



Role of letters of credit in international trade

Monica Raje

Associate Professor, National Law Institute University, Bhopal, Madhya Pradesh, India

Abstract

Financing of an international transaction is an important concern for all parties involved in such a transaction. The seller wishes to be paid as soon as he ships the goods and fulfills his contractual obligations. The buyer on the other hand wants to delay payment till the goods arrive in his jurisdiction and he has an opportunity to examine them and satisfy himself that the goods meet the contractual requirements. A letter of credit as a means of financing an international transaction mitigates the risks for both the buyer and the seller. Letters of credit are indispensable for international transactions since they ensure that payment will promptly be received by the seller. Using letters of credit allows the seller to significantly reduce the risk of non-payment for delivered goods, by replacing the risk of the buyer with that of the banks. Letters of credit have become a crucial aspect of international trade, due to differing laws in each country and the difficulty of knowing each party personally. This paper seeks to understand the importance of letters of credit in international trade. It will also study how a letter of credit transaction operates and the two important principles of doctrine of autonomy and the doctrine of strict compliance governing letters of credit transaction. It will also study the fraud exception to the doctrine of autonomy as carved by Courts in the U.S., UK, and India

Keywords: international trade, letter of credit, autonomy principle, strict compliance, fraud exception

Introduction

In an international transaction as the buyer and seller belong to different jurisdictions, there is a greater element of risk involved as compared to a domestic transaction. One of the major concerns of parties to an international sales transaction is the payment mechanism. The financing of international trade has its peculiar problems as a result of different locations or residence of the contracting parties. Very often parties may be dealing with each other for the first time and hence are not able to be aware of, or be able to ascertain not only the financial status of the other party but also of each other's reputation in his home country. Because of this the seller is not willing to part with his goods without being assured of payment and the buyer is not willing to pay for the goods without assurance of delivery of the same. In this context letters of credit are indispensable for international transactions since they ensure that payment will be received. Using letters of credit allows the seller to significantly reduce the risk of non-payment for delivered goods, by replacing the risk of the buyer with that of the banks. Letters of credit have become a crucial aspect of international trade, due to differing laws in each country and the difficulty of knowing each party personally.

Letter of Credit: Meaning

A letter of credit is basically an undertaking by a bank to make payment to a named beneficiary (usually the seller) within a specified time, against the presentation of documents which is strictly in compliance with the terms of the letter of credit. Their popularity in international commerce has led judges to describe them as "the life blood of international commerce" in *United City Merchants Investment Ltd V Royal Bank of Canada* ^[1].

The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication No. 600 ("UCP")

are rules that apply to documentary credit define the term credit as under:

Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.

Article 5 of the Uniform Commercial Code (U.C.C.) defines a letter of credit as under:

Letter of credit means a definite undertaking by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.

Parties to a Letter of Credit

Buyer and seller enter into a contract for the sale of goods. The agreement includes a term whereby the buyer agrees to establish a letter of credit with a bank to the tune of the contract price. The bank issues such a credit letter promising to pay the seller upon presentation of appropriate documents specified in the credit. Seller performs its obligations, and in so doing, gathers the necessary documents, e.g., bills of lading from the carrier, invoices, and inspection certificates. Seller presents the complying documents and the bank makes payment under the transaction. Buyer reimburses the bank, takes the documents to the carrier, and gets the goods. In letter of credit terms, buyer is the customer, seller is the beneficiary, and the bank is the issuer of the letter of credit. In addition, a letter of credit transaction may involve other intermediaries like a confirming bank and an advising bank. A confirming bank honours the letter of credit already issued by another bank. The confirming bank is obligated to honour the letter of credit as if it were the issuer. As a result, the beneficiary of a confirmed letter of credit has the independent obligations of both the issuer and the

confirming bank ^[2]. The advising bank is the correspondent bank of the issuing bank. The advising bank gives the beneficiary notification of the issuance of a letter of credit. Generally, it does not agree to honour payment under the letter of credit unless it is also a confirming bank. Should a bank notify the beneficiary that it confirms a letter of credit instead of merely advising of its issuance, the bank is deemed to have undertaken the obligation of a confirming bank ^[3].

The UCP 600 defines ^[4] these terms as under

Advising bank means the bank that advises the credit at the request of the issuing bank.

Beneficiary means the party in whose favour a credit is issued.

Confirmation means a definite undertaking of the confirming bank, in addition to that of the issuing bank, to honour or negotiate a complying presentation.

Confirming bank means the bank that adds its confirmation to a credit upon the issuing bank's authorization or request.

Issuing bank means the bank that issues a credit at the request of an applicant or on its own behalf.

Types of Letters of Credit

A bank may issue any of the following type of letter credit according to the requirements of the parties involved:

1. Revocable and Irrevocable Letter of Credit

Letters of credit can be revocable. This means that they can be cancelled or amended at any time by the issuing bank without notice to the beneficiary. An irrevocable letter of credit cannot be cancelled without the consent of the beneficiary. An irrevocable credit therefore gives a higher level of protection to the beneficiary.

2. Confirmed and Unconfirmed Letter of Credit

An unconfirmed letter of credit carries the obligation of the issuing bank to honour the payment, provided that the terms and conditions of the letter of credit have been complied with. A confirmed letter of credit also carries the obligation of another bank which is normally located in the beneficiary's country, thereby giving the beneficiary the comfort of dealing with a bank known to him.

3. On Sight and Deferred Letter of Credit

Letters of credit can permit the beneficiary to be paid immediately upon presentation of specified documents (sight letter of credit), or at a future date as established in the sales contract (deferred letter of credit).

4. Red Clause Letter of Credit

This is the specific type of letter of credit that carries a provision (traditionally written or typed in red ink) which allows the beneficiary to receive a fixed sum from the paying bank, in advance of the shipment or before presenting the prescribed documents ^[5].

5. Revolving Letter of Credit

When the buyer and seller are doing business on a regular basis, they may not want to obtain a letter of credit for every transaction. A revolving letter of credit allows businesses to use a single letter of credit for multiple transactions ^[6].

6. Standby Letter of Credit

The standby letter of credit is very much similar in nature to

a bank guarantee. The main objective of issuing such a credit is to secure bank loans. Standby credits are usually issued by the applicant's bank in the applicant's country and advised to the beneficiary by a bank in the beneficiary's country ^[7].

Advantages of a Letter of Credit

To the Exporter/Seller

1. A letter of credit transaction gives the seller an assurance that a bank will make payment. Hence it substitutes the promise of payment by an individual (buyer) with that of a bank.
2. A bank will make payment as soon as the seller ships the goods and presents necessary documents to the bank evidencing shipment of goods as per contract terms. This assures the seller of early payment and he does not have to wait the extended time period, till the goods arrive in the importing country and are examined by the buyer in order to make payment.
3. In case of a confirmed letter of credit the seller can get payment from his bank situated in his own country.

To the Importer/Buyer 1. Bank will make payment only when the seller presents necessary documents evidencing shipment of goods as per contract terms. This assures the buyer that the seller has fulfilled his contractual obligations and when the goods arrive in his country they will conform as per the contract.

Rules governing letters of credit

As letters of credit became the most often resorted mechanism to finance international transactions, a need was felt to harmonise banking practices related to letters of credit across the globe. With the primary objective of facilitating international trade, the International Chamber of Commerce introduced the Uniform Customs and Practices for Documentary Credit (UCP) to alleviate the confusion caused by individual countries promoting their national rules on letter of credit practice ^[8]. The UCP was first published in 1933, and has been periodically revised and updated to reflect the experience of the parties involved in international letter of credit transactions. The current version of the UCP, published in 2007, is ICC Publication No. 600, commonly referred to as UCP 600. The applicability of these rules to a letter of credit is provided in Article 1 of the UCP which reads as under:

Application of UCP

The Uniform Customs and Practices for Documentary Credits, 2007 Revision, ICC Publication no. 600 ('UCP') are rules that apply to any documentary credit ('credit') when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit.

The above Article makes it clear that the UCP does not have force of law, but must be incorporated by express reference in the commercial letter of credit.

Further every letter of credit is governed by the principles of 'doctrine of strict compliance' and 'the autonomy principle'. Each of these principles is explained below

Doctrine of Strict Compliance

This doctrine requires that the documents tendered by the beneficiary to the bank in order to receive payment must strictly comply with the terms of the letter of credit. This

doctrine protects the issuing bank and the buyer. It ensures that the bank will make payment only when the documents tendered by the beneficiary strictly conform. This assures the buyer that when the goods arrive in his country they conform to the contract. The leading case on the doctrine of strict compliance is *Equitable Trust Company of New York v. Dawson Partners Ltd* ^[9].

In this case one of the documents to be presented by the beneficiary was a certificate of quality which was to be signed by 'experts'. The document presented by the beneficiary to the bank was signed only by one expert. The court held that the bank was well within its right to refuse payment to the beneficiary. Lord Summer held:

There is no room for documents which are almost the same or which will do just as well. If a bank 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 does so at its own risk.

The principle of strict compliance ensures that the issuer will not be required to make a factual determination or look to the underlying contract to determine whether the party's performance is satisfactory ^[10]. However it is argued that this doctrine defeats the purpose of a letter of credit transaction as the issuer may refuse payment to the beneficiary on minor, trivial discrepancies in the documents. The Courts therefore sometimes adopt the principle of substantial compliance. Under this principle as long as the documents conform to the material terms of the letter of credit the issuer must honour the documents ^[11]. The rationale behind the substantial compliance doctrine is to promote equity to the beneficiary. The UCP 600 provides for the standard of compliance to be met by banks examining documents in a letter of credit transaction under Article 14(a) which reads:

A nominating bank, a confirming bank if any and the issuing bank must examine a presentation to determine, on the basis of documents alone, whether or not the documents appear on their face to constitute a complying presentation.

The doctrine of strict compliance has been relaxed by the provisions introduced by the UCP 600. Article 14(d) states: Data in document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to. But must not conflict with data in that document, any other stipulated document or credit.

In a letter of credit, discrepancies get cleared if they are waived off by the applicant/buyer. As a buyer wants his goods and the beneficiary the payment in case of minor discrepancies the issuing bank approaches the applicant/buyer to waive off the discrepancies. Once the discrepancies are waived off the bank accepts the documents and makes payment to the beneficiary. By approaching the applicant for waiver, the bank thus transfers the risk of non-complying documents to the buyer.

Article 16(b) of UCP 600 provides:

When an issuing bank determines that a presentation does not comply, it may in its sole judgement approach the applicant for a waiver of the discrepancies.

Autonomy principle

The basic structure of a letter of credit provides for three independent commitments.

1. A contract between the beneficiary and the applicant (the underlying transaction)
2. A contract between the applicant and the issuing bank for opening the letter of credit for an amount to be

reimbursed by the applicant (the application)

3. The issuing bank's undertaking towards the beneficiary that will honour the L/C if the requirements are complied with ^[12].

As a general principle of letter of credit is that banks deal in documents and not in goods and credits by nature are separate transactions from the underlying transaction. This principle is enshrined in the UCP 600 in Articles 4 and 5.

Article 4 of the UCP 600 reads as under

Credits v. Contracts

- a. A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfill any other obligation under the credit is not subject to claim or references by the applicant resulting from its relationships with the issuing bank or beneficiary.
- b. An issuing bank should discourage any attempt by the applicant, to include as an integral part or the credit, copies of the underlying contract, proforma invoice and the like.

Article 5 of the UCP 600 reads as under

Documents v. Goods, Services or Performance

Banks deal with documents and not with goods, services or performance to which the documents may relate.

As in a letter of credit transaction banks deal in documents and not in goods a letter of credit transaction is also referred to as a documentary credit transaction. For the successful completion of a letter of credit transaction bank must swiftly examine documents presented to them with a request for payment by the beneficiary. And for this purpose, banks are only required to examine the documents and not the goods to which the documents may relate. At the core of the autonomy principle is that the letter of credit transaction is separate from the underlying sales or other contract. Accordingly, the seller/beneficiary will receive payment if he presents documents to the bank which strictly comply with the terms of the letter of credit. The UCP 600 codifies the autonomy principle in Article 4.

The autonomy of the letters of credit is what gives them their appeal; they guarantee payment of the purchase price irrespective of the performance of the underlying transaction to which they relate. If the seller was not guaranteed payment their utility would be undermined ^[13].

The consequence of this principle is that the performance of the underlying transaction is irrelevant to the payment of the credit, thus payment may be made on the documents even if the goods never arrive and the buyer has to seek damages from the carrier ^[14]. The principle can therefore cause injustice to the buyer where the seller has breached his contractual obligation and shipped goods which do not conform but has presented conforming documents to the bank. It is the independence from the performance of the underlying contract that gives documentary credits their international commercial utility and efficacy ^[15]. The courts have traditionally been reluctant to deviate from the autonomy principle. They refrain from granting an injunction to the applicant to prevent the bank from making payment to a beneficiary who presents conforming documents. There is one exception to this autonomy

principle and that is the fraud exception.

Discount Records Ltd. v. Barclays Bank Ltd ^[16]. Megarry J., refused to grant injunction on an allegation of fraud. He observed:

I would be slow to interfere with banker's irrevocable credits, and not least in the sphere of international banking, unless a sufficiently good cause is shown; for interventions by the court that are too ready or too frequent might gravely impair the reliance which, quite properly, is placed on such credits ^[17].

The Indian Supreme Court upholding the autonomy principle in *United Commercial Bank v. Bank of India* ^[18] observed as under:

Opening of a letter of credit constitutes a bargain between the banker and the seller of the goods which imposes on the banker an absolute obligation to pay ^[19].

In *Tarapore & Co v. V/O Tractors Export, Moscow* ^[20], the Supreme Court refused to grant an injunction restraining the issuing bank from making payment on the ground that the letter of credit was independent of the contract of sale. The Court observed:

An irrevocable letter of credit is a mechanism of great importance in international trade and so the autonomy of the irrevocable letter of credit is entitled to protection. Any interference with that mechanism is bound to have serious repercussions on the international trade of the country, and the courts ought not to interfere with the mechanism except under very exceptional circumstances ^[21].

Fraud Exception

The issuing bank is not bound to make payment when it has clear evidence of fraud. The gravity of fraud has been identified by the House of Lords in *Standard Chartered Bank v. Pakistan National Shipping Co.* ^[22] as under:

Fraud is a significant risk to the banks and buyers involved in credit transactions and has been described as "cancer in international trade" ^[23].

In *Bank of Nova Scotia v. Angelica Whitewear Ltd* ^[24] the Supreme Court of Canada has recognised the fraud exception to a letter of credit. It made the following observation.

An issuing bank is obliged to honour a draft under a documentary letter of credit when it is accompanied by documents which appear on their face to be regular and in accordance with the terms and conditions of the credit. This obligation is independent of the performance of the underlying contract for which the credit was issued. The issuing bank agrees to pay upon presentation of documents, not goods. There is an exception to this rule: a bank should not pay where a fraud by the beneficiary of the credit has been sufficiently brought to its knowledge before payment of the draft or demonstrated to a court called on by the customer of the bank to issue an interlocutory injunction to restrain the bank from honouring the draft.

Sztejn v. Henry Schroder Banking Corp ^[25]. Is widely recognised as the leading American authority on the fraud exception. In this case the plaintiff who is applicant of the letter of credit filed a suit to restrain the defendant bank from making payment to the beneficiary alleging that the beneficiary had filled the fifty crates with cow hair, other worthless material and rubbish with the intent to simulate genuine merchandise and defraud the plaintiff.

Justice Shientag first acknowledging the autonomy principle observed as under:

It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade. One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped ^[26].

The Judge then went on to identify the fraud exception to the autonomy principle

Of course, the application of [the principle of independence] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit. However, I believe that a different situation is presented in the instant action. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving an intentional fraud on the part of the seller which was brought to the bank's notice with the request that it withhold payment of the draft on this account ^[27].

Sztejn's case has laid down the following two principles. First, payment under a letter of credit may only be interrupted in a case of fraud; mere allegation of breach of warranty cannot be an excuse for such an interruption. Second, payment under a letter of credit can only be interrupted when fraud is proven or established; mere allegation of fraud should not be an excuse for such an interruption ^[28].

The English Court has recognised the fraud exception to the autonomy principle in *United City Merchants (Investments) Ltd. Royal Bank of Canada* ^[29]. The issue before the house of Lords in this case was whether the fraud exception could be enforced if the beneficiary presenting the documents was unaware of the fraud. Answering in the negative Lord Diplock held:

Payment could only be legitimately refused where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue ^[30].

In holding that the only fraud sufficient to invoke the exception was that of the beneficiary himself or that to which he was a party, thus excluding the fraud of a third party, Lord Diplock supported a narrow formulation of the exception ^[31].

The Indian Supreme Court has also applied the fraud

exception to cases involving a letter of credit. In *UP. Cooperative Federation Ltd. v Singh Consultants and Engineers P.Ltd* ^[32]. Case the Supreme Court observed:

An irrevocable commitment either in the form of confirmed bank guarantee or irrevocable letter of credit cannot be interfered with except in case of fraud or in case of question of apprehension of irretrievable injustice has been made out. This is a well-established principle of the law in England. This is also a well settled principle of law in India ^[33].

Conclusion

In an international sales transaction, where parties belong to different jurisdictions and have no idea about the reputation and credit worthiness of each other, a letter of credit as a means of financing brings in a lot of certainty. It secures the interest of all parties involved in international trade. An irrevocable letter of credit, on the one hand, assures the seller the right of payment on presentation of necessary documents even before he has parted with the goods and on the other hand assures the buyer that payment will not be made to the seller unless he presents necessary documents to the bank, which evidence that the seller will ship goods as per the contract terms. Banks, which act as intermediaries in a letter of credit transaction earn commission for acting as such. When a bank issues a letter of credit, that credit becomes a separate contract from the underlying transaction on which the credit is based. It is this independent nature of a letter of credit which makes it the lifeblood of international trade and commerce. Banks deal in documents and not in goods. However, as this autonomy principle may be abused by the seller to ship non-conforming, inferior quality goods to the buyer, the Courts have developed the fraud exception to the autonomy principle.

References

1. (1982)2 Lloyd's Rep.1.
2. Christopher Leon, *Letters of Credit: A Primer*, 45 *Md.L. Rev.* 1986, 432-453.
3. *Id.*
4. Article 2.
5. https://instruction2.mtsac.edu/rjagodka/Importing_Information/Letter_Of_Credit_Guide.pdf. Last visited on 2/02/2021.
6. *Id.*
7. *Id.*
8. https://instruction2.mtsac.edu/rjagodka/Importing_Information/Letter_Of_Credit_Guide.pdf. Last visited on 2/02/2021.
9. (1972) 2 Lloyd's Rep. 49.
10. *Supra* note 2, at 453.
11. *Id.*
12. Robert D. Aicher *et al*, *Credit Enhancement: Letters of Credit, Guarantees, Insurance and Swaps (The Clash of Cultures)*, 59 *The Business Lawyer*, 2004, 897-899.
13. *Id.*
14. Felicity Monteiro, *Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand*, 13 *Auckland U.L.Rev.* 2007, 144-147.
15. *Id.*
16. (1975) *All.E.R.* 1071.
17. *Id.*, at 1075.
18. 1981)3 *S.C.R.* 300.

19. *Id.*, at 317.
20. (1969) 2 *S.C.R.* 920.
21. *Id.*, at 929.
22. (1998) 1 *Lloyd's Rep.* 684.
23. *Id.*, at 686.
24. (1987) 1 *S.C.R.* 59.
25. 31 *N.Y.S. 2d* 631(1941).
26. *Id.*, at 633
27. *Id.*, at 634.
28. Ross Buckley & Xiang Gao, *The Development of the Fraud Rule in the Letter of Credit Law: The Journey so Far and The Road Ahead*, 23 *U.P.A.. J.Int'l. L* 663,678 (2202).
29. (1982)2 *Lloyd's Rep.*1.
30. *Id.*, at 6.
31. *Supra* note 1, at 150.
32. (1988) 2 *S.C.R.* *Supl.* 859.
33. *Id.*, at 1126.