

Rethinking the Law of Letters of Credit

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Synopsis

The documentary letters of credit transaction is the most common method of payment for goods in international trade. Its use has been considered so important that it is referred to as the “lifeblood” of international commerce.

The purpose of this thesis is, through analysing the present regime of documentary credit established under the *The Uniform Customs and Practice for Documentary Credits*, 1993 Revision (“UCP”), to identify the rights and duties of all parties in such transactions and the reasons for the frequent occurrence of fraudulent activities associated with the documents required under the credits. It identifies that the present system fails to either encourage or implement substantial realisation of “reasonable care” or “good faith” on the part of the banks, or realisation of the requirement of “good faith” from beneficiaries. As a result, the independence principle has been left without substance, with resulting huge opportunities for fraudsters to cheat on the documents and obtain payment without the need to actually perform their duties to banks and buyers.

Such issues have become more acute against the background of an underlying shift in the allocation of risk between the respective parties to letters of credit. There has been a depreciation in the value of the primary document of title and security held by the issuer, the bill of lading, with the advent of container shipping. As the letter of credit system is wholly dependent on the integrity of the documents, it is being undermined by these developments. This has represented a shift in the traditional scheme of risk allocation from the seller to the bank. In practice, banks have taken countermeasures by insisting that applicants provide other types of collateral, and by subjecting applicants to rigorous credit checks. Thus, applicants ultimately have had to bear the brunt of costs associated with this reallocation of risk. It will be demonstrated that the UCP does not incorporate adequate or clear enough duties to be exercised on the part of issuers toward applicants, and severely restricts the applicant’s right to sue if the issuer has wrongfully honoured. Ultimately, a balance must be struck between the desirability of protecting the applicant from the beneficiary’s fraud against the benefits gained by maintaining the letter of credit as a commercial instrument and business device. Obviously, there is public interest in protecting both of these commercial values. This thesis advocates that a mechanism in addition to the fraud exception must be introduced to safeguard the system against the

ramifications of these changes — increased fraud.

The thesis is structured into five chapters. Chapter 1 sets out to demonstrate the circumstances under which the respective risks are borne by each participant in the letter of credit transaction, and how developments in trade practice have caused the burden of certain of these risks among the parties to a letter of credit transaction to shift. Chapter 2, after briefly visiting the historical origins of the letter of credit and the birth of the UCP, explores the implications of the dominance of banking interests over the drafting and interpretation of the UCP, how the UCP has in practice excluded the intrusion of other sources of law and the general reluctance of courts to intervene by applying non-letter of credit principles, the implication of the UCP's assumption of the law in practice, the resulting marginalisation of local laws, and the inequality in bargaining power between banks and applicants that precludes a choice of law other than the UCP. Chapter 3 explores the independence principle and question of documentary compliance, why the system is ridden with non-compliant documents and the lack of incentive and meaningful duty for the banks to check for “red flags” that may indicate fraud on the documents or in the transaction. It will be emphasised that documentary validity, rather than mere documentary compliance, should be the focus under the letter of credit. Chapter 4 examines the fraud exception to the independence principle, the typical high thresholds of proof that applicants had to overcome to estopp payment, and explores recent trends towards the gradual lowering of such thresholds. Finally, Chapter 5 considers practical measures and proposals for reform that would help to redress the imbalance in the allocation of risk identified in the thesis.

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