

# The Obligation of the Issuing Bank towards Beneficiary in the System of International Documentary Credit

Doctor Nashat Mahmoud Abdalla Jaradat

LL.B., LL.M., Ph.D, Faculty of Law Department of Private Law-Commercial Law  
University of Northern Border, Former University of Bahrain

## ABSTRACT

*The paper focuses on the need for this system of the documentary credit. The paper also analyzes the entire procedure involved in the implementation of the documentary credit system. The paper further analyzes the basic principles of Documentary Credit: the independence principle (that letter of credit is independent of the underlying sales contract) and strict compliance principle (that the documents submitted by the seller must conform to the terms of the credit in the strictest sense). The body of the paper will analyze in detail the legal obligations and duties of the issuing bank towards the beneficiary, in the light of basic principles of the letter of credit and vice-versa; the study also examines the effect of different circumstances on these duties. In doing so the author focuses on the common law principles evolved over the period of time on the issue; in addition to that the paper also examines the Uniform Customs and Practice for Documentary Credit (UCP 500) issued by the International Chamber of Commerce in 1993, as it is the only international instrument on the subject and even UCP provides for application of domestic law and common law.*

**Keywords:-** Uniform Customs and Practice (UCP). Documentary Credit, International Chamber of Commerce.

## 1. INTRODUCTION

The international trading system has evolved over the period of years and with the evolution of the new modes of transaction new types of risks have come to the surface.<sup>1</sup>This has also resulted in lot of cases of fraud.<sup>2</sup>Thus new modes of payment have evolved with time and one such mode is “documentary credit” or “letter of credit”; this system can be traced back to twelfth century practices of Europe.<sup>3</sup> The system of documentary credit is said to have evolved in the middle age in connection with the trade of goods, became popular in nineteenth century and was widely used after the 1<sup>st</sup> World War.<sup>4</sup> There are evidences to suggest that the system was used in Renaissance Europe, Imperial Rome, ancient Greece, and Phoenicia and even in early Egypt.<sup>5</sup>Richard Schaffer makes an interesting observation that the evolution of the system of letter of credit has been an evolution of mercantile speciality and has nothing to do with the common law development of concept of contract, though multiple contracts are involved in it.<sup>6</sup> Also that letter of credit is a deviation from the “lex mercatoria” , the customary law of the merchants which are used in international trade law, and is a separate system in itself.<sup>7</sup> The documentary credit is an independent undertaking on the part of the bank which adds a secure paymaster for discharging buyer’s obligation to pay the purchase price, at the same time it is fully independent of the underlying sale contract between the buyer and the seller, because of this seller knows that the payment is secured unless and until he commits a default in production of documents as per the condition of letter of credit.<sup>8</sup> It is conditional promise issued by the issuing bank, thus there is contractual relationship between the beneficiary and issuing bank.<sup>9</sup>In other words letter of credits are essentially conditional promises to pay for goods and services made by one bank to another bank, substituting the credibility of the banks promise for the buyers promise to pay; they can be considered as risk mitigation tools.<sup>10</sup> There are several factors and risk that has made this mode of payment popular among both the seller and the buyer: firstly that the parties might not know each other as well as they know in domestic set up, several types of delay in transit might block the flow of capital, then is at all there is a dispute then the parties will have a cross- border dispute at their hand, further the risk of bankruptcy as far as the seller is concerned, the buyer is also benefited as he can decide what documents he want to see before he makes the payment so that he is assured about the quality and other aspects of the goods, then the buyer can finance his purchase by taking advance from his bank, and finally this will help both the party in smooth transaction.<sup>11</sup>It was interestingly defined:<sup>12</sup>

*“An open letter of request where one person ( usually a merchant or banker) requests some other persons to advance money or give credit to ta third person named there in , for a certain amount, and promises that he will repay the same to the person advancing the same, or excepting bills drawn upon himself, for the like amount. It is called general letter of credit when it is addressed to all merchants or other persons in general, requesting such advance to third person; and it is called the special letter of credit when it is addressed to a particular person by name requesting him to make such advance to a third person.”*

According to this definition the sole purpose of this instrument is to extend the credit to one person on the promise or another who will be a banker. The Banker will act as a paymaster to the person extending the credit. Many English writers have adopted this definition.<sup>13</sup> Hart<sup>14</sup> refers to documentary letter of credit as the undertaking on the part of the bank is to accept draft against documents of titles to, goods particulars of the merchandise in respect of which the bills are to be drawn being stated; it is a documentary credit.<sup>15</sup> Further the definition has been modified by Gutteridge<sup>16</sup>:

*“One which provided the banker’s liability to pay or accept the seller’s draft is conditional on his being furnished with certain documents (generally a bill of lading, policy of insurance and invoice) which are to be pleaded to him as security as an advance”<sup>17</sup>*

It is important at this juncture to note the definition provided by the Halsbury’s Laws of England<sup>18</sup>, it defines a letter of credit as an undertaking by a banker to meet drafts drawn under the credit by beneficiary of the credit in accordance with the condition laid down therein. A judicial attempt to define the letter of credit can be seen in *Voest-Alpine International Corporation v. Chase Manhattan Bank*,<sup>19</sup> as: “A typical letter of credit transaction involves three separate and independent relationships- an underlying sale of goods contract between the buyer and the seller, an agreement between a bank and its customer (buyer) in which the banks undertakes to issue a letter of credit and the banks resulting engagement to pay the beneficiary (seller) providing that certain documents presented to the bank conform with the terms and conditions of the credit issued on its customers behalf. Significantly the banks payment obligation to the beneficiary is primary, direct and completely independent of any claims which may arise in underlying sale of good transaction.” Two international instruments on the subject are Uniform Customs and Practices for Documentary Credit<sup>20</sup> (UCP 600 being the latest one) and Uniform Commercial Code. U.C.P 500 Article 221 and UCP 600 Article 222 provide the definition of letter of credit. But both the definitions are not perfect, because firstly all the aspects of letter of credit are not covered and secondly the definition also treats irrevocable letter of credit over the revocable credit.

## **2. AIM AND OBJECTIVE**

The paper analyzes the legal relationship between the beneficiary and the issuing bank in case of letter of credit. It would give a critical analysis of the extent of the obligation issuing bank has towards the beneficiary and viceversa. The paper has targets judicial pronouncement and UCP for the analysis.

## **3. SCOPE**

The researcher has limited the scope of the paper to the common law judicial pronouncement and has given less space to the provisions of the UCP 500 and 600. The author has referred to case laws from different jurisdictions to give a wider prospective but comparative study of different legal regimes have been done very briefly.

## **4. HYPOTHESIS**

The paper emphasis on the legal relationship between the issuing bank and the beneficiary with regard to the letter of credit system; the focus is on the nature of the contractual relationship between the issuing bank and beneficiary, their legal obligation towards each other and the independence of this relationship form other parties to the letter of credit.

## **5. RESEARCH PROBLEM**

The system of letter of credit is complex and has many parties and many contractual relationships; thus it is important to analyze the relationship between the beneficiary and the issuing bank in isolation to draw the extent and ambit of their legal relationship.

## **6. RESEARCH QUESTION**

What is the importance system of letter of credit? What are the role of the beneficiary and the issuing bank? What is the extent of obligation of the issuing bank towards the beneficiary?

## **7. RESEARCH METHODOLOGY**

A descriptive style of writing has been used throughout the paper. Doctrinal method of research has been adopted. Case laws form different jurisdiction and UCP are being used as primary sources, whereas different legal commentaries and articles written by various author on the subject have been used as secondary sources for the purpose of analysis in this paper.

## **8. PROCEDURE INVOLVED IN LETTER OF CREDIT**

The letter of credit involves four different parties with different contractual relationship involving a chain of transactions.<sup>23</sup> Four parties<sup>24</sup> involved are: the buyer,<sup>25</sup> the seller,<sup>26</sup> the bank issuing the credit<sup>27</sup> and the bank making the payment.<sup>28</sup> Lord Wright describes the functions of letter of credit in following word: "The General Course of International Commerce involves the practice of raising money on the documents so as to bridge the periods between the shipment and the time of obtaining payment against the document."<sup>29</sup> Once the sale has been agreed the buyer apply to his bank and obtains a letter of credit from his bank (the issuing bank) in favour the seller (beneficiary), the application form for letter of credit given by the Buyer acts as contract between the buyer and the issuing bank, if the issuing bank agrees to issue the letter of credit.<sup>30</sup> The seller needs to be advised of the letter of credit usually by the issuing bank but it is more commonly done by the bank in seller's country; if the seller confirms the letter of credit the bank becomes "confirming bank" and thus a contract is created between the seller and the confirming bank.<sup>31</sup> In order to claim the payment the seller has to produce the documents stipulated in the letter of credit before the issuing bank or the confirming bank as the case may be, the bank may reject the documents or accept them and make the payment, in case the documents are rejected then they are to be submitted again but before the period of credit has expired (the bank may also waive<sup>32</sup> certain small discrepancies).<sup>33</sup> If the confirming bank has done the payment it will then submit the documents to the issuing bank for reimbursement.<sup>34</sup> Finally the issuing bank will produce the documents before the buyer for reimbursement and the buyer will check if the documents are accurate, if satisfied he will make the payment.<sup>35</sup> With those documents the buyer will then take the delivery of the goods. It is an essential to open the letter of credit in time to enable the shipment of goods, in *Garcia v. Page & Co. Ltd.*<sup>36</sup> The Court held that it is prerequisite to open a letter of credit to the duty of the seller to ship the goods; the Court further held that if the original contract of sale stipulates a date, to open the letter of credit, then that date International Journal of Application or Innovation in Engineering & Management has to be complied with. It is also well settled that it is not only to be opened but also to be communicated to the beneficiary (seller), in *Bunge Corp v. Vegetable Vitamin Food (Pte) Ltd.*,<sup>37</sup> the letter of credit is only considered to be opened when the seller has been advised about the same or the confirmation of the letter of credit has been confirmed to the beneficiary.<sup>38</sup> In *Pavia & Co SpA v. Thurmann-Nielsen*,<sup>39</sup> the Court of Appeal was dealing with the cases where no time was stipulated and the Court held that in such cases the seller must be provided with the credit before the beginning of the shipment period so that he is assured that shipping the goods will not land him into any type of risk as the payment is secured, Lord Denning observed: "[The seller] may ship on the very first day of the shipment period. If, therefore, the buyer is to fulfil his obligations he must make the credit available to the seller at the very first date when the goods may be lawfully shipped in compliance with the contract."<sup>40</sup>

## **9. ESSENTIAL FEATURES OF LETTER OF CREDIT**

### **9.1. The Independence Principle**

This principle says that the letter of credit is independent to the underlying sale contract between the seller and the buyer. UCP Article 3(a)<sup>41</sup> states that the very nature of the credit makes it different from the contract of sale on which they might be based and thus the banks are absolutely free from them.<sup>42</sup> In addition to this the principle also finds backing in Article 443 of UCP which states that though the letter of credit may be based on goods and services but operation of all the parties under the contract is based on documents. This principle is one of the touch-stone when it comes to the obligation of the issuing bank towards the beneficiary and visa versa.

### **9.2. The Strict Compliance Principle**

This principle requires that the Banks must pay against the documents submitted to it by the beneficiary and that there should be strict compliance of the same. Article 1344 of the UCP recognizes this principle, it states that the bank must scrutinize all the documents carefully keeping in mind all the international standards and the conditions mentioned in the letter of credit and make the payment only when all the document appear to be consistent with the requirement of the letter of credit.<sup>45</sup> In this case the bank not only protects itself but also the interest of the buyer (applicant of the letter of credit).

### **10- Beneficiary and the Issuing Bank: Legal Duties and Obligation**

The contractual relationship between the issuing bank and the beneficiary is more important in the case of irrevocable letter of credit,<sup>46</sup> generally irrevocable letter of credit more over Article 2,<sup>47</sup> only refers to irrevocable letter of credit. The contract between the issuing bank and the beneficiary can come into effect by four different means, firstly when the issuing bank instructs the advising bank to advise the credit; is the advising bank sends out the advice of the opening of the credit, at the time of receiving the notification of the credit by the beneficiary and at the time when the beneficiary acts in reliance of the credit.<sup>48</sup> One can refer to Article 749 of the UCP and judicial pronouncement to see the obligation of the advising bank toward the beneficiary. The contractual relationship between the beneficiary and the issuing bank is based on indirect consideration, because there is no element of consideration from the beneficiary to the issuing bank, but the documents produced by the beneficiary are used by the issuing bank for reimbursement.<sup>50</sup> Peter Ellinger and Dora Neo,<sup>51</sup> in their book observe that the system of letter of credit is so well established that any attempt to avoid the obligation on the plea of absence of consideration is set to be "doomed to failure". As mentioned earlier it

is the cardinal principle in the system of letter of credit that the relationships are independent of the underlying sales contract between the seller and the buyer (i.e. the beneficiary and the applicant of the letter of credit) though the letter of credit is a result of that contract of sale and most of these contract of sale also mandate for letter of credit. Thus in their relationship neither the beneficiary nor the issuing bank can rely on the underlying contract of sale.<sup>52</sup> Lord Diplock<sup>53</sup> rightly observed that there can be four contractual relationships in the case of letter of credit but each is autonomous and independent to each other. In the case of *Banker's Trust Co. v. State Bank of India*,<sup>54</sup> Sir John Megaw cautioned about the principle of independence and rightly observed: "The metaphor "autonomous" means only that one does not read into any of the four contracts the term of any of the other three contracts. But the 'genesis and the aim of the transaction' are not to be ignored where they may be relevant to assist in the interpretation of the terms of the contract." Thus the terms of letter of credit must be unambiguous and clear. In *Commercial Banking Co of Sydney Ltd. v. Jalsard Pty Ltd.*,<sup>55</sup> it was held that the terms of letter of credit have to be mentioned and it must be clear as to what documents the beneficiary needs to produce to claim the payment, the buyers instruction in this regard are paramount and if the bank has paid out contrary to the given instruction it has no recourse for reimbursement, but if the instructions are not clear then the bank cannot be blamed to have adopted a reasonable interpretation.<sup>56</sup> Further Lord Diplock<sup>57</sup> observed that: "Both the issuing banker and its correspondent bank have to make quick decision as to whether a document which has been tendered by the seller complies with the requirements of the letter of credit at risk of incurring liability to one or other parties to the transaction if the decision is wrong. Delay in deciding may in itself result in breach of his contractual obligations to the buyer or to the seller. This is the reason of the rule that where banker's instructions from his customer are ambiguous or unclear he commits no breach of his contract with the buyer if he has construed them in a reasonable sense, even though upon closer consideration which can be given to questions of construction in an action in a court of law, it is possible to say that some other meaning is to be preferred." This observation makes it clear that there is obligation on the part of the issuing bank to decide as soon as possible the correctness of the documents produced by the beneficiary.<sup>58</sup> Moreover a failure to decide in the stipulated time may lead to the conclusion that the bank has accepted the documents.<sup>59</sup> In the case of *Urquhart Industry and Co. Ltd. v. Eastern Bank Ltd.*,<sup>60</sup> the letter of credit was irrevocable one and the bank on instruction for its customer deferred payment. The Court held that the letter of credit and the underlying sale contract are different, and the obligation of the bank is independent for the contract of sale between the seller and the buyer and thus the banker is in breach of its contractual obligation. Further in the case of *Maurice O'Meara Co. v. National Park Bank of New York*,<sup>61</sup> McLaughlin J., observed that the letter of credit is between the seller and the banker once the issuing bank on application from the buyer issues it in the favour of the beneficiary (seller), it only signifies that the banker has to make the payment on production of the documents mentioned in the letter of credit, he can deny the payment if the documents produced do not match to the ones mentioned in the terms of the letter of credit and nothing more; the contract of sale is a contract between the seller and the buyer, the bank is not privy to that contract and must refrain from relying on the same, thus the banker cannot deny his obligation under the letter of credit under the cover of the contract of sale between the seller and the buyer. The independence of the letter of credit goes along way and even the buyer (the applicant of the letter of credit) cannot alter the rights and duties between the bank and the beneficiary. In the case of *Hamzeh Malas & Sons v. British Imex Industires Ltd.*,<sup>62</sup> the buyer claimed that the goods were defective and were inconsistent with the description mentioned in original contract of sale, and thus applied for injunction to stop the bank from making payment against the letter of credit to the beneficiary, the Court denied to issue such an injunction and Jenkins L.J. rightly pointed out: "It seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the seller and the vendor of goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to the goods are up to contract or not." Probably this cannot be put in any words simpler than the words used by Jenkins L.J that the obligation of bank towards the beneficiary is totally independent of the underlying contract of sales. Further Article 34 provides for the benefit that the bank has due to this absolute liability, he is not at all bothered with the quality etc. of the goods. In the case of *Dexter Ltd. v. Schenker & Co.*<sup>63</sup> the Court held that in the cases where on production of valid documents the payment has been deferred by the bank in the stipulated time, the action to recover the money will be treated as an action for damages for breach of contractual obligation,<sup>64</sup> and Greer J observed: "...the date of the payment has passed and the payment has not been made, the way to read the claim of this sort is that it is the claim for damages for non-payment of money, and in ninety-nine out of hundred cases the amount of damages will be the sum which there has been the undertaking to pay."<sup>65</sup> But not always the "damages" are equal to the money due. In the case of *Prehn v. Royal Bank of Liverpool*,<sup>66</sup> the applicant of the letter of credit and the beneficiary were the same merchant's two different wings, the bank refused the payment. In the action to claim the money the Court allowed the beneficiary to also claim as the part of "damages": the expenditure for protest and the cost of cables. In certain cases the amount of damages will be calculated by placing the bank in the shoes of the buyer and checking what the buyer would have paid as damages in the case of refusal to accept the goods.<sup>67</sup> A different remedy for damages was provided to the beneficiary in the case of *Urquhart Industry and Co. Ltd. v. Eastern Bank Ltd.*,<sup>68</sup> in that case the Court held that the breach by the bank of non-payment can be seen as repudiatory breach and thus the beneficiary can avoid the contract and also claim for damages.

In case there has been a late payment by the bank and it has led to the beneficiary suffering damages he might claim damages if the principle of remoteness of damages<sup>69</sup>. In *Ozalid Group (Export) Ltd v. African Continental Bank Ltd.*,<sup>70</sup> due to the delay in the payment the exchange rate of currency changed and as a result of which the beneficiary suffered loss and the facts clearly showed that the bank was aware that this could happen and therefore it was easy for the Court to decide in favour of the beneficiary and award damages accordingly. The claim for damages in such cases will be successful as long as the principle of remoteness is satisfied and the defaulter has reasons to believe that the delay might cause some harm.<sup>71</sup> Since the facts of the *Ozalid Case*<sup>72</sup> were simple thus the Court did not go into the details but the case was again analyzed by House of Lords in *President of India v. La Pintada Compania Navegacion SA*,<sup>73</sup> and the Court held that such damages will only be awarded when the damage was reasonably anticipated by both the parties. The Bank is perfectly within its right to deny the payment if the required documents are not produced by the beneficiary or otherwise the production is non-complying with the terms of letter of credit, e.g. after the stipulated time etc.<sup>74</sup> In the case of *JH Rayner & Co. Ltd. v. Hambro's Bank Ltd.*,<sup>75</sup> the terms of the letter of credit defined the goods as "Coromandel groundnuts" and the seller produced a bill of lading of the good termed as "machine-shelled groundnuts kernels" and the invoice for "Coromandel groundnuts" to the issuing bank. The bank refused the payment on the grounds that the documents produced did not match the terms of letter of credit, but the beneficiary claimed that it was well known in the trade that the two terms "Coromandel groundnuts" and "machine-shelled groundnuts kernels" are one and the same, but still the Banker was well within his rights to deny the payment under the principle of strict compliance, as the Banker is not supposed to know the common usage of all the trades. This case suggests how serious the implication of strict compliance can be. The religious following of the principle of strict compliance finds backing in the observation of Lord Sumner<sup>76</sup>: "It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorized to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same or which will do just as well. Business could not proceed securely on any other ground 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; it departs from the conditions laid down, it acts at its own risk." The necessity for the principle of strict compliance has been very appropriately put by Lord Sumner. Further in the case of *Seaconsar Far East Ltd v. Bank Markazi jomhourī Islami Iran*,<sup>77</sup> the Court observed that the strict compliance has to be constructed strictly and that the arguments of "de minimis" cannot be accepted in this case. But UCP Article 30 allows slight deviation and provides little discretion on the part of the issuing bank to waive little discrepancies.<sup>78</sup> But again this is not universal, in the case of *Moralice (London) Ltd. v. F Man*,<sup>79</sup> Court pointed out that de minimis non curat lex will not be applicable where strictness is paramount.<sup>80</sup> In these types of cases where documentary obligations are to be fulfilled there is always a big space for interpretation and this could lead to subjectivity, therefore in the case of *Credit Agricole Indosuez v. Muslim Commercial Bank Ltd.*,<sup>81</sup> Court of appeal held that in the cases where there is room for ambiguity and interpretation is required, the interpretation should be done in the lines of international banking practices. Though the bank is obliged to pay on the production of documents and has to check them without reference to nothing but the letter of credit, the bank is not obliged to check the genuineness of the documents or whether the documents are a result of fraud.<sup>82</sup> In *Gian Singh & Co. Ltd. v. Banque de l'Indochine*,<sup>83</sup> the Privy Council held that, if the bank pays on the production of forged documents he cannot be held liable, under law it was supposed to check the documents that were mentioned into the letter of credit and nothing beyond unless otherwise mentioned in the letter of credit, thus he cannot be supposed to check if the signatures were forged. In *Standard Bank of London v. The Bank of Tokyo Ltd.*,<sup>84</sup> Walker J observed: "The duty to inquire will depend on the circumstances of each and every case and what should, or may, put someone on enquiry will also depend on the circumstance of an individual case thus the more usual the circumstance and the clearer a representation appears to be the less the duty to inquire should be and the less likely there will be to be circumstances which will put anyone on inquiry."<sup>85</sup> In the case of *Sztjen v. Henry Schroder Banking Co.*,<sup>86</sup> before the payment was made it was brought to the notice of the bank that the documents produced by the seller were fraudulent and that he shipped different goods which were not mentioned in the terms of the letter of credit, the Court came down very harshly on the practice of fraudulent claims in the cover of strict compliance and observed: "It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller.....This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade.....It would be most unfortunate interference with business transactions if a bank before honouring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into the controversy between the seller and the buyer regarding the quality of merchandise shipped. But in this case the seller has intentionally failed to ship any goods ordered by the buyer. In such situations, where the seller's fraud has been called to the bank's attention before the draft 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 executed to protect the unscrupulous seller."<sup>87</sup> In an very interesting case of *Hong Kong and Shanghai Banking Corp. v. Kloeckner & Co. AG*,<sup>88</sup> the issue of set off came before the Court, as to whether the issuing bank can set-off other claims it has against the beneficiary against the money payable under the letter of credit. The facts of the case clearly showed that the money that the bank wanted to set-off was a result of previous transaction

on the same letter of credit. Nevertheless the beneficiary opposed this set-off relying on the cardinal principle of letter of credit: autonomy of letter of credit, but the Court denied this contention stating that the object of this principle is to save the transaction between the issuing bank and the beneficiary from the underlying sales contract and related problems between the seller and buyer, thus has no relevance for the case of set-off where the Bank wants to set-off the previous obligation of the beneficiary. Though the Court allowed the set-off in the present case but one of the strong grounds in favour of doing so was the fact that the amount to be set-off was the result of the same transaction. It therefore seems that there is still scope and necessity of the application of judicial mind on the issue, but the chance of the Court getting opportunity like this is less as the chances that the beneficiary would have any amount due to be set-off by the issuing bank is very less as generally the issuing bank is the bank whose customer is the buyer and not the seller (the beneficiary).

## **11. TREATMENT IN DIFFERENT JURISDICTIONS**

In the United Kingdom, the system of letter of credit became popular with the passage of time and evolution through common law; earlier banks and courts both were reluctant to use/enforce the system. But slowly the Courts<sup>89</sup> have given recognition to the system of letter of credit thus even in business the stakeholders are now comfortable to use the system. Although, there is no specific legislation to deal with the same till now. In Australia on the other hand the evolution of the system of letter of credit is a direct result of the judicial interpretation of the contractual principles and has been parallel to other commonwealth jurisdictions.<sup>90</sup> Later even the judiciary has adopted the use of provisions of UCP in deciding the case.<sup>91</sup> The United States of America is perhaps the only jurisdiction where the evolution of the system of letter of credit has happened with the help of legislations, though courts have also played their role.<sup>92</sup> As early as in 1846, in the case of *Brando v. Barnett*,<sup>93</sup> Lord Campbell pointed out: "... when a general usage has been judicially ascertained and established, it becomes a part of the law merchant, which courts of justice are bound to know and recognize." The Uniform Commercial Code is the legislation governing the letter of credit system, it is a joint product of the American Law Institute and the conference of commissions on Uniform State Laws.<sup>94</sup> Since then a number of cases have been decided on the lines of this instrument and the Courts have given varying and often contradicting interpretations.<sup>95</sup> As mentioned earlier internationally the customary usage of the system has gained recognition. The International Chamber of Commerce has contributed by the UCP.<sup>96</sup>

## **11. CONCLUSION**

The system of letter of credit has evolved as a mercantile practice and is a result of practical difficulties in crossborder business transactions and to avoid difficulties like fraud, different types of risk, cross-border litigation.<sup>97</sup> It has also been pointed out earlier that though it contains four different sets of contract the letter of credit has evolved separately from common law development of contract.<sup>98</sup> But even today there are some problems as the system takes too long for the entire process.<sup>99</sup> There is a special type of relationship between the parties to the letter of credit. One such relationship is beneficiary and the issuing bank. The issuing bank is under obligation to pay the beneficiary as long as the beneficiary produces the documents as mentioned in the letter of credit, however if the documents produced by the beneficiary does not correspond to the terms of the letter of credit. This contractual relationship is governed by two cardinal principles of the letter of credit: 1) the independence principle- that the contractual relationship between the beneficiary and the issuing bank is independent of the underlying sales contract and 2) the strict compliance principle- that the terms of the letter of credit must be followed in strict sense by the issuing bank and the beneficiary. The relationship between the issuing bank and the beneficiary is a special type of contract, because there is no direct presence of consideration in these cases, one might say that the documents submitted by the beneficiary to the issuing bank, as the issuing bank claim reimbursement, but then there is no obligation on the beneficiary as far as the reimbursement is concerned only, the applicant of the letter of credit and issuing bank are the concerned party. It is clear that the issuing bank has an obligation to furnish payment to the beneficiary on the production of documents required under the letter of credit, and he cannot under the garb of the underlying contract of sale, in *International Journal of Application or Innovation in Engineering & Management* anyway dilute this obligation. Not even the applicant of the letter of credit, who is actually paying, in the larger picture, can stop the payment if the beneficiary has produced the required documents. Thus the system provides a actual assurance of payment to the beneficiary and thus securing the entire business environment. It has also been seen that though the contract involved are autonomous, they are nevertheless product of each other. The issuing bank is not obliged or required to go into the examination of the documents to check if the documents are fraudulent or the shipment is defective; but it has also been cautioned that this does not mean that the issuing bank's conduct should encourage the fraudulent seller if the fraud is apparent and known to the issuing bank before making the payment.

## REFERENCES

- [1] Daniel C.K. Chow and Thomas J. Scheonbaum, *International Business Transaction: Problem, Cases, and Materials*, Aspen Publishers, p. 251.
- [2] Catty Gunn, "Financial Fraud", 1984, *Banking World* 21.
- [3] Id.
- [4] E.P. Ellinger, *Documentary Letter of Credit- A comparative Study*, 1970, University of Singapore Press, at p. 106. Singapore,
- [5] Rufus James Trimble, "The Law Merchant and the Letter of Credit", 1948, 61 *Harvard Law Review* 981.
- [6] Richard Schaffer, Beverley Earle, *International Business Law and its Environment*, West Educational Publishing Co., Ohio, at p. 254.
- [7] M. Kurkela, *Letter of Credit under International Trade Law: U.C.C.U.C.P. and Law Merchant*, Oceana Publications Inc. New York, at p. 321; see also Janak De Silva, "The New Law Merchant: Fact or Fiction?" 17, 2005, *Sri Lanka Journal of International Law*, at p. 167; see also H. Veytia, "The Requirement of Justice and Equity in Contracts" 1995, 68 *Tul.L. Rev.* 1191 at p. 1197.
- [8] Simone Schitzer, *Understanding International Trade Law*, 1st ed., 2007, Universal Law Publication Co. Pvt. Ltd., p. 81.
- [9] Peter Gillies and Gabriel Monens, *International Trade and Business: Law, Policy and Ethics*, Cavendish Publishing, London, (1998), p. 387.
- [10] Janet Koen Levit, "A Bottom-up Approach to International Law Making: The Tale of Three Trade Finance Instruments", 30 *Yale Journal International Law*, 125(2005).
- [11] J.C.T. Chuah, *Law of International Trade: Cross Border Commercial Transactions*, 4th ed., 2009, Swwet&Maxwell Thomson Reuters, p. 518.
- [12] A.G. Davis, *The Law Relating to Commercial Letters of Credit*, Sir Issac Pitman and Sons Ltd., London, (1963) p. 1.
- [13] Id.
- [14] Herbert L. Hart, *Law of Banking*, Stevenson and Sons Ltd., London, (1931), p. 640.
- [15] Id.
- [16] H.C. Gutteridge and Mourice Megrah, *The Law of Banker's Commercial Credit*, Europa Publications Ltd., London, (1979) p. 5.
- [17] This is a definition which brings the liability of the bank under its preview but it does not mention the role of the bank as conforming or negotiating bank.
- [18] 3 *Halsbury Laws of England* 209 (1989).
- [19] 707 F. 680 (1983)
- [20] Issued by the International Chamber of Commerce in the year 1993.
- [21] Article 2. Meaning of Credit: For the purpose of these Articles, the expressions 'Documentary Credit(s)' and 'Standby Letter(s) of Credit' (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') or on its own behalf:**
- i. Is to make a payment to or to the order of a third party (the 'Beneficiary'), or is to accept and pay bills of exchange (Draft(s)) drawn by the Beneficiary, or
- ii. Authorises another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s)),
- or
- iii. Authorises another bank to negotiate, against stipulated document(s), provided that the terms and conditions of the Credit are complied with. For the purpose of these Articles, branches of a bank in different countries are considered another bank.
- [22] 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.
- [23] Paul Todd, *Bill of Lading And Bankers' Documentary Credits*, 4th ed., 2007, Informa London, at p. 9.
- [24] The parties might be three if the issuing bank is the one making the payment and the intermediary bank is not in the picture; but the general practice is to have an intermediary bank in which case the parties involved are four.
- [25] The applicant of the credit.
- [26] The beneficiary of the credit.
- [27] Issuing Bank.
- [28] The intermediary bank or the paying bank.
- [29] T.D. Bailey Son & Co. v. Ross T. Smyth & Co. Ltd. (1940) 56 T.L.R 825 ; see also Leo'D Arcy, Carole Murray, *Schmithoff's Export Trade: The Law and Practice of International Trade*, Sweet&Maxwell, London , at p. 167.
- [30] *Supra* note 11 at p. 518.
- [31] Id.

- [32] But this discretion is very limited as strict compliance is one of the features of the letter of credit.
- [33] Supra note 31.
- [34] Id. at p. 519.
- [35] Id.
- [36] (1936) 55 L.L.R. 391.
- [37] [1985] 1 Lloyd's Rep. 613.
- [38] It seems to be going on the same line as the principle of common law in *Brinkibon Ltd. v. Stahag Stahl und Stahlwarenhandels GmbH* [1983] 2 A.C. 34, which held that the acceptance of revocation notices would only take effect upon their communication to the respondent, the mere act of sending the notice is insufficient.
- [39] [1952] 2 Q.B. 84.
- [40] See also *Glencore Grain Rotterdam BV v. Lebanese Organization for International Commerce*, [1997] 4 ALL E.R. 514.
- [41] 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. Consequently the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfil any other obligation under the Credit, is not subject to claims or defences by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary
- [42] Supra note 1 at p. 258.
- [43] Article 4. Documents vs. Goods/Services/Performances: In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate.
- [44] Article 13. Standard for Examination of Documents:
- A. Banks must examine all documents stipulated in the Credit with reasonable care to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles. Documents, which appear on their face to be inconsistent with one another, will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit. Documents not stipulated in the Credit will not be examined by banks. If they receive such documents, they shall return them to the presenter or pass them on without responsibility.
- B. The Issuing Bank, the Confirming Bank, if any, or a Nominated Bank acting on their behalf, shall each have a reasonable time, not to exceed seven banking days following the day of receipt of the documents, to examine the documents and determine whether to take up or refuse the documents and to inform the party from which it received the documents accordingly.
- C. If a Credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them
- [45] Supra note 1 at p. 270.
- [46] UCP 500 Art. 8(a): A revocable credit may be amended or cancelled by the Issuing Bank at any moment and without prior notice to the Beneficiary.
- [47] Supra note 21.
- [48] Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit*, 2010, Hart Publishing Oxford and Portland, Oregon, at p. 109-110.
- [49] Article 7. Advising Bank's Liability:
- A credit may be advised to a Beneficiary through another bank (the 'Advising Bank') without engagement on the part of the Advising Bank, but that bank, if it elects to advise the Credit, shall take reasonable care to check the apparent authenticity of the Credit which it advises. If the bank elects not to advise the Credit, it must so inform the Issuing Bank without delay.
- B. If the Advising Bank cannot establish such apparent authenticity it must inform, without delay, the bank from which the instructions appear to have been received that it has been unable to establish the authenticity of the Credit and if it elects nonetheless to advise the Credit it must inform the Beneficiary that it has not been able to establish the authenticity of the Credit.
- [50] See *Observation of Donaldson J., in Elder Dempster Lines Ltd v. Ionic Shipping Agency Inc*, [1968] 1 Lloyd's Rep. 529 at p. 535. But this argument has a loop hole in the cases of where the bank is denied payment by the buyer on the grounds that the documents were not as specified by the letter of credit.
- [51] Supra note 48 at p. 110
- [52] Supra note 11 at p. 519.
- [53] *United City Merchants (Investments) Ltd. v. Royal Bank of Canada (the American Accord)*, [1983] 1 A.C. 168 at para 1.57
- [54] [1991] 2 Lloyd's Rep 433.
- [55] [1973] A.C. 279.
- [56] Supra note 11 at p. 523.

- [57] Supra note 47.
- [58] Article 13 and 14 of the UCP recognize this principle.
- [59] *Westminster Bank Ltd. v. Banca Nazionale di Credito*, (1928) 31 LI L Rep 306.
- [60] [1921] 1 King's Bench 318.
- [61] 239 N.Y. 386, 146 N.E. 636.
- [62] [1958] 2 Q.B. 127.
- [63] (1923) 14 Lloyd's Rep 586.
- [64] See also *Mannesman Handel AG v. Kaunlaren Shipping Corp*, [1993] Lloyd's Rep 89.
- [65] Supra note 60 at p. 588.
- [66] (1870) LR 5 Ex 92.
- [67] For more information see *Belgian Grain and Produce Ltd v. Cox & CO. (France) Ltd.*, (1919) 1 Lloyd's Rep 256; *Stein v. Hambros Bank of Northern Commerce*, (1921) 9 Lloyd's Rep 433.
- [68] [1922] 1 KB 318.
- [69] See *Hadely v. Baxendale* (1854) 9 Exch 341; *Victoria Laundry (Windsor) Ltd v. Newman Industries Ltd* [1949] KB 528 and *Koufos v. C Czarnikow Ltd*, [1969] 1 AC 350/
- [70] [1979] 2 Lloyd's Rep 231.
- [71] *International Minerals and Chemical Corporation v. Karl O Helm AG*, [1986] Lloyd's Rep 81, at p. 104-05.
- [72] Supra note 70.
- [73] [1985] AC 104.
- [74] This has the backing in the second feature of letter of credit: strict compliance.
- [75] [1943] K.B. 37.
- [76] *Equitable Trust Company of New York v. Dawson Partners Ltd*, (1927) 27 LI. L. Rep. 49.
- [77] [1993] 3 W.L.R 756, CA; [1993] 3 W.L.R. 756, H.L.
- [78] Supra note 33.
- [79] [1954] 2 Lloyd's Rep. 526.
- [80] See also *Bunge Corp v. Vegetable Vitamin Foods (Private) Ltd.*, [1985] 1 Lloyd's Rep. 613.
- [81] [2000] 1 Lloyd's Rep. 275.
- [82] Article 34 give effect to this.
- [83] [1974] 1 W.L.R. 1234
- [84] [1995] 2 Lloyd's Rep 169.
- [85] *Id.* at p. 174.
- [86] 31 N.Y.S.2d 631 (Sup. Ct. 1941).
- [87] *Id.* at para 6.
- [88] [1990] 2 QB 514.
- [89] *Banque de l'Indoschine et de Suez v. J.H. Rayner (Mincing Lane) Ltd.*, [1983] Q.B. 711; *Forestal Mimosa v. Oriental Credit Ltd.*, [1986] 1 W.L.R. 631.
- [90] V.V. Keshkamat, *Documentary Letter of Credit- Uniform Customs and Practice*, 1976, Vivek Publications Bombay, at p. 55.
- [91] Australian High Court used it in *Singer & Friedlander v. Creditanstalt-Bankverein*, 17 cg 72180, 1980; see also Rolf Eberth and E.P. Ellinger, *Assignment and Presentation of Documents in Commercial Credit Transactions*, 1980, 24 *Arizona Law Review*, at p. 285.
- [92] *Moss v. Old Colony Trust Co.*, 149 N.E.803; see also H.C. Gutteridge and Murice Megrah, *The Law of Banker's Commercial Credit*, Eurpoa Publications Ltd., 1979, London.
- [93] (1846) 12 Cl. & F 787.
- [94] Walter D Malcom, *The Uniform Commercial Code in the United States*, 1963, 12 *International Comparative Law Quarterly* 226.
- [95] Henry Harfield, *Secondary Uses of Commercial Credits*, 1944, 44 *Columbia Law Review*, at p. 899.
- [96] The modified version UCP 600 came to effect in 2007.
- [97] Supra note 2.
- [98] Supra note 5.
- [99] Leonard W. Krouner, *The Profile on Endorsements in Letter of Indemnity*, 1986, 14 *Journal of International Business Law* 271, at p. 275