendered were not a good tender against the letter of credit”<sup>265</sup> as they were not consistent with each other.

<sup>258</sup> [1922] 13 Lloyd’s Rep 21

<sup>259</sup> Ibid at 24

<sup>260</sup> [1927] 27 Lloyd’s Rep 49

<sup>261</sup> Ibid at 52 (emphasis added)

<sup>262</sup> See Article 13 of the UCP 500

<sup>263</sup> [1966] 1 Lloyd’s Rep. 367

<sup>264</sup> Ibid at 368

<sup>265</sup> Ibid at 390

The more recent case of *Credit Agricole Indosuez v. Generale Bank and Seco Steel Trading Inc. and Considar Inc.*<sup>266</sup> analysed the interesting question whether a non-documentary condition has to be consistent with the documentary conditions required by the credit. The case involved the purchase of 7000 tonnes of prime newly produced hot rolled steel by Seco Trading Inc. A letter of credit was opened in favour of the seller, Midland Resources Ltd, by Generale Bank. The credit, payable at sight at the counters of Credit Agricole Indosuez, called for an invoice and a full set of clean bills of lading and stated the latest shipment date as of 30 July, 1998. It also contained special instructions requesting the seller to provide the buyer with a notice of readiness upon which the buyer had 21 days to nominate a vessel. Failing to do so, the seller was entitled to substitute the bill of lading with a forwarders receipt dated “not earlier than 21 days after the date of notice of readiness of the goods for shipment”<sup>267</sup>. The seller tendered the following documents to the advising bank: a forwarders receipt dated 19 August; a notice of readiness dated 26 July and a statement dated 20 August, declaring that the buyer did not nominate a suitable vessel in time. The plaintiff found the documents complying and effected payment. The issuing bank however rejected the documents on the alleged discrepancy that the notice of readiness and the seller’s statement were inconsistent with each other, since the notice of readiness should have been dated on or before 9 July to allow for the 21 days grace period for the buyer to nominate a vessel as per the credit. The plaintiff claimed that since the latest shipment date did not state the document to be presented, it should be disregarded as a non-documentary condition based on Article 13(c) of the UCP 500; and the credit did not contain any specification as to the date of the notice of readiness.

The court ruled against the plaintiff and observing that the terms of the credit were “somewhat unusual”<sup>268</sup> stated that although a date requirement can be a non-documentary condition, if the dates stated on the different documents are inconsistent with each other, the presentation is discrepant. It emphasized that “the proximity of the notice of readiness to the last date of shipment ... should inevitably have raised concerns”<sup>269</sup> and should have resulted in rejection.

The Banking Commission of the ICC also dealt with the question of consistency of the documents. It was asked to clarify the meaning of Article 13 referred above (at that time it was Article 7 of the 1973 Revision). The Commission answered that “the notion of “consistency” ... should be understood as meaning that the whole of the documents must obviously relate to the same transaction, that is to say, that each should bear a relation (link) with the others on face, and the documents should not be inconsistent with one another”<sup>270</sup>.

### Original documents

It is a basic rule in letter of credit law that original documents are required unless otherwise stated by the credit. Due to modern technology it may not always be easy to decide whether a document is original, or a printed version, or a photocopy. In documentary credit operations uncertainty creates debate, which undermines the efficiency of the instrument.

Thus the drafters of the UCP felt it important to create a straightforward mechanism under which documents produced in a certain way must be treated in a certain way.

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<sup>266</sup> [2000] 1 Lloyd’s Rep. 123

<sup>267</sup> Ibid

<sup>268</sup> Ibid at 127

<sup>269</sup> Ibid at 127

<sup>270</sup> Decisions (1975-1979) of the ICC Banking Commission on queries relating to Uniform Customs and Practice for Documentary Credits, Ref. 11, ICC Publication No. 371. The same view is reflected in Paragraph 24 of the ISBP that reads as follows: ‘Documents presented under a credit must not appear to be inconsistent with each other. The requirement is not that the data content be identical, merely that the documents not be inconsistent.’

The issue of original documents is addressed by Article 20 (b) of the UCP 500 that reads:

*“Unless otherwise stipulated in the Credit, banks will also accept as an original document(s), a document(s) produced or appearing to have been produced:*

*(i) by reprographic, automated or computerized systems;*

*(ii) as carbon copies;*

*provided that it is marked as original and, where necessary, appears to be signed. A document may be signed by handwriting, by facsimile signature, by perforated signature, by stamp, by symbol, or by any other mechanical or electronic method of authentication.”*

Therefore, documents produced by the above mentioned means must be marked original, otherwise they will be discrepant.

The question of the originality of a document was the subject of three important cases:

- a) Glencore International A.G. and Bayerische Vereinsbank A.G. v. Bank of China;*
- b) Kredietbank Antwerp v. Midland Bank PLC; and*
- c) Crédit Industriel et Commercial v. China Merchants Banks*

*Glencore International A.G. and Bayerische Vereinsbank A.G. v. Bank of China*<sup>271</sup> involved a sales contract of 1.500 tonnes of aluminium ingots concluded between Glencore as the seller and Shan He Trade Co. Ltd as the buyer. Payment was effected by an irrevocable letter of credit. Bank of China in fact issued two letters of credit, one for 800 tonnes and a separate one for 700 tonnes. The credits called for presentation of various documents, including a commercial invoice, producer’s weight/packaging list and a certificate of origin.

A question arose regarding the beneficiary’s certificates which were rejected by Bank of China alleging that they “were neither original documents nor, as required by UCP 500 Article 20(b), marked as original”<sup>272</sup>. Evidence given by Glencore showed that documents created by the company were first printed with a printer then they were photocopied in the required number. Since both the printer and the photocopy machine used identical, plain white paper, “it is impossible by the ordinary eye to distinguish the printed and the photocopied versions. One document [which may either be the printed version or a copy] is then signed in ball-point pen ... for the purpose of submission under the relevant letter of credit. ... It follows that, although the document tendered is in one sense a copy, for it was produced by reprographic means, in another sense it is an original, for it is the only version of the document to bear an original handwritten signature”<sup>273</sup>.

The Trial Court rejected the plaintiff’s claim and held that “a photocopied document must be marked as original, that is to say the production of the document is one thing, and its subsequent marking is another”<sup>274</sup>.

The Court of Appeal, upholding the Trial Court’s decision, further emphasized that “a signature on a copy does not make an original, it makes an authenticated copy; and art. 20(b) does not treat a signature as a substitute for a marking as “original”, merely as an additional requirement in some cases”<sup>275</sup>.

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<sup>271</sup> [1996] 1 Lloyd’s Rep. 135

<sup>272</sup> Ibid at 149

<sup>273</sup> Ibid at 151

<sup>274</sup> Ibid at 147-148

<sup>275</sup> Ibid at 153.

The meaning of “original documents” also appeared in the later case of *Kredietbank Antwerp v. Midland Bank PLC*<sup>276</sup>, which involved the original nature of an insurance policy. The letter of credit was issued by Midland Bank on behalf of his customer, an American company in favour of the seller, a Swedish company. The letter of credit was available at the plaintiff bank by negotiation. Kredietbank discounted the credit and forwarded the documents to Midland Bank, which after scrutiny, rejected them alleging that the insurance document was not marked original. It was revealed during the trial that the insurance policy was prepared by computer and printed by a laser printer on a blue ink letter head paper, and then it was photocopied. Unlike the *Glencore* case, it was visible which one was printed and which one was photocopied.

The court held that because the document was produced, or appeared to have been produced, by computerized system it falls under the regulation of Article 20(b), in which case – following the reasoning given in *Glencore* – it should have been stamped “original”. However, if certain features of the document make it clear that it should be regarded as original (e.g.: in the present case paper bearing the original blue coloured logo and watermark of the insurance company), then it does not have to be stamped. With this reasoning the court stated that Article 20(b) does not apply to an obviously original document. Therefore, the court rejected the construction of Article 20(b) which focuses on the means of production of a document and establishes clear rules for documents produced by the means described. The Court’s decision was widely criticized by commentators emphasizing that the “obviously original” test would require banks to enter into a factual inquiry as to how the documents were produced.<sup>277</sup>

Under Article 15 of the UCP “banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s)”. Moreover they cannot and do not undertake to determine whether a document is original or not.<sup>278</sup> The bank’s duty is to determine whether a document appears on its face to be an original document. Reflecting to the number of queries received on what constitutes an “original” document under the UCP 500<sup>279</sup> the ICC Banking Commission in 1999 issued a policy statement<sup>280</sup> on the correct interpretation and application of Article 20(b). The Commission stated that:

“Banks treat as original any document bearing an apparently original signature, mark, stamp, or label of the issuer of the document, unless the document itself indicates that it is not original. Accordingly, unless a document indicates otherwise, it is treated as original if it:

- (a) appears to be written, typed, perforated, or stamped by the document issuer’s hand; or
- (b) appears to be on the document issuer’s original stationery; or
- (c) states that it is original, unless the statement appears not to apply to the document presented (e.g. because it appears to be a photocopy of another document and the statement of originality appears to apply to that other document).”

<sup>276</sup> [1999] 1 All ER (Comm) 801, the case is also available at <http://www.bailii.org>

<sup>277</sup> See Adam Johnson, *Letters of Credit and Original Documents –Again* In JIBL Issue 9, 1999 p. 287; Nick Archer and Richard Swallow report on the key case of *Kredietbank NV v. Midland Bank PLC* In DC Insight Vol.5. No.3. Summer 1999; *Kredietbank v. Midland Bank PLC* In Legal Cases 1999-2000, summaries provided by the Institute of International Banking Law and Practice.

<sup>278</sup> Except in some cases required by the UCP itself. See Articles 23( a)(iv) and 34(b)

<sup>279</sup> See for example Heinz Hertl calls for clearing up the confusion surrounding the term “original documents” in sub-Articles 20(b) and 20(c)(i) In DC Insight Vol.4. No.3. Summer 1998

<sup>280</sup> The statement bears the title ‘The determination of an “Original” document in the context of UCP 500 sub-Article 20(b)’ and was issued on 12 July 1999. See at <http://www.iccwbo.org/id415/index.html>; also *Full text of the ICC Banking Commission’s recent Decision on original documents* In DC Insight Vol.5 No.3 Summer 1999

The third case, *Crédit Industriel et Commercial v. China Merchants Banks*<sup>281</sup> from 2002, gives important guidance to how the question of “original document” should be answered in light of the *Glencore* case, the *Kredietbank* case and the ICC Policy Statement.

The case involved the sale and purchase of logs sent from Gabon to China by Societe J. Lalanne, the seller to Jiangsu Overseas Group Corporation, the buyer. In order to facilitate the payment China Merchants Bank opened an irrevocable credit, which was confirmed by Crédit Industriel et Commercial, a French bank. The credit called for several documents including a certificate of quality, a certificate of quantity and a packing list. The documents tendered by the beneficiary were accepted by the confirming bank and were forwarded to the issuing bank. On receipt, the defendant issuing bank rejected the documents alleging, among others, that no original certificate of quality, certificate of quantity and packing list had been tendered.

The court was asked to determine whether China Merchants Bank had rightly rejected the documents as non-original. On the documents tendered the name, address and telephone number of the beneficiary had been apparently stamped and they also bore an ink signature. However, they were not marked “original”.

The curiosity of the case was that it was not possible to determine the method used to produce the documents concerned. The court held that “as regards appearances:

- a) the documents did not appear to have been produced on a conventional type writer,
- b) the documents may have been photocopied or may have been produced by a computer controlled printer,
- c) the documents may not have been wholly produced at one time: the body of the document may have been inserted on a document already containing the details of name, address and so on beneath the pecked line.<sup>282</sup>

The Court’s conclusion was that in light of *Glencore* and *Kredietbank* the certificates of origins were not discrepant. The decision in *Glencore* underlined that a document created by means described in Article 20(b), whether actually an original or not, had to be marked “original” in order to be acceptable as original. In *Kredietbank* it was stated that despite a document had been prepared by means described in Article 20(b), it did not have to be marked “original” if it was obviously an original. Furthermore, it would be acceptable as an original if it clearly was an original and would have been accepted as such prior to UCP 400 and UCP 500.<sup>283</sup>

In the present case it was a common ground that the certificates presented to the issuing bank would have been accepted as originals prior to the introduction of UCP 400 and UCP500.

It is important to note that the judge considered the above mentioned Policy Statement of the ICC as the interpretation of international banking practice and rendered it binding on the parties.<sup>284</sup> He found that this way the conclusion was “consistent with the commercially beneficial aim of reinforcing standard banking practice in regard to the “appearance” of documents and consequent reduction in the risk of inconsistent decisions, all in a field crying out for international consistency”<sup>285</sup>.

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<sup>281</sup> [2002] EWHC 973 Comm, available also at <http://www.bailii.org>

<sup>282</sup> Ibid at 42, 43

<sup>283</sup> The Article on what constitutes an original document was first introduced into the UCP with the 1983 revision. With some modifications the Article was reproduced as Article 20(b) in UCP 500.

<sup>284</sup> At this respect the court also took note of the American case, *Voest Alpine Trading USA Corp. v. Bank of China* ([2002] US App, 5<sup>th</sup> Cir., where the court specifically rendered the ICC Policy Statement as determinative (see in Chapter IV, 4.2.3.).

<sup>285</sup> [2002] EWHC 973 Comm at 63

### Issuer of the Document

In case of transport documents, insurance documents and commercial invoices the UCP 500 gives a clear description as to who the issuer of the named document can be.

In case of other documents the credit itself should explicitly state the required issuer. If the credit does not so stipulate, banks will accept such documents as presented, provided that their data content is not inconsistent with any other stipulated document presented.<sup>286</sup>

Article 20 further states that:

*“Terms such as “first class”, “well known”, “qualified”, “independent”, “official”, “competent”, “local”, and the like, shall not be used to describe the issuers of any document(s) to be presented under a Credit. If such terms are incorporated in the Credit, banks will accept the relative document(s) as presented, provided that it appears on its face to be in compliance with the other terms and conditions of the Credit and not to have been issued by the Beneficiary.”*

### Issuance date

Article 22 of the UCP 500 states that:

*“Unless otherwise stipulated in the Credit, banks will accept a document bearing a date of issuance prior to that of the Credit, subject to such document being presented within the time limits set out in the Credit and in these Articles.”*

This provision first appeared in the 1983 Revision of the UCP reflecting the view of the ICC Banking Commission that “shipping documents bearing a date of issuance prior to that of the documentary credit should be accepted”<sup>287</sup>.

If documents dated prior to the issuance of the credit should not be accepted by the bank, the applicant has to give specific instructions to this regard.

### Date terminology

Under Article 47:

- a) The words “to”, “until”, “till”, “from”, and words of similar import applying to any date or period in the Credit referring to shipment will be understood to include the date mentioned.
- b) The word “after” will be understood to exclude the date mentioned.
- c) The terms “first half”, “second half”, of a month shall be construed respectively as the 1st to the 15th, and the 16th to the last day of such month, all dates inclusive.
- d) The terms “beginning”, “middle”, or “end” of a month shall be construed respectively as the 1st to the 10th, the 11th to the 20th, and the 21st to the last day of such month, all dates inclusive.

It shall be noted that these terms apply to all dates referring to shipment in the letter of credit and not to days or dates related to payment or acceptance.<sup>288</sup>

<sup>286</sup> Article 21 of the UCP 500

<sup>287</sup> Decisions (1975-1979) of the ICC Banking Commission on queries relating to Uniform Customs and Practice for Documentary Credits, Ref. 50, ICC Publication No. 371.

<sup>288</sup> The former version of the UCP applied a more general terminology, extending the ‘wording of the Article to all date terms in the Documentary Credit whether those dates were the expiry date, shipment date, payment or acceptance date’. (Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.118)

## 5.2 Transport documents

As Bernard Wheble once stated “with international trade, geographical distancing and differences in culture, language, law and local commercial usages present problems in matching delivery and payment. A link has had to be developed – and this link is the transport documents”.<sup>289</sup>

A transport document has two basic functions: (a) it evidences the contract between the shipper and the carrier; and (b) evidences the receipt of the goods by the carrier. The negotiable bill of lading also serves as a document of title.

Whereas the UCP 400 referred to three different types of transport documents (the marine bills of lading, post receipts and other transport documents), the 1993 Revision has extended their number and set out the regulations under which banks may accept these documents in relation to the following categories<sup>290</sup>:

- Marine/ocean bill of lading (Article 23.)
- Non-negotiable sea waybill (Article 24.)
- Charter Party bill of lading (Article 25.)
- Multimodal transport documents (Article 26.)
- Air transport documents (Article 27.)
- Road, rail or inland waterway transport documents (Article 28.)
- Courier and post receipts (Article 29.)
- Transport documents issued by freights forwarders (Article 30.)

### 5.2.1 Marine/ocean bill of lading

The bill of lading is the “creation of the mercantile custom, a typical institution of international trade”<sup>291</sup>, which has been widely used in international trade from the 13<sup>th</sup> century<sup>292</sup>. An early appearance of the bill of lading from 1248 reads as follows:

“We, Eustace Cazal and Peter Amiel, carriers, confess and acknowledge to you, Falcon of Acre and John Confortance of Acre, that we have had and received from you twelve full loads of brazil wood and nine of pepper and seventeen and a half of ginger for the purpose of taking them from Toulouse to Provence, to the fairs of Provence to be held in the coming May, at a price or charge of four pounds and fifteen solidi in Vienne currency for each of the said loads. And we confess we have had this from you in money, renouncing, etc. And we promise by this agreement to carry and look well after those said loads with our animals, without carts, and to return them to you at the beginning of those fairs and to

<sup>289</sup> Bernard S. Wheble on the reasoning behind the UCP Transport Articles In DC Insight, Vol.1.No.1 Winter, 1995

<sup>290</sup> The reason why it became necessary to rewrite the Articles of UCP 400 addressing the transport documents was that since the drafting of the UCP 400 various modes of transport have developed that were not covered by the regulations.

<sup>291</sup> Schmitthoff's *Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London, p.267. For a detailed description of the operation of the bill of lading, see Schmitthoff's *Export Trade – The Law and Practice of International Trade* (10th ed., 2000) Ch. 15; Paul Todd, *Bills of Lading and Bankers' Documentary Credits* (1990) Ch. 4

<sup>292</sup> Gerard Malynes' famous book of *Consuetudo vel Lex Mercatoria*, which was published in 1622 in London stated that ‘bills of lading are commonly to be in print in all places and several languages’. (op.cit. at 97)

wait upon you and do all the things which carriers are accustomed to do for merchants. Pledging all our goods, etc.; renouncing the protection of all laws, etc.”<sup>293</sup>

The mercantile use of the bill of lading was judicially recognized in the often quoted case of *Lickbarrow v. Mason*<sup>294</sup> in 1794, in which the court held that by the custom of merchants the delivery of a bill of lading transferred the property in the goods, that is to say, it was recognised as a document of title.

In the harmonisation of laws related to bills of lading, one of the most important international instruments is the International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading (“Hague Rules”)<sup>295</sup> of 1924, which was revised by the Brussels Protocol in 1968 (known as the “Hague –Visby Rules”)<sup>296</sup>.

At the request of the developing countries<sup>297</sup> the UNCITRAL drafted a new convention, called the United Nations Convention on the Carriage of Goods by Sea, which was adopted in 1978 in Hamburg (and is often referred to as the “Hamburg Rules”). The Hamburg Rules entered into force on November 1, 1992. Up until today, the Convention has been ratified by 30 countries<sup>298</sup>, however the big shipping nations have not accepted it.

At its 34th session in 2001 the UNCITRAL established a Working Group to commence works “towards an international instrument, possibly having the nature of an international treaty, that would modernize the law of carriage, take into account the latest developments in technology, including electronic commerce, and eliminate legal difficulties in the international transport of goods by sea”<sup>299</sup>. The Working Group commenced drafting an instrument on the carriage of goods - wholly or partly - by sea in 2002 in close cooperation with interested international organizations, among others with the Comité Maritime International (CMI), the International federation of freight Forwarders (FIATA), the Baltic and International Maritime Council (BIMCO), the International Chamber of Commerce (ICC), and the International Chamber of Shipping (ICS). The process of drafting a new convention has not yet been concluded.

The bill of lading serves three basic purposes. It is:

- a formal receipt by the ship-owner acknowledging that the goods were received for shipment
- an evidence of contract of carriage between the shipper and the carrier
- a document of title enabling the person entitled to the goods to dispose of them while the goods are in transit. “By mercantile custom, possession of the bill is in many respects equivalent to possession of goods [the holder of the bill of lading has constructive

<sup>293</sup>L. Blancard, ed., *Documents Inédits sur le Commerce de Marseille au Moyen Age*, (Marseille: Barlatier-Feissat, Pere et Fils, 1884), Vol. II., p. 109; reprinted in Roy C. Cave & Herbert H. Coulson, eds., *A Source Book for Medieval Economic History*, (Milwaukee: The Bruce Publishing Co., 1936; reprint ed., New York: Biblio & Tannen, 1965), pp. 159-160. The text has been modernized by Prof. Jerome Arkenberg

<sup>294</sup> [1794] 5 T.R. 683

<sup>295</sup> It entered into force on 2 June, 1931

<sup>296</sup> It entered into force on 23 June 1977.

<sup>297</sup> One of the main reasons for the revision of the Hague-Visby Rules was that the Hague-Visby rules contain a list of exclusions under which the carrier is not liable for the damage or loss of goods. One of the exclusions is the so called ‘error in navigation’. For further information see Bánrévy Gábor, *A nemzetközi gazdasági kapcsolatok joga* (2003) Ch. 4.

<sup>298</sup> See <http://www.uncitral.org> on the Status of the Convention

<sup>299</sup> Report of the Secretary-General on the Possible future work on transport law, A/CN.9/497 2 May, 2001 at <http://daccessdds.un.org/doc/UNDOC/GEN/V01/831/87/PDF/V0183187.pdf?OpenElement>, date visited: 25 July 2005.

possession of the goods; the actual possession is with the carrier as long as the goods are in his charge] and the transfer of the bill of lading has normally the same effect as the delivery of the goods themselves. This is why it is referred to as a document of title.”<sup>300</sup>

It can be:

- non-negotiable (or straight), meaning that the title to the goods is not transferable to another party by endorsement; or
- negotiable, which means that the title to the goods is transferable to another party by endorsement.<sup>301</sup>

The UCP 500 sets the following requirements to a marine bill of lading covering a port-to-port shipment. The bill of lading must:

- appear on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by the carrier, the master or their named agent (indicating on whose behalf he is signing the document)<sup>302</sup>;
- indicate that the goods have been loaded on board, or shipped on a named vessel;
- indicate the port of loading and the port of discharge as stipulated by the credit;
- appear to contain all terms of carriage. Some of these terms may be contained in a separate document, in which case the bill of lading must refer to this document.
- contain no indication that it is subject to a charter party and/or no indication that the carrying vessel is propelled by sail only;
- comply with all requirements of the credit.

A bill of lading can be issued in a sole original, or in a set. A set contains at least two original documents, however, in practice, a set of three originals is the most common.<sup>303</sup> Usually the letter of credit will require the presentation of the full set, meaning the presentation of all the original documents.

In relation to transshipment<sup>304</sup>, under the UCP 500 a bank may accept a bill of lading indicating that transshipment will take place, even though the credit itself prohibits transshipment. “If the goods are transported in containers, trailers or LASH barges<sup>305</sup> then the practice in the transport industry is that the goods may be carried from port “A” to port “B” directly, or at time the goods may be unloaded onto smaller feeder vessels that have the capacity to navigate into the main port itself. The unloading and reloading of the goods may take place directly onto a feeder vessel. ... This industry practice is worldwide and it is not considered ... to constitute transshipment.”<sup>306</sup>

<sup>300</sup> *Schmitthoff's Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London, p.289.

<sup>301</sup> In bills of lading there is usually a box on the left hand side stating ‘Consignee (if ‘Order’ state Notify Party)’. If the shipper intends to obtain a negotiable bill of lading this box should be filled in.

<sup>302</sup> Note that the UCP 400 only required the bill of lading to be issued by the carrier or his agent.

<sup>303</sup> The number of original bills of lading may be expressed as 2/2 (read as ‘two of two’) or 3/3 (read as ‘three of three’). The sole bill of lading is usually indicated as 1/1 (read as ‘one of one’).

<sup>304</sup> The ISBP defines transshipment as ‘unloading and reloading of goods from one vessel to another during the course of ocean carriage from the port of loading to the port of discharge stipulated in the credit’. (Paragraph 87)

<sup>305</sup> LASH, an acronym for **L**ighter **A**board **S**hip vessels each carry about 82 LASH barges. The barges, all of a standard size with cargo capacity of 385 tons, are towed in ports and on inland waterways to various shipping points where they are loaded with cargo and then returned to the oceangoing vessel. They are hoisted aboard by a special shipboard gantry-type crane and transported overseas where the process is reversed. LASH ships do not require special docks or terminals. (<http://www.waterman-steamship.com/lash.htm>, date visited: 25 July, 2005)

<sup>306</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.68

### 5.2.2. Non-negotiable sea waybills

Sea waybills are documents that – unlike the bill of lading – give no title to the goods, thus they do not need to be presented at the port of destination to take delivery of the goods. When a sea waybill is involved in the transaction, the carrier will deliver the goods to the person specifically named in the document upon proof of identity (unlike in case of a bill of lading, where the carrier delivers the goods against presentation of the document), thus a sea waybill is non-negotiable.

It also evidences the contract of carriage and constitutes a receipt for the goods by the carrier.

Generally, in order to protect its rights, the bank – accepting a sea waybill – would name itself as consignee and its applicant (the buyer) as the party to be notified.

According to Article 24 of the UCP 500<sup>307</sup>, a non-negotiable sea waybill has to

- appear on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by the carrier or the master or by their named agent (stating on whose behalf he is signing the document)
- indicate that the goods have been loaded on board, or shipped on a named vessel;
- indicate the port of loading and the port of discharge as stipulated by the credit;
- appear to contain all terms of carriage. Some of these terms may be contained in a separate document, in which case the bill of lading must refer to this document.
- contain no indication that it is subject to a charter party and/or no indication that the carrying vessel is propelled by sail only;
- comply with all requirements of the credit.

The provisions of the sea waybill are similar to those of the bill of lading.

### 5.2.3. Charter Party Bill of Lading

The term “charter party” refers to a contract between the owner of a vessel and the charterer (shipper). Under the charter party contract the owner of the vessel agrees to “rent” the whole or part of the vessel to the shipper who, using the vessel, delivers the cargo to a specific destination port.

The various conditions of transport and delivery and the responsibilities of each charter party, including the freight rate and when it is payable, are regulated under the contract.

There are three main types of charter:

- *Voyage (Line) Charter*: the charterer hires the vessel for a single voyage. The vessel is operated by the owner and his crew.
- *Time Charter*: the vessel is hired for a specific period of time under a permanent arrangement of the parties. Under a time charter the charterer selects the ports of destination and controls the operation of the ship.
- *Demise or Bareboat Charter*: the charterer takes full control of the vessel. The charterer bears the full costs of operation of the vessel along with the legal responsibility.

Article 25 of the UCP states that a charter party bill of lading has to

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<sup>307</sup> This article is a new article in the UCP, which did not appear before the 1993 Revision. Since the use of non-negotiable sea waybills has increased in the European, Scandinavian, North American and Far Eastern regions, the ICC decided to address this document in the UCP 500.

- contain that it is subject to a charter party;
- appear on its face to have been signed or otherwise authenticated by the master or the owner or by their named agent (stating on whose behalf he is signing the document);
- indicate that the goods have been loaded on board, or shipped on a named vessel;
- indicate the port of loading and the port of discharge as stipulated by the credit;
- contain no indication that the carrying vessel is propelled by sail only;
- comply with all requirements of the credit.

Under the UCP 500 the bank is not obliged to examine the charter party contract.

#### **5.2.4. Multimodal transport documents**

The quick development of the transport technology including the advent of containers has made it possible to transport goods from one country to another on a door-to-door basis, using more than one mode of transport and more than one carrier. By stowing the goods into containers, they can be transported from the port of origin to the port of destination by different means of transportation, such as railway wagons, road vehicles, aircrafts or ships, without being unpacked. In the chain of the transport it has proved to be more practical to use a single operator who would be responsible for the loss or damage during the overall transport, than involving several unimodal carriers.

Such unbroken multimodal transportation of goods is being done under a single transport document, called a “Multimodal (Combined) Transport Document”.

The first attempts to harmonise the rules of multimodal transport<sup>308</sup> took place in the 1960’s under the auspices of the International Institute for the Unification of Private Law (UNIDROIT)<sup>309</sup> and the Comité Maritime International (CMI)<sup>310</sup>. The UNIDROIT drafted the so called Draft TCM<sup>311</sup> Convention (Draft Convention on the International Combined Transport of Goods), which has, however, never entered into force due to the little support it received.

Foreseeing the risk that without an international convention applicable to multimodal transport the commercial parties offering these modes of transport would have to provide their own documents suitable to their needs, which may lead to the development of several types of multimodal transport documents, the ICC issued the so-called ICC Uniform Rules for a Combined Transport Document<sup>312</sup> in 1973.

In 1975 the Rules were revised in order to take into account the practical difficulties of application concerning the multimodal operator’s liability for delay.

The main aim of the Rules was to provide some uniformity, which has been achieved by the fact that it forms the basis of the most widely used multimodal transport documents such as the COMBIDOC Combined Transport Document issued by BIMCO (The Baltic and International

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<sup>308</sup> For more information on the history of harmonizing the rules on multimodal transport see the Report of the UNCTAD Secretariat on the Implementation of Multimodal Transport Rules, 25 June, 2001 at <http://www.unctad.org/en/docs/posdtetlbd2.en.pdf>, date visited: 26 July, 2005

<sup>309</sup> The UNIDROIT is an independent intergovernmental organization set up in 1926 in order to prepare modern and where appropriate harmonised uniform rules of private law (mainly substantive law). The seat of the organization is in Rome. For further information visit <http://www.unidroit.org>

<sup>310</sup> The CMI, which was formally established in 1897, is the oldest international organization in the maritime field, seated in Antwerp. Its objective is to contribute by all means and activities to the unification of maritime law. For further information visit <http://www.comitemaritime.org>

<sup>311</sup> The abbreviation uses the French acronym for ‘Transport Combiné de Marchandises’.

<sup>312</sup> ICC Publication No. 298

Maritime Council)<sup>313</sup> in 1977 and the FIATA (The International Federation of Freight Forwarders' Associations)<sup>314</sup> combined Transport Bill of Lading.

In 1980 a new convention was born under the auspice of the United Nations. The United Nations Convention on International Multimodal Transport of Goods (The MT Convention) was drafted in order to "stimulate the development of smooth, economic and efficient multimodal transport services adequate to the requirements of the trade concerned, to ensure the orderly development of international multimodal transport in the interest of all countries and the need to consider the special problems of transit countries and to determine certain rules, including equitable provisions concerning the liability of multimodal transport operators"<sup>315</sup>. This convention has not been widely accepted either.

As a result, the Committee on Shipping of UNCTAD<sup>316</sup> instructed the UNCTAD Secretariat, in close co-operation with other industry parties, to "elaborate provisions for multimodal transport documents based on the Hague Rules<sup>317</sup> and the Hague-Visby Rules and the existing ICC Uniform Rules for a Combined Transport Document. This initiative resulted in the joint UNCTAD/ICC Rules for Multimodal Transport Documents<sup>318</sup> which entered into force from 1 January 1992, effectively superseding the previous ICC Uniform Rules."<sup>319</sup>

The most authoritative definition for the multimodal transport and its related instrument is given by the MT Convention, according to which:

*"International multimodal transport"* means the carriage of goods by at least two different modes of transport on the basis of a multimodal transport contract from a place in one country at which the goods are taken in charge by the multimodal transport operator to a place designated for delivery situated in a different country.<sup>320</sup>

*"Multimodal transport operator"* means any person who on his own behalf or through another person acting on his behalf concludes a multimodal transport contract and who acts as a principal, not as an agent or on behalf of the consignor or of the carriers

<sup>313</sup> BIMCO, one of the world's largest and most diverse private shipping organizations, traces its origins back to 1905, when 112 distinguished gentlemen assembled in Copenhagen and formed the organisation. Today, BIMCO's members includes more than 2,550 companies from 123 countries. For further information visit <http://www.bimco.dk>

<sup>314</sup> FIATA, a non-governmental organization founded in 1926, represents an industry covering approximately 40,000 forwarding and logistics firms, known as the "Architects of Transport". For further information visit <http://www.fiata.com>

<sup>315</sup> See Preamble of the United Nations Convention on International Multimodal Transport of Goods, Geneva 24 May, 1980 at <http://www.jus.uio.no/lm/un.multimodal.transport.1980/pre>, date visited: 26 July, 2005.

<sup>316</sup> United Nations Conference on Trade and Development (UNCTAD) is a permanent organ of the General Assembly of the United Nations, established by General Assembly resolution 1995 (XIX). The general aim of UNCTAD is to promote international trade and economic development, especially those of developing countries. (<http://r0.unctad.org/en/subsites/multimod/mt2brf0.htm>, date visited: 26 July, 2005)

<sup>317</sup> International Convention for the Unification of Certain Rules of Law relating to Bills of Lading ('Hague Rules'), 1924. The Hague Rules represented the first attempt by the international community to find a solution to the problem of ship owners regularly excluding themselves from all liability for loss or damage of cargo. Under the Hague Rules the shipper bears the cost of lost/damaged goods if they cannot prove that the vessel was unseaworthy, improperly manned or unable to safely transport and preserve the cargo. Thus, the carrier can avoid liability for risks resulting from human errors provided they exercise due diligence and their vessel is properly manned and seaworthy..

<sup>318</sup> ICC Publication No. 481.

<sup>319</sup> <http://www.bimco.dk/Corporate%20Area/Documents/Document%20samples/Waybills%20and%20Cargo%20Receipts/MULTIWAYBILL%2095.aspx>, date visited: 26 July, 2005

<sup>320</sup> Article 1.1

participating in the multimodal transport operations, and who assumes responsibility for the performance of the contract.<sup>321</sup>

“*Multimodal transport contract*” means a contract whereby a multimodal transport operator undertakes, against payment of freight, to perform or to procure the performance of international multimodal transport.<sup>322</sup>

“*Multimodal transport document*” means a document which evidences a multimodal transport contract, the taking in charge of the goods by the multimodal transport operator, and an undertaking by him to deliver the goods in accordance with the terms of that contract.<sup>323</sup>

The UNCTAD/ICC Rules define the multimodal transport document with the following alteration:

“*Multimodal transport document*” (MT document) means a document evidencing a multimodal transport contract and which can be replaced by electronic data interchange messages insofar as permitted by applicable law and be,

- (a) issued in a negotiable form or,
- (b) issued in a non-negotiable form indicating a named consignee.<sup>324</sup>

The UNCTAD/ICC Rules do not have the force of law, they gain legal effect by being incorporated it into the multimodal transport contract.

Therefore, in 2000 the UNCTAD has launched a new initiative to try to draft an international convention on multimodal transport.<sup>325</sup> The work is currently in progress.

Realizing that “the Documentary Practice should reflect the transport industry’s evolution and the extensive number of shipments made under a multimodal transport contract of carriage”<sup>326</sup> the ICC established the following rules in UCP 500.

Under Article 26 banks will accept a document, however named, that

- appears on its face to indicate the name of the carrier or multimodal transport operator and to have been signed or otherwise authenticated by the carrier, or the multimodal transport operator, or the master or by their named agent (stating on whose behalf he is signing the document)
- indicates that the goods have been dispatched, taken in charge or loaded on board;
- indicates the place of taking in charge stipulated by the credit which may be different from the port, airport or place of loading, and a place of final destination stipulated by the credit which may be different from the port of discharge;
- appears to contain the terms of carriage or merely contains some or all of such conditions by reference to a source or document other than the multimodal transport document;
- contains no indication that it is subject to a charter party and/or no indication that the carrying vessel is propelled by sail only;
- complies with all requirements of the credit.

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<sup>321</sup> Article 1.2

<sup>322</sup> Article 1.3

<sup>323</sup> Article 1.4

<sup>324</sup> Article 2.6

<sup>325</sup> See the Report by the UNCTAD Secretariat on Multimodal Transport: The feasibility of an international legal instrument, 13 January, 2003 at [http://www.unctad.org/en/docs/sdtetlb20031\\_en.pdf](http://www.unctad.org/en/docs/sdtetlb20031_en.pdf), date visited: 27 July, 2005

<sup>326</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.77

Even if the credit prohibits transshipment, banks will accept a multimodal transport document which indicates that transshipment will or may take place, provided that the entire carriage is covered by one and the same multimodal transport document.

### 5.2.5. Air transport documents

The regulation of air transport document is a new article incorporated into the UCP 500. Air waybills serve the same function as bills of lading when the goods are transported via air. It is a receipt for goods and an evidence of the contract of carriage, but it is not a document of title to the goods.

Under Article 27 the air waybill has to meet the following requirements. It has to:

- appear on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by the carrier or its named agent on behalf of the carrier;
- indicate that the goods have been accepted for carriage;
- indicate the date of dispatch<sup>327</sup>;
- indicate the airport of departure and the airport of destination;
- appear to contain all terms of carriage, or some of such terms and conditions, by reference to a source or document other than the air transport document;
- comply with all requirements of the credit.

If the air waybill indicates that transshipment will or may take place, then the transshipment is allowed regardless of the prohibition in the letter of credit, provided that the entire carriage is covered by one and the same air transport document.

The air waybill is usually issued in a set of twelve copies, out of which the first three samples are deemed to be originals. The first original is signed by the consignor (or its agent), the second original, which accompanies the goods, is signed by the carrier, and the third original is signed by the carrier, and is handed to the consignor or its agent after the goods have been accepted for carriage. If the letter of credit requires a full set of original, presentation of the third original is satisfactory.

### 5.2.6. Road, rail or inland waterway transport documents<sup>328</sup>

The new Article 28 of the UCP covers the requirements of a road, rail or inland waterway transport document, according to which, the banks will accept such document, however named, if it

- appears on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by the carrier or its named agent on behalf of the carrier;
- bears a reception stamp or other indication of receipt<sup>329</sup>;

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<sup>327</sup> If the credit does not require the indication of the date of dispatch, the date of issuance of the air waybill will be deemed to be the date of shipment

<sup>328</sup> International transport of goods overland is carried out by the following main international conventions: the Convention on the Contract for the International Carriage of Goods by Road (CMR) of 1956; and the Convention Concerning the Carriage of Goods by Rail (CIM) of 1961, which became the Appendix of the Convention Concerning the International Carriage by Rail (COTIF from Convention de l'Organisation Intergouvernementale pour les Transports Internationaux Ferroviaires) in 1980 and is generally referred to as the CIM-COTIF Convention. The inland waterway transport is regulated by the Budapest Convention on the Contract for Carriage of Goods in Inland Waterways (CMNI) of 2000.

- indicates that the goods have been received for shipment, dispatch or carriage or wording to this effect;
- indicates the place of shipment and the place of destination;
- complies with all requirements of the credit.

The road, rail or inland waterway transport document serves as a receipt for goods and an evidence of the contract of carriage, but it is not a document of title to the goods.

Transshipment is allowed as indicated above in case of an air waybill.

### **5.2.7. Courier and post receipts**

The courier receipt is a transport document issued by a courier (or expedited delivery service), whereas the post receipt (or postal receipt, or certificate of posting) is a transport document issued by the post office for goods sent by parcel post.

Article 29 of the UCP 500, which is a rewritten version of the former Article 30 of the UCP 400<sup>330</sup>, regulates the requirements relating to courier and post receipts. According to the Article, the

- post receipt has to appear on its face to have been stamped or otherwise authenticated and dated in the place from which the Credit stipulates the goods are to be shipped or dispatched;
- courier receipt has to evidence the receipt of goods for delivery provided that it appears to indicate on its face the name of the courier. Furthermore, it has to be stamped, signed or otherwise authenticated by the courier. It also has to indicate a date of pick-up or of receipt or wording to this effect.

### **5.2.8. Transport documents issued by freights forwarders**

Transport document issued by freight forwarders<sup>331</sup> are acceptable since the 1983 Revision of the UCP.<sup>332</sup>

A freight forwarder is a company or individual, who renders cargo delivery, that is to say, arranging for the delivery of goods from the point of origin to the point of destination. It is responsible for completing all procedural and documentation formalities involved in custom and port clearance on behalf of the shipper, and - if necessary - for arranging for warehousing of cargo before shipment. A freight forwarder also assists the exporter in “selecting economical shipping routes; arranging packaging and marking of shipments; preparing shipping and regulatory documents; delivering goods to carriers; collecting transport documents; arranging insurance and processing claims; booking shipping space; and providing advice on the relative costs of sending goods by sea and air.”<sup>333</sup>

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<sup>329</sup> If the document contains a reception stamp, the date of the reception stamp is considered to be the date of shipment. Otherwise, the date of issuance shall be considered to be the date of shipment.

<sup>330</sup> The UCP 400 only regulated shipments by post. The Working Group of the ICC however felt it necessary to include the possibility of shipment by courier.

<sup>331</sup> The international organization of freight forwarders is the FIATA (International Federation of Freight Forwarders Associations) which acts as an umbrella organisation for the national and regional associations of freight forwarders throughout the world. For further information visit <http://www.fiata.com>.

<sup>332</sup> See Article 25 and 26 of the UCP 400

<sup>333</sup> <http://www.ociped.com/ts/112.htm>, date visited: 30 July, 2005

The current regulation of the UCP 500 in Article 30 indicates that “any freight forwarder”’s document will be accepted by the bank provided: (1) it is authorized in the Credit, or (2) it is issued and signed by the freight forwarder according to the conditions of the UCP 500<sup>334</sup>.

These conditions require the transport document to be issued by a freight forwarding company acting

- as a carrier or multimodal transport operator; or
- as an agent for or on behalf of the carrier or multimodal transport operator.

### 5.2.9. Regulations common to all transport documents

#### “Clean” or “claused” transport documents

A transport document can be “clean” or “claused” (or as often called “foul”). A clean transport document bears no notation expressly declaring the defective nature of the goods and/or the packaging. The transport document usually states that the goods were received “in apparent good order and condition”.

As opposed to a clean transport document, a claused transport document bears an indication that the goods were received with irregularities, damages, or short shipment. This fact is referred to by the terms “unclean on board”, “insufficient packing”, “missing safety seal”, “one carton short” or the like.

Under Article 32 of the UCP 500 banks will not accept a transport document that is not clean<sup>335</sup>, unless the credit expressly authorizes the bank to accept a foul document. Banks cannot of course judge what kind of clause or notation is acceptable. Therefore, in order to avoid misunderstanding, the applicant has to state expressly the specific clause allowed to appear on a transport document.

Practice has shown that many banks only accepted transport documents bearing the term “clean”. In order to stop this practice the Working Group of the ICC included into the 1993 Revision of the UCP that the word “clean” does not need to appear provided the transport document does not indicate that the goods and/or packaging are defective.<sup>336</sup>

The difficulties arising from the “cleanness” of a bill of lading can be described by the *Galatia*<sup>337</sup> case. The *Galatia* involved the sales of sugar. The seller shipped the sugar, a part of which was destroyed in a fire after loading. This part of the cargo had to be unloaded and a separate bill of lading was issued in relation to that part of the cargo stating that it had been loaded in apparent good order and condition, but bore a typewritten notation saying that “Cargo covered by this bill of lading has been discharged Kandla view damaged by fire and/or water used to extinguish fire for which general average declared”<sup>338</sup>.

<sup>334</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.87

<sup>335</sup> In common law jurisdictions the general view is that a clean bill of lading is required even if the credit is silent on this point. As Judge Salmon stated in the *British Imex Industries Ltd v. Midland Bank Ltd* case: ‘the letter of credit stipulated that payment would be made against bills of lading without qualification. The plaintiffs suggest that this does not necessarily mean clean bill of lading. In my judgment, when a credit calls for bills of lading, in normal circumstances it means clean bills of lading. I think that in normal circumstances the ordinary business man who undertakes to pay against presentation of bills of lading means clean bills of lading: and he would probably consider that that was so obvious to any other business man that it was hardly necessary to state it’. [1958] 1 QB 542. at 551

<sup>336</sup> Article 32(c) of the UCP 500

<sup>337</sup> *Golodetz & Co Inc v. Czarnikow-Rionda Co Inc* [1979] 2 Lloyd’s Rep 450

<sup>338</sup> *Ibid* at 451

The Court of Appeal held that the clause stating that the cargo had been damaged after loading did not render the bill of lading unclean.

### Payment of freight

The term “freight” refers to the transportation charges. Depending on the international commercial term used under the contract, the shipper or the consignee may be responsible for paying the freight.<sup>339</sup>

The term “freight prepaid” refers to the fact that the freight has been paid or prepaid by the shipper. On the other hand, the term “freight collect” means that the freight has to be paid by the consignee at destination.

Realising that no uniform rules can be established in relation to the payment of freight, the UCP 500 contains the following rule in Article 33:

- a) *“Unless otherwise stipulated in the Credit, or inconsistent with any of the documents presented under the Credit, banks will accept transport documents stating that freight or transportation charges (hereafter referred to as “freight”) have still to be paid.*
- b) *If a credit stipulates that the transport document has to indicate that freight has been paid or prepaid, banks will accept a transport document on which words clearly indicating payment or prepayment of freight appear by stamp or otherwise, or on which payment or prepayment of freight is indicated by other means.”*

### **5.3. The Commercial Invoice**

The commercial invoice is the “accounting document by which the seller claims payment from the buyer for the value of the goods and/or services being supplied”<sup>340</sup>.

The commercial invoice is the primary document that describes the goods in relation to which the presentation of documents is made and states the price which is being claimed from the bank.

A commercial invoice normally contains the followings:

- name and address of the seller
- date of issue
- invoice number
- name and address of the buyer
- quantity and description of the goods
- unit price
- total invoice price
- terms of delivery and payment
- shipping details
- other information required by the documentary credit

### Name and address of the buyer

<sup>339</sup> For example, under a c.i.f. contract, the seller is responsible for paying the freight, whereas in an f.o.b. contract the buyer has to pay for it.

<sup>340</sup> Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p.65

Article 37 of the UCP 500 requires that, unless otherwise stipulated in the credit, the commercial invoice must state the name of the applicant.<sup>341</sup> In practical terms it means that the invoice has to be addressed to the buyer.

The only exception to this rule appears in case of a transferable credit<sup>342</sup>. When the credit is transferred the UCP 500 allows the first beneficiary (the seller) to supply his own invoice in exchange for the second beneficiary's (the supplier) invoice.

If the first beneficiary fails to do so, the bank may forward the documents with the invoice of the second beneficiary, which names the first beneficiary as the buyer.<sup>343</sup>

### Description of the goods

The commercial invoice has to describe the goods in the manner as required by the credit. As Article 37(c) of the UCP 500 states:

*“The description of the goods in the commercial invoice must correspond with the description in the Credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the Credit.”*

The term “must correspond” does not mean that the exact words of the credit have to be applied in the commercial invoice as well. It means that this rule is underlined by Paragraph 62 of the ISBP which specifically states that there is no requirement for a mirror image. However, in order to avoid misunderstanding and a possible rejection of documents by the bank, it is advisable to follow the wording of the credit precisely.

The question of the wording of the commercial invoice appeared in *Kydon Compania Naviera S.A v. National Westminster Bank Ltd. (The Lena)*<sup>344</sup>, where the plaintiff company sold the Greek vessel, named Lena, to Eurasia Carriers Ltd. in 1974. Payment was to be made through a confirmed, irrevocable letter of credit, which stated that

“the amount of US \$ 953771.00 ...available by ... drafts on them at sight without recourse for full invoice value ... purporting to be 100% value of the Greek flag Motor vessel “Lena”, built January 1952 of about 11250 tons gross register 6857 tons net register and about 5790 long tons light displacement “as built”, with all equipment outfit and gear belonging to her on board, as per M.O.A. [Memorandum of Agreement] dated the 2<sup>nd</sup> July, 1974...”<sup>345</sup>

The plaintiff tendered the document with the commercial invoice that read:

“To net sale price of “LENA” ...(US \$ 953,771.00) We hereby certify that the m.t “LENA” registered under the Greek Flag under official number 3723 of 11,123.89 tons gross and 6,297.41 tons net is as per Memorandum of Agreement dated 2<sup>nd</sup> July 1974...”<sup>346</sup>

Comparing the wording of the credit with that of the commercial invoice, it is apparent that in the invoice (a) both the gross and the net tonnage are different; (b) the year of the construction is not

<sup>341</sup> The same requirement is reflected in Paragraph 61 of the ISBP.

<sup>342</sup> See description of the transferable credit in Chapter III., 3.3.6.

<sup>343</sup> See Article 48 (i) of the UCP 500

<sup>344</sup> [1981] 1 Lloyd's Rep. 68

<sup>345</sup> Ibid at 70

<sup>346</sup> Ibid at 72

stated; (c) the light displacement tonnage “as built” is not stated and (d) it does not mention that all equipment outfit and gear belonging to the vessel were on board.

After examining the documents the bank refused payment referring to, among other things, the defective nature of the invoice. The plaintiff brought an action against the bank for wrongful rejection of payment under the letter of credit. The plaintiff argued that the credit only required a certificate that the vessel complied with the memorandum of agreement and that it would have been a sufficient description if the invoice simply referred to the vessel as “the vessel Lena certified to be as per memorandum of agreement dated the 2<sup>nd</sup> of July 1974”.

The Court dismissed the claim, stating that:

“Unless otherwise specified in the credit, the beneficiary must follow the words of the credit and this is so even where he uses an expression, which, although different from the words of the credit, has, as between buyers and sellers, the same meaning as such words. It is important that this principle should be strictly adhered to. ... Departure from the principle would involve banks in just those sorts of uncertainties which, it is essential for the proper operation of the credit system, should be avoided. ...

The obligation was ... to provide an invoice in accordance with the terms of the UCP. The description of the vessel in the invoice must therefore correspond with the description in the credit. On the face of it, it does not. It may be that the year of building, light displacement tonnage “as built” and so on set out in the letter of credit do appear in the memorandum of agreement so that the certificate incorporates them, but this is not a matter which is of any concern of the bank.”<sup>347</sup>

This case demonstrates the importance of using the precise wording of the credit in the commercial invoice, as even the smallest difference may give rise to the rightful rejection of the documents.

The Banking Commission of the ICC also expressed its view on the requirements of the goods description appearing in the commercial invoice.

In 1995 a query was submitted to the Banking Commission whether a trade term can be considered as part of the goods description.<sup>348</sup> The letter of credit covered the shipment of “silk ladies blouses FOB Shanghai”. The commercial invoice did not contain the trade term “FOB Shanghai”, thus the bank rejected the tender. The seller argued that the trade term is not part of the goods description.

The Banking Commission stated that the trade term mutually agreed upon by the parties is often placed in the field “Goods description” of the letter of credit; therefore it is regarded as part of the description. In this case the commercial invoice must contain the trade term.<sup>349</sup>

The Banking Commission dealt with the question of trade terms again, however from an other aspect.<sup>350</sup> In the specific case the documentary credit called for, among other documents, an invoice covering goods to be shipped from a China port to “CFR Vancouver, WA, USA Port”. The invoice tendered to the bank indicated the trade term, but only as “CFR Vancouver, WA”.

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<sup>347</sup> Ibid at 76

<sup>348</sup> Opinion of the ICC Banking Commission R237 - 1995/96

<sup>349</sup> This also appears in Paragraph 65 of the ISBP that reads as ‘If a trade term is part of the goods description in the credit, or stated in connection with the amount, the invoice must state the trade term specified, and if the description provides the source of the trade term, the same source must be identified (e.g. a credit term "CIF Singapore Incoterms 2000" would not be satisfied by "CIF Singapore Incoterms", etc.).’

<sup>350</sup> Opinion of the ICC Banking Commission R362 - 1998/99

The Banking Commission found that omitting the words “USA port” did not give ground for rejecting the invoice, as the appearance of the abbreviation WA itself referred to a USA port.

In 2000 the Banking Commission received a query considering a case that involved the sale and purchase of “frozen chicken leg quarters and sub-products” at a value of USD 1,200,000.<sup>351</sup> Partial shipment was allowed under the credit. The seller presented an invoice describing the goods as “frozen chicken leg quarters” only, at a value of USD 1,199,999.59. The question arose, whether the goods description was consistent with the credit requirements. The Banking Commission in its opinion stated, that since partial shipment was allowed, this invoice can be regarded as covering the first shipment of goods. It further stated that “the fact that a partial shipment was effected for almost the whole value of the credit but only covered the “Frozen Chicken Leg Quarters” leaving a balance of USD 0.41 for the sub-products, is of no concern to the banks given the absence of any specific pricing per item in the credit”<sup>352</sup>.

A further query, appearing in the Unpublished Opinions of the Banking Commission<sup>353</sup>, was submitted regarding a commercial invoice that described the goods as “Men’s suede jackets (imitation suede with 100% polyester knitted backing) plain suede fabric”. The letter of credit stipulated the goods description only as “Men’s suede jackets, plain suede fabric”. The Banking Commission found that the detail in brackets gave reasonable ground for rejecting the commercial invoice as by adding the words “imitation suede with 100% polyester knitted backing”, the commercial invoice “indicates a different category or classification of the goods, which is not apparent in the goods description within the credit”<sup>354</sup>.

#### Quantity of the goods

The letter of credit may not stipulate the quantity of the goods in a stated number of units (such as piece, set, box, dozen, or gross). In such case, unless the credit stipulates that the quantity of the goods specified must not be exceeded or reduced, a tolerance of 5% more or 5% less is permitted, provided that the total amount does not exceed the amount of the letter of credit.<sup>355</sup>

On the other hand, if the quantity is indicated in the letter of credit using the words “about”, “approximately”, “circa” or similar expressions, the quantity in the invoice may appear as maximum 10% more or 10% less than the quantity indicated in the credit.<sup>356</sup>

#### Amount

According to Article 37 (b) of the UCP 500 banks may refuse commercial invoices exceeding the amount stipulated by the credit. However, if the credit indicates the amount using the words “about”, “approximately”, “circa” or similar expressions, the amount of the invoice may exceed the amount indicated in the credit with a maximum of 10% more or 10% less of the indicated amount.<sup>357</sup>

#### Signature

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<sup>351</sup> Opinion of the ICC Banking Commission R477 - 2000/01

<sup>352</sup> Ibid

<sup>353</sup> *Whether the description of the goods in the credit corresponded with the description in the commercial invoice*, Official Opinion of the ICC Banking Commission – Unpublished.

<sup>354</sup> Ibid

<sup>355</sup> Article 39(a) of the UCP 500

<sup>356</sup> See Article 39 (a) of the UCP 500

<sup>357</sup> See Article 39 (a) of the UCP 500

Article 37 (a) (iii) states that no signature is required on the commercial invoice unless expressly stated by the credit.<sup>358</sup> This sub-article was incorporated into the UCP at its 1993 Revision. The reason – as the Working Group explained - was “to correct the misconception by some parties that invoices must be signed, whether stipulated in the Credit or not”<sup>359</sup>. This also allows the acceptance of invoices produced by electronic means which do not necessarily carry a traditional signature.

#### 5.4. Insurance Documents

The documentary credit often requires an insurance document covering the risk of the goods being destroyed or lost during transport.

The requirements of the insurance document are detailed in Articles 34 and 35 of the UCP 500. According to these regulations, the insurance document must be issued and signed by an insurance company, or an underwriter or their agent.<sup>360</sup> Similarly to the transport documents if the insurance document indicates that it has been issued in more than a sole original, all originals must be presented to the bank.<sup>361</sup>

Unless otherwise stipulated by the credit, a summary in writing of the contents and details of the insurance contracts concluded (or with other words the “broker’s cover note”) will not be accepted.<sup>362</sup> However, an insurance certificate under an open cover<sup>363</sup> is acceptable on the condition that it is pre-signed by an insurance company, an underwriter or their agents.<sup>364</sup>

Article 34(f)(ii) states that the goods must be insured at least 110 % of their c.i.f.<sup>365</sup> value. If the c.i.f. value cannot be determined from the documents the bank is entitled to accept an insurance document with a minimum value of coverage equalling to 110 % of the amount for which payment, acceptance or negotiation is requested under the credit, or 110 % of the gross amount of the commercial invoice, whichever is the greater.

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<sup>358</sup> The same provision is contained in Paragraph 66 of the ISBP.

<sup>359</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.100

<sup>360</sup> Article 34 (a) of the UCP 500. The former UCP 400 gave the option of the insurance document either being issued or being signed by insurance companies, underwriters or their agents. The 1993 Revision denied this option and now the insurance document has to be issued and signed by the appropriate authority.

<sup>361</sup> Article 34 (b) of the UCP 500

<sup>362</sup> Article 34 (c) of the UCP 500

<sup>363</sup> Open Cover means an agreement whereby the assured undertakes to declare every item (e.g. shipment, vessel, etc. as appropriate) that comes within the scope of the cover in the order in which the risk is attached. The insurer agrees, at the time of concluding the contract, to accept all valid declarations up to the agreed limit. An open cover may be for a fixed period or always open; subject to a cancellation clause. (<http://www.imarine.co.za/glossary.htm>, date visited: 25 July, 2005)

<sup>364</sup> Article 34 (d) of the UCP 500

<sup>365</sup> c.i.f. stands for ‘cost, insurance and freight’, an internationally recognized shipping term (INCOTERMS). Under CIF the seller pays the costs and freight necessary to bring the goods to the named port of destination and has to procure marine insurance against the buyer’s risk of loss or of damage to the goods during the cargo. Consequently, the seller contracts for insurance and pays the insurance premium. The risk of loss or of damage however passes from the seller to the buyer when the goods pass the ship’s rail in the port of shipment. (For a detailed description of the parties’ rights and obligations under CIF, see *INCOTERMS 2000* published by ICC, p. 65-71

The insurance document must be expressed in the same currency as the credit.<sup>366</sup> This rule avoids the problem of evaluating the cover which could arise if the currency of the insurance document differed from that of the credit. More importantly, it avoids the devaluation of the cover, which may arise with the fluctuation of the exchange rates.

The cover must be effective at the latest from the date of loading on board, dispatch or taking in charge, unless otherwise stipulated by the credit<sup>367</sup>.

It is an important requirement of the UCP 500 that the credit should stipulate the type of insurance required and any additional risks covered.<sup>368</sup> In most cases the buyer will have no difficulty in specifying the appropriate insurance cover. However, if the buyer fails to give precise instructions to the bank in relation to the insurance document, the bank will be entitled to accept any insurance document tendered by the seller without responsibility for any risks not covered.<sup>369</sup>

Often the insurance document will contain that it gives coverage against “all risks”. The term “all risks” is misleading, as it does not mean that certain types of risks (e.g.: the risk of war) cannot be excluded under the insurance contract.

Article 36 of the UCP 500 reflects this question as:

*“Where a Credit stipulates “insurance against all risks”, banks will accept an insurance document which contains any “all risks” notations or clause, whether or not bearing the heading “all risks”, even if the insurance document indicates that certain risks are excluded, without responsibility for any risk(s) not being covered.”*

## 5.5. Other Documents

The letter of credit may call for documents not covered by Articles 23-37 of the UCP 500. The UCP does not give a list of these documents, as the different types of documents required by the buyer in order to safeguard the fulfilment of the seller’s obligations may vary from transaction to transaction.<sup>370</sup>

These documents may be a:

- Certificate of origin: that certifies the country in which the product was manufactured
- Country of origin: certifies the country where the goods are grown, produced or manufactured.<sup>371</sup>
- Weight Certificate: states the weight of the goods. It is issued by the official weigher on the dock or the independent certified weigher.<sup>372</sup>

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<sup>366</sup> Article 34 (f)(i) of the UCP 500

<sup>367</sup> Article 34 (e) of the UCP 500

<sup>368</sup> Article 35 (a) of the UCP 500

<sup>369</sup> Article 35 (b) of the UCP 500

<sup>370</sup> An other reason why the UCP does not give a list of other documents that the credit may call for is that since the 1983 Revision the UCP is applicable also in case of standby credits. The documentation under the normal letter of credit transaction may not be appropriate in case of standby credits, so listing the ‘other documents’ (which appeared before the UCP 400) has become pointless.

<sup>371</sup> Paragraphs 196-200 of the ISBP contain a detailed description of the required content of the certificate of origin.

<sup>372</sup> Under Article 38 ‘if a Credit calls for an attestation or certification of weight in the case of transport other than by sea, banks will accept a weight stamp or declaration of weight which appears to have been superimposed on the transport document by the carrier or his agent unless the Credit specifically stipulates that the attestation or certification of weight must be by means of a separate document.’

The other documents that the credit may call for are regulated by Article 21 of the UCP 500, as follows:

*“When documents other than transport documents, insurance documents and commercial invoices are called for, the Credit should stipulate by whom such documents are to be issued and their wording or data content. If the Credit does not so stipulate, banks will accept such documents as presented, provided that their data content is not inconsistent with any other stipulated document presented.”*

Thus, it is the applicant’s duty to give specific instructions to the bank as to the form and acceptability of the documents. Failing to do so, the bank is entitled to accept the document as tendered.

## VI.

### GOVERNING PRINCIPLES OF THE LETTER OF CREDIT TRANSACTION

The efficient functioning of the letter of credit lies in two fundamental principles: the principle of independence and the principle of strict compliance.

#### 6.1. Principle of Independence

##### 6.1.1. General overview

In international transactions there are usually more parties involved than the seller and the buyer. The seller usually has to obtain goods from a supplier in order to fulfil its obligations under the contract concluded with the buyer. The seller may not have enough funds to make payment to the supplier thus an other party's involvement is necessary. The funds usually come through a letter of credit, which require the active participation of at least one, but in the majority of the cases two or more banks. This financing mechanism would break down, if the buyer could "freeze" the payment upon a dispute with the seller. To safeguard and facilitate the smooth operation of this financing mechanism banking practice established the principle of independence in relation to letter of credit transactions.

The principle of independence, or as otherwise referred to the "autonomy principle", is the cornerstone of the law relating to letters of credit.<sup>373</sup> It refers to the understanding that the credit is independent of and separate from the underlying contract between the seller and the buyer, and also from the agreement between the applicant and the issuer.

As J.E Byrne points out, the "issuer must honour its obligation to the beneficiary under the letter of credit, irrespective of any disputes or claims relating to either the underlying transaction or the application agreement, unless fraud is established in the transaction".<sup>374</sup>

In England leading judges referred to the letter of credit as "the life blood of international commerce"<sup>375</sup>. A typical example is the *Bhoja Trader*<sup>376</sup> case, where Judge Donaldson stated, that:

"irrevocable letters of credit and bank guarantees given in circumstances such that they are the equivalent of an irrevocable letter of credit have been said to be the life blood of commerce. Thrombosis will occur if, unless fraud is involved, the Courts intervene and thereby disturb the mercantile practice of treating rights there under as being the equivalent of cash in hand."

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<sup>374</sup> J.E. Byrne, *Critical Issues in the International and Domestic Harmonization of Letter of Credit Law and Practice* In Commercial Law Annual, 1995, p. 389 at 392

<sup>375</sup> For example, Justice Kerr in *R.D. Harbottle (Merchantile) Ltd v. National Westminster Bank Ltd.* [1978] 1 Q.B. 146; Justice Griffiths in *Power Curber International Ltd v. National Bank of Kuwait S.A.K.* [1981] 2 Lloyd's Rep. 394, 400; Justice Stephenson and Justice Ackner in *United City Merchants (Investment) Ltd v. Royal Bank of Canada* [1981] 3 W.L.R. 242, 253

<sup>376</sup> *Intraco Ltd v. Notis Shipping Corporation of Liberia (The Bhoja Trader)* [1981] 2 Lloyd's Rep. 256, 257 E.P. Ellinger, Letters of Credit In Norbert Horn, Clive M.Schmitthoff (ed.), *The transnational law of international commercial transactions*, Vol.2 (1982), The Netherlands, p. 263

The principle of independence is clearly stated in the UCP 500 itself:

Article 3 provides:

- (a) *“Credits, by their nature, are separate transactions from the sales of other contract(s) on which they may be 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. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfil any other obligation under the Credit, is not subject to claims or defences by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary.*
- (b) *A Beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the Applicant and the Issuing Bank.”*

Article 4 provides:

*“In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate.”*

### **6.1.2. The Principle of Independence in the case law**

The independence principle is widely acknowledged in the case law. In the *SL Jones & Co v. Bond*<sup>377</sup> case it was stated that “the letter of credit was ... an entirely separate and independent contract between the bank and the seller”.

In *Sztejn v. Henry Schroeder Banking Corporation*<sup>378</sup> it was pointed out that “a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods”.

In the *Power Curber International Ltd v. National Bank of Kuwait*<sup>379</sup> case it was held that “it is vital that every bank which issues a letter of credit should honour its obligations. The bank is in no way concerned with any dispute that the buyer may have with the seller. The buyer may say that the goods are not up to the contract. Nevertheless the bank must honour its obligations. The buyer may say that he has a cross-claim in a large amount. Still the bank must honour its obligations.”

In *Westpack Banking Corporation v. South Carolina National Bank*<sup>380</sup> the Privy Council stated that “it is well settled that a bank which issues a letter of credit is concerned with the form of the documents presented to it, and not with the underlying facts. It forms no part of the bank’s function, when considering whether to pay against the documents presented to it, to speculate about the underlying facts”.

The independence principle imposes duties on all parties involved in the transaction. The buyer has to give precise and unambiguous instructions<sup>381</sup> to the issuer to enable the bank to properly exercise its duties. It is in the buyer’s best interest to “draft the letter of credit” (more specifically

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<sup>377</sup> [1923] 191 Cal 551 at 555

<sup>378</sup> [1941] 31 NYS 2d 631 at 633

<sup>379</sup> [1981] 2 Lloyd’s Rep 394 at 398

<sup>380</sup> [1986] 1 Lloyd’s Rep 311 at 315

<sup>381</sup> Article 5 of the UCP requires that ‘instructions for the issuance of a Credit, the Credit itself, instructions for an amendment thereto, and the amendment itself, must be complete and precise’.

to fill in the application) carefully in order to ensure that no payment will be made unless the seller fully performs his obligations.

The seller has the duty to present documents which are in strict compliance with the terms and conditions of the credit. If the seller fails to present the documents in the manner and within the time stated in the credit, he is jeopardizing the payment due to him.

The bank's duty is to examine the documents presented by the beneficiary with reasonable care to "ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the credit"<sup>382</sup>. Under the independence principle, if the documents comply with the terms and conditions of the credit, the bank has to effect payment, even if the applicant has gone bankrupt or the underlying transaction has been cancelled.

The principle of independence is supported by the rule that banks deal only with documents and not with the goods covered by them.<sup>383</sup> The bank's decision whether to accept or reject the documents presented by the seller depends only on a formal examination of the documents. The rules on how the bank shall conduct its examination are described in Chapter IV.<sup>384</sup>

The independence of the bank's undertaking in an irrevocable letter of credit is so vital, that courts usually refuse to grant injunction "to restrain the seller from making a demand under the credit on any grounds related to the quality of goods"<sup>385</sup>. Nobody, not even the buyer can stop the payment if fully conforming documents have been tendered to the bank.

In the *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*<sup>386</sup> case Lord Diplock stated:

"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, the 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."<sup>387</sup>

In case the seller breaches the underlying contract, the buyer's only recourse is to take legal actions.

There are only two exceptions to the principle of independence: the case of illegality and the so called fraud exception.

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<sup>382</sup> Article 13(a) of the UCP 500

<sup>383</sup> See Article 4 of the UCP 500

<sup>384</sup> See Chapter IV., 4.2.3.

<sup>385</sup> E.P. Ellinger, Letters of Credit In Norbert Horn, Clive M.Schmitthoff (ed.), *The transnational law of international commercial transactions*, Vol.2 (1982), The Netherlands, p. 263

<sup>386</sup> [1983] 1 AC 168, the facts of the case are summarized in Chapter VII., 7.2.1.

<sup>387</sup> Ibid at at 183

If the transaction has an illegal element, the beneficiary will not be able to enforce the credit. To explain what it means, Ellinger gives the following example: if a buyer furnishes an irrevocable credit for an amount higher than the amount stated in the underlying sales contract for the purpose of obtaining extra funds overseas in breach of the exchange control legislation prevailing in his country, the letter of credit will not be enforceable.<sup>388</sup>

The second exception to the principle of independence is the fraud exception where the seller commits a fraudulent act (e.g.: tenders forged documents) in order to obtain payment. The fraud exception is thoroughly analysed in Chapter VII.

## 6.2. Principle of Strict Compliance

### 6.2.1. General overview

The Principle of Strict Compliance is the other basic principle of letter of credit law. It means that the bank is entitled to reject documents which do not comply strictly with the terms and conditions of the credit. The reasoning behind this rule is, as Schmitthoff explains, that the issuing bank

“is a special agent of the buyer. If an agent with limited authority acts outside that authority (in banking terminology: his mandate) the principal is entitled to disown the act of the agent, who cannot recover from him and has to bear the commercial risk of the transaction.”<sup>389</sup>

The Principle of Strict Compliance is embodied in the UCP 500.

Article 13 (a) states that

*“Banks must examine all document stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.”*

The principle of strict compliance gives protection to the buyer. It guarantees that the buyer will have to reimburse the issuing bank only against documents it has specified in the letter of credit triggering the obligation. On the other hand, by virtue of the principle, the bank does not have to judge the possible discrepancies of a document, and is saved from scrutinizing the underlying agreement.<sup>390</sup>

### 6.2.2. The Principle of Strict Compliance in the case law

The principle of strict compliance has been long endorsed by the judiciary. Without aiming to give a full survey of the relevant case law, the following cases stand here as illustrations to the principle.

<sup>388</sup> See E.P. Ellinger, Letters of Credit In Norbert Horn, Clive M.Schmitthoff (ed.), *The transnational law of international commercial transactions*, Vol.2 (1982), The Netherlands, p. 264

<sup>389</sup> *Schmitthoff's Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London, p.172

<sup>390</sup> See Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 26-27

One of the most often cited cases is the *Equitable Trust Co of New York v. Dawson Partners*.<sup>391</sup> The case involved the sale and purchase of vanilla between the defendant and a seller in Batavia (now Jakarta). The defendant arranged with the plaintiff to open a credit in favour of the seller and to make payment available on presentation of a complete set of shipping documents and a certificate of quality to be issued “by experts who are sworn brokers”. Due to some ambiguities of the telegraphic code used by the issuing bank, the advising bank in Batavia informed the seller that the required certificate was to be issued “by expert who is sworn broker”. The shipment was made and payment was effected to the seller by the bank based on the tendered documents, including one expert’s certification.

Later it was revealed that the seller was fraudulent and that the shipment was mainly rubbish containing less than 1 % of the contracted goods.

The House of Lords held that the bank was not entitled to get reimbursement from the buyer, as “one of the conditions on which the defendant undertook to reimburse the plaintiff – namely that there should be ... a certificate of quality to be issued by experts – has not been complied with”<sup>392</sup>.

Lord Sumner stated, that

“it is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorized to accept are in the matter of the accompanying documents strictly observed. *There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines.*”<sup>393</sup>

An other often cited example is the case of *J.H. Rayner & Co Ltd v. Hambros’s Bank Ltd*.<sup>394</sup> The case involved an English seller that sold groundnuts to a Danish buyer. Payment was made through an irrevocable letter of credit opened by the defendant bank. The credit was issued with the following terms: “Confirmed credit No. 14597. We beg to inform you that a confirmed credit has been opened with us in favour of yourselves for an amount of up to about 16,975 l. account of Aarhus Oliefabrik available by drafts on this bank at sight to be accompanied by the following documents – invoice, clean on board bills of lading in complete set ... covering a shipment of about 1400 tons Coromandel groundnuts in bags.”

The plaintiff presented a bill of lading that described the goods as “machine-shelled groundnut kernels” and contained the abbreviation C.R.S. in the margin, which in commercial practice was used for “Coromandels”. The plaintiff also presented an invoice in which the description of the goods, Coromandel groundnuts, complied with the requirements of the credit. The defendant refused to honour the draft on the ground that the bill of lading did not contain the word “Coromandel” but “machine-shelled groundnut kernels”. The Court of Appeal held that the defendant had rightly refused payment under the credit on the ground that the documents tendered did not comply precisely with the terms of the credit. The abbreviation C.R.S. may be understood as “Coromandels” in trade practice, however the bank is not obliged to have knowledge of this.

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<sup>391</sup> [1927] 27 Lloyd’s L Rep 49

<sup>392</sup> Ibid at 52

<sup>393</sup> Ibid at 52. Emphasis added. This repeats the statement of the court made in the earlier case of *English, Scottish and Australian Bank Ltd v. Bank of South Africa* [1922] 13 Lloyd’s Rep 21 at 24, that ‘it is elementary to say that a person who ships in reliance on the letter of credit must do so in exact compliance with its terms. It is also elementary to say that a bank is not bound or indeed entitled to honour drafts presented to it under a letter of credit unless those drafts with the accompanying documents are in strict accord with the credit as opened’.

<sup>394</sup> [1943] 1. KB. 37.

Justice Goddard further explained that even if the bank had knowledge of this trade practice, it made the promise of paying against a bill of lading describing the goods in a particular way. Therefore, it was only obliged to effect payment if the bill of lading stated the required goods description.<sup>395</sup>

The *Bank Melli Iran v. Barclays Bank (Dominion, Colonial and Overseas)*<sup>396</sup> case involved the sale and purchase of Chevrolet trucks. Payment was made against two letters of credit issued by Bank Melli and confirmed by Barclays Bank, one of which called for a delivery order, insurance policy, invoice and a US Government undertaking confirming that the trucks are new. The other called for an “on board” bill of lading and an insurance certificate. The confirming bank made payment to the beneficiary and transferred the documents to the issuing bank. The issuing bank, however, rejected the documents and refused to reimburse the confirming bank on the ground of discrepant documents.

The plaintiff alleged that the delivery order was not for “new” trucks but for “new-good” trucks; the invoice was not for “new” but for “in good condition” trucks. And the bill of lading was marked “said to contain lorries”. The Counsel stating that “the documents upon which a bank could pay must correspond strictly with the documents as defined in the mandate”<sup>397</sup> held that the confirming bank was not entitled to reimbursement by the issuing bank.

The *Lena*<sup>398</sup> case from the 1980s is an other accurate example. The letter of credit asked for the presentation of a commercial invoice, specifying its content. The documents tendered by the beneficiary were rejected by the bank on discrepancies of the invoice.

The Court held that:

“Unless otherwise specified in the credit, the beneficiary must follow the words of the credit and this is so even where he uses an expression, which, although different from the words of the credit, has, as between buyers and sellers, the same meaning as such words.”<sup>399</sup>

In the more recent case of *Chailease Finance Corporation v. Credit Agricole Indosuez*<sup>400</sup> the defendant bank issued a letter of credit in favour of the plaintiff as beneficiary. The credit was for an amount of US \$ 556,750 - covering “vessel MV “Mandarin” sale agreement dated July 31, 1998 for delivery in Taipei during August 17-20, 1998 ... available ... against presentation of the following documents: [among others] ... a bill of sale... and a copy of acceptance of sale.” The seller presented the documents, including a bill of sale dated August 21 and an acceptance of sale stating that delivery had taken place on August 21.

The bank rejected the documents because “date of delivery of the vessel was stated in the bill of sale and the signed acceptance of sale to be 21 August 1998 when the letter of credit stated that the vessel was for delivery...August 17-20 1998”<sup>401</sup>.

The court found that the delivery date was not part of the goods description thus the documents complied with the requirements of the credit. It stated that:

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<sup>395</sup> Similarly, in the *Bank of Italy v. Merchants National Bank* case the court found that the term ‘dried grape’ is not the same as ‘raison’.

<sup>396</sup> [1951] 2 Lloyd’s Rep 367

<sup>397</sup> Ibid at 368

<sup>398</sup> *Kydon Compania Naviera S.A. v. National Westminster Bank Ltd* [1981] 1 Lloyd’s Rep 68, the facts of the case are summarized in Chapter V., 5.3.

<sup>399</sup> Ibid at 76

<sup>400</sup> [2000] 1 Lloyd’s Rep. 348

<sup>401</sup> Ibid at 351

“the letter of credit does not state that the documents and in particular, the acceptance of sale and bill of sale, have to show that the vessel has been delivered within any range of dates, in particular the period August 17-20. .... If it had been intended that the bank was obliged to pay only against documents showing that delivery of the vessel had been effected by a particular date, that could readily have been provided for.”<sup>402</sup>

In obvious cases courts (especially in the United States, Canada<sup>403</sup> and the Far-East<sup>404</sup>) are ready to bend the rule of strict compliance to a standard of substantial compliance if it makes more sense in the specific case. In the recent case of *All American Semiconductor Inc. v. Wells Fargo Bank, Minnesota N.A.*<sup>405</sup> the bank issued a letter of credit payable to the plaintiff against, among other documents, sight drafts accompanied by a statement made by the beneficiary and the relevant invoices. The beneficiary tendered a statement on a company letter head that named the company only as “All American” and included an address in Miami, and invoices containing the name and purchase order of the buyer and “All American Semiconductor Inc” as the invoicing party.

The bank rejected the presentation alleging that the statement discrepantly stated the beneficiary’s name and at the referred address two “All American” companies resided.

The court observed that the statement alone might have justified dishonour but the documentary presentation, taken as a whole, unambiguously identified the beneficiary, thus the presentation was complying.

In *Carter Petroleum Products Inc. v. Brotherhood Bank and Trust Co.*<sup>406</sup> the credit named the applicant as “Highway 210, LLC”. The draft presented by the beneficiary listed the name of the applicant as “Highway 210 Texaco Travel Plaza, LLC”. The bank rejected the presentation alleging, among others, that the draft did not strictly comply with the requirements of the credit. The court did not accept this reasoning and ruled against the bank. It emphasized, that “although the draft request submitted by Carter was not in complete conformity with the letter of credit issued by the bank, it did contain all the necessary information requested by the letter of credit. ... Moreover, the bank could not have been misled by the nonconformity.”<sup>407</sup>

### 6.2.3. The bank’s duty in the examination of documents

In relation to the bank’s duty to examine the documents tendered under the letter of credit the question may arise as to what extent is the bank obliged to conduct the examination.

<sup>402</sup> Ibid at 358

<sup>403</sup> In *Bank of Nova Scotia v. Angelica-Whitewear Ltd.* (1987, 1 S.C.R. 59, 1987 Can LII 78, S.C.C.) the court emphasized that ‘there must be some latitude for minor variations or discrepancies which are not sufficiently material to justify a refusal of payment’.

<sup>404</sup> In *Bank of China (Fujian Branch) v. Bank of East Asia* (Civil Judgment, 2002 Min Jing Zhong Zi No. 126; Fujian High People’s Court, China), the court held that strict compliance does not mean slavish conformity to the terms of the letter of credit and the letter of credit is a means to make payment rather than a means to refuse payment.

In *Korea First Bank v. Korean Export Insurance Corp.*, (2000 DA 63691, Supreme Court, 3rd Div. 2002, Korea) the court stated that ‘when there exists a little difference in words and phrases which is slight but the bank, if taking reasonable care, can understand that it does not cause the [grave] difference and does not harm the terms and conditions of the letter of credit at all from its face, it must be regarded as in accordance with the terms and conditions of the letter of credit’.

<sup>405</sup> 105 Fed.Appx. 886 (8th Cir. 2004)

<sup>406</sup> 97 P.3d 505 (Kan. Ct. App. 2004), the case is also available at <http://www.kscourts.org/ksccases/ctapp/2004/20040917/90998.htm>, date visited: 2 October, 2005

<sup>407</sup> Ibid. The court in another case, *Adaro Indonesia v. Rabobank*, [2002] 3 SLR 258, also arrived to the conclusion that obvious mistyping of the beneficiary’s address does not itself make the document discrepant.

Article 14 (b) of the UCP states that:

*“Upon receipt of the documents the Issuing Bank and/or Confirming Bank, if any, or a Nominated Bank acting on their behalf, must determine on the basis of the documents alone whether or not they appear on their face to be in compliance with the terms and conditions of the Credit. If the documents appear on their face not to be in compliance with the terms and conditions of the Credit, such banks may refuse to take up the documents.”*

#### “On their face”

The term “on their face” has been a subject of several discussions amongst both legal scholars and the banking practice.

Questions were posed whether this expression refers to the face of the document as opposed to the reverse (on which the small print may appear in the case of bills of lading and other transport documents).<sup>408</sup>

The ICC explained the term as follows:

*“...the decision as to whether the documents do or do not comply with the terms and conditions of the Credit and are consistent with one another is based exclusively upon the banker’s examination of the document, and not upon someone else’s understanding. In other words, there is a method for examination of documents under the Documentary Credit which is peculiar to bankers. This method attempts to find whether certain statements, terms or conditions appear on the document. The phrase “on their face” is not to be interpreted as meaning either the “face” or the “reverse” of the document.”<sup>409</sup>*

The fact that banks are not required to look behind the face of the document is further emphasized by Article 15 of the UCP:

*“Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s), or for the general and/or particular conditions stipulated in the document(s) or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any document(s), or for the good faith or acts and/or omissions, solvency, performance or standing of the consignors, the carriers, the forwarders, the consignees or the insurers of the goods, or any other person whomsoever.”*

#### Reasonable care

The bank’s duty as to conduct the examination of documents with reasonable care as required by Article 13 of the UCP 500 can be illustrated with *Gian Singh & Co Ltd v. Banque de l’Indochine*<sup>410</sup>. The case involved the purchase of a new fishing vessel by the plaintiffs, to be built in Taiwan. The credit required, amongst other documents, the presentation of a certificate signed by Balwant Singh, holder of Malaysian passport E-13276, and certifying that the vessel was built according to the specifications and was in proper condition to sail.

The defendant bank paid against the documents, but later it was found that the certificate had been forged and was not issued by Balwant Singh. When the bank debited the applicant’s

<sup>408</sup> Raymond Jack, *Documentary Credits* (1991) London, p. 136

<sup>409</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.39

<sup>410</sup> [1974] 2 Lloyd’s Rep 1

account, the applicant turned to court alleging that the bank acted negligently when examining the documents.

Lord Diplock stated that:

“the duty of the issuing bank, which it may perform either by itself, or by its agent, the notifying bank, is to examine the documents with reasonable care to ascertain whether they appear on their face to be in accordance with the terms and conditions of the credit. The express provision to this effect in ... the Uniform Customs and Practice for Documentary Credits does no more than re-state the duty of the bank at common law. In business transactions financed by documentary credits banks must be able to act promptly on presentation of the documents.”<sup>411</sup>

The court found that the additional duty imposed upon the bank to take reasonable care to see whether the signature on the certificate appeared to correspond with the signature in the passport presented by the beneficiary was fulfilled, and rejected the plaintiff’s claim.

The level of reasonable care can only be decided on a case-by-case basis. However, “since Documentary Credit banking is a competitive endeavour, to succeed in it banks must develop customs and practices that encourage their customers” and correspondents” trust. Sharp, dishonest or negligent practices are inevitably short-lived and do not constitute good international standard banking practice.”<sup>412</sup>

Article 13(a) attempts to establish a “standard” for the banks when examining the documents. It states that “compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles”.

In other words, in making the decision whether or not there are any discrepancies in documents presented for payment, banks should rely on the standard practice of international banks, as stated in the UCP.

Reflecting to the growing need for collecting the standard banking practice, the ICC drafted and adopted the ISBP (International Standard Banking Practice for the Examination of Documents under Documentary Letters of Credit)<sup>413</sup> in 2002. Wishing to reduce the number of documentary credits rejected by the banks the ISBP gives a detailed explanation of how the rules of the UCP 500 on the examination of documents are to be applied on a day-to-day basis.

#### Non-documentary requirements

Under Article 13(c) of the UCP 500 “if a Credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them”.

The difficulty of non-documentary conditions appeared both in the case law and in scholarly writings.

In *Banque de l’Indochine et de Suez SA v. JH Rayner (Mincing Lane) Ltd.*<sup>414</sup> the credit stipulated for a special condition, namely, that the shipment was to be effected on a vessel belonging to a shipping company being member of the International Shipping Conference. Regarding this condition Sir John Donaldson stated:

<sup>411</sup> Ibid at 11.

<sup>412</sup> Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p.39

<sup>413</sup> ICC Brochure No. 645. For more information on the ISBP see Chapter II., 2.1.3.

<sup>414</sup> [1983] QB 711

“This is an unfortunate condition to include in a documentary credit because it breaks the first rule of such a transaction, namely, that the parties are dealing in documents, not facts. The condition required a state of fact to exist. What the letter of credit should have done was to call for a specific document which was acceptable to the buyer and his bank evidencing the fact that the vessel was owned by a member of a conference.”<sup>415</sup>

In his often cited book “The Law of Banker’s Commercial Credits” Gutteridge<sup>416</sup> also suggested that there should be a provision in the UCP on non-documentary conditions.

However, it was not until the current version of the UCP that a provision explicitly stated that non-documentary conditions are to be ignored by the bank.<sup>417</sup>

#### Duration of the examination

For conducting the examination of the documents the banks have a definite period of time, which the UCP 500 determines as a “reasonable time, not to exceed seven banking days following the day of receipt of the documents”.<sup>418</sup>

The seven-day limit was agreed upon by the members of the Working Group reviewing the UCP 400 as a compromise between the suggested 5 to 10 days.<sup>419</sup>

However, although the bank has a maximum of seven days for concluding the examination, it does not mean that it is prudent to use all the time in order to determine whether it accepts or rejects the tender. The reasonable time for the examination (of course within the seven-day period) can only be decided on a case-by-case basis, depending on several factors such as the nature of the transaction, the number and length of documents presented, the circumstances of presentation, the number of staff available for processing the transaction.

#### Discrepancies

Article 39 of the UCP 500 allows the bank to disregard certain minor discrepancies, unless the credit expressly forbids it. It states that unless the credit refers to the quantity of goods in terms of a stated number of packing units or individual items the quantity specified in the documents may be 5 per cent more or less than that specified in the credit. This means that in case credit refers to 100.000 kg a document that contains 995.000 kg is acceptable; however, if the credit refers to 100.000 sacks, no difference is allowed.

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<sup>415</sup> Ibid at 728 G-H

<sup>416</sup> H.C. Gutteridge, Maurice Megrah, *The Law of Banker’s Commercial Credits* (1955) London, p. 119

<sup>417</sup> The former versions of the UCP did not state this provision, although it was assumed from many other articles. See Articles 1,4, 15, 22(a) of the UCP 400

<sup>418</sup> See Article 13(b) of the UCP 500

<sup>419</sup> The landmark court case which had a significant influence on including a maximum period of time for the documentary checking was the *Bankers Trust Co. v State Bank of India* [1991] 2 Lloyd’s Rep. 443. The case involved the sale of steel products by an Indian seller to a US buyer. Upon shipment the beneficiary presented 967 sheets of paper to the confirming bank, which after checking the documents in a day, found everything complying and effected payment. The documents were checked by the issuing bank as well, which took a total of eight days. The issuing bank rejected the documents on several discrepancies and refused reimbursing the confirming bank. Although the confirming bank admitted that the documents were discrepant it argued that the issuing bank did not act within a reasonable time, thus it was precluded from rejecting them. (The letter of credit was subject to the UCP 400, which only stated that the bank shall have a reasonable time for examining the documents, without giving a time frame.) The Court of Appeal held that in the particular case the period of eight working days was excessive considering the number and complexity of the presented documents.

The ISBP also suggests that certain abbreviations, obvious misspellings or typographical errors may not be regarded as discrepancies. Paragraph 6 states that generally accepted abbreviations such as “Int’l” instead of “International” or “Co” instead of “Company” does not make a document discrepant.

Paragraph 28 declares that documents containing misspellings and typing errors that do not affect the meaning of the word are not considered discrepant.<sup>420</sup>

The important question is: how can the beneficiary tendering the documents avoid the discrepancies. The answer may be self-evident, however, not always easily achieved.

A commentator suggests that “at least half of the final (correctable) errors leading to discrepancies would be avoided (even those involving late shipment) were the credits to be examined in detail, on receipt, checked as acceptable operationally by all the departments of the firm and any necessary amendments sought from the opener at that time.”<sup>421</sup> He further emphasizes the importance that the credit should be “100 per cent clear and unambiguous ... properly representing the terms of the underlying sales contract”<sup>422</sup>.

International organisations, such as the ICC<sup>423</sup> and SITPRO<sup>424</sup>, also provide checklists detailing the important issues that beneficiaries should pay attention to when preparing and assembling the documents the credit calls for. They provide guidance not only before the presentation of documents, but also in the event that discrepancies are found by the bank.

In case of discrepancies found in the documents the bank may seek the applicant’s instructions. The UCP 500 allows the bank to approach the applicant for a waiver of discrepancies<sup>425</sup>, however this cannot extend the seven banking days available for the examination of the documents.<sup>426</sup> The confirming or the nominated bank may also decide to pay “under reserve” or “against an indemnity”.

It is also understood that the beneficiary may replace any discrepant documents with conforming documents until the expiry date of the credit.<sup>427</sup>

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<sup>420</sup> The ISBP gives the following examples: ‘a description of the merchandise as ”mashine” instead of “machine”, “fountan pen” instead of “fountain pen” or “modle” instead of “model” would not make the document discrepant. However, a description as “model 123” instead of “model 321” would not be regarded as a typing error and would constitute a discrepancy.

<sup>421</sup> See *DCI’s independent observer offers some commonsense tips about how to avoid the dreaded discrepancies* In DC Insight Vol.1. No.1. Winter 1995

<sup>422</sup> Ibid

<sup>423</sup> See *Suggested Checklist for Document Preparation and Examination* In Charles Del Busto, *ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*, ICC Publication No. 515, p.97.

<sup>424</sup> See *Letter of Credit Checklists and Guides* at <http://www.sitpro.org.uk/trade/letcred.html>, date visited 30 September, 2005

<sup>425</sup> The question of waiver is analyzed in more details in Chapter IV., 4.2.3.

<sup>426</sup> See Article 14(c) of the UCP 500

<sup>427</sup> See *The ICC’s Group of Experts has handed down its second set of responses to queries on UCP 500* In DC Insight Vol.1.No.3.Summer 1995

## VII.

### THE FRAUD EXCEPTION

As it was explained earlier in Chapter VI., one of the main principles of letter of credit law is the Principle of Independence. Without repeating those stated earlier, the essence of this principle may be summarized as the letter of credit is independent of both the underlying contract between the seller and the buyer and of the contract between the applicant and the issuer. Thus, the bank does not get involved in any dispute arising between the seller and the buyer.

There are two exceptions to the principle of independence: the case of illegality and the so called fraud exception. The case of illegality has been described in the previous Chapter.<sup>428</sup> The fraud exception, or often referred to as the “fraud rule” is the core issue of the present Chapter.

Fraud is not a new phenomenon. “As long as there have been commercial systems in place there have been those who have tried to manipulate these systems.”<sup>429</sup> Defrauding banks is believed to be as old as banking itself.

Law has attempted to react to this threat; however national legal systems approach the question in a different way and set different standards for defining what constitutes fraud under a letter of credit transaction.

The fraud rule is the “most controversial and confused area” of the law governing letters of credits. This chapter aims to give a thorough analysis of the divergent approaches of the different jurisdictions to this rule.

Fraud in documentary credits can take various forms. The fraudulent party can be the beneficiary, the applicant, both of them in co-operation, or a third party issuing a document. This Chapter focuses primarily on the beneficiary fraud since this is the most common in international transactions.

The Chapter is divided into five sections. The First Section provides a general explanation of what is understood under the expression “fraud rule”, which is followed by a summary of its historical origins in English and American case law in Section Two.

Section Three provides an overview of the fraud rule in selected jurisdictions. For purposes explained in the general overview of the referred section, the law of the United States, the United Kingdom, Hungary and Greece are analyzed.

Section Four gives an introduction to the fraud rule applied by the United Nations Convention on Independent Guarantees and Standby Letters of Credit.

The last section deals with the UCP exploring why the Code is silent on the fraud rule.

#### 7.1. The meaning of the fraud rule

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<sup>428</sup> See Chapter VI., 6.1.2.

<sup>429</sup> *Trade Finance Fraud – Understanding the Threats and reducing the Risk*, A Special Report prepared by the ICC International Maritime Bureau (Paris) 2002, p. 9

“The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour the draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued.”<sup>430</sup>

Under the principle of independence as emphasized by Article 4 of the UCP 500 all parties concerned in the credit operation deal with documents, and not with goods, services and/or other performances to which the documents may relate. As Harfield emphasized: “banks deal in written representations, not in facts”<sup>431</sup>.

Thus, the beneficiary does not have to prove that he fulfilled his duties under the underlying contract. He simply has to provide documents facially conforming to the terms of the credit. This separation of the documents from the actual performance “creates ... a loophole for those unscrupulous beneficiaries [third parties, or sometimes applicants] to abuse the system”<sup>432</sup>.

If the documents tendered appear on their face to be strictly in compliance with the terms and conditions of the credit, the issuer will effect payment regardless of any dispute between the buyer and the seller.

If the documents do not strictly comply with the terms and conditions of the credit or are inconsistent with each other, the bank may reject them<sup>433</sup>.

There is also a third scenario which to some extent differs from the first two: the beneficiary may present documents, which on their face appear to be complying, but they are actually forged. Since the bank is only dealing with documents and does not and can not look into the fulfilment of the underlying contract, nor does it have the means to detect the fraud, it will effect payment which may result in the unjust enrichment of the beneficiary.

The classic example is when the seller obtains a forged bill of lading facially conforming to the terms of the credit and receives payment from the bank<sup>434</sup>. However, there is no real performance behind these documents. Upon arrival, the buyer discovers that the goods do not meet the requirements of the underlying contract, they are actually worthless rubbish. By the time he takes legal actions the seller has already disappeared.

It is common knowledge that fraud is wrong, immoral and should not be allowed in any circumstances. It attacks public policy and poses “an equally serious threat to the commercial utility of the letter of credit”<sup>435</sup>.

Now, the question is how can the participants of international trade prevent the occurrence of fraud?

Banks claim that their role is merely to finance the commercial sale and they cannot take responsibility for the quality or the existence of the goods traded. It is accepted that this is the “only practical way for the documentary credit system to work”<sup>436</sup>. Permitting the buyer to stop

<sup>430</sup> J.F. Dolan, *Documentary Credit Fundamentals: Comparative Aspects*, 3 Bank. & Fin.L.R 121 (1988)

<sup>431</sup> Henry Harfield, *Bank Credits and Acceptances* (5<sup>th</sup> ed., 1974) New York, p. 69

<sup>432</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002) The Hague, p. 30

<sup>433</sup> See Article 13 of the UCP 500

<sup>434</sup> It is often referred to as “unfair calling”.

<sup>435</sup> G.W.Smith, *Irrevocable Letters of Credit and Third Party Fraud: The American Accord* (1983) 24 Va J Int'l L 55, p. 96

<sup>436</sup> *Trade Finance Fraud – Understanding the Threats and Reducing the Risk*, A Special Report prepared by the ICC International Maritime Bureau (2002) ICC Publication No. 643, p. 28

the payment mechanism simply alleging that the goods do not conform to the underlying contract would destroy the utility of letters of credit. On the other hand, allowing the seller to receive payment from the bank upon presentation of false or forged documents would be equally unjustifiable. This way the letter of credit would become an “automatic and unstoppable vehicle for the perpetration of fraud”<sup>437</sup>, and the whole transaction could fail causing serious losses to the participants, if any of them acted in bad faith.

To tackle this problem letter of credit law has created the so called fraud rule. The fraud rule is described in several different ways. Xiang Gao calls it “an extraordinary rule as it represents a departure from the cardinal principle of the law of letters of credit – the principle of independence. It allows the issuer or a court to view the facts behind the face of conforming documents and to disrupt the payment of a letter of credit when fraud is seen to be involved in the transaction”<sup>438</sup>.

Schmitthoff refers to the fraud rule as the one that “permits a court to consider evidence other than the actual terms and conditions of the credit and is founded on the maxim *ex turpi causa non oritur actio*”<sup>439</sup>, which means that the plaintiff cannot found an action based on its own wrongdoing.

Raymond Jack describes the fraud rule as an “exception to the rule that the contracts made in connection with credits are autonomous”<sup>440</sup>.

In essence the fraud rule entitles the bank to refuse payment in case it alleges fraud and provides a defence should the bank be sued by the applicant or the presenter of the documents.

## 7.2. Historical background of the fraud rule

The occurrence of fraud in international transactions is not a new phenomenon. The international trading community has been facing this problem for many years now. As Simon Jones points out “defrauding banks is an activity which is no doubt as old as banking itself”<sup>441</sup> and courts are continuously facing the dilemma of where to draw the line beyond which a fraudulent act shall not to be left without the court intervening into the trade relationship of the parties.

### 7.2.1 The fraud exception in the early English case law

#### Pillans v. Van Mierop

One of the earliest cases on letter of credit fraud mentioned by legal scholars is the *Pillans v. Van Mierop*<sup>442</sup>. In this case, dating back to 1765, White, a merchant from Ireland wished to draw on the plaintiffs, Pillans and Rose, who were merchants of Rotterdam, Holland, a sum of 800 pounds. In order to secure the repayment of the requested amount White offered to give a credit

<sup>437</sup> B.Kozolchyk, *The Immunisation of Fraudulently Procured Letter of Credit Acceptances: All services Exportacao Comercio SA v. Banco Bamerindus Do Brazil SA*, (1992) Brroklyn L Rev 369, 370

<sup>438</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 29

<sup>439</sup> Schmitthoff's *Export Trade – The Law and Practice of International Trade* (10th ed., 2000) London, p. 210

<sup>440</sup> Raymond Jack, *Documentary Credits* (1991) London, p. 195

<sup>441</sup> Simon Jones reports on court cases dealing with L/C fraud, In *Documentary Credit Insight*, Vol 5 No.2 Spring 1999

<sup>442</sup> [1756] 97 Eng Rep 1035

issued by the defendants Van Mierop and Hopkins, seated in London. The plaintiffs then wrote to Van Mierop and Hopkins, desiring to know “whether they would accept such bills as they, the plaintiffs, should in about a month”’s time draw upon the said Van Mierop and Hopkins”’s house here in London, for 800 pounds upon the credit of White”<sup>443</sup>. The defendant agreed. Later, when White became insolvent the defendants gave notice to the plaintiffs not to draw on them. Nevertheless, they did and the defendants refused to pay.

Plaintiffs turned to court. At the Court it was stated that:

“Van Mierop and Hopkins were bound by their letter; unless there was some fraud upon them: for that they had engaged under their hands, in a mercantile transaction, “to give credit for Pillans and Rose”’s reimbursement”<sup>444</sup>.

Although this case, decided almost 250 years ago, did not involve the analysis of the fraud rule, it clearly communicates that fraudulent conducts have not been tolerated by courts from a very early time.

#### Ulster Bank v. Synnott

Ellinger reports on an other, less well-know, however important case of *Ulster Bank v. Synnott*<sup>445</sup>. Synnott was a merchant who “instructed the plaintiff, his bank, to accept a draft of one L., provided a bill of lading was attached”<sup>446</sup>. The bank accepted the draft and made payment on presentation of the bill of lading, which subsequently turned out to be forged. The defendant refused to reimburse the bank. Chatterton V.C. held that:

“the plaintiff”’s only duty was to ascertain that the bill of lading was regular on its face. ... The defendant was the person who introduced the drawer of the draft to the plaintiff. The latter agreed to deal with the drawer solely on the authority of the defendant. Once the plaintiff was satisfied that the bill of lading was regular on its face, the defendant bore the risk of its being a forgery”<sup>447</sup>.

#### Societe Metallurgique v. British Bank for Foreign Trade

The next milestone in the letter of credit law of the UK is the *Societe Metallurgique v. British Bank for Foreign Trade*<sup>448</sup> from 1922. In this case the French plaintiffs, sellers of pig iron entered into a sales contract with a buyer, Mr. Ford. The payment was made by letter of credit opened by the defendant, the British Bank for Foreign Trade, against the presentation of a weight receipt of the buyer’s agent in Antwerp and the invoice. The seller presented the documents for the first shipment and received payment. Later, the buyer instructed the bank to deny payment for the second shipment on the ground that the quality of the iron did not meet the contracted requirements. The buyer’s allegation was based on the fact that he had received quality complaints from his customers to whom the iron had been sold.

The seller brought an action against the issuing bank claiming damages for breach of contract. The defendant argued that (a) the quality of the goods was not as required by the contract, and (b)

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<sup>443</sup> Ibid at 1037

<sup>444</sup> Ibid at 1036

<sup>445</sup> [1871] 5 Ir.R.Eq. 595

<sup>446</sup> E.P.Ellinger, Documentary Credits and Fraudulent Documents In. C.M. Chinkin, R.J.Davidson, W.J.M.Ricquier (ed.), *Current Problems of International Trade Financing* (1983) Singapore, p. 196.

<sup>447</sup> Ibid at 196-197

<sup>448</sup> [1922] 11 Lloyd’s Rep. 168

that the documents presented were not in order. The English Court ruled for the plaintiff. Justice Bailhache rejected both of the defendant's arguments and said:

“...there was a good deal of evidence given as to the actual quality of the iron, and in any action against a bank for failure to honour credit for goods which are not in order the question of quality only comes in on one or other of two ways. First of all, did the person presenting misdescribe the goods in such a way as to be guilty of fraud. If that were so, then the bank in refusing to pay would be justified. But nothing of that sort is suggested in this case. There is another case in which the bank would be entitled not to pay, i.e., if the goods were innocently misdescribed in the documents tendered to them – so far misdescribed that the goods might be rejected by the buyers and were so rejected by the buyers. ... But here not only am I satisfied that they were not misdescribed, but the buyer has not rejected them, but has sold 400 tons of these goods to other buyers.”<sup>449</sup>

This case did not involve fraud, nor was it alleged. However, the Court's view cited above suggests, that the court would have been willing to interfere with the payment had the transaction been fraudulent.

#### Bank Russo-Iran v. Gordon Woodroffe & Co Ltd

In the earlier *Ulster Bank* case, although the documents were forged, the court strictly followed the principle of independence and concluded that the risk of fraud on the seller's part has to be born ultimately by the buyer. The same reasoning was followed in the unreported case of *Bank Russo-Iran v. Gordon Woodroffe & Co Ltd*.<sup>450</sup> in which a letter of credit was issued in Tehran in favour of the defendant company. The defendant issued an invoice of £229,000 and received payment from the bank. However, it turned out later that the invoice was massively in excess of the real value of the goods and the court ruled that the bank could recover the money paid to the beneficiary based on fraudulent misrepresentation. Lord Justice Brown held that:

“In my judgment, if the documents are presented by the beneficiary himself, or are forged or fraudulent, the bank is entitled to refuse payment if it finds out before payment, and is entitled to recover the money as paid under a mistake of facts if it finds out after payment.”<sup>451</sup>

#### Edward Owen Engineering Ltd v. Barclays Bank International Ltd. and Umma Bank

An other often cited case is the *Edward Owen Engineering Ltd v. Barclays Bank International Ltd. and Umma Bank*.<sup>452</sup> Although the main question of this case was related to a performance guarantee, this instrument operates the similar way as a standby letter of credit. Moreover, Lord Denning made some very interesting statement considering letters of credit, thus it is worth summarizing this case. In 1976 the English supplier, Edward Owen Engineering Ltd., entered into a contractual relationship with a Libyan customer, Agricultural Development Council of Libya, for the supply and installation of glasshouses. The payment was to be made by an irrevocable documentary credit opened in favour of the plaintiff at the Libyan Umma Bank. Upon the Libyan party's request and in order to effect performance, the plaintiff instructed the defendant Barclays Bank to issue a performance guarantee, which opened the instrument

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<sup>449</sup> Ibid at 170

<sup>450</sup> The Times, 4th October, 1972, p.7

<sup>451</sup> Ibid

<sup>452</sup> [1978] 1 Lloyd's Rep. 166

“payable on demand without proof or condition”. The Umma Bank then sent the guarantee to the customer.

The Libyan Bank also opened a letter of credit and sent it to its London correspondent, who sent it to the plaintiff, however stating, that

“Although our principals make provision for us to add our confirmation to this credit kindly note that we are unable to effect such action in view of the payment terms.”<sup>453</sup>

The plaintiff made every effort to get the Libyan party amend the letter of credit for it to be a confirmed one, but he failed. Thus, the plaintiff repudiated the contract. The Libyan customer raised claims under the performance guarantee.

The English supplier applied for and obtained a court injunction to prevent payment under the performance guarantee. The injunction was later discharged and this decision was upheld by the Court of Appeal. Lord Denning explained as follows:

“The bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulent in circumstances where there is no right to payment. ...

... the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligations or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or condition. The only exception is when there is a clear fraud of which the bank has notice.”<sup>454</sup>

Lord Geoffrey Lane further clarified:

“The only circumstances which would justify the bank not complying with a demand would be those which would exonerate them under similar circumstances if they had entered into a letter of credit, and that is this, if it had been clear and obvious to the bank that the buyers had been guilty of fraud.”<sup>455</sup>

#### Ettablissement Esefka International Anstalt v. Central Bank of Nigeria

An other case that must be mentioned, as one of the leading cases in which the British Court has given a thorough analysis of the effect of fraud in documentary credits is the *Ettablissement Esefka International Anstalt v. Central Bank of Nigeria*.<sup>456</sup> In 1974 the Ministry of Defence of Nigeria ordered 240,000 tonnes of cement<sup>457</sup> from the plaintiffs, a company in Liechtenstein actually operated in London. Payment was by an irrevocable letter of credit issued by the Central Bank of Nigeria and advised to the seller by Midland Bank. The letter of credit called for, among other documents, a commercial invoice, a full set of four bills of lading and an insurance policy. On presentation of the documents the bank paid out a substantial part of the amount of the credit. However, there was strong evidence that the bills of lading were forged and there was a suspicion that part of the shipment has not been made at all. The bills of lading stated the port of shipment

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<sup>453</sup> Ibid at 166-167

<sup>454</sup> Ibid at 171-172

<sup>455</sup> Ibid at 174

<sup>456</sup> [1979] 1 Lloyd’s Rep. 445.

<sup>457</sup> This case was one in the line of the so called “cement cases”. In the 1970s Nigeria ordered vast quantities of cement from all over the world. The Central Bank of Nigeria issued letters of credit to pay for the cement. Great quantity of cement was shipped to the port of Lagos where they could not be unloaded due to congestion. The holders of letters of credit claimed demurrage.

as Volos, Greece but the Greek harbourmaster knew nothing about the vessels named in the bills of lading, or about any cement loaded on board in the port of Volos. Thus, the bank refused further payment. The plaintiffs brought an action against the bank, the bank counterclaimed and applied for security of costs.

Lord Denning held that:

“The documents ought to be correct and valid in respect of each parcel. If that condition is broken by forged or fraudulent documents being presented – in respect of any one parcel – the defendants have a defence in point of law against being liable in respect of that parcel. And they have a claim, not only as to any outstanding claim but also they have a counterclaim for the money which they have overpaid and which they paid on false documents.”<sup>458</sup>

The importance of this case lies in the fact that it clearly recognizes that the bank’s primary obligation to effect payment is clearly overridden in case of an established fraud made known to the bank.

#### United City Merchants (Investments) Ltd v. Royal Bank of Canada

One of the most well-known and leading English cases on the fraud rule is the *United City Merchants (Investments) Ltd v. Royal Bank of Canada*<sup>459</sup>. Considering the importance of the case, it is essential to give a detailed description on the merits of the events and the conclusions driven by the court.

#### *The facts*

In December 1975 Vitrorefuerzos SA (Vitro), a Peruvian company concluded a sale and purchase contract with Glass Fibres, an English company, under which Vitro agreed to buy plant and equipments for manufacturing glass fibre. The purchase was to be financed by an irrevocable, transferable letter of credit. Upon the buyer’s request, in March 1976 the credit was opened by Banco Continental SA, a Peruvian Bank and was confirmed by the defendant, the Royal Bank of Canada.

According to the terms of the letter of credit:

- the amount of the credit was \$ 794,503.20
- shipment was to be made from London to Callao (Peru) on or before (after an extension) the 15<sup>th</sup> of December 1976,
- payment was to be made in London by the defendant’s London branch by sight drafts against clean bill of lading on or before (after an extension) the 31<sup>st</sup> of December 1976.<sup>460</sup>

On 22 July, 1976 Glass Fibres assigned its rights and benefits under the credit to the plaintiff, United City Merchants (Investments) Ltd. The equipments were ready for shipment on the 2<sup>nd</sup> of December and the seller advised their freight forwarding agent that the goods have to be shipped from London to Callao by the 15<sup>th</sup> of December at the latest. The agent instructed the loading brokers of the American Prudential Lines likewise. However, due to the cancellation of the departure of the original vessel, the goods were shipped in a replacing vessel, called American Accord on the 16<sup>th</sup> of December 1976.

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<sup>458</sup> [1979] 1 Lloyd’s Rep 445 at 447

<sup>459</sup> [1979] 1 Lloyd’s Rep. 267, [1981] 1 Lloyd’s Rep 604, [1983] AC 168. This is also the most often cited English case.

<sup>460</sup>[1981] 1 Lloyd’s Rep 604 at 608

Mr. Baker, an employee of the carrier made out the bill of lading on the 16<sup>th</sup> of December altering the date of issuance as of 15 December 1976. The bill of lading also contained a stamped and signed notation as “these goods are actually on board”. It further described the port of loading as London and the port of destination as Callao, when the shipment was actually made from Felixstowe.

On the 20<sup>th</sup> of December, 1976 United City Merchants presented the documents to the Royal Bank of Canada, which refused payment on the ground that:

- the commercial invoice tendered did not conform with the terms and conditions of the credit, and
- the information in their possession suggested that the bill of lading was forged.

The plaintiff initiated proceedings against the defendant for wrongful rejection of payment under the letter of credit, alleging that he had no knowledge on the fraudulent act of Mr. Baker and he believed that shipment had been effected as stated on the bill of lading.

#### *The decision of the Queens’ Bench Division*

The case was first decided by Judge Mocatta in 1979.<sup>461</sup> He gave judgment for the bank, although not on the ground of the fraud rule. He held that the agreement of the seller and the buyer was in fact a disguised “exchange contract”, and the parties with the agreement and the letter of credit opened pursuant thereto tried to avoid the strict regulations of the Bretton Woods Agreement of 1946<sup>462</sup>, which both Peru and England were members to. Thus the court should not by enforcing the letter of credit enable the Breton Woods Agreement to be avoided.<sup>463</sup>

Judge Mocatta, also gave an interesting opinion considering the fraud rule. He recalled the cases of *Edward Owen Engineering* and *Sztejn*<sup>464</sup> and accepted that the bank under a confirmed credit must pay against documents appearing on their face to comply with the terms of the credit, irrespective of any dispute between the seller and the buyer, except if the bank knows that the documents tendered are forged or the request for payment is made fraudulently. However, he stated that this case was “vitally different” from *Edward Owen* and *Sztejn* and rejected the defendant’s arguments on the ground that:

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<sup>461</sup> It was referred to as the “American Accord” case, [1979] 1 Lloyd’s Rep 267.

<sup>462</sup> Article 8 section 2(b) of the Agreement stated that ‘exchange contracts which involve the currency of any member and which are contrary to the exchange regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member’. Based on this Peru initiated regulations prohibiting for individuals or corporations in Peru to maintain or establish deposits in a foreign currency in banks in the country or abroad.

<sup>463</sup> The case involved an other important issue, namely, if the underlying contract is illegal, can the letter of credit nonetheless be enforced. In the present case the buyer requested the seller, who agreed to double the original purchase price for the same items on the conditions that the excess amount was to be remitted within 10 days of negotiation of credit to Nanke International, a company closely associated with Vitro and seated in Miami, US. This way Nanke, on behalf of Vitro, could have obtained a large amount of US dollars, which he would have had to pay back within 5 years by selling Peruvian soles for dollars. The reason for this was to avoid the strict Peruvian foreign exchange regulations. The Court of First Instance held that the underlying contract between the seller and the buyer constituted an ‘exchange contract by being a monetary transaction in disguise contrary to the Exchange Regulations of Peru’, thus it was illegal and unenforceable in line with the letter of credit opened pursuant to the underlying contract. The Court of Appeal upheld this part of the decision, agreeing on that the sales contract was a ‘monetary transaction in disguise’ and emphasized that the credit was a ‘part and parcel’ of the scheme to go around the Peruvian regulations. The House of Lords also upheld the decision of the Court of Appeal on this issue.

<sup>464</sup> *Sztejn v. Henry Schroeder Banking Corporation* [1941] 31 N.Y.S. 2d 631, analyzed below in 7.2.2

“... although Mr. Baker had acted fraudulently, neither he nor his company were acting on behalf of either of the plaintiffs but were acting as loading brokers on behalf of the American Prudential Lines from whom they received their remuneration...

[...]

There was no fraud by the plaintiffs nor was there any finding that they knew the date on the bill of lading to be false when they presented the documents...”<sup>465</sup>

The seller appealed against the judgment.

### *The judgment of the Court of Appeal*

The Court of Appeal reversed the judgment of the Trial Court on the issue of the fraudulent act of a third party.

The Court emphasized the well-known principle of autonomy, according to which “the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to the contract or not. Under a letter of credit, the contract is to buy documents not goods”<sup>466</sup>. The established exception to the strict principle of autonomy is the fraud rule.

In regard to the extent of the fraud exception, Justice Ackner posed the question:

“... is the fraud exception to the strict rule that the bank must pay if the documents are, on their face, in order, limited to the case where the fraud is that of the seller/presenter, or does it apply in all cases of fraud to the knowledge of the bank?”<sup>467</sup>

And he answered it as follows:

“...the buyer, unless otherwise agreed, cannot be deemed to have authorized the banker to pay against documents which are known to be forged. If the documents are forged, then obviously they are not valid. The buyer’s instructions to the banker must be construed as requiring the acceptance of valid documents only, and the banker’s promise to the seller must be similarly construed. ...

The banker’s authority or mandate is to pay against genuine documents and that is what the bank has undertaken to do. It is the character of the document, not its origin, that must decide whether or not it is a “conforming” document, that is a document which complies with the terms of the credit. ...

... if I am correct in my view that it is the character of the document that decides whether it is a conforming document and not its origin, then it must follow that if the bank knows that a bill of lading has been fraudulently completed by a third party, it must treat that as a nonconforming document in the same way as if it knew that the seller was party to the fraud.”<sup>468</sup>

An other important issue the court dealt with was the allocation of risk between the innocent parties. The court considered which party, namely the bank, the buyer or the beneficiary, should bear the risk of loss in case of fraud in the documents committed by a third party.. Referring to Justice Mocatta’s decision, Justice Stephenson stated, that:

<sup>465</sup> [1979] 1 Lloyd’s Rep 267 at 278

<sup>466</sup> [1981] 1 Lloyd’s Rep 604 at 626

<sup>467</sup> Ibid at 627

<sup>468</sup> Ibid at 628-629

“The Judge [Mocatta] accepted that the exception rests on the principle “*ex turpi causa non oritur actio*”. It was because he held that there was no fraud on the part of the plaintiffs, or knowledge that the date on the bills of lading was false when they presented the documents, that the plaintiffs were ... entitled to succeed. I would agree that that is a good ground for dismissing a beneficiary’s claim to be paid under a letter of credit. I would agree also that the fewer the cases in which the bank is entitled to hold up payment the better for the smooth running of international trade. But I do not think that the Courts have a duty to assist international trade to run smoothly if it is fraudulent any more than when it violates an international agreement. Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for the documents they present, it is important to all concerned that those documents should accord, not merely with the requirements of the credit but with the facts, and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer.”<sup>469</sup>

He continued:

“There was fraud in the transaction and our Court should adopt - ... the flexible standard to be applied as the circumstances of a particular situation mandate ... We should not apply it only to - ... situations in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer’s obligation could no longer be served.

It should also be applied to any fraud which, if known to the issuing or confirming bank, would entitle it to refuse payment. In that situation the bank owes no duty to the beneficiary to pay and, I would say, owes a duty to the customer not to pay. ...

Even though the Judge [Mocatta] was not able to find that Baker was the plaintiff’s agent in making the bill of lading for presentation to the defendants, the plaintiffs were the innocent party who put him in the position in which he made the bill, and made it fraudulently, and in my judgment it is they rather than the defendants ... who should bear the loss.”<sup>470</sup>

This view was further emphasized by Justice Griffiths, saying that:

“The bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the documents are forgeries it must refuse to accept them. It may be that the party presenting the documents has himself been duped by the forger and believes the documents to be genuine but that surely cannot affect the bank’s right to refuse to accept the forgeries. The identity of the forger is immaterial. It is the fact that the documents are worthless that matters to the bank. In such a case the right of the bank to refuse payment does not rest upon the application of the maxim *ex turpi causa non oritur actio*, but upon the fact that the bank’s obligation is to pay upon presentation of genuine documents in accordance with the requirements of the letter of credit.”<sup>471</sup>

### *The House of Lords*

Upon appeal the case was submitted to the House of Lords, which agreeing with the Trial Court’s opinion, reversed the decision of the Court of Appeal on the issue of the third party fraud.

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<sup>469</sup> Ibid at 620

<sup>470</sup> Ibid at 623

<sup>471</sup> Ibid at 632

Lord Diplock explained that:

“It is trite law that there are four autonomous though interconnected contractual relationships involved: (1) the underlying contract for the sale of goods ... (2) the contract between the buyer and the issuing bank ... (3) if payment is to be made through a confirming bank, the contract between the issuing bank and confirming bank, and ... (4) the contract between the confirming bank and the seller. ...

Again, it is trite law that in contract (4), with which alone the instant appeal is directly concerned, the parties to it, the seller and the confirming bank, “deal in documents and not in goods,” ...

[...]

To this general statement of principle ... there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue.”<sup>472</sup>

After referring to the *Sztejn* case he continued:

“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 actio*, 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.”<sup>473</sup>

The sellers were not aware of the fact that Mr. Baker completed the bills of lading not stating the actual truth of the date of shipment, and because they in fact “believed that it was true and the goods had actually been loaded on or before the 15<sup>th</sup> of December 1976, as required by the documentary credit”<sup>474</sup>, the beneficiaries were innocent. Thus, the House of Lords concluded that “the instant case ... does not fall within the fraud exception”<sup>475</sup>.

#### *Remarks on the case*

The three judgements show that each court dealing with the fraud exception approached the question from a different aspect and arrived to contradicting conclusions.

The Trial Court held that only fraud committed by the beneficiary could invoke the fraud rule. This is the typical approach of the English courts requiring the active participation of the beneficiary in or at least knowledge of the fraud.

The Court of Appeal – on the contrary – stated that the fraudulent nature of the documents and not their origin bore relevance. If the documents tendered were not genuine, the fraud rule applies regardless of who has been the perpetrator.

The House of Lords, upholding the Trial Court’s decision, based its conclusions on the maxim *ex turpi causa non oritur actio* and stated that the seller was entitled to the payment as it was not party to the fraud and had acted in good faith.

The spirit of the UCP and commercial sense suggest that, with dues respect, the decision of the Court of Appeal should be supported. Commentators point out that “there appears to be no

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<sup>472</sup> [1982] 2 All ER 720, re-printed also in R. H. Folsom, M.W. Gordon, J.A Spanogle jr., *International Business Transactions* (5<sup>th</sup> ed., 2002) West Group, p. 298 at 300

<sup>473</sup> Ibid at 301

<sup>474</sup> Ibid at 302

<sup>475</sup> Ibid at 301

commercial justification for assuming that the risk of this supplier's fraud or forgery is to be borne by the bank ... rather than by the beneficiary"<sup>476</sup>.

The main function of the documents tendered under a letter of credit is to provide security. If the forged documents constitute a worthless security, the bank should be under no obligation to pay. Furthermore, it is the seller who prepares the documents or obtains them from third parties, thus there is a contractual relationship between the seller and the third party. It is against the principles of contract law to "punish" the bank for fraud deriving from a contractual relationship to which the bank is not a party, and which is beyond the control of the bank.

The letter of credit as a payment instrument is the result of a bargain between the seller, the buyer and the bank, based on the prerequisite that the documents tendered evidence the truth. Under their agreement the seller has a "duty to tender documents which are in order, and the fact that he acted in good faith in tendering forged documents is thus irrelevant"<sup>477</sup>. Holding a view to the contrary encourages sellers not to inquire into the genuineness of the documents obtained from third parties, moreover it "has the potential to make fraud by the beneficiary easier to conceal"<sup>478</sup>. This is clearly against one of the main purposes of letters of credit, namely to reduce the risk of the contractual parties; more specifically to eliminate the buyer's risk of non-shipment or defective shipment. It also goes beyond the principle of faultless tender.

When a seller sues the bank for wrongful dishonour claiming that he had no knowledge of the third party fraud, as described in the present case, the burden of proof to establish that the seller in fact was aware of the fraud is shifted on the bank. This, in the majority of the cases, is not possible, or may happen only by chance. International trade cannot properly operate within uncertain circumstances or events that may be revealed by chance; it requires a more rational base for determining in which situations the bank is obliged to pay.<sup>479</sup>

In conclusion, it is the nature of documents, and not the identity of the perpetrator should matter, as correctly reflected by the UNCITRAL Convention and the UCC.

### 7.2.2. Important early cases in the United States

The development of the fraud rule in the US can be described through the following cases. This thesis does not intend to cite all of the important cases, which would certainly fill up several volumes, only those representing a milestone in American case law.

#### Higgins v. Steinharterter

One of the earliest examples of American fraud cases is the *Higgins v. Steinharterter*<sup>480</sup> case from 1919. The case involved a purchase of walnut by Higgins, shipped on or before the 7<sup>th</sup> of

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<sup>476</sup> E.P.Ellinger, Documentary Credits and Fraudulent Documents In. C.M. Chinkin, R.J.Davidson, W.J.M.Ricquier (ed.), *Current Problems of International Trade Financing* (1983) Singapore, p. 206.

It has also been emphasized by several commentators that there is an implied warranty by the seller for the genuineness of the documents. See *Benjamin's Sale of Goods*, (1981) London; John F. Dolan, *The Law of Letters of Credit* (1984) Boston; Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002) The Hague

<sup>477</sup> R.M. Goode, *Reflections on Letters of Credit – I*, *The Journal of Business Law*, July 1980, p. 291 at 294

<sup>478</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 133. The same was expressed by G.W.Smith, *Irrevocable Letters of Credit and Third Party Fraud: The American Accord* (1983) 24 Va J Int'l L 55, p. 96

<sup>479</sup> See the analysis of the case in Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 121-135

<sup>480</sup> [1919] 175 NYS 279, see also Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002) The Hague, p. 34

November in 1918. Payment was to be made by a letter of credit issued by Monroe & Co. The action was brought by the plaintiff in order to restrain the issuing bank from payment under the letter of credit and to cancel the credit on the ground that the shipment was not made until December 1918, thus the seller breached the contract. The plaintiff further alleged that the bill of lading was forged and falsely stated the shipment date as 30 October, 1918. When he informed the issuing bank of the alleged fraud, the bank in its reply stated that it is obliged to effect payment in presentation of a facially conforming bill of lading.

An injunction was granted and Judge Finch explained:

“It is clear that the plaintiff authorized a credit to apply only to a shipment made on or before November 7<sup>th</sup>, and hence, if shipment was made subsequent to that date, a payment made against said credit would be unauthorized. It became an unused credit, cancelled by limitation of time.”<sup>481</sup>

Xiang Gao points out that in this case the plaintiffs’ main argument was the seller’s breach of the underlying contract and they did not sue the seller for fraud. Nor the court based its judgment on the fraud exception but rather on the unauthorized nature of the credit due to the lapse of time. He suggests that it may be due to the fact that “the fraud rule in the law of the letters of credit was so embryonic at that time at least in the United States that even people in financial centres like New York did not contemplate its relevance”<sup>482</sup>.

#### Old Colony Trust Co v. Lawyer’s Title & Trust

In the case of *Old Colony Trust Co v. Lawyer’s Title & Trust*<sup>483</sup> the plaintiffs had advanced a large sum to the seller. A letter of credit issued by the defendant stood as a collateral security. The letter of credit called for, among other documents, a warehouse receipt, which is issued if the goods are in possession of the warehouseman. Facially conforming documents were tendered to the bank, however the bank refused payment on the ground that the examination of the documents disclosed that the goods were actually still on board.

The seller sued the defendant for breach of contract, but the claim was rejected by the court. The Appellate Court affirmed the original judgment and held:

“Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such document as complying with the terms of the letter of credit.”<sup>484</sup>

In the present case the court gave its judgment on contract law principles, namely that a fraudulent document cannot be considered as complying. Similarly to the previously mentioned *Higgins v. Steinharterter*, the fraud rule at this time was not referred to.

#### Maurice O’Meara Co v. National Park Bank

In 1925 Judge Cardozo made an important statement in *Maurice O’Meara Co v. National Park Bank*<sup>485</sup>. In this case the plaintiff entered into a contract of sale of newsprint paper of a specified tensile strength with the Sun-Herald Corporation. National Park Bank of New York issued confirmed irrevocable letter of credit. The plaintiff presented facially complying documents and

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<sup>481</sup> Ibid

<sup>482</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002) The Hague, p. 35

<sup>483</sup> [1924] 297 F 152

<sup>484</sup> Ibid at 158

<sup>485</sup> [1925] 146 N.E. 636

required payment. However, the National Park Bank refused to pay, claiming that “[t]here has arisen a reasonable doubt regarding the quality of the newsprint paper”<sup>486</sup>.

The plaintiff sued the bank for damages suffered because of the issuer’s wrongful dishonour. In his defence the bank argued that the quality of the paper did not meet the contracted quality. The majority judgment of the Court of Appeals of New York rejected the issuing bank’s claim and held:

“[The contract between the buyer and the seller] in no way concerned the bank. The bank’s obligation was to pay sight drafts when presented if accompanied by genuine documents specified in the letter of credit. If the [goods] when delivered did not correspond to what had been purchased, either in weight, kind or quality, then the purchaser had his remedy against the seller for damages.

[...]

The bank was concerned only in the drafts and the documents accompanying them. ... If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for.

[...]

To hold otherwise is to read into the letter of credit something which is not there, and this the court ought not to do, since it would impose upon a bank a duty which in many cases would defeat the primary purpose of such letter of credit. This primary purpose is an assurance to the seller of merchandise of prompt payment against documents.”<sup>487</sup>

It is clear from this wording that the majority of the judges believed that if facially complying documents are tendered it is outside the bank’s liability and concern to inquire into evidence indicating fraud. The above cited reasoning also gives clear indication that American courts accepted the autonomy principle.

Justice Cardozo dissented and said:

“I dissent from the view that, if [the issuing bank] chooses to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise which the documents describe, it may be forced by the delinquent seller to make payment of the price irrespective of its knowledge. ... We are to bear in mind that this controversy ... arises between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated payment may be resisted if the documents are false.

I think we lose sight of the true nature of the transaction when we view the bank as acting upon the credit of its customer to the exclusion of all else. It acts not merely upon the credit of its customer, but upon the credit also of the merchandise which is to be tendered as security. ... I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face.”<sup>488</sup>

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<sup>486</sup> Ibid at 639

<sup>487</sup> Ibid

<sup>488</sup> Ibid. at 641.

The view expressed by Judge Cardozo is significant as it reflected on the rules of letter of credit law, not on general contract law as pointed out in the earlier cases. He implied that if the seller had perpetuated the fraud, the issuing bank may be entitled to refuse payment if the fraud was discovered before payment was due. This argument was later used in *Sztejn v. Henry Schroeder Banking Corporation*, described below.

### The Sztejn case

The most important and most often cited case in the history of the fraud rule, often referred to as the “landmark American case” is the *Sztejn v. Henry Schroeder Banking Corporation et al*<sup>489</sup>. The reasoning of the court had a major influence on the letter of credit law in and outside the United States<sup>490</sup> and the findings concerning the fraud exception have been embodied in Article 5 of the UCC.

### *The facts*

On the 7<sup>th</sup> of January, 1941 the plaintiff, Charles Sztejn, entered into a sales contract of a number of hog bristles with the Indian seller, Transea Traders Ltd. Payment was by an irrevocable letter of credit. The letter of credit was issued by the defendant Schroeder Bank and presented to the seller by Chartered Bank of India. It called for, among other documents, a draft, a commercial invoice and a bill of lading. The seller submitted documents that on their face complied with the terms and conditions of the credit to the Chartered Bank of India for collection for the amount. The bank sougthed payment from Schroeder on behalf of Transea. However, before payment was made, Sztejn had filed a suit at the New York Court enjoining the bank from honouring the demand, alleging that the beneficiary had in fact shipped “cowhair, other worthless material and rubbish with intent to stimulate genuine merchandise and defraud the plaintiff”<sup>491</sup>. The defendant argued that the plaintiff did not have a cause of action as the “Chartered Bank is only concerned with the documents and on their face these conform to the requirements of the letter of credit”<sup>492</sup>.

### *The Court’s decision*

The court examined the elements of fraud and drew a careful rule. First acknowledged the independent nature of the credit from the underlying transaction. It stated that:

“It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade. One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a most unfortunate interference with business transactions if a bank before honouring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped.”<sup>493</sup>

Then the court established an exception to the principle in cases where there has been an active fraud on the part of the beneficiary. Justice Shientag explained it as follows:

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<sup>489</sup> [1941] 31 N.Y.S. 2d 631, available also at <http://international.westlaw.com/search>

<sup>490</sup> Among others, the well-known English case, *United City Merchants (Investments) Ltd v. Royal Bank of Canada*, contains specific reference to the *Sztejn* case as the ‘most illuminating’ case on the fraud rule.

<sup>491</sup> *Ibid* at 633

<sup>492</sup> *Ibid* at 632

<sup>493</sup> *Ibid* at 633

“Of course, the application of this [independence] doctrine presupposes that the documents accompanying the draft are genuine and conform to the requirements of the letter of credit. However, I believe that a different situation is presented in the instant action. ...

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 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. ... However, in the instant action Schroeder has received notice of Transea's active fraud before it accepted or paid the draft.”<sup>494</sup>

Ruling for the plaintiff and rejecting the Chartered Bank's claim the court also stated that:

“no hardship will be caused ... where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish, where the draft and the accompanying documents are in the hand of one who stands in the same position as the fraudulent seller, where the bank has been given notice of the fraud before being presented with the drafts and documents for payment. ...

I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the amount of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied. If it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated.”<sup>495</sup>

The facts of the case are typical: a buyer learns that the seller has defrauded him before payment is effected to the seller, and tries to protect his interest. The court showed that the buyer can indeed rely on the fraud exception as a defence against the unscrupulous seller. There are circumstances where “the balance favouring convenience, reliability, economy and flexibility would be upset by the notion operating against unjust enrichment of the beneficiary. When this happens, the court should step in to restore justice”<sup>496</sup>.

Looking at the findings of the previous cases it can be stated that the Szejn decision did not create a new exception to the independence principle.<sup>497</sup>

Its importance however lies in the fact that it listed the major elements of the fraud exception and considered the commercial utility of the letter of credit and the unjust enrichment of a fraudulent party. Acknowledging the autonomy principle as the base of letter of credit law the judgement concluded that the payment mechanism can be stopped by the court if (a) there is fraud in the transaction, (b) caused intentionally by the beneficiary, (c) the fraud is known to the bank before payment and (d) the beneficiary is not a holder in due course.

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<sup>494</sup> Ibid at 634-635

<sup>495</sup> Ibid at 635

<sup>496</sup> Ho Peng Kee, The Fraud Rule in Letters of Credit Transactions, In C.M. Chinkin, P.J. Davidson, W.J.M. Ricquier (eds), *Current Problems of International Trade Financing* (1983) Singapore, p. 235 at 240

<sup>497</sup> It has been emphasized in *Higgins v. Steinhardter* ([1919] 175 NYS 279) that the court ‘could enjoin an issuer from honouring a credit, even though the beneficiary had presented documents that technically conformed to its terms, when allowing honour would defraud the customer’.

### 7.3 The regulation of fraud in documentary credits in selected jurisdictions

When fraud occurs, a dispute arises whether the bank is or would have been obliged to pay or not. Such a dispute is likely to happen in the following situations:

- a) where the applicant wishes to stop the paying bank effecting payment to the beneficiary on the ground that the beneficiary acted fraudulently and turns to court for injunction
- b) where the paying bank has refused to pay on the ground of fraud and the beneficiary is suing the bank for wrongful dishonour of the presentation of documents
- c) where fraud is alleged after the bank has effected payment to the beneficiary and the bank wishes to get recovery
- d) where the bank evoking the fraud exception refuses to pay to a third party, who obtained the beneficiary's right after the bank had accepted the documents tendered by the beneficiary

National courts have approached the fraud rule in different ways and have required different standards of fraud in order to justify the disruption of the normal course of the documentary credit operation.

This section intends to examine the approach of different jurisdictions in relation to the fraud rule.

First the approach of the United States will be analyzed. Letter of credit law has its statutory foundation in Article 5 of the Uniform Commercial Code, which is often referred to as the most comprehensible and detailed statutory regulation on letters of credit, including a separate article on the fraud exception.

There is no statutory equivalent of the fraud rule in the United Kingdom, the second subject of the examination. The fraud rule has developed in the case law. British courts have continuously recognized the concept of the autonomy of the credit and have developed a very strict approach towards the fraud rule, as the exception to the independence principle. The British approach may be well described by the statement of Justice Kerr in *R.D. Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd*, that "it is only in exceptional cases that the Court will interfere with the machinery of irrevocable obligations assumed by banks".<sup>498</sup>

The section also gives a brief summary of Hungary and Greece representing two civil law countries. When selecting these two countries consideration was given to the fact that there are no specific regulations on documentary credits in Hungarian law (apart from a short section in a decree of the President of the National Bank of Hungary), whereas Greece has developed its own statutory provisions and up until the last enlargement of the European Union it was the only member state which codified the letter of credit law.

#### 7.3.1. The position of the United States of America

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<sup>498</sup> [1977] 2 All ER 862 at 870

### The first draft of Article 5 of the UCC

The fraud rule in the United States legislature is covered by Article 5 of the UCC. Its first drafting in 1954 involved a serious debate between the drafters and the banking society, represented by the United States Council on International Banking (USCIB)<sup>499</sup>.

The members of USCIB found it “highly undesirable ... to attempt legislation in this particular area of trade and finance”. They felt “no demand or need for legislation” based on their “experience that the institutions and persons who use documentary letters of credit are for the most part thoroughly familiar with this financial medium and with its terms, customs and practices”<sup>500</sup>.

Despite the opposition, Article 5 of the UCC was drafted and adopted by every state of the United States. Although first New York, then later Alabama, Arizona and Missouri adopted a so called “non-uniform section”<sup>501</sup> - the purpose of which was to support the application of the UCP as opposed to the UCC in letter of credit transactions -, Article 5 has gained an increasing importance in the United States. The main reason behind this is that the UCP does not address every issue that may appear in a letter of credit transaction. For these issues – an example of which is the fraud exception - the courts of the United States look into the provisions of Article 5 of the UCC.

In the first draft of the letter of credit provisions the fraud rule was regulated by Article 5-114<sup>502</sup>. The drafting of Article 5-114 was highly influenced by the *Sztejn* case. It embodied both the independent principle and the fraud exception.

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<sup>499</sup> The United States Council on International Banking is a trade association representing more than 350 banks involved in international banking operations. It traces its origins back to 1924, when a Junior Committee was founded in New York by investment and commercial bankers. In 1998 its name was changed to International Financial Services Association (IFSA). The Association has an important role in the formation of regulations on letters of credit and has actively participated in the revision of Article 5 of the UCC. More than 80 percent of the letters of credits issued in the US are issued by banks being members of the IFSA. (For more information on IFSA visit <http://www.ifsonline.org>, date visited: 16 August, 2005)

<sup>500</sup> New York Law Revision Commission, 1954 Report 40. , cited by James J. White, *The Influence of International Practice on the Revision of Article 5 of the UCC* In.: Northwestern Journal of International Law and Business, Vol 16, No. 2, Winter, 1995, p. 191

<sup>501</sup> The ‘non-uniform’ section of the UCC Article 5 as adopted by the named states reads as follows: ‘unless otherwise agreed, Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits...’ (NY UCC Law § 5-102(4) )

<sup>502</sup> Article 5-114 reads as follows:

- (1) An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.
- (2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction:
  - (a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and
  - (b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not

One of the greatest achievements of Article 5-114 was that it made it clear to the applicant that he can protect its interest under a letter of credit transaction by applying the fraud rule only. Using the fraud rule, the applicant could turn to the court to request injunctive relief in order to stop the bank effecting payment.

The Article also entitled the issuing bank to refuse to honour a draft drawn under a letter of credit even though the documents presented appeared on their face to comply with the terms of the letter of credit, if

- the documents were forged or fraudulent, or there was fraud in the transaction; and
- no innocent third parties (for example a negotiating bank or a holder in due course) were involved.

Although the issuing bank was not under the obligation to refuse to honour the fraudulent documents, it could merely do so upon its own judgment if the fraud was brought to its attention.

On the other hand, Article 5-114 left an important question open, as what is the standard of fraud which could suspend the application of the independence principle, or in other words, what constitutes a fraud under the fraud rule. We may seek the answer in the case law.

The courts of the United States have not given a definite answer and the cases suggest that there is a variety of standards used to define what constitutes fraud. At one end is the standard of egregious fraud, followed by the intentional fraud. Below the standard of intentional fraud is a “flexible standard that can be applied as the circumstances of a particular situation mandate”<sup>503</sup>. This line is closed by a broader approach, where the intention to defraud is not a necessary element.<sup>504</sup>

### *Egregious fraud*

The term “egregious fraud” has been explained by commentators as “a flagrant violation of the beneficiary’s obligation under the letter of credit”<sup>505</sup>, or as an “outrageous conduct which shocks the conscience of the court”<sup>506</sup>.

The egregious fraud standard was used in the case of *Intraworld Industries Inc v. Girard Trust Bank*<sup>507</sup>, which involved the lease of a luxury Swiss hotel. The applicant, the lessee, obtained a standby letter of credit in favour of the beneficiary, the lessor, under which the bank promised to pay against a draft accompanied by the beneficiary’s signed statement declaring that the applicant had not paid an instalment of rent due under the lease.

The beneficiary presented a draft accompanied by a statement conforming to the terms of the letter of credit. However, the applicant turned to court alleging that the documents presented by

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apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.

(c)

<sup>503</sup> Ho Peng Kee, *The Fraud Rule in Letters of Credit Transactions* In. C.M. Chinkin, P.J. Davidson, W.J.M. Ricquier (eds), *Current Problems of International Trade Financing* (1983) Singapore, p. 235 at 242

<sup>504</sup> For a detailed analysis of the different standards see Ho Peng Kee, *The Fraud Rule in Letters of Credit Transactions* In. C.M. Chinkin, P.J. Davidson, W.J.M. Ricquier (eds), *Current Problems of International Trade Financing* (1983) Singapore, p. 235; Xiang Gao, Ross P Buckley *A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law* In Oxford University Comparative Law Forum, (<http://ouclf.iuscomp.org/articles/gao-buckley.shtml#fn1anc>, date visited: 16 August, 2005); and E.L. Symons, *Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief* In (1980) 54 Tulane L.Rev. p. 338

<sup>505</sup> Henry Harfield, *Enjoining Letter of Credit Transactions* (1978) 95 Business L J p. 596 at 602

<sup>506</sup> E.L. Symons, *Letter of Credit: Fraud, Good Faith and the Basis for Injunctive Relief* (1980) 54 Tulane L Rev p.338 at 347

<sup>507</sup> [1975] 336 A.2d 316

the beneficiary were false and fraudulent on the ground that: (1) no rent was due because the beneficiary had terminated the lease; and (2) the beneficiary's claim was not for rent but rather for a stipulated penalty.

The Pennsylvania Court rejected the applicant's claim for an injunction against payment of the letter of credit, and held that:

“In light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purposes of the letter of credit, we think that the circumstances which will justify an injunction against honor *must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.*”<sup>508</sup>

### *Intentional fraud*

The standard of intentional fraud is based on the common law definition of fraud, which requires the following elements to be present:

- a false presentation of the fact
- a knowledge or belief on the part of the beneficiary; and
- an intention to induce the issuer to act or to refrain from action in reliance upon the misrepresentation<sup>509</sup>.

A good illustration of the intentional fraud is the *American Bell International v. Islamic Republic of Iran*<sup>510</sup> case, the facts of which have been summarized earlier.<sup>511</sup>

The Court rejected the plaintiff's arguments and Judge MacMahon explained that:

“Even if we accept the proposition that the evidence does show repudiation, plaintiff is still far from demonstrating the kind of *evil intent* necessary to support a claim of fraud. Surely, plaintiff cannot contend that every party who breaches or repudiates his contract is for that reason culpable of fraud.”<sup>512</sup>

### *The flexible approach*

The flexible standard approach was used in the case of *United Bank Ltd v. Cambridge Sporting Goods Corporation*<sup>513</sup>. In 1971 Cambridge Sporting Goods Corp. (Cambridge) entered into a contract to buy boxing gloves from Duke Sports (Duke), a Pakistani Corporation. Duke arranged with its Pakistani bankers, the United Bank Limited and The Muslim Commercial Bank to finance the sale. Cambridge was requested by the financing banks to cover the payment of the purchase price by opening an irrevocable letter of credit with its bank, Manufacturers Hanover Trust Company (Manufacturers). Manufacturers issued the letter of credit.

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<sup>508</sup> Ibid at 324, emphasis added

The same standard was used in the case of *New York Life v. Hartford National Bank & Trust Co* (378 A. 2d 562 (1977)), where the court held that ‘only in rare situations of *egregious fraud* would Article 5 -114 have justified the issuer, on the facts presented here, in going behind apparently regular, conforming documents’.

<sup>509</sup> *Derry v. Peek*, (1889) 14 App. Cas. 337, 347, (Lord Herschell)

<sup>510</sup> [1979] 474 F. Supp 420

<sup>511</sup> See Chapter III., 3.2.2.

<sup>512</sup> Ibid at 425

<sup>513</sup> [1976] 392 N.Y.S.2d 265

Later Duke informed Cambridge that he will not be able to deliver the gloves within the period stated and sought an extension of time for performance. Due to its resale commitments, Cambridge did not agree to the postponement of the delivery and cancelled the contract. Cambridge simultaneously notified United Bank of the cancellation.

Despite the cancellation, Cambridge was informed that Manufacturers received the documents requested under the letter of credit from the United Bank and later from the Muslim Commercial Bank.

When the shipments arrived, the inspection revealed that Duke had shipped old, unpadded, ripped and mildewed gloves rather than the new gloves contracted for. Cambridge commenced an action against Duke, joining Manufacturers as a party, and obtained a preliminary injunction prohibiting the issuer from paying the drafts, and subsequently levied on the funds subject to the credit.

The Pakistani financing banks instituted proceedings to vacate the levy and to obtain payment of the drafts, claiming they were holders in due course of the drafts and hence were entitled to the proceeds. In refusing the petitioners' request, the Court of Appeal of New York observed:

"It should be noted that the drafters of section 5-114, in their attempt to codify the *Sztejn* case and in utilizing the term "fraud in the transaction", have eschewed a dogmatic approach and adopted *a flexible standard* to be applied as the circumstances of a particular situation mandate. It can be *difficult to draw a precise line between cases involving breach of warranty* (or a difference of opinion as to the quality of goods) *and outright fraudulent practice* on the part of the seller. To the extent, however, that Cambridge established that Duke was guilty of fraud in shipping, not merely nonconforming merchandise, but worthless fragments of boxing gloves, this case is similar to *Sztejn*."<sup>514</sup>

#### *The broader approach*

The standard of a broader approach was suggested in *Dynamics Corp. of America v. Citizens & Southern National Bank*<sup>515</sup>. The case involved a contract between the plaintiff and the Indian government, whereby the plaintiff agreed to sell to the Indian government defence-related equipments. The defendant bank issued standby letters of credit by which it promised to pay drafts drawn by the Indian government, and accompanied by the Indian government's certification that Dynamics had failed to carry out certain of its obligations under the underlying contract.

In 1971 a war broke out between India and Pakistan as a result of which the US government imposed an embargo on military supplies to the region, thus Dynamics was not able to make further delivery of the equipments. The Indian government thereafter presented a draft accompanied by a certificate that purported to comply with the terms of the letter of credit.

The plaintiff sought an injunction to prevent the issuer from honouring the draft, alleging that the certificate provided by the Indian government was fraudulent in that the plaintiff had actually performed its obligations under the contract. The United States District Court of Georgia granted the injunction and stated:

"The law of "fraud" is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society. ...

<sup>514</sup> Ibid at 271, emphasis added.

<sup>515</sup> [1973] 356 F. Supp. 991

In a suit for equitable relief — such as this one — it is not necessary that the plaintiffs establish the elements of actionable fraud required in a suit for monetary damages. ... Fraud has a broader meaning in equity and an intention to defraud or to misrepresent is not a necessary element. Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscious advantage is taken of another.<sup>516</sup>

### *Remarks on the standard of fraud*

It can be concluded from the cases illustrating the development of the fraud rule in the United States that the first draft of the UCC Article 5-114 did not give a definite answer for the standard of fraud. Lacking a definite answer, the courts adopted different views, diverging from a very strict to a constructive standard.

Setting the standard of fraud at an extremely high, egregious level, may result in the applicant not being able to defend its interest, as it is not without difficulties to evidence that the only intention of the unscrupulous seller was to run away with the applicant's money, thus he violated the underlying contract to such an extent which may give rise to the elimination of the autonomy principle.

On the other hand, setting the standard of fraud too low may lead to the abuse of the rule by the applicant. This way “the inherent commercial functions of the letter of credit instrument such as prompt payment, allocation of risks and shifting of the forum may disappear”<sup>517</sup>.

As a result of the above concluded outcomes, the most favourable approaches are the standard of intentional fraud and the flexible approach. They both serve the purpose of the fraud exception, which is to stop the dishonest beneficiary from abusing the letter of credit system and obtaining unjust enrichment, while preventing any infringe on the part of the applicant.

### The Iranian Cases

The Iranian revolution had an important role in the development of standby credits. Although standby letters of credit are outside the scope of this thesis, since the so called Iranian cases had a major impact on the letter of credit law from the aspect of the fraud rule, it is significant to provide a brief summary.

US banks issue billions of dollars of standby credit every year in order to facilitate overseas transactions, often in connection with construction projects.<sup>518</sup> A standby credit is attractive to a foreign developer, as a simple statement that the contractor failed to perform his contractual obligations may effect payment.

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<sup>516</sup> Ibid at 998-999

<sup>517</sup> Xiang Gao, Ross P Buckley: A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law In.: Oxford University Comparative Law Forum, (<http://ouclf.iuscomp.org/articles/gao-buckley.shtml#fn1anc>, date visited: 16 August, 2005)

<sup>518</sup> In 1979 more than \$ 11 billion of standby credits were issued by American banks in support of overseas transactions, half of which were in connection with construction projects. See Peter Lloyd-Davies, *Standby letters of credit of commercial banks*, In *Below the Bottom Line: The Use of Contingencies and Commitments by Commercial Banks* (Staff Studies 113, Board of Governors of the Federal Reserve System (U.S.)) 1982

In the 1970s the Imperial Government of Iran initiated an extensive project to modernize the country. Billions of dollars were offered to contractors, many of which came from the United States on this “gold rush”<sup>519</sup>. In order to secure the good performance or the return of advanced payments the Iranian Government requested standby letters of credit issued in favour of the Iranian party. The transactions usually involved four parties: an American company, an Iranian government agency, a US bank and an Iranian bank. The American company contracted with the Iranian government agency to provide equipments and/or service. The contract required the American company to provide a guarantee. Normally an Iranian bank provided this guarantee on the condition that it was counter-guaranteed by standby letters of credit issued by a US bank in favour of the Iranian bank. In case of a dispute the Iranian party would demand payment from the Iranian bank under the guarantee. The Iranian bank would then demand payment from the US bank under the standby letter of credit, which would then turn to the American company for reimbursement.<sup>520</sup> Under the long recognized independence principle applicable to letters of credit, it was not necessary for the US bank to establish non-performance of the seller before paying the Iranian bank.<sup>521</sup>

In 1979 a revolution broke out in Iran, the result of which was a widespread blocking of former government regulations by the new Islamic Republic of Iran. The political turmoil prevented performance of the underlying contracts. Fearing that the new Iranian regime would demand payment under the standby letters of credits, the American companies turned to courts trying to invoke the fraud rule to enjoin their banks from honouring the letter of credit. At first, the American companies had “only marginal success in the courts”<sup>522</sup> as in most cases injunction was either denied or only “notice injunction”<sup>523</sup> was granted.<sup>524</sup> In denying injunction relief the courts often referred to the fact that the plaintiffs failed to evidence the evil or fraudulent intent of the Iranian party. This is well illustrated by *American Bell Int’l. Inc. v. Islamic Republic of Iran*<sup>525</sup>, summarized earlier.<sup>526</sup>

However, after hostages were taken at the US Embassy in Tehran in November 1979, the courts’ approach to the fraud exception changed. They began to issue preliminary injunctions holding that “the Iranian demand for payment threatened the contractors with immediate irreparable injury”<sup>527</sup>.

In 1981 the hostages were released and a Tribunal, called the Iran-United States Claims Tribunal was established to resolve the outstanding financial claims of US nationals against Iran. Although

<sup>519</sup> R.J. Driscoll, *The Role of Standby Letter of Credit in International Commerce: Reflections after Iran*, In 20 Va J Int’l L (1980) p. 459

<sup>520</sup> See Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 79

<sup>521</sup> See Arthur Loke, *The Iranian Experience* In. C.M. Chinkin, R.J.Davidson, W.J.M.Ricquier (ed.), *Current Problems of International Trade Financing* (1983) Singapore, p. 283

<sup>522</sup> Mark P. Zimmet, *Standby Letters of Credit in the Iranian Litigation: Two hundred problems in search of a solution*, In Law & Policy in International Business, Vol 16. No. 3 (1984), p. 927 at 930

<sup>523</sup> By granting a ‘notice injunction’ the banks were prohibited from paying to the Iranian beneficiaries except upon previously informing the American company of the demand for payment.

<sup>524</sup> Xiang Gao point out that there were only two cases reported: *John Carl Warnecke & Assocs v. Bank of America Nat’l Trust & Savings Ass’n*, [No. 749626 ND Cal 17 April 1979]; and *KNW International v. Chase Manhattan Bank NA* [No. 79 Civ 1067 SDNY 29 March 1979] where injunction was granted but the were later vacated. (See Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p.79, Note 54)

<sup>525</sup> [1979] 474 F. Supp 420, case is reported by R.H.Folsom, M.W.Gordon, J.A.Spanogle, *International Business Transactions – A problem oriented coursebook* (5<sup>th</sup> ed., 2002), p.329

<sup>526</sup> See Chapter III., 3.2.2

<sup>527</sup> Mark P. Zimmet, *Standby Letters of Credit in the Iranian Litigation: Two hundred problems in search of a solution*, In Law & Policy in International Business, Vol 16. No. 3 (1984), p. 927 at 942

hundreds of claims were submitted to the Tribunal, the injunction litigation filed with US courts did not stop and the courts continued to enjoin the payments under the standby credits.

In *Rockwell International Systems, Inc. v. Citibank N.A.*<sup>528</sup> the court emphasized that it must look to the circumstances surrounding the transaction in order to determine whether there had been an “outright fraudulent practice”. It held that the beneficiary acted fraudulently when it created circumstances that prevented the performance of the underlying contract in order to attempt to reap the benefit of the credit.

In *Touche Ross & Co. v. Manufacturers Hanover Trust Co.*<sup>529</sup> the underlying contract contained a force majeure clause, which entitled the parties to cancel the contract in case of such an event. Furthermore, evoking the force majeure clause would result in the termination of all letters of guarantee. After the hostages were taken the plaintiff cancelled the contract referring to the force majeure. Nevertheless the Iranian party obtained payment from the Iranian bank which made a demand on the US bank. Touche moved for injunction, which the court granted on the following two basis:

- no legitimate call could be made on the letter of credit since the contract had been cancelled; and
- due to the nationalization all financial institutes became owned by the Islamic Republic of Iran. Thus, the Iranian bank “could not have legitimately paid on the guarantee as ... [it] would be simply paying itself. Therefore, any call on the letter of credit would be fraudulent”<sup>530</sup>.

This approach of the court to the fraud rule alerted commentators worldwide.<sup>531</sup> It was feared that this too flexible view of the fraud exception would undermine the stable, substantive law of letters of credit and would “take the fraud rule very long way from its purpose”<sup>532</sup>. They urged for a proper definition of the standard of fraud and the revision of the UCC on the relevant issue.

## Revised UCC Article 5

### *General overview*

In 1986 a Task Force composed of lawyers from the American Bar Association and the representatives of the USCIB was formed to study the previous case law and to analyze the inadequacies of the 1962 version of the UCC Article 5.

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<sup>528</sup> [1983] 719 F.2d 583

<sup>529</sup> [1980].434 N.Y.S.2d 575

<sup>530</sup> Ibid at 578

<sup>531</sup> Zimmet asks the following question: ‘... was the Appellate Division’s decision in Touche Ross influenced by the widespread sentiment that Iran should be punished?’ (*Standby Letters of Credit in the Iranian Litigation: Two hundred problems in search of a solution*, In *Law & Policy in International Business*, Vol 16. No. 3 (1984), p. 927 at 946)

Wolfgang Freiherr von Marschall wrote: ‘... the Iranian experience seems to be a good illustration of the saying that hard cases make bad law. Cases deciding problems arising out of the Iranian revolution should be examined carefully and it should always be asked whether their reasoning is generally acceptable or whether the judge may have acted with a mind influenced by a recent television-picture of a commercially irresponsible Ayatollah. (*Recent developments in the field of standby letters of credit, bank guarantees and performance bonds* In C.M. Chinkin, R.J.Davidson, W.J.M.Ricquier (ed.), *Current Problems of International Trade Financing* (1983) Singapore, p. 260 at 282, footnote omitted)

<sup>532</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p.82

With respect to the fraud rule the Task Force made the following observations:

“The reported cases indicate general agreement that the defence of fraud in the transaction must be based on serious conduct that “has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer’s obligations would no longer be served”.

The reported cases differ, in rhetoric if not result, as to whether fraud in transaction refers to “egregious fraud” or “intentional fraud” or involves application of a flexible fraud standard ... Most of the cases favoring a flexible standard have nonetheless been supported by a showing of serious misconduct equivalent to the shipment of rubbish.

The “fraud-in-the-transaction”<sup>533</sup> defence has generally been construed to require proof of an active intent and proof of no colorable or plausible basis under the underlying contract for the beneficiary to call the credit.”<sup>534</sup>

Professor James E. Byrne, Chair of the Task Force explained that “forty years of hard use has revealed weaknesses, gaps, and errors in the original statute which compromise its relevance.”<sup>535</sup> Additionally, it was observed that the development of case law did not accord to the developments in letter of credit practices.

The Task Force also agreed that the revised UCC should conform to the Uniform Customs and Practices for Documentary Credits, which contains internationally recognized standards for letters of credit.

In response to the Task Force’s opinion, a drafting committee was appointed to draft a revised Article 5. The process of revision extended over several months and produced a vigorous and public debate among interested parties. Between 1991 and 1995 several drafts were concluded. Finally, the Revised UCC Article 5 was adopted in 1995. The question of fraud is dealt with Revised Article 5-109 under the heading of “Fraud and Forgery”, and it reads as follows:

- (a) *“If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:*
- (1) *the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a*

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<sup>533</sup> Under of UCC 5-114(2) the issuer could dishonour the credit if there was fraud in the transaction. The term ‘fraud in the transaction’ created some problems. Commentators were debating whether the term referred to fraud in the underlying transaction, or in the credit transaction itself. Many courts and commentators argued for a broad view, where the ‘fraud in the transaction’ term was used to frauds outside the credit, usually in the underlying transaction. Others favoured a narrower approach under which the fraud has to relate intimately to the credit transaction. The issue was solved by the Revised Article 5-109, which expressly includes the fraud in the underlying transaction within the fraud rule, although the ‘fraud in the transaction’ term has been changed to ‘honour of presentation would facilitate a material fraud’.

For a staled analysis of the ‘fraud in the transaction’ issue, see John F. Dolan, *The Law of Letters of Credit* (1984) Boston, Ch. 7.04

<sup>534</sup> Report of the Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5 (Letters of Credit)*, presented to the Letter of Credit Subcommittee of the Uniform Commercial Code Committee of the American Bar Association’s Business Law Section and the U.S. Council on International Banking, Inc., reprinted in [1990] 45 Bus. Law 1521 at 1613-1614

<sup>535</sup> *Ibid* at 1532

*holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and*

*(2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.*

*(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:*

*(1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;*

*(2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;*

*(3) all of the conditions to entitle a person to the relief under the law of this State have been met; and*

*(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1)."*

Under the Revised UCC Article 5, an issuer must honour presentation of complying documents under a letter of credit transaction, regardless of whether the documents conform to the underlying contract between the seller and the buyer.<sup>536</sup>

There is however an exception to this general principle, where fraud is committed by the beneficiary on the issuer or the applicant; or is found in the documents. In such a case, the

a) issuer may refuse to honour the presentation, or

b) the applicant can turn to the court for enjoining the issuing bank from honouring the presentation.

Similarly to the 1962 version of Article 5-114 of the UCC it is not a *must* for the issuing bank to dishonour the presentation if fraud was brought to its attention, but rather a possibility. Thus, the applicant may expect a better result to stop the payment by turning to the court to obtain injunction.

In order to disrupt the normal operation of letter of credit in case of an alleged fraud, the fraud must be "material".

The term "materiality" – as explained by the Official Comment to the UCC – means that the fraudulent act must be "significant to the participants to the underlying transaction"<sup>537</sup>.

The following example has been provided to illustrate the issue:

"Assume ... the beneficiary has a contract to deliver 1,000 barrels of salad oil. Knowing that it has delivered only 998, the beneficiary nevertheless submits an invoice showing 1,000 barrels. If two barrels in a 1,000 barrel shipment would be an insubstantial and immaterial breach of the underlying contract, the beneficiary's act, though possibly

<sup>536</sup> See Article 5-103 (d)

<sup>537</sup> Official Comment to the Revised UCC Article 5-109 In. Douglas G. Baird, Theodore Eisenberg, Thomas H. Jackson (comp), *Commercial and Debtor-Creditor Law*, Selected Statutes (2002 ed.) New York, p. 545

fraudulent, is not materially so and would not justify an injunction. Conversely, the knowing submission of those invoices upon delivery of only five barrels would be materially fraudulent.”<sup>538</sup>

Whether a fraudulent act is material or not, the court has to look into the underlying transaction and determine upon presentation of evidence, whether the alleged fraud occurred and if so, whether it is material. The burden of proof evidencing the alleged fraud rests on the applicant.

On the other hand, the examination of the underlying transaction by the court violates the principle of independence “on which so much of letter of credit law and practice rests”<sup>539</sup>. Therefore, the standard for an injunctive relief granted by the court is high. The four conditions that have to be met are listed in subparagraph (b). The Official Comments tries to make it clear for judges that injunction is an extraordinary remedy and it can only be granted in special circumstances.<sup>540</sup>

Furthermore, the UCC protects the innocent parties (such as a nominated person who has given value in good faith, a confirmer, a holder in due course of the beneficiary’s draft after acceptance, or an assignee) who have taken the beneficiary’s documents without knowing that the documents were forged or fraudulent.

As Xiang Gao points it out the “Revised UCC Article 5, s 5-109, now stands as the most comprehensive code of the fraud rule in the law of letters of credit in the common law world”<sup>541</sup>. It is adopted by every state of the United State<sup>542</sup>.

#### *Presenters immune from the fraud exception under Revised Article 5*

Under the fraud exception the issuing bank is entitled to dishonour the credit and the court may disrupt the payment by enjoining the bank from honouring the demand.

Fraud in documentary credit transactions is a significant risk primarily for the applicant and the bank(s) involved. However, often there are third parties (other than the issuing bank, the applicant and the beneficiary) involved in the transaction. These third parties may - for instance - purchase the beneficiary’s draft; may be transferees, creditors or assignees of the beneficiary’s rights under the credit or of his proceeds; or may be creditors of the applicant. If fraud occurs, these parties’ rights may also be effected.

In order to protect these parties the UCC has created an exception to the fraud rule, that applies when fraud occurs, and the party seeking payment is an innocent third party. In such a case the fraud rule will not apply.

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<sup>538</sup> Ibid at 545-546

<sup>539</sup> John F. Dolan, Letters of Credit: *A Comparison of UCP 500 and the New U.S. Article 5*. In: (1999) J.B.L., November Issue, p. 532

<sup>540</sup> The Official Comment emphasizes that ‘courts should not allow the “sacred cow of equity to trample the tender vines of letter of credit law”’. (see Official Comment to the Revised UCC Article 5-109 In. Douglas G. Baird, Theodore Eisenberg, Thomas H. Jackson (comp), *Commercial and Debtor-Creditor Law*, Selected Statutes (2002 ed.) New York, p. 547)

<sup>541</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 47

<sup>542</sup> See the homepage of The National Conference of Commissioners on Uniform State Laws at <http://www.nccusl.org/Update/ActSearchResults.aspx>, date visited 19 August, 2005

Under Revised Article 5-109(a)(1) the third parties immune from the fraud rule are the followings:

- a nominated persons who has given value in good faith and without notice of forgery or material fraud
- a confirmer who has honoured its confirmation in good faith
- a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person
- an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.

#### *Nominated person*

Under the UCC a nominated person is person designated or authorised by the issuer to pay, accept, negotiate, or otherwise give value under the letter of credit.<sup>543</sup> The status of being a nominated person involves several legal consequences. By nominating a person, the issuer gives authority to the nominated person to pay, or give value. Unless otherwise provided in the credit, the beneficiary has to make presentation to the nominated person before the expiry of the credit.<sup>544</sup>

The legal status of a nominated person under the UCC is “in rare cases ... an agent of the issuer and its act might be the act of the issuer itself”<sup>545</sup>. In most cases he is not an agent of the issuer but an independent person engaged in the credit transaction. For example, it can be a confirmer undertaking to honour the presentation in case of conforming document, or may act simply as a forwarder of the documents presented by the beneficiary to the issuing bank.

Once a nominated person honours the presentation and gives value in good faith against document strictly complying with the terms and conditions of the credit, it is entitled to reimbursement from the issuing bank, even if fraud has occurred.

#### *Confirmer of the credit*

A confirmer in most cases is a bank located at the beneficiary’s place, requested or authorized by the issuing bank to honour the presentation under a letter of credit.

Confirmation constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, to pay, accept draft or to negotiate. By adding its confirmation, the confirming bank is directly obliged under the letter of credit and has the rights and obligations of an issuer to the extent of its confirmation.<sup>546</sup>

The UCC specifically names the confirmer as a protected party under the fraud exception. Revised Article 5-109(a)(1)(ii) obliges the issuing bank to honour the presentation in case of fraud, if it is demanded by a confirmer who has honoured its confirmation in good faith. This means that a confirmer who has paid in accordance with the terms and conditions of the credit is

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<sup>543</sup> Revised UCC Article 5-102(11)

<sup>544</sup> Official Comment to the Revised UCC Article 5-102(11) In. Douglas G. Baird, Theodore Eisenberg, Thomas H. Jackson (comp), *Commercial and Debtor-Creditor Law*, Selected Statutes (2002 ed.) New York, p. 531

<sup>545</sup> Official Comment to the Revised UCC Article 5-107 In. Douglas G. Baird, Theodore Eisenberg, Thomas H. Jackson (comp), *Commercial and Debtor-Creditor Law*, Selected Statutes (2002 ed.) New York, p. 538

<sup>546</sup> Revised UCC Article 5-107(a)

entitled to reimbursement from the issuing bank, even if fraud has occurred, assuming that the confirmer submits conforming documents.<sup>547</sup>

The widely debated and often cited case of *Banco Santander SA v. Bayfern Limited (and others)*<sup>548</sup> may serve as a good example to highlight the legal status of a confirming bank. Although the case is one from England, its analysis well worth the time and effort, as it clearly shows the difference of the English and the American courts' approach in the limits of the fraud exemption.

The case involved the sale and purchase of crude oil between the buyer, Napa Petroleum Trade Inc. and the seller, Bayfern Limited. Payment was arranged through a letter of credit. Upon the buyer's application, Banque Paribas issued a deferred payment credit in favour of the defendant. The credit required presentation of documents in London at any time until the 15<sup>th</sup> of September 1999 and payment was to be made 180 days after the issuance of the bill of lading. The letter of credit was subject to the UCP 500 and provided that the issuing bank undertook at maturity to cover Banco Santander in accordance with their instructions. Banque Paribas requested Banco Santander to add its confirmation, which it did, furthermore in its confirmation sent to Bayfern also offered the possibility of discounting the credit upon prior arrangements. Banque Paribas was not informed of the possibility of discounting.

The seller presented documents which, after examination, the plaintiff bank accepted as conforming to the terms and conditions of the credit, therefore, Banco Santander became liable to pay to Bayfern the sum appearing in the letter of credit on the maturity date, 27 November 1998. Nevertheless, Bayfern requested the plaintiff to discount the credit which the bank did – on the 17<sup>th</sup> of June, 1998 - against a letter written by Bayfern in which he irrevocably assigned to Banco Santander all his rights under the letter of credit. Banque Paribas was not informed about the assignment either.

After effecting payment, the plaintiff sent the documents to the issuing bank and claimed reimbursement, which was refused on the ground that the documents were forged.

Banco Santander applied for a summary judgment against Paribas Bank. It was assumed by the court that:

- the confirming bank was not aware of the fraud when it discounted the deferred payment credit on the 17<sup>th</sup> of June, 1998,
- the documents presented were forged,
- Bayfern had committed the fraud, and
- both Banque Paribas and Banco Santander had notice of established fraud before the maturity date of the credit, the 27<sup>th</sup> of November, 1998.

The main preliminary issue in the trial was the legal effect of a beneficiary fraud on the confirming bank's right to reimbursement, or other words, whether the confirming bank was immune from the fraud rule.

Banco Santander argued that it was a nominated bank under Article 10(b)(i) of the UCP 500<sup>549</sup> and it had the issuing bank's authority to incur a deferred payment undertaking to the beneficiary against documents which appear on their face to be complying. It duly incurred a deferred

<sup>547</sup> Official Comment to the Revised UCC Article 5-107 In. Douglas G. Baird, Theodore Eisenberg, Thomas H. Jackson (comp), *Commercial and Debtor-Creditor Law*, Selected Statutes (2002 ed.) New York, p. 537

<sup>548</sup> [1999] Lloyd's Rep Bank 239, [2000] Lloyd's Rep Bank 165

<sup>549</sup> Article 10(b)(i) reads as follows:

Unless the Credit stipulates that it is available only with the Issuing Bank, all Credits must nominate the bank (the 'Nominated Bank') which is authorized to pay, to incur a deferred payment undertaking, to accept Draft(s) or to negotiate.

payment undertaking to the beneficiary to pay on the 27<sup>th</sup> of November 1998 and discharged its undertaking by effecting payment on the 17<sup>th</sup> of June, 1998. By reason of the foregoing, the issuing bank became bound to reimburse the confirming bank on the basis of Article 14(a) of the UCP 500<sup>550</sup>, regardless of the fact that the fraud was known to the banks before the maturity date of the credit. Subsequently, the confirming bank claimed that it was entitled to reimbursement as assignee of proceeds, or based on the “implied, usual or customary” authority received from the issuing bank to discount the credit.

Banque Paribas on the other hand argued that the obligation of the issuing bank to reimburse the confirming bank is included in Article 10(d)<sup>551</sup> and not Article 14(a) of the UCP, but in any event, the articles has the same effect, namely that the right to reimbursement only arises at the maturity date.

The court examined what exactly Banque Paribas, as the issuing bank had requested of Banco Santander, as confirming bank. It concluded that the issuing bank only requested confirmation of the credit to effect payment on the 27<sup>th</sup> of November but did not request that Banco Santander should discount the credit or give value for it prior to the 27<sup>th</sup> of November, 1998. Although, the discount of the credit was not a breach of mandate, Banco Santander did it on its own account.

Therefore, the Appellate Court concluded, accepting the issuing bank’s defence and upholding the Trial Court’s decision, that Banque Paribas was entitled to refuse reimbursement under the fraud exception since the right to reimbursement arises only at maturity date.

The Court explained that

“Santander had no authority to negotiate from Paribas to discount, and did not seek it. It was something they were entitled to do on their own account. If they had not chosen to discount and had waited until 27 November, they would have had a defence. ... If a confirming bank in the position of Santander wishes to be free to give value for documents when it accepts the documents, it can do so either by insisting on the use of an acceptance credit or by insisting on obtaining authority to negotiate and confirmation of reimbursement if it does.”<sup>552</sup>

Referring to the *European Asian v. Punjab & Sid Bank* case the court continued, that:

“... if Santander had informed Paribas that it had discounted, and had received confirmation from Paribas that Paribas would still reimburse on 27 November 1998, Paribas would not be able to raise the fraud exception because they would be estopped from disputing Santander’s authority to discount.”<sup>553</sup>

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<sup>550</sup> Article 14(a) reads as follows:

When the Issuing Bank authorizes another bank to pay, incur a deferred payment undertaking, accept Draft(s), or negotiate against documents which appear on their face to be in compliance with the terms and conditions of the Credit, the Issuing Bank and the Confirming Bank, if any, are bound:

- i. to reimburse the Nominated Bank which has paid, incurred a deferred payment undertaking, accepted Draft(s), or negotiated,
- ii. to take up the documents.

<sup>551</sup> Article 10(d) reads as follows:

By nominating another bank, or by allowing for negotiation by any bank, or by authorising or requesting another bank to add its confirmation, the Issuing Bank authorises such bank to pay, accept Draft(s) or negotiate as the case may be, against documents which appear on their face to be compliance with the terms and conditions of the Credit and undertakes to reimburse such bank in accordance with the provisions of these Articles.

<sup>552</sup> [2000] Lloyd’s Rep Bank 165 at 172

<sup>553</sup> Ibid

In the course of the proceedings the question of assignment also arose. Under English law assignment is subject to equity, meaning that an assignee can not obtain a better title than the assignor had at the time of the assignment. Thus, if the assignor had no right to payment because of fraud, then the confirming bank as the assignee can not have a right to payment either.

The court examined the main differences between an acceptance credit and a deferred payment credit as the two types of credit where presentation of documents is followed by an acceptance of obligation to pay at a future date. It concluded that the main difference between the two is that an acceptance credit calls for the acceptance of a draft in favour of the beneficiary, which allows for discounting, while the deferred payment credit does not involve a negotiable instrument, thus financing cannot be provided.

The court further stated that in case a draft is called for and the confirming bank – by purchasing the draft in good faith – becomes a holder in due course, it is entitled to sue on the drafts and receive reimbursement from the issuing bank even if fraud is discovered prior to the maturity date. However, since no drafts were provided for, Santander could not become a holder in due course.

Lord Justice Waller stated that:

“I have ultimately concluded that if the parties agree for whatever reason that they will not provide a negotiable instrument, and do not provide by terms of the trade or even by the express terms of the instrument itself the protection for assignees that a negotiable instrument would provide, they must live with the consequences.”<sup>554</sup>

The case gave ground for criticism within the banking community<sup>555</sup>, although from an English legal point of view it is well-founded. In a letter of credit transaction the parties have to act according to their authority in order to meet the expectations of the others involved in the letter of credit.

The independence of the letter of credit and the scope of the fraud exception are fundamental issues, which are approached differently by the different jurisdiction. The Banco Santander case supports this statement well, as under American law the case would have been decided differently. As James G. Barnes explains “in re-codifying letter of credit law in the early 1990s, US letter of credit bankers and lawyers answered the question posed in Santander and similar questions, in which the desire to deter fraud must be balanced against the desire that non-fraudulent demands under letter of credit be honoured, with certainty”<sup>556</sup>. Under Revised UCC Article 5-109 –as already noted above - third parties, such as

- a nominated person who has given value in good faith and without notice of forgery or material fraud,
- a confirmer who has honoured its confirmation in good faith,
- a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person,

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<sup>554</sup> Ibid at 170

<sup>555</sup> See Bob Foster, *The UCP in court* In DC Insight Vol.5 No.4 Autumn, 1999; Adam Johnson, Daniel Aharoni, *Fraud and Discounted Deferred Payment Documentary Credits: The Banco Santander Case* In (2000) JIBL Issue 1., p. 22; Adam Johnson, Stuart Peterson, *Fraud and Documentary Credits* In (2001) JIBL Issue 2, p. 37; King Tak Fung, *Leading Court Cases on Letters of Credit*, ICC Publication No. 658, p. 38; Roger Fayers, James G Barnes, *Contrasting UK and US views of the controversial Banco Santander case* In DC Insight Vol. 6 No.3 Summer, 2000

<sup>556</sup> James G Barnes In *Contrasting UK and US views of the controversial Banco Santander case* In DC Insight Vol. 6 No.3 Summer, 2000

– an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of fraud  
are protected, and the issuing bank is required, despite beneficiary fraud, to honour their demand.

Banco Santander falls in the first category, as it became a nominated, confirming bank when Banque Paribas requested confirmation of the credit and Banco Santander accepted it. Assuming that Banco Santander can establish that it honoured its confirmation in good faith, Banque Paribas would be obliged to pay him on the deferred payment date under the UCC.

#### *Holder in due course*

According to UCC Article 3-302 a holder in due course is a person who:

- has given value for the draft prior to receipt of notice of injunction,
- has acted in good faith in the taking up of the documents, and
- was unaware of any fraud at that time.

Similarly to the UCC local laws usually protect holders in due course from court orders that stop an issuing bank from honouring the presentation.

The protection of a holder in due course was already recognized in the *Sztejn* case, where it was stated that “if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud”<sup>557</sup>.

The “holder in due course” exception and the requirement to act in good faith may be illustrated by *Brenntag International Chemicals, Inc. v. Bank of India*<sup>558</sup> where the negotiating bank gave value for the documents but did not act in good faith and were aware of the fraud. In March 1996 Brenntag International Chemicals contracted with Petro Pharma to purchase about 15,000 metric tons of chemicals for resale to a third party. Payment was assured by an irrevocable standby letter of credit issued by Norddeutsche Landesbank and payable at sight, but not earlier than 360 days after the loading date.

Under the letter of credit the buyer was entitled to draw upon the non-performance of Brenntag and upon submitting to the bank a copy of the commercial invoice covering the purchased goods, a copy of the negotiable bill of lading indicating that the goods were shipped, and a letter signed by an authorized representative of Petro stating that “payment, which was due 360 days after completion of loading, has not been received and is due”. The letter of credit was available by negotiation by the Bank of India.

Shortly after opening the credit, the beneficiary requested the negotiating bank to discount the credit and presented, among other documents, an undated default letter of non-receipt of payment signed by one of the officers of the company, who was later replaced. Some of the documents were discrepant, for instance the default letter as it noticed Brenntag’s default a year earlier than it could actually be in default. Despite the circumstances the negotiating bank gave value for the documents. Bank of India also gave a loan to Petro under a separate agreement.

<sup>557</sup> *Sztejn v. J. Henry Schroeder Banking Corp* [1941] 31 NYS 2d 631 at 635

<sup>558</sup> [1999] 175 F.3d 245 (2d Cir.), the case is also available at <http://caselaw.lp.findlaw.com/cgi-bin/getcase.pl?court=2nd&navby=case&no=987992>, date visited: 25 August, 2005

In summer 1996 Petro faced financial difficulties and was not able to ship the goods to Brenntag. Subsequently, Brenntag cancelled its purchase contract.

Early February an involuntary liquidation proceeding was announced against Petro upon which Bank of India contacted Petro requesting the company to send a new default letter signed by an authorised person, as the officer whose signature appeared on the first default letter had long resigned. Instead of a new default letter Petro informed Bank of India that collection under the letter of credit would be improper because no goods were shipped, thus Brenntag could not be in default. Despite its actual knowledge that Brenntag did not default, Bank of India date-stamped the original default letter and on March 14, 1997, 360 days after the completion of loading as stated by the bill of lading, presented the documents to the issuing bank. The issuer rejected the documents based on discrepancies.

Wishing to stop the payment under the letter of credit Brenntag turned to court and obtained a preliminary injunction against honour by the issuing bank.

The court held that:

“the evidence strongly supports the proposition that the documents that Bank of India presented in demanding payment under the letter of credit were known by Bank of India to be noncompliant. The default letter was not dated by Petro and was signed by someone who was not an authorized signatory of Petro at the relevant time. The evidence also indicates that Bank of India knew that these documents were noncompliant and materially inaccurate at the time it obtained them, knew that they remained false and fraudulent at the time it sought to collect upon them. ... For these reasons, there was ample reason for the district court to conclude that Bank of India was not entitled to payment from Norddeutsche Landesbank and was not a holder in due course.”<sup>559</sup>

#### *Assignee of deferred payment obligation*

A deferred payment letter of credit is a credit under which the bank undertakes to effect payment at a specified future date (maturity date) after the presentation of strictly complying documents. A deferred payment credit usually provides for payment at a fixed date following the date of shipment (date of issuance of the bill of lading) or the presentation of documents.

However, often the beneficiary needs funds before the maturity date of the credit. In such case it may request the issuing bank or an other bank “to advance to it all or part of the funds owed under the deferred payment obligation, or to discount the deferred payment obligation by assigning the proceeds of the letter of credit<sup>560</sup> to the discounter as security for the advance”<sup>561</sup>. The bank that discount the deferred payment credit is an assignee.

The legal protection of an assignee of a deferred payment obligation in case of fraud is embodied in the UCC. Article 5-109(1)(a) specifically mentions the “assignee of the issuer’s or nominated person”’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person” as the one, enjoying protection from the fraud rule.

However, not all jurisdictions give special protection to assignees in case of a deferred payment credit.

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<sup>559</sup> Ibid

<sup>560</sup> Under Article 5-114(a) of the UCC the term ‘proceeds of a letter of credit’ means cash, check, accepted draft, or other item of value paid or delivered upon honor or giving of value by the issuer or any nominated person under the letter of credit.

<sup>561</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 151

The above analyzed *Banco Santander*<sup>562</sup> case serves as a good example to highlight the difference between English and American law to this question.

The English court held that financing the beneficiary by the nominated bank is not permitted under a deferred payment credit, or in other words deferred payment credit does not authorize the nominated bank to negotiate the shipping documents.

Although during the trial an expert witness testified that “it is common market practice in London to discount deferred payment letters of credit where the beneficiary requested it”<sup>563</sup>, the court did not find this expert testimony to be a sufficient basis for implying authorization to discount under deferred payment credit, but considered it merely a reflection of bankers’ expectation.<sup>564</sup>

The court also explained that by discounting the documents presented in good faith, the confirming bank became an assignee of the beneficiary, and was thereby put into the same position as the beneficiary. Based on the initial assumption that there was established fraud committed by the beneficiary, thus the beneficiary was not entitled to payment, the confirming bank had no right to claim payment either.

This view of the British court is not only contrary to the American approach, which reflects the market practice, but has generated several debates between the commentators.

Those disagreeing with the judgment of the English court often refer to the fact that by saying that “under a deferred payment credit the beneficiary just has to wait until maturity for its payment and that any bank paying the proceeds of the documents to the beneficiary before maturity will be penalized in the event of fraud”, the deferred payment credit loses its commercial function”<sup>565</sup>. Some also call for the codification of English law and for bringing it in harmony with international practice.<sup>566</sup>

On the other hand some English commentators argue that while under the UCC there is a statutory protection to assignees of a deferred payment credit, “there is no statutory equivalent in Britain” and the “expectation of bankers cannot establish a custom”<sup>567</sup>.

Some commentators emphasize that this contradicting situation “could disrupt letter of credit financing arrangements between an exporter and its banker”<sup>568</sup>. The solution may be provided by the next revision of the UCP. Currently the UCP does not address the problem, nor has the Banking Commission made any statement on it. Therefore it is up to the drafters of UCP 600 to clarify the exact meaning of the deferred payment credit and to define the role of the nominated and the confirming banks authorized under such credit.

### **7.3.2. The position of the United Kingdom**

The fraud rule, although not in a statutory provision but in the common law, is also recognized by the English courts.

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<sup>562</sup> *Banco Santander SA v. Bayfern Limited* [1999] Lloyd’s Rep Bank 239, [2000] Lloyd’s Rep Bank 165

<sup>563</sup> [1999] Lloyd’s Rep Bank 239 at 247

<sup>564</sup> Summary given to the *Banco Santander SA v. Bayfern Limited* case In Legal Cases 2000-2001 summaries by the Institute of International Banking Law and Practice

<sup>565</sup> Chang Soon Thomas Song In *Personal views of country correspondents* In DC Insight Vol. 9 No.1 Winter 2003

<sup>566</sup> James Barnes In *Contrasting UK and US views of the controversial Banco Santander case* In DC Insight Vol. 6 No. 3 Summer 2000

<sup>567</sup> Roger Fayers In *Contrasting UK and US views of the controversial Banco Santander case* In DC Insight Vol. 6 No. 3 Summer 2000

<sup>568</sup> Fung King-tak, *Availability of credits and bills of exchange* In Recent cases from several countries In DC Insight Vol. 10 No.1 Winter 2004; John Turnbull : *Co-Chair of the UCP Consulting Group speaks out* In DC Insight Vol. 9 No.4 Autumn 2003

The leading and most well-known case on the fraud rule is the *United City Merchants (Investments) Ltd v Royal Bank of Canada*<sup>569</sup>, in which payment was refused by the bank when the bill of lading presented by the beneficiary was found fraudulently pre-dated by a third party. The facts of the case have been summarized earlier.<sup>570</sup>

In the judgment Lord Diplock stated that to the principle of independence:

“... there is one exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of facts that to his knowledge are untrue. Although there does not appear among 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” is *Sztejn v J Henry Schroder Banking Corp* (1941) 31 N.Y.S. 2d 631.”<sup>571</sup>

This opinion not only shows that the fraud exception is recognized in the United Kingdom, but it indicates that the *Sztejn* case is “the foundation stone of English law in this area”<sup>572</sup> as well.

Despite its recognition the fraud rule has not often be applied by the English courts. As Xiang Gao points it out “English courts have traditionally been very reluctant to interfere with the operation of a letter of credit and have adopted a relatively inflexible and narrow approach towards the application of the fraud rule”<sup>573</sup>.

Lord Jenkins explains this reluctance in *Hamzeh Malas & Sons v. British Imex Industries Ltd*<sup>574</sup> as follows:

“... it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers’ confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice. ...

... That system ... would break down completely if a dispute as between the vendor and the purchaser was to have the effect of “freezing”, ..., the sum in respect of which the letter of credit was opened.”<sup>575</sup>

### Requirements in order to invoke the fraud rule

Under English law, in case of presentation of facially conforming documents, payment can be refused invoking the fraud rule, if

- there is a clear evidence of the fraud,
- the bank has knowledge of the evidence of fraud,
- the bank’s awareness of the fraud was “timely”<sup>576</sup>, and

<sup>569</sup> [1979] 1 Lloyd’s Rep. 267, [1981] 1 Lloyd’s Rep 604, [1983] AC 168

<sup>570</sup> See 7.2.1.

<sup>571</sup> [1983] AC 168 at 183

<sup>572</sup> Raymond Jack, *Documentary Credits* (1991) London, p.191

<sup>573</sup> Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002), The Hague, p. 48. The same is emphasized by Ho Peng Kee, *The Fraud Rule in Letters of Credit Transactions* In C.M. Chinkin, P.J. Davidson, W.J.M. Ricquier (eds), *Current Problems of International Trade Financing* (1983) Singapore, p. 235

<sup>574</sup> [1958] 2 Q.B. 127. The case is summarized in Chapter III., 3.3.3

<sup>575</sup> *Ibid* at 129

- the beneficiary is involved or has knowledge of the fraud.

#### *Clear evidence of fraud*

The first requirement to invoke the fraud rule in the courts of the United Kingdom is to evidence the fraud.

Often, to give clear evidence of the fraud is easier said than done and the plaintiff may run into serious difficulties when trying to defend its case.

The difficulty to evidence fraud can be illustrated by the *Discount Records Ltd v. Barclays Bank*<sup>577</sup> case, which involved the purchase of a consignment of records and cassettes from a French company. The plaintiff, the English buyer, arranged for the opening of a letter of credit in favour of the French seller. The seller shipped the goods in 94 cartons out of which two were found to be empty, five were filled with rubbish, and 28 were only partly filled. 275 records and 518 cassettes were actually delivered, but out of this latter only 25 per cent conformed to the underlying contract.

Nevertheless, the seller presented facially conforming documents which the confirming bank accepted.

The buyer requested injunction alleging fraud but failed to restrain the confirming bank from paying under the credit.

In rejecting the buyer's claim Justice Megarry held that:

“It is important to notice that in the *Sztejn* case the proceedings consisted of a motion to dismiss the formal complaint on the ground that it disclosed no cause of action. That being so, the court had to assume that the facts stated in the complaint were true. The complaint alleged fraud, and so the court was dealing with a case of established fraud. In the present case *there is*, of course, *no established fraud, but merely an allegation of fraud*. The defendants, who were not concerned with that matter, have understandably adduced no evidence on the issue of fraud. Indeed, it seems unlikely that any action to which Promodisc [the Seller] was not a party would contain the evidence required to resolve this issue. Accordingly, the matter has to be dealt with on the footing that this is a case in which fraud is alleged but has not been established.”<sup>578</sup>

Although the buyer inspected the goods in the presence of the issuing bank this evidence did not seem to be satisfactory for the court to interfere with the normal course of the letter of credit transaction. This highlights the high standard of proof demanded by the English courts in order to invoke the fraud, since “it is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. ... Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated by the contract.... Otherwise, trust in international commerce could be irreparably damaged”.<sup>579</sup>

#### *The bank has knowledge of the evidence of fraud*

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<sup>576</sup> *Trade Finance Fraud – Understanding the Threats and Reducing the Risk*, A Special Report prepared by the ICC International Maritime Bureau (2002) ICC Publication No. 643, p. 49

<sup>577</sup> [1975] 1 WLR 315.

<sup>578</sup> *Ibid* at 320

<sup>579</sup> *R D Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd*, [1977] 2 All ER 862 at 870 citation by Lord Kerr

The second criteria that has to be met - in order for the court to enjoin the bank from effecting payment when the fraud rule is invoked - is to show that the bank had knowledge of the fraud. The question of when the bank has to be aware of the fraud is dealt with in the next section.

This criteria was clearly stated in the *Edward Owen Engineering Ltd v. Barclays Bank International Ltd. and Umma Bank*<sup>580</sup> case.

As Lord Justice Geoffrey Lane emphasized:

“The only circumstances which would justify the bank not complying with the demand would be those ... if it had been clear and obvious to the bank that the buyers had been guilty of fraud.”<sup>581</sup>

It was also pointed out in *Bolivinter Oil Sa v. Chase Manhattan Bank*<sup>582</sup>, where the Court stated that:

“The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank’s knowledge.”<sup>583</sup>

The case involved a contract of carriage of crude oil between the plaintiff freight contractor and Homs, a Syrian refinery, from Iran to Syria. Securing the plaintiff’s performance a performance guarantee was issued by the Commercial Bank of Syria, which was counter-guaranteed by a letter of credit issued by Chase Manhattan Bank. Following the arrival of the vessels the plaintiff informed Chase Manhattan Bank that the performance guarantee was released by Homs. This led Chase Manhattan Bank to turn to the Syrian Bank seeking confirmation that the letter of credit had been cancelled and that Chase Manhattan was released from all liabilities. In his reply the Syrian Bank informed Chase Manhattan that Homs had demanded payment under the performance guarantee based on the breach of contract of Bolivinter. The plaintiff obtained an injunction to stop payment to Homs.

*The bank’s awareness of the fraud was “timely”*

The use of the fraud exception under English law also requires that the bank’s knowledge of the fraud is “timely”.

If the bank has clear knowledge of the fraud committed by the beneficiary at the time of the presentation, or between the time of presentation and the date of payment, the bank is entitled to refuse payment.

On of the questions discussed in *Czarnikow-Rionda Sugar Trading Inc v. Standard Bank London Limited*<sup>584</sup> was the question of “timeliness”. In 1993 Czarnikow-Rionda Sugar Trading Inc. (Rionda), an internationally well-known sugar trader commenced a long-time business relationship with the Brazilian Dine Group, owner of three sugar mills which was manifested in long-term purchase contracts signed by the parties in 1995. The contracts were pre-financed by Rionda against the security of pledges on sugar cane and alcohol. Alcohol was produced as a by-product of sugar cane.

<sup>580</sup> [1978] 1 Lloyd’s Rep. 166. The case is summarized in Chapter VII., 7.2.1.

<sup>581</sup> Ibid at 174 (emphasis added)

<sup>582</sup> [1984] 1 Lloyd’s Rep.251.

<sup>583</sup> Ibid at 251. This was later cited in the *United Trading Corpn SA v. Allied Arab Bank* case ([1985] 2 Lloyd’s Rep 554 at 861)

<sup>584</sup> [1999] 2 Lloyd’s Rep 187

In 1997 in order to help the Dine Group overcome its cash flow problem, Rionda also assisted in the financing of alcohol by the Dine Group for resale in Brazil. Both the seller and the buyer were subsidiaries of the Dine Group and payment was to be made by a letter of credit. Rionda agreed to lend its name to the application for the opening of the letter of credit. This way Rionda became party to the underlying contracts as a financial intermediary. The credit was issued by Rionda's bank, the Standard Bank London with payment at 390 days from the date of the bill of lading, and was confirmed by the United European Bank and the Banque Cantonale de Geneve. The buyer obtained the sugar from a supplier under a back-to-back credit issued by the United European Bank and the Banque Cantonale de Geneve.

Upon presentation of documents the United European Bank and the Banque Cantonale de Geneve pointed out some discrepancies which were waived by Rionda, therefore the banks accepted the tender and forwarded the documents to Standard Bank requesting payment at maturity, which the issuing bank acknowledged. Additionally upon the beneficiary's request, the two Swiss banks discounted the letter of credits.

Later Rionda learned that the cane sugar that was pledged to it had also been pledged several times and, in fact, did not exist, and in addition the alcohol that had also been pledged was mostly water.

Seeking protection against the fraud Rionda informed its banks and applied and was granted a pre-trial injunction against Standard Bank to prevent it from reimbursing the two Swiss confirming banks on the basis that the confirming banks effected payment to the beneficiary although they were aware of the fraud. Rionda also applied for a worldwide Mareva injunction<sup>585</sup> restraining any members of the Dine Group from disposing of their assets up to a value of US \$ 50 million. In subsequent proceedings Rionda sought to maintain the pre-trial injunction which the Queen's Bench Division discharged.

In relation to the bank's timely knowledge of fraud the court held that:

“The interest in the integrity of banking contracts under which banks made themselves liable on their letters of credit or their guarantees is so great that not even fraud can be allowed to intervene unless the fraud comes to the notice of the bank (a) in time, i.e. in any event before the beneficiary is paid, and (b) in such a way that it can be said that the bank had knowledge of the fraud.”<sup>586</sup>

Since the Swiss banks had discounted the letters of credits well before the question of fraud was raised, Rionda could not invoke the fraud exception and stop the payment mechanism.

*The beneficiary is involved or has knowledge of the fraud*

English courts are reluctant to invoke the fraud rule if the fraud is committed by a third party, and the beneficiary has no knowledge of the fraud.

In the *United City Merchants (Investments) Ltd v. Royal Bank of Canada*<sup>587</sup> case the House of Lords – overruling the decision of the Court of Appeal – stated that since the beneficiary was not

<sup>585</sup> The Mareva injunction is a special order restraining a defendant from removing his assets out of the jurisdiction. It is granted if the plaintiff can establish that there is a real risk of the assets being removed or otherwise disposed of, in which case the plaintiff would not be able to satisfy any judgment it obtained. It is named after the *Mareva Compania Naviera SA v International Bulkcarriers SA* case [1975] 2 Lloyd's Rep 509.

<sup>586</sup> [1999] 2 Lloyd's Rep 187 at 202

<sup>587</sup> [1979] 1 Lloyd's Rep. 267, [1981] 1 Lloyd's Rep 604, [1983] AC 168

aware of the fraud committed by a third party and acted in good faith when tendering the document, he was entitled to receive payment.

The same reasoning was followed in the *Montrod Ltd v. Grundkötter Fleischvertriebs GmbH*<sup>588</sup> case, in which a German seller, Grundkötter Fleischvertriebs GmbH, and a Russian buyer, Ballaris, entered into a contract for the sales of frozen pork meat. The buyer engaged Montrod, a finance and investment company, to facilitate the purchase by being the applicant for a credit. Montrod applied for the credit through its bank, Fibi Bank who arranged for the opening of the credit by Standard Chartered Bank in favour of the seller. The credit, which was advised to the seller by a German bank, was payable 45 days after sight on presentation of specified documents, including inspection certificates signed by Montrod.

This was a device<sup>589</sup> ensuring that the credit would only be operable if Montrod had been put in funds to cover its liabilities by the buyer. This was important for Montrod because although the credit named him as the applicant, he was not the buyer in the underlying contract and had no contractual relationship with the seller.

In the course of negotiations the buyer informed the seller that one of its employees should sign the inspection certificates on behalf of Montrod. The seller, believing that he had authority to sign on behalf of Montrod, presented certificates so signed to the bank. The goods were delivered to the buyer in Moscow.

Between the date of presentation and the date of payment, Montrod informed the issuing bank that the certificates of inspection presented were forgeries and also applied for injunction restraining the bank from making payment under the credit.

The trial court held that the seller was entitled to payment under the credit, since the seller had not acted fraudulently. In the light of the judgment, the bank made payment to the seller.

Montrod appealed but the Court of Appeal upheld the trial Court's decision and Lord Justice Potter stated, that:

“The fraud exception to the autonomy principle recognised in English law has hitherto been restricted to, and it is in my view desirable that it should remain based upon, the fraud or knowledge of fraud on the part of the beneficiary or other party seeking payment under and in accordance with the terms of the letter of credit. It should not be avoided or extended by the argument that a document presented, which conforms on its face with the terms of the letter of the credit, is nonetheless of a character which disentitles the person making the demand to payment because it is fraudulent *in itself*, independently of the knowledge and bona fides of the demanding party. In my view, that is the clear import of Lord Diplock's observations in *Gian Singh* and in the *United City Merchants* case, in which all their Lordships concurred.”<sup>590</sup>

The above mentioned cases clearly show that English courts apply the fraud rule only if the beneficiary is involved or has knowledge of the fraud. This approach puts an emphasis on the identity of the party involved in the fraud, not on the nature of the document. Furthermore, the

<sup>588</sup> [2001] EWCA Civ 1954, the judgment of the Appellate Court is also available at <http://www.bailii.org> , date visited: 16 August, 2005

<sup>589</sup> It was referred to as a ‘locking device’ as Montrod held the key ‘to unlock the right of the beneficiary to be paid by the issuer’. (see Paul Turner, Favourees, “locking devices”, the “nullity doctrine” and “third party fraud” In *Recent cases from several countries* In DC Insight Vol. 10. No.1 Winter, 2004)

<sup>590</sup>[2001] EWCA Civ 1954, the judgment of the Appellate Court is also available at <http://www.bailii.org>, date visited: 16 August, 2005

court requires the beneficiary not only to be involved, but be involved knowingly in the fraudulent act, thus it is the intention of the beneficiary that really matters.

In the *United City Merchants* case the fraud was committed by a third party, of which fact the beneficiary was unaware. In the *Montrod* case the beneficiary itself committed the fraud, although not knowing of its fraudulent act. Its innocence deprived the bank to invoke the fraud rule and was ordered to effect payment even though the documents tendered were fraudulent.

As Xiang Gao points it out “the prevalence of the letter of credit lies in the fact that it can provide a fair balance of competing interests among the parties involved. The normal operation of the letter of credit not only provides the beneficiary with safe and rapid access to the purchase price or a sum of money when the applicant defaults, but also provides the applicant with credit and/or other commercial benefits and protects the applicant against improper calls on the credit by requiring the beneficiary to present *genuine* documents indicating that it has properly performed its obligations under the underlying transaction. If forged or fraudulent documents are allowed to trigger payment, the balance assumed in the letter of credit scheme will be undermined”<sup>591</sup>.

The *Montrod* case involved an other important issue, the question of a nullity, which is discussed below.

#### The nullity exception

As Raymond Jack explains “a document will be a nullity if it is forged or fraudulent in such a way as to destroy its essence”<sup>592</sup>. A bill of lading would be null and void if it was issued in the name of a shipping company by a person who has no authority to do so. Such a bill of lading amounts to a document of no value.

English courts have been faced with the question whether in case a document presented by the beneficiary is null and void but the beneficiary is not aware of the nullity, should the bank be entitled to refuse payment or not. In other words, should there be a general nullity exception upon which the bank could successfully defend the non-payment independently of the knowledge and bona fides of the demanding party. Case law shows that the question has been decided in a negative way.

The question of nullity was first raised in the *United City Merchants (Investments) Ltd v. Royal Bank of Canada*<sup>593</sup> case. However, Lord Diplock reserved judging the question when stated, that:

“I would prefer to leave open the question of the rights of an innocent seller beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him that it was forged by some third party, for that question does not arise in the instant case”<sup>594</sup>.

As it has already been referred to above, the nullity exception was extensively dealt with in the *Montrod* case in 2001. Lord Justice Potter explained the issue as follows:

“Most documentary credits issued in the United Kingdom incorporate the UCP by reference. Various revisions of the UCP have been widely adopted in the USA and by United Kingdom and Commonwealth banks. They are intended to embody international

<sup>591</sup> Xiang Gao, Ross P Buckley A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law In.: Oxford University Comparative Law Forum, at <http://ouclf.iuscomp.org/articles/gao-buckley.shtml#fn1anc>, date visited: 16 August, 2005

<sup>592</sup> Raymond Jack, *Documentary Credits* (1991) London, p.198

<sup>593</sup> [1983] AC 168

<sup>594</sup> *Ibid* at 187-188

banking practice and to create certainty in an area of law where the need for precision and certainty are paramount. The creation of a general nullity exception, the formulation of which does not seem to me susceptible of precision, involves making undesirable inroads into the principles of autonomy and negotiability universally recognised in relation to letter of credit transactions. In the context of the fraud exception, the courts have made clear how difficult it is to invoke the exception and have been at pains to point out that banks deal in documents and questions of apparent conformity. In that context they have made clear that it is not for a bank to make its own enquiries about allegations of fraud brought to its notice; if a party wishes to establish that a demand is fraudulent it must place before the bank evidence of clear and obvious fraud (see *Edward Owen v Barclays Bank International Ltd* [1978] QB 159 c.f., *Turkiye Is Bankasi A.S. v Bank of China* [1996] 2 Lloyd's Rep 611 per Waller J at 617). If a general nullity exception were to be introduced as part of English law it would place banks in a further dilemma as to the necessity to investigate facts which they are not competent to do and from which UCP 500 is plainly concerned to exempt them. Further such an exception would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question. Such a development would thus undermine the system of financing international trade by means of documentary credits.”<sup>595</sup>

The question whether the Court of Appeal rightly rejected the nullity exception has been debated by commentators. Richard Hooley<sup>596</sup> mentions three reasons against the rejection of the nullity exception. He points out that the primary undertaking of the bank under the letter of credit is to pay against conforming documents, not against documents that only appear to conform. Furthermore, a “nullity document, is a worthless piece of paper”<sup>597</sup>, which does not secure the bank's position in seeking reimbursement for the amount he had paid under the credit. Thirdly, the commentator feels that the “*Montrod* decision appears to tolerate the circulation of forged documents”<sup>598</sup>.

The denial of a general nullity exception supports the view that English courts approach the fraud exception with a very strict look, not allowing interference with the general course of payment under a letter of credit unless fraud can be established on the part of the beneficiary or third party seeking payment.

### 7.3.3. The position of Hungary

In Hungary letters of credit are currently governed by Article 26 of Decree No. 9/2001 (MK 147) of the National Bank of Hungary on Payment – and Clearing Transactions, which is in effect since 19 March, 2004.

Article 26 reads as follows:

(1) “By issuing the documentary credit the credit institution (issuing credit institution) undertakes – on the basis of a mandate by the debtor of the underlying transaction – an

<sup>595</sup> [2001] EWCA Civ 1954, the judgment of the Appellate Court is also available at <http://www.bailii.org>, date visited: 16 August, 2005

<sup>596</sup> Richard Hooley, *Fraud and Letters of Credit (Part 1)*, In.: *Butterworths Journal of International Banking and Financial Law*, Vol 18 No 3. March 2003. p. 91

<sup>597</sup> *Ibid* at 95

<sup>598</sup> *Ibid*

*obligation in its own name to pay the amount stipulated in the documentary credit to the beneficiary if complying documents are presented and such documents are presented by the beneficiary in the stipulated period.*

- (2) The beneficiary shall present the documents stipulated in the documentary credit – together with a demand letter – directly or via his firm’s credit institution to the issuing credit institution.*
- (3) The issuing credit institution pays to the beneficiary the amount of the documentary credit by remittance to his cash bank account referred to in the documentary credit or in the demand letter.*
- (4) The debtor of the underlying transaction pays or reimburses the issuing credit institution the amount paid by the issuing credit institution to the beneficiary according to the provisions of the mandate.*
- (5) The provisions of the Uniform Customs and Practice for Documentary Credits issued by the International Chamber of Commerce, Paris, shall be binding for documentary credits.*
- (6) The credit institution shall set forth in its internal rules the maximum amount on which it accepts mandates to issue documentary credits.*
- (7) It is not possible to issue documentary credits for the benefit or at the expense of a private bank account.”*

It is understood, that in Hungary documentary credit transactions are governed by the UCP due to the provision of Article 26(5). There are no specific regulations on the fraud exception in a documentary credit transaction, either in the UCP 500 or in the above referred Article 26 of Decree No. 9/2001 (MK 147) of the National Bank of Hungary. Thus, the fraud exception falls under general contract law.

In 2001 the High Court of Justice of Hungary was called upon to decide in a case involving a letter of credit fraud.<sup>599</sup> The case involved a sales contract on steel concluded between a Hungarian buyer and an Austrian seller. Payment was to be effected by a letter of credit. Upon the buyer’s application, the bank having its seat of business in Hungary opened an irrevocable, deferred payment letter of credit in favour of the buyer. The credit called for the presentation of a commercial invoice and a warehouse bill.

The seller tendered the documents to the Hungarian bank, which after examination, accepted the tender and promised payment at a later date determined by the credit.

Following the acceptance of the tender, the proceeds under the credit were assigned to three foreign banks. The Hungarian bank was informed of and acknowledged the assignments. However, when the foreign banks requested payment the Hungarian issuing bank refused to pay on the ground that the warehouse bill tendered by the beneficiary and accepted by the bank has turned out to be forged. The three foreign banks commenced proceedings at the Hungarian court.

The Court of First Instance brought judgment for the plaintiffs and ordered the defendant Hungarian bank to effect payment. The Court’s reasoning was based on the fact that under Article 13(a) and 14(b) of the UCP the issuing bank’s obligation was to examine the documents if they strictly appear on their face complying with the terms and conditions of the credit. Although

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<sup>599</sup> *Baden-Württembergische Bank AG v. Postabank és Takarépszövetés Rt.*, BH 2002.274, EBH 2001.537. There was some other, although not a considerable number of cases involving documentary credit transactions that has been litigated before Hungarian courts (see for example BH 1998.189; BH 1997.196). The reason why their analysis is not included here is that these cases did not involve fraud and the main issues were decided strictly upon Hungarian civil law.

it was evidenced during the court procedure that the warehouse bill was indeed forged, since the bank accepted the tender and undertook the obligation to pay, it could not later invoke the fraud exemption in order to avoid payment.

The Appellate Court reversed the judgment and ruled against the plaintiffs.<sup>600</sup> The Appellate Court held that under the letter of credit relationship, the bank irrevocably undertook to effect payment if certain conditions determined in the credit are met. Under Article 3 of the UCP 500 the obligation of the bank to pay to the beneficiary is independent from the relationship of the applicant and the beneficiary or any dispute between them. It only depends on whether the beneficiary fulfils its obligations under the letter of credit, namely, that it presents documents that not only facially but also in their content conform to the terms and conditions of the credit. The Court referred to Article 4 of the Hungarian Civil Code requiring the parties to act in good faith. If the documents presented and accepted by the bank turn out to be fraudulent, the beneficiary has not fulfilled its obligations thus it is not entitled to request payment. It is so, regardless of the fact that the beneficiary may not be aware that the warehouse bill, issued by a third party, is forged. Upon Article 315 a person who employs another person to perform his obligations or exercise his rights is liable for the conduct of that person.

Furthermore, the assignees are not entitled to claim more than the assignor. According to Article 329 an assignee shall subrogate the original obligee through the assignment, and the rights proceeding from the lien and suretyship that secure the claim shall also pass to him. An obligor shall be entitled to enforce the objections and offset the counter-claims against the assignee that arise with regard to the assignee on the legal grounds that were in existence at the time of notification.

In the present case the bank fulfilled its obligation by examining the documents within the seven banking days available for him under the UCP 500. It is the beneficiary who has not acted in conformity with the rules, thus the obligation of the bank to effect payment cannot be invoked. The obligation of the bank derives from the opening of the credit, and not from the acceptance of the documents tendered. If the fraudulent act is revealed and evidenced after the acceptance of the documents, the bank cannot be obliged to pay.

The High Court of Justice of Hungary later partly rejected the decision of the Appellate Court and ordered the retrial of the case due to lack of evidence. In its ruling, the High Court made the following observation. By opening the letter of credit, the issuing bank undertook the irrevocable obligation of effecting payment if the beneficiary presents complying documents. The beneficiary tendered forged documents, which the bank examined and found facially complying. Later on the bank refused payment referring to the fact that the content of the documents did not comply with the factual situation and they were actually forged.

The High Court of Justice emphasized that the UCP 500, to which the credit was subjected, is silent on the fraud exception. Thus, the fraudulent content of the documents does not effect the obligation of the bank to effect payment. If the documents tendered are found to be complying on their face, the bank cannot avoid its obligation to pay the beneficiary. The only example to this rule is if the fraud was committed by the beneficiary itself or he was involved and was aware of the fraudulent act, for the court cannot assist the scrupulous beneficiary to obtain unjust funds. Since neither the Court of First Instance nor the Appellate Court examined to which extent, if

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<sup>600</sup> Ormai Gabriella, Barna András, *Okmányos meghitelezés – visszavonható-e a banki fizetési ígéret?* In Napi Jogász, 2001.szeptember, I.évf., 6.szám, p.8

any, the beneficiary had been involved in the fraud, the High Court of Justice ordered the retrial of the case.<sup>601</sup>

The High Court of Justice based on its judgment on the requirement that the court should not lend his aid to the fraudulent party to obtain unjust funds due to its fraudulent act. The Court emphasized that the fraud rule can only be invoked if the beneficiary itself commits the fraud or is involved in it. This reasoning shows that the Hungarian court approaches the fraud exemption similarly to the English courts and accepts it only in a very narrow sense and under strict conditions.

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<sup>601</sup> Gfv.X.30.354/2001/8

### 7.3.4. The position of Greece

Documentary credit transactions in Greece are governed by Articles 25 to 34 of the Regulation of 17 July/13 August 1923 on Special Provisions for Stock Corporations.<sup>602</sup>

Up until the last enlargement Greece was the only member of the European Union, which had statutory provisions on documentary credits.<sup>603</sup>

Article 25 contains general requirements as to the form of the credit and gives its commercial definition.

Section 1 states:

*“A documentary credit is an agreement between a banking corporation (creditor) and another party (debtor) to issue a credit for the benefit of a third party (beneficiary). By this agreement the bank undertakes to pay to such third party the credit amount upon presentation of the bill of lading. Such amount shall be reimbursed by the debtor upon forwarding the bill of lading.”*<sup>604</sup>

Section 3 explicitly requires, in line with the commercial practice, to conclude the letter of credit in a written form.

Section 4 states that letters of credit are considered to be commercial transactions.

Article 26 provides that:

1. *“A bill of lading or the waybill shall be issued or endorsed in the name of or by order of the bank or shall be presented to the bank if it is a bearer bill of lading.*
2. *If the parties agree in the contract on a credit that the third party shall present a full set of documents, the bank shall be obliged to demand presentation of the insurance policies and the commercial invoices in addition to the bill of lading.”*<sup>605</sup>

Article 28 presumes the credit to be irrevocable unless the opposite is expressly stated in the credit.

Article 30 contains provisions on the liability of the bank. It exempts the bank from being liable for accidental loss of the goods, as well as for failure of any telegraphic services. On the other hand, the bank is liable for intentional or negligent acts, including negligence in the choice of the correspondent bank.

Articles 29 to 32 contain special provisions on the securities provided by the applicant to the bank for issuing the credit. Greek law requires the bank to pledge these securities, even if the formalities are not complied with.

Under Article 31:

1. *“The bank is authorised to sell the goods according to the provisions on the sale of pledged property if after receipt of the bills of lading at the final destination the applicant does not meet its obligations to pay its debts and to take over the goods despite request to do so.*

<sup>602</sup> Νομοθετικό Διάταγμα της 17.7/13.8.1923 ‘Περί ειδικών διατάξεων επί ανωνύμων εταιριών’.

<sup>603</sup> Amongst the new member states for example the Czech Republic and Slovakia have statutory regulations on documentary credits in their Commercial Code. For reference see

<sup>604</sup> Rolf A.Schütze, Gabriele Fontane, *Documentary Credit Law Throughout the World – Annotated legislation from more than 35 countries*, ICC No. 633, (2003), Paris, p. 69

<sup>605</sup> Ibid

2. *Such sale may only be carried out after the expiry of a period of 24 hours for perishable goods or a period of 10 days for all other goods. The period shall run from the time of the request. The type of goods shall be determined by the presiding judge of the District Court based on an opinion by the President of the Chamber of Commerce if there is a Chamber of Commerce at the place of the District Court. Such opinion shall be completed within 24 hours after the time of the request.*
3. *If the bank carries out the sale upon the permission by the presiding judge the bank shall not be liable to the debtor or a third party unless the bank acts intentionally or with gross negligence in the sale.*<sup>606</sup>

If the bank's claim is not covered by the sale of the pledged security the applicant is liable for the remaining amount.<sup>607</sup>

Article 34 states that the provisions of the Regulation are applicable *mutatis mutandis* to the letter of credit.

In the late 1980s the Greek Parliament made an effort to revise the 1923 Regulation. The rules governing letters of credit were intended to be included in the new Commercial Code, in Articles 290 to 297. The committee authorised with the revision of the existing regulation prepared two drafts. The eight articles of the first draft contained provisions on the definition of the letter of credit, the different types of the credit, the basic liabilities of the parties and on the transfer of credit. The first draft received many critics for using confusing terms and containing provisions not consistent with the UCP 400 which was in force at that time. Upon the critics the committee prepared a second draft, which was in essence a translation of the UCP 400. The second draft did not attain the approval of the banking community either and it was never submitted to the Parliament.<sup>608</sup>

As a result, the 1923 Regulation still provides for the only statutory regulation of letters of credit in Greek law. However, since Greek banks collectively adhere to the UCP the Regulation has lost its relevance.

Greek law acknowledges the Independence Principle, although it is not explicitly stated in the referred regulation, nor does it implicitly derive from its wording. The independence principle is embodied in general contract law.

The fraud exception is not codified either. In case of fraud in order to enjoin the bank from effecting payment to a fraudulent beneficiary, Greek courts usually refer to violation of contract law principles and general ethics.<sup>609</sup>

In a case between a Swedish seller and a Greek buyer<sup>610</sup> the court of Kavala stated that the seller's act requesting payment against a false bill of lading was against good faith and general ethics. The case concerned the sale of machinery in the amount of 550.000 Swedish Krona. Upon

<sup>606</sup> Ibid at 70

<sup>607</sup> See Article 32.

<sup>608</sup> For more on Greek law on letters of credit see Αιγυπτιαδης, Α, *Ομοιόμορφοι κανόνες και συνήθειες του διεθνούς εμπορικού επιμελητηρίου για τις ενέγγυες πιστώσεις*, (2002) Αθήνα

<sup>609</sup> Article 200 of the Greek Civil Code states that contracts shall be interpreted according to good faith and taking into consideration the relevant trade custom.

Article 281 emphasizes that the exercise of right is forbidden if it obviously exceeds the limits set by good faith or general ethics or by the social or economic purpose of the right.

Article 288 provides that contracts shall be interpreted according to good faith, taking into consideration the relevant trade custom.

<sup>610</sup> 220/1997 ΠΠρωτΚαβ (278871)

the buyer's request the Greek bank issued an irrevocable, deferred payment letter of credit. In January 1995 the seller provided a bill of lading which showed the contracted goods but did not expressly state that shipment had taken place. Despite the discrepancies, the buyer accepted the documents relying on its good commercial relationship with the seller and instructed the bank to effect payment. When the goods failed to arrive on the agreed date, the buyer instructed the bank to revoke its payment obligation.

The court held that although the seller's act violated the requirement of good faith and general ethics the bank cannot refuse payment as the buyer accepted the documents and gave express order to the bank for payment.

One of the most recent cases in letter of credit fraud in Greece concerns the sale and purchase of sugar. Although fraud in relation to sugar is not rare<sup>611</sup>, the peculiarity of the case lies in the fact that the bank was defrauded by the seller and the buyer acting in cooperation.<sup>612</sup>

Cereals SA. is a Greek company dealing in starch and glucose. It wished to buy sugar from Brazil, one of the world top-ten sugar producers. In order not to jeopardize its close links to Greek sugar providers Cereals persuaded his partner, Praxis AE, to appear in the transaction as the buyer. Based on its good relationship with the bank, Cereals also convinced the Greek branch office of Societe Generale to issue an irrevocable letter of credit in the amount of 1.941.000 US dollars covering the purchase of 3.000 tonnes of sugar.

The letter of credit, among others, requested the presentation of a full set of bill of lading and a certificate of origin, showing the Dutch Antilles as country of origin. Although both buyer and seller were aware of the fact that the sugar would actually come from Brazil, the buyer wishing to avoid payment of duty on the import sugar insisted that an EUR 1 certificate of origin should be provided by the seller. Praxis contacted Family AE, an other Greek company, which agreed to arrange for the EUR 1 certificate indicating the Dutch Antilles, overseas territory of the Netherlands, as country of origin.

Then Praxis assigned its rights to Family and informed the bank accordingly. Upon this notification and the specific request of Cereals, the Greek bank issued the letter of credit, specifying Family as the buyer. Securing its reimbursement obligation towards the bank Family provided a corporate check in the amount of 1.941.000 US dollars.

The American seller presented the false certificate of origin along with the other documents through its corresponding bank to Societe Generale. The issuing bank found some discrepancies, one of which referred to the certificate of origin, and contacted the buyer for waiver. The buyer instructed the issuing bank in writing to accept the documents, so the bank informed the seller that it would effect payment 90 days after the issuance date of the bill of lading as per credit. In the meantime the seller sent a new set of documents to Family, which notified the bank to disregard the first set of documents.

When the shipment reached the port of destination the Greek authorities discovered that the country of origin was falsely stated and seized the cargo.

The buyer refused to reimburse the bank claiming that the bank effected payment against non-conforming documents, furthermore that it notified the bank to disregard the first set of documents. Soon after this the buyer went bankrupt.

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<sup>611</sup> On sugar fraud see 'CCS issues warning about online sugar fraud' on [http://www.iccwbo.org/home/news\\_archives/2002/sugar\\_fraud.asp](http://www.iccwbo.org/home/news_archives/2002/sugar_fraud.asp), date visited: 5 March, 2006

<sup>612</sup> *Societe Generale v. G. Kouzaraky and others*, Πολυμελής Πρωτοδικείο Αθήνας 6785/7.12.2004

The bank started proceedings against Family, Praxis and Cereals. The court stated that the bank acted in good faith when notified its customer of the discrepancies found in the documents. Since the buyer expressly waived the documents, the bank was right to effect payment. Moreover, when the buyer's notification reached the bank about the second set of documents, it had already undertaken to pay the seller as per credit.

In its ruling the court relied on the provisions of the Greek Civil Code, quoting Article 281 which states that the exercise of right is forbidden if it obviously exceeds the limits set by good faith or good morals or by the social and economic purpose of the right; and Article 914 which provides that a person acting illegally and intentionally is liable for the damages caused by his act. The case is currently before the Court of Appeal.

#### **7.4. The position taken by the United Nations Convention on Independent Guarantees and Standby Letters of Credit**

Unlike the UCP 500, the UN Convention addresses the question of fraud. By defining situations when the payment can be blocked the Convention attempts to "establish greater uniformity internationally in the manner in which guarantors/issuers and courts respond to allegations of fraud"<sup>613</sup>.

Article 19 of the Convention entitles the issuer to withhold payment if it is manifest and clear that:

- the documents is not genuine or has been falsified,
- no payment is due on the basis asserted in the demand and the supporting document, or
- the demand has no conceivable basis.

The Convention deliberately avoids using the term "fraud" as it may have different meanings in the various jurisdictions.

Article 19(2) gives illustrative examples of situations in which it is to justified to be exempted from the obligation to effect payment. These situations are the followings:

- a) the contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;
- b) the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;
- c) the underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
- d) fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary; or

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<sup>613</sup> Explanatory note by the UNCITRAL Secretariat on the United nations Convention on Independent Guarantees and Standby Letters of Credit, note 45.

See [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention\\_guarantees\\_credit.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_credit.html), date visited: 22 August, 2005

- e) in the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

In case a), b) and c) the applicant may seek injunction from the court. The court may block payment on the basis of “immediately available strong evidence”<sup>614</sup> that fraud has happened.

One of the greatest advantages of the Conventions is that it gives a list of misconducts that may invoke the fraud rule. Although this list is not exhaustive, it attempts to provide a practical guidance for courts where the demand has no conceivable basis.

It is important to note that the Convention does not require the intention of the fraudulent party to be proven, nor does it require that the beneficiary should take part or be aware of the fraud (as opposed to the approach of the English courts). Thus, the Convention (similarly to the UCC) is more concerned about the nature of fraud than the fraudulent party itself.

### 7.3. UCP

The UCP does not address the fraud exception, which of course does not in any way indicate that the drafters were unmindful and were not willing to face the challenge the fraud rule poses for the letter of credit law. The reason why the drafters of the UCP deliberately left out the fraud rule lies in the consideration that the fraud rule is within “the province of the applicable law and of the courts of the forum”<sup>615</sup>.

Under the UCP banks deal with documents not with goods.<sup>616</sup> The bank’s duty is to examine the documents with reasonable care if they appear on their face to be in compliance with the terms and conditions of the credit.<sup>617</sup> The decision of the bank is based strictly upon the examination of the documents.<sup>618</sup> If the documents comply, the bank is entitled and should pay. The UCP also provides that banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of the documents or for the good faith or acts or omissions, solvency, performance or standing of any other person.<sup>619</sup> Although the UCP specifically mentions the autonomy principle<sup>620</sup> as one of the basic principle of the letter of credit transaction, it does not expressly points out any exception to it.

The ICC Banking Commission expressed its supporting view to the existence of the fraud rule several times.

In the early 1980s when it was asked to comment on the liability of a negotiating bank which had paid against a forged bill of lading, it gave the following answer:

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<sup>614</sup> Article 20 of the Convention

<sup>615</sup> R.M.Goode, *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, In (1995) 39 Saint Louise U LJ p. 725 at 727

<sup>616</sup> See Article 4 of the UCP 500

<sup>617</sup> See Article 13(a) of the UCP 500

<sup>618</sup> See Article 14(b) of the UCP 500

<sup>619</sup> See Article 15 of the UCP 500

<sup>620</sup> See Article 3 of the UCP 500

“The commission expressed its opinion that the negotiating bank passing forward what proved to be a forged bill of lading was protected by Article 9 [now Article 15] unless it was itself a party to the fraud, or it had knowledge of the fraud prior to presentation of the documents, or unless it had failed to exercise reasonable care, e.g., if the forgery was apparent “on the face” of the document.”<sup>621</sup>

In 1995 the ICC Banking Commission further emphasized that:

“there is an exception to these provisions [principle of autonomy and that the bank deals with documents not with goods] in many jurisdictions, namely abuse of rights, or fraud. The ambit of this exception and the ensuing consequences for the beneficiary and/or the nominated bank may differ from one local jurisdiction to another. It is up to the courts to fairly protect the interests of all bona fide parties concerned.”<sup>622</sup>

Many commentators have applauded this approach and found it unnecessary to include the fraud rule into the UCP<sup>623</sup>. Others however argued that the UCP should not remain silent on this issue.<sup>624</sup>

Those arguing against the inclusion often say, that:

- the fraud exception is sensitive to local rules;
- the standard of fraud has been determined differently in the various jurisdictions;
- because of the great diversity of the approaches to the fraud rule, harmonization is bound to fail;
- harmonization can only be successful in form of a convention, and the ICC is not international organisation vested with this right;
- Article 15 of the UCP protects the banks from fraud when stating that banks assume no liability for the form, sufficiency, accuracy, genuineness or falsification or legal effect of the documents.<sup>625</sup>

The favouring opinions, on the other hand, emphasize that:

- fraud is an everyday reality, thus the UCP should address the question;
- by being silent on the fraud exception, the UCP has created a gap, which the international banking community should respond to;
- currently fraud cases are decided upon national laws. Since the courts approach the issue differently, the outcome varies from jurisdiction to jurisdiction. Diversity creates uncertainty;
- judges are not commercial experts, they need guidelines to decide cases where fraud is involved.<sup>626</sup>

<sup>621</sup> Opinions of the ICC Banking Commission (1980-1981) p. 27

<sup>622</sup> Opinions of the ICC Banking Commission (1995-1996) R 202

<sup>623</sup> For example John F. Dolan says that ‘It is important to understand that the Uniform Customs are not law; they are a compilation of what thoughtful bankers feel are good practice; and they fashion what is in the nature of the code of those practices. ...but the idea that they can fashion fraud law or trial procedures in the more than one hundred jurisdictions that recognizes the UCP is a fanciful notion.’ (*Letters of Credit: A Comparison of UCP 500 and the New U.S. Article 5*. In.: (1999) J.B.L., November Issue, p.533), also E.P. Ellinger, *The UCP 500: considering a new revision* In Lloyd’s Maritime and Commercial Law Quarterly, February, 2004

<sup>624</sup> See *Shiao-Lin Kuo on the scope of letter of credit fraud* In DC Insight Vol.1 No.4. Autumn, 1995

<sup>625</sup> See *Gerold Herrmann on why ICC rules and international conventions are both necessary* In DC Insight Vol.5 No.2 Spring, 1999

<sup>626</sup> See *Do we need a transnational law on documentary credits? Michael Rowe & Bernard Wheble debate* In DC Insight Vol. No.2 Spring, 1998; *Simon Jones reports on court cases dealing with L/C fraud* In DC Insight Vol. 5 No. 2 Spring, 1999; *P.K. Mukundan warns about cyber crime, phony bills of lading and other scams* In DC Insights Vol.

The revision of the UCP 500 is currently in progress. One of the issues being discussed is whether the new UCP should include provisions on the fraud exception or not. There are as many supporters for the inclusion as opponents against it. Therefore, the Banking Commission is facing the dilemma to steer a course between the Scylla of opening an endless debate by trying to outline the fraud exception, and the Charybdis of ignoring the question altogether.

Although the outcome of the debate cannot yet be predicted, I personally support the view calling for the inclusion of the fraud rule into the next version of the UCP.

The analysis presented in this Chapter on the divergent approaches of the selected jurisdictions to the fraud rule has shown that the same facts may result in different outcomes, when the case is decided by an English or an American judge. This works against standardization and harmonization and does not facilitate international trade.

It is understood that the UCP is not the only source of letter of credit law, moreover, it does not overrule the mandatory regulations of national laws. However, giving directions on how fraudulent acts should be treated, could significantly influence the decisions of the courts thus, it could assist international harmonization.

Moreover, by providing more sophisticated guidance to the parties as to how they are expected to act and what the most likely outcomes of their actions are, several court cases could be avoided.

## VIII.

### THE FUTURE OF THE UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS

Financing international trade has gone through rapid changes since the UCP 500 was put into use on 1 January 1994. With the help of the SWIFT<sup>627</sup> system and the so-called Electronic Data Interchange (“EDI”) the computer-to-computer communication of information contained in commercial documents has become an everyday reality. This has had a major effect on documentary credit operations as well, and called for adopting the UCP to the new circumstances.

On the other hand since UCP 500 came into force the ICC has been continuously facing the difficulty of clarifying the ambiguous provisions, misunderstandings and inconsistencies that have been revealed. The growing number of queries has led the ICC Banking Commission to consider a thorough revision of the current UCP.

This Chapter summarizes the effect of the electronic age on letter of credit transactions and introduces the Supplement to UCP 500 for Electronic Presentation (eUCP). The second part of the Chapter deals with the revision of the UCP 500 currently in progress and discusses the main issues under debate.

#### 8.1 eUCP

The transmission of documents involved in international transactions has become faster and more inexpensive. The internet has made it possible to transmit data without delay offering high-quality payment security for both parties of the business transaction and has also predicted an era in which letter of credit transaction will not depend on paper documents. On the other hand, the transmission of information in an electronic form may be hindered by legal obstacles or by uncertainty as to their legal validity or effect.<sup>628</sup>

Realising the growing need for setting standards for electronic presentation of documents in May 2000 the Banking Commission of the International Chamber of Commerce authorized the creation of a Working Group “to formulate rules for the evolution from paper-based credits to electronic credits”<sup>629</sup>. The 21 members of the Working Group were well-known scholars and letter of credit practitioners as well as attorneys and representatives of the transport industry from all over the world.

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<sup>627</sup> Until 1973 banks were communicating via telex, a not very secure system lacking minimum standards and automatism. To tackle this problem 239 banks from 15 countries formed a cooperative to ‘automate the telex’. They named it the Society for Worldwide Interbank Financial Telecommunication (S.W.I.F.T.) which today has 7600 members in 200 countries with daily messages regularly exceeding 9 million. For more information on SWIFT visit <http://www.swift.com>

<sup>628</sup> For a summary of some of the legal difficulties that may arise see Michael Rowe, *What legal issues will arise when paper documents are replaced by computer data?* In DC Insight Vol.2 No.1 Winter, 1996

<sup>629</sup> James E. Byrne, Dan Taylor, *ICC Guide to the eUCP*, ICC Publication No. 639 (2002), p.12. For a summary of the reasons that led to the drafting of the eUCP see *Dan Taylor explains why ICC is developing a text to interpret UCP for electronic documents* In DC Insight Vol. 6 No. 4 Autumn, 2000

The main goal of the Working Group was to set up a technology independent solution, which allows for future practice to emerge free from most technological constraints.

During a period of over 18 months the Working Group prepared three drafts and received more than 200 suggestions.<sup>630</sup>

The Supplement to UCP 500 for Electronic Presentation, or as generally referred to the eUCP, was finally approved at the ICC Banking Commission meeting in Frankfurt in November 2001 and came into force on 1 April 2002.

The greatest achievement of eUCP is that it brings the documentary credit into the electronic age and revolutionizes its use. By introducing the concept of “mixed presentation” that permits electronic or part-electronic (using both paper documents and electronic records) presentation of documents, it represents an important step towards the era of paperless commerce in which the vast majority of the presentation of the documents will be made electronically.

### 8.1.1 Structure of the eUCP

With its 12 articles, the eUCP is a relatively short publication of the International Chamber of Commerce. It is organised in a way that conforms to the UCP 500.

The first two articles of the eUCP reflect the relationship of the eUCP to the UCP. The third article redefines the common terms of UCP 500 which have a different meaning in the electronic commerce. In addition, it sets up new definitions unique to the eUCP.

Thereafter, the rules follow the order of presentation of a credit: format, presentation, examination, notice of refusal.

The eUCP also deals with the issues of originals, and copies, and place and date of issuance, which have a different meaning in eCommerce.

The last two articles reflect on the problem of corruption of an electronic record and allow the bank to disclaim liability under certain conditions.

### 8.1.2. Scope of the eUCP

According to Article e1(b)<sup>631</sup> “the eUCP shall apply as a supplement to the UCP where the credit indicates that it is subject to eUCP”.

As UCP 500 applies to a letter of credit if it is expressly stated in the text, no credit can be subject to the eUCP unless it states so. The eUCP deals only with electronic presentation of documents, not with electronic creation or delivery of letters of credit.

The eUCP is not a stand-alone set of rules and is neither a revision nor a replacement of UCP but an extension of it. As the ICC defines it is an update rather than a full revision of the rules. It represents a “bridge between current UCP 500 and the processing of the electronic equivalent of paper-based credits. ... The eUCP provides definitions to allow current UCP terminology to accommodate electronic presentation and the necessary rules to allow the UCP and the eUCP to work together”<sup>632</sup>.

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<sup>630</sup> For a summary of the drafting process see *René Müller discusses the current thinking of the working party drafting the electronic supplement to the UCP (eUCP)* In DC Insight Vol. 7 No. 2 Spring, 2001; *Bill Cameron on what remains to be done before the new eUCP takes final form* In DC Insight Vol. 7 No. 3 Summer 2001; *Excerpts from the final working party draft* In DC Insight Vol. 7 No 4 Autumn, 2001

<sup>631</sup> The Working Group wished to avoid confusion between the existing articles of the UCP and the eUCP so articles of the eUCP are numbered with an „e” preceding the actual number. (e.g.: Article e1).

<sup>632</sup> *Supplement to UCP 500 for Electronic Presentation*, ICC Publication No. 500/3 (2002) Paris, p.6-7

Thus, the eUCP cannot stand on its own and therefore incorporates the UCP 500.

The relationship of the eUCP to the UCP is declared by Article e2:

*“a Credit subject to the eUCP is also subject to the UCP without express incorporation of the UCP”* and

*“where the eUCP applies, its provisions shall prevail to the extent that they would produce a result different from the application of the UCP”.*

This automatic incorporation of UCP 500 in a credit subject to the eUCP and the prevailing role of the eUCP in case there is a conflict between a provision of the eUCP and UCP 500 makes it possible to avoid future problems, which might arise due to the fact that a considerable part of the eUCP is made up of definitions and principles and it does not address any issues relating to issuance or examination.

The intent of eUCP was to provide rules for full or partly electronic presentation of documents. This intent is made clear by Article e2(c) that exempts transactions not involving electronic documents from the scope of the eUCP even if the credit has been issued subject to it. In this case the rules of UCP 500 will solely apply.

Concerning its personal scope, the eUCP remains silent and does not indicate whether its rules apply to advisers, confirming banks, negotiating banks, paying banks or other parties. However, reading eUCP in conjunction with the relevant article of UCP 500 that reads:

*“the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication N°500, shall apply to all Documentary Credits where they are incorporated into the text of the Credit. They are binding on all parties thereto...”*<sup>633</sup>

it is clear that the provisions of eUCP, where incorporated into the text, apply to any person acting on the credit.

The eUCP is issued in “versions”. This will allow for a revision every time it is deemed necessary due to the constant development of the banking practice. As indicated by Article e1(c) the current version is Version 1.0. Therefore, when subjecting a credit to eUCP, it is recommended to include the applicable version number. Failing to do so, the eUCP declares that the version to be applied shall be the one in effect when the credit is issued.

### 8.1.3. Principles

Like most of the ICC rules, the eUCP is a set of general principles. The eUCP principles reflect those forming the base of the UCP and standard banking practice existing for electronic commercial transactions. Professor Byrne points out that “the eUCP draws on the principles of electronic issuance and analogizes from practice in the paper world in equivalent situations for electronic presentations”<sup>634</sup>.

Most of these principles are included in the definitions declared by Article e3, which is divided into two parts. The first part contains definitions (e.g.: “appears on its face”, “document” or “place of presentation”) that are used in the UCP but have an additional meaning when an electronic presentation is involved. The second part lists terms (e.g.: “electronic record”,

<sup>633</sup> Article 1 of the UCP 500

<sup>634</sup> James E. Byrne, Dan Taylor, *ICC Guide to the eUCP*, ICC Publication No. 639 (2002), p.14

“electronic signature” or “format”) drawn from the current eCommerce law and adjusted to accommodate letter of credit practice.

Considering the importance of these terms and in order to demonstrate the underlying concepts of the eUCP, excerpts are introduced below.

### Document

The concept of “document” is at the centre of the letter of credit transaction. The banks deal only with documents. Their obligation to honour the credit is brought forth only if the documents appear, on their face, strictly in compliance with the terms and conditions of the credit.

The definition of “document” does not expressly appear in the UCP 500 although, it is used extensively. As the ICC Guide to the eUCP points out it, refers to the:

- piece of paper that contained the representation,
- representations on which the obligation to honour is conditioned,
- document of title, and
- papers presented under the letter of credit.

Further more, it indicates the “original” of that document as opposed to a “copy”<sup>635</sup>.

Under eUCP Article e3(a)(ii) a document shall include an electronic record. This definition breaks with the traditional implication to paper and focuses on the data presented. Under an eUCP credit a data can be submitted both on paper and by electronic means; the main rule is that documents must consist of at least one electronic record.

### Electronic record

The eUCP defines the “electronic record” as a

*“data created, generated, sent, communicated, received, or stored by electronic means that is capable of being authenticated as to the apparent identity of a sender and the apparent source of the data contained in it, and as to whether it has remained complete and unaltered, and is capable of being examined for compliance with the terms and conditions of the eUCP credit.”*

The term electronic is technology neutral. It does not determine the way the record has to be transmitted. However, as the ICC Guide emphasizes it, the electronic record is “more than a message transmitted electronically”<sup>636</sup>. It must be received into the bank’s information system in a manner capable of being authenticated:

- in a means that verifies the identity of the sender;
- with respect to the apparent source of the data; and
- with respect to its completeness and unaltered character.

The method of authentication is not defined in the eUCP. The parties are free to decide the level of security used to authenticate the electronic message. The UNCITRAL Model Law on

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<sup>635</sup> James E. Byrne, Dan Taylor, *ICC Guide to the eUCP*, ICC Publication No. 639 (2002), p.49

<sup>636</sup> *Ibid* at p. 62

Electronic Commerce<sup>637</sup> and the ICC General Usage for International Digitally Ensured Commerce (Version II.)<sup>638</sup> provide guidance to this question.

Currently most banks use two methods for authentication: the so-called “proprietary” and the “open” method.

- the “proprietary” method requires the party creating the documents to use a website hosted by the bank. First, the party has to obtain a password or other secure means enabling the bank to identify him/her. After completing the document the person has to inform the bank so the bank can “lock down” the document to make its content unalterable.
- the “open” method involves Identrus digital signatures. Banks authorised to issue Identrus certificates offer a means of creating digital signatures that identify the signer. As soon as a character in a data file that has been signed gets changed, the signature is no longer valid, which assures the unalteration of the document<sup>639</sup>.

The question arises: what happens if the bank cannot authenticate a document. Article e5(f) clarifies the issue by stating that in such a case the document is deemed not to have been presented.

#### Sign and Electronic signature

The terms “sign” and “electronic signature” are closely related to each other. The signature assures the authenticity of the document and the information contained in it; and also identifies the person assuming responsibility for the document.

Under the UCP 500 a document may be signed in handwriting, by facsimile signature, by perforated signature, by stamp, by symbol, or by any other mechanical or electronic method of authentication.<sup>640</sup>

On the contrary, the eUCP defines “electronic signature” as a data process attached to or logically associated with an electronic record and executed or adopted by a person in order to identify that person and to indicate that person’s authentication of the electronic record.<sup>641</sup> The digital signature can be done by public-key cryptography, hash codes, a private key or any combination of the aforementioned methods. The eUCP does not specify the method of digital signature, which has to be agreed on by the parties.

#### Format

The issue of format is unique for the eUCP and has no equivalent in the paper based credit. According to the eUCP, definition “format” means the data organisation in which the electronic record is expressed or to which it refers.<sup>642</sup>

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<sup>637</sup> The Model Law was adopted by the UNCITRAL on its 29<sup>th</sup> session on 12 June, 1996, New York. Since its adoption it has influenced the national legislation of several countries. For the list of these countries and the full text of the convention visit [http://www.uncitral.org/uncitral/en/uncitral\\_texts/electronic\\_commerce/1996Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/1996Model.html), date visited: 23 January, 2003

<sup>638</sup> The ICC GUIDEC II. was published in October 2001 aiming to promote to the understanding of the business community of the world relating to the use of techniques in electronic commerce. For further information visit <http://www.iccwbo.org/policy/ebitt/id2340/index.html>, date visited: 23 January, 2006

<sup>639</sup> For more information on Identrus visit <http://www.identrus.com>

<sup>640</sup> See Article 20(b) of the UCP 500

<sup>641</sup> Article e3 (b) ii

<sup>642</sup> Article e3(b) iii

As the ICC Guide to the eUCP indicates, the term “format” is used in several senses. It means the version of a certain format, the system language by which data is organised or the short name by which the protocol is recognised.

At the current stage of technology a format is readable only if the data processor is able to recognize the manner in which the data is organized. Although the eUCP does not specify the format, it must be one that the beneficiary is able to create and the nominated bank (and the applicant) can read<sup>643</sup>.

Under Article e4 the burden of specifying the formats in which electronic records are to be presented lies on the issuer. In case the format is not specified in the credit the electronic record may be presented in any format, meaning that the bank cannot refuse the acceptance of the document even if it is unable to read it in the presented format.

Article e6(c) states that the inability of the issuer to read a required format is not a basis for dishonour.

It is also possible to specify different formats for various documents.

#### The Independence Principle

As it has been emphasized several times, the integrity of the letter of credit is based on the independence principle. In a paper based letter of credit relationship the independence principle has two sides, namely that:

- the obligation of the issuing bank to the beneficiary to honour the credit is independent of the rights and obligations of the parties (the seller and the buyer) in the underlying agreement; and
- the parties deal only with documents<sup>644</sup>.

The independence principle maintains its importance in an eUCP credit as well. The bank only examines the data contained in the electronic record and it does not engage itself into the examination of facts related to the underlying transaction.

#### **8.1.4. Electronic presentation**

Presentation of documents includes both the place and the time of presentation, and also answers the question when the presentation is considered to be complete.

##### Place of presentation

Under UCP 500 the place of presentation means a physical address. One may conclude that in the case of an electronic record this place shall be an electronic address, e.g. an e-mail address of the bank.

Although the ICC Guide to the eUCP draws the attention to the fact that an electronic record can also be sent to a physical address (e.g.: when a data is saved on a disk and mailed to the bank) it is, in my opinion, not likely in a world where telecommunications are this advanced.

In the event the credit does not indicate the place of presentation, neither the UCP nor the eUCP include any rules declaring the rights of the parties. It is suggested that in this case the beneficiary is entitled to present the documents at the address of the bank as indicated in the credit, or at any place the bank has a branch. However, failure to indicate the electronic address of the bank endangers the ability to deliver data in a fast and secure way the eUCP intends to support.

<sup>643</sup> Logical formats can be \*.doc, \*.txt, or \*.pdf.

<sup>644</sup> See Articles 3 and 4 of the UCP 500

### Time of presentation

The obligation of the bank is conditioned to the timely presentation of the documents fully complying with the terms of the credit.

The presentation is timely, if the bank – as described below - receives the “notice of completeness” on or before the expiration date stipulated by the credit. Concerning that the transmission of data may involve different time zones between the beneficiary and the receiver, attention must be paid to the time as the date expires according to the time zone of the receipt and not the place of the transmission.

The eUCP addresses the situation when the bank’s system is unable to receive a transmitted document by the deadline defined in the credit within its opening hours. In this case the expiration date shall be extended to the first following banking day on which the bank is able to receive an electronic record.

### Notice of completeness

Since, eUCP allows for mixed presentation of paper-based and electronic documents and also permits the separate presentation of electronic records, the beneficiary is required to send a “notice of completeness” when all the documents have been presented. Unless otherwise stipulated by the credit, the notice can be presented electronically or as a paper document. In the event the bank is unable to receive the electronic notice sent in time and this is the only remaining document to be presented, the beneficiary may use other means of telecommunication or may present a paper document and this presentation will be deemed timely.

Although the eUCP does not declare the content of the notice of completeness, the ICC Guide to the eUCP suggests that the notice should include:

- a statement that the presentation under “Letter of Credit Number...” is now complete and the examination should commence as of the receipt of the notice,
- a list of the various documents presented and the mode and date of presentation, and
- any relevant details regarding the electronic record.<sup>645</sup>

Absence of a notice of completeness signifies that the presentation is considered not to have been made.

### Other issues related to presentation

Article e5(d) requires that each presentation of an electronic record – and also presentation of a paper document under eUCP - shall identify the credit. Identification can be made by reference to the number of the credit or to the name of the issuer and the amount and date of credit or in any other ways enabling the bank to link the document to the credit based on the information provided.

Failing to do so, the beneficiary is risking the dishonour of the credit, as the bank is entitled to treat the document as not received. Although the eUCP does not require the bank to ask the beneficiary to identify the credit, it may decide to do so.

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<sup>645</sup> James E. Byrne, Dan Taylor, *ICC Guide to the eUCP*, ICC Publication No. 639 (2002), p.91

**8.1.5. The obligation of the bank to examine the electronic record and the notice of refusal**  
Upon receipt of the notice of completeness the bank is obliged to examine the documents presented. As other provisions of the eUCP, the rules of examination shall be read in conjunction with UCP 500.

The UCP rule obliging the bank to examine the documents in a reasonable time not exceeding seven banking days applies in case of an eUCP credit as well. The time period for the examination commences on the banking day following the banking day on which the beneficiary's notice of completeness was received.

The eUCP also addresses issues not existing in a paper-based system of presentation of documents. An electronic record may contain a hyperlink to an external system in which case the bank shall examine the data referred to by the hyperlink.

The term "hyperlink" is generally understood as a special area on a web page or a document appearing as text or graphic and which takes the user to another web page, document or area of the same web page or document.

However, access to data referred to by the hyperlink may require a special code or key. The access code or key must be provided by the beneficiary. A failure to provide access to the required electronic record at the time of the examination constitutes a discrepancy.

Once the bank examined the documents, it shall give notice of refusal under the procedure set forth in Article 14 of UCP 500 in case the documents do not fully comply with the terms of the credit.

In addition to the reasons constituting ground for refusing to honour the documents under UCP 500, the eUCP provides other reasons like the wrong format, a non-accessible hyperlink or a non-authenticated electronic record that enable the bank to dishonour the presentation.

#### Corruption of an Electronic Record after Presentation

Article e11 of the eUCP deals with a special issue arising only in electronic transmission of documents, namely the method by which the issuer may obtain data that has been corrupted after having been received from the beneficiary.

Based on this provision the bank may request that the electronic record be re-presented, during which time the examination is suspended.<sup>646</sup> However, Article e11 is optional. Banks are free to modify these rules in the credit or can even exclude them.

#### **8.1.6. Disclaimer of bank's liability**

The final article of the eUCP emphasizes the independent character of the eUCP credit. Under this provision – reading in conjunction with the UCP 500 – the bank assumes no liability for the identity of the sender, source of information or its complete or unaltered character other than that which is apparent in the electronic record.

It means that banks undertake the obligation of authentication only on the level of appearance and they do not examine the underlying transaction, the intention of the parties to the transactions, or whether the representations in the document are genuine.

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<sup>646</sup> It basically means that in case the electronic record is corrupted after the presentation, the original date of presentation will be considered and not the re-presentation date. It is analogous to losing a paper document after its submission to the bank.

On the other hand, banks entering into eUCP transactions must use and maintain a commercially acceptable data processing system. Failing to do so does not excuse the bank from responsibility, if the authentication is not possible due to the inadequacy of the system.

### 8.1.7. Fraud

The question of fraud and the fraud exception under a documentary credit is not addressed by the eUCP, similarly to the UCP 500.

However, it has been argued that the possibility of electronic presentation, the digital signature and other cryptographic techniques can significantly reduce the occurrence of fraud.<sup>647</sup>

James Byrne emphasized that “with the additional requirements for authentication of electronic records and today’s technology related to digital signatures and message authentication, these [fraud and safety] issues should diminish. ... That is not to say that fraud can be eliminated from credit transactions simply by the use of electronic presentation, but only that the possibilities for fraud become more limited”<sup>648</sup>.

### 8.1.8. Summary

The ICC supplement to the UCP 500 sets a standard framework for electronic presentation of documents that anticipates and accommodates the letter of credit practice, evolving alongside technology. It is not complete in the sense that further revisions will be inevitable as new technologies develop.

As of today, the use of electronic documents involves many problems that parties to the transaction have to face. Parties have to be able to create, send, receive and process electronic documents and have to agree on types of documents, formats and levels of safety. Third party issuers (e.g. carriers, insurance companies, etc.) need to possess the ability to issue electronic records, and the national legislations also have to take positions with respect to the status of electronic documents and electronic signature. Thus, many banking practitioners believe that the eUCP is ahead of its time and the technical conditions to its applicability have not yet been achieved.<sup>649</sup>

Even so, it is beyond doubt that the creation of the eUCP marks the beginning of a new era that will lead the letter of credit into a total electronic process and that will also change the underlying principles of the UCP 500.<sup>650</sup>

As Dieter Kiefer said: “the publication of the eUCP is a watershed event in the history of the documentary credit. Clearly, future UCP revisions will have to take into account the growing use of electronic documents and the trend towards electronic trade. This will mean that professionals

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<sup>647</sup> See *Christiaan van der Valk explains the basics of digital signatures and certifications* In DC Insight Vol. 3 No.2 Spring, 1997; *Valerie Slowther explains the ICC’s Electronic Commerce Project* In DC Insight Vol. 4 No. 1 Winter, 1998; *Dan Taylor explains why ICC is developing a text to interpret UCP for electronic documents* In DC Insight Vol. 6 No. 4 Autumn, 2000

<sup>648</sup> James E. Byrne, Dan Taylor, *ICC Guide to the eUCP*, ICC Publication No. 639 (2002), p. 18

<sup>649</sup> See *Final version approved* In DC Insight Vol. 8 No. 1 Winter, 2002; *Will the eUCP help electronic trade grow up?* In DC Insight Vol. 9 No.1 Winter, 2003; *In brief* In DC Insight Vol. 11 No. 1 Winter, 2005

<sup>650</sup> See *Is the internet the new frontier for the documentary credit? Yes, says Vincent O’Brien* In DC Insight Vol. 7 No. 2 Spring, 2001; *The electronic supplement & the future of documentary credits* In DC Insight Vol.9 No. 3 Summer, 2003

working in the field will have to make adjustments and that rule makers will have to give them the legal framework within which they can do their jobs”<sup>651</sup>.

## 8.2. The revision of the UCP: UCP 600 is on its way

The current version of the Uniform Customs and Practice for Documentary Credits, the UCP 500 came into effect on 1 January 1994.

As Charles del Busto emphasized it “this revision was required to address new developments in the transport industry and new technological applications. It is also intended to improve the functioning of the UCP. Some surveys indicate that approximately fifty per cent of the documents presented under the Documentary Credit are rejected because of discrepancies or apparent discrepancies. This diminishes the effectiveness of the Documentary Credit and can have a financial impact on those involved in the product. It may also increase the costs and reduce the profit margins of importers, exporters and banks. The marked increase in litigation involving Documentary Credits has also been of great concern”<sup>652</sup>.

Following the publication of the UCP 500 the ICC Commission on Banking Technique and Practice has taken several measures to facilitate the smooth running of the documentary credits.<sup>653</sup>

- In May 1994 a Group of Experts was established with the mandate to review queries relating to the UCP 500.
- On 1 September 1994 the Banking Commission published four so called “Position Papers” in order to clarify “misinterpretations and misapplications of the particular Articles of UCP 500”<sup>654</sup>. The Position Papers addressed the issue of amendments, negotiation, non-documentary conditions and transport documents articles.
- Since 1995 the Commission have been responding to questions raised by bankers, exporters, importers, shipping companies, freight forwarders and lawyers. Each year the Commission ratifies the most important responses and publishes them as Official ICC Opinions. The aims of these Official Opinions are to (a) encourage uniformity of practice in a field where individual document checkers often differ in the way that they approach documents that they have to review; (b) provide guideposts to courts in interpreting ICC Rules; and (c) prevent the development of disputes that would otherwise lead to court action.
- In October 1997 the ICC published the so called “Rules for Documentary Credit Dispute Resolution Expertise” (DOCDEX) to facilitate the settlement of letter of credit disputes. The DOCDEX rules allow for a cost-effective, quick procedure in which the dispute is decided by a panel of three experts.<sup>655</sup> Unless otherwise agreed by the parties, the DOCDEX decision is not binding.

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<sup>651</sup> *Final version approved* In DC Insight Vol.8 No.1 Winter, 2002

<sup>652</sup> Preface to the UCP 500 by Charles del Busto

<sup>653</sup> For a summary of the different measures taken by the ICC see Gary Collyer, *the Banking Commission's Technical Adviser, discusses trends in the queries being received on UCP 500* In DC Insight, Vol. 3 No.3 Summer 1997

<sup>654</sup> Foreword to the Position Papers n° 1, 2, 3, 4 on UCP 500 by Charles del Busto at <http://www.iccwbo.org/id357/index.html>, date visited: 7 September, 2005

<sup>655</sup> The experts are appointed by the ICC International Center of Expertise, which administers the system.

Besides, the Banking Commission has conducted seminars for ICC national committees in several countries in order to help the banking and trading society understand the wording and the rationale behind the different articles of the UCP 500.<sup>656</sup>

### 8.2.1. The revision of the UCP 500

Although the reception of the UCP 500 was favourable<sup>657</sup>, since its entry into force several ambiguous provisions, misunderstandings and inconsistencies have been revealed by the banking and trading community, as well as by lawyers and courts.<sup>658</sup>

As Professor Ellinger stated the UCP 500 is “neither a perfect nor an up-to-date Code”<sup>659</sup>, thus its revision has become essential.

For some time, the Banking Commission rejected the need for a revised code. At its meeting in 3-4 November 1999 the Commission stated that “after an analysis and discussion of issues that have arisen since UCP 500 became effective, we see no significant reason to undertake a revision at this time”<sup>660</sup>. They argued that “the majority of the issues brought before the Banking Commission are issues that are educational in nature or involve interpreting the provisions of UCP 500”<sup>661</sup>. Instead, the Commission issued policy statements on some of the most debated topics<sup>662</sup>, launched the eUCP, a Supplement to UCP 500 for Electronic Presentation and approved the ISBP<sup>663</sup>.

Confucius once said that “a journey of a thousand miles starts with a single step”. However, it seemed rather hard for the ICC Banking Commission to make this first single step. It was not until its April meeting in 2002<sup>664</sup> when the Commission agreed on the preliminary review of the seven most debated articles of the UCP 500.<sup>665</sup>

The Banking Commission established a Task Force to give recommendations on how the revision should be conducted. The Task Force concluded, that:

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<sup>656</sup> About the ICC seminars see *Gary Collyer on why UCP 500 will not be revised soon* In DC Insight Vol. 6, No. 1 Winter 2000

<sup>657</sup> On the reception of UCP 500 see Charles del Busto, *The UCP rules will never be perfect...* In DC Insight, Vol.1 No.1 Winter 1995

<sup>658</sup> See for example *Reinhard Langerich claims that “negotiation” is still a word with problems* In DC Insight Vol.3 No.3 Summer 1997; *The old L/C principle of documents against payment has considerably changed, maintains Georges Kobakhidze* In DC Insight Vol. 4 No.1 Winter 1998; *Frank Reynolds has some straight talk about traders problems with L/Cs* In DC Insight Vol 4 No.3 Summer 1998; *N.D. George responds to Gary Collyer’s conclusion that UCP will not be revised soon* In DC Insight Vol.6. No.2 Spring 2000; *T.O. Lee argues there are inconsistencies among terms used in ICC rules* In DC Insight Vol.6 No. 4 Autumn 2000

<sup>659</sup> E.P.Ellinger, *The UCP-500:considering a new revision* In Lloyd’s Maritime and Commercial Law Quarterly, February, 2004, p.31

<sup>660</sup> *Approved at the meeting of the Commission in Hong Kong (3-4 November 1999)* In DC Insight Vol.6 No.1 Winter 2000

<sup>661</sup> *Ibid*; On the same issue see also *Gary Collyer on why UCP 500 will not be revised soon* In DC Insight Vol.6 No.1 Winter 2000

<sup>662</sup> For example: The determination of an “Original” document in the context of UCP 500 sub-Article 20(b) (12 July 1999); Examination of Documents, Waiver of Discrepancies and Notice under UCP 500 (9 April, 2002)

<sup>663</sup> The ISBP was approved by the Commission at its meeting in Rome in October 2002.

<sup>664</sup> It is interesting to note that the ICC national committees of most of the highly developed countries (eg.: US, UK, Switzerland, Germany, Singapore) were against the revision, while the less developed countries (eg.: Cyprus, India, Iran, the Russian federation) were in favour of a new UCP.

<sup>665</sup> These articles were: 9 (Liability of Issuing and Confirming Bank), 13 (Standard for Examination of Documents), 14 (Discrepant Documents and Notice), 21 (Unspecified Issuers or Contents of Documents), 23 (Marine/Ocean Bill of Lading), 37 (Commercial Invoices) and 48 (Transferable Credit).

- There should be a technical and not a line-by-line review<sup>666</sup>;
- The revision of the ICC Opinions, Decisions, DOCDEX cases and court decisions is also necessary;
- More than 58 per cent of all ICC Opinions has been given on the seven mentioned articles;
- Seventeen articles have not been queried at all, or only once; and
- It should be considered to incorporate the URR 525, ISP98 and the eUCP into the new Code.<sup>667</sup>

The original plan to conduct a technical revision changed as more and more debated questions arose and the idea of a more fundamental revision has started to take shape. Supporting this latter it was argued that the UCP is built on a coherent system of provisions and the revision of an article may have an effect on other articles as well. Furthermore, a thorough revision would give the opportunity to develop a set of rules reflecting the fast-changing technology and rapidly improving means of communication.<sup>668</sup>

In spring 2003 a Drafting Group<sup>669</sup> and a Consulting Group<sup>670</sup> was established. The role of the Drafting Group is to review the debated issues and prepare the drafts of the suggested revision. The Drafting Group is conducting its work with the philosophy of :

- Trying to use “plain and simple” English in the revision;
- Not attempting to fix what is not broken;
- Removing outdated articles;
- Considering the inclusion of new concepts and the alignment with other ICC rules;
- Seeking to close loopholes that have resulted in discrepancies; and
- Providing a commentary that will accompany the publication of the new UCP in order to facilitate the implementation of the rules.<sup>671</sup>

The Consulting Group’s main task is to comment on the drafts before they are sent to the national committees.

The different opinions of the national committees are discussed during the meetings of the Banking Commission. The two latest meetings took place on the 27-28<sup>th</sup> of June, 2005 in Dublin and on the 24-25<sup>th</sup> of September, 2005 in Paris where 170 participants from 40 countries were present. The attendance of the meetings clearly indicates the importance of the revision of the UCP 500.

### 8.2.2. Selected issues

In the course of the revision of the UCP 500, without aiming to give a full record, the following main issues have been raised and have been debated by the national committees, the Drafting Group, the Consulting Group, bankers, academic scholars and trade experts.

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<sup>666</sup> See *UCP: What kind of revision?* In Brief In DC Insight Vol.8 No.2. Spring 2002; *Themes in the queries and the future of UCP* In DC Insight Vol.8. No.3. Summer 2002

<sup>667</sup> See *Notes from the UCP Drafting Group* In DC Insight Vol. 11 No.2 Spring 2005

<sup>668</sup> Nicole Keller, *The shape of the new UCP* In DC Insight Vol.9 No.3. Summer 2003

<sup>669</sup> The Drafting Group is composed of 9 members and it is chaired by Gary Collyer, technical advisor of the ICC Banking Commission.

<sup>670</sup> The Consulting Group has 41 members, who are leading experts from many fields related to the letter of credit (e.g.: lawyers, bankers, experts on transporting, etc)

<sup>671</sup> See *Notes from the UCP Drafting Group* In DC Insight Vol. 11 No.2 Spring 2005

### Title of the Code

It has been suggested that the title of the UCP should change to Uniform Rules on Letters of Credit (URLC) as it better reflects the true nature of the Code.

My personal view is that it would only cause confusion. Both the current title “Uniform Customs and Practice for Documentary Credits” and the three-letter abbreviation “UCP” have been used by the parties involved in international trade and finance for over 70 years since the first publication of the Code in 1933. They are embedded in the professional trade jargon so deeply that altering the title would only result in misunderstandings without providing a better description of the Code.

### Scope of the UCP

According to the current version of the UCP it applies to both documentary and standby credits.<sup>672</sup> It has been pointed out earlier that the UCP was originally designed to suit documentary letters of credit. However, when standby letters of credit started emerging in the 1950s for lack of a set of rules specifically designed for this instrument, banks subjected them to the UCP. For a long time the UCP did not refer to standbys at all, and it was not until the 1983 revision that the scope of application of the UCP was expressly extended to standby letters of credit.<sup>673</sup>

Unfortunately, apart from mentioning standby credits in Article 1, no real changes have happened in the Code in order to make it more usable for standbys. It has been often argued by commentators that several provisions of the UCP are inappropriate for standbys and some issues that are important in standby practice are not addressed at all.

Reflecting the growing commercial need the ICC adopted the International Standby Practices, drafted by the Institute of International Banking Law and Practice, Inc. It has been in effect since the 1<sup>st</sup> of January 1999.

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<sup>672</sup> See Article 1 of the UCP 500

<sup>673</sup> The reasoning behind the inclusion of standby credits to the UCP is explained in ICC Publication No. 411, comparing UCP 290 and UCP 400, which reads as follows:

‘In March 1977 the Banking Commission expressed its opinion that a stand-by letter of credit fell within the UCP (publication No. 290, General Provisions and Definitions, paragraph b) definition of a documentary credit and should therefore be subject to UCP (No. 371, p11). Since stand-by credits are being increasingly used in a growing number of countries and publication 371 may not be known to all concerned with standby credits, it was felt desirable to remove any doubt and make it clear by wording in the UCP that the UCP applied to such letters of credit.

[...]

The role of the traditional documentary credit (commercial credit ... has been to enable the seller to obtain the payment due to him from the buyer when he, the seller, has fulfilled his part in the commercial contract and “evidenced” this fact by presenting “stipulated documents”.

The role of the stand-by credit is different, although it possesses all the elements of a documentary credit subject to UCP. ... [It] is intended to cover a “NON-PERFORMANCE” (default) situation instead of a “PERFORMANCE” situation, as with the traditional documentary credit. This affects both the position of the issuing bank and the type of documentation called for. Even if the applicant claims that he has “performed”, the bank must pay under the terms of the credit if the specified document is presented - usually a sight draft on the issuing bank accompanied by a statement of claim issued by the beneficiary. ...

The type of documentation referred to above gives some indication of the “extent to which they (UCP) may be applicable” to stand-by letters of credit. Thus, Articles 23 and 46 would seem likely to apply, whereas articles dealing with “Documents” would seem likely not to be applicable.’ (Quoted by Vincent Maulella, *Should reference to Standbys remain in UCP?* In Expert Article, DC Insight)

Since the ISP 98 is a set of regulations designed specifically for standby letters of credits it is time for standby to be excluded from the scope of the UCP<sup>674</sup> and the current revision process provides an excellent occasion to do so.

#### Definitions and Interpretations

Several terms used by the UCP 500 are either ambiguous (e.g.: negotiation) or hard to translate to other languages (e.g.: on their face).

Therefore, the Drafting Group has decided to create a separate section devoted exclusively to the definitions of terms.<sup>675</sup> The Definitions Article – placed in the beginning of the UCP – will contain description of terms, such as: issuing bank, advising bank, confirming bank or negotiation, confirmation, presentation, honouring a credit, banking day.

A new article under the title “Interpretations” will be introduced to give guidance on general expressions and date terminology.

#### Revocability of a credit

The current version of UCP distinguishes between a revocable and an irrevocable credit, stating that in case of no indication the credit is deemed to be irrevocable. It has been already referred to earlier that revocable credits are very rare; they might as well be considered as an “extinct species” in international trade finance. Therefore, it has become unnecessary to contain reference to revocable credits. The future UCP will only deal with irrevocable documentary credits.

#### Deferred payment credit

The difficulties of discounting a deferred payment credit have been highlighted by the famous and earlier analysed *Banco Santander SA v. Bayfern Limited*<sup>676</sup> case. The current UCP is not clear on the question whether financing is allowed under a deferred payment credit. Nevertheless, as it appeared from the expert testimony given during the trial, it is common banking practice to discount such letters of credit.

The new UCP should better reflect the banking practice and should contain clear rules on this issue.

#### Amendment of the credit

Admittedly, the present Article 9(d) dealing with the question of amending the letter of credit, proved to be one of the most difficult from a drafting point of view as there has been a widespread banking practice on how and upon which conditions the credit can be amended.<sup>677</sup>

According to the current provisions a letter of credit can not be amended without the beneficiary’s consent. In case the beneficiary fails to notify the bank of his intentions, the amendment will not enter into force unless the beneficiary tenders documents complying with the amendment. It is presumed that the tender of such complying documents amounts to acceptance of the amendment.

In my opinion this article calls for a more comprehensible wording. In order to avoid misunderstanding, the beneficiary should be requested to communicate its rejection or acceptance

<sup>674</sup> See E.P.Ellinger, *The UCP-500: considering a new revision* In Lloyd’s Maritime and Commercial Law Quarterly February, 2004, p.34; Vincent Maulella, *Should reference to Standbys remain in UCP?* In Expert Article, DC Insight

<sup>675</sup> *Some key issues in the UCP revision* In DC Insight Vol.11 No.1. Winter 2005

<sup>676</sup> [1999] Lloyd’s Rep Bank 239, [2000] Lloyd’s Rep Bank 165. The case is summarized in Chapter VII, 7.3.1.

<sup>677</sup> See Charles Del Busto (ed.), *UCP 500 & 400 Compared – An Article-by-Article detailed analysis of the new UCP 500 compared with the UCP 400*, ICC Publication No. 511, p. 24-25

of amendments in writing. In case the beneficiary's notification is received by an advising bank, this bank should inform the issuing bank, again in writing, about the number of received amendments and which one was accepted or rejected. If there is no answer received from the beneficiary this should be clearly indicated.

#### "On their face"

Article 13 requires the bank to "examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear, *on their face*, to be in compliance with the terms and conditions of the Credit".

The term "on their face" has been the subject of enquires submitted to the Commission. In some cases it has been (wrongly) understood that it means the first page of the document as opposed to the back of the document.

The Banking Commission has expressed its opinion on this term several times<sup>678</sup> emphasizing that the term means the requirement that the bank should not go beyond the documents. Considering its problematic nature the banking community is considering deleting the entire term from the UCP.

I believe that there is no real reason to remove this term entirely from the UCP. Its meaning is self-evident, and has been used or referred to by courts for a long time. All reasonable documentary checkers understand that "on their face" means that it is decided upon the documents alone whether the presenter has fulfilled the requirements of the credit or not; and the bank is not obliged to ask further questions.

#### Reasonable time

The current version of the UCP allows a reasonable time, not exceeding seven banking days for the banks to check the documents.<sup>679</sup> This period of time starts from the day after the documents are received by the bank.

There has been a debate on the length of this period. Some commentators argue that it should be replaced with a fixed time limit, preferably a shorter period of five days<sup>680</sup>, while others favour to keep the current version. It has also been suggested that a so called "safe harbour" rule should be included in the wording, meaning that a certain number of days would always be reasonable, above that until the maximum it would depend on the circumstances.<sup>681</sup>

The Drafting Group has suggested modifying the maximum period to six banking days from the day after the receipt of the documents or keep the current seven days but starting from the day of the receipt of the documents.<sup>682</sup>

Personally I believe that the current wording of the UCP is sufficient enough, no modification is required. There are not two identical documentary credit transactions; one may involve the

<sup>678</sup> See Opinion of the ICC Banking Commission R211 – 1995/97; Opinion of the ICC Banking Commission R279 – 1997

<sup>679</sup> Article 13 (b) currently reads:

'The Issuing Bank, the Confirming Bank, if any, or a Nominated Bank acting on their behalf shall each have a reasonable time, not to exceed seven banking days following the day of receipt of the documents, to examine the documents and determine whether to take up or refuse the documents and to inform the party from which it received the documents accordingly.'

<sup>680</sup> See for example N.D. George, *Delete "reasonable time" and "without delay" from the UCP* In DC Insight Vol. 11 No. 3 Summer 2005; E.P.Ellinger, *The UCP-500: considering a new revision* In Lloyd's Maritime and Commercial Law Quarterly, February, 2004.

<sup>681</sup> *Intense discussion at the Dublin meeting* In DC Insight Vol. 11 No. 3 Summer 2005

<sup>682</sup> See *Reasonable time, transferable credits and other UCP revision issues* In DC Insight Vol.11 No. 2 Spring, 2005

checking of a few pages, another may sum up to hundreds of pages. Furthermore, the capabilities and skills of the documentary checkers in different banks throughout the world are not the same. One may examine a certain amount of documents in a day, while it would take a day and a half for his overseas colleague. Thus, the “reasonable time” to conclude an examination differs from case to case.

Applying the “safe harbour” rule would lead to nonsense results, when in a theoretic transaction involving the submission of one single page the examination could be safely concluded in three days.

Similarly, giving a specific period of time, as the suggested five days while removing the relatively flexible “reasonable time” rule, would again allow banks to decide on the honour or dishonour of the documents on the very last day, even when the decision could have reasonably been made much earlier.

In my opinion the current “reasonable time” requirement not only puts an obligation on the banks not to spend more time on the examination of documents than necessary, but it also allows for the consideration of the differences between the various documentary transactions.

#### Notice of rejection – waiver and release of documents

Under Article 14 of the UCP 500 the bank may reject the document in case it finds some discrepancies. The rejection notice, sent to the presenter without delay but within the seven-day period, has to list all discrepancies and must state that the bank is holding the documents at the presenter’s disposal or returning them to him. Failing to act in accordance with these provisions precludes the bank to refuse payment.

On the other hand, the UCP allows the bank to turn to the applicant for waiver of discrepancies.

The wording of Article 14 is cumbersome and has created difficulties for the banks, which has resulted in several court cases and inquiries submitted to the ICC Banking Commission. The objective of the bank is to refuse the immediate payment in case of discrepancies found in the documents but at the same time to allow for negotiation between the commercial parties.

It is suggested to modify the relevant UCP provisions to allow the bank to either follow the instructions of the presenter or seek waiver of the applicant upon its own initiative, in the latter case the bank may hold the documents and release them to the applicant in case the waiver is granted and is accepted.

#### Force majeure

Article 17 discharges the bank of its contractual obligations in case of force majeure, namely in case of interruption of their business by Acts of God, riots, civil commotions, insurrections, wars or any other causes beyond their control, or by any strikes or lockouts. Several national committees are favouring the amendment of this article to align it with the principle in ISP98, namely to allow for a specific period of time following the reopening of a bank during which the beneficiary can present its documents<sup>683</sup>.

#### Transport documents

One of the innovations of the UCP 500 was that it has recognized the different types of transport documents and extended their number from three to eight.

Traders claim that the transport details indicated in these articles are not always adequate to the routing for the transportation of the goods<sup>684</sup>.

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<sup>683</sup> *Notes from the UCP Drafting Group* In DC Insight Vol.11 No.2. Spring 2005

<sup>684</sup> Helena Kwok in *World-wide comments on LCs and UCP 500* In DC Insight Vol.2 No.1 Winter 1996

It has also been argued that “the introduction of new articles in the UCP 500 dealing with the acceptability of the various transport documents under a documentary credit might have led to a decrease in the number of disputes that arose”<sup>685</sup>.

Although the ICC Banking Commission has published a Position Paper on the transport documents<sup>686</sup>, full clarification has not been achieved. Therefore an adequate revision is necessary.

### 8.2.3. Summary

According to its schedule, the major topic of the next two meetings of the ICC Banking Commission in May 2006 in Vienna and in October 2006 in Paris will be the progress of the revision of the UCP 500. Although these meetings do not aim at the drafting of the articles, they provide an excellent forum for national committees to express and discuss their views on the draft articles, thus communicate to the Drafting Group whether there is a general agreement on the principles and wording of the new Code.<sup>687</sup>

Observers believe that “2006 will be the decisive year for the next revision”<sup>688</sup>, however a date for the submission of a final draft has not been set by the Drafting Group.

It may be too early to estimate when the UCP 600 will be adopted. Judging from the number of issues the Drafting Group has to agree on, there are several steps yet to be made on the journey of the thousand miles.

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<sup>685</sup> Mark Ford, *The transport sector views UCP 600* In DC Insight Vol.11 No.3 Summer 2005

<sup>686</sup> Position Paper of the ICC Banking Commission n°4 on UCP 500 - Transport documents articles, 1 September 1994, available at <http://www.iccwbo.org/id357/index.html>, date visited: 7 September, 2005

<sup>687</sup> See *Notes from the UCP Drafting Group* In DC Insight Vol. 11 No.2 Spring 2005

<sup>688</sup> *In brief* In DC Insight Vol.11. No.3. Summer 2005; also *Intense discussion at the Dublin meeting* In DC Insight Vol. 11 No. 3 Summer 2005

## IX.

### CONCLUDING REMARKS

Merchants are desirous to minimize their risk when entering into commercial relationships. This objective receives even higher awareness when the relationship enters the international field, and involves transportation of goods over frontiers, differences in language, currency, culture and jurisdiction.

To reconcile the various economic interests of the parties, as well as to protect themselves from the pitfalls of international engagements, merchants have developed different methods to finance international trade.

The device to which merchants have traditionally resorted to is the letter of credit. The letter of credit is a unique financial instrument. Although its history is closely related to other negotiable instruments, specifically to that of the bill of exchange, as it has been described in Chapter I., it has maintained its special role in international trade. It gives safe and rapid access for the seller-beneficiary to the purchase price while protecting the buyer-applicant against improper demands.

Letter of credit law has emerged from the banking practice and has developed alongside with banking customs. These customs have been compiled and standardised by the International Chamber of Commerce in the UCP. Legitimacy of the UCP derives from the parties' voluntary submission to its provisions. Banks throughout the world adhere to the UCP, which has proven to be the most successful act in the harmonisation of international commercial law.

Without doubt the UCP is the primary source of letter of credit law. Nevertheless, one shall remember the other essential sources introduced in Chapter II., such as the ICC regulations and the Uniform Commercial Code, which play an active role in shaping the letter of credit law. A Convention on Independent Guarantees and Standby Letters of Credit United Nations has also been drafted under the auspice of the United Nations. Despite its failure to be accepted by many countries, it still serves as an important interpretative instrument.

Letters of credit involve a series of complex commercial relationships between the seller, the buyer and the banks. The thesis has provided a thorough analysis of the role, as well as of the rights and obligations of all parties involved. Upon the buyer's detailed application the bank will issue the letter of credit listing the documents required to be submitted by the seller. The bank's obligation to make payment is conditional to the documents, outlined in Chapter V., strictly complying with the terms of the credit.

In letters of credit transactions banks deal with documents and not with goods. The Principle of Independence and the Principle of Strict Compliance, as explained, preserve the fundamental nature of letter of credit; that is to provide a secure mechanism for financing international trade. The Principle of Independence allows for the smooth operation of the mechanism, prohibiting the buyer from blocking the payment upon claims arising from the sales contract. On the other hand the Principle of Strict Compliance ensures that the seller gets paid only if the terms of the credit are strictly met.

The fact that banks are concerned only with documents provides opportunity to fraudulent parties to abuse the system. Documents can easily be forged or fabricated to appear complying without covering goods in fact.

The fraud rule, presenting an exception to the Independence Principle and allowing the court to look into the underlying contract, is still a developing and highly debated area of letter of credit law. It has been demonstrated how differently courts approach the payment obligation of banks when fraud is involved in the transaction. It has also been pointed out that regrettably, the UCP does not address the issue. By leaving a gap in the operation the UCP undeniably creates a “potential threat to the commercial utility of the letter of credit”<sup>689</sup>.

The primary objective of the UCP, which now forms an integral part of international trade law, has been to provide clear, unambiguous rules applicable all over the world, thus creating uniformity in the field of letter of credit transactions. A good commercial law is the one that provides the highest certainty and predictability. It has been proven that local fraud rules are diverse and lacking clarity and may result in contradicting judgments despite the same factual background. It is up to the international banking community, as experts of the subject matter, to provide guidance for the courts in dealing with fraud. Therefore, the author strongly supports the inclusion of the “fraud rule” into the future UCP.

The UCP 500 is neither complete, nor static. Its provisions require continuous revision alongside with the changes in international commerce. As Petkovic appropriately pointed out, the UCP is an “Evolution not Revolution”<sup>690</sup>.

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<sup>689</sup> G.W.Smith, *Irrevocable Letters of Credit and Third Party Fraud: The American Accord*, (1983) 24 Va J Int'l L. 55 at 96

<sup>690</sup> Petkovic, *UCP 500: Evolution not Revolution*, (1994) 2 JIBL 39

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T.O. Lee argues there are inconsistencies among terms used in ICC rules, Vol.6 No.4 Autumn

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