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MANIFESTATIONS, COMPLICATIONS AND LEGAL CONSEQUENCES OF THE USE OF
DOCUMENTARY CREDITS IN INTERNATIONAL CONTRACTS.

ELI
LEENAAARS

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EUROPEAN UNIVERSITY INSTITUTE

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PREFACE

This study was originally planned to be an empirical analysis of the usage of documentary credits by contracting parties in international contracts, but it turned out to become an analysis of the basic characteristics of documentary credits and the emergence of standby letters of credit.

Over the last few years the documentary credit also has been used in situations in which it was not meant to be used. Besides using documentary credits in trade transactions, it became common to issue standby letters of credit as a guaranty device in construction contracts, Commercial Paper programmes etc..

Rules and Case Law concerning documentary credits, however, were designed to serve the use of documentary credits in trade transactions. It resulted in a conflict between theory and the practical use of documentary credits.

This conflict bursted out in the so called Iranian Cases, in which some fundamental questions concerning standby letters of credit were brought to Courts. The outcome of these Cases was very unsatisfactory.

In this study I would like to discuss this development and its legal implications. Especially I would like to discuss the possible implications for the ICC-rules. Before doing this, however, I will describe the traditional commercial documentary credit.

In Chapter 1 I will discuss the basic characteristics of traditional documentary credits which are used by contracting parties in trade transactions. Furthermore I will describe the role and function of the ICC-rules.

In Chapter 2 I will describe some special forms of documentary credits within their economical context.

In Chapter 3 I will analyze the basic principles of documentary credits: the principle of strict compliance and the principle of independence.

In this chapter I will try to integrate these two principles in an overall theory of documentary credit, especially the relationship between the applicant and the beneficiary of the credit.

In Chapter 4 I will discuss the emergence of standby letters of credit. First of all I will give a description of a standby letter of credit, then I will discuss the differences between a commercial documentary credit and a standby letter of credit.

I will try to analyze the implications and consequences of the emergence of standby letters of credit.

And finally I will try to define some proposals for new ICC-rules, which should deal with standby letters of credit.

Last but certainly not least, I would like to thank Professor Daintith

for his very useful remarks on previous drafts and for his supervision at the European University Institute in Florence.

I am very grateful for the possibility I have had to do my reearch at the European University and to enjoy the international academic atmosphere there.

Eli Leenaars

Amsterdam, 26th February 1988



CHAPTER 1

THE TRADITIONAL DOCUMENTARY CREDIT.

Paragraph 1.1

Legal typification

Terminology.

Especially in English and American literature the term Letter of Credit (it is however far more common in banking circles to use its abbreviation: LC) is used instead of the term documentary credit. But the term Letter of Credit only covers a part of the total documentary credit operations, namely the letter of the bank to the beneficiary, which constitutes the bank's obligation to make a payment to the beneficiary when the latter hands over certain stipulated documents¹.

The term documentary credit covers the whole operation. Since I have the intention to discuss the whole documentary credit operation, I will use this term hereafter.

The documentary credit has been defined in several ways:

The Uniform Customs and Practices (UCP) of the International Chamber of Commerce:²

¹. See Paragraph 1.4.

². Hereafter I will use the abbreviation: UCP.

"Article 2 UCP: For the purposes of these articles, the expressions 'documentary credit(s)' and 'standby letter(s) of credit' used herein (hereinafter referred to as 'credit(s)'), mean any arrangement, however named or described, whereby a bank (the issuing bank), acting at the request and on the instructions of a customer (the applicant for the credit),

- i. is to make a payment to or to the order of a third party (the beneficiary), or is to pay or accept bills of exchange (drafts) drawn by the beneficiary,
- or
- ii. authorizes another bank to effect such payment, or to pay, accept or negotiate such bills of exchange (drafts), against stipulated documents, provided that the terms and conditions of the credit are complied with."

Gutteridge and Megrah:

"The main object of the banker's commercial credit is to provide a means of payment for goods and services supplied by a seller to a buyer, usually to facilitate dealings between merchants domiciled in different countries, by ensuring payment to the seller for the contract goods or services on the one hand and their delivery to the buyer on the other hand."³

Zahn:

"Das Dokumenten-Akkreditiv: Das ist die Verpflichtungserklärung einer Bank, Zug um Zug gegen die das exportierte Gut repräsent-

³. Gutteridge, H.C. and Maurice Megrah, The Law of Banker's Commercial Credits, p. 1.

ierende -und/oder eventuell andere- Dokumenten den Kaufpreis an den Verkäufer auszuzahlen."⁴

"Das Wesen des Dokumentenakkreditivs besteht demnach in den vertraglichen Zusicherung einer Bank, für Rechnung ihres Auftraggebers innerhalb eines festgelegten Zeitraumes an einen bestimmten Empfänger unter der Voraussetzung der Einreichung vorgeschriebener Dokumente einen bestimmten Betrag in einer vorgeschriebenen Währung zu zahlen."⁵

De Vuyst:

"Terwijl op de rechtsnatuur van het documentair crediet en de verhoudingen tussen de betrokken partijen verder zal worden ingegaan zal het thans volstaan het documentair crediet te beschrijven als die situatie waarin een bank in opdracht en voor rekening van een koper, haar cliënt, zich op enigerlei wijze verbindt jegens de verkoper, om onder bepaalde voorwaarden een som die overeenstemt met de koopprijs van een goederen-

⁴. Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, p. 1.

⁵. Zahn, Johannes, C.D., Zahlung und Zahlungssicherung im Aussenhandel, p.1.

Translation:

"The documentary credit; that is the statement obliging a bank to pay the purchase-price to the seller upon presentment of documents which are representing the goods and/or other documents."

"The essence of the documentary credit is the contractual promise of a bank for account of its principal to pay within a certain period of time to a certain beneficiary under the condition of presentment of the agreed documents a certain amount of money in a certain currency."

overeenkomst te betalen, in de regel tegen overgave van documenten die betrekking hebben op de goederenovereenkomst."⁶

As I will show later in this study, these definitions only cover a part of the present uses of documentary credits.⁷

However, for the time being I would like to limit myself to the elaboration of these basic definitions. The more complicated devices, I would like to discuss at a later stage.

In my opinion the UCP-definition suits the best for the usage as a starting-point. Why? Internationally the UCP is used almost everywhere, so art. 2 is applicable in every documentary credit relationship.⁸ Besides this I think the UCP-definition to be clear and without much difficulties applicable.

The main features of the UCP-definition are as follows:

1. Standby letters of credit are treated in the same way by the UCP-rules.
2. It is an arrangement between the issuing bank and the applicant (the customer of the bank).

⁶. De Vuyst, B.M., Dokumentaire kredieten, p. 1.

Translation:

"..... the documentary credit has to be described as a situation in which a bank instructed by and for account of a buyer, its client, undertakes an obligation towards the seller to pay under certain conditions, normally the presentment of the relevant documents, an amount of money which is equal to the purchase price."

⁷. De Vuyst, B.M., Dokumentaire kredieten, p. 2.

⁸. For position and role of UCP-rules see Paragraph 1.2.

3. The arrangement is established at the request and on the instructions of the applicant.

4. The obligation of the issuing bank is to make a payment to the beneficiary or to accept or pay drafts drawn by the beneficiary.

5. The issuing bank can authorize another bank to effect these obligations.

6. The obligation of the beneficiary in order to receive the payment is to give the stipulated documents to the bank.



Paragraph 1.2

The ICC-Rules.

1.2.1. Introduction.

Very striking about the existence of documentary credits is the lack of national law. Only in a very limited number of countries there exists some kind of national documentary credit law⁹.

Documentary credits are governed by the ICC-rules (UCP: Uniform Customs and Practice for documentary credits¹⁰), national law, case law, and doctrine.

In this paragraph I would like to describe these elements with the emphasis on the ICC-rules¹¹ due to their great importance.

1.2.2. National Law.

As said before the lack of national law concerning documentary credits

⁹. Statutory law is found in Columbia, El Salvador, Greece, Guatamala, Honduras, Lebanon, Mexico, Syria, U.S.A., Csechoslovakia, and the GDR;
Also: Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, p. 3.

¹⁰. See Appendix 1 for the text.

¹¹. ICC is the abbreviation of International Chamber of Commerce.

is a striking feature of this instrument. One should see this in the light of the international character of documentary credits¹².

In my opinion this is a positive element of documentary credits. The lack of special national law creates a high level of uniformity of documentary credit law. This is necessary for the instrument with its international character and favours the development of it in international commerce¹³.

This does not mean in my opinion, that national law does not have a role at all in documentary credit operations.

A documentary credit operation with the contracts which emerge from this operation is not an island within legal practice. It will be influenced by the respective national laws, especially as far as the establishment and enforceability of a documentary credit is concerned the normal national law of contract will be applicable¹⁴.

Which national law will be applicable will be determined by the rules of international private law. On several occasions these rules of international private law have been defined¹⁵.

¹². Kurkela, Matti, Letters of credit under international trade law, 1985, p. 1;
De Rooy, F.P., Documentaire credieten, 1980.

¹³. Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, p. 4.

¹⁴. Rowe, Michael, Letters of credit, 1985, p. 31 and 33.

¹⁵. Kurkela, Matti, Letters of credit under international trade law, 1985;
De Rooy, F.P., Documentaire credieten, 1980;
Gutteridge, H.C., and Maurice Megrah, The law of bankers' commercial credits, 1984, p. 240 - 250;
Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, 1976, p. 17 - 22.

In the United States, however, the UCC (Uniform Commercial Code¹⁴) deals with documentary credit in quite an extensive way. Since this country is one of the biggest issuers of documentary credits this can mean a potential threat to the documentary credit uniformity, which is indispensable for the international development of the device.

Art. 5 UCC regulates documentary credits or letters of credit, which is the name the UCC uses.

The UCC's threat to the documentary credit's uniformity, however, is mitigated by the UCC itself.

Art. 5 - 101 sub 3 UCC:

This Article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop. The fact that this article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation nor provided for or to a person not specified by this article.

According to the Official Comment on this article this provision makes it possible that rules which are contrary to the UCC prevail¹⁷.

The State of New York version of this article goes even further. Since most of the documentary credits in the U.S.A. are issued under New York law, this version is of great importance.

Art. 5 UCC New York:

¹⁴. See Appendix 2 for text.

¹⁷. Kurkela, Matti, Letters of credit under international trade law, 1985, p. 24.

Unless otherwise agreed, this article 5 does not apply to a letter of credit or a credit if by its terms of 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 fixed by the Thirteenth or by any subsequent Congress of the International Chamber of Commerce.

This brings me to the ICC-rules: UCP (Uniform Customs and Practice for Commercial Documentary Credits).

1.2.3. ICC-rules.

These rules play an important role in documentary credit law.

The UCP are defined by the ICC Commission on Banking Technique and Practice, and lastly revised in 1983. The UCP are accepted by almost all the banks in the world.

Art. 1 UCP describes the way the UCP function within the documentary credit operation.

Art. 1 UCP:

These articles apply to all documentary credits, including, to the extent to which they may be applicable, standby letters of credit, and are binding on all parties thereto unless otherwise expressly agreed. They shall be incorporated into each documentary credit by wording in the credit indicating that such credit is issued subject to Uniform Customs and Practice for Documentary Credits, 1983 revision, ICC Publication no 400.

The question which arises is whether the UCP are just general conditions incorporated in the contract in a contractual way or something more, for instance an example of 'lex mercatoria'.

Several writers have discussed this question and in general come to the conclusion that the UCP are an example of 'lex mercatoria'¹⁶.

I agree with these opinions, if at least three requirements are fulfilled¹⁷:

1. the legal relationship is international in character;
2. the existence of such uniformity and 'custom' that parties in that particular field may reasonably be expected to be aware of it; and
3. the uniform principles should be reasonable and equitable and not dictated or unduly influenced by a dominant party in the market.

In my opinion the UCP fulfills these requirements.

Moreover, considering the absence of national law and considering the preference of an international regulation of such an international instrument¹⁸, the UCP provides us with the only necessary international set of rules and should be regarded as such.

¹⁶. Kurkela, Matti, Letters of credit under international trade law, 1985, p. 319;
De Rooy, F.P., Documentaire credieten, 1980;
Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, p. 8;
Eisemann, F., Le crédit documentaire dans le droit et dans la pratique, 1963, p. 4 and 5.

¹⁷. Kurkela, Matti, Letters of credit under international trade law, 1985, p. 12.

¹⁸. Eisemann, F., Le crédit documentaire dans le droit et dans la pratique, p. 4 and 5;
Kurkela, Matti, Letters of credit under international trade law, 1985, p. 11 and 12.

This conclusion is not without consequences.

It means, that the UCP also will be applicable even if this is not explicitly regulated in the contract^{e1}.

It gives us a set of norms which have to be interpreted as a coherent set of rules^{e2}. This will put a stress on the UCP. The UCP will have to become normative in its character, whereas it was originally set up as a compilation of banking practices concerning documentary credits.

1.2.4. Case Law.

Since most of the documentary credits are issued under English and New York Law and the Courts of both countries have in fact developed the legal practice of documentary credits, I will use in this study especially the English and American Case Law^{e3}.

Kurkela:

"The international or *lex mercatoria* character of U.S. letter of credit Case Law in particular but also that of England is thus evident. Therefore to a great extent the Case Law in the USA and England covers *lex mercatoria* as codified in the UCP and possibly *lex mercatoria* beyond the coverage of the UCP."^{e4}

^{e1}. Zahn, Johannes C.D., *Zahlung und Zahlungssicherung in Aussenhandel*, p. 8.

^{e2}. Eisemann, F., *Le crédit documentaire*, p. 4.

^{e3}. Kurkela, Matti, *Letters of credit under international trade law*, p. 46 and 47.

^{e4}. Kurkela, *idem*.

Paragraph 1.3

The documentary credit operation

What is the chronological order of a documentary credit operation?

During the negotiations between the buyer and the seller about the conditions of the contract of sale they also have to discuss the way of payment to be made by the buyer. There is a range of payment-instruments available to the contracting parties. So, because of their particular circumstances²⁵ they may use a documentary credit for the payment²⁶.

Then a part of the contract of sale is the obligation of the buyer to issue a documentary credit. Sometimes this general obligation also consists of other conditions, like the stipulated documents, the choice of the issuing and/or confirming bank etc..

In order to fulfill this obligation to pay by means of documentary credit, the buyer goes to his bank and makes a request to open a documentary credit in favour of the seller. On the moment the bank favours this request there exists a contract between the buyer and the bank, to open a documentary credit. But the documentary credit itself only exists on a later stage, e.g. when the bank has sent a letter of credit (an advisory credit) to the seller.

From this moment on there is a 'contractual' obligation from the issuing/advising bank towards the beneficiary to pay a certain amount

²⁵. See paragraph 1.6 and chapter 2.

²⁶. Gutteridge, H.C., and Maurice Megrah, *The Law of Bankers' Commercial Credits*, 1984, p. 35.

of money in a certain form, when the beneficiary/seller hands over the stipulated documents.

If the paying bank is not the issuing bank the latter has an obligation to reimburse the paying bank. Between the buyer and the issuing bank there must be an agreement how to finance the payment. The buyer can pay the full or a partial amount in advance, or he can ask the bank to give him a loan.

Legally there at least three, or four, sometimes even five contractual relationships:

1. The underlying contract between the buyer and the seller, in which the clause to make payment by documentary credit.
2. The contract between the buyer and the bank to open a documentary credit in favour of the seller.
3. The 'contract' between the bank and the beneficiary to pay the purchase-price, when the latter hands over the stipulated documents.
4. If the paying/advising bank is not the same as the issuing bank, there is a contractual relationship between both.

Together these contracts constitute the whole documentary credit-operation.

In order to make the whole operation a little bit less complicated I would like to discuss the four different contractual relationships more or less separately.

I will restrict myself in this first chapter to a basic model of a documentary credit operation, in order to analyze its legal nature and to describe its basic characteristics.

In the following chapters I will elaborate the more complicated forms, which have emerged from this basic model.

This basic model is an irrevocable, un-confirmed and non-transferable documentary credit.

Paragraph 1.4.

The contractual relationship between buyer and seller.

This relationship has two aspects. The contract of sale relationship and the documentary credit relationship.

Although the seller and the buyer are the contracting parties in the underlying contract they are not the parties in the documentary credit operation in the same capacity. In the latter situation there is a three party-relationship^{e7}.

The buyer is also the issuer of the credit; the seller is also the beneficiary of the credit. Because of this, this relationship is the only legal connection between the underlying contract and the documentary credit itself.

This connection can be regarded as a mother/child relationship. The documentary credit originates from the underlying contract, and influences to a great extent the form of documentary credit. I will deal with this last aspect later on chapter 2.

As I have said this is the only legal connection between the documentary credit operation and the underlying contract. This does not mean, that there are no other connections. There are, but they have a more factual character, e.g. the documents.

During the negotiations the seller will stipulate that payment shall be

^{e7}. Schoordijk, H.C.F., Beschouwingen over drie-partijen-verhoudingen van obligatoire aard, *Ars Aequi* 34, 1985, p. 749.

made by documentary credit. They also have to agree on the other conditions, like the required documents, irrevocability etc..

What is the legal position of the clause in the contract of sale constituting the obligation of the buyer to make the payment by a documentary credit?

Some writers argue that this clause is a condition precedent in the contract of sale.

Davis, A.G.:

"Provision of the necessary credit is a condition of the contract, and, if the condition is not complied with, the seller has the right to treat the contract as at an end. But it is open to the seller to waive performance of this condition, and if he does so, and thus leads the buyer reasonably to suppose that he does not intend to treat the contract as at an end, then he cannot thereafter purport to cancel the contract without giving notice to the buyer, so as to enable him to comply with the stipulation in the contract that a credit or a particular form of credit, shall be provided."²⁸

I agree with Davis to a certain extent. The clause to make the payment by documentary credit is an essential part of the whole contract of sale. In my opinion this does not mean that the simple opening of a credit constitutes the existence of the contract of sale. In other words it is in principle not a condition precedent to the contract of sale.

²⁸. Davis, A.G., The Law relating to Commercial Letters of Credit, 1954, p. 44/45.

After the agreement between the contracting parties the contract as such exists in full capacity, including the payment-conditions.

If the buyer does not comply with these payment-conditions, the seller is not bound to ship the goods and he even can sue the buyer for non-fulfilment of the contract-conditions.²⁹

Schmitthoff:

"Where the contract does not provide when the credit shall be opened, the parties are not normally entitled to assume that the existence of the contract of sale depends on the opening of the credit by the buyer. Although the parties are at liberty to agree that that the contract shall be 'subject to the opening of a credit' in which case the opening of the credit is a condition precedent to the formation of the contract and, in the words of Denning L.J., 'if no credit is provided, there is no contract between the parties'³⁰, such interpretation of the buyer's promise is only possible where the parties have expressly or impliedly agreed that the promise shall be subject to that condition. In the normal cases in which the contract is unqualified, the stipulation to open a documentary credit relates to the performance of the contract and is only a condition precedent to the performance of the contract; it is the mechanism agreed upon for the payment of the price."³¹

²⁹. De Vuyst, B.M., *Dokumentaire kredieten*, no. 80.

³⁰. *Trans Trust S.P.R.L. v Danubian Trading Co. Ltd.*, [1952] 2 Q.B. 297, 304.

³¹. Schmitthoff, Clive, *Export Trade*, 7th. Ed., 1980, p. 253.

How must the credit legally be qualified?

Has the documentary credit to be considered to be a conditional or an absolute payment?

An absolute payment means that the buyer is released from the liability to make the payment by the mere opening of the credit.

From the point of view of the buyer this means that he has fulfilled his contractual payment-obligations by the opening of the credit.

Lord Denning, M.R., described the question as follows:

"If the letter of credit is absolute payment of the price, the consequences are these: The seller can only look to the banker for payment. He can in no circumstances look to the buyer. The seller must present the documents to the banker and get payment from him in cash or get him to accept sight or time drafts. If the banker takes up the documents in exchange for time drafts, and the banker afterwards becomes insolvent, the seller must prove in the liquidation. He cannot sue the buyer."³²

Saying this Lord Denning regarded the credit not to be an absolute payment, unless this is expressly stipulated in the contract.

So does Pabbruwe, H.J.:

"Wanneer men bedenkt, dat het doel van het accreditief is het verschaffen aan de verkoper van -meer- zekerheid voor de betaling van de koopprijs, ligt het dunkt mij voor de hand dat het in beginsel niet de bedoeling van contractspartijen is dat de oorspronkelijke betalingsplicht van de koper tegenover de

³². Alan (W.J.) and Co. Ltd. v El Nasr Export and Import Co., [1972] 2 W.L.R. 800.

verkoper door het stellen van een accreditief is weggeval-
len."³³

Gutteridge and Megrah:

"The credit may, usually, by the contract of sale be made absolute payment. Acceptance by the seller of a commercial credit constituting absolute payment would debar him from his ordinary right to pursue the buyer if he (the seller) did not receive payment under the credit."³⁴

"If the bank wrongly refuses to pay, it is in breach and the buyer also unless the sales contract provides that the mere issue of the credit shall be absolute and final payment, for which provision would have to be in such terms as made clear beyond doubt what the parties intended."³⁵

These opinions are confirmed by several examples in Case Law: Soproma v Marine and Animal By-Products Corporation³⁶, Sale Continuation Ltd v

³³. Pabbruwe, H.J., De overeenkomst bank-begunstigde bij het onherroepelijk documentair crediet, Weekblad voor Privaatrecht, Notarisambt en Registratie, WPNR 4960, 2 september 1967, p. 337.

Translation:

"If one keeps in mind, that it is the purpose of the documentary credit to provide the seller security that he will be paid, it is obvious in my opinion that in principle it is not the intention of the contracting parties that the buyer has fulfilled his payment obligation by the issuance of the documentary credit."

³⁴. Gutteridge, H.C., and Maurice Megrah, The Law of Bankers' Commercial Credits, 1984, p. 35.

³⁵. Gutteridge, H.C., and Maurice Megrah, *ibid*, p. 36.

³⁶. Soproma S.p.A. v Marine and Animal By-Products Corporation, [1966] 1 Lloyd's Rep. 367.

Austin Taylor and Co. Ltd.³⁷ and J. Alan and Co. Ltd. v El Nasr Export and Import Co.³⁸. This last case has been discussed by Schmitthoff in this sense³⁹.

I wonder whether the opening of a credit can be regarded as a payment, either conditional or absolute, at all. The mere opening of a credit is not a payment, but only the creation of the possibility for the seller to obtain the purchase-price.

Lord Denning:

"A banker's confirmed credit is a different thing from payment.

It is an assurance in advance that the seller will be paid."⁴⁰

The documentary credit only is a payment at the moment the seller receives the money, or on the moment the money is at his disposal.⁴¹ On the other hand as long as the documentary credit is still available, the seller has the obligation to use it in order to obtain the purchase price. Without this obligation, the buyer cannot take advantage of the advantages which the documentary credit can offer to him.

McNair, J.:

³⁷. Sale Continuation Ltd. v Austin Taylor and Co. Ltd., [1967] 2 Lloyd's Rep. 403.

³⁸. J. Alan and Co. v El Nasr Export and Import Co., [1972], 2 W.L.R. 800.

³⁹. Schmitthoff, Clive, Journal of Business Law, 1972, p. 132.

⁴⁰. Trans Trust S.p.a. v Danubian Trading Co. Ltd., [1952] 2 Q.B. 297, 304.

⁴¹. Also: Kurkela, Matti, Letters of Credit under International Trade Law, 1985, p. 183.

"It seems to me 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 direct to the buyers. Assuming that the letter of credit has been opened by the buyer for the opening of which the buyer would normally be required to provide the bank either with cash or some form of authority, could the seller at this option disregard the contractual letter of credit and present the documents direct to the buyer? As it seems to me the answer must plainly be in the negative."⁴²

However, there are situations imaginable, in which the seller does not have the opportunity to use the documentary credit. For instance after the expiry date or in the case of bankruptcy of the bank⁴³. In these cases the buyer still has a liability towards the seller to pay the purchase price. Since the opening of the credit in itself does not constitute a payment, the buyer has to fulfill his obligation to pay in another way, although he has fulfilled his obligation to open a credit. Because of this a documentary credit has to be regarded as a conditional payment, unless otherwise explicitly stipulated in the purchase contract. It is legally a payment on the moment the seller receives the purchase price or has it at his disposal.⁴⁴

⁴². Soproma S.A. v Marine and Animal By-Products Corporation, [1966] 1 Lloyd's Rep. 367.

⁴³. Gutteridge, H.C., and Maurice Megrah, The Law of Bankers' Commercial Credits, 1984, p. 35/36.

⁴⁴. Kurkela, Matti, Letters of Credit under International Trade Law, 1985, p. 183.

The independent character of the documentary credit-relationship. The obligation of the bank to pay the seller on the moment the latter has fulfilled his obligation is independent from the contract of sale itself.

The establishment of the obligation constitutes an autonomous contract.

Art. 3 UCP:

"Credits by their nature, are separate transactions from the sales or 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."

Art. 5-114 UCC⁴⁵ states:

"An issuer must honor a draft or demand for payment which comes within the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary."

I will discuss this subject and the case of fraud in paragraph 3.3.

There is one issue however, I would like to make some remarks about in this context. The problem of the situation when the conditions of the

⁴⁵. UCC is the abbreviation for: United States Uniform Commercial Code. Hereafter I will use the abbreviation UCC.

documentary credit do not meet the agreed conditions of the contract of sale.

On the moment the beneficiary receives the letter of credit, this constitutes an obligation for the bank to pay, even if the conditions do not meet the specific conditions of the contract of sale.

The only way to recover this, is to amend or cancel it. But the UCP demands a difficult procedure for doing that.⁴⁶

Art. 10, sub d UCP:

"Such undertakings can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank (if any), and the beneficiary. Partial acceptance of amendments contained in one and the same advice of amendment is not effective without the agreement of all above mentioned parties."

In this case it is rather important to determine at what moment the documentary credit has to be taken established.⁴⁷

⁴⁶. Gutteridge, H.C., and Maurice Megrah, *The Law of Bankers' Commercial Credits*, 1984, p.35.

⁴⁷. See paragraph 1.5 and 1.6.



Paragraph 1.5

The contractual relationship between buyer and the bank.

I would like to distinguish two moments in the relationship between the buyer and the bank:

1. The moment of the opening of the credit.
2. The moment of the settlement of the credit.

Ad 1. In order to fulfill his contractual obligation originating from the contract of sale, the buyer goes to his bank with the request to open a documentary credit. After some negotiations, or even without⁴⁸, the bank and the buyer will reach an agreement about the terms and conditions, under which the documentary credit will be opened.

This contract between the bank and the buyer will consist of two categories of conditions:

- a) the conditions related to the operation of the documentary credit as such.
- b) the conditions related to the settlement of the documentary credit after the payment to the beneficiary.

For the first category art. 5 UCP gives the following statement:

"Instructions for the issuance of credits, the credits themselves, instructions for any amendments thereto and the amendments themselves must be complete and precise.

⁴⁸. For instance when the bank and buyer are doing business already for a longer period of time, or when the opening of a documentary credit has become a routine operation.

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."

Although the documentary credit operation is fully independent from the underlying contract⁴⁷, sometimes the issuing bank does want to know the character of the underlying contract. The bank does not want to get involved in controversial transactions.^{50 51}

One of the most important parts of the instructions are the instructions from the buyer to the bank concerning the documents.

For, these documents have to give to the buyer the possibility to check the goods and therefor trustworthiness of the seller/beneficiary.⁵²

The second category of conditions in the contract between the bank and the buyer are those about the arrangement between the buyer and the bank regarding the financing of the documentary credit operation.

Two examples, which can give an understanding of the possible conditions:

⁴⁷. Art. 3 UCP.

See for further elaboration of this chapter 3: principle of independence.

⁵⁰. De Rooy, F.P., Documentaire credieten, p. 71. De Rooy uses here the adage, often used in English banking circles: 'Banks do not want to become front-page news!.

⁵¹. Pabbruwe, H.J., De overeenkomst bank-begunstigde bij het onherroepelijk documentair crediet, Weekblad voor Privaatrecht, Notaris-ambt en Registratie, WPNR 4985, 12 aug. 1967, p. 316.

Pabbruwe, H.J., De betekenis van de onafhankelijke bankgarantie, 28 October 1983, p. 12..

⁵². See for further elaboration of this chapter 3: principle of strict compliance.

Example 1.

Before the advisory letter has been sent to the beneficiary, which establishes the obligation of the bank towards the beneficiary to make the payment on the moment the latter has presented the stipulated documents, the buyer must have transferred the equivalent amount of money and the agreed provision for the bank to the bank. In this example the relationship between the buyer and the bank is restricted to the mere facilitation by the bank of making the payment originating from a trade transaction. There hardly is any risk involved for the bank; the provision is a secure profit for the service provided by the bank.

Example 2.

The bank also agrees to finance the trade transaction. Normally the buyer has to pay the bank back after a period of time. Then there are all kinds of agreements possible in this situation. In order to limit his risk in the undertaking, the bank will stipulate some kind of securities; for instance the documents, which are representing the right of ownership of the goods, which are dealt with in the underlying contract.

In example 2 one has to question the function of the documentary credit-operation.

It may be the case that the documentary credit-operation rather is used as a financing-instrument than as a payment-instrument. This element of the use of the documentary credit in international transactions will be discussed at a later stage.

Harfield⁵³ has questioned the credit-element of a documentary credit operation.

Harfield:

"We are here concerned with the broader proposition that the letter of credit and the bankers' acceptance are the means by which a bank lends its credit rather than its money to a customer."⁵⁴

Without going into economical theories concerning the differences of loans of money and loans of credit⁵⁵, Harfield's remark can be important regarding the financing-element of the documentary credit-operation.

Harfield describes the situation as following:

When a seller wants immediate payment and a buyer is not prepared to pay until delivery, this period of time has to be bridged.

"In these circumstances, the buyer's present need is not for money but for credit. He may borrow that credit from the bank through the device of a letter of credit. The cost to the buyer for this use of the bank's credit will ordinarily be less than the cost to him of the use of the bank's money." (.....)

⁵³. Harfield, Henry, Bank Credits and Acceptances, 5th Edition, 1974, p. 10.

⁵⁴. Also: Oppenheim, Peter K., International Banking, 1983, p. 43.

⁵⁵. Morse, Banks and Banking, 6th Ed. 1928, at 183-184:
"Indeed, lending credit is the exact opposite of lending money, which is the real business of a bank, for while the latter creates a liability in favor of the bank, the former gives rise to a liability of the bank to another."

"Thus, when a bank lends its credit to a customer, by engaging for his account to make a payment at a future date to a third party, the bank has undertaken a liability in order to balance its books, it must acquire an off-setting asset. The liability is reflected in its letter of credit or other commitment to make the payment. The asset is reflected in the customer's agreement either to put the bank in funds to make the promised payment, or to reimburse the bank simultaneously with its making the promised payment, or to reimburse the bank thereafter over a period of time.

In the last case, the transaction is in effect a commitment by the bank to make a loan to its customer on the date or at the time stipulated for payment by the bank to the third party under its letter of credit or other engagement. In such case, except for the fact that the loan transaction occurs in the future, it is no different from the classic deposit and loan function."⁵⁴

In my opinion this rather long citation shows to a great extent the 'credit'-aspect of the documentary credit-operation.

Once the buyer and the bank have agreed on the conditions of the documentary credit, the bank has the obligation to execute the instructions of the buyer strictly. If it does not do so, the buyer can refuse to reimburse the bank for the payment because of non-fulfilment of a contractual obligation.

⁵⁴. Harfield, Henry, Bank Credits and Acceptances, 5th Edition, 1974, p. 11 and 12.



So, not strictly complying with the instructions of the buyer means great risk for the bank. The provision of art. 5 UCP, which demands for clear and precise instructions, is an attempt to prevent conflicts between the buyer and the bank in these circumstances.

The principle of strict compliance is somewhat mitigated in regard to the examination of the documents.⁵⁷

Ad 2) The relationship between the buyer and the bank on the moment of the settlement of the credit.

One has to distinguish two different situations:

- a) The beneficiary does not use the documentary credit to receive his payment.
- b) The beneficiary presents the documents in order to receive payment.

In the first situation there is not an obligation of the buyer to reimburse the bank for the purchase-price, because the bank did not make the payment. Despite this the buyer has to pay the provision for the documentary credit. For, the bank provided for the service to keep the money available for the beneficiary until the expiry date.

In the second situation the bank has to check the presented documents.

Art. 15 UCP gives the following obligation to the bank:

"Banks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit.

Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face

⁵⁷. See Chapter 3: the principle of strict compliance.



to be in accordance with the terms and conditions of the credit."

According to art. 17 UCP the acceptance of the documents does not exclude any falsification of the documents. For, the bank only has the obligation to examine the documents 'on their face'. The bank has no obligation to guarantee the validity of the documents.⁵⁸

Art. 17 UCP:

"Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents or superimposed thereon;..."

Reading these UCP-provisions one should keep in mind, that the intention of the provisions is to limit the liability of the bank towards the customer/buyer. It does not contain a norm which the bank has to apply when examining the documents. It does not say anything about the bank/beneficiary relationship.

After the examination of the documents there are two possibilities:

- a) The documents are in accordance with the documentary credit conditions;
- b) The documents are not in accordance with the agreed conditions.

In the first case, the bank will make the payment to the beneficiary, and the rest of the documentary credit-operation will be continued.

⁵⁸. This shows the independence of the documentary credit from the underlying contract.

In the second case, the bank has to decide on the basis of art. 16b UCP whether to make the payment or not.

Art. 16b UCP:

"If, upon receipt of the documents, the issuing bank considers that they appear on their face not to be in accordance with the terms and conditions of the credit, it must determine, on the basis of the documents alone, whether to take up such documents, or to refuse them and claim that they appear on their face not to be in accordance with the terms and conditions of the credit."

I would like to make some remarks about this provision.

What means 'on the basis of the documents alone'?

Some authors think, that this means that the bank is not allowed to contact the buyer in order to discuss the fact, that the documents are not in accordance with the conditions.

I do not agree with this opinion. Although the examination by the bank of the documents is a formal one, which means that the bank only has to look to the documents themselves, not what is really happening³⁹, the bank nevertheless is obliged to inform the buyer about irregularities. It is in the interest of the buyer, whether the bank accepts irregularities or not. The delivery of the goods depends on this acceptance. If the buyer for instance needs them urgently he will be prepared to accept minor irregularities⁴⁰.

³⁹. Again another example of the principle of independence of the documentary credit from the underlying contract.

⁴⁰. Oppenheim, Peter K., International Banking, 1983, p. 148/149; Kurkela, Matti, Letters of credit under international trade law, 1985, p. 184.

This will be dependent from for instance the market-situation. In a declining market non-conforming documents are seldom, if ever, accepted by the customer for obvious reasons.⁴¹

The bank is only interested to be reimbursed. Acceptance by the buyer of irregularities covers the risk of the bank. So there is no interest at all anymore for the bank.

It must be said, that a prudent banker will ask the buyer to give his permission to accept irregular documents in writing, in order to prevent a possible future conflict⁴².

In my opinion the meaning of this provision is to limit the bank's liability. For, the article is placed in the chapter on the bank's liability. Art. 16b UCP gives the bank permission to determine whether the documents appear on their face to be in accordance without consulting the buyer. If the buyer does not agree with the bank's opinion, he has the burden of proof. He has to prove that it should have been clear to the bank that the documents do not appear to be in accordance with the terms and conditions of the credit.

Although the principle of strict compliance is applicable for the examination by the bank, one has to remember art. 15 UCP, that stated that banks must examine all documents with 'reasonable care'.

Lord Sumner has interpreted 'reasonable care' as 'in accordance with prompt commerce'.

"..... they (EL:the documents) have to be such as can be retendered to sub-purchasers, and it is essential that they

⁴¹. For instance: Banco di Roma v Fidelity Union Trust Co., 27 UCC R.S. 515 (1979).

⁴². Oppenheim, Peter K., International Banking, 1983, p. 149.



should so conform to the accustomed shipping documents as to be reasonably and readily fit to pass current in commerce."⁶³

⁶³. *Hannson v Hamel and Horley*, [1922] A.C. 36, 46.

Paragraph 1.6

The relationship between the bank and the beneficiary.

1.6.1 What are the mutual obligations in this relationship?

The bank has to pay a certain amount of money to the beneficiary, on the moment the latter hands over the stipulated documents.

The beneficiary however does not have a real obligation towards the bank. In order to receive the payment he only has the obligation to hand over the stipulated documents.

This feature of the relationship between the bank and the beneficiary has been and still is causing a lot of theoretical difficulties as well in the Civil Law countries as in the Common Law countries.

In the Civil Law system the documentary credit has to fit in already existing contractual devices in order to guarantee the enforceability of the documentary credit obligation. This is the problem of classification. A contract has to be classified under an existing contract in the Civil Code. This will determine the applicable law and its interpretation. Furthermore it is of importance to determine the law applicable under the international private law rules.

Ellinger, E.P.:

"In civil law countries it is not surprising to find attempts to solve the difficulties of letters of credit by way of classification. It would, in these systems, be sufficient to show that letters of credit fall within the scope of one of the

specific contracts of instruments regulated in the civil or commercial law codes. Similar solutions were, from time to time, proposed in England and the USA.

It is interesting to note that the attempted classifications are very similar in the different systems. Moreover, similar objections are raised against each classification-solution in each of the systems under discussion."⁶⁴

This problem not only exists in the Civil Law countries, but also in the Common Law countries. The biggest theoretical problem is the absence of consideration in 'the contract' between the seller and the bank. In Common Law countries a consideration is necessary for a contract to be valid.

Rowe, M.:

"If the letter of credit is a contract between bank and beneficiary it is a rather odd one -especially for English lawyers.

(.....)

English Law has theoretical problems with this approach because of what it calls the doctrine of consideration; a contract is binding only if each party is obliged to give something to the other. The credit beneficiary will not be paid unless he presents his documents to the bank but he is not in breach of obligation towards the bank if he fails to do so. He may be in

⁶⁴. Ellinger, E.P., *Documentary Letters of Credit; A comparative study*, Singapore, 1970, p. 44.

breach of his contract with the buyer, but there is nothing the bank can do about it."⁶⁵

Gutteridge and Megrah have raised the same problem:

"The difficulty arising out of absence of consideration for the bank's undertaking is still unsolved because the English courts have never decided it in terms."⁶⁶

In my opinion this theoretical problem can be concluded for its practical consequences with the following remark of Harfield:

"To conclude, then, the banker's letter of credit is a legally enforceable instrument, rooted in the law merchant and contractual in its nature. There is neither need nor utility to employ Procrustean techniques to establish its validity."⁶⁷

By saying so Harfield avoids a theoretical discussion about the lack of consideration in the promise of the bank to pay the beneficiary.

Gutteridge and Megrah:

"While consideration is still a real factor in the English Law of contract, the attempt to find a legal basis for the contract between a banker issuing a credit and the beneficiary is yet

⁶⁵. Rowe, M., *Letters of Credit*, 1985, p. 32.

⁶⁶. Gutteridge, H.C., and Maurice Megrah, *The Law of Bankers' Commercial Credits*, 1984, p. 26.

⁶⁷. Harfield, H., *Bank Credits and Acceptances*, 1974, p. 55.

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academic because of the view of the Courts that a binding contract arises."⁶⁸

In my opinion Harfield's remark and Gutteridge's opinion also are valid for the Civil Law situation. For, in practice a documentary credit-obligation of the bank towards the beneficiary is enforced by the courts. Kurkela has expressed the same opinion.⁶⁹

This does not mean that this theoretical problem of classification is without any importance. It is for instance very important in a comparative approach which is outside the scope of this study. But for my research, which has a more practical approach, this conclusion gives me reason to consider the enforceability as a starting-point.

1.6.2. The moment of establishment of the documentary credit.

As I have already mentioned in paragraph 1.5 and 1.6, the moment at which the documentary credit is taken to be established is of great importance for the relationship between the bank and the beneficiary. For, at this moment the bank will be bound to make the payment, when the beneficiary hands over the stipulated documents.

As I have said De Rooy's opinion is, that the documentary credit has to be considered to be established on the moment the bank has sent the advisory letter to the beneficiary, because on this moment the bank

⁶⁸. Gutteridge, H.C., and Maurice Megrah, *The Law of Bankers' Commercial Credits*, 1984, p. 30.

⁶⁹. Kurkela, Matti, *Letters of Credit under International Trade Law*, 1985, p. 4.

does not have the possibility anymore to change or even not to fulfill its obligation.⁷⁰

But there also are some other opinions.

For instance, the opinion that the documentary credit is established on the moment the beneficiary has received the advisory letter. This opinion has been defended by both Stoufflet⁷¹ and Eisemann⁷².

The both above mentioned opinions are the most current ones.

These different opinions probably are caused by the differences of national legal systems concerning contractual law. Subject to rules of International Private Law a certain national law of contract is applicable to this aspect of a documentary credit operation.⁷³

The applicable law determines the moment at which the documentary credit is taken to be established.

1.6.3. The independence from the underlying contract.

One of the most important features of the obligation of the bank to pay the beneficiary is its independence from the underlying contract.⁷⁴

⁷⁰. De Rooy, F.P., Documentaire credieten, 1980, p. 79.

⁷¹. Stoufflet, J., Le Crédit documentaire, 1957, p. 301.

⁷². Eisemann, F., Le Crédit documentaire, 1963, p. 45.

⁷³. Kurkela, Matti, Letters of Credit under International Trade Law, 1985, p. 33.

⁷⁴. Art. 3 UCP.



I will discuss the meaning of this rule and its exception in paragraph
3.3.

Paragraph 1.7.

The functions of a documentary credit.

So far this study has been a descriptive analysis of the occurrence of a documentary credit in its environment.

What does this description say about the documentary credit itself? In other words: can a description of a documentary credit in its environment provide a more abstract analysis of the function of a documentary credit.

First of all the question should be answered, what the advantages for the parties involved are when using a documentary credit. Or, what are the elements the contracting parties seek, when using a documentary credit?

I will derive the answers to these questions from the description given in this chapter.

The beneficiary.

The beneficiary can generally be regarded as the party involved, who has the biggest advantage when using a documentary credit.

His biggest advantage is the security of the payment. By using a documentary credit he will have a legal mechanism available, which provides him with a security that he will be paid, if he will fulfill certain conditions; that is, if he will deliver certain documents which have been agreed upon.



Besides the simple payment function the documentary credit will have a finance function (the so called spontaneous financing).

As soon as the beneficiary has shipped the goods, he will be able to present the documents and receive the payments. The consequence of this is, that the period of time during which the beneficiary will have to apply capital for the shipped goods will be short as well.

Summarizing the documentary credit has for the beneficiary a payment-function. The finance-function can be considered to be a payment-related function, since its goal is to shorten the payment-period⁷⁵.

The buyer.

Using a documentary credit also has a purpose for the buyer. The buyer mainly will consider the documentary credit as a security-device. He will know that at the moment the actual payment is made the documents which are presented by the beneficiary are in accordance with the buyer's demands as they are laid down in the advisory letter.

So, except for the case of fraud the buyer can be certain that he will receive the goods which have been agreed upon.

When financing the trade-transaction he can use the documents representing the shipped goods as collateral for the bank's credit⁷⁶.

Summarizing: also for the buyer the documentary credit is mainly used to smooth the payment mechanism.

⁷⁵. Armstrong, A.W., The letter of credit as a lending device in a tight money market, *The Business Lawyer*, V22, N4, July 1967.

⁷⁶. Dolan, John F., Strict compliance with letters of credit - striking a fair balance, *Banking Law Journal*, V102, N1, 1985, p. 26: "They (EL: the letters of credit) facilitate the financing of the underlying transaction "; Driscoll, R.J., The role of standby letters of credit in international commerce - reflections after Iran, *Virginia Journal of International Law*, V20, N2, 1980, p. 464.

The bank.

Of course, the documentary credit as such does not have any advantage for the bank. For, the bank only will be confronted with the transaction once it has been called upon to issue the documentary credit. But once having issued the documentary credit, it can fulfill for the bank a relevant purpose.

First of all it is for the bank a way to generate income by charging provisions, expressed by a percentage of the total amount involved. That is the reward for the bank for lending its trustworthiness.

Furthermore, it will give the bank the possibility to ask the documents representing the ownership of the goods involved in the trade-transaction as collateral, if the bank is requested by the buyer to finance the transaction⁷⁷.

Commercially the documentary credit can even be a marketing tool. It can be a way to get involved in the transaction with a possibility to get invited to finance it as well.

Conclusion.

Although using a documentary credit in a trade transaction can have for all the parties involved different purposes, one can say that a documentary credit as a whole serves as a payment-mechanism⁷⁸.

⁷⁷. Dolan, John F., Strict compliance with letters of credit - striking a fair balance, *Banking Law Journal*, idem; Driscoll, R.J., The role of standby letters of credit in international commerce - reflections after Iran, *Virginia Journal of International Law*, V20, N2, 1980, p. 466.

⁷⁸. Gutteridge, H.C., and Maurice Megrah, *The law of bankers' commercial credits*, 1984, p. 1; Kurkela, Matti, *Letters of credit under international trade law*, 1985, p. 9; Pabbruwe, H.J., *De betekenis van de onafhankelijke bankgarantie*,

The basic purpose of a documentary credit-operation is to provide the contracting parties with a way, however with some very specific characteristics, to settle their payments; it is a payment mechanism with a high level of security⁷⁹.

This high level of security is needed when parties do not know each other or one of the parties has identified a risk in the transaction.

The security element for the beneficiary is provided by the principle of independence, which assures the beneficiary that whatever happens to the underlying contract (except for the case of fraud) he will receive his payment⁸⁰.

Kurkela:

"In commercial letters of credit the main purpose is to provide a certainty of payment regardless of and independent from any justification aspect under the main agreement."⁸¹

The security element for the buyer is provided by the principle of strict compliance, which assures the buyer that he will receive the goods which have been determined in the advisory letter⁸².

The principle of independence and the principle of strict compliance

Inaugural Speech Professor of Law University of Leiden, 28 october 1983, p. 7/8;

Driscoll, R.J., The role of standby letters of credit in international commerce - reflections after Iran, Virginia Journal of International Law, V20, N2, 1980, p. 464.

⁷⁹. De Rooy, F.P., Standby letters of credit, Nederlands Juristenblad, 8 october 1983, p. 1113.

⁸⁰. See paragraph 3.3.

⁸¹. Kurkela, Matti, Letters of credit under international trade law, 1985, p. 203.

⁸². See paragraph 3.2.

form together the balance of power of the whole documentary credit operation⁸³.

⁸³. See chapter 3.



CHAPTER 2

DEVIATIONS FROM THE BASIC MODEL.

Paragraph 2.1

Introduction.

In chapter 1 I have described a basic model of a documentary credit. This means an irrevocable, un-confirmed and non-transferable documentary credit.

In this chapter I would like to describe the main deviations from this basic model. Further on they will be called basic types^{e4}.

In paragraph 2.2 a revocable documentary credit.

In paragraph 2.3 a confirmed documentary credit.

In paragraph 2.4 a transferable documentary credit.

^{e4}. De Rooy, F.P., Documentaire credieten, 1980, p. 23.

Paragraph 2.2

A revocable documentary credit.

A revocable documentary credit.

Art. 9 sub a UCP:

"A revocable credit may be amended or cancelled by the issuing bank at any moment and without prior notice to the beneficiary."

The cancellation cannot take place at any moment, like the literal interpretation of this provision could be.

For, when this would be the case, the beneficiary never will be certain that he has received the payment legitimately.

The revocability ends on the moment the obligation of the bank to pay becomes irrevocable.

In my opinion the revocable credit becomes irrevocable on two moments. Primarily when the bank explicitly expresses that he is willing to be bound⁸⁵, because a revocable credit postulates that the bank is not to be bound unless and until he is willing to be bound.

Secondly when the beneficiary hands over the documents. I would like to give two arguments for this:

⁸⁵. Gutteridge, H.C. and Maurice Megrah, The Law of Bankers' Commercial Credits, 1984, p. 31.



1. On the moment the beneficiary has handed over the documents he has fulfilled all his obligations, in order to receive his payment⁶⁶.

2. On this moment the beneficiary has handed over the documents and lost because of this control over the goods. This fact has to be compensated by the irrevocability of the bank's obligation. Otherwise the balance of power in the documentary credit operation will be disturbed.

So, the difference between a revocable and an irrevocable documentary credit is the security for the seller to receive his payment. Under certain circumstances the buyer has the right to amend or to cancel the documentary credit. I would say therefore, that a revocable documentary credit lacks one of the most important advantages of a documentary credit as a device to secure payment.

Mainly for this reason this method of payment is rarely used⁶⁷.

A revocable letter of credit can be useful however, in a situation in which the goods involved in the underlying contract easily can be resold to other buyers. For, in that case he will be paid anyway, and a relatively expensive payment device like a documentary credit is not very useful.

⁶⁶. De Rooy, F.P., *Documentaire credieten*, 1980, p. 28/29; Cour de Cassation 12 Jan. 1959, *Bulletin des Arrêts, Chambres Civiles*, 1959 III no 14; Zahn, Johannes C.D., *Zahlung und Zahlungssicherung im Aussenhandel*, p. 79 (Zahn has a different opinion): According to Zahn a revocable documentary credit becomes irrevocable at the moment the bank has actually made the payment.

⁶⁷. Oppenheim, Peter K., *International Banking*, 1983, p. 179.

Paragraph 2.3

A confirmed documentary credit.

2.3.1 Legal typification.

In the situation of an un-confirmed documentary credit only the opening bank or its foreign affiliation is bound to make a payment, not the advising bank. The latter will normally state explicitly in its advisory letter that the advising bank only advises without binding itself in one way or another.

According to De Rooy 90 % of the used documentary credits is un-confirmed⁸⁸.

Art. 10 sub b, c and d UCP:

Art. 10 sub b UCP:

"When an issuing bank authorizes or requests another bank to confirm its irrevocable credit and the latter has added its confirmation, such confirmation constitutes a definite undertaking of such bank (the confirming bank), in addition to that of the issuing bank, provided that the stipulated documents are presented and that the terms and conditions of the credit are complied with:

i. if the credit provides for sight payment - to pay, or that the payment will be made;

⁸⁸. De Rooy, F.P., Documentaire credieten, 1980, p. 34.



ii. if the credit provides for deferred payment - to pay, or that payment will be made, on the date(s) determinable in accordance with the stipulation of the credit;

iii. if the credit provides for acceptance - to accept drafts drawn by the beneficiary if the credit stipulates that they are to be drawn on the confirming bank, or to be responsible for their acceptance and payment at maturity if the credit stipulates that they are to be drawn on the applicant for the credit or any drawee stipulated in the credit;

iv. if the credit provides for negotiation - to negotiate without recourse to drawers and/or bona fide holders, draft(s) drawn by the beneficiary, at sight or at tenor, on the issuing bank or on the applicant for the credit or on any other drawee stipulated in the credit other than the confirming bank itself."

Art. 10 sub c UCP:

"If a bank is authorized or requested by the issuing bank to add its confirmation to a credit but it is not prepared to do so, it must so inform the issuing bank without delay. Unless the issuing bank specifies otherwise in its confirmation authorization or request, the advising bank will advise the credit to the beneficiary without adding its confirmation."

Art. 10 sub d UCP:

"Such undertakings can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank (if any), and the beneficiary. Partial acceptance of amendments

contained in one and the same advice of amendment is not effective without the agreement of all the above named parties."

From these UCP-provisions I would like to conclude the following features of a confirmed documentary credit:

1. Only a irrevocable documentary credit can be confirmed;
2. Only the issuing bank can request confirmation of another bank;
3. The confirmation constitutes a definite undertaking of the confirming bank;
4. This confirmation is added to that of the opening bank.

Ad 1) Is it possible to confirm a revocable credit ?

The UCP does not give an explicit answer to this question. Implicitly the UCP does, because art. 10 UCP gives some provisions for an irrevocable documentary credit. The provision concerning confirmed documentary credits is part of art. 10, so reasoning a contrario one can say that according to the UCP a confirmed documentary credit is not possible.

Still I cannot think of a reason, why a confirmed revocable documentary credit legally should not be possible.

Probably it will be the case, that such a documentary credit is without much practical use, so it will not be used very often. For, a confirmation of a revocable obligation is not worth more than the revocable

obligation itself. A confirmation only becomes important when the primary obligation is irrevocable. This can explain the fact, that the confirmation-provisions (art. 10 sub b and c UCP) are part of the irrevocable credit-provision (art. 10 UCP).

It is academically risky to apply to the UCP-rules a systematical interpretation, since the UCP-rules do not form a kind of systematical regulation but more a compilation of rules which are applied to the use of documentary credits in practice⁸⁷.

The previous conclusion that a confirmation of revocable documentary credits is not possible because the confirmation-provisions are incorporated in the irrevocable credit-provision may therefore be doubtful.

I would say that it will depend on the applicable national law whether a confirmation of a revocable credit is possible or not⁸⁸.

Another solution may be that the credit will be confirmed on the condition that the credit becomes irrevocable. This condition will be a part of the letter of the confirming bank to the beneficiary.

Ad 2) Because the issuing bank is bound under the documentary credit, only the issuing bank can request another bank to confirm its obligation.

In practice however, because of the extra cost of such a confirmation, such a confirmation will be requested by the beneficiary/seller in the underlying contract. Therefore the buyer will request a confirmation in the issuing contract, in order to comply with this clause in the underlying contract.

⁸⁷. See paragraph 1.2.

⁸⁸. See paragraph 1.2.

The request by the issuing bank is just a consequence of this chain of clauses.

Ad 3) The confirmation itself of an irrevocable documentary credit is also irrevocable, definite.

Ad 4) The confirmation does not replace the obligation of the issuing bank. The obligation of the confirming bank is just added to the one of the issuing bank⁷¹.

This does not mean that the beneficiary can make a choice between the issuing and confirming bank. In first instance the beneficiary has to ask the confirming bank for payment. Only in the circumstances that the confirming bank refuses or is not able to pay the beneficiary can request the issuing bank to make the payment⁷².

This situation between the issuing bank and the confirming bank shows a great resemblance to the situation between the buyer and the issuing bank in the case of an un-confirmed irrevocable credit. In the last case is the buyer still liable to make the payment when the issuing bank refuses or is not able to pay⁷³.

Per analogiam I would say that the issuing bank is liable to make the payment, if the confirming bank refuses or is not able to do so. For, as well the buyer as the issuing bank have requested respectively the issuing bank and the confirming bank to make a certain payment under

⁷¹. Kurkela, Matti, Letters of credit under international trade law, p. 71.

⁷². De Rooy, F.P., Documentaire credieten, 1980, p. 38; Tribunal Fédéral Suisse 22 Janvier 1952.

⁷³. See paragraph 1.4.

certain conditions. Neither the issuance nor the confirmation of a documentary credit constitutes a payment as such.

2.3.2 The economical context of a confirmation.

As said before, the confirmation as such does not render an extra benefit to the beneficiary. It just adds a second identical obligation to the first one of the issuing bank. In exchange for this the confirming bank will charge one of the other parties, probably the issuing bank, for a provision-fee. According to Oppenheim this provision/commission-fee will be more or less similar to the interest rate.

Oppenheim:

"When a U.S. bank adds its confirmation to a letter of credit issued by a foreign bank, it does so for a fee charged to the foreign bank and ultimately passed on to the foreign buyer. This fee, which may be called a commission, represents the bank's charge for extending credit. Even though the competition for such business has made the confirmation commission relatively uniform, it is nonetheless the confirming bank's compensation for extending credit."⁹⁴

Alltogether this will raise the cost of the documentary credit-operation as a whole, and therefor the price of the transaction for the buyer will be higher as well.

⁹⁴. Oppenheim, Peter K., International banking, 1983, p. 166 and p. 168.

What are the possible reasons for contracting parties to use a confirmed irrevocable documentary credit:

1. If the beneficiary does not consider the issuing bank to be reliable enough, he shall request in the underlying contract the confirmation by a bank which is reliable in his opinion. Probably this will be his own bank. For instance a documentary credit of a bank in a third world-country is generally considered to be less trustworthy than that of a well-known European or American bank.

2. If the underlying contract demands for a payment of tens of millions dollars, a beneficiary will wonder whether a single bank will be able to make this payment alone.

If the beneficiary hesitates he will demand confirmation by another bank, mostly his own.

Such a confirmation will spread the financial risk, because two banks are independently from each other liable. If the confirming bank does not pay or only pays partly, the issuing bank will remain to be bound for the (rest of) payment.

3. If a documentary credit is confirmed the beneficiary will have a debtor in his own country.

This has several advantages for the beneficiary, because he will not be depending on a possible foreign legal procedure and possible foreign currency measures or instable political situations abroad⁷⁵.

⁷⁵. Oppenheim, Peter K., International banking, 1983, p. 165.

Legally speaking a confirmed documentary credit will result in the biggest security for the exporter/beneficiary that he eventually will be paid by the buyer⁷⁴.

So, summarizing one can say, that a confirmed irrevocable documentary credit will give the highest security for the highest price.

⁷⁴. De Rooy, F.P., Documentaire credieten, 1980, p. 38.

Paragraph 2.4

A transferable documentary credit.

2.4.1. The principle of non-transferability.

In principle the documentary credit is non-transferable.

This principle can be explained by the fact, that the particular characteristics of a beneficiary are important for the documentary credit operation. For instance the beneficiary has to present the documents and can, while doing this, commit a fraud. So for the opener of the credit, the buyer, it can be of great importance to know who the beneficiary is.

Despite the general principle of non-transferability of the documentary credit, the credit can be made transferable if this is expressly stated in the advisory letter.

Art. 54 sub b UCP:

"A credit can be transferred only if it is expressly designated as 'transferable' by the issuing bank. Terms such as 'divisible', 'fractionnable', 'assignable' and 'transmissible' add nothing to the meaning of term 'transferable' and shall not be used."

If a credit is not expressly made transferable, this does not mean that the future creditor's claim on the bank originating from the documentary credit cannot be transferred. Such a transfer is ruled by the

general rules of transferring a creditor's claim to a third person⁷⁷. In general such a transfer is not prohibited⁷⁸, but this question should be answered by the national law which is applicable⁷⁹.

Art. 55 UCP:

"The fact that a credit is not stated to be transferable shall not affect the beneficiary's right to assign any proceeds to which he may be, or may become, entitled under such credit, in accordance with the provisions of the applicable law."

2.4.2. The legal nature of a transfer.

The transfer of a documentary credit has to be considered to be an opening of a new credit. This is the consequence of the UCP: art. 54 sub a, sub e, sub f, and sub g UCP.

The second credit is therefore fully independent from the first credit¹⁰⁰.

Is this independence the same kind of independence as the independence of the documentary credit from the underlying contract?

I would say this is the case. A documentary credit is, like the first documentary credit, an autonomous obligation of the bank to make a payment. This principle also has to apply to the second documentary credit.

⁷⁷. De Rooy, F.P., Documentaire credieten, 1980, p. 40.

⁷⁸. Harfield, H., Bank Credits and Acceptances, 5th Ed., 1974, p. 191/192.

⁷⁹. See paragraph 1.2.

¹⁰⁰. De Rooy, F.P., Documentaire credieten, 1980, p. 43/44; Stoufflet, J., Le Credit Documentaire, 1957, p. 343.



2.4.3. Economical context of a transfer.

Using a transferable documentary credit will only give advantages to the contracting parties in very particular situations.

1. A transferable documentary credit will be requested by a beneficiary, who is acting as a distributor. When he buys goods and will sell them almost immediately, he can ask the his buyer to issue a transferable credit. The distributor then can transfer the documentary credit to his seller.

In this way a distributor can take part in trade-transactions, without financing it by his own means¹⁰¹.

2. A transferable documentary credit is also very useful for an agent. An agent will sell goods in his own name and also will receive payment like this. But the original sellers are entitled to this payment. The agent can transfer the documentary credit in parts¹⁰².

3. A transferable documentary credit also can be used in cases, where regulation prohibits trade between the original seller and the ultimate buyer¹⁰³.

¹⁰¹. De Rooy, F.P., Documentaire credieten, 1980, p. 41.

¹⁰². De Rooy, F.P., Documentaire credieten, 1980, p. 41.

¹⁰³. Idem.

4. According to Oppenheim¹²⁴ transferable letters of credit can be used by businessmen making a business trip.

"He (EL: the businessman) can take with him a letter of credit to himself and transfer portions of it from time to time as he arranges for purchases from manufacturers."

¹²⁴. Oppenheim, Peter K., International banking, 1983, p. 173.



CHAPTER 3

THE BALANCE OF POWER THEORY

Paragraph 3.1

Introduction

If one regards a contract as a way or an agreement to regulate a relationship and the possible conflicts originating from this relationship, then the contract itself and the law should provide norms to solve these conflicts.

This is not different in the case of documentary credits.

A documentary credit operation is a mechanism which provides contracting parties with a mean to settle their payment obligations¹⁰⁵.

This mechanism is governed by norms which are set by national law, ICC-rules (Uniform Customs and Practice for Documentary Credits), Courts and doctrine¹⁰⁶.

Considering the factual operation of a documentary credit one can determine and define two essential and central norms, as has been done in Chapter 1: the principle of independence and the principle of strict compliance. These two norms are the essential principles of a documentary credit operation and provides the device with the necessary

¹⁰⁵. See paragraph 1.7.

¹⁰⁶. See paragraph 1.2.



security. Their interpretations and applications determine the degree of security.

In this chapter I would like to describe these norms and their implications for the usage of documentary credits in the daily practice of commerce.

Paragraph 3.2

Principle of strict compliance

3.2.1. Definition.

Art. 15 UCP:

Banks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit.

Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit.

Lord Sumner:

"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 authorised to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same, or will do just as well.

Business could not proceed securely on any other lines. The bank's branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not.

If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk. The documents tendered were



not exactly the documents which the defendants had promised to take up, and prima facie they were right in refusing to take them."¹²⁷

The Equitable Trust Company Case is an essential case which has established the strict compliance rule.

One can summarize the principle of strict compliance by saying, that it is the principle that the documentary demands as laid down in the advisory letter should be strictly complied with by the beneficiary when presenting the documents to the bank in order to get paid.

After the Equitable Trust Company Case, the principle has been broadly accepted among Lawyers¹²⁸ and Courts¹²⁹.

¹²⁷. Equitable Trust Company of New York v Dawson Partners, Ltd., 2 Lloyd's Law Reports 49 [1927]

¹²⁸. Gutteridge, H.C., and Maurice Megrah, The Law of Bankers' Commercial Credits, 1984, p. 118;
Kurkela, Matti, Letters of Credit under international trade law, 1985, p. 298;
Eisemann, Le crédit documentaire dans le droit et dans la pratique, 1963, p.63;

"C'est justement pourquoi la plus stricte observance des instructions formulées dans les conditions du crédit documentaire (....) constitue le principe suprême de la vérification des documents - pour et contre le bénéficiaire."

Kozolchyck, Boris, Commercial Letters of Credit in the Americas, 1966, p. 416;

Mukoie-Okitunungu, Le Crédit Documentaire, p. 112;

Harfield, Henry, Bank Credits and Acceptances, 1974, p. 74;

De Vuyst, B.M., Documentaire credieten, 1981, no 116;

Rowe, M., Letters of Credit, 1985, p. 57;

Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, p. 105;

Dolan, John F., Strict compliance with letters of credit - striking a fair balance, Banking Law Journal, V102, N1, 1985, p. 18 - 32.

¹²⁹. Equitable Trust Company of New York v Dawson Partners, Ltd, 2 Lloyd's Law Reports 49 [1927];

North Woods Paper Mills v National City Bank of New York, 121 N.Y.S. 2d



3.2.2 The background of the principle of strict compliance.

The background for this principle is to protect the buyer:

Kurkela:

"Any deviation from this principle as to the first tender would be equal to denying the customer's right to reasonable expectations and protection given by this doctrine."¹¹⁰

The buyer wants to derive a certain level of security from the documentary credit operation. He wants to be certain that if the paying bank makes the payment to the beneficiary the latter has shipped the right quantity and quality of the agreed goods at the time as is agreed upon. In order to achieve this the beneficiary is subjected to some documentary demands. He has to fulfill these demands strictly. This is the only way for the buyer to be certain that the payment is made conform the purchase contract, the case of fraud excluded. In order to guarantee a certain degree of objectivity, most of the documents will be issued by third parties, like public authorities or persons which are appointed by the seller and the buyer together.

There is however another reason for the establishment of this doctrine.

543 (Sup. Ct. 1953), aff'd mem. 283 App. Div 731, 127 N.Y.S. 2d 663 (2d Dept. 1954);
Consolidated Aluminium Corp. v Bank of Virginia, 544 F. Supp. 386 (1982);
Bank of America Nat. T. and S. Ass.n. v Liberty Nat. B. & T. Co., 116 F. Supp. 233 (1953);
Insurance Co. of N. America v Heritage Bank, 595 F. 2d 171 (1979);
Banque de l'Indochine et de Suez S.A. v J.H. Rayner (Mincing Lane) Ltd., [1982] 2 Lloyd's Rep. 476.

¹¹⁰. Kurkela, Matti, Letters of credit under international trade law, 1985, p. 298.

This reason concerns the limitation of the bank's obligation.¹¹¹

The bank has to fulfill its obligation to examine the documents (art. 15 UCP) and is liable towards the buyer that he will do this correctly. If for instance the bank accepts documents which do not strictly conform to its demands in the advisory letter without having permission from the buyer to do so, the bank is liable towards the buyer for possible damages.¹¹²

Gutteridge and Megrah:

"Any default in this respect will debar it from claiming reimbursement by the customer of any amount paid against the documents and will also cause it to forfeit its right to remuneration".¹¹³

3.2.3. Exceptions to the principle of strict compliance.

If for instance the documents which are presented by the beneficiary appear to have some minor irregularities, a strict application of the principle of strict compliance can result in the rejection of the documents. Such a rejection can be in the interest of the buyer, for instance because the goods in question have decreased in price in the mean time. In such a situation the buyer likely will try to find a reason to get rid of his contractual obligations.

¹¹¹. Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, p. 105.

¹¹². See paragraph 1.5;
Dolan, John F., Strict compliance with letters of credit - striking a fair balance, Banking Law Journal, V102, N1, 1985, p. 21.

¹¹³. Gutteridge, H.C., and Maurice Megrah, The Law of Bankers' Commercial Credits, 1984, p. 120.

In order to prevent a possible abuse of the principle of strict compliance the application of it should be more or less be mitigated.-

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Gutteridge and Megrah:

"The strict compliance to which Lord Summer drew attention in *Equitable Trust Company of New York v Dawson Partners* does not extend to the dotting of i's and the crossing of t's or to obvious typographical errors either in the credit or the documents."¹¹⁵

This rule which can be called 'the substantial compliance rule'¹¹⁶ has been established before the English Courts in the *Rayner Case*, in which the Court stated that 'compliance of documents with those called for by the credits must entail some license in favour of a tender, for otherwise most credits would be defective in this sense'.¹¹⁷

Before the *Rayner Case*, the rule already had been accepted in the United States Case Law¹¹⁸.

¹¹⁴. See paragraph 1.6;
Dolan, John F., *Strict compliance with letters of credit - striking a fair balance*, *Banking Law Journal*, V102, N1, 1985, p. 21.

¹¹⁵. Gutteridge, H.C., and Maurice Megrah, *idem*, p. 120.

¹¹⁶. Dolan, John F., *Strict compliance with letters of credit*, p. 22.

¹¹⁷. *Banque de l'Indochine et de Suez S.A. v J.H. Rayner (Mincing Lane) Ltd*, [1982] 2 *Lloyd's Rep.* 476, [1983] 1 *Lloyd's Rep.* 228 C.A.

¹¹⁸. *Banco Espanol de Credito v State Street Bank & Trust Company*, 385 F. 2d 230 1st Cir. (1967), 390 U.S. 1013 (1968);
Crocker Commercial Services, Inc. v Countryside Bank, 538 F. Supp. 1360, N.D. Ill. (1981);
Flagship Cruises Ltd. v New England Merchants National Bank, 569 F. 2d

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Dolan has defined some objections against 'the substantial compliance rule'.

Dolan:

"In short, the substantial compliance standard is no standard at all. It is an invitation to controversy. It promotes dispute. It is anathema to the effective functioning of a marvelous commercial device. It transforms the quick, efficient, inexpensive letter of credit into the lumbering, expensive performance bond."¹¹⁷

When saying this Dolan fears that applying 'the substantial compliance rule' implies endangering the main function of a documentary credit: securing a certain payment.

For this reason Courts should in my opinion be very reluctant applying 'the substantial compliance rule'. Non-strictly complying documents should only be honoured by a bank if it is obvious that the buyer does not have a justifiable interest to refuse these documents and only refuses to accept the documents in order to frustrate the normal course of the transaction. I would like to stress that it must be obvious before the Courts and therefore cannot become a subject of discussion that the buyer abuses the principle of strict compliance by refusing the documents; the buyer has not a substantial reason to do so. So, the only reason to mitigate the principle of strict compliance is

699 , 1st Cir. (1978).

¹¹⁷. Dolan, John F., Strict compliance with letters of credit—striking a fair balance, Banking Law Journal, V102, N1, 1985, p. ??.

to prevent giving one of the parties a mechanism which can lead to abuse.

It will depend on the factual circumstances of every individual case, whether there is an event of abuse or not.



Chapter 3.3

The principle of independence

3.3.1 The context of the principle of independence.

Also of great importance for the documentary credit is its independence from the underlying contract, once the documentary credit has been established. I will call this further on the principle of independence.

Zahn, J.C.D.:

"Aus der Natur des Akkreditivs als abstraktem Schuldversprechen mit dem Zweck, dem Begünstigten eine möglichst grosse Sicherheit für die Erlangung des Kaufpreises zu gewährleisten, folgt, dass die Bank dem Begünstigten weder Einwendungen aus dem Kaufvertrag zwischen Käufer und Bank oder zwischen den beiden Banken entgegenhalten kann. Dies entspricht allgemeiner Auffassung und kommt auch deutlich in den ER (EL: UCP) zum Ausdruck."¹⁰⁰

Mukoie-Okitunungu:

"Ce troisième rapport est juridiquement indépendant des deux contrats d'origine - le contrat de vente entre l'acheteur et le

¹⁰⁰. Zahn, Johannes C.D., Zahlung und Zahlungssicherung im Aussenhandel, p. 155.

Translation:

"From the character of a documentary credit, i.e. an abstract promise to pay with the purpose to render the beneficiary a possible higher security that he will be paid, follows, that the bank cannot use a demurrer originating from the buyer-bank relationship or bank-bank relationship."

vendeur et le contrat d'émission de crédit entre l'acheteur et le banquier."¹²¹

This principle of independence also is expressly recognized in the UCP, art. 3 together with art. 4 UCP.

Art. 3 UCP:

"Credits by their nature, are separate transactions from the sales or 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."

Art. 4 UCP:

"In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate."

Of course this independence only exists legally. Economically there is a strong relation between both.

What is the legal situation then. On the moment the documentary credit is established, there will exist for the bank the obligation to pay when the beneficiary hands over the stipulated documents.

Although the buyer of the underlying contract and the opener of the credit may be the same person, although the seller of the underlying contract and the beneficiary of the credit may be the same person,

¹²¹. Mukoie-Okitunungu, Le crédit documentaire, 1976, p. 145.

Translation:

"This third relation is legally independent from the two original contracts - the purchase contract between buyer and seller and the issuing contract between buyer and bank."



legally the documentary credit-relationship and the relationship originating from the underlying contract are absolutely independent from each other.

Legally in both contractual relationships there are different parties:

1. In the documentary credit-operation the bank has a relationship with the parties in their capacity as opener and beneficiary of the credit, not in their capacity as buyer and seller in the underlying contract.
2. In the documentary credit-operation there is no direct relationship between opener and beneficiary.

The bank does not want to get involved legally in the underlying contract. He is just bound to make the payment to the beneficiary for which service the opener of the credit will pay a certain provision. The bank does not want to get involved legally, because of the risk that the bank has to act in a market, in which it's not an expert¹²². In that case one better can stay out of the market.

Sometimes the bank becomes involved in an unknown market, when he demands the documents which are representing the concerned goods to be pledged, in order to secure the bank's involvement¹²³.

In general the bank only wants to act in the financial market, related to other markets. Schmitthoff: "The bank deals in finance, not in goods."¹²⁴ The legal independence of the documentary credit has to be regarded in this light.

¹²². Schmitthoff, Clive, Export Trade, 1980, p. 248.

¹²³. Pabbruwe, H.J., De overeenkomst bank-begunstigde bij het onherroepelijk documentair crediet, p. 316.

¹²⁴. Schmitthoff, Clive, Export Trade, 1980, p. 248.



The less the bank wants to get involved legally, the more probably it is economically^{1e5}. This certainly is the case, if the bank also finances the transaction, what happens very often^{1e6}.

Harfield, H.:

"The banker's function is to finance the transaction, not to participate in it as a principal or immediate party. This separation of financier from the mercantile agreement is the root of commercial credit law and practice. The commercial banker is intimately involved in the commercial transaction, but he is not a party to it.

(.....)

It is essential at the outset, however, to recognize the fundamental precept of commercial credit banking, which is that the bank approaches the mercantile transaction from the outside, remains on the outside, and is bound and governed only by the contract which he himself makes and not by the contract which the commercial parties may have made."^{1e7}

The principle of independence can be regarded as the pendant of the principle of strict compliance^{1e8}.

^{1e5}. Pabbruwe, H.J., De overeenkomst bank-begunstigde bij het onherroepelijk documentair crediet, p. 314.

^{1e6}. Pabbruwe, H.J., *ibid*, p. 316.
and,
De Rooy, F.P., Documentaire credieten, 1980, p. 70/71.

^{1e7}. Harfield, H., *Bank Credits and Acceptances*, 1974, p. 28.

^{1e8}. Mukoie-Okitunungu, *Le crédit documentaire*, p. 145;
See paragraph 3.4.

3.3.2 The acceptance of the principle of independence.

The principle of independence of the underlying contract has generally been accepted among lawyers in different countries.

United Kingdom.

Michael Rowe¹²⁹, The Bhofa Trader Case¹³⁰, the Hamzeh Malas v British Imex Industries Ltd Case¹³¹, Urquhart Lindsay and Co. v Eastern Bank¹³², Dexters v Schenker and Co.¹³³, Stein v Hambros Bank of Northern Commerce¹³⁴ and Scott v Barclays Bank Ltd¹³⁵.

United States.

The principle of independence has been recognized by the United States Commercial Code in art. 5-114 UCC.

¹²⁹. Rowe, M., Letters of Credit, 1985, p. 32.

¹³⁰. The Bhofa Trader Case, [1981] Lloyd's Rep. 256, 257.

¹³¹. Hamzeh Malas v British Imex Industries Ltd, [1957] 2 Lloyd's Rep. 549; 1958 2 Q.B. 127.

¹³². Urquhart Lindsay and Co. v Eastern Bank, [1922] 1 K.B. 318; 9 Lloyd's Law Rep. 572.

¹³³. Dexters v Schenker and Co., [1923] 14 Lloyd's Law Reports 586.

¹³⁴. Stein v Hambros Bank of Northern Commerce, [1921] Lloyd's Law Reports, 433, 507.

¹³⁵. Scott v Barclays Bank Ltd., [1923] 2 KB 1.



Courts: The Case of *Sztejn v J. Henry Schroder Banking Corporation*¹³⁶,
The *Maurice O'Meara Co v National Park Bank Case*¹³⁷.
Doctrine: Oppenheim, Kurkela, Justice and Driscoll¹³⁸.

Germany.

German Jurisprudence¹³⁹ and legal writing¹⁴⁰ take the principle of independence to be established.

France:

*Mukoie-Okitunungu*¹⁴¹.

The Netherlands.

Also Dutch Jurisprudence has recognized the principle of independence

¹³⁶. *Sztejn v J. Henry Schroder Banking Corporation*, 177, Msc. 719, 31 N.Y. Supp. 2d 613, (1941).

¹³⁷. *Maurice O'Meara Co. v National Park Bank*, 239 N.Y. 386, 146 N.E. 636, (1925).

¹³⁸. Oppenheim, Peter, *International Banking*, 1983, p. 141 and p. 150;
Kurkela, Matti, *Letters of Credit under International Trade Law*, 1985, p. 286;
Justice, J.B., *Letters of Credit - Expectations and Frustrations I*, *Banking Law Journal*, V94, N5, 1977, p. 428/429;
Driscoll, Richard J., *The role of standby letters of credit in international commerce - reflections after Iran*, *Virginia Journal of International Law*, V20, N2, 1980, p. 461.

¹³⁹. Reichsgericht 14. November 1919 (*Entscheidungen des Reichsgericht im Zivilsachen* 97, 114.)
and,
Reichsgericht 16. Februar 1923 (*Deutsche Juristen-Zeitung* 1923, 631).

¹⁴⁰. Zahn, Johannes C.D., *Zahlung und Zahlungssicherung im Aussenhandel*, p. 23 and 34.

¹⁴¹. *Mukoie-Okitunungu*, *Le crédit documentaire*, p. 145.

in the *Banque Nationale pour le Commerce et l'Industrie v Nederlandse Credietbank* Case¹⁴².

This judgement has been confirmed by the highest Civil Court in The Netherlands in the *Bulk Oil v Mac Oil* Case¹⁴³ in 1976.

3.3.3 What are the legal consequences ?

1. On the moment the documentary credit has been established, the bank has an autonomous and independent obligation towards the beneficiary, whatever happens with the underlying contract¹⁴⁴.

Any possible nullity of the underlying contract cannot effect any influence on the documentary credit. Any possible nullity of the contract between the issuing bank and the buyer to issue the documentary credit does not effect the documentary credit either.¹⁴⁵

A demurrer originating from the underlying contract (the contract between the buyer and the seller) or originating from the contract between the issuing bank and the buyer to issue the credit (the issuing contract) cannot be put in the bank/beneficiary relationship.¹⁴⁶

¹⁴². *Banque Nationale pour le Commerce et l'Industrie v Nederlandse Credietbank*, Hof Amsterdam, 16 mei 1963, S & S 2 januari 1964, nr 5; NJ 1964, 375.

¹⁴³. *Bulk Oil v Mac Oil*, Hoge Raad 21 mei 1976, NJ 77, 209.

¹⁴⁴. Rowe, M., *Letters of Credit*, p. 32; *The Bhofa Trader* [1981] Lloyd's Rep. 256, 257; *Hamzeh Malas v British Imex Industries Ltd* [1957] 2 Lloyd's Rep. 549, 2 Q.B. 127.

¹⁴⁵. Justice, J.B., *Letters of Credit - Expectations and Frustrations I*, *Banking Law Journal*, V94, N5, 1977, p. 428/429.

¹⁴⁶. Pabbruwe, H.J., *De overeenkomst bank-begunstigde bij het onherroepelijk documentair crediet*, *Weekblad voor Privaatrecht, Notaris-ambt en Registratie*, WPNR 4960, 2 september 1967, p. 337/338.

"Wanneer art. 1 der Regles en Usances het documentair crediet omschrijft als een handeling, onafhankelijk van de koopovereenkomst die er de grondslag van vormt en waar de banken geheel buiten blijven, dan dient daaruit a fortiori te volgen, dat ook een, geheel buiten deze koopovereenkomst staande gebeurtenis als een op de verkochte en geleverde goederen gelegd beslag de rechten en verplichtingen der banken onverlet laat."¹⁴⁷

A bad performance of the seller does not effect the obligation of the bank.

Rowlatt, J.:

"The obligation of the bank is absolute and is meant to be absolute, that when the documents are presented ... (it has) ... to accept the bill. That is the commercial meaning of it ..."¹⁴⁸

2. Any possible nullity of the 'contractual' relationship bank/beneficiary cannot originate from the underlying contract¹⁴⁹ or issuing contract. It must originate from the relationship bank/beneficiary itself.

¹⁴⁷. Banque Nationale pour le Commerce et l'Industrie v Nederlandse Credietbank, Rechtbank Amsterdam 17 mei 1961.

Translation:

"Art. 1 UCP defines the documentary credit as an operation independent from the contract of sale which is the basis for the documentary credit; then this means a fortiori that an event which has nothing to do with the contract of sale like an attachment on the sold goods cannot effect the rights and obligations of the bank."

¹⁴⁸. Stein v Hambros Bank of Northern Commerce, [1921] Lloyd's Rep. 433, 507.

¹⁴⁹. Pabbruwe, H.J., De overeenkomst bank/begunstigde bij het onherroepelijk documentair crediet, Weekblad voor Privaatrecht, Notaris-ambt en Registratie, WPNR 4960, 2 september 1967, p. 340.

Pabbruwe, H.J.:

"Indien de bank geen verweren uit de koopovereenkomst tegenover de verkoper mag invoeren, ligt het voor de hand dat de bank evenmin verweren, welke zij aan de overeenkomst bank-koper mocht ontleenen, tegenover de verkoper mag laten gelden. Het tegendeel zou immers tot onaanvaardbare consequenties leiden."¹⁵⁰

Mukoie-Okitunungu:

"En effet, dès l'instant de crédit est expédiée au vendeur, le banquier est définitivement lié envers lui: il doit payer. Aucun moyen déduit des contrats de base ne justifierait l'inexécution de son engagement (le principe de l'inopposabilité des exceptions)"¹⁵¹

"La règle de l'inopposabilité des exceptions joue donc du fait de ce caractère 'autonome'. (.....)

Le banquier ne peut opposer au vendeur que les exceptions résultant des termes mêmes de la lettre de crédit."¹⁵²

¹⁵⁰. Pabbruwe, H.J., De rechtspositie van de bank bij het documentair crediet, Tijdschrift voor Privaatrecht, 1968, p. 288. The English translation: "The bank is not allowed to put in demurrers originating from the underlying contract into the bank/beneficiary relationship. It seems logical that the same will happen to demurrers originating from the bank/buyer relationship. The contrary would lead to unacceptable consequences."

¹⁵¹. Mukoie-Okitunungu, Le crédit documentaire, p. 139. Translation: "Indeed, from the moment on the credit has been established, the bank is definitively bound: he has to pay. No reason originating from the underlying contract can justify a possible frustration of this obligation (the principle that demurrers cannot be used in the bank/beneficiary relationship).

¹⁵². Mukoie-Okitunungu, Le crédit documentaire, p. 145. Translation: "The principle that demurrers cannot be used in the bank/beneficiary



3. If the conditions of the documentary credit do not meet with the agreed conditions of the underlying contract, the bank remains to have his obligation to pay the beneficiary, when the latter hands over the documents, which are stipulated in the advisory letter. This is for instance the case, if the buyer demands certain documents in the underlying contract and in the issuing contract, but the bank does not do so in the advisory letter. The advisory letter constitutes the documentary credit, so these conditions are the only valid ones.

Gutteridge and Megrah:

"The resulting credit stands by itself, whether or not it is in accordance with the sale contract; if it is not, the seller may either accept it as it stands, repudiate it altogether or persuade the buyer to have it amended to bring it into line with the agreed terms of payment."¹⁵³

Mukoie-Okitunungu:

"L'engagement du banquier étant abstrait, il est difficile de déterminer sa portée et son étendue avec exactitude. Aussi, dans la pratique, cet engagement se matérialise dans un acte écrit: la lettre de crédit. Celle-ci fixe les conditions et les limites de l'engagement du banquier (celui-ci est soumis aux seules conditions de la lettre de crédit).

relationship originates from the character of autonomy of the documentary credit. The banker only can use demurrers originating from the conditions of the advisory letter against the seller."

¹⁵³. Gutteridge, H.C., and Maurice Megrah, *The Law of Bankers' Commercial Credits*, 1984, p. 35.

Ce document prouve l'autonomie de l'engagement du banquier. Il s'exprime en termes indépendants de la vente (le premier rapport juridique) et du crédit (le deuxième rapport juridique). (.....)

'Littéral' et 'autonomie' sont donc les deux faces d'une même réalité puisque 'autonomie' signifie l'abstraction de l'engagement du banquier et 'littéral' est la traduction de cet engagement en termes écrits."¹⁵⁴

If the bank and/or buyer and/or beneficiary want to change the conditions of the advisory letter, the UCP provides for a difficult procedure, see art. 10 sub d UCP. For, the agreement of all the parties concerned is needed.

4. The examination of the documents by the bank is a formal one.

The bank only has to look to the documents, not what is really happening. This is expressly embodied in the UCP-rules in art. 4 juncto art. 16 sub b UCP.¹⁵⁵

Art. 4 UCP:

¹⁵⁴. Mukoie-Okitunungu, Le crédit documentaire, p. 145.

Translation:

"Since the obligation of the bank is independent, it is difficult to determine exactly its intention and the way it has to be understood. In practice however the obligation is laid down in a written document: the advisory letter.

In this letter the conditions and limits of the bank's obligation are fixed.

The letter proves the independency of the bank's obligation. The obligation is expressed in conditions which are independent from the contract of sale (the first legal relationship) and the issuing contract (the second legal relationship). (.....)

So, 'literal' and 'autonomy' are two sides of the same reality, because 'autonomy' means the independence of the bank's obligation and 'literal' is the translation of this obligation in written conditions."

¹⁵⁵. Also: Oppenheim, Peter, International Banking, 1983, p. 142.

In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate.

Art. 16 sub b UCP:

If, upon receipt of the documents, the issuing bank considers that they appear on their face not to be in accordance with the terms and conditions of the credit, it must determine, on the basis of the documents alone, whether to take up such documents, or to refuse them and claim that they appear on their face not to be in accordance with the terms and conditions of the credit.

A fortiori the bank has no obligation to guarantee the validity of the documents. This rule is embodied in art. 17 UCP.

Art. 17 UCP:

Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents or superimposed thereon;
.....

5. Conclusion.

As a conclusion one can say that the principle of independence has two opposite effects, namely:

aa. If the documents are in order, but the seller nevertheless delivers a bad performance, the bank remains to be bound to pay the beneficiary.

The bad performance or even non-performance does not effect the documentary credit.

bb. If the documents are not in order, but the seller nevertheless delivers a good performance the bank is not allowed, or at any case is not bound to pay.

Of course he can pay the beneficiary, but only for his own account. The bank takes then the risk, that he will not be reimbursed. If the bank pays upon presentment of documents which are not in order, the buyer will not have the obligation to reimburse the bank.

3.3.4. The exceptions to the principle of independence.

The consequences of the principle of independence in practice can be rather hard.

For instance in the case of fraud. If one does apply the principle strictly, this can result in a situation that the beneficiary will receive the purchase-price, although it is obvious that the goods are not shipped, or if the goods are shipped, they are of less quality.

In order to prevent this kind of abuse of the principle of independence, the application of the principle has been mitigated.¹⁵⁶

In this context I would like to discuss the mitigation of the principle of independence.

In general lawyers agree on the adage: 'fraus omnia corrumpit.'

¹⁵⁶. See paragraph 3.2

If fraud on behalf of the beneficiary/seller can be proved, the bank in general can refuse payment.

In this sense the *Sztejn v J. Henry Schroder Banking Corporation* Case¹⁵⁷ described the exception of fraud to the principle of independence:

"It is well established that a letter of credit is independent on 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 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."¹⁵⁸

The *Sztejn* Case has established the fraud exception worldwide¹⁵⁹ and also has been accepted by other Courts¹⁶⁰.

¹⁵⁷. *Sztejn v J. Henry Schroder Banking Corporation*, 177 Misc. 719, 31 N.Y.S. 2d 631 (1941).

¹⁵⁸. Also: *Edward Owen Engineering v Barclays Bank International Ltd*, [1978] Q.B. 159; *Intraworld Industries Inc v Girard Trust Bank*, 336A 2d 316 (Pa. Sup. Ct., 1975), 17 UCC Rep. 191 (1975).

¹⁵⁹. Stern, Michael, The independence rule in standby letters of credit, *University of Chicago Law Review*, V52, N1, 1985, p. 219.

¹⁶⁰. *United City Merchants v Royal Bank of Canada*, [1979] 1 Lloyd's L.R. 267, 275 - 277; *Etablissement Esefka International Anstalt v Central Bank of Nigeria*, [1979] 1 Lloyd's L.R. 445, 449.



This exception has been broadly accepted by lawyers: De Vuyst¹⁶¹, Pabbruwe¹⁶², De Rooy¹⁶³, Gutteridge¹⁶⁴, Kozolchyk¹⁶⁵ and Davis¹⁶⁶.

Sometimes however lawyers seem to go beyond this 'fraud omnia corrumpit'-rule. For instance Schoordijk. According to his opinion the bank is not bound to pay the beneficiary, if it is clear 'beyond any reasonable doubt' that in the contractual relationship between buyer and seller/beneficiary the obligation of the buyer to pay does not exist anymore. So this is every situation in which the beneficiary will be bound to repay the purchase-price to the buyer, if he uses his right to be paid by the bank by means of documentary credit. For instance because of the nullity of the contract¹⁶⁷.

In my opinion Schoordijk's opinion goes too far. If the underlying contract will be allowed to influence the documentary credit in whatsoever sense, the main advantage of the documentary credit as an

¹⁶¹. De Vuyst, B.M., Documentaire credieten, 1981, p. 157.

¹⁶². Pabbruwe, H.J., De overeenkomst bank-begunstigde bij het onherroepelijk documentair crediet, Weekblad voor Privaatrecht, Notaris-ambt en Registratie, WPNR 4958, 12 aug. 1967, p. 315; Pabbruwe, H.J., De rechtspositie van de bank bij het documentair crediet, Tijdschrift voor Privaatrecht, 1968, p. 286.

¹⁶³. De Rooy, F.P., Documentaire credieten, 1980, p. 104.

¹⁶⁴. Gutteridge, H.C., and Maurice Megrah, The Law of Bankers' Commercial Credits, 1984, p. 179.

¹⁶⁵. Kozolchyk, Boris, Commercial Letters of Credit in the Americas, 1966, p. 530.

¹⁶⁶. Davis, A.G., The Law relating to Commercial Letters of Credit, 1954, p. 155.

¹⁶⁷. Schoordijk, H.C.F., Beschouwingen over drie-partijen-verhoudingen van obligatoire aard, Ars Aequi 34, 1985, p. 753.

independent security for the beneficiary/seller that he will be paid
will be effected.

Also the bank will be forced to become an actor in the underlying contractual relationship, which is exactly the bank does not want to happen.

"The fewer the cases in which a 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 if it is fraudulent."¹⁶⁶

In my opinion, the only but very important mitigation of the principle of independence is the case of fraud.

Kurkela:

"The only significant exception to the rule that parties in letters of credit deal in documents only and are not concerned with the reality of the transaction is fraud."¹⁶⁷

¹⁶⁶. United City Merchants (Investments) Ltd v Royal Bank of Canada (1977) V no 111.

¹⁶⁷. Kurkela, Matti, Letters of Credit under International Trade Law, 1985, p. 31.

Paragraph 3.4

The balance of power theory

The two above mentioned and described norms, the principle of independence and the principle of strict compliance, as they have been established and developed by Courts and doctrine form in my opinion the balance of power in the documentary credit operation.

The principle of independence can be regarded as the pendant of the principle of strict compliance and vice versa.

Together they keep the balance of power in the documentary credit operation.

They can be regarded as scales. If the principle of independence will be applied less severe, this will favour the buyer/issuer. If the principle of strict compliance will be applied less severe, this will favour the seller/beneficiary.

The two principles therefore provide regulators and Courts with tools to manipulate the balance of power within the documentary credit operation in order to maintain the balance of power in the right balance.

In my opinion this theory applies to all forms of documentary credits. It is an essential part of the theory of documentary credit.

CHAPTER 4

STANDBY LETTERS OF CREDIT.

Paragraph 4.1.

Definition.

Over the last few years one can observe a tremendous growth in the use of standby letters of credit¹⁷⁰. This is especially the case in the United States of America.

This is generally explained by the fact that banks in the USA are not allowed to issue guaranties. Since they are allowed to issue letters of credit, the letter of credit was constructed as a guaranty device: the standby letter of credit¹⁷¹.

One should remember however that guaranties and standby letters of credit differ substantially; they only serve the same function¹⁷².

¹⁷⁰. Dolan, John F., Strict compliance with letters of credit—striking a fair balance, *Banking Law Journal*, V102, N1, 1985, p. 19.

¹⁷¹. Lord, R.A., No-guaranty rule and the standby letter of credit controversy, *Banking Law Journal*, V96, N1, 1979, p. 46 - 63.

¹⁷². Driscoll, Richard J., The role of standby letters of credit in international commerce: reflections after Iran, *Virginia Journal of International Law*, V20, N2, 1980, p. 471:
"Banks lack the statutory authority to guarantee the indebtedness of other parties and therefore commit an ultra vires act when becoming a guarantor."
Lord, R.A., No-guarantee rule and the standby letter of credit controversy, *Banking Law Journal*, V96, N1, 1979, p. 46 - 63.

In 1979 was the total amount in the US of domestic standby letters of credit about \$ 25 bn.; in 1984 this already amounted to \$ 95 bn.¹⁷³ The American Banker reported a total of by the major U.S. banks issued standby letters of credits in 1985, which amounted to \$132 bn¹⁷⁴. Not only U.S. banks issue standby letters of credit. So the total amount of globally outstanding standby letters of credit must be of an enormous seize.

This seize combined with the problems concerning that status and enforceability of standby letters of credit (for instance in the so called Iranian cases¹⁷⁵) seems to make it of interest to have a closer look to the background of this development, the essence of standby letters of credit and possible consequences.

A standby letter of credit is generally considered to be a special kind of documentary credit.

It is defined by legal authorities and lawyers on different occasions.

United Nations Commission on International Trade Law (UNCITRAL):

"The parties to a contract sometimes agree that, in the event of non-performance or defective performance by the obligor, a specified sum is to be payable to the obligee under a letter of credit to be openend in favor of the obligee at the instance of

¹⁷³. Gubernick, Lisa, See footnote (Standby letters of credit), Forbes, V134, Sept. 24 1984, p. 160.

¹⁷⁴. Weiner, L., Standby letters of credit jump 25% in 1984, American Banker, V150, August 28 1985, p. 1.

¹⁷⁵. Driscoll, Richard J., The Role of Standby Letters of Credit in International Commerce: Reflections after Iran, Virginia Journal of International Law, V20, N2, 1980, p. 459 - 504.

the obligor. This standby letter of credit seeks to ensure that the obligor will perform or, in the event of non-performance, or defective performance, that the obligee will be compensated for resulting loss by payment under the credit."¹⁷⁶

The U.S. Comptroller of the Currency's Interpretive Ruling No. 7-1160:

"A standby letter of credit is any letter of credit or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of any obligation".¹⁷⁷

Summarizing one can say that a standby letter of credit creates for the bank a primary obligation to pay a specific amount of money to the beneficiary (a guaranty creates a secondary obligation)¹⁷⁸. As such this is not a difference from a traditional documentary credit, since also a documentary credit creates such an obligation.

Both are mechanisms to allocate contracting parties' risks, by securing payments under certain conditions.¹⁷⁹

¹⁷⁶. UNCITRAL document A/CN.9/163, May 9, 1979.

¹⁷⁷. 12 C.F.R. Sec 7.1160.

¹⁷⁸. Pabbruwe, H.J., De betekenis van de onafhankelijke bankgarantie, 1984.

¹⁷⁹. Stern, Michael, The Independence Rule in Standby Letters of Credit, The University of Chicago Law Review, V 52, N1, 1985, p. 222.

There is however a significant difference.

Stern, M.:

"The traditional letter of credit usually requires a third party to generate some of the documents that the beneficiary must present to the issuer (usually a bill of lading); under the standby letter of credit, the beneficiary usually generates all of the necessary documents himself (usually a simple statement that the customer is in default)."¹⁸⁰

This is one of the most significant differences among others.

It takes however more than just comparing the definitions of a documentary credit and a standby letter of credit to understand the fundamental nature of a standby letter of credit.

In the next paragraph I will try to study the presence of a standby letter of credit in its natural environment, i.e. in what kind cases is a standby letter of credit used.

I will describe two characteristic situations in which a standby letter of credit is used: a standby letter of credit as a performance bond and a standby letter of credit to backstop Commercial Paper programmes.

This does not mean that the device is not used in other situations. On the contrary, it is used in any situation involving an unexecuted promise.¹⁸¹

¹⁸⁰. Stern, Michael, *idem*, p. 222.

¹⁸¹. Dolan, John F., Strict compliance with letters of credit—striking a fair balance, *Banking Law Journal*, V102, N1, 1985, p. 20: "Bail bonds, municipal obligations, child custody arrangements, local

The reason I have chosen these two examples to describe the phenomenon is that most of the standby letters of credit concern these two situations.

improvements, federal food stamp distribution, supply contracts, tax shelter investments, and even the international sale of goods now give rise to standby letters of credit".

Harfield, H., The increasing domestic use of the letter of credit, Uniform Commercial Code Journal, 1972;

Murray, D.E., Letters of credit in nonsale of goods transactions, The Business Lawyer, V30, N4, 1975, p. 1103 - 1123;

Armstrong, A.W., The letter of credit as a lending device in a tight money market, The Business Lawyer, V22, N4, July 1967, p. 1105 etc.

Manifestations of a standby letter of credit.

4.2.1. Standby letter of credit as a performance bond.

To a large extent standby letters of credit have been and still are used in lieu of performance bonds, guaranteeing to the beneficiary one or another performance by the creditor¹⁸². If a certain performance does not take place the bank is obliged to pay a certain amount of money when the guarantor claims the guaranty.¹⁸³

One should note however, that a performance guaranty and a performance letter of credit are not the same despite their similarity. The first one creates for the bank a secondary obligation, whilst the latter creates a primary obligation, which is an essential difference¹⁸⁴.

Especially in construction contracts a standby letter of credit as a performance bond is used.¹⁸⁵

¹⁸². Zimmet, Mark P., Standby letters of credit in the Iran litigation: two hundred problems in search of a solution, Law and Policy in International Business, V16, Fall 1984, p. 928.

¹⁸³. Becker, Joseph D., Standby Letters of Credit and the Iranian Cases: will the independence of the credit survive?, Uniform Commercial Code Journal, V13, N4, 1981, p. 339; Stern, Michael, The Independence Rule in Standby Letters of Credit, The University of Chicago Law Review, V52, N1, 1985, p. 224; Editorial of Harvard Law Review, Fraud in the transaction: enjoining letters of credit during the Iranian Revolution, Harvard Law Review, N5, 1980, p. 992.

¹⁸⁴. Driscoll, Richard, J., The role of standby letters of credit in international commerce: reflections after Iran, Virginia Journal of International Law, V20, N2, 1980, p. 470; Pabbruwe, H.J., De betekenis van de onafhankelijke bankgarantie, 1984.

¹⁸⁵. Murray, D.E., Letters of Credit in Nonsale of goods Transactions, The Business Lawyer, V30, N4, 1975, p. 1104.

In the Middle East tenderers demand a performance standby letter of credit from the contractor. In former times deposits on special escrow accounts were used to guarantee the contractor's performance. Capital however which was used for this purpose could not be used anymore as working capital. A standby letter of credit does not have this disadvantage¹⁹⁶, so it became an attractive and very frequently used alternative.

The buyer of the plant is the beneficiary; the contractor is the issuing party. The buyer requests a standby letter of credit as a security in case of an event of default by the contractor while performing the contract.

construction contract

Contractor	Tenderer/buyer of plant
Issuing	
Contract	Standby letter of credit
Bank	

The advantage for the beneficiary is the simple way of claiming upon this security device. He only has to fulfill some conditions, ranging from certificates of default by engineers to a simple statement of default by the beneficiary himself, in order to receive the payment. The latter usually is the case.

¹⁹⁶. Stern, Michael, The independence rule in standby letters of credit, The University of Chicago Law Review, V52, N1, 1985, p. 226.

Of course this advantage for the beneficiary can cause an unfavourable situation for the contractor, as will be discussed later on. But since the beneficiary normally is in a bargaining position while negotiating a construction contract, he often will be successful in demanding a standby letter of credit.

Gutteridge and Megrah:

"The effect of such a bond or guarantee must depend upon its terms and when first introduced it included an undertaking to pay, but without conditions. This unreasonable requirement was justified by reason that the underlying contract could not have been obtained without it."¹⁸⁷

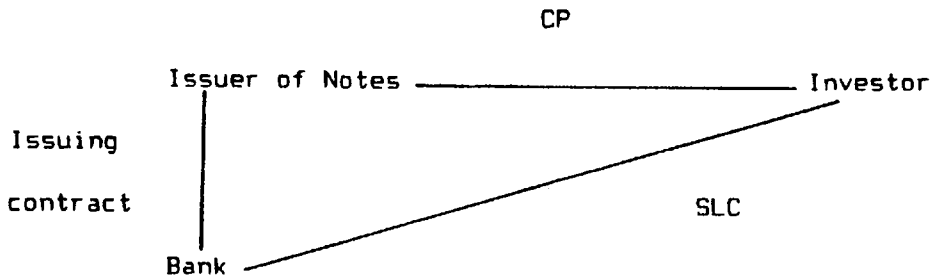
4.2.2. The standby letter of credit to back the issue of Commercial Paper.

Backing the issuance of commercial paper programmes or other bonds by issuing standby letters of credit is one of the fastest developing mechanisms of external corporate financing, especially in the United States.¹⁸⁸

¹⁸⁷. Gutteridge, H.C., and Maurice Megrah, *The Law of Bankers' Commercial Credits*, 1984, p. 15.

¹⁸⁸. Commercial Paper (CP) is a short term (360 days or less), negotiable, unsecured promissory note.

The situation is as follows:



A corporation (issuer) wishes to finance its investment by the issuance of commercial paper. In order to get low funding costs, the issuer will try to get high demand from the investors for its notes. So, the issuer will try to launch a low risk programme.

An investor will judge the risk by looking at the rating of the issuer (Moody and Poor; Standard and Poor). Companies with a bad financial situation will get low ratings or no rating at all and will therefore face high funding costs¹⁸⁹. In order to prevent this, the company will back the issuance of commercial paper by a standby letter of credit issued by a high rated commercial bank. Such a standby letter of credit will secure the interest payments and instalments from the company to the investor. The bank will pay upon the investor's statement that the company is in default.

The advantages for the company issuing commercial paper is clear. It will get low funding costs for its financing. This advantage surpasses the fee the issuer has to pay the banks for issuing the standby letter of credit (3/8% - 5/8% p.a.).

¹⁸⁹. Compare for instance the interest rate on junk bonds.

Another advantage is its irrevocability. Since the standby letter of credit will be an irrevocable commitment, the issuance of commercial paper which is backed by a standby letter of credit is a more reliable source of funds to the borrower than an open line of credit which can be pulled by the bank in case of a material adverse change in the financial position of the borrower.¹⁷⁰

The banks will receive fee income for the issuance of standby letters of credit. Since letter of credit commitments were classified as contingent liabilities and therefore were not reported on the balance sheet, the bank was not required to allocate any equity capital.

At least this was the case before the Iranian crisis. After the crisis standby letters of credit were regarded as loans and the same solvency demands became applicable. The traditional documentary credit is still a contingent liability.

The advantage for the investor is obvious. If commercial paper is backed by a standby letter of credit issued by a prime bank, it enables the investor to look through the creditworthiness of the underlying issuer and buy the paper based on the credit of the bank¹⁷¹. This will on the one hand result in lower yields for the investor, on the other hand it will result in high security for him since the risk of the

¹⁷⁰. Editorial of American Banker, Risks and rewards of standby letters of credit (research into the reasons for the expansion of the negotiable instruments market), V146, December 24 1981, p. 4.

¹⁷¹. Driscoll, Richard J., The role of standby letters of credit in international Commerce: reflections after Iran, Virginia Journal of International Law, V20, N2, 1980, p. 461.

letter of credit-backed commercial paper is the insolvency risk of the issuing bank.

Altogether the letter of credit backed commercial paper market has shown a tremendous growth over the last few years.

1978: \$800 mln.

1981: \$6000 mln.¹⁹⁸¹

After 1981 it has continued growing at even a higher speed.

¹⁹⁸¹. Source: American Banker 1981.

Differences in the use of documentary credits and standby letters of credit.

As said before both documentary credits and standby letters of credit are mechanisms to allocate risks among parties.¹⁷³

In the case of documentary credits this is done by way of introducing a payment mechanism. In the case of a standby letter of credit this is done completely different.

The goal of a documentary credit is to be used, the goal of a standby letter of credit is not to be used. In the case of a documentary credit a normal execution of the underlying contract means that the documentary credit will be used to settle the payment, whereas in the case of a standby letter of credit this means that the standby letter of credit will not be used¹⁷⁴.

Harfield:

"The classic credit contemplates payment upon performance. The standby credit contemplates payment upon failure to perform."¹⁷⁵

¹⁷³. Stern, Michael, The Independence rule in Standby Letters of Credit, University of Chicago Law Review, V52, N1, 1985, p. 222.

¹⁷⁴. Kurkela, Matti, Letters of Credit under International Trade Law, 1985, p. 191;
Driscoll, Richard J., The role of standby letters of credit in international commerce, Virginia Journal of International Law, V20, N2, 1980, p. 468.

¹⁷⁵. Harfield, H., The increasing domestic use of the letter of credit, Uniform Commercial Code Law Journal, 1972, p. 258.

Summarizing one can say that a standby letter of credit is rather a guaranty device, than a payment device.¹⁷⁶ I would regard this to be a very significant and determining difference between a documentary credit and a standby letter of credit.

Another striking difference between both is the documentary element of a documentary credit on the one hand and a standby letter of credit on the other hand.

In order to receive payment, the beneficiary of a documentary credit has to hand over the agreed documents, like bills of lading, insurance documents, certificates of origin etc.. Most of these documents have to be issued by third parties, which renders at least some protection against fraudulent behaviour.

Driscoll:

"To the extent of their liability for erroneous documents, these outside parties provide some measure of protection to the customer against the beneficiary making an invalid demand upon the letter of credit."¹⁷⁷

In the case of a standby letter of credit, the beneficiary will receive payment on single demand, or sometimes upon presentation of documents

¹⁷⁶. Kurkela, Matti, Letters of Credit under International Trade Law: UCC, UCP and Law Merchant, 1985, p. 5, p. 193; Driscoll, Richard J., The role of standby letters of credit in international commerce, p. 468.

¹⁷⁷. Driscoll, Richard J., The role of standby letters of credit in international commerce, p. 467.

which are issued by the beneficiary himself, like a certificate of default¹⁹⁹.

Consequence of all this in the case of a standby letter of credit is a greater risk of fraud.

Stern:

"The standby letter of credit thus involves a greater risk of improper demand than the traditional letter of credit, both for the customer and for the issuing bank."¹⁹⁹

In banker's slang a standby letter of credit on single demand sometimes is called a suicide letter of credit, because of this reason²⁰⁰.

In the following paragraphs I would like to study the consequences of these differences between documentary credits and standby letters of credit.

A question, which should be answered first however, is whether a standby letter of credit should be regarded as a form of a documentary credit or not?

The answer to this question is crucial to determine the rules applicable to standby letters of credit and the method of interpretation of these rules.

¹⁹⁹. Poullet, Yves, Les garanties contractuelles dans le commerce international, Droit et Pratique du Commerce International, Septembre 1979, p. 416.

¹⁹⁹. Stern, Michael, The Independence Rule in Standby Letters of Credit, University of Chicago Law Review, V52, N1, 1985, p. 222; Driscoll, Richard J., The role of standby letters of credit in international commerce, p. 470.

²⁰⁰. To both devices different solvency demands are applicable, because of the different degree of risk which is involved.

If a standby letter of credit can not be regarded as a specific form of a documentary credit, a different set of rules can be applicable to standby letters of credit in international contracts, for instance the rules of Contract Guarantees²⁰¹

If a standby letter of credit should be regarded as a form of documentary credit, despite the differences as I have described, one has to determine the consequences of these differences in the legal approach by Courts and doctrine regarding standby letters of credit.

Is a standby letter of credit a special form of documentary credit or not a documentary credit at all?

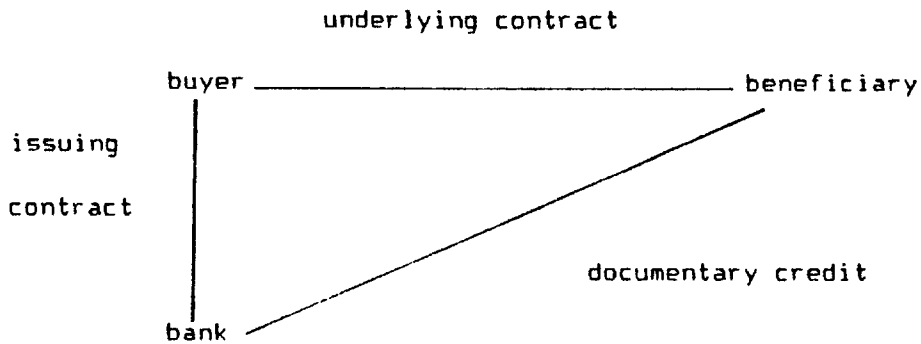
In chapter 1 I have given the main elements of a documentary credit:

1. It is an arrangement between the issuing bank and the applicant (the customer of the bank).
2. The arrangement is established at the request and on the instructions of the applicant.
3. The obligation of the issuing bank is to make a payment to the beneficiary or to accept or pay drafts drawn by the beneficiary.
4. The issuing bank can authorize another bank to effect these obligations.
5. The obligation of the beneficiary in order to receive the payment is to give the stipulated documents to the bank.

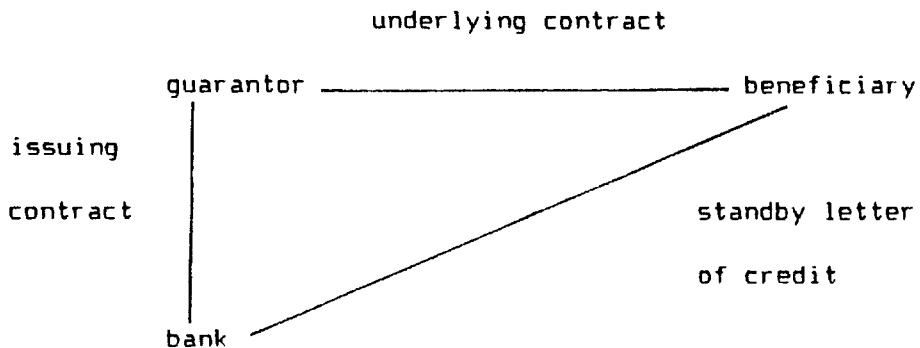
²⁰¹. Also for Contract Guarantees the ICC has developed rules: 'Uniform Rules for Contract Guarantees', ICC-Publication no 325 and no 406.

The case situation in case of a documentary credit:

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The case situation in case of a standby letter of credit:



At first sight there is no difference at all^{POB}. The same contracting parties which are involved in a documentary credit operation are also involved in a standby letter of credit and they have similar obligations.

There is an underlying contract, from which the issuance of the documentary credit/standby letter of credit at the request of the buyer/guarantor originates.

The bank has to make the payment, if the beneficiary fulfills some documentary conditions.

^{POB}. Driscoll, Richard J., The role of standby letters of credit in international commerce: reflections after Iran, Virginia Journal of International Law, V20, N2, 1980, p. 462, 464,

Probably on this moment one can distinguish a significant difference; the documentary element of the respective mechanisms. . . .

In order to receive payment, the beneficiary of a documentary credit has to submit documents proving that he has shipped the right goods at a certain time, whilst the beneficiary of a standby letter of credit mostly will receive payment on single demand. The reason for the latter is, that because of its guaranty character a simple and quick payment is of essential interest to the beneficiary.

So, it might be possible to say that a documentary credit has a high documentary element and a standby letter of credit has a low documentary element²⁰³.

Can this fact stop a standby letter of credit to be regarded as a special form of documentary credit?

In my opinion this is not the case. In principle also a documentary credit can show such a low documentary element.

There are no rules concerning minimal demands of documents. The UCP-rules only require 'documents'.

Tandau de Marsac:

"The documents to be presented (as a condition precedent to the payment) could in theory be clippings from the day's 'Le Monde' or documents of like character or availability."²⁰⁴

²⁰³. Kurkela, Matti, Letters of credit under international trade law, 1985, p. 195.

²⁰⁴. Tandau de Marsac, Xavier, Le paiement et ses garanties dans la vente internationale de biens mobiliers corporels, Droit e Practique du Commerce International, Tome 6, N2, June 1980.

Furthermore, as well a documentary credit as a standby letter of credit creates a primary obligation of the bank towards the beneficiary. This element distinguishes both from a banker's guarantee.

Conclusive one can say that a standby letter of credit in its essence is a specific form of a documentary credit²⁰⁵.

Also Harfield:

"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 documentary credits".²⁰⁶

It is used as a guaranty device and not as a payment device; it has a low documentary element. Also Case Law treats standby letters of credit as a specific form of documentary credit, by applying the normal documentary credit rules²⁰⁷.

²⁰⁵. Kurkela, Matti, Letters of credit under international trade law, 1985, p. 203.

²⁰⁶. Harfield, Henry, The increasing domestic use of the letter of credit, Uniform Commercial Code Law Journal, 1972, p. 258.

²⁰⁷. See the Iranian Cases.

Paragraph 4.4.

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Crisis in the use of standby letters of credit.

4.4.1. The facts.

Buyers of equipment/buildings in the Middle East demanded contractors to issue a guarantee in order to secure their performance²⁰⁰. This guarantee had to be issued by a bank resident in the buyer's country. This bank demanded thereupon a counter standby letter of credit from another bank, mostly a contractor's country's bank. Those guarantees respectively standby letters of credit were issued on single demand, which means that a single statement by the beneficiary respectively the bank that the contractor is in default performing his contract respectively that there has been claimed upon the guarantee is enough for the respective banks to arise an obligation to pay under the guarantee respectively the standby letter of credit.

These standby letters of credit are not without risk and can be considered as blank cheques in favour of the beneficiary. Nevertheless the contractor takes this risk because he thinks also the beneficiary is dependent on this commercial relationship and will probably therefore be reluctant to claim. The only protection for the contractor was the willingness of the beneficiary not to claim.

This normally was the way standby letters of credit were treated by their Middle East beneficiaries, until the Iranian revolution which ringed in the standby letter of credit crisis.

²⁰⁰. See section 4.2.1.

After the Iranian revolution American contractors were not able anymore to perform their contracts, although they were still willing to. Another factor was that that the buyers (mostly the Iranian government) had stopped to make their payments.

It was obvious that the contractors were going to be in default performing their contract and that the Iranian government and other buyers were going to claim the guarantees and consequently the standby letters of credit.

A few companies started to try to prevent the banks from paying upon the claims.

The contractors stated that the beneficiaries would be fraudulent, if they would claim upon the standby letter of credit.

In by far most of the cases the companies were not able to prove fraudulent behaviour, and the beneficiaries were protected by the principle of independence, which was according to the courts also applicable to standby letters of credit.

4.4.2. The Iranian Cases.

The crisis consisted then of two elements which were in conflict and were consequently brought to the Courts attention:

1. if the Courts would enjoin payment in the given circumstances the letter of credit device might possibly lose its trustworthiness, especially if they were used by American Banks.

2. if the Courts would not enjoin payment a standby letter of credit

would potentially become a dangerous instrument, especially in the hands of a mala fide beneficiary, it would become a time bomb.

In the Iranian Cases the Courts were to chose between these elements. Maybe it is possible to say, that the Iranian cases were attempts from the side of the contractors to expand the fraud exception that much, that practically spoken the principle of independence would have disappeared in the case of standby letters of credit.²⁰⁹

The Courts however firmly have prevented these attempts.

Courts have generally chosen in the Iranian Cases not to enjoin payment in order to save the trustworthiness of the standby letter of credit device for the beneficiary²¹⁰.

One has to wonder whether this was the right decision. In the next paragraphs I will do an attempt to answer this question.

²⁰⁹. Becker, Joseph D., Standby Letters of Credit and the Iranian Cases: will the Independence of the Credit survive, Uniform Commercial Code Law Journal, V13, N4, 1981, p. 342.

²¹⁰. KMW v Chase Manhattan, 27 U.C.C.R.S., 203 (1979); American Bell International v Islamic Republic of Iran, 27 U.C.C.R.S. 223 (1979); United Technologies Corp. v Citibank, 469 F. Supp. 473 (S.D.N.Y. 1979); Stromberg Carlson Corp. v Bank Melli Iran, 467 F. Supp. 530 (S.D.N.Y. 1979).

The balance of power theory and Standby Letters of Credit.

4.5.1. Introduction.

As stated in Chapter 3 the independence principle fulfills an essential role in the use of documentary credits in trade transactions. Without this principle the documentary credit could not provide both beneficiary and buyer with the security they wanted to derive from the use of documentary credits.

This principle has been mitigated in its practical consequences by the fraud-exception in the Sztejn Case²¹¹ and in further Case Law.

The question however is arising whether the Sztejn exception concerning fraud also is adequate for standby letters of credit.

Another more fundamental question, which should be answered first however, is whether the principle of independence should be upheld at all in the case of standby letters of credit.

These questions should be seen in the light of the different function which a standby letter of credit has compared to a documentary credit in a trade transaction.

4.5.2. Application of principle of independence to standby letters of credit.

²¹¹. Sztejn v J. Henry Schroder Banking Corporation, 177, Msc. 719, 31 N.Y. Supp. 2d 613, 1941.

Is the principle of independence applicable at all to standby letters of credit?

I would say this is the case. Without this principle a standby letter of credit would lose its main attraction: security, and would in my opinion stop being a documentary credit. The principle of independence is a 'condicio sine qua non' for the existence of a documentary credit. Courts have reaffirmed the applicability of this principle with regard to standby letters of credit.²¹²

As is stated in chapter 3 the principle of strict compliance and the principle of independence form an unity. Together they form the balance of power in the documentary credit-operation. The principle of strict compliance is the scale for the buyer/opener of the credit. The principle of independence is the scale for the seller/beneficiary.

If one applies this theory to the situation of a standby letter of credit, it is obvious that this situation is completely different from a traditional documentary credit.

First of all there hardly are any documentary demands for a beneficiary. He will receive payment on single demand.

If under these circumstances the principle of independence will be applied invariably, the beneficiary will be in an advantageous posi-

²¹²Chase Manhattan v Equibank, 550 F. 2d 882, 3d Circuit (1977); Prudential Insurance Co. v Marquette National Bank, 419 F. Supp. 734, D Minn. (1976); Bossier Band and Trust Company v United Planters National Bank, 550 F. 2d 1077, 1081-82 (6th Cir. 1977); Cappaert Enterprises v Citizens & Southern International Bank, 486 F. Supp. 819, 826 (E.D. La. 1980); Foreign Venture Ltd. Partnership v Chemical Bank, 59 A.D. 2d 352, 399 N.Y.S. 2d 114 (N.Y. App. Div. 1977).

tion, since he does not have an obligation to present strictly complying documents to the bank. This consequence is contrary to the intentions of the principle of independence and strict compliance, since their goal was to establish a balance of power.

If the principle of strict compliance has less meaning because of the lack of documentary demands, the principle of independence should be applied differently. Otherwise the balance of power will be disturbed and the beneficiary will be favoured unjustifiably.

On the other hand however, it is not right to restrict the consequences of the principle of independence in general. This would undermine the legal security of the device and furthermore it would interfere in the parties' intentions. For, it was the intention of parties to provide the beneficiary an unconditional and irrevocable primary guaranty that a certain sum will be paid on first demand²¹³.

A general restriction of the principle of independence could even lead to the situation that a mechanism which is called a standby letter of credit in fact is a guaranty. This is especially relevant in the American situation:

"where as here, the substantive provisions require the issuer to deal not simply in documents alone, but the facts relating to the performance of a separate contract, all distinction between a letter of credit and an ordinary guaranty would be obliterated by regarding the instrument as a letter of credit."²¹⁴

²¹³. Stern, Michael, The independence rule in standby letters of credit, University of Chicago Law Review, V52, N1, 1985, p. 224.

²¹⁴. Wichita Eagle & Beacon Publishing Co v Pacific National Bank, 493 F 2d 1285, 9th Cir. (1974).



If a US Court finds a standby letter of credit to be in fact a guaranty the device becomes illegal, because of the ultra vires rule which prohibits U.S. banks to issue guaranties. So, the principle of independence as such cannot be mitigated, in order to restore the balance of power.

4.5.3. The fraud exception and standby letters of credit.

In order to restore the balance of power between the beneficiary and the issuer of the standby letter of credit (customer of the bank), judges can adapt their application of fraud as an exception to the principle of independence.

The question, however, is how this has to be done. In my opinion all possible solutions have to comply with two conflicting demands:

1. The standby letter of credit has to remain a device fit to irrevocably secure a party's obligation independent from the underlying contract.

2. The standby letter of credit should not become a device which can be easily abused by a beneficiary by unjustifiably demanding payment.

In an editorial of the Harvard Law Review²¹⁵ a possible solution has

²¹⁵. 'Fraud in the transaction': enjoining letters of credit during the Iranian Revolution, Harvard Law Review, V93, 1980, p. 992 - 1015.

been defined, which was called by Stern the 'Breach of Contract Standard'¹⁶.

Harvard Law Review:

"The Code should provide that as to any letter of credit payable not upon evidence of the beneficiary's performance of the underlying contract, but rather upon evidence of the customer's default, the customer should be entitled:

(1) to prior notice of any demand for payment on the credit, and (2) to enjoin payment upon a showing of any valid defense he has on the underlying contract.

Under such a provision, standbys would still guarantee payment to the beneficiary by substituting the bank's solvency for the customer's but would not longer put the customer at risk when the contract breaks down through no fault of his own. The standby would function more like the surety bond....."¹⁷

This solution does not comply with demand 1 and endangers a standby letter of credit to be a primary obligation. With such a rule in force the device would rather be a guaranty or surety than a letter of credit¹⁸.

Furthermore it would endanger the attraction of a standby letter of credit, that it renders a mechanism for prompt payment.

¹⁶. Stern, Michael, The independence rule in standby letters of credit, The University of Chicago Law Review, V52, N1, 1985, p. 229.

¹⁷. 'Fraud in the Transaction': Enjoining letters of credit during the Iranian revolution, Harvard Law Review, V93, 1980, p. 1014.

¹⁸. Also: Stern, Michael, The independence rule in standby letters of credit, p. 238.

After having criticized the 'Breach of Contract Standard' Stern suggests that the fraud exception in the case of standby letters of credit has to be given a narrower definition than the fraud standard applicable to traditional letters of credit²¹⁹.

In my opinion Stern's solution does not meet with requirement 2. If the fraud exception even has to be applied more narrowly, this will favour the beneficiary's position even more, whereas the purpose of the fraud definition should be to reinforce the issuer's/customer's position.

Considering these two proposed solutions it seems that one has to make a choice between the two elements. The same thing happened in the Iranian Cases. A consequence will be, whatsoever choice is made, that the position of either the issuer/customer either the beneficiary will become weaker. Since the balance of power theory integrates both elements, I would like to try to define the fraud exception on this basis.

One has to distinguish two elements when defining the fraud exception in the case of standby letters of credit:

1. the content itself of the fraud exception;
2. rules to substantiate fraud in the case of standby letters of credit.

²¹⁹. Stern, Michael, The independence rule, p. 242, 246.

Together they determine the respective position of the beneficiary and the issuer/customer.

Ad 1) The content of the fraud exception.

Contrary to the opinion of Stern, fraud has in my opinion to be defined broadly in the case of standby letters of credit.

To some extent judges have done this already, albeit very rarely, but they did not derive their legal arguments from the theory of documentary credit, but from the applicable national general theory of contract; arguments like good faith etc.²²⁰

I would say that it is preferable and possible to derive the definition of the fraud exception from the general principles of documentary credits. Such a definition can be internationally uniform, which is an advantage.

The theory of the balance of power gives some points of contact.

Since the beneficiary of a standby letter of credit does not have any documentary demands to fulfill, except from his own statement that the issuer/customer is in default, it is very easy for the beneficiary to abuse rights which he derives from the standby letter of credit²²¹.

²²⁰. Roman Ceramics Corp. v Peoples National Bank, 714 F. 2d 1207, 1212-13 (3d Cir. 1983); Harris Corp v National Iranian Radio and Television, 691 F. 2d 1344, 1354-56 (11th Cir. 1982).

²²¹. Stern, Michael, The independence rule, p. 228; Kimball, George and Barry A. Sanders, Business Lawyer, V39, February 1984, p. 434 - 436; Zimmet, Mark P., Standby letters of credit in the Iran litigation: two hundred problems in search of a solution, Law and Policy in International Business, V16, Fall 1984, p. 935.

I would say that for this reason the Sztejn exception²²² does not go far enough in the case of standby letters of credit, since the Court demanded in this case an 'egregious fraud on the part of the beneficiary'.

Considering the advantageous position of the beneficiary, I would say that it is enough that the beneficiary makes his demand without a reasonable basis²²³.

Whether this is the case will depend on the factual circumstances of every single case. It is for instance the case if the demand only is politically motivated, like in the Iranian cases.

It is obvious that the fraud exception is not restricted to forged documents in the case of standby letters of credit. On the contrary, whether there is fraud will depend on all the factual circumstances surrounding the standby letter of credit²²⁴.

Denning, M.R.:

"That case shows that there is this exception to the strict rule: 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 fundamentally in circumstances in which there is no right to payment"²²⁵.

²²². Sztejn v J. Henry Schroder Banking Corporation, 177 Misc. 719, 31 N.Y.S., 2d 631 (1941).

²²³. Stern, Michael, The independence rule ... ,p. 223.

²²⁴. Driscoll, Richard J., The role of standby letters of credit in international commerce, p. 492:
"With the typical standby letter of credit, the threat of fraud derives not from forged or fraudulent documents but from fraud in the transaction".

²²⁵. Edward Owen v Barclays Bank International Ltd and Another, [1977] 3 W.L.R. 764, 771; [1978] 2 Lloyd's Rep. 106.

Ad 2) Rules to substantiate fraud in case of standby letters of credit.

In the Intraworld Case²²⁶ a Pennsylvania Court has set a standard to prove fraud in the case of a traditional documentary credit.

Intraworld Case:

"We think that the circumstances which will justify an injunction against honor must be narrowly limited to situations of fraud in which 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. A court of equity has the limited duty of guaranteeing that the beneficiary not be allowed to take unconscientious advantage of the situation and run off with the customer's money on a pro forma declaration which has absolutely no basis in fact."

Driscoll regarded the Court's decision as an almost insurmountable barrier for establishing the fraud in the transaction necessary for an injunction against the issuer, by requiring the customer to prove the negative of 'no basis in fact'²²⁷.

I think this hard standard is justified if the fraud exception has been as broadly defined as I have done in the case of standby letters of credit. A soft standard to prove fraud combined with a broad definition

²²⁶. *Intraworld Industries v Girard Trust Bank*, 336 A 2d 316 (Pa. Sup. Cit., 1975), 17 UCC Rep. 191 (1975).

²²⁷. Driscoll, Richard J., *The role of standby letters of credit*, p. 483.

of fraud makes a standby letter of credit too unreliable; something which has to be prevented.

Another reason for such a hard standard to prove fraud is, that it enables Courts and banks to stay outside the underlying contract. The issuer/customer has to show, that it is obvious, considering all the circumstances, that the beneficiary is abusing his rights by demanding payment without a reasonable basis.

If this definition of the fraud exception would have been applied to the Iranian Cases, would the outcome have been different?

I think this definitely would have been the case. And in my opinion the outcome would have been fairer.

It was clear in the Iranian Cases that in general beneficiaries were demanding payment without any reasonable basis, but especially politically motivated.

In the Cases contractors were still busy to perform their contract²²⁸ or even had not started to perform²²⁹.

So, they were definitely not in default when the beneficiary (mostly the State of Iran) claimed upon the standby letter of credit.

²²⁸. American Bell International, Inc v Manufacturers Hanover Trust, 70 A.D. 2d 838, 418 N.Y.S. 2d 551 (1979); Stromberg Carlson Corp v Bank Melli Iran, 467 F. Supp. 530 (S.D.N.Y. 1979); Balfour, Maclaine International Ltd. v Manufacturers Hanover Trust, No 20801/78 (N.Y. Sup. Ct. July 16, 1979).

²²⁹. KMW v Chase Manhattan Bank, 606 F. 2d 10 (2d Cir. 1979).

Under these circumstances there was not a reasonable basis for payment, which was to prove without much difficulties by the issuer/customer.

4.5.4. The practical consequences.

In section 4.5.3. I have attempted to define the fraud exception in the case of standby letters of credit. In this section I would like to suggest some practical consequences of this theoretical discussion of standby letters of credit.

The first problem is that the balance of power theory refers to the beneficiary/customer relationship. How can this theory effect the beneficiary/bank relationship?

For, it is in this relationship that the balance of power theory should have its practical effect. If the beneficiary demands payment under a standby letter of credit, there should be a kind of mechanism which delays the actual payment without endangering the security and irrevocability of a standby letter of credit.

For instance a mechanism which will delay the actual payment obligation of the bank for a few days²³⁰. In this period of time the bank is obliged to notify the customer who can take steps if he thinks that the demand is fraudulent.

One can think of a contractual mechanism.

For instance it is possible to embody in the advisory letter a condition which gives the bank a few days' period of time between the

²³⁰. For instance in the case of *Harris Corp v National Iranian Radio and Television*, 691 F 2d. 1344, 1354-56 (11th Cir. 1982), the Court allowed a preliminary injunction where the beneficiary's demand 'was made in a situation that was subtly suggestive of fraud'.

payment demand and the actual payment. In this period of time the bank is obliged to notify the customer and if necessary the customer can take action if he thinks the payment demand is unjustifiable.

In my opinion this contractual mechanism will not work, since the beneficiary normally is in the bargaining position when negotiating a standby letter of credit²³¹ and will therefore not accept such a condition.

Another possibility is to ask the beneficiary to present documents from independent third parties. For the same reason this will probably not be accepted by the beneficiary²³².

The solution has to be found by adapting the ICC-rules as far as standby letters of credit are concerned.

²³¹. Driscoll, Richard J., The role of standby letters of credit in international commerce, p. 503, 495.

²³². De Vuyst, B.M., Het documentaire crediet als loutere waarborg: de standby letter of credit, Tijdschrift voor Privaatrecht, N3, 1984, p. 1033.

Standby Letters of Credit and the ICC-rules

4.6.1. General.

When the ICC-rules were defined they were meant to be a compilation of existing practices concerning the use of documentary credits.

For that reason the ICC-rules contain that much technical provisions concerning for instance documents.

Originally the UCP did not contain any provision stating a principle or norm of documentary credits.

But once the UCP developed further into a form of lex mercatoria and the UCP became a set of international almost supranational rules, it became necessary to embody some principle or normative rules.

At the occasions of the last revisions some principles were inserted in the UCP, like art. 1 till art. 6 UCP.

But considering the lack of national rules, the role and position of the ICC-rules²³³ and the further development of the documentary credit device, practice will do more and more an appeal on the ICC-rules to cope with these developments. Moreover, practice will need uniform rules in order to establish further development.

In order to do so, the ICC-rules should, without loosing their facilitative function, get a more normatative function.

²³³. See paragraph 1.2.

There is no reason not to do so. Eisemann, who is one of the authors of the ICC-rules, said about it:

"C'est d'autant plus frappant que, officiellement tant les 'Incoterms' que les 'Règles et Usances uniformes relatives aux Crédits documentaires' n'ont d'autre prétention que de constituer des directives non obligatoires, voire de simple recommandations

..... Ceci ne veut cependant pas dire que l'on ait entendu exclure aussi la possibilité que ces règles deviennent plus tard obligatoires en tant qu'usage commercial international"²³⁴

In this context it is remarkable to see that the UCP does not contain a provision regarding fraud, which is one of the corner stones of documentary credit law.

I think it to be very useful to insert in the UCP an article 3a saying for instance:

"In case of egregious fraud from the side of the beneficiary which has come to the knowledge of the bank, the obligation of the bank to make payment to the beneficiary will be suspended."

and in relation with this article a new article 15a:

²³⁴. Eisemann, F., Le crédit documentaire dans le droit et dans la pratique, 1963, p. 4:

Translation:

"It is even more astonishing, that, at least officially, both the 'Incoterms' and the 'Uniform Customs and practice for Documentary Credits' do not have another pretension than establishing non-obligatory directives, considering the simple recommendations

...This will not say, however, that it was also meant to exclude the possibility that these rules would become later obligatory as an international commercial custom".

"If the bank knows or should have known without any reasonable doubt, that the demand for payment from the beneficiary was egregiously fraudulent and the bank nevertheless makes the payment, the obligation of the applicant of the credit to reimburse the bank will terminate".

I think that this last provision is necessary for two reasons:

1. it counterbalances the numerous provisions, in which the banks limit their liabilities,
2. it is an incentive for the bank to be careful, without getting interfered in the underlying contract itself, which would be contrary to the principle of independence.

Another criticism to the UCP is that the UCP is very much written from the point of view of banks. Examples are the articles 15 till 21, in which the banks are extensively protected. In my opinion the UCP needs to be more balanced.

It is however not within the scope of this study and, more importantly, very much beyond my authority to do a proposal for a new definition of the ICC-rules. I would like to restrict myself to standby letters of credit.

4.6.2. ICC-rules and standby letters of credit.

Art. 1 UCP:

"These articles apply to all documentary credits, including, to the extent to which they may be applicable, standby letters of

credit, and are binding on all parties thereto unless otherwise expressly agreed."

The ICC-rules were designed for the traditional commercial documentary credits. For instance the attention which is paid to the documents is a striking example.

This does in my opinion not mean, however, that they are not suited at all to govern standby letters of credit. In principle they do, but to the extent traditional commercial documentary credits are not compatible with standby letters of credit, special rules should be made.

In paragraph 4.5 I came to the conclusion that the best way to create a solution for the standby letter of credit crisis was to adopt some new rules, specially formulated for standby letters of credit.

I would suggest to create a new section G, in which at least the following provisions will be embodied:

Section G Standby letters of credit.

Article 56:

"The articles in this section only apply to standby letters of credit"

Article 57:

"A standby letter of credit is a documentary credit, with the restriction that payment has to be made by the bank on single demand from the side of the beneficiary".

Article 58:

"The bank is obliged to notify the applicant of the credit as soon as possible, if the beneficiary demands payment"

Article 59:

"The bank is obliged to delay to make the payment

1. until 5 official banking days are expired, or

2. until the applicant of the credit has approved for payment.

After one of these events, the bank is obliged to make the payment, subject to article 60".

Article 60:

"In case of a payment demand without a reasonable basis which has come to the knowledge of the bank, the obligation of the bank to make the payment to the beneficiary will be suspended."

I do not have the pretension that my attempt to formulate some new ICC-rules for standby letters of credit is faultless nor exhaustive.

One should regard it solely as an indication how to solve the standby letter of credit crisis by adapting the ICC-rules.

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Practice

As an instrument for conducting business, often on an international level, documentary credits had to have standard definitions and terminology to be fully effective. Principles had to be formulated which were to be applicable to international law and set up in the form of brief concise rules for common usage and practice. These would have to suit all users without causing hindrance or restraint.

The ICC carried out a number of projects in this connection as part of its general activities. Based on a brochure published in 1924 by Union syndicale des banques françaises and reversing rules formulated at ICC Congresses in 1933 and 1951, the results appeared in 1962 as "Brochure No. 222".

Further work, done by the ICC Commission on Banking Technique and Practice, under the chairmanship of Mr. B.S. Wheble, led to a revised version in 1974. This became "Publication No. 290" under the title "Uniform Customs and Practice for Documentary Credits" to which banks in some 156 countries have already adhered.

The latest up-dating is the 1983 Revision (Publication No. 400). It became effective from 1st October, 1984.

It has received the following "blessing" of UNCITRAL.

The United Nations Commission on International Trade Law

Expressing its appreciation to the International Chamber of Commerce for having transmitted to it the revised text of "Uniform Customs and Practice for Documentary Credits", which was approved by the Commission on Banking Technique and Practice of the ICC and adopted by the Council of the ICC on 21 June 1983;

Congratulating the ICC on having made a further contribution to the facilitation of international trade by bringing up to date its rules on documentary credit practice to allow for developments in transport technology and changes in commercial practices;

Having regard to the fact that, in revising the 1974 text of "Uniform Customs and Practice for Documentary Credits", the ICC has taken into account the observations made by Governments and banking and trade institutions of countries not represented within it and transmitted to it through the Commission;

Noting that "Uniform Customs and Practice for Documentary Credits" constitutes a valuable contribution to the facilitation of international trade;

Commends the use of the 1983 revision, as from 1 October 1984, in transactions involving the establishment of a documentary credit.

A. General provisions and definitions

Article 1

These articles apply to all documentary credits, including, to the extent to which they may be applicable, standby letters of credit, and are binding on all parties thereto unless otherwise expressly agreed. They shall be incorporated into each documentary credit by wording in the credit indicating that such credit is issued subject to Uniform Customs and Practice for Documentary Credits, 1983 revision, ICC Publication No. 400.

Article 2

For the purposes of these articles, the expressions "documentary credit(s)" and "standby letter(s) of credit" used herein (hereinafter referred to as "credit(s)"), mean any arrangement, however named or described, whereby a bank (the issuing bank), acting at the request and on the instructions of a customer (the applicant for the credit),

i is to make a payment to or to the order of a third party (the beneficiary), or is to pay or accept bills of exchange (drafts) drawn by the beneficiary, or

ii authorizes another bank to effect such payment, or to pay, accept or negotiate such bills of exchange (drafts), against stipulated documents, provided that the terms and conditions of the credit are complied with.

Article 3

Credits, by their nature, are separate transactions from the sales or 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.

Article 4

In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate.

Article 5

Instructions for the issuance of credits, the credits themselves, instructions for any amendments thereto and the amendments themselves must be complete and precise.

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.

Article 6

A beneficiary can in no case avail himself of the contractual relationships existing between the

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banks or between the applicant for the credit and the issuing bank.

B. Form and notification of credits

Article 7

Credits may be either

i revocable, or

ii irrevocable.

1. All credits, therefore, should clearly indicate whether they are revocable or irrevocable.

2. In the absence of such indication the credit shall be deemed to be revocable.

Article 8

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 shall take reasonable care to check the apparent authenticity of the credit which it advises.

Article 9

1. A revocable credit may be amended or cancelled by the issuing bank at any moment and without prior notice to the beneficiary.

2. However, the issuing bank is bound to:

i reimburse a branch or bank with which a revocable credit has been made available for sight payment, acceptance or negotiation, for any payment, acceptance or negotiation made by such branch or bank prior to receipt by it of notice of amendment or cancellation, against documents which appear on their face to be in accordance with the terms and conditions of the credit.

ii reimburse a branch or bank with which a revocable credit has been made available for deferred payment, if such branch or bank has, prior to receipt by it of notice of amendment or cancellation, taken up documents which appear on their face to be in accordance with the terms and conditions of the credit.

Article 10

1. An irrevocable credit constitutes a definite undertaking of the issuing bank, provided that the stipulated documents are presented and that the terms and conditions of the credit are complied with:

i if the credit provides for sight payment – to pay, or that payment will be made;

ii if the credit provides for deferred payment – to pay, or that payment will be made, on the date(s) determinable in accordance with the stipulations of the credit;

iii if the credit provides for acceptance – to accept drafts drawn by the beneficiary if the credit

stipulates that they are to be drawn on the issuing bank, or to be responsible for their acceptance and payment at maturity if the credit stipulates that they are to be drawn on the applicant for the credit or any other drawee stipulated in the credit;

iv if the credit provides for negotiation – to pay without recourse to drawers and/or bona fide holders, draft(s) drawn by the beneficiary, at sight or at a tenor, on the applicant for the credit or on any other drawee stipulated in the credit other than the issuing bank itself, or to provide for negotiation by another bank and to pay, as above, if such negotiation is not effected.

2. When an issuing bank authorizes or requests another bank to confirm its irrevocable credit and the latter has added its confirmation, such confirmation constitutes a definite undertaking of such bank (the confirming bank), in addition to that of the issuing bank, provided that the stipulated documents are presented and that the terms and conditions of the credit are complied with:

i if the credit provides for sight payment – to pay, or that payment will be made;

ii if the credit provides for deferred payment – to pay, or that payment will be made, on the date(s) determinable in accordance with the stipulations of the credit;

iii if the credit provides for acceptance – to accept drafts drawn by the beneficiary if the credit stipulates that they are to be drawn on the confirming bank, or to be responsible for their acceptance and payment at maturity if the credit stipulates that they are to be drawn on the applicant for the credit or any other drawee stipulated in the credit;

iv if the credit provides for negotiation – to negotiate without recourse to drawers and/or bona fide holders, draft(s) drawn by the beneficiary, at sight or at a tenor, on the issuing bank or on the applicant for the credit or on any other drawee stipulated in the credit other than the confirming bank itself.

3. If a bank is authorized or requested by the issuing bank to add its confirmation to a credit but is not prepared to do so, it must so inform the issuing bank without delay. Unless the issuing bank specifies otherwise in its confirmation authorization or request, the advising bank will advise the credit to the beneficiary without adding its confirmation.

4. Such undertakings can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank (if any), and the beneficiary. Partial acceptance of amendments contained in one and the same advice of amendment is not effective without the agreement of all the above named parties.

Article 11

- a. All credits must clearly indicate whether they are available by sight payment, by deferred payment, by acceptance or by negotiation.
- b. All credits must nominate the bank (nominated bank) which is authorized to pay (paying bank), or to accept drafts (accepting bank), or to negotiate (negotiating bank), unless the credit allows negotiation by any bank (negotiating bank).
- c. Unless the nominated bank is the issuing bank or the confirming bank, its nomination by the issuing bank does not constitute any undertaking by the nominated bank to pay, to accept, or to negotiate.
- d. By nominating a bank other than itself, or by allowing for negotiation by any bank, or by authorizing or requesting a bank to add its confirmation, the issuing bank authorizes such bank to pay, accept or negotiate, as the case may be, against documents which appear on their face to be in accordance with the terms and conditions of the credit, and undertakes to reimburse such bank in accordance with the provisions of these articles.

Article 12

- a. When an issuing bank instructs a bank (advising bank) by any teletransmission to advise a credit or an amendment to a credit, and intends the mail confirmation to be the operative credit instrument, or the operative amendment, the teletransmission must state "full details to follow" (or words of similar effect), or that the mail confirmation will be the operative credit instrument or the operative amendment. The issuing bank must forward the operative credit instrument or the operative amendment to such advising bank without delay.
- b. The teletransmission will be deemed to be the operative credit instrument or the operative amendment, and no mail confirmation should be sent, unless the teletransmission states "full details to follow" (or words of similar effect), or states that the mail confirmation is to be the operative credit instrument or the operative amendment.
- c. A teletransmission intended by the issuing bank to be the operative credit instrument should clearly indicate that the credit is issued subject to Uniform Customs and Practice for Documentary Credits, 1983 revision, ICC Publication No. 400.
- d. If a bank uses the services of another bank or banks (the advising bank) to have the credit advised to the beneficiary, it must also use the services of the same bank(s) for advising any amendments.
- e. Banks shall be responsible for any consequences arising from their failure to follow

the procedures set out in the preceding paragraphs.

Article 13

When a bank is instructed to issue, confirm or advise a credit similar in terms to one previously issued, confirmed or advised (similar credit) and the previous credit has been the subject of amendment(s), it shall be understood that the similar credit will not include any such amendment(s) unless the instructions specify clearly the amendment(s) which is/are to apply to the similar credit. Banks should discourage instructions to issue, confirm or advise a credit in this manner.

Article 14

If incomplete or unclear instructions are received to issue, confirm, advise or amend a credit, the bank requested to act on such instructions may give preliminary notification to the beneficiary for information only and without responsibility. The credit will be issued, confirmed, advised or amended only when the necessary information has been received and if the bank is then prepared to act on the instructions. Banks should provide the necessary information without delay.

C. Liabilities and responsibilities

Article 15

Banks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit.

Article 16

- a. If a bank so authorized effects payment, or incurs a deferred payment undertaking, or accepts, or negotiates against documents which appear on their face to be in accordance with the terms and conditions of a credit, the party giving such authority shall be bound to reimburse the bank which has effected payment, or incurred a deferred payment undertaking, or has accepted, or negotiated, and to take up the documents.
- b. If, upon receipt of the documents, the issuing bank considers that they appear on their face not to be in accordance with the terms and conditions of the credit, it must determine, on the basis of the documents alone, whether to take up such documents, or to refuse them and claim that they appear on their face not to be in accordance with the terms and conditions of the credit.
- c. The issuing bank shall have a reasonable time

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in which to examine the documents and to determine as above whether to take up or to refuse the documents.

d. If the issuing bank decides to refuse the documents, it must give notice to that effect without delay by telecommunication or, if that is not possible, by other expeditious means, to the bank from which it received the documents (the remitting bank), or to the beneficiary, if it received the documents directly from him. Such notice must state the discrepancies in respect of which the issuing 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 (remitting bank or the beneficiary, as the case may be). The issuing bank shall then be entitled to claim from the remitting bank refund of any reimbursement which may have been made to that bank.

e. If the issuing bank fails to act in accordance with the provisions of paragraphs (c) and (d) of this article and/or fails to hold the documents at the disposal of, or to return them to, the presenter, the issuing bank shall be precluded from claiming that the documents are not in accordance with the terms and conditions of the credit.

f. If the remitting bank draws the attention of the issuing bank to any discrepancies in the documents or advises the issuing bank that it has paid, incurred a deferred payment undertaking, accepted or negotiated under reserve or against an indemnity in respect of such discrepancies, the issuing bank shall not be thereby relieved from any of its obligations under any provision of this article. Such reserve or indemnity concerns only the relations between the remitting bank and the party towards whom the reserve was made, or from whom, or on whose behalf, the indemnity was obtained.

Article 17

Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents 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 documents, or for the good faith or acts and/or omissions, solvency, performance or standing of the consignor, the carriers, or the insurers of the goods, or any other person whomsoever.

Article 18

Banks assume no liability or responsibility for the

transit of any messages, letters or documents, or for delay, mutilation or other errors arising in the transmission of any telecommunication. Banks assume no liability or responsibility for errors in translation or interpretation of technical terms, and reserve the right to transmit credit terms without translating them.

Article 19

Banks assume no liability or responsibility for 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 authorized, banks will not, upon resumption of their business, incur a deferred payment undertaking, or effect payment, acceptance or negotiation under credits which expired during such interruption of their business.

Article 20

a. Banks utilising the services of another bank or other banks for the purpose of giving effect to the instructions of the applicant for the credit do so for the account and at the risk of such applicant.

b. Banks assume no liability or responsibility should the instructions they transmit not be carried out, even if they have themselves taken the initiative in the choice of such other bank(s).

c. The applicant for the credit shall be bound by and liable to indemnify the banks against all obligations and responsibilities imposed by foreign laws and usages.

Article 21

a. If an issuing bank intends that the reimbursement to which a paying, accepting or negotiating bank is entitled shall be obtained by such bank claiming on another branch or office of the issuing bank or on a third bank (all hereinafter referred to as the reimbursing bank) it shall provide such reimbursing bank in good time with the proper instructions or authorization to honour such reimbursement claims and without making it a condition that the bank entitled to claim reimbursement must certify compliance with the terms and conditions of the credit to the reimbursing bank.

b. An issuing bank will not be relieved from any of its obligations to provide reimbursement itself if and when reimbursement is not effected by the reimbursing bank.

c. The issuing bank will be responsible to the paying, accepting or negotiating bank for any loss of interest if reimbursement is not provided on first demand made to the reimbursing bank, or as otherwise specified in the credit, or mutually

D. Documents

Article 22

a. All instructions for the issuance of credits and the credits themselves and, where applicable, all instructions for amendments thereto and the amendments themselves, must state precisely the document(s) against which payment, acceptance or negotiation is to be made.

b. Terms such as "first class", "well known", "qualified", "independent", "official", and the like shall not be used to describe the issuers of any documents to be presented under a credit. If such terms are incorporated in the credit terms, banks will accept the relative documents as presented, provided that they appear on their face to be in accordance with the other terms and conditions of the credit.

c. Unless otherwise stipulated in the credit, banks will accept as originals documents produced or appearing to have been produced:

- i by reprographic systems;
 - ii by, or as the result of, automated or computerized systems;
 - iii as carbon copies,
- if marked as originals, always provided that, where necessary, such documents appear to have been authenticated.

Article 23

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 makes it possible to relate the goods and/or services referred to therein to those referred to in the commercial invoice(s) presented, or to those referred to in the credit if the credit does not stipulate presentation of a commercial invoice.

Article 24

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.

D1. Transport documents (documents indicating loading on board or dispatch or taking in charge)

Article 25

Unless a credit calling for a transport document stipulates as such document a marine bill of lading (ocean bill of lading or a bill of lading covering

carriage by sea), or a post receipt or certificate of posting:

a. banks will, unless otherwise stipulated in the credit, accept a transport document which:

- i appears on its face to have been issued by a named carrier, or his agent, and
- ii indicates dispatch or taking in charge of the goods, or loading on board, as the case may be, and
- iii consists of the full set of originals issued to the consignor if issued in more than one original, and
- iv meets all other stipulations of the credit.

b. Subject to the above, and unless otherwise stipulated in the credit, banks will not reject a transport document which:

- i bears a title such as "Combined transport bill of lading", "Combined transport document", "Combined transport bill of lading or port-to-port bill of lading", or a title or a combination of titles of similar intent and effect, and/or
- ii indicates some or all of the conditions of carriage by reference to a source or document other than the transport document itself (short form/blank back transport document), and/or
- iii indicates a place of taking in charge different from the port of loading and/or a place of final destination different from the port of discharge, and/or
- iv relates to cargoes such as those in Containers or on pallets, and the like, and/or
- v contains the indication "intended", or similar qualification, in relation to the vessel or other means of transport, and/or the port of loading and/or the port of discharge.

c. Unless otherwise stipulated in the credit in the case of carriage by sea or by more than one mode of transport but including carriage by sea, banks will reject a transport document which:

- i indicates that it is subject to a charter party, and/or
- ii indicates that the carrying vessel is propelled by sail only.

d. Unless otherwise stipulated in the credit, banks will reject a transport document issued by a freight forwarder unless it is the FIATA Combined Transport Bill of Lading approved by the International Chamber of Commerce or otherwise indicates that it is issued by a freight forwarder acting as a carrier or agent of a named carrier.

Article 26

If a credit calling for a transport document stipulates as such document a marine bill of lading:

a. banks will, unless otherwise stipulated in the credit, accept a document which:

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- i** appears on its face to have been issued by a named carrier, or his agent, and
 - ii** indicates that the goods have been loaded on board or shipped on a named vessel, and
 - iii** consists of the full set of originals issued to the consignor if issued in more than one original, and
 - iv** meets all other stipulations of the credit.
 - b.** Subject to the above, and unless otherwise stipulated in the credit, banks will not reject a document which:
 - i** bears a title such as “Combined transport bill of lading”, “Combined transport document”, “Combined transport bill of lading or port-to-port bill of lading”, or a title or a combination of titles of similar intent and effect, and/or
 - ii** indicates some or all of the conditions of carriage by reference to a source or document other than the transport document itself (short form/blank back transport document), and/or
 - iii** indicates a place of taking in charge different from the port of loading, and/or a place of final destination different from the port of discharge, and/or
 - iv** relates to cargoes such as those in Containers or on pallets, and the like.
 - c.** Unless otherwise stipulated in the credit, banks will reject a document which:
 - i** indicates that it is subject to a charter party, and/or
 - ii** indicates that the carrying vessel is propelled by sail only, and/or
 - iii** contains the indication “intended”, or similar qualification in relation to
 - the vessel and/or the port of loading – unless such document bears an on board notation in accordance with article 27 (b) and also indicates the actual port of loading, and/or
 - the port of discharge – unless the place of final destination indicated on the document is other than the port of discharge, and/or
 - iv** is issued by a freight forwarder, unless it indicates that it is issued by such freight forwarder acting as a carrier, or as the agent of a named carrier.

Article 27

- a.** Unless a credit specifically calls for an on board transport document, or unless inconsistent with other stipulation(s) in the credit, or with article 26, banks will accept a transport document which indicates that the goods have been taken in charge or received for shipment.
- b.** Loading on board or shipment on a vessel may be evidenced either by a transport document bearing wording indicating loading on board a named vessel or shipment on a named vessel, or,

“received for shipment”, by means of a notation of loading on board on the transport document signed or initialled and dated by the carrier or his agent, and the date of this notation shall be regarded as the date of loading on board the named vessel or shipment on the named vessel.

Article 28

- a.** In the case of carriage by sea or by more than one mode of transport but including carriage by sea, banks will refuse a transport document stating that the goods are or will be loaded on deck, unless specifically authorized in the credit.
- b.** Banks will not refuse a transport document which contains a provision that the goods may be carried on deck, provided it does not specifically state that they are or will be loaded on deck.

Article 29

- a.** For the purpose of this article transhipment means a transfer and reloading during the course of carriage from the port of loading or place of dispatch or taking in charge to the port of discharge or place of destination either from one conveyance or vessel to another conveyance or vessel within the same mode of transport or from one mode of transport to another mode of transport.
- b.** Unless transhipment is prohibited by the terms of the credit, banks will accept transport documents which indicate that the goods will be transhipped, provided the entire carriage is covered by one and the same transport document.
- c.** Even if transhipment is prohibited by the terms of the credit, banks will accept transport documents which:
 - i** incorporate printed clauses stating that the carrier has the right to tranship, or
 - ii** state or indicate that transhipment will or may take place, when the credit stipulates a combined transport document, or indicates carriage from a place of taking in charge to a place of final destination by different modes of transport including a carriage by sea, provided that the entire carriage is covered by one and the same transport document, or
 - iii** state or indicate that the goods are in a Container(s), trailer(s), “LASH” barge(s), and the like and will be carried from the place of taking in charge to the place of final destination in the same Container(s), trailer(s), “LASH” barge(s), and the like under one and the same transport document, or
 - iv** state or indicate the place of receipt and/or of final destination as “C.F.S.” (container freight station) or “C.Y.” (container yard) at, or associated with, the port of loading and/or the



Article 30

If the credit stipulates dispatch of goods by post and calls for a post receipt or certificate of posting, banks will accept such post receipt or certificate of posting if it appears to have been stamped or otherwise authenticated and dated in the place from which the credit stipulates the goods are to be dispatched.

Article 31

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 (hereinafter 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 of freight is indicated by other means.

c. The words "freight prepayable" or "freight to be prepaid" or words of similar effect, if appearing on transport documents, will not be accepted as constituting evidence of the payment of freight.

d. Banks will accept transport documents bearing reference by stamp or otherwise to costs additional to the freight charges, such as costs of, or disbursements incurred in connection with, loading, unloading or similar operations, unless the conditions of the credit specifically prohibit such reference.

Article 32

Unless otherwise stipulated in the credit, banks will accept transport documents which bear a clause on the face thereof such as "shippers load and count" or "said by shipper to contain" or words of similar effect.

Article 33

Unless otherwise stipulated in the credit, banks will accept transport documents indicating as the consignor of the goods a party other than the beneficiary of the credit.

Article 34

a. A clean transport document is one which bears no superimposed clause or notation which expressly declares a defective condition of the goods and/or the packaging.

b. Banks will refuse transport documents bearing such clauses or notations unless the credit expressly stipulates the clauses or notations which may be accepted.

c. Banks will regard a requirement in a credit for

a transport document to bear the clause "clean on board" as complied with if such transport document meets the requirements of this article and of article 27 (b).

D2. Insurance documents

Article 35

a. Insurance documents must be as stipulated in the credit, and must be issued and/or signed by insurance companies or underwriters, or their agents.

b. Cover notes issued by brokers will not be accepted, unless specifically authorised by the credit.

Article 36

Unless otherwise stipulated in the credit, or unless it appears from the insurance document(s) that the cover is effective at the latest from the date of loading on board or dispatch or taking in charge of the goods, banks will refuse insurance documents presented which bear a date later than the date of loading on board or dispatch or taking in charge of the goods as indicated by the transport document(s).

Article 37

a. Unless otherwise stipulated in the credit, the insurance document must be expressed in the same currency as the credit.

b. Unless otherwise stipulated in the credit, the minimum amount for which the insurance document must indicate the insurance cover to have been effected is the CIF (cost insurance and freight... "named port of destination") or CIP (freight/carriage and insurance paid to "named point of destination") value of the goods, as the case may be, plus 10%. However, if banks cannot determine the CIF or CIP value, as the case may be, from the documents on their face, they will accept as such minimum amount the amount for which payment, acceptance or negotiation is requested under the credit, or the amount of the commercial invoice, whichever is the greater.

Article 38

a. Credits should stipulate the type of insurance required and, if any, the additional risks which are to be covered. Imprecise terms such as "usual risks" or "customary risks" should not be used; if they are used, banks will accept insurance documents as presented, without responsibility for any risks not being covered.

b. Failing specific stipulations in the credit, banks will accept insurance documents as presented, without responsibility for any risks not being covered.

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Article 39

Where a credit stipulates "insurance against all risks", banks will accept an insurance document which contains any "all risks" notation or clause, whether or not bearing the heading "all risks", even if indicating that certain risks are excluded, without responsibility for any risk(s) not being covered.

Article 40

Banks will accept an insurance document which indicates that the cover is subject to a franchise or an excess (deductible), unless it is specifically stipulated in the credit that the insurance must be issued irrespective of percentage.

D3. Commercial invoice**Article 41**

- a. Unless otherwise stipulated in the credit, commercial invoices must be made out in the name of the applicant for the credit.
- b. Unless otherwise stipulated in the credit, banks may refuse commercial invoices issued for amounts in excess of the amount permitted by the credit. Nevertheless, if a bank authorised to pay, incur a deferred payment undertaking, accept, or negotiate under a credit accepts such invoices, its decision will be binding upon all parties, provided such bank has not paid, incurred a deferred payment undertaking, accepted or effected negotiation for an amount in excess of that permitted by the credit.
- c. 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.

D4. Other documents**Article 42**

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.

E. Miscellaneous provisions

Quantity and amount**Article 43**

- a. The words "about", "circa" or similar

of the credit or the quantity or the unit price stated in the credit are to be construed as allowing a difference not to exceed 10% more or 10% less than the amount or the quantity or the unit price to which they refer.

- b. Unless a credit stipulates that the quantity of the goods specified must not be exceeded or reduced, a tolerance of 5% more or 5% less will be permissible, even if partial shipments are not permitted, always provided that the amount of the drawings does not exceed the amount of the credit. This tolerance does not apply when the credit stipulates the quantity in terms of a stated number of packing units or individual items.

Partial drawings and/or shipments**Article 44**

- a. Partial drawings and/or shipments are allowed, unless the credit stipulates otherwise.
- b. Shipments by sea, or by more than one mode of transport but including carriage by sea, made on the same vessel and for the same voyage, will not be regarded as partial shipments, even if the transport documents indicating loading on board bear different dates of issuance and/or indicate different ports of loading on board.
- c. Shipments made by post will not be regarded as partial shipments if the post receipts or certificates of posting appear to have been stamped or otherwise authenticated in the place from which the credit stipulates the goods are to be dispatched, and on the same date.
- d. Shipments made by modes of transport other than those referred to in paragraphs (b) and (c) of this article will not be regarded as partial shipments, provided the transport documents are issued by one and the same carrier or his agent and indicate the same date of issuance, the same place of dispatch or taking in charge of the goods and the same destination.

Drawings and/or shipments by instalments**Article 45**

If drawings and/or shipments by instalments within given periods are stipulated in the credit and any instalment is not drawn and/or shipped within the period allowed for that instalment, the credit ceases to be available for that and any subsequent instalments, unless otherwise stipulated in the credit.

Expiry date and presentation**Article 46**

- a. All credits must stipulate an expiry date for presentation of documents for payment,



1 Except as provided in Article 48 (a), documents must be presented on or before such expiry date.

2 If an issuing bank states that the credit is to be available "for one month", "for six months" or the like, but does not specify the date from which the time is to run, the date of issuance of the credit by the issuing bank will be deemed to be the first day from which such time is to run. Banks should discourage indication of the expiry date of the credit in this manner.

Article 43

In addition to stipulating an expiry date for presentation of documents, every credit which calls for a transport document(s) should also stipulate a specified period of time after the date of issuance of the transport document(s) during which presentation of documents for payment, acceptance or negotiation must be made. If no such period of time is stipulated, banks will refuse documents presented to them later than 21 days after the date of issuance of the transport document(s). In every case, however, documents must be presented not later than the expiry date of the credit.

1 For the purpose of these articles, the date of issuance of a transport document(s) will be deemed to be:

i in the case of a transport document evidencing dispatch, or taking in charge, or receipt of goods for shipment by a mode of transport other than by air – the date of issuance indicated on the transport document or the date of the reception stamp thereon whichever is the later.

ii in the case of a transport document evidencing carriage by air – the date of issuance indicated on the transport document or, if the credit stipulates that the transport document shall indicate an actual flight date, the actual flight date as indicated on the transport document.

iii in the case of a transport document evidencing loading on board a named vessel – the date of issuance of the transport document or, in the case of an on board notation in accordance with article 27 (b), the date of such notation.

iv in cases to which Article 44 (b) applies, the date determined as above of the latest transport document issued.

Article 44

1 If the expiry date of the credit and/or the last day of the period of time after the date of issuance of the transport document(s) for presentation of documents stipulated by the credit or applicable by virtue of Article 47 falls on a day on which the bank to which presentation has to be made is

closed for reasons other than those referred to in Article 19, the stipulated expiry date and/or the last day of the period of time after the date of issuance of the transport document(s) for presentation of documents, as the case may be, shall be extended to the first following business day on which such bank is open.

2 The latest date for loading on board, or dispatch, or taking in charge shall not be extended by reason of the extension of the expiry date and/or the period of time after the date of issuance of the transport document(s) for presentation of document(s) in accordance with this article. If no such latest date for shipment is stipulated in the credit or amendments thereto, banks will reject transport documents indicating a date of issuance later than the expiry date stipulated in the credit or amendments thereto.

3 The bank to which presentation is made on such first following business day must add to the documents its certificate that the documents were presented within the time limits extended in accordance with Article 48 (a) of the Uniform Customs and Practice for Documentary Credits, 1983 revision, ICC Publication No. 400.

Article 45

Banks are under no obligation to accept presentation of documents outside their banking hours.

Article 46

Article 47

Article 48

1 Unless otherwise stipulated in the credit, the expression "shipment" used in stipulating an earliest and/or a latest shipment date will be understood to include the expressions "loading on board", "dispatch" and "taking in charge".

2 The date of issuance of the transport document determined in accordance with Article 47 (b) will be taken to be the date of shipment.

3 Expressions such as "prompt", "immediately", "as soon as possible", and the like should not be used. If they are used, banks will interpret them as a stipulation that shipment is to be made within thirty days from the date of issuance of the credit by the issuing bank.

4 If the expression "on or about" and similar expressions are used, banks will interpret them as a stipulation that shipment is to be made during the period from five days before to five days after the specified date, both end days included.

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Date terms

Article 51

The words "to", "until", "till", "from", and words of similar import applying to any date term in the credit will be understood to include the date mentioned. The word "after" will be understood to exclude the date mentioned.

Article 52

The terms "first half", "second half" of a month shall be construed respectively as from the 1st to the 15th, and the 16th to the last day of each month, inclusive.

Article 53

The terms "beginning", "middle", or "end" of a month shall be construed respectively as from the 1st to the 10th, the 11th to the 20th, and the 21st to the last day of each month, inclusive.

F. Transfer

Article 54

- a. A transferable credit is a credit under which the beneficiary has the right to request the bank called upon to effect payment or acceptance or any bank entitled to effect negotiation to make the credit available in whole or in part to one or more other parties (second beneficiaries).
- b. A credit can be transferred only if it is expressly designated as "transferable" by the issuing bank. Terms such as "divisible", "fractionable", "assignable", and "transmissible" add nothing to the meaning of the term "transferable" and shall not be used.
- c. The bank requested to effect the transfer (transferring bank), whether it has confirmed the credit or not, shall be under no obligation to effect such transfer except to the extent and in the manner expressly consented to by such bank.
- d. Bank charges in respect of transfers are payable by the first beneficiary unless otherwise specified. The transferring bank shall be under no obligation to effect the transfer until such charges are paid.
- e. A transferable credit can be transferred once only. Fractions of a transferable credit (not exceeding in the aggregate the amount of the credit) can be transferred separately, provided partial shipments are not prohibited, and the aggregate of such transfers will be considered as constituting only one transfer of the credit. The credit can be transferred only on the terms and conditions specified in the original credit, with the exception of the amount of the credit, of any unit prices stated therein, of the period of validity, of

the last date for presentation of documents in accordance with Article 47 and the period for shipment, any or all of which may be reduced or curtailed, or the percentage for which insurance cover must be effected, which may be increased in such a way as to provide the amount of cover stipulated in the original credit, or these articles. Additionally, the name of the first beneficiary can be substituted for that of the applicant for the credit, but if the name of the applicant for the credit is specifically required by the original credit to appear in any document other than the invoice, such requirement must be fulfilled.

- f. The first beneficiary has the right to substitute his own invoices (and drafts if the credit stipulates that drafts are to be drawn on the applicant for the credit) in exchange for those of the second beneficiary, for amounts not in excess of the original amount stipulated in the credit and for the original unit prices if stipulated in the credit, and upon such substitution of invoices (and drafts) the first beneficiary can draw under the credit for the difference, if any, between his invoices and the second beneficiary's invoices. When a credit has been transferred and the first beneficiary is to supply his own invoices (and drafts) in exchange for the second beneficiary's invoices (and drafts) but fails to do so on first demand, the paying, accepting or negotiating bank has the right to deliver to the issuing bank the documents received under the credit, including the second beneficiary's invoices (and drafts) without further responsibility to the first beneficiary.
- g. Unless otherwise stipulated in the credit, the first beneficiary of a transferable credit may request that the credit be transferred to a second beneficiary in the same country, or in another country. Further, unless otherwise stipulated in the credit, the first beneficiary shall have the right to request that payment or negotiation be effected to the second beneficiary at the place to which the credit has been transferred, up to and including the expiry date of the original credit, and without prejudice to the first beneficiary's right subsequently to substitute his own invoices and drafts (if any) for those of the second beneficiary and to claim any difference due to him.

Assignment of proceeds

Article 55

The fact that a credit is not stated to be transferable shall not affect the beneficiary's right to assign any proceeds to which he may be, or may become, entitled under such credit, in accordance with the provisions of the applicable law.



§ 4-504 UNIFORM COMMERCIAL CODE
§ 4-504. Privilege of Presenting Bank to Deal With Goods;
Security Interest for Expenses

(1) A presenting bank which, following the dishonor of a documentary draft, has seasonably requested instructions but does not receive them within a reasonable time may store, sell, or otherwise deal with the goods in any reasonable manner.

(2) For its reasonable expenses incurred by action under subsection (1) the presenting bank has a lien upon the goods or their proceeds, which may be foreclosed in the same manner as an unpaid seller's lien.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes: To give the presenting bank, after dishonor, a privilege to deal with the goods in any commercially reasonable manner pending instructions from its transferor and if still unable to communicate with its principal after a reasonable time, a right to realize its expenditures as if foreclosing on an unpaid seller's lien (Section 2-706). The provision includes situations in which storage of goods or other action becomes commercially necessary pending receipt of any

Official Comment requested instructions, even if the requested instructions are later received.

The "reasonable manner" referred to means one reasonable in the light of business factors and the judgment of a business man.

Cross References: Sections 4-503 and 2-706.

Definitional Cross References: "Presenting bank", Section 4-105.
 "Documentary draft", Sections 4-104, 5-103.

ARTICLE 5

LETTERS OF CREDIT

Section

- 5-101. Short Title.
- 5-102. Scope.
- 5-103. Definitions.
- 5-104. Formal Requirements; Signing.
- 5-105. Consideration.
- 5-106. Time and Effect of Establishment of Credit.
- 5-107. Advice of Credit; Confirmation; Error in Statement of Terms.
- 5-108. "Notation Credit"; Exhaustion of Credit.
- 5-109. Issuer's Obligation to Its Customer.
- 5-110. Availability of Credit in Portions; Presenter's Reservation of Lien or Claim.
- 5-111. Warranties on Transfer and Presentation.
- 5-112. Time Allowed for Honor or Rejection; Withholding Honor or Rejection by Consent; "Presenter".
- 5-113. Indemnities.
- 5-114. Issuer's Duty and Privilege to Honor; Right to Reimbursement.
- 5-115. Remedy for Improper Dishonor or Anticipatory Repudiation.
- 5-116. Transfer and Assignment.
- 5-117. Insolvency of Bank Holding Funds for Documentary Credit.

§ 5-101. Short Title

This Article shall be known and may be cited as Uniform Commercial Code—Letters of Credit.

Official Comment

Letters of credit have been known and used for many years, in both international and domestic transactions, and in many forms; but except for a few provisions, like Section 135 of the Negotiable Instruments Law, they have not been the subject of statutory enactment, and the law concerning them has been developed in the cases.

This provision of the Negotiable Instruments Law is no longer in the Code. See the contrary rule in Section 3-410 on the definition of acceptance. The other source of law respecting letters of credit is the law of contracts with occasional unfortu- nate excursions into the law of guaranty. This Article is intended within its limited scope (see Comment to Section 5-102) to set an independent theoretical frame for the further development of letters of credit.

Cross References: Sections 5-102, 5-103, and 3-410.

(1) This Article applies

(a) to a credit issued by a bank if the credit requires a documentary draft or a documentary demand for payment; and

(b) to a credit issued by a person other than a bank if the credit requires that the draft or demand for payment be accompanied by a document of title; and

(c) to a credit issued by a bank or other person if the credit is not within subparagraphs (a) or (b) but conspicuously states that it is a letter of credit or is conspicuously so entitled.

(2) Unless, i.e. engagement meets the requirements of subsection (1), this Article does not apply to engagements to make advances or to honor drafts or demands for payment, to authorize to pay or purchase, to guarantee or to general agreements.

(3) This Article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop. The fact that this Article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this Article.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes: To define the transactions to which this Article applies and to indicate that the rules stated are not intended to be exhaustive of the law applicable to letters of credit.

1. Although letters of credit are commonly thought of as being issued by banks and private bankers, other financing institutions can and do enter into transactions which fit the traditional concept of letters of credit. This is particularly true when the financing institution at the request of a buyer of goods promises the seller of the goods

that it will pay or accept drafts or demands for payment on either the buyer or itself if the drafts are accompanied by documents of title covering the goods involved in the sales contract. Banks and private bankers also issue money credits which do not require documents of title to be presented as one of the conditions of honor. So far as these institutions are concerned the accompanying papers can range from a certification that certain building contracts have been performed in whole or in part or a notice that goods have been sent or a notice of default of some kind into the more traditional document of title. Subsection (1) attempts to make clear that automatic

application of this Article to the transaction in question depends upon the nature of the issuer. Paragraph (1) (a) is applicable to banks and states that whenever the promise to honor is conditioned on presentation of any piece of paper, the transaction is within this Article whereas paragraph (1) (b) makes automatic application of the Article to transactions involving issuers other than banks dependent upon the requirement of a document of title.

Since banks issue "clean" as well as "documentary" credits and since other persons may desire to bring transactions involving papers other than documents of title within the coverage of this Article, paragraph (1) (c) permits the issuer to do so by conspicuous notation that the paper is a letter of credit. Whether a transaction falls within the mandatory or the permissive paragraphs of subsection (1) is also of importance on the question of payment of funds held by an issuer at the time of its insolvency (See Section 5-117).

Subsection (2) states the negative of the rules of applicability of subsection (1) for greater clarity but is not intended to either enlarge or limit the tests of applicability there laid down.

2. Subsection (3) recognizes that in the present state of the law and variety of practices as to letters of credit, no statute can effectively or wisely codify all the possible law of letters of credit without stultifying further development of this useful

financing device. The more important areas not covered by this Article revolve around the question of when documents in fact and in law do or do not comply with the terms of the credit. In addition such minor matters as the absence of expiration dates and the effect of extending shipment but not expiration dates are also left untouched for future adjudication. The rules embodied in the Article can be viewed as those expressing the fundamental theories underlying letters of credit. For this reason the second sentence of subsection (3) makes explicit the court's power to apply a particular rule by analogy to cases not within its terms, or to refrain from doing so. Under Section 1-102(1) such application is to follow the canon of liberal interpretation to promote underlying purposes and policies. Since the law of letters of credit is still developing, conscious use of that canon and attention to fundamental theory by the court are peculiarly appropriate.

Cross Reference:
Section 1-102.

Definitional Cross References:
"Agreement", Section 1-201.
"Bank", Section 1-201.
"Conspicuous", Section 1-201.

"Credit", Section 5-103.
"Documentary draft", Section 5-103.
"Document of title", Section 1-201.
"Draft", Section 3-104.
"Honor", Section 1-201.
"Person", Section 1-201.



03. Definitions

In this Article unless the context otherwise requires

"Credit" or "letter of credit" means 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. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor.

"Documentary draft" or a "documentary demand for payment" is one honor of which is conditioned upon the presentation of a document or documents. "Document" means any paper including document of title, security, invoice, certificate, notice of default and the like.

An "issuer" is a bank or other person issuing a credit. A "beneficiary" of a credit is a person who is entitled under its terms to draw or demand payment.

An "advising bank" is a bank which gives notification of the issuance of a credit by another bank.

A "confirming bank" is a bank which engages either that it will itself honor a credit already issued by another bank or that such a credit will be honored by the issuer or a third bank.

A "customer" is a buyer or other person who causes an issuer to issue a credit. The term also includes a bank which procures issuance or confirmation on behalf of that bank's customer.

her definitions applying to this Article and the sections they appear are:

tion of Credit".

Section 5—108.

Section 5—112(3).
Definitions in other Articles applying to this Article and in which they appear are:

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Section 3—410.

tract for sale".

Section 2—106.

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Section 3—104.

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Section 8—102.

(4) In addition, Article 1 contains general definitions and principles of construction and interpretation applicable throughout this Article.

Official Comment

Prior Uniform Statutory Provisions: None.

Purposes:

To define terms used in this Article.

1. Paragraph (a) of subsection (1) in defining a "credit" or "letter of credit" sets forth the requirement that the engagement of the bank or other person to honor drafts or other demands for payment be at the request of another and involve a transaction falling within the scope of this Article (Section 5—102). It then makes clear that the "engagement" may be by way of agreement, that is, a promise to honor, or by way of an authority to honor, thus including within the definition of letter of credit, papers called "authorities to purchase or pay". The definition also makes clear that the engagement may be either revocable or irrevocable, the legal consequences of which are spelled out in Section 5—106 on the time and effect of establishment of a credit. Neither the definition nor any other section of this Article deals with the issue of when a credit, not clearly labelled as either revocable or irrevocable falls within the one or the other category although the Code settles this issue with respect to the sales contract (Section 2—325). This issue so far as it affects an issuer under this Article is intentionally left to the courts for decision in the light of the facts and gen-

eral law (Section 1—103) with due regard to the general provisions of the Code in Article 1 particularly Section 1—205 on course of dealing and usage of trade.

2. Paragraph (b) is intended to show that the word "document" is far broader than "document of title" for the purposes of this Article. This is of special importance with respect to the application of the Article to banks under Section 5—102(1) (a) and differs from the definition of "document" in Article 9 on secured transactions which is here limited to documents of title. See Section 9—106(1) (e).

3. The legal relations between the issuer (1) (c) and the beneficiary (1) (d) and between the issuer and the customer (1) (g) are spelled out in other sections of this Article. The legal relations between the customer and the beneficiary turn on the underlying transaction between them: if that transaction be one of sale of goods, their rights depend upon Article 2; if the transaction involves the sale of investment securities, Article 8 will be applicable; if the transaction involves the transfer of commercial paper, Article 3 will be applicable; if documents of title are transferred, Article 7 will be applicable; and if the transaction is intended to create a security interest, Article 9 will apply. The issuer is not a guarantor of the performance of



se underlying transactions. Section 5-109. 107 on advice of credit; confirmation; error in statement.

The definition of customer in subsection (1) (r) is expressly made to include a bank which is acting for its customer so that a particular transaction may well involve a merchant issuing bank and two customers, one of whom is the male customer as, e.g., the owner of goods and the other of whom is the buyer's local bank which has requested the merchant bank to issue the credit.

The definitions of "adviser" and "confirming" banks in section (1) (e) and (f) do not include a statement of their legal consequences. These are set out primarily in Section 5-104.

5-104. Formal Requirements: Signing
1) Except as otherwise required in subsection (1) (c) of Section 5-102 on scope, no particular form of phrasing is required for a credit. A credit must be in writing and signed by the issuer and a confirmation must be in writing and signed by the issuing bank. A modification of the terms of a credit or confirmation must be signed by the issuer or confirming bank.

A telegram may be a sufficient signed writing if it identifies sender by an authorized authentication. The authentication may be in code and the authorized naming of the issuer and advice of credit is a sufficient signing.

Official Comment
Uniform Statutory Provisions: None.

Subsection (1) is to make that, except for the state or title required by Section 5-102(1) (c) to bring certain transactions within the scope of this Article, no particular form need be followed. It is

107 on advice of credit; confirmation; error in statement.
Cross References:
Point 1: Sections 5-102, 5-106, 1-103, 1-205, 2-325 and Article 1.
Point 2: Sections 5-102, 1-201 and 9-105.
Point 3: Articles 2, 3, 7, 8 and 9; Section 5-109.
Point 5: Section 5-107.

Definitional Cross References:
"Agreement", Section 1-201.
"Bank", Section 1-201.
"Document of title", Section 1-201.
"Give notice", Section 1-201.
"Honor", Section 1-201.
"Person", Section 1-201.

any modification is subject to the same requirements of signing and writing. Compare Section 2-209(3) on sale of goods. Questions of mistake, waiver or estoppel are left to supplementary principles of law. See Section 1-103.

2. Subsection (2), although perhaps unnecessary in view of the definition of "signed" in Section 1-201, is inserted here to make certain that code and authorized naming of an issuer is a sufficient signing. These forms of signing are so customary that their explicit inclusion is useful to eliminate all controversy on the point.
Cross References:
Point 1: Sections 5-102, 2-209, and 1-103.
Point 2: Section 1-201.
Definitional Cross References:
"Confirming bank", Section 5-103.
"Credit", Section 5-103.
"Issuer", Section 5-103.
"Signed", Section 1-201.
"Telegram", Section 1-201.
"Term", Section 1-201.
"Writing", Section 1-201.

5-105. Consideration
No consideration is necessary to establish a credit or to enlarge or otherwise modify its terms.

Official Comment
Prior Uniform Statutory Provisions: None.

Purposes:
It is not to be expected that a financial institution will engage its credit without some form of expected remuneration. But it is not expected that the beneficiary will know what the issuer's remuneration was, or whether in

fact there was any identifiable remuneration in a given case. And it would be extraordinarily difficult for the beneficiary to prove the issuer's remuneration. This section dispenses with such proof.
Definitional Cross References:
"Credit", Section 5-103.
"Terms", Section 1-201.

5-106. Time and Effect of Establishment of Credit
(1) Unless otherwise agreed a credit is established

(a) as regards the customer as soon as a letter of credit is sent to him or the letter of credit or an authorized written advice of its issuance is sent to the beneficiary; and
(b) as regards the beneficiary when he receives a letter of credit or an authorized written advice of its issuance.

(2) Unless otherwise agreed once an irrevocable credit is established as regards the customer it can be modified or revoked only with the consent of the customer and once it is established as regards the beneficiary it can be modified or revoked only with his consent.

(3) Unless otherwise agreed after a revocable credit is established it may be modified or revoked by the issuer without advice to or consent from the customer or beneficiary.

(4) Notwithstanding any modification or revocation of a revocable credit any person authorized to honor or negotiate under the terms of the original credit is entitled to reimbursement for or honor of any draft or demand for payment duly honored or negotiated before receipt of notice of the modification or revocation and the issuer in turn is entitled to reimbursement from its customer.

Official Comment

Prior Uniform Statutory Provisions: None.

Purposes:

To define when a letter of credit is established in relation to the customer and the beneficiary, and to set forth for both irrevocable and revocable credits the legal consequences of the fact of establishment.

1. The primary purpose of determining the time of establishment of an irrevocable credit is to determine the point at which the issuer is no longer free to take unilateral action with respect to the cancellation of the credit or modification of its terms. So far as the customer is concerned this point of time is reached when the issuer "sends" (as that term is defined in Section 1-201) the credit or when its authorized agent, the advising bank, sends the advice of the credit to the beneficiary. Since the sending is pursuant to an agreement between the issuer and the customer, it is the issuer's performance of the first stage of the contract and under Section 5-107(4) the risk of transmission is on the customer. The beneficiary, however, cannot rely upon the credit until and unless he receives it. His right to protest to the issuer in the

event of cancellation or modification, therefore, turns on receipt. Nothing in this section affects the beneficiary's right to protest the improper nature of the credit or its cancellation (i. e., its non-receipt) as against the customer, who will normally have agreed to have a letter of credit issued in favor of the beneficiary under some underlying contract. See, e. g., Section 2-325(1) on buyer's failure to seasonably furnish an agreed letter of credit pursuant to a sales contract.

2. So far as a revocable letter of credit is concerned, the rules stated in subsections (3) and (4) are intended to show that so far as the customer or beneficiary are concerned establishment of such a credit has no legal significance unless the parties provide otherwise in their contracts with the issuer. The primary significance of the establishment of a revocable letter of credit is the obligation it imposes upon the issuer to innocent third parties who have negotiated or honored drafts drawn under the credit before receiving notice of its cancellation or change. The purpose of this rule is to further the movement of goods which the underlying transaction typically envisages and to preserve the so-

identity of American credits. As a necessary consequence of the imposition of this duty upon the issuer, a duty of reimbursement of the issuer is placed upon the customer by explicit mention here even though it would fall within the general duty of reimbursement imposed by Section 5-114(3).

Cross References:

Point 1: Sections 5-107, 2-325.
Point 2: Section 5-114.

§ 5-107. Advice of Credit; Confirmation; Error in Statement of Terms

(1) Unless otherwise specified an advising bank by advising a credit issued by another bank does not assume any obligation to honor drafts drawn or demands for payment made under the credit but it does assume obligation for the accuracy of its own statement.

(2) A confirming bank by confirming a credit becomes directly obligated on the credit to the extent of its confirmation as though it were its issuer and acquires the rights of an issuer.

(3) Even though an advising bank incorrectly advises the terms of a credit it has been authorized to advise the credit is established as against the issuer to the extent of its original terms.

(4) Unless otherwise specified the customer bears as against the issuer all risks of transmission and reasonable translation or interpretation of any message relating to a credit.

Official Comment

Prior Uniform Statutory Provisions: None.

Purposes:

1. An "advising bank" is defined in Section 5-103. Subsection (1) of this section states its obligations to transmit accurately but not to honor drafts. The advice may of course not be accurate. The advising bank is responsible for its own error; under subsection (3), however, the issuer is bound to honor only in accordance with the original terms of the credit.

2. A "confirming bank" is defined in Section 5-103. Subsection (2) of this section states its obligations and rights. The ob-

litation, to the extent of the confirmation and translation by placing them on the customer in the absence of specific agreement to the contrary. See also Section 5-109(1) (b).

Cross References:
Sections 5-103 and 5-109.

Definitional Cross References:

"Advising bank". Section 5-

103.

"Bank". Section 1-201.

"Confirming bank". Section

5-103.

"Credit". Section 5-103.

"Customer". Section 5-103.

"Draft". Section 3-104.

"Honor". Section 1-201.

"Issuer". Section 5-103.

§ 5-108. "Notation Credit"; Exhaustion of Credit

(1) A credit which specifies that any person purchasing or paying drafts drawn or demands for payment made under it must note the amount of the draft or demand on the letter or advice of credit is a "notation credit".

(2) Under a notation credit

(a) a person paying the beneficiary or purchasing a draft or demand for payment from him acquires a right to honor only if the appropriate notation is made and by transferring or forwarding for honor the documents under the credit such a person warrants to the issuer that the notation has been made; and

(b) unless the credit or a signed statement that an appropriate notation has been made accompanies the draft or demand for payment the issuer may delay honor until evidence of notation has been procured which is satisfactory to it but its obligation and that of its customer continue for a reasonable time not exceeding thirty days to obtain such evidence.

(3) If the credit is not a notation credit

(a) the issuer may honor complying drafts or demands for payment presented to it in the order in which they are presented and is discharged pro tanto by honor of any such draft or demand;

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(b) as between competing good faith purchasers of complying drafts or demands the person first purchasing has priority over a subsequent purchaser even though the later purchased draft or demand has been first honored.

Official Comment

Prior Uniform Statutory Provisions: None.

Purposes:

1. Practice has varied in regard to requiring notation on a letter of credit of the drafts drawn thereunder, and dispute has been rife for more than a century over the effect of failure by a purchaser to make such notations when they are required. The confusion has been due to a failure to distinguish two different types of credit and the different results which flow from each.

Under subsection (3), if an issuer chooses to issue a credit not requiring notation or if the credit is available in portions (see Section 5-110) without requirement of notation the issuer avoids all troubles attendant on any purchaser's failure to make notations, but he also imperils the utility of the credit to a beneficiary by reason of its possible exhaustion before any particular purchaser may have discounted drafts under it, so that there may be no market at all for such drafts. Yet this way of operation becomes useful and desirable at least whenever the credit is "domiciled," i.e., when it is explicitly made available only through one particular named correspondent, who will have his own records of prior drafts.

Subsection (3) expressly protects the issuer under such a

credit (almost exactly as in the case of drafts drawn in a set under Section 3-801) in regard to any drafts which he honors in good faith, even though they are in the hands of a party who as against some other purchaser of drafts is not entitled to their proceeds. Similarly, in the last sentence, the rights of successive good faith purchasers are regulated as with drafts in a set.

2. Under subsection (2), on the other hand, the notation machinery is made available where the credit provides for notation in accordance with subsection (1). This is useful particularly where the credit is intended (as a traveler's letter would be) for roving use, but the responsibility is put upon the purchaser to make the appropriate notation on pain of reimbursing the issuer for any loss occasioned by the failure. The provision in regard to delay of honor while evidence of notation is being procured is novel in the law, but is believed to be a necessary addition first, to protect the issuer, and second, to educate purchasers.

Subsection (2) (a) avoids a difficult question of conflict of laws by making the obligation to note a condition of the credit itself, governed, therefore, by the law which controls the issue of the credit.

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Cross References:
 Sections 3-801 and 5-110. "Good faith". Section 1-201.
 "Honor". Section 1-201.

Definitional Cross References:
 "Beneficiary". Section 5-103.
 "Credit". Section 5-103.
 "Customer". Section 5-103.
 "Document". Section 5-103.
 "Draft". Section 3-104.

§ 5-109. Issuer's Obligation to Its Customer

(1) An issuer's obligation to its customer includes good faith and observance of any general banking usage but unless otherwise agreed does not include liability or responsibility

- (a) for performance of the underlying contract for sale or other transaction between the customer and the beneficiary; or
- (b) for any act or omission of any person other than itself or its own branch or for loss or destruction of a draft, demand or document in transit or in the possession of others; or
- (c) based on knowledge or lack of knowledge of any usage of any particular trade.

(2) An issuer must examine documents with care so as to ascertain that on their face they appear to comply with the terms of the credit, unless otherwise agreed, assumes no liability or responsibility for the genuineness, falsification or effect of any document which appears on such examination to be regular on its face.

(3) A non-bank issuer is not bound by any banking usage of which it has no knowledge.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. The extent of the issuer's obligation to its customer is based upon the agreement between the two. Like all agreements within the Code, that agreement is the bargain of the parties in fact as defined in Section 1-201(3) and includes the

Section 1-102(3); conflict between express terms and a usage otherwise applicable is governed by Section 1-205(4).

Subsection (1) also clarifies the areas over which the issuer assumes no liability or responsibility except as the agreement of the parties may indicate the contrary. Paragraph (a) rests on the assumptions that the issuer has had no control over the making of the underlying contract or over the selection of the beneficiary, and that the issuer receives compensation for a payment service rather than for a guaranty of performance. The customer will normally have direct recourse against the beneficiary if performance fails, whereas the issuer will have such recourse only by assignment of or in a proper case subrogating to the rights of the customer.

Paragraph (b) also rests in part on the assumption that the issuer has not selected the other persons who may be involved in the transaction. Even though this assumption fails, however, as where the issuer selects the advising bank, the customer by entering the underlying transaction has assumed the risks inherent in it, including the risk of loss or destruction of the papers involved. The allocation of such risks between the parties to the underlying transaction is a proper subject for agreement between them, and the small charge for the issuance of a letter of credit ordinarily indicates that the issuer assumes minimum risks as against its customer. For comparable reasons Section 5-107(4) puts risks of transmission and translation upon the customer.

Paragraph (c) again emphasizes that normally an issuer performs a banking and not a trade function. This paragraph makes an exception to Section 1-205(3), giving effect to usages of which the parties "are or should be aware." The comparable provision for non-bank issuers in subsection (3) of this section is limited to unknown banking usages and is thus merely a definition of a particular type of case not included by the words "should be aware" in Section 1-205(3).

2. Subsection (2) states the basic obligation of the issuer to examine with care the documents required under the credit. Under Section 1-102(3) this obligation cannot be disclaimed but standards of performance can be determined by agreement if not manifestly unreasonable. There are not infrequent cases in which both parties understand that peculiar circumstances make any check-up on some particular type of document impossible and it is agreed that the issuer may take it "as presented"—*e.g.*, export licenses in politically disturbed conditions, or "shipping documents" when no document in standard or regular form can be procured. These agreements will be controlling provided they are not manifestly unreasonable.

The purpose of the examination is to determine whether the documents appear regular on their face. The fact that the documents may be false or fraudulent or lacking in legal effect is not one for which the issuer is bound to examine. His duty is limited to apparent regularity on the face of the documents. The duties, privileges



and rights of an issuer who has received documents which are regular on their face but are in fact improper because forged or fraudulent are dealt with in Section 5-114.

"Beneficiary". Section 5-103.
 "Branch". Section 1-201.
 "Contract". Section 1-201.
 "Contract for sale". Section 2-106.

"Credit". Section 5-103.
 "Customer". Section 5-103
 "Document". Section 5-103
 "Draft". Section 3-104.

"Genuine". Section 1-201.
 "Good faith". Section 1-201.
 "Issuer". Section 5-103.

"Knowledge". Section 1-201.
 "Person". Section 1-201.
 "Term". Section 1-201.

§ 5-110. Availability of Credit in Portions; Presenter's Reservation of Lien or Claim

(1) Unless otherwise specified a credit may be used in portions in the discretion of the beneficiary.

(2) Unless otherwise specified a person by presenting a documentary draft or demand for payment under a credit relinquishes upon its honor all claims to the documents and a person by transferring such draft or demand or causing such presentment authorizes such relinquishment. An explicit reservation of claim makes the draft or demand non-complying.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. The beneficiary may desire to draw more than one draft under the credit, each draft accompanied, for instance, by documents evidencing a single shipment under the underlying sales contract. Subsection (1) makes clear that unless otherwise specified he may do so. Of course, if he does, each draft and its accompanying documents must satisfy the terms of the credit and their total must not exceed its amount. See comment to Section 5-108(3) on exhaustion

credit is not for the full invoice price and any reservation of claim makes the draft non-complying. A beneficiary who wishes to prevent such delivery must do so by agreement with the customer in the underlying contract and must treat the failure to provide a sufficient letter of credit as a breach of that contract (Section 2-325). So far as the issuer's duty to honor is concerned, the terms of the letter of credit are controlling and the rule of subsection (2) is applicable.

Cross References:

Point 1: Section 5-108.
 Point 2: Sections 2-325, 5-114.

Definitional Cross References:

"Beneficiary". Section 5-103.
 "Credit". Section 5-103.
 "Documentary draft". Section 5-103.
 "Document". Section 5-103.
 "Draft". Section 3-104.
 "Honor". Section 1-201.
 "Person". Section 1-201.

§ 5-111. Warranties on Transfer and Presentment

(1) Unless otherwise agreed the beneficiary by transferring or presenting a documentary draft or demand for payment warrants to all interested parties that the necessary conditions of the credit have been complied with. This is in addition to any warranties arising under Articles 3, 4, 7 and 8.

(2) Unless otherwise agreed a negotiating, advising, confirming, collecting or issuing bank presenting or transferring a draft or demand for payment under a credit warrants only the matters warranted by a collecting bank under Article 4 and any such bank transferring a document warrants only the matters warranted by an intermediary under Articles 7 and 8.

Official Comment

Prior Uniform Statutory Provision: None.

Purpose:

1. The purpose of this section is to state the peculiar warranty of performance made by a beneficiary and to make clear the intermediary character of the persons moving the documents from the beneficiary to the customer. The beneficiary's warranty of compliance with the conditions of the credit in subsection (1) is expressly extended to all interested parties unless agreed to

Cross References:

Sections 3-417, 4-207, 7-507, 7-508, 8-306.

Definitional Cross References:
 "Advising bank". Section 5-103.
 "Confirming bank". Section 5-103.
 "Credit". Section 5-103.
 "Documentary draft". Section 5-103.
 "Bank". Section 1-201.
 "Beneficiary". Section 5-103.
 "Collecting bank". Section 5-103.
 "Draft". Section 3-104.
 "Party". Section 1-201.

§ 5-112. Time Allowed for Honor or Rejection; Withholding Honor or Rejection by Consent; "Presenter"

(1) A bank to which a documentary draft or demand for payment is presented under a credit may without dishonor of the draft, demand or credit

- (a) defer honor until the close of the third banking day following receipt of the documents; and
- (b) further defer honor if the presenter has expressly or impliedly consented thereto.

Failure to honor within the time here specified constitutes dishonor of the draft or demand and of the credit [except as otherwise provided in subsection (4) of Section 5-114 on conditional payment].

Note: The bracketed language in the last sentence of subsection (1) should be included only if the optional provisions of Section 5-114(4) and (5) are included.

(2) Upon dishonor the bank may unless otherwise instructed fulfill its duty to return the draft or demand and the documents by holding them at the disposal of the presenter and sending him an advice to that effect.

(3) "Presenter" means any person presenting a draft or demand for payment for honor under a credit even though that person is a confirming bank or other correspondent which is acting under an issuer's authorization.

Official Comment

Prior Uniform Statutory Provision: Subsection (1) of this section therefore allows a longer period than in the case of ordinary drafts (Section 8-606) for the decision. The language in the purposes:

1. A bank called on to honor drafts under a credit must examine the accompanying documents with care. See Section 5-109(2). That may take time.

statements (Section 3-607) and makes it clear that not only the draft but the credit is dishonored. If the particular draft is for a portion of the credit only, its wrongful dishonor is anticipatory repudiation of the entire credit and the beneficiary may proceed under Section 5-115(2) as well as 5-115(1).

2. Many letters of credit involve transactions in international trade and include as required documents the documents of title controlling the possession of goods on their way to the place of issuance of the credit. The ordinary rule requiring physical return of dishonored documentary drafts (Section 4-302) would therefore frequently work commercial hardship on the mercantile parties to the transaction; resale of the goods might be more difficult if the controlling documents of title were not available at the place of arrival of the goods. Subsection (2) therefore expressly permits the issuer to retain the documents as bailee for the presenter if it advises the presenter of its retention for that purpose. Compare Sections 4-202(1) (b), 4-503 and 4-504 on the duties of presenting banks.

3. The definition of "presenter" is to make clear that the term may include a bank which has rights in the documentary draft or which is in one sense the agent of the issuer. Such a bank may nevertheless give consent under subsection (1), and the advice authorized in subsection (2) may be sent to it.

4. Insofar as the banks involved may also be depository, collecting or paying banks, Article 4 is applicable. Article 3 applies to the extent that a negotiable instrument is involved.

Cross References:
 Point 1: Sections 3-606, 3-607, 5-109, 5-114 and 5-116.
 Point 2: Sections 4-202, 4-302, 4-503 and 4-504.
 Point 4: Articles 3 and 4.

Definitional Cross References:
 "Bank". Section 1-201.
 "Confirming bank". Section 5-103.
 "Credit". Section 5-103.
 "Documentary draft". Section 5-103.
 "Draft". Section 3-104.
 "Honor". Section 1-201.
 "Issuer". Section 5-103.
 "Send". Section 1-201.

§ 5-113. Indemnities

(1) A bank seeking to obtain (whether for itself or another) honor, negotiation or reimbursement under a credit may give an indemnity to induce such honor, negotiation or reimbursement.

(2) An indemnity agreement inducing honor, negotiation or reimbursement

- (a) unless otherwise explicitly agreed applies to defects in the documents but not in the goods; and
- (b) unless a longer time is explicitly agreed expires at the end of ten business days following receipt of the documents.



ments by the ultimate customer unless notice of objection is sent before such expiration date. The ultimate customer may send notice of objection to the person from whom he received the documents and any bank receiving such notice is under a duty to send notice to its transferor before its midnight deadline.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. A draft and accompanying documents may almost comply with the terms of the credit, but fall in some particular. The issuer is then not obligated to honor the draft, but it may be willing to do so if properly indemnified against the particular defect. Subsection (1) makes clear that it is proper for a bank seeking payment, acceptance, negotiation or reimbursement under the credit to give such indemnities, and that doing so is a proper part of the business of banking and therefore not ultra vires.

2. Subsection (2) (a) limits the agreed indemnity to defects in the documents, since under Section 5-109(1) (a) the issuer is ordinarily not responsible for performance of the underlying transaction. The parties are free to agree further on the scope of the indemnity, but the agreement must be explicit, since an indemnity against defects in the goods would be most unusual.

3. Subsection (2) (b) makes it clear that the indemnity in the absence of explicit agreement for a longer time continues for ten days after the receipt of the document by the ultimate

customer, i.e., the customer who is a party to the underlying transaction. This ten day period may not be shortened. If the customer fails to send notice of objection within the period, he loses his right to object and the need for the indemnity disappears. Compare Section 2-605 (2). Thus indemnitors are free of the possibility of unknown long-continuing contingent liability, a danger under existing law.

4. The question whether a particular banking usage may require honor of documentary drafts accompanied by indemnities for particular defects goes to the meaning of the terms of the credit and is beyond the scope of this section. See, e.g., *Dixon, Irmaso & Cia, Ltda., v. Chase Nat. Bank of City of New York*, 144 F.2d 759 (2d Cir., 1944). If by virtue of indemnities and usage the credit is complied with, the rights of the customer rest on the implications of the usage rather than on breach of the issuer's duty under this Article. Even so, the policy of this section and its terms require notice before the expiration date.

Cross References:

Point 2: Section 5-109.
Point 3: Section 2-605.
Point 4: Section 1-205.

Definitional Cross References:
"Bank". Section 1-201.
"Credit". Section 5-103.
"Customer". Section 5-103.
"Documents". Section 5-103.
"Honor". Section 1-201.
"Midnight deadline". Section 4-104.
"Person". Section 1-201.
"Send". Section 1-201.

§ 5-114. Issuer's Duty and Privilege to Honor; Right to Reimbursement

(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 7-307) 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 apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.

(3) Unless otherwise agreed an issuer which has duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit and to be put in effectively available funds not later than the day before maturity of any acceptance made under the credit.

[(4) When a credit provides for payment by the issuer on receipt of notice that the required documents are in the possession of a correspondent or other agent of the issuer

- (a) any payment made on receipt of such notice is conditional; and
- (b) the issuer may reject documents which do not comply with the credit if it does so within three banking days following its receipt of the documents; and
- (c) in the event of such rejection, the issuer is entitled by charge back or otherwise to return of the payment made.]

[(5) In the case covered by subsection (4) failure to reject documents within the time specified in sub-paragraph (b) constitutes acceptance of the documents and makes the payment final in favor of the beneficiary.]
Amended in 1977.

See Appendix I for changes made in former text and the reasons for change.

Note: Subsections (4) and (5) are bracketed as optional. If they are included the bracketed language in the last sentence of Section 5-112(1) should also be included.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes:

To define the areas in which the issuer must honor drafts or demands for payment under a credit and those in which he has an option to do so and to make explicit the customer's duty of reimbursement.

1. The letter of credit is essentially a contract between the issuer and the beneficiary and is recognized by this Article as independent of the underlying contract between the customer and the beneficiary (See Section 5-109 and Comment thereto). In view of this independent nature of the letter of credit engagement, the issuer is under a duty to honor the drafts or de-

torer once the credit has been issued and received by the beneficiary. See Section 5-106.

2. Documents, however, may appear regular on their face and apparently conforming to the credit whereas in fact they are forged or fraudulent or in other respects non-conforming to the warranties which arise under other Articles of the Code on their transfer or negotiation. Since the issuer's duties to its customer are limited to examination of the documents with care (Section 5-109) and since it is important to preserve both the independent character of the issuer's engagement and the reasonable reliance on that engagement of persons dealing with papers regular on their face and in apparent compliance with the terms of the credit, subsection (2) (a) includes as an area in which the issuer's duty to honor exists cases in which persons have acted in a manner which would make them the equivalent of holders in due course under Article 3 or, where relevant, persons to whom documents have been duly negotiated under Article 7 or bona fide purchasers of certificated securities under Article 8. The risk of the original bad-faith action of the beneficiary is thus thrown upon the customer who selected him rather than upon innocent third parties or the issuer. So, too, is the risk of fraud in the transaction placed upon the customer.

When, however, no innocent third parties as defined in subsection (a) are involved the issuer is no longer under a duty to honor; but since these matters frequently involve situa-

tions in which the determination of the fact of the non-conformance may be difficult or time-consuming, the issuer if he acts in good faith is given the privilege of honoring the draft as against its customer, that is to say, with a right of reimbursement against him. The issuer may, however, refuse honor. In the event of honor an action by the customer against the beneficiary will lie by virtue of either the underlying contract or Section 5-111(1) of this Article. In the event of dishonor, if the presenter is a person who has parted with value, he also may recover against the beneficiary under Section 5-111(1).

3. Subsection (3) represents the standard form for reimbursement. The words "duly honored" include not only situations where the issuer has honored because it was his duty to do so but also where he was privileged to do so as in subsection (2) (b) or has done so as under Section 5-106(4).

4. Optional subsections (4) and (5) are for the purpose of clarifying a situation which has arisen under the currency restrictions of a few nations and in which payment is required to be made under the credit before opportunity exists to examine the documents. The Article resolves this situation by making clear that the payment is conditional in nature and may be reversed by subsequent timely discovery of defects in the documents.

Cross References:

Point 1: Sections 5-106 and 5-109.

- Point 2: Sections 5-106, 5-109, 5-111 and Articles 3, 7 and 8.
- Point 3: Section 5-106.
- Definitional Cross References:
 - "Bank", Section 1-201.
 - "Beneficiary", Section 5-103.
 - "Contract", Section 1-201.
 - "Contract for sale", Section 2-106.
 - "Credit", Section 5-103.
 - "Customer", Section 5-103.
 - "Document", Section 5-103.
- "Document of title", Section 1-201.
- "Draft", Section 3-104.
- "Good faith", Section 1-201.
- "Holder", Section 1-201.
- "Honor", Section 1-201.
- "Issuer", Section 5-103.
- "Notification", Section 1-201.
- "Receives notice", Section 1-201.
- "Security", Section 8-102.
- "Term", Section 1-201.

§ 5-115. Remedy for Improper Dishonor or Anticipatory Repudiation

(1) When an issuer wrongfully dishonors a draft or demand for payment presented under a credit the person entitled to honor has with respect to any documents the rights of a person in the position of a seller (Section 2-707) and may recover from the issuer the face amount of the draft or demand together with incidental damages under Section 2-710 on seller's incidental damages and interest but less any amount realized by resale or other use or disposition of the subject matter of the transaction. In the event no resale or other utilization is made the documents, goods or other subject matter involved in the transaction must be turned over to the issuer on payment of judgment.

(2) When an issuer wrongfully cancels or otherwise repudiates a credit before presentment of a draft or demand for payment drawn under it the beneficiary has the rights of a seller after anticipatory repudiation by the buyer under Section 2-610 if he learns of the repudiation in time reasonably to avoid procurement of the required documents. Otherwise the beneficiary has an immediate right of action for wrongful dishonor.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. Subsection (1) states the rights of a person entitled to honor, both with respect to any documents and against the issuer, when there is wrongful dishonor. Whether dishonor is wrongful and whether a particu-
2. Subsection (2) states the rights of the beneficiary upon repudiation of the credit, both

against the issuer and with respect to any documents or goods. Note that wrongful dishonor of a draft for a portion of the credit is dishonor of the credit under Article 5-112(1), and makes applicable subsection (2) of this section as well as subsection (1).

3. Both subsections are limited to irrevocable credits. Since under Section 5-106(3) revocable credits may be modified or revoked without notice to the customer or the beneficiary, rights against the issuer like those here provided can hardly arise under them. The rights of innocent third persons under revocable credits are governed

§ 5-116. Transfer and Assignment

(1) The right to draw under a credit can be transferred or assigned only when the credit is expressly designated as transferable or assignable.

(2) Even though the credit specifically states that it is non-transferable or nonassignable the beneficiary may before performance of the conditions of the credit assign his right to proceeds. Such an assignment is an assignment of an account under Article 9 on Secured Transactions and is governed by that Article except that

- (a) the assignment is ineffective until the letter of credit or advice of credit is delivered to the assignee which delivery constitutes perfection of the security interest under Article 9; and
- (b) the issuer may honor drafts or demands for payment drawn under the credit until it receives a notification of the assignment signed by the beneficiary which reasonably identifies the credit involved in the assignment and contains a request to pay the assignee; and
- (c) after what reasonably appears to be such a notification has been received the issuer may without dishonor refuse to accept or pay even to a person otherwise entitled to honor until the letter of credit or advice of credit is exhibited to the issuer.

(3) Except where the beneficiary has effectively assigned his right to draw or his right to proceeds, nothing in this section limits his right to transfer or negotiate drafts or demands drawn under the credit. Amended in 1972.

See Appendix II for changes made in former text and the reasons for change.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. The situation involved is typified by that of an exporter who has made a contract for sale with a foreign buyer and is beneficiary of a letter of credit initiated by the buyer, especially where the subject matter involves goods still to be manufactured. The exporter is frequently in need of the wherewithal not only to finance payment to his supplier but to assure the latter against cancellation of the order during the process of manufacture. For this purpose assignment of the exporter's rights under the letter of credit is frequently desirable.

Since, however, there is general confusion of thought as to the meaning of "assignment or transfer of a credit," the law remains uncertain. If "assignment of the credit" includes delegation of performance of the conditions under the credit then the initiating customer, who in many cases has put his faith in performance or supervision of performance by a beneficiary of established reputation, may be deprived of real and intended security. See Comment to Section 2-210 on the comparable situation as to the sales contract. On the other hand, all "negotiation credits" involve a transfer

of the rights of the beneficiary by way of negotiations of the draft and such transfer involves no important loss of the initiating party's intended safety. Meanwhile, the exceedingly useful institution of "back to back" credits, in which an American bank issues a credit with the exporter as the initiating customer and the exporter's supplier as the beneficiary, is dangerous for the banker unless he can secure in advance an effective assignment from the exporter of the latter's rights under the initial credit issued on behalf of his foreign buyer. Against this background, the section is drawn.

2. Subsection (1) requires the beneficiary's signature on drafts drawn under the credit unless it is expressly designated as assignable or transferable. If it is so designated, the normal rules of assignment apply and both the right to draw and the performance of the beneficiary can be transferred, subject to the beneficiary's continuing liability, if any, for the nature of the performance.

3. Subsection (2) makes clear that to safeguard among other things the letter of credit "back to back" practice, the assignability of proceeds in advance of performance cannot be prohibited in advance of performance. In this respect the letter of credit is treated like

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any other contract calling for money to be earned. See Section 9-318 generally and Section 2-210 as to sales contracts. But the special nature of the letter of credit as evidence of the right to proceeds is recognized by the additional requirement of delivery of the letter to the assignee as a condition precedent to the perfection of the assignment. Similarly, the fact that letters of credit normally require presentation of drafts or demands for payment which are drawn under it and that as a result notice of assignment of proceeds can exist simultaneously with a draft payable by order or indorsement to either the beneficiary or another third person leads to the necessity for permitting an issuer to protect itself against exhibition of the letter or advice of credit.

Cross References:

Point 1: Section 2-210.
Point 3: Sections 2-210 and 9-318 and Article 9.

Definitional Cross References:

"Accept": Section 3-410.
"Account": Section 9-106.
"Beneficiary": Section 5-103.
"Credit": Section 5-103.
"Draft": Section 3-104.
"Honor": Section 1-201.
"Issuer": Section 5-103.
"Receiver": notification, Section 1-201.

§ 5-117. Insolvency of Bank Holding Funds for Documentary Credit

(1) Where an issuer or an advising or confirming bank or a bank which has for a customer procured issuance of a credit by another bank becomes insolvent before final payment under the credit and the credit is one to which this Article is made applicable by paragraphs (a) or (b) of Section 5-102(1) on scope, the receipt or allocation of funds or collateral to secure or meet obligations under the credit shall have the following results:

(a) to the extent of any funds or collateral turned over after or before the insolvency as indemnity against or specifically for the purpose of payment of drafts or demands for payment drawn under the designated credit, the drafts or demands are entitled to payment in preference over depositors or other general creditors of the issuer or bank; and

(b) on expiration of the credit or surrender of the beneficiary's rights under it unused any person who has

- Given such funds or collateral is similarly entitled to return thereof; and
- (c) a charge to a general or current account with a bank if specifically consented to for the purpose of indemnity against or payment of drafts or demands for payment drawn under the designated credit falls under the same rules as if the funds had been drawn out in cash and then turned over with specific instructions.
- (2) After honor or reimbursement under this section the customer or o her person for whose account the insolvent bank has acted is entitled to receive the documents involved.

Official Comment

Prior Uniform Statutory Provision: None.

Purposes:

A bank which issues a letter of credit acts as a principal, not as agent for its customer, and engages its own credit. But the resulting liability is not like that to its depositors, and the security and indemnity furnished by the customer against it and the documents which it receives on honor of complying drafts are not like its own investments.

The typical letter of credit transaction facilitates the movement of goods. The bank's credit is engaged, but it expects to be put in funds by its customer before it makes disbursements, or to be reimbursed immediately afterwards. And everybody understands that the documents received upon honor of complying drafts are to be turned over to the customer at once when he makes reimbursement or signs trust receipts. Only the bank's commission, if the transaction is completed, will enter the bank's general assets and join the other backing of its deposit liabilities.

It is therefore proper, when insolvency occurs before the letter of credit transaction is completed, to regard both the outstanding liabilities, the security held and funds provided to indemnify against those liabilities, and the related drafts and documents, as separate from deposit liabilities and from general assets, and to deal with them as separate. To do so carries out the original purpose, which is to facilitate the underlying mercantile transaction, and does no wrong to the bank's depositors and other general creditors.

This section states appropriate rules to carry out these principles. The section is limited to transactions under Section 5-102(1) (a) and (b) to prevent abuse in situations where the commercial purpose of facilitating the movement of goods, securities or the like may be lacking.

Cross Reference:
Compare Section 4-214, and the Comment thereto.

- Definitional Cross References:
"Advising Bank", Section 5-103.
"Bank", Section 1-201.
"Beneficiary", Section 5-103.
"Confirming Bank", Section 5-103.
"Credit", Section 5-103.
- "Customer", Section 5-103.
"Document", Section 5-103.
"Draft", Section 3-104.
"Honor", Section 1-201.
"Insolvent", Section 1-201.
"Issuer", Section 5-103.
"Person", Section 1-201.

