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The Letter of Credit, its resilience and viability in securing international commercial transactions

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Abstract

Purpose – This paper aims to address issues of law and policy, the potential pitfalls such as fraud, conflict of law and documents discrepancies that are often encountered by the parties in usage and practice of the Letter of Credit (LC). The article has gleaned other forms of payment mechanisms in international commercial trade to demonstrate that despite the upsurge in international payment instruments, the LC has remained a viable commercial product. This article aims to provide an in-depth analysis of the law governing the LC and why it has remained resilient and a viable commercial product for many years.

Design/methodology/approach – The author has utilized the current version of UCP 600 (2007) and the legislation such as Brussels Convention (2000) in Europe, litigated cases and secondary data sources in writing the paper. The data generated were then evaluated taking into account the most recent legal and policy changes regarding the usage and practice of the LC in international commercial transactions. The paper straddles many issues but evaluated in a distinctive way to underscore the purpose for writing it.

Findings – The findings of the paper have demonstrated that despite a myriad of payment mechanisms as a result of innovation in international trade, the LC is still a viable commercial product. Parties will need to be knowledgeable and skilled enough to keep abreast of dynamic changes on law and policy relating to usage and practice of LCs. Short of that parties could be vulnerable to risk exigencies inherent in international trade they sought to eliminate by subscribing to the LC.

Research limitations/implications – The limitations lie in realm that the paper was largely library-based and the author did not carry out extensive corroborative research studies on issues it was written on. Thus, any future work on the LC will try to corroborate issues of policy and practice and how they are internalized in commercial practice.

Practical implications – The paper has articulated the governing law of the LC and the context in which it is harnessed in commercial practice. It has articulated potential risk areas that the parties ought to watch out for before and during the process of harnessing the LC as a payment mechanism. The paper has demonstrated that risks inherent in international trade are now higher than in past decades because of globalization and its attendant fluid environment. The paper is relevant to banks, regulators, governments and also students because it internalizes most recent changes in the usage and practice of the LCs in international trade.

Social implications – International trade affects local businesses, banks, ordinary people, national governments and it has far reaching implications for societies as whole. The LC is utilized to mitigate, if not eliminate, potential risks in international trade transactions, and it has far reaching social implications for economies to be overlooked.

Originality/value – The article has gleaned other forms of payment mechanisms in international commercial trade to tease out that despite the upsurge in international payment mechanisms, the LC has remained a viable commercial product. This article is a MUST read because it internalizes recent

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changes in the usage and practice of documentary credit which have not been addressed in its context. Even though the article has been undertaken by analysis of secondary and primary data sources, the author has done so in a distinctive way to underscore the most recent changes to the usage and practice of the LC and the purpose it was written.

Keywords Potential pitfalls to watch out, Its commercial viability, Letter of Credit, Why its resilience

Paper type Research paper

1. Introduction

This article aims to provide an in-depth analysis of the law governing the Letter of Credit (hereinafter LC) to demonstrate its resilience and commercial viability for many years. The LC is a commercial specialty used to guarantee payment of goods by banks (on behalf of the buyer) to the seller and it has performed this fundamental function for more than 150 years (Ellinger, 2007). The applicable version of UCP depends on the one in force at any particular time (Debattista, 2007)[1]. The interposition of banks between the parties is designed to provide enhanced security by minimizing information asymmetries between the parties. More often, the parties to the LC would be based in different foreign countries (jurisdictions), with little knowledge of each other and also the potential of a language barrier. Therefore banks are interposed to bridge the information gap between the buyer and the seller. However, it needs to be noted that while banks are not concerned with[2] underlying sales contracts, the LC is undertaken pursuant to sales contracts between the buyer and seller. Parties would have nominated a clause into the sale contract to the effect that payment will be made by the LC. Banks are also interposed into the LC process to provide security to the parties with regard to rigorous examination of[3] tendered documents. Thus, this article addresses recent changes introduced by UCP 600 and a shift in policy on documentary credit practice in international commercial transactions. The article addresses issues of law and policy, the potential pitfalls that are often encountered by the parties and usage in practice of the LC. The article has explored other forms of payment mechanisms in international commercial trade to tease out that despite the upsurge in international payment mechanisms, the LC has remained a viable commercial product. This article is a MUST read because it internalizes recent changes in the usage and practice of documentary credit which have not been addressed in its context. Even though the article has been undertaken by analysis of secondary and primary data sources, the author has done so in a distinctive way to underscore the most recent changes to the usage and practice of the LC and the purpose it was written. The article is structured in three parts, where part one addresses the process within which the LC is executed, part two addresses the role of banks and part three deals with issues of law and policy on documentary credit practice.

2. The mechanics of the LC

The main feature of the LC is that it is separate and separable from underlying sales contract for which they are generated (Bridge, 1999). As a commercial product, the purpose of LC is to perform two principal functions: first, it is a source of finance to the buyer to effect commercial transactions and thus boosts the buyer's capacity to engage in international trade with ease. Second, it provides security to the seller, ensuring (through a reliable paymaster-the bank-of payment) that he will get paid. However, it

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needs to be noted that payment of the goods will only be made once the requisite documents have been tendered in conformity with the agreed terms of credit. It is a requirement that the tendered documents must conform to the terms and conditions of credit. The standard practice is that once the documents tendered are free of any latent defects, the corresponding bank has no choice but to honor its obligations regardless of any defects in the underlying sales or any other ancillary contract(s)[4]. On many occasions, the seller and the buyer would most likely be living in different countries – which means the possibility of information asymmetries or little knowledge about each other. While banks play a fundamental function of promoting the usage of LC in commercial transactions, it needs to be noted that they are not parties to the underlying transactions. This also means that much as banks guarantee to pay credit on behalf of the buyer, goods are not to be sent to the banks, as they incur no duty to protect them[5]. The bank's duty is to ensure that documents received are in conformity with the terms and conditions as specified in the LC contract. The documentary credit system is utilized for payment of the sums due under international sales and similar transactions (Bridge, 1999). The commonality in all the foregoing variants (LC and standby LC) is that the issuer is usually a bank or some other financial institution of standing who promises to pay a certain amount of money (or to negotiate without recourse a bill of exchange for such an amount) on the occurrence of a given event (Bridge, 1999). It needs to be noted that in the majority of legal systems, LCs are not yet subject of specific legislation but are a form of customary practice (*Shanghai Commercial Bank Ltd* v. *Bank of Boston Int'l* [1976] 385 N.Y.S 2d 548). In this same regard, courts of law have been reluctant to give full effect to the principles governing LCs developed by the mercantile community, as to do so would be seen as interfering with commercial customary practices. This is because, traditionally, customs cannot be imposed on a community; they grow from a practice going back many years. Given the foregoing customary practice, any disagreements concerning the LC are settled at a respective community level where the custom is recognized and respected. The last thing courts would not want is to interfere with important commercial customs such as documentary credit practice. The role of courts in the LC practices has also been sidelined by the fact that the substantial part of the law of the LC is based on the rules of Uniform Customs and Practice of Documentary Credits (2007) promulgated by the International Chamber of Commerce.

3. A short glimpse into the technicalities and LC processes

The LC process is initiated when the buyer and the seller of goods agree that the method of payment for goods is to be by way of the foregoing payment mechanism. They would have enacted a clause in the sale agreement to the effect that payment is to be by way of a banker's documentary credit, of a designated type, to be procured by the buyer. In the second stage of the transaction, the buyer completes an application form proffered by the bank (Debattista, 2007). This is a standard form setting out terms and conditions on which the bank is prepared to open the credit line. It includes the blank spaces in which the bank lists the documents to be tendered by the seller, the manner in which the goods are to be described in the documents, and the type of documentary credit to be issued. In the third stage of the transaction, the issuing bank notifies the seller that an LC has been opened in his favor of a designated person. Usually this is done through the second bank (the correspondent bank) which operates in the seller's country (Debattista, 2007). The correspondent bank's role may be confined to advising the seller in opening the credit by

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the issuing bank; to "confirming the credit". In such a case, the "confirming bank" adds its own undertaking to that of the issuing bank. There is an intermediary case in which the correspondent bank might not have been instructed to confirm the credit, but asked to accept on behalf of the issuing bank a set of regular documents tendered by the seller. In case the correspondent bank assumes the role of an "advising bank", the documentary credit constitutes a contract solely based on the agreement between the seller and the issuing bank (*Midland bank Ltd* v *Seymour* [1955] 2 Lloyd's Report 147). The fourth stage of the transaction involves the realization of the documentary credit. At this stage, the seller ships the goods, obtains the required documents and arranges for the presentment of the same documents to the correspondent bank for payment. The rule of thumb is that if documents are in strict conformity to the terms and conditions of the credit, the bank is under an obligation to accept or honor them. A bank, which accepts such a tender, is entitled to be indemnified as, indeed, do in the case of first demand guarantees and the performance bonds[6].

4. The LC and other forms of payment mechanism

The LC has held its ground over other methods of payment mechanisms in international trade because it has proved popular due to its enhanced security to the parties (Dolan, 2001)[7]. In a fluid global climate characterized by regulatory challenges at multiples levels (as demonstrated by the recent banking scandals of the past decade), sellers of goods could potentially be dealing with criminals. Banks provide an essential interface between the seller and the buyer of goods and foreclose potential information gaps between them. By interfacing between the parties, banks help to streamline and spot any flaws such as the fraudulent conduct of the parties, who may want to take advantage of existing information asymmetries. It is worth mentioning that banks are also endowed with the capacity to ensure that LC agreements are properly constituted. This is so because where the LC has not been properly constituted, such as failure to clearly articulate the position of commercial parties, contracts might not be easily enforceable. In English contract law, if there is illegality in the underlying sales transactions, technically the LC contracts will be void. This is the position relating to all commercial contracts where contract agreed through illegality are technically unenforceable. Banks could also be enjoined if there is a clear case of fraud, nullity, unconscionable conduct and restrictive trade practices (Mugasha, 2004). Besides the LCs, there are other international payment mechanisms operated between banks such as real-time gross settlement systems (RTGS). These are funds transfer systems (RTGS) where transfer of money or securities takes place from one bank to another in "real-time" and on a "gross" basis[8]. The implementation of RTGS systems by central banks throughout the world is driven by the goal to minimize risk in high-value electronic payment settlement systems. Fedwire is an RTGS operated by the US Federal Reserve banks. In conjunction with the privately held Clearing House Interbank Payments System (CHIPS), Fedwire is the primary US network for large-value or time-critical domestic and international payments[8]. In the UK, the Clearing House Automated Payment System (CHAPS) is one of the largest RTGS in the world. However, the challenge is that the safety of the global payment and settlement infrastructure requires that system operators, financial institutions and service providers have a robust understanding of payment and settlement risks, and that they manage those risks effectively[8].

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5. Variants of the LC

The obligations generated by the LC vary according to the type subscribed for by the parties. There are two main types of the LC: irrevocable[9] and revocable credits. As the name connotes, an irrevocable LC is the one which cannot be revoked and assures the seller that it is safe to press ahead with contractual performance of the transaction. In addition, it might also be confirmed, which means that the seller receives an undertaking from the confirming bank (situated in his country) that it is safe to press ahead with performance of the contract (*Malas (Hamzeh) & Sons* v *British Imex Industries Ltd* [1958] 2 QB 127). This means that the seller is assured of payment by the issuing bank on presentation of stipulated documents. With confirmed credit[10], there is a direct undertaking by the banker that the seller will be paid if he presents the required documents in the agreed period (*Ian Stach Ltd* v. *Baker Bosley Ltd* [1958]). The UCP 600 takes the same approach on confirmed irrevocable credits under Article 9(b) to that of its predecessor – the UCP 500. This gives maximum security to the seller, if the seller is a reputable bank it is certain of receiving payment once the stipulated documents have been tendered. More so, should the seller wish to initiate proceedings against the buyer, he will do so in his own jurisdiction. However, if the credit is revocable, the issuing bank may withdraw the credit at any time and without prior notice being given to the beneficiary. Back-to-back credits are mainly used where the seller is a middleman, for example an agent in United Kingdom buys goods from the manufacturer, say (x), in Australia and sells them to the buyer in Kenya. In this type of credit management, (s) will use the credit opened in his favor by (b) as a security for opening a credit in favor of (x) (Ellinger, 2007).

6. Gleaning duties of the applicant bank

The applicant bank would have entered the transaction earlier by asking the issuer to open the credit. This process could be initiated with a community bank (often having little experience) asking the larger correspondent bank to issue credit for the customer[11]. The issuer not knowing anything about the applicant bank's customer relies on the applicant's bank credit, just as the issuer relies on the buyer's credit to process the transaction. If the applicant's bank is the buyer's analogue whereby the issuer has relied on the applicant's credit, the issuer would have the right of reimbursement against the applicant's bank. The foregoing right would have been generated by the practice that the applicant's issuer takes from the applicant's bank when the applicant's bank applies for credit. Similarly, the applicant's bank's rights against the issuer are measured by the right of a customer against the issuer. The role of the applicant's bank in LC transactions is to bring the customer and the issuer bank together, but also to provide an information service to its own customer and to the issuer, acting as a classic middleman in arranging and executing LC credit transactions. It gives the issuer the information to incorporate into the credit agreement. Thus, the applicant's bank provides the issuer with:

- the name of the seller and buyer;
- the maximum amount of the credit;
- the documents that the buyer wants to obtain from the seller before payment (e.g. bills of lading, invoices, insurance documents, inspection certificates); and

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- the terms such as whether the seller may make partial draws or installment shipment, the period within which documents must be presented and the description of the goods (Goode, 1995).

It needs to be noted that requisite is essential for any commercial transaction to take place and so is needed in LC transactions. However, the influence of the applicant bank can sometimes be undercut by direct contact between the buyer and the issuer, and the fact that issuers may supply some of the terms of the credit themselves. If, for example, the issuer is going to extend credit by honoring the seller's draft before the issuer receives funds from the buyer or the applicant bank, the issuer may be concerned about documents presented and the period during which the seller has the right to draw. Issuers, for example, might provide that the bill of lading be issued in a negotiable form to the order of the issuer. This would thereby strengthen the issuer's claim to the goods in the event of the buyer's failure to reimburse it (Goode, 1995). The issuer also may add terms relating to the payment of charges and the buyer's method of reimbursement. The applicant bank performs a second function of furnishing the issuer with requisite information to facilitate the issuer's credit decision. Issuers would not offer LCs unless they are satisfied with the information received and enhanced chances of reimbursement when they honor the seller's draft. If the issuer does not know the buyer, it incurs credit assessment costs that are absent in transactions involving an applicant's bank. The issuer would vulnerable to fraud, if it issues an LC without first generating enough information about the parties. In sum, the LC law regards the relationship between the issuer and the applicant's bank as that of issuer and customer and as such the issuer requires the applicant's bank to execute an application agreement containing a reimbursement obligation. This notwithstanding, issuers know pretty well that they have rights against the applicant's bank. They might go ahead and issue credits at the request of an applicant's bank without having to investigate the buyer's credit worthiness to avoid costs. This will particularly be so where the tendered documents are free of any latent defects.

7. What about the correspondent bank?

The correspondent bank enhances the LC as a commercial product in many ways. The correspondent bank can sometimes be known as an "adviser" if it undertakes to issue advice usually directly to the issuer at the behest of the seller. Sometimes it may employ an independent person with expert advice to advise on behalf of the independent bank. In this case, the adviser speaks on behalf of the correspondent bank but does not undertake to do more than offer advice. The seller cannot be sure that the letter he/she receives is not a forgery and may not be able to determine easily whether the foreign bank mentioned in the documents exists. The advisor using its knowledge of international banking and communications technology can verify inter-bank communications[12] and render the advice with virtue certainty that the original communication from the issuer is genuine. Thus, the advice facilitates the establishment of the credit line by permitting the seller to rely on the seller draft. Similarly, when the issuing bank agrees to act on the instructions of the applicant, a contract is generated between them involving rights and obligations on each side. The advice of the credit to the beneficiary brings into being an enforceable contract between the issuing bank and the beneficiary. It has to be noted that, if the issuing bank does not confirm the credit, no

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contract between it and the beneficiary is created, the beneficiary only has rights against the issuing bank (Raymond *et al.*, 2001).

8. Potential pitfalls to watch out by both parties

There are mainly four identifiable potential pitfalls inherent in the use of LC in international commercial transactions that parties need to pay attention to: document discrepancies, fraud, correspondent breach and issuer insolvency. If any of the foregoing problem areas are identified, the issuer is faced with two stuck choices. The issuer can either dishonor the seller's draft and the seller will dispute the nature of non-conformity; or it can honor the draft and the buyer will argue that the honor was wrongful and that the issuer has lost his right of reimbursement (Dolan, 1985). As regards documentary discrepancies, the prime duty of the issuer of LC and any other bank undertaking is to honor the beneficiaries' draft, and to examine tendered documents to determine whether they comply on their face with the terms and conditions of the credit. The law recognizes that the LC is a payment mechanism quite distinct from a bond and that issuers do not undertake to police underlying transactions to determine whether the seller has complied with obligations under the sales goods agreement. LCs are documentary transactions, and the bank has an obligation to examine and ensure that the tendered documents are ministerial (Dolan, 1985). Another potential pitfall to the correspondent bank is fraudsters posing as legitimate business parties in LC transactions. The *raison d'être* of the LC is to provide absolute assurance of payment to a seller once the seller tenders conforming documents with the terms and conditions of credit (Dolan, 1985)[13]. Fraud is an exception for the following reasons. The fraud exception is important to interrupt the activities of a fraudster from undermining the commercial usage of the LC as a commercial product. But it is also important to uphold public policy of limiting fraud. As regards fraud, documents might have been in partial conformity, but could also contain latent defects whereby one or more of the documents might have been forged or fraudulent. The correspondent issues arising out of this second occasion relate to the correspondent power to compel reimbursement from the issuer in the face of such fraud. In such a case, the issuer's honor of the seller's draft undermines the buyer's bargain. For example, the buyer who would have entered the application agreement by authorizing the issuer to pay a draft accompanied by the bill of lading would not be satisfied with a forged bill. Fraud poses serious problems for the LC, not least that it inhibits prompt payment and risk function of the device and embroils the issuer, a non-party to the commercial transaction out of which fraud arises in ensuing litigation. Fraud is an exception to the general rule that issuers will pay against facially conforming documents, imposes uncertainty costs on the bank and on the commercial parties to the detriment of the LC as a commercial product (Dolan, 1987). There is also a question of policy to protect banks from fraudsters; but also to secure the commercial viability of the LC as a financial product. Then there is misperformance of the correspondent bank's duties regarding the draft. The correspondent bank breach may come about in a number ways. The correspondent bank as an adviser fails to advise correctly or in a timely fashion; or where a confirmer, because of the delay, may become obligated to pay over non-conforming documents; or a payer may wrongfully dishonor a complying presentation or wrongfully honor a nonconforming one. In both cases a correspondent's conduct may cause a commercial party loss and may subsequently be held liable for it (Dolan, 1987). The fourth problem

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is insolvency, which creates pressure on the correspondent bank to claim subrogation rights or direct rights against one of the commercial parties, usually the buyer. It should be noted that the essence of the credit is to exchange the weak credit of the buyer to the stronger credit of the issuer. Issuer insolvency then undermines the edifice of the LC transaction and corrodes the product's efficacy (Dolan, 1987). It also leaves the commercial parties and the correspondent bank in a predicament that, in the former case, they may have ineffectively guarded against and that, in the latter, they had incorrectly assumed would not arise. Correspondent banks that are obliged to honor their undertaking in these circumstances have resorted to subrogation as a means of reimbursement. A confirmer that honors the seller's draft may argue that it is subrogated to the buyer's property held by the issuer's receiver as collateral for the buyer obligation to reimburse the issuer (Dolan, 1987). Or a confirmer may contend that, by virtue of its payment to the seller, it should be subrogated to the seller's right against the buyer's right against the seller (Dolan, 1987). In this same regard, Dolan (1987) argues that some correspondent may claim rights directly against the commercial parties and makes arguments quite inconsistent with defenses banks invoke when, in correspondent breach context, the commercial parties sue them. Whether the commercial parties and correspondents may, in the event of issuer insolvency, alter the expected pattern of liability to meet the exigencies of that insolvency should also depend on the nature of the relevant relationship (Dolan, 1987).

9. Document discrepancy

The issue of document discrepancy is another issue of the LC where banks could find themselves embroiled in problems. The seriousness of documents in the LC process is underscored by the doctrine of strict compliance[14]; documents presented by the beneficiary to the bank must comply[15]. The issue of documents is so strict that they have to conform in entirety: documents which are "almost the same" are not sufficient (*Equitable trust Co of New York* v, *Dawson Partners* [1927] 27 Lloyds LR 49). If a beneficiary tenders correct documents, under a confirmed irrevocable credit, there is no reason why he/she will not get paid (*Malas (Hamzeh) & Sons* v. *British Imex Industries Ltd* [1958] 2 QB 127). A bank that pays against correct documents knows that they are entitled to be reimbursed, the fact that there may be a fraud notwithstanding: *United City Merchants (Investments) Limited v Royal Bank of Canada* (*Malas (Hamzeh) & Sons* v. *British Imex Industries* [1983] AC 168). The above case was decided on the premise that banks deal in documents[16] and therefore courts must decide whether payment should have been made to the beneficiary on the strength of tendered documents alone. The bank is seen as an agent of the applicant and therefore by law, if the bank acts outside its mandate, its act may be ratified by the applicant, subsequently forfeiting its right of reimbursement (*Bank Melli Iran* v *Barclays Bank DCO* [1951] 2 Lloyds Rep 367). If the tendered documents are ambiguous, the banks should ask for clarification or they should be rejected. Otherwise, if banks honor against the ambiguous documents, they will lose the right to reimbursement[17].

If the bank decides to reject tendered documents[18], it is required to inform the beneficiary directly (if they are received directly from him), clearly stating all discrepancies (*Rafsanjan Pistachio Producers Co-operative* v *Bank Leaum* [1996] 1 Lloyds Rep 68). The UCP 600 says that notification has to be by telecommunication, and only if telecommunication is not possible, may it be effected by an expeditious means;

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notification could be oral pursuant to the implied terms of the contract. The notification in that case could be after a meeting between senior officials of the collecting bank and the sales manager of the beneficiaries. It was the principle propounded in *Glencore International AG Ltd v Bank of China* that the statement of discrepancies on the bank, which may thereafter raise grounds. The position articulated in the foregoing case clearly represents a departure from the case of *Kydon Cia Naviera SA v National Westminster Bank Plc.*, where on a number of occasions, the bank was found to be acting inconsistently as to the grounds of rejection. The court held the bank had made no representation for the purpose of binding estoppel. Any duty owed by the bank when paying against an LC was owed to the applicant and not to the beneficiary (*Rafsanjan Pistachio Producers Co-operative* v *Bank Leaum* [1996] 1 Lloyds Rep 68; Goode, 1995).

10. Substantive compliance rule

The foregoing rule was adopted to mitigate the harshness of the doctrine of strict compliance on the parties. Substantive compliance rule was devised to strike a balance of ensuring that the bank does not palter with justice by "nit picking through the beneficiary's documents and raising a hyper technical argument" (Dolan, 1984). The challenges posed by strict adherence to strict compliance doctrine was underscored in the case of *Banco Espanol de Credit v State Street Bank & Trust Co Ltd.* (Goode, 1995). In this case, the credit called for an inspection certificate to ensure "goods are in conformity with the order". The beneficiary supplied the certificate based on a 10 per cent sample the "whole […] was found conforming to the conditions stipulated on the order sheets" (Goode, 1995). The court's reasoning was that "the Order Stock Sheets" mentioned in the certificate referred to certain stock sheets with which the parties had dealt and which, because of those dealings, had supplanted the original orders. Thus, courts have resorted to substantial compliance rule[19] in an LC cases because they ensure that justice is not only done but is seen to have been done. Where, for example, an issuing bank argues that it is justified in dishonoring a draft because a certificate refers to "stock sheets", instead of "order forms", courts may want to know whether in reality the deviation is substantial to undo or undermine the contract (Goode, 1995). Banks and their customers sometimes abuse the compliance standard to avoid their obligations and courts will not become a party to such a conduct.

11. The independence (autonomy) principle

In a documentary credit system, independence or autonomy seeks to ensure that the credit is to be treated as an independent transaction. In other words, the LC is independent of the underlying sales transactions generating it, and its performance has nothing to do with the underlying transactions. The case of *United City Merchants (Investments)* v. *Canada* (Goode, 1995) highlights the principle of autonomy as underpinning the continuance of the documentary credit system in international trade. The premise on which this principle is based is that documentary credit is a transaction in documents, and decided on the strength of documents and documents alone[20]. Thus, because LCs are transactions in documents, if the documents are correct with respect to the terms of the credit, the bank must honor its payment obligations under the credit. The basic rule governing payment under the LC is that the beneficiaries need to formally comply (Bridge, 1999). The bank will accept the seller's documents only if they conform to the LC

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before making payment. In the case of standby credit, the bank will pay the buyer as the beneficiaries of the credit, when the buyer duly invokes the payment machinery in the LC. The bank's obligation to pay in the LC is an absolute one (*Hamzeh Malas & Sons Ltd* v. *British Imex Industries Ltd* [1958] 2QB 127, 129). Both types of the LC generate the possibility of fraud by the beneficiary, and fraud is the only exception to the rule that banks must pay without question or inquiry into the concrete transaction (Goode, 1995). The risk of fraud is greater in the case of standby LC: depending on the credit, the standby LC may call for nothing more from the buyer than the simple demand[21]. The seller must provide the documents called for by the LC and the bank may be astute to look out for documentary non-compliance, which occurs with remarkable regularity in practice, though excused or waived in countless transaction. The reason for the independence principle is best stated in the case of *RD Harbottle (Mercantile) Ltd v National West Minister Bank Ltd* (*Society of Lloyd's* v. *Canadian Imperial Bank of Canada* [1993] 2 Lloyd's Rep 579, 582; Hooley, 2003), where Kerr J said as follows: "It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks". LCs are the lifeblood of international commerce and obligations generated by it are regarded as collateral to the underlying rights and obligations between merchants at either ends of the banking chain. Except possibly in clear-cut cases of fraud of which the bank has notice, the courts will leave the merchants to settle their disputes under the contract by way of litigation or arbitration. The courts are never at all concerned with the difficulties to enforce such claims, as these are risks which the merchants take. As such, the LC must be allowed to be honored, free from the interference of courts, which could irreparably trust in its international usage as a financial product.

The independence principle is enshrined in Article 3[22] and 4[23] of the Uniform Customs and practice of documentary credits (UCP 600). The leading authority is now the *United City Merchants Ltd v Royal bank of Canada*. In the words of Lord Diplock (Goode, 1995):

> If on their face the documents presented to the Bank by the seller conform with the requirements of credit as notified to him by the confirming bank, the bank is under a contractual obligation to the seller to honour the credit. This will still be the case even if the bank has knowledge that the seller at the time of presentation of the conforming documents has already committed a breach of his contract with the buyer for the sale of goods tendered documents relate. In principles, such knowledge would entitle the buyer to treat the contract of sale as rescinded and to reject the goods and refuse to pay the seller the purchase price (*Discount Records* v *Barclays Bank* [1975] 1 WLR 315). The rationale for this argument in international trade law is the desire to give sellers of goods an assured right to be paid before he/she parts with the control of the goods which doesn't permit of any disputes with the buyer as the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment (Raymond, 1999).

12. The fraud exception

The independence principle is so entrenched in commercial practice that it is more or less set in stone (literally speaking). The only permissible exception that detracts from the independence principle is where the LC is used to perpetuate fraud. Fraud happens when the documents presented to a bank by or on behalf of a party which knows that the

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documents are not what they purport to be because they are forged, or, for other reasons, the bank can refuse payment, or, if it has paid before discovering the position, it can recover any losses it has made as demonstrated in the case of *Bank Russo-Iran v London Woodroffe & Co Ltd*[24]. In this case, the defendant presented documents, which they knew included, invoices in a sum massively in excessive of the real value of the goods. It was held by Browne J that if a beneficiary presented forged or fraudulent documents, a bank was entitled to refuse payment and to recoup money already paid, in the same way as money paid under a mistake of fact (*Bank Russo-Iran Case in Edward Owen Engineering Ltd* v. *Barclays Bank* [1978] QB 159 at 169). In the foregoing case, *Bank Russo-Iran* failed to recover because it was found to have agreed to release the defendant. The defendant on presentation of documents argued that he had done so in good faith unaware of any forgeries that were purported to have been presented. In *United City Merchants (investments) Ltd v Royal Bank of Canada* (Raymond, 1999), it was held by Lord Diplock that:

> […] the fraud exception on the part of the beneficiary seeking to avail himself of 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 court will not allow their processes to be exploited by a dishonest person to carry out fraud or perpetuate illegality. The rationale for fraud exception was more recently considered by Rix J in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd*[25], where it was held that the rationale for fraud exception is the laws prohibition to exploit its process to carry out a fraud. While reiterating Lord Diplock's exposition in *United City Merchants* (*Investments) Ltd v Royal Bank of Canada* stated that:

> […] it is appropriate and an authoritative expression of the source of law of the implied limitation on the bank's mandate. If the source of the power to injunct were purely the laws interest in preventing the beneficiary from benefiting from his own fraud, I do not see why there should be an added requirement that the fraud be patent to the bank.

13. Aspects of conflict of law in LC contracts

The tradition is that the law governing the LC contracts will be governed by the law of the place where the issuing bank carries on business[26]. This is because, the law of the issuing bank is the law of performance of its instruction and because also, the issuing bank acts as the agent[27] of the instructing party (the applicant bank). The common law position is that the contract between the issuing bank and the confirming bank is governed by the law of the place[28] where the confirming bank makes payment against the presentation of the documents. The above principle is supported by the case of *Bank of Credit and Commerce Hong Kong Limited v Sonali Bank*[29]. In this case, "Sonali Bank", a Bangladesh bank, issued various LCs in favor of a Hong Kong seller, on the application of a Bangladesh importer. The bank of Credit and Commerce of Hong Kong Ltd (BCCHK) also added its confirmation. On presentation of the documents to BCCHK in Hong Kong, BCCK negotiated the documents and presented them to Sonali. Sonali refused to reimburse BCCHK for payment under the credits, serving the process on Sonali's London branch. As part of its submission that the London proceedings be stayed on the ground of *forum non coneniens*, Sonali contended that the contract between it and the BCCHK was governed by the law of Bangladesh. The contract did not contain any express clause

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as to the choice of law in the event of conflicts. Cresswell J. held that the contract between BCCHK and Sonali had the closest and most real connection of Hong Kong because: BCCHK (in Hong Kong) had added its confirmation to the Sonali LC and by doing so incurred an obligation itself to negotiate the documents; the credits contemplated that the negotiation of the documents and the payments would themselves take place in Hong Kong.

Creswell J. did not consider the fact that the obligation to reimburse BCCHK was to be performed in other countries as a relevant consideration or connecting factor[30]. The obligation to reimburse, much as it is commercial consideration, is not generally regarded as a significant factor in the determination of where the contract has its closest and most real connection. Indeed for purposes of the contract Act[31], it is not regarded as the "characteristic performance" of the contract. Reimbursement merely amounts to counter-performance for the other performance which is the "Centre of gravity and the social-economic function of the contractual obligation"[32]. The result of the decision was that the confirming bank's contract is governed by its own law, of course, to its benefit. It means that it is unlikely that the confirming bank could be placed in the position where it has an obligation to pay out on the LC, but has its corresponding reimbursement right blocked by the laws of the issuing bank. This is the justification for the analogous rule in relation to the counter-guarantees involved in the issue of a performance bond (*Turkiye Is Bankasi AS* v *Bank of China* [1993] 1Lloyd's Rep. 132). It does not have regard to the fact that the choice leaves the issuing bank open exactly to the same dilemma: that it may have an obligation to reimburse the confirming bank, but no corresponding right to indemnification by its customers.

The LC itself is governed by the laws of the place in which it is payable against presentation of the documents. In case of a credit confirmed by a bank in a jurisdiction other than that in which the issuing bank carries on business, the LC will be governed by the laws of the jurisdiction in which the confirming bank carries on business. In case of the LC which is merely advised (not confirmed), the governing law will be the law of the place of business of the issuing bank at which the credit is payable against presentation of the documents (*Westpac Banking Corporation* v *Common Wealth Steel Co. Ltd* [1983] N.S.W.L.R 735). This position is propounded in the case of *Offshore International SA v Banco Central* (*Westpac Banking Corporation* v. *Common Wealth Steel Co. Ltd* [1976] 2 Lloyd's Rep. 402) *and Power Curber International Ltd v National Bank of Kuwait* (*Westpac Banking Corporation* v *Common Wealth Steel Co. Ltd* [1981] 1 W.L.R at 1233). This case concerned the issue by the Spanish bank (Banco Central) of an LC in favor of a Panamanian company (Offshore), operating out Houston, Texas. The LC was issued through the Banco Central's US correspondent Chase Manhattan in New York but, despite there being no confirmation by Chase, it was payable in US dollars against presentation of the documents in New York (Bridge, 1999). The LC did not contain an express choice of law clause. Ackner J. on being required to determine whether the contract between Offshore and Banco was governed by the Spanish Law or New York. It was held that the system of law with which the contract had its closest and most real connection was the law of New York (the place of business of the correspondent bank) and not the law of Spain. His lordship was persuaded by the fact that great inconvenience would arise, if the law of the issuing bank was considered to be the governing law.

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However, if the place of business of the issuer was United Kingdom, the Contracts Act 1991 would have superseded the choice of law nominated by the parties[33]. The Contracts Act, which transposes the Rome Convention (1980) into UK, will apply to contracts entered into after April 1, 1991 (Ellinger, 1993; *Bank of Baroda* v. *Vysya Bank Ltd* [1994] 2 Lloyd's Rep. 87). By virtue of Article 3(1) of Contract Act, the parties are free to nominate a choice of law to govern their agreements. It may be express or demonstrated with reasonable certainty by the terms of the contract or the circumstances of the case. General condition of business or previous course of dealing may also signpost the demonstrated choice of law of the parties. With this in mind, in Article 4(1)[34], if there is no express or demonstrated choice of law provision, then the contract shall be governed by the law of the country with which it is most closely connected. Article 4(2)[35] contains certain presumptions as to which country a contract is most closely connected. The contract is presumed to be most closely connected with the country where the party, who is to performance – characteristic of the contract, has at the time of concluding the contract, his habitual residence, or in case of a body corporate or unincorporated, its central administration. However, if the contract is entered into in the course of the "characteristic performer's trade or profession, the country with which the contract is closely connected is the country in which the characteristic principal place of business is situated. If the characteristic performance is to be effected through a place of business other than the principal place of a business (e.g. a branch), the country with which the country is presumed to be most closely connected is the country in which the branch is located. Article 4(5) provides that Article 4(2) will not apply if the characteristic performance cannot be determined. It also provides that the presumption in Article 4(2) shall be disregarded if it appears from the circumstances as a whole that the contract is more closely connected with another country. The leading case on the above conflict as to the choice of law was the *Bank of Baroda v Vysya Bank Ltd* (Goode, 1995), where an Indian bank issued the LC in favor of an Irish seller (which had a London office) at the request of an Indian buyer. The credit was advised and confirmed by the Bank of Baroda – London branch. Bank of Baroda was to be reimbursed by Vysya from an account with Citibank in New York. Bank of Baroda eventually negotiated the documents by payment under the LC and claimed reimbursement. Meanwhile, Vysya had informed Bank of Baroda that it had withdrawn the reimbursement instructions for reasons related to the underlying sales contract. Bank of Baroda sued Vysya in London for anticipatory or actual breach of the reimbursement contract. It was held (Mance J.) that the contract between Vysya and Bank of Baroda was governed by the English law[36]. Mance J. was persuaded by the fact that the performance which was characteristic of the contract was the addition and honoring of the Bank of Baroda's confirmation of the credit in favor of the beneficiary. He argued that as the performance was to be done by Bank of Baroda's London branch, the country with which the contract was presumed to be closely related under Article 4(2) of the Convention was England and therefore England was deemed the right place for litigating the issue. It had been submitted on behalf of Vysya (albeit wrong) that it was in fact the reimbursement obligation which was the characteristic performance of the contract and that, as that would be carried out by Vysya, the governing law was that of Vysaya principal place of business: India. The judge rejected this preposition having due regard to Giuliano-Legarde Report to the effect that payment of money would only be the counter-performance in return for characteristic performance[37].

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14. Conclusion

In a fluid global market environment characterized with challenges at various levels including in international trade, the LC as a secure payment mechanism has never been important. This article has demonstrated that the LC is a unique commercial product, utilized to perform a fundamental function in stabilization of markets for a very long time. There has been a myriad of innovative payment methods in contemporary international trade but the LC remains as popular as ever before. In terms of policy, the LC has been helped to promote economic and market stability, as already noted in the preceding sections of the text. Perhaps needless to reiterate that it also provides the badly needed credit to the buyer and hence promotes trade by eliminating potential risks inherent in other forms of international payment mechanisms. As far as the buyers of goods are concerned, the LC mitigates or eliminates anxieties of transmitting money either through agents or through other risky methods of payment. All the buyer needs to do is to maintain a good credit record so that banks do not refuse to open credit lines to facilitate him pursue his business transactions. In so doing the LC facilitates commercial transactions by increasing the volume of goods traded across countries. Experience has demonstrated that rogue elements have demonstrated the propensity to exploit legitimate commercial transactions for their expediency. Some of the foregoing risks are minimized, if not removed because of the interposition of banks between commercial parties. As noted earlier, banks are endowed with the potential to detect, identify and eliminate potential risks parties might have overlooked or been ignorant about. Banks are endowed with the resources and the infrastructure to undertake necessary checks and balances and deter fraud. However, it needs to be noted that banks are interposed between commercial parties not for their commercial expediency and wider policy reasons too. It also needs to be noted that not every bank can be authorized by central banks to engage in LCs transactions. Governments rely on businesses to implement anticipated fiscal policies, for creation of jobs, and it needs to be noted that trade can utilized to foster cooperation and harmony between partner states. Also as a matter of policy if the parties sought the LC to perpetuate illegality or commit fraud or the contract secured through unconscionable conduct or by violating public policy[38], courts would not lend their support to the LC processes. Courts would not allow their processes to be exploited for criminal expediency. As noted earlier, courts would not want to interfere with the LC processes given that they are governed by commercial practices (customs); they would only do so prevent criminality or abuse of the process. It is worthy of mention that modern globalization is driven by an array of innovative payment systems such as SWIFT and CHAPs, and one wonders whether the foregoing payment methods will hold out what the LC has done for a long time. As regards the issue of conflict of laws in commercial contracts, there has been significant progress in this respect manifested that many countries have undertaken measures to address this challenge. While the UK is not a signatory state to Vienna Convention on international Sale of Goods in (1980), it has softened its position and adopted the Brussels Regulation (2000) on recognition and enforcement of judgments in civil and commercial matter in European Union (EU). The regulation lays down rules governing the jurisdiction of courts in civil and commercial matters. A judgment given in a EU country is to be recognized without special proceedings, unless the recognition is contested. A declaration that a foreign judgment is enforceable is to be issued following purely formal checks of the documents supplied. The regulation lists grounds for non-enforcement; however, courts are not to raise these

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of their own motion. The regulation does not cover revenue, customs or administrative matters. This also applies to all parties including LC transactions. Initially the UK did not opt in to the Rome I Regulation because of concerns about certain provisions. However, after protracted negotiations, the UK has now agreed to opt in. On 17 June 2008, the European Parliament and Council adopted Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I)[39]. The UK notified the Commission by a letter dated 24 July 2008, received by the Commission on 30 July 2008, of its intention to accept and participate in the Regulation. On 11 November 2008, the Commission gave a positive opinion to the Council on the request from the UK and on 22 December 2008, the Commission published its decision[39]. The Rome I Regulation (like the new Brussels I Regulation) is thus a community measure adopted by the Community under the new Treaty of Rome mechanism. The Rome Convention will continue to apply to contracts entered into before 17 December 2009 and thus will feature in courts for some time[39]. The common law applies where neither regime is applicable. The foregoing regulatory changes will enhance in international commercial transactions such as LC by minimizing or eliminating risks of conflicts between commercial parties and how they are settled. In final analysis, the LC will continue to hold its ground because of its enhanced security an important consideration for international trade to prosper.

Notes

1. The UCP code was first published in 1933 but has since been revised six times by its sponsor, namely, the International Chamber of Commerce (ICC), which is headquartered in Paris. The Current edition of UCP now in force is UCP 600. The UCP 600 three main areas for the revisions were geared toward incorporating changes in the banking, transport and insurance industries. There was also the need to remove words and phrases in the earlier version of UCP 500 (1994) that were inconsistent and capable of leading to misleading interpretation. The third objective was to stem a rate of rejection which was regarded as being so high to have serious implications for maintaining or increasing the market share of the LC as a recognized payment mechanism in international trade. For a detailed reading on UCP 600, see Debattista (2007).
2. The banks duty is to examine documents and make they comply "on their face" with the credit (see Article 4 of UCP 600 (2007).
3. Article 14, 15 (b) of UCP 600.
4. See, Article 14 of UCP 600 (July 2007).
5. This is clearly articulated in Article 10 of UCP 600 (2007).
6. All three types of credits cover the beneficiary against loss sustained from the faulty performance of the contract by the account party.
7. First, the LC is deliberately chosen for substituting the issuer for the applicant as a source of payment. The parties interpose between themselves a reliable paymaster – the Bank-to Bridge "the gap of trust" which may exist between them and ensures that payment is made when it is demanded. Second, LCs are intended to provide liquidity to the beneficially. The commercial intention of the parties to the underlying transaction is that a standby LC should be as good as cash, and that the beneficiaries claim on the credit should result in liquid funds to be utilized as substitutes for the applicant's performance.

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Third, and perhaps very important, is that LCs are supposed to shift litigation costs by reversing the usual principle that the debtor has the use of the funds during litigation which the debtor obtains after a successful claim. For advantages of the LC in commercial transaction, see Dolan (2001).

8. (www.gfmag.com/component/content/article/119-economic-data/12528-payments-volumes-worldwide-new.html (date accessed 13/01/2014).
9. For an example of such a credit, see *Furst (Enrico) & Co* v *Fischer (WE)* Ltd [1960] 2 Lloyd's Rep. 340. In this case, the LC was opened by the Geneva bank and advised, but not confirmed, by a London bank when the contract of sale called for an irrevocable credit opened in London. It seems the contract of sale would have been satisfied by a credit confirmed by the London bank, even though issued overseas. The combination of a Geneva issue and a London advice fell short of the contract. See also Bridge (1999, p. 245). Bridge contends that in revocable LCs, the promise of the issuing bank to pay the draft is subject to revocation up until the moment of acceptance or payment. On the converse, irrevocable credit embodies a firm commitment by the issuing bank and is not subject to revocation once it has been set up. This variant of the LC can be enforced not only against the issuing bank, but also against another bank, which acted as a confirming bank usually located in the beneficiary's country. Irrevocable credit also enables the beneficiary to discount or negotiate the draft against the issuing or confirming bank. For more reading on the contrast of these two types of credits, see Kozolchyk (1965/1966).
10. In *International Banking Corporation v Barclays Bank Ltd* [1925] 5 Legal Decisions Affecting Bankers 1, Atkin J, stated in respect of the admittedly unusual credit which he was considering that in his view a credit is irrevocable unless it appears on the face of it to be revocable.
11. In this transaction, the applicant bank applies for the credit for the account of the buyer. The bank is the applicant and the buyer is the account party; the bank is also a customer party of the issuer. Today the LC practice tends to use the terms "applicant", "account party" and "a customer" interchangeably.
12. Today most international credit transactions with a transmission via Society for World Wide Inter-bank Financial Telecommunications (SWIFT), a Belgian co-operation established by banks to carry their messages. SWIFT employs electronic data interchange (EDI) technology that permits the issuer operator to key punch relatively few bits of information into the SWIFT system, which receives the information at the SWIFT switch and relays it to the adviser. The adviser's computer programs then translate the input into a readable output on the advising banks premises. It is remarkably quick and error-free and affects small savings in high volumes for the LC industry in particular, and the international banking industry in general.
13. It should be remembered that the seller asks for a credit in order to shift a number of risks: the risk of the buyer insolvency from the seller to the issuer; the currency exchange risk from the seller to the issuer; the risk of litigation without the purchase price from the seller to the buyer; and the risk of having to litigate in foreign courts from the seller to the buyer. The fraud defense to payment imperils these risk allocations. See, also Dolan (1987).
14. This doctrine may sometimes be seen to cause injustice in that if banks do not comply with their instructions to the letter, the applicant may refuse reimbursement. It is therefore

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incumbent on the banks to ensure that all documents tendered to the bank comply with the instructions and act within their agent's authority.

15. Article 13 of UCP 500.
16. Article 4 of UCP 600 (2007).
17. See *Commercial Banking Co of Sydney* v. *Jalsard Pty Ltd* [1973] AC 279; see also a fairly recent of *Hing Yip Hing Fat Co ltd* v. *Daiwa Bank Ltd* [1992] 2 HKLR 35.
18. For what constitutes rejection, see *SeaCansor Far East Limited* v *Bank Leami Plc.* [1992] 1 Lloyds Rep 513, 531.
19. When the beneficiary's documents fail to comply, the issuer may, under the strict rule, refuse to honor the credit even though the account party is satisfied with the beneficiaries' documents.
20. The word "Autonomous" is used to denote a form of self-governance or independence of the parties.
21. See, Article 20 (a) of the URDG (1992).
22. It states that credits are by their nature separate transaction from the sales or other contracts on which they may be based and the banks are in no way concerned with or bound by such contracts, even if in any reference whatsoever to such contracts is included in the credit. Consequently, the undertaking of a bank to pay, accept and pay draft(s) and negotiate and/or to fulfill any obligation under the credit is not subject to claims or defenses by the applicant resulting from his relationship with the issuing bank or the beneficiary. A beneficiary can in no way avail himself of the contractual relationships existing between the banks or between the applicant and the bank.
23. This states that the principle of autonomy is linked to the rule that in credit operations all parties concerned deal with documents and not with goods, services and/or other performance to which the documents relate.
24. [1972] 116 Sol Jo 921; [1972] 'Times', 4 October.
25. [1999] 1 All ER (Comm) 890 at 914.
26. In the case of the overseas branch issuing the LC, the law of the place of the overseas branch because each branch of the bank is regarded as separate for conflict purposes: see *Power Curber International Limited* v. *National Bank of Kuwait* SAK [1981] WLR 1233 at 1241.
27. According to Schmitthoff, in agency contracts, there is a rebuttable presumption in favor of the law of the agent.
28. The Choice of law clause has posed significant conceptual problems in the application of Article 4(1), 4(2) and 4(5) of the Rome Convention (1980).
29. [1995] 1 Lloyd's Rep. 227.
30. [1995] 1 Lloyd's Rep. 227.
31. In United Kingdom the Contract Act was to supersede any contracts entered into after April 1, 1991. As to the contracts entered into before that date and in common law countries which are not signatories to the Rome Convention on the Law Applicable to Contractual obligations 1980 ("Rome Convention"), the common would continue to apply.

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32. Creed (2001) citing the Report by Professor Giuliano and Legarde [1980] O.J C 282/1 at 21 (Giuliano-Legarde Report).
33. This Legislation gives UK Courts Jurisdiction on matter regarding commercial transaction of the parties' resident in UK. Remember also that the UK is not signatory to the CISG (1980); it applies the SOGA (1979).
34. "To the extent that the law applicable to the contract has not been chosen in accordance with Article 3, the contract shall be governed by the law of the country with which it is most closely connected […]".
35. "Subject to the provisions of paragraph 5 of this Article, it shall be presumed that the contract is most closely connected with the country where the party who is to effect the performance which is characteristic of the contract has, at the time of conclusion of the contract, his habitual residence, or, in the case of the body corporate or unincorporated, its central administration […]" Article 4(2) might be disregarded only exceptionally and has thus been called a "strong modal". Alternatively, the presumption could be rendered meaningless by Article 4(5): often the characteristic performer's residence will have little obvious connection with the contract – thus a "weak modal". In view of all these problems a third way has been suggested: a third modal. Instead of applying a strong or weak modal presumption in all cases, according to Fentiman, it is preferable to consider in each case whether the result of applying either provision would be consistent with the commercial expectation of participants in the relevant market, objectively determined. See Fentiman (2002).
36. [1994] 2 Lloyd's Rep. 87 at 92.
37. Under s.3 (3) (a) of the Contract Act 1991, the court may have regard to the Giuliano-Legarde report in applying the convention.
38. Here the contract is deemed to lack some of the essential ingredients to be enforceable.
39. See, Regulation (EC) No 4/2009.

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