

Chapter 1

Reallocation of Risk under the Letter of Credit Transaction

1. 1. Introduction

The letter of credit¹ 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.²

This thesis sets out to identify the deficiencies in the letters of credit system — focusing primarily on those areas in which it exhibits a lack of justice and equity in its operation, and, in addition, on those areas which render the system particularly vulnerable to fraudulent activities. It will identify the rights and duties of parties to such transactions and the reasons for the apparent ease with which fraudulent activities associated with the required documents under the credits can be executed. It further argues that overemphasis and overprotection of the “independence principle”,³ and the failure to

¹ In this thesis, which does not include ‘standby’ letters of credit within its scope, the term ‘letters of credit’ signifies ‘documentary credits’ and not standby letters of credit.

² Per Stephenson L. J. in *United City Merchants (Investments) Ltd v. Royal Bank of Canada* [1982] Q.B. 208 at 222; Per Kerr L.J. in *R.D. Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd* [1978] Q.B. 146 at 155; *Hong Kong and Shanghai Banking Corporation v. Kloeckner & Co AG* [1989] 2 Lloyd’s Rep. 323, at 330.

³ The independence principle, recognised as the cornerstone of the letter of credit system, emphasises that banks should only deal with documents, and not be concerned with the underlying sales transaction between the buyer-applicant and the seller-beneficiary. The independence principle is discussed in Chapter 3.

encourage substantial realisation of “good faith” on the part of the banks or beneficiaries, or the proper exercise by banks of “reasonable care”, invariably leads to opportunities for fraudulent sellers to cheat on the documents and obtain payment without the need to actually perform their duties to banks and buyers — a situation that threatens to have a serious impact on the integrity of the overall letter of credit system.⁴

This dissertation analyses the reasons for court passiveness in the face of such system defects, and questions how civilised society has tacitly permitted “uncivilised”⁵ practices to penetrate the financing of international sales of goods. Recent decisions of certain English courts⁶ on letters of credit practices will further be examined as evidence of a promising new trend in judging the rights and duties of all parties participating in the letter of credit transaction.

1.2 Outline of the Letter of Credit Transaction

International sales pose problems about payment because of the time between dispatch and delivery. The seller would like to receive payment for the goods when delivering them to the carrier and parts

⁴ Indeed, recent trends as published by the OECD show a declining reliance on letters of credit, although the underlying reason for such trend remains unclear, K. Godier, “Trends Show a Declining Reliance on Letters of Credit”, Vol. 7, No. 3, *DCInsight*, July-September 2001: 1 at 1; Byrne also reports a gradual decline in use of traditional letters of credit, citing figures from the October 2002 edition of *Documentary Credit World*, based on Call Reports for the top 300 US banks, a decline of 3.8% in the usage of letters of credit in the second quarter of 2002 compared to the same period in 2001, as compared to a 4.1% increase in the use of standby letters of credit during the same period., J.E. Bryne, “Overview of Letter of Credit Law and Practice in 2002”, Vol. 7, No. 2, *Documentary Credit World*, February, 2003, 25 at 25.

⁵ *Mannesman Handel AG v. Kaunlaran Shipping Corporation and Others (Third Parties)*, [1993] 1 Lloyd’s Rep 89.

⁶ See for example *Solo Industries UK Ltd v Canara Bank* [2001] EWCA Civ 1041.

with possession of the goods. The buyer would prefer to delay the payment of the price until receipt of the goods.⁷ A letter of credit solves the problem of an importer agreeing to import goods from an overseas supplier, and the supplier having to either insist on prepayment or wait for its money. With the credit, the seller gets prompt payment upon shipment of the contracted goods.⁸

A letter of credit transaction generally involves three separate transactions. The first is between a seller and a buyer, which is often called an underlying transaction, and where the seller provides contracted goods to the buyer. The second transaction is between the buyer-applicant and the issuer of the letter of credit, typically a bank, in which the bank issues a letter of credit to the seller-beneficiary. Finally, the letter of credit itself creates a relationship between the issuer and the beneficiary. Under this relationship, the issuer makes payment for goods shipped upon the beneficiary's presentation of the required documents, such as commercial invoice, bills of lading and insurance certificate, in accordance with the conditions the seller and the buyer have agreed upon. This is all reflected in the terms and conditions of this letter of credit. The bank's performance is conditional on the tender of conforming documents by the beneficiary. The banks are called issuers and are usually the applicant's bank.⁹ Normally the issuing bank opens a

⁷ E.P. Ellinger, *Documentary Letters of Credit - a Comparative Study*, University of Singapore Press, Singapore: 1970, 3.

⁸ J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, Warren, A.S. Pratt & Sons; Detroit: 2001 edition, Update, No. 2., at 3.07(7). Note that this illustration is only from the perspective of international sales of goods. In a standby credit situation, a beneficiary draws on the credit upon non-performance of the underlying contract.

⁹ According to Article 2 of The *Uniform Customs and Practice for Documentary Credits*, 1993 Revision, ICC Publication N 500 ("UCP"), only "banks" may issue credits governed by the UCP

letter of credit in its own name and instructs its correspondent bank to notify the seller. Sometimes, the issuing bank instructs the correspondent bank not only to notify the seller of the issuing bank's undertaking but also to add a confirmation.¹⁰ In this case, the credit is known as a confirmed credit and the correspondent bank as a confirming bank.

The issuing bank's payment obligation is triggered by the beneficiary's presentation of complying documents to the confirming bank or to any other nominated bank provided that the terms and conditions of the credit are complied with. Under general practice, presenting "complying documents" means that they comply with the conditions of the credit "on their face".¹¹ From the point of view of banking practice, compliance "on their face" of the presented documents has been treated as being sufficient. The "independence principle", which has traditionally been insisted upon by bankers and pro-bank scholars as the cardinal principle of the letter of credit system, is said to prohibit banks from looking beyond facial compliance of the documents, and therefore exclude whether or not there is actual performance by the seller-beneficiary from the banks' concern.

It is also argued in this thesis that overemphasis of the financial element of the letter of credit system conveys a distorted picture —

unless otherwise agreed by the parties. Whether an institution is a bank, however, depends on its domestic laws. Branches of a bank in different countries are considered separate legal entities for the purposes of the UCP thereby enabling, for example, a branch of a bank in one country to advise or confirm a credit issued by one of its foreign branches.

¹⁰ A confirming bank often becomes involved at the insistence of the seller-beneficiary, which requires a bank in its own locale to become involved in the letter of credit transaction.

such an approach presents the transaction as if letters of credit are only about bank's payment and buyers' reimbursement and have no relationship whatsoever with the performance of the underlying sales of goods transaction. In pursuit of this line of thinking, it is not surprising that the letters of credit system emphasises the independence principle to such an extent that banks have been able to comfortably ignore performance of the underlying contract. It is asserted that the sense of comfort of the banks in neglecting underlying performance and associated "red flags" is heightened by their sense of familiarity (through thorough screening) with the applicants' financial strength and the elaborate lengths to which they go to obtain security.¹² This was illustrated when real estate values were plummeting by as much as 50% in Hong Kong — banks only issued credits half the face value of assets where customers had been hit by the market crash.¹³ The security of the banks is also reinforced by their use of waiver: often stated as the right of the buyers yet used by banks' as a means to facilitate payment irrespective of discrepancies of documents and non-performance of the sale contract.¹⁴ The consequence of the banks' ability to secure their position and to ignore underlying performance is that honest

¹¹ Article 13, UCP 500.

¹² Such due diligence process is described by eminent banker N.D. George, head of trade finance at the National Bank of Fujairah, Dubai, as first "involving a thorough study of financials, visits to the borrowers premises, several face to face sessions with the borrower, obtaining credit reports, etc — once these are completed, the proposing officer submits a proposal, which is read by several other officials before it is approved — this process can go on for weeks or even months — there is ample opportunity to examine the relationship's viability", N.D. George, "The Insight Interview: N.D. George on the Stresses Facing Trade Finance Specialists and the Future of the Profession", Vol. 7, No. 3, *Insight*, July-September 2001: 9.

¹³ Information collected from interviews conducted with George Sheung, Manager - Operations, Svenska Handelsbanken, Hong Kong Branch, in Hong Kong while attending Letter of Credit Survey 2001, July, 2001, Hong Kong, held under the auspices of *Documentary Credit World*.

¹⁴ See R.J. Mann, "Discrepancies in Presentation Against Commercial Letters of Credit", *Documentary Credit World*, November/December 2000: 21, at 39.

buyers are, in effect, bearing the risk of paying for goods that they had not contracted for.

Honest buyers are not the only losers in this equation. Amazingly, the letters of credit system continues to insist on banks looking no further than the face of the documents despite irrefutable evidence of increasing bank loss arising out of collusion between fraudulent buyers and sellers.¹⁵

1.3 Increasing Strain on the System

This seemingly self-contained structure might have worked perfectly well under the assumption that accurate documents were always presented by honest beneficiaries who always performed their contractual duties of shipping the goods ordered by the buyer in accordance with the terms and conditions of the credit. However, the reality of international trade demonstrates that, over time, there has been an erosion in the reliability of the documents, a trend that has been accompanied by an increase in fraudulent activities. Even though, thankfully, the cases of fraud are relatively rare when compared with the vast volume of international trade — for the unfortunate victims, fraud can be devastating.¹⁶

This thesis further asserts that the banks' duty of checking

¹⁵ See, for example, an article written by the Director of ICC Commercial Crime Services, P. Mukandan, entitled "Trade Finance Fraud: When Buyers and Sellers Collude", Vol. 9, No. 1, *DCInsight*, Jan.-Mch. 2003: 1.

¹⁶ Maria Livanos Cattai, (Secretary General of ICC), cited in Preface of *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, A Special Report prepared by the ICC

documents with “reasonable care” needs to be imbued with more substance. Nowhere in letter of credit law is a duty of care explicitly expressed to be owed by banks toward applicants. This is exacerbated by the fact that applicants are not considered even to be a party to the letter of credit itself. The duty of banks to exercise “reasonable care” as expressed under the UCP was devised and interpreted by the banking community, with no provision for an independent and neutral party to check on compliance. Almost nothing in the system therefore operates to discourage beneficiaries from practising fraud — risks are left, in the main, to the buyer-applicants to absorb (if they can) by suing the seller-beneficiary for non-performance under the underlying sales contract. As mentioned above, as the International Maritime Bureau has been at pains to point out,¹⁷ banks are also in effect increasingly exposed in a fraud-friendly environment despite their attempts to pass on such risks to applicants. It is evident, however, as will be discussed in Chapter 4 of this dissertation, that the traditional operation of this system is increasingly being questioned by courts under recent case law.

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. As will be discussed below, there has been 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

International Maritime Bureau ICC Commercial Crime Services, ICC Publication No. 643, ICC Publications; Paris: 2002, at 3.

¹⁷ See, for example, reference to statements made by IMB Director Pottengal Mukundam in “LC Fraud on the Rise”, *Documentary Credit World*, February 2002.

shipping.¹⁸ This has represented a shift in the traditional scheme of risk allocation from the seller to the bank. In practice, banks have, as mentioned above, taken counter-measures 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.

To redress the balance so that the seller assumes a reasonable and proportionate degree of risk, and for the letter of credit system to reflect an equitable allocation of risk between the parties, this thesis will argue for the adoption of certain counter-measures. While being careful to limit the scope of such measures due to the intrinsic value and fragility of the letter of credit system, it is argued that, ultimately, in order to defend system integrity, a balance must be struck between the desirability of protecting the applicant from the beneficiary's fraud against the benefits of maintaining the letter of credit system, unaltered, as a commercial instrument and business device. Obviously, there is public interest in protecting both of these commercial values.¹⁹

1.4 Scope of Legal Coverage

The focus of this study is on the Uniform Customs and Practice for Documentary Credits (UCP 500), as well as statutory and/or case law of England and other Commonwealth jurisdictions including Australia.

¹⁸ See, for example, C. Eden, "Country Correspondent Reports: United Kingdom", Vol. 7, No. 3, *DC Insight*, July-September 2001: 16. Cyril Eden is of the International Trade Services Department of Bank Elumi (UK) plc, London.

Where relevant, reference will also be made to the US statute that governs letters of credit, the Unified Commercial Code, Article 5 ('95), as well as previous versions of the same statute, particularly the 1962 version as it embodied certain desirable features that are no longer reflected in contemporary legislation.

The eUCP, which came into effect on 31 March 2002, and governs electronic presentations under letters of credit, will not be addressed in this thesis. Demand from bank customers for eUCP services at the time of writing has been miniscule. E-Trade services, such as SWIFT's "E-Payment Plus", "Tradecard", "LC Connect", "@Globaltrade" and "BoleroSURF", represent a supplement, or even an alternative to,²⁰ the letter of credit system, but reportedly still constitute less than 1% of the trade finance market.²¹ As Professor James Byrne has stated, "LC practice is still grounded in a paper mentality" and the laws of most nations, as well as the UCP itself, are based on the assumption of paper documents.²² The electronic medium is not expected to make significant inroads into the paper-based letter of credit market for quite some years.²³ Reflecting this, despite several banks reportedly migrating some limited aspects of

¹⁹ E.L. Symons, Jr, "Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief", (1980) 54 *Tul. L. Rev.* 338, at 343.

²⁰ J. Katsman, "The Insight Interview: A Time for Realism in Electronic Trade", Vol. 8, No. 4, *DCInsight*, Oct.-Dec. 2002: 16, at 17.

²¹ See K. Godier, "Electronic Trading: New Systems Emerge", Vol. 6, No. 2, *DCInsight*, Spring 2000: 1 at 1; J. Katsman, "The Insight Interview: A Time for Realism in Electronic Trade", Vol. 8, No. 4, *DCInsight*, Oct.-Dec. 2002: 16 at 16; and K. Christensen, "Will the UCP Help Electronic Trade Grow Up?", Vol. 9, No. 1, *DCInsight*, Jan.-Mch. 2003: 3, at 3. Virtually all drawings by electronic means to date have been standby letters of credits - J.G. Barnes, "E-Commerce and Letter of Credit Law and Practice", Vol. 5, No. 7, *Documentary Letter of Credit World*: 30, at 33.

²² *Ibid.*, J.G. Barnes, at 32-33.

²³ Christensen, *op.cit.*, 3, and Katsman, *op.cit.*, at 16-17.

their letters of credit processing system online,²⁴ there is continuing hesitation by customers and banks alike to invest in and/or employ electronic solutions.²⁵ Indeed, it is reported that many e-projects within banks have been stopped or stalled for economic reasons.²⁶

One of the chief obstacles to the implementation of “straight through” processing of letter of credit documents is the fact that all parties would need to be integrated into the same platform. For this purpose, buyers, sellers, banks, and all other trade service providers and parties in the respective trade chains will have to be registered and authenticated before any transaction can start.²⁷ Add to this the issue that in many parts of the world there is no legal infrastructure to deal with legal certification,²⁸ that one begins to appreciate the lengthy time frame required for the widespread adoption of electronic letter of credit applications. Under these circumstances, the eUCP is likely only to have a hortative function for the immediate future, hence its exclusion from this study.

By emphasising the obstacles to the widespread adoption of electronic presentations and the application of the eUCP, the author does not mean to deny the desirability to letter of credit users of migrating to a non-paper environment. It should ultimately be possible to incorporate relatively effective authentication processes under an eUCP credit. Hence, the possibilities for documentary fraud under the eUCP should be more limited than is currently the case in

²⁴ “LC Processing On-Line”, Vol. 9, No. 1, *DCInsight*, Jan.- Mch. 2003: 4; Godier, op.cit., at 23.

²⁵ See Godier, op.cit., 1; Katsman, op.cit., 16; Christensen, op.cit., at 3.

²⁶ Christensen, op.cit., at 4.

²⁷ Katsman, op.cit., at 16.

the paper world.²⁹

1.5 Significance of this Research

1.5.1 *Why this thesis is topical*

Fraud is a persistent thorn in the side of international commerce. The letter of credit system is established with its primary purpose, apart from generating profit for banks, to facilitate international commerce. It is not designed to prevent fraud. As fraudsters have become more sophisticated, there has been a trend for the number and size of letter of credit frauds to increase, and this has become more marked since 2001.³⁰ Over the last several years, the International Maritime Bureau has reported some of the most spectacular letter of credit frauds in history, one involving a metals trading and processing company in the United Arab Emirates engaging in fraud worth \$US 400 Million, another involving a Nigerian oil trader, and the spectacular Solo Industries scam involving fraud estimated to amount

²⁸ Ibid.

²⁹ J.E. Bryne and D.Taylor, *ICC Guide to the eUCP: Understanding the Electronic Supplement to the UCP 500*, ICC Publishing S.A.; Paris, 2002: 18.

³⁰ See, for example, "LC Fraud on the Rise", Vol. 6., No. 2, *Documentary Letter of Credit World*, February 2002, at 4, in which letter of credit fraud was reported to have doubled since September 11, 2001; "Container Fraud on the Rise", Vol. 5, No. 7 *Documentary Credit World*, July/August 2001: 6-7, in which it is reported that the IMB "has detected a higher frequency of container fraud which shows no sign of abating"; and J. E. Bryne, "Overview of Letter of Credit Law and Practice in 2001", Vol. 6, No. 3, *Documentary Letter of Credit World*, March 2002: 22, at 28 in which Professor Bryne reports that "losses due to prime bank investment scams continued to mount in 2001 with estimates of losses in 2000 of excess of US\$ 3 billion world-wide". The same author reported that the trend continued during 2002, stating that "it becomes apparent that LCs are a preferred vehicle for fraudsters, and noting that at its 35th Session in 2002, the United Nations Commission on International Trade Law (UNCITRAL) at its 2002 meeting requested the Secretariat to address commercial fraud, J.E. Bryne, "Overview of Letter of Credit Law and Practice in 2002", Vol. 7, No. 2, *Documentary Credit World*, February, 2003, 25, at 36, citing A/57/17 para. 279-290.

to \$US 600 Million.³¹ A single bank reportedly lost \$US 200 Million in one instance.³² The increasing sophistication of fraudsters is demonstrated by their ability to woo even experienced buyers into a false sense of comfort; after engaging in a series of authentic smaller transactions, they entice their counterparty to enter into a huge transaction, which the unfortunate buyer ultimately discovers is bogus. Buyers are particularly vulnerable to such practices under the letter of credit system: research by Professor Ronald Mann indicates that the letter of credit is chosen as the preferred payment mechanism where the parties are not familiar with each other.³³

This situation suggests that the letter of credit system has loopholes that are being exploited with ease by fraudsters. This thesis, in examining the rules governing letter of credit practice and identifying those areas which leave the system open to exploitation, adopts an analytical perspective that differs from the traditional approach favoured by many banking scholars that focuses on the position of the bank as service provider. Following this line of analysis, it focuses on the parties' rights and duties as a fundamental issue, and questions the traditional allocation of risk that underpins the letter of credit transaction.

This thesis asserts that problems arising from such risk apportionment have been exacerbated by a further shift in the allocation of risk from the seller to the buyer, explained below under

³¹ See *Solo Industries UK Ltd v. Canara Bank* [2001] EWCA Civ 1059, and M. Ford, "Crumbs of Comfort in Massive Metals Frauds", Vol. 8, No. 4, *Insight*, Oct-Dec 2002.

³² *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op. cit., at 26-28.

³³ Mann, "Discrepancies in Presentation Against Commercial Letters of Credit", op. cit., at 34.

paragraphs 1.7 and 1.8 of this Chapter. In examining the implications of this development, it advocates in Chapters 3 and 4 that under the letters of credit, greater emphasis should be given to sellers' fundamental duties of providing to confirming banks not only conforming but *genuine* documents that accurately reflect the reality of the underlying sales transaction. In Chapter 5, it further asserts that certain practices should be institutionalised that will ensure that sellers rather than banks or buyers bear the losses arising from seller deceit, thereby giving rise to a new equilibrium in the apportionment of risk between the respective parties – a change which recent field work suggests will not affect the rate of usage of letters of credit by sellers,³⁴ despite bleak predictions by banking advocates to the contrary.³⁵

The thesis will also identify those areas of banking practice which, if improved, would serve to inhibit fraud, and advocates further delineation of the rules governing such practices to clarify the content of bank duties and to whom such duties are owed. It is argued that such reforms will enhance the letter of credit system by promoting greater transparency and enhanced security in letter of credit banking services – hence less fraud.

1.5.2 *Why the focus of this research is worthy of pursuit*

Over the years, numerous eminent mainstream and non-mainstream letter of credit scholars have contributed to scholarship in this area by

³⁴ Ibid.

³⁵ Infra., Chapter 2..

identifying certain deficiencies in the system. Such writers have identified, for example, the high thresholds of proof that constitute obstacles to a disaffected buyer from enjoining payment under the credit,³⁶ the virtual absence of duties under the letter of credit transaction expressed to be owed to the applicant,³⁷ the lack of balance of rights and duties, and absence of equity under the UCP,³⁸ and the high level of discrepancies and vulnerable position of the buyer under the credit.³⁹ None of these writings have however set out to provide a detailed picture of system dysfunctionality in the context of the overall operation of the system.

Most mainstream scholars on letters of credit⁴⁰ have had as their underlying focus the doctrinal aspects of the system and the perfection of the letter of credit device from the perspective of bank efficiency. The result has been that such scholarship has tended to gloss over the interests of parties other than banks. The question of sellers' duties has escaped detailed attention – and the treatment of buyers' rights has been, as a consequence, similarly insubstantial. It is submitted that the traditional focus of mainstream scholars on the protection and promotion of bank interests under the UCP has been pursued at the expense of the elaboration of sellers' duties and buyers' rights under this transactional device.

³⁶ Symons, *op.cit.*

³⁷ M. Kurkela, *The Liability of Banks Under Letters of Credit*, The Union of Finnish Lawyers Publishing Company Ltd; Finland: 1982.

³⁸ R. Buckley, "Potential Pitfalls with Letters of Credit", (1996) 70 *Australian Law Journal*, 217.

³⁹ R.J. Mann, "Symposium Empirical Research in Commercial Transactions: II. Transactional Design: the Role of Letters of Credit in Payment Transactions", 2000, 98 *Mich. L. Rev.*: 2494, at 2525.

⁴⁰ See Dolan, *op.cit.*; R. King, *Gutteridge and Megrah's Law of Bankers' Commercial Credits*, Eighth Edition, Europa Publications: London and New York: 2001; R. Goode, "Abstract Payment Undertakings", in P.Cane and J. Stapleton, *Essays for Patrick Atiyah*, 1991: 209-236.

In consolidating and furthering the research of various writers into the disparate areas of system dislocation, this thesis focuses on the functioning of the system as an integrated whole. In contrast to the doctrinal approach favoured by most mainstream writers, this thesis, although discussing where relevant various doctrinal issues, takes as its focus the balance of rights and duties in system's operation. In adopting an holistic approach in its analysis of the system, this dissertation advocates elevation of the letter of credit from essentially an administrative tool determined by banks for the benefit of banks into a legal system that addresses the rights and duties of all parties to the transaction.

1.6 Structure of Analysis and Thesis Summary

This thesis is structured into five chapters. This chapter 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. Chapter 4 examines the fraud exception to the independence principle, the typical high thresholds of proof that applicants have 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 this chapter.

1.7 The Classical Positions of the Parties to a Letter of Credit Transaction and their Respective Risks

1.7.1 Explanation of contractual inter-relationships under the letter of credit

A letter of credit transaction is a complex matrix of three linked but independent contracts or arrangements. The first step, which leads to the issuance of a letter of credit, is the making of the contract of sale between the buyer and the seller, the underlying contract. Subsequently the buyer signs an application form requesting the bank to open a credit. This is called the arrangement between the buyer-applicant and the issuer. The third step is that the issuing bank informs the seller, who is the beneficiary of the letter of credit, of the credit and promises to pay against the stipulated documents provided

the terms and conditions of the credit are met.⁴¹ This relationship may be direct, but more often there are interposed between these parties additional persons such as a confirming, advising or negotiating bank. For the purposes of this thesis, it will be regarded simply as a direct three party relationship.

Although there are some theoretical objections to the use of contract to describe the relationship between the issuer and seller-beneficiary based on the apparent absence of consideration moving to the bank from the seller, courts have consistently upheld the validity and enforceability of irrevocable credits. It has been held that such an instrument establishes a contract between the issuing bank and the seller.⁴²

According to Dolan, a credit is an original undertaking by the issuer to substitute its financial strength for that of the account party (the buyer-applicant). In other words, the beneficiary (seller) would not extend credit by selling goods to the account party without the assurance of the issuer's financial integrity or reputation.⁴³ Dolan thinks that a letter of credit is a 'credit in nature' which is regulated by credit law and which needs no consideration. It is independent of the contract directly related to it and is not a contract. According to Article 5-105 of the UCC, no consideration is necessary to establish a credit or to enlarge or otherwise modify its terms.⁴⁴ This theory is also

⁴¹ See Art. 2 of UCP 500.

⁴² See the theoretical argument set forth in Part 2 of E. P. Ellinger, *Documentary Letters of Credit – a Comparative Study*, University of Singapore Press; Singapore: 1970.

⁴³ Dolan, op. cit., at 3-27(2). This is supported by research undertaken by Mann, "Symposium Empirical Research in Commercial Transactions: II", op. cit., at 2525.

⁴⁴ Kurkela, op. cit., at 24.

supported by Trimble who explains that "... the argument for regarding the irrevocable credit as a mercantile specialty is that the promise of the bank to the seller is binding because it is so considered by the business world and because it is couched in a form recognized by the customs of merchants..."⁴⁵ and by Goode, who states that the letter of credit "constitutes an autonomous undertaking, distinct from and independent of the underlying contract of sale and, in the absence of fraud, enforceable by the beneficiary even where he has failed to perform his part of the contract."⁴⁶

When an irrevocable letter of credit has been opened, the beneficiary, after notification, will usually start carrying out its obligations under the main contract, e.g., shipping the goods, and will be paid against the tender of conforming documents in accordance with the terms and conditions of the letter of credit. It is therefore considered that the letter of credit has a "go-ahead effect".⁴⁷

1.7.2 Classical positions of respective risk

The letter of credit represents an allocation of risk between the applicant and the beneficiary. By requiring use of a letter of credit, the beneficiary may greatly reduce the risk of not being paid — essentially allowing the beneficiary of the letter to reallocate the risk of non-payment for delivered goods that allegedly do not conform to

⁴⁵ Trimble, cited in Ellinger, op. cit., at 106.

⁴⁶ Goode, op. cit., 219.

⁴⁷ Kurkela, op. cit., at 25.

the underlying sale contract to the buyer.⁴⁸ Thus, certainty of payment for the beneficiary is risk of loss for the applicant. Dolan expresses this process as a negotiation of litigation risk:

“When the buyer and the seller agree on a sale against documents in which the buyer has no right to inspect the goods before payment, the parties have in fact agreed that, in the event that the buyer raises such questions, he bears the cost of litigating without the purchase money.”⁴⁹

The rule of independent contracts produces desirable commercial results in most cases, as the applicant has agreed to expose itself to a risk of loss arising from defective goods for eventual commercial gain.⁵⁰ However, since the rule of independent contracts requires the issuer to honour the drafts of the beneficiary despite defective performance of the underlying contract, the applicant will be without a remedy if, for some reason, it is not able to make itself whole by suit on the contract.⁵¹

⁴⁸ Of course, where goods have been shipped but have been delivered on the basis of a forged bill of lading, the sellers of the cargo, if not paid, might face difficulty of getting the money back from the buyers. Sometimes the sellers of the cargo can claim against their underwriters if insured under Clause A of the Institute Cargo Clauses. Their underwriters in turn claim against the carrier of wrongful delivery of the cargo. However, most cargo insurance policies will not cover non-payment by a buyer because they are designed to cover physical loss or damage to cargo - *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op. cit., at 30. Where price for the cargo has dropped, buyers often are not keen to take delivery of the cargo. In order to protect themselves, sellers might take out a sellers' interest insurance policy, which covers them from losses that may arise from the buyer's rejection of the documents under a letter of credit especially when dealing with a commodity the price of which fluctuates, *ibid.*, at 31.

⁴⁹ Dolan, *op.cit.*, 3.07[4].

⁵⁰ N. Faruqi, "Letters of Credit: Doubts as to Their Continued Usefulness", (1987), Vol.8, *N.Y.L.Sch. J. Int'l & Comp. L.*, 332.

⁵¹ In most international transactions, an action on the contract is a difficult undertaking because it must usually be litigated in the beneficiary's country. Engaging in litigation in other countries may be prohibitively expensive. *Ibid.*

Generally, banks are reluctant to dishonour a credit, since to do so may damage the bank's reputation as a credit issuer. The cost of honour, however, falls on the honest applicant, not the bank.⁵² "If the beneficiary has breached the underlying transaction, payment under the credit to him will occasion loss, but that loss will not be the bank's; it will be the applicant's."⁵³

In accordance with Dolan's analysis, the litigation risk that the applicant has agreed to bear under the letter of credit pertains to the condition of the goods. Could it be said, however, that the risk that applicant has agreed to bear also extends to the risk of fraud being committed on the documents or in respect of the underlying transaction? It is submitted that the risk associated with intentional wrongdoing, such as fraud, is not consciously negotiated between the seller beneficiary and the buyer applicant, and that it should not follow that the risk of fraud is assumed together with the risk in respect of good quality by the buyer.

What of risk of error or negligence on the part of the bank? The bank under the traditional letter of credit transaction was well insulated from risk. Banks are even better insulated under the conventional letter of credit transaction subject to the UCP. If the issuer does pay on the letter of credit, it receives documents of title representing the right to the underlying goods, which usually would have some value. Even if the goods did not have substantial value, the issuer would

⁵² "The UCP: A Final Report", (1994), No. 9, *Banking and Finance Law Review*, at 177.

have perfected a claim against the customer for reimbursement and the customer would typically have sufficient financial stability to perform its obligation to the issuer.⁵⁴ In Chapter 2, it will be demonstrated that there is in fact very little opportunity for applicants to negotiate error and negligence risk with banks, with such risks being *imposed* on the applicant under a UCP regime in respect of whose drafting non-banking interests had minimal, if any input.

As discussed below under paragraph 1.8, the major risk that banks face is that arising from potential collusion between buyer and seller.

1.7.3 Minimisation of bank risk and exacerbation of applicant's burden under the UCP

As will be discussed in Chapter 2, “the Uniform Customs were drafted by banks, for banks, largely to govern relations among themselves.”⁵⁵ Not surprisingly, the UCP contains rules that reduce bank risk. Moreover they do not invite judicial intervention to compensate letter of credit parties for bank negligence or for overly formalistic conduct. The provisions that favour banks fall into two categories. The first provides sweeping immunity from liabilities that national legal systems may impose.⁵⁶ The most obvious example of such a disclaimer is Article 15. Under Article 15, banks assume no liability

⁵³ Ibid., 177; also see Mann, “Symposium Empirical Research in Commercial Transactions: II”, *op. cit.*, at 2525.

⁵⁴ Symons, *op. cit.*, at 342.

⁵⁵ R.A. Wiley, “How to Use Letters of Credit in Financing the Sale of Goods”, April, 1965, *Business Lawyer*, 495, at 519.

⁵⁶ P.B. Stephan, “The Futility of Unification and Harmonisation in International Commercial Law”, 39 *Va. J. Int'l L.*, Spring, 1999, 743, at 782.

for the genuineness, falsification or legal effect of any documents and therefore the issuer is exonerated from liability for paying against forged documents, which on their face appear regular. If documents appear on their face to be in compliance but are in fact forged, the issuing bank is protected and is not liable to its applicant.⁵⁷

The fact of payment by the issuing bank therefore does not ensure that the buyer gets the goods contracted for. The security the beneficiary enjoys does not reflect the security the buyer has for the procurement of the contracted goods. The buyer/applicant may get the documents, which on their face justify the issuing bank in paying, but if the documents do not represent the goods the buyer/applicant wants, his recourse is to the seller, not the buyer's bank.⁵⁸

The second category of pro-bank provisions contains rules that set precise boundaries on what the banks must do, which reduces uncertainty about bank responsibility and provides clear guidance to bank employees.⁵⁹ For example, the customer cannot stipulate non-documentary conditions of payment,⁶⁰ and time limits on examination of documents are fixed rather than open-ended.⁶¹

⁵⁷ M. Megrah, "Risk Aspects of the Irrevocable Documentary Credit", (1982), v.24, *Arizona Law Review*, 255, at 256.

⁵⁸ The buyer normally suffers loss under a letter of credit when false documents are presented by the seller to the bank. The confirming bank pays against such documents, which on their face comply with the terms of the credit and debits the account of the issuing bank and sends the documents to the issuing bank. The buyer believes that the contracted goods are on the way and pays out under spurious documents. Only when the vessel is due to arrive at the destination port that the buyer discovers that the cargo has not been loaded on board. By then the fraudulent seller, having collected the purchase price under the letter of credit, has long disappeared, *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op. cit., at 4.

⁵⁹ P.B. Stephan, "The Futility of Unification and Harmonisation in International Commercial Law", op.cit., at 783.

⁶⁰ UCP, Article 13(c).

⁶¹ UCP, Article 13(b).

For relief, the buyer, which is the applicant⁶² for a credit, must proceed against the seller for breach of contract or fraud, which is not an attractive proposition at any time because of the cost and uncertainty that such a suit entails.⁶³ An applicant's legal remedy for breach of the underlying contract may be ineffectual for several reasons. The most common is the impending insolvency of either the applicant or the beneficiary. The nearly insolvent applicant may be faced with bankruptcy if it has to reimburse the issuer without receiving the anticipated benefits of the underlying contract.⁶⁴ Moreover, an action on the underlying contract may be fruitless if the beneficiary is insolvent at the time of payment or becomes insolvent after disposing of the proceeds of the credit.⁶⁵ An action in deceit, available against the dishonest seller, is of little value as such a rogue usually absconds before the fraud or forgery is discovered.⁶⁶

With the exception of collusion risk, most risks thus are ultimately borne by the applicant. Applicants have few rights, as their position under the UCP as a party to the credit is unclear. However, when talking about risks, all applicants are exposed even when it is the banks that have committed negligence in advising or transmitting a letter of credit. Banks bear little responsibility for the consequences of mistaken acceptance or rejection.⁶⁷ Moreover, as will be discussed

⁶² In UCP 500, the connotation 'Applicant' is used to denote the applicant. The use of the word 'Applicant' creates the impression that there is no contract between the Applicant and the bank.

⁶³ Megrah, *op. cit.*, at 256.

⁶⁴ *Dynamics Corp. of America v Citizens and S. National Bank*, 356 F Supp. 1000 (N.D. Ga 1973).

⁶⁵ *Shaffer v Rookly Pard Harden Apartments*, 250 NW 2d 172, at 181 (Minn. 1977).

⁶⁶ Ellinger, 'Documentary Credits and Fraudulent Documents', *op. cit.*, at 191.

⁶⁷ See Articles 14(c), 15, 16 & 17, UCP.

in chapter 4, the traditional threshold of proof for invoking the fraud exception to enjoin payment under the letter of credit has been prohibitively high, so the risk associated with intentional wrongdoing under the letter or credit or underlying transaction is effectively shifted to the buyer.⁶⁸

Under the UCP, the buyer is being placed in an absurdly vulnerable position. Although the letter of credit mechanism stabilises international transactions and therefore may be said to serve the interests of both buyers and sellers, often the result is that certainty of payment for the beneficiary amounts to unconscious assumption of fraud risk as well as bank error and bank negligence risk for the applicants.⁶⁹ In this sense, arguments that buyers and sellers are ‘as one’ for the purpose of risk allocation do not make sense; and those advocating such a position make unsustainable assumptions about the balance of commercial activities of traders and manufacturers alike.⁷⁰ In a legal sense, analysis of risk should take place in respect of the individual transaction. There would appear to be no justification (and no comfort for the affected party) in the assertion that the fact that a party has to bear risk of loss and indeed suffers losses in the transaction in question is balanced by the possibility that it will “shift” a commensurate amount of risk to buyers in other transactions in which it will assume the role of seller. Two examples

⁶⁸ Symons, *op.cit.* 7.

⁶⁹ G.A. Fellinger. “Letters of Credit: The Autonomy Principle and the Fraud Exception”, vol. 1, (1990) *Journal of Business & Finance Law and Practice*, at 6.

⁷⁰ When the author raised this question at the 2001 Annual Letters of Credit Survey held in Hong Kong with the letter of credit expert, James E. Barnes, she was told that this is not of concern as buyers are not normally the end users and that most times they are sellers down the trade line. The argument is essentially that buyers become sellers in other transactions, and therefore are compensated elsewhere as a result of their role reversal in other transactions.

of businesses that are most adversely affected by this “holistic” risk assessment approach are importers, and manufacturers that source their raw materials and parts offshore but whose sales of finished products are made to the domestic market.

Sound of Mkt. St., Inc. v. Continental Bank Int'l,⁷¹ illustrates how the system operates to relieve banks from potential liability. An adviser received a credit from the issuing bank on August 9 and failed to review the credit and send its advice until August 18th. The beneficiary did not receive the advice until Aug. 25. The beneficiary claimed that it was too late to meet the latest shipping date of the credit and avoid a consequent loss. The court held that there was no privity between the adviser and the beneficiary and the beneficiary should recover its damages from the applicant, not the adviser. Not surprisingly, this decision is considered by banking experts as significant and persuasive because “it imposed liability on the applicant for the commercial losses and relieved the banking system from commercial loss burdens and because beneficiaries have a cause of action against an applicant when the adviser or the issuer fails to establish the credit in time”.⁷² To permit a beneficiary to recover from a bank about which the beneficiary had no knowledge whatsoever and on whom the beneficiary placed no reliance is to give the beneficiary a fortuitous recovery.⁷³

1.8 The Rise of Container Shipping and Implications for the Allocation of Risk

⁷¹ 623 F. Supp. 93 (ED Pa1985), reversed, 819 F 2d 384 (3d Cir. 1987).

⁷² Dolan, op. cit., at 1-17.

1.8.1 Implications on the value of the bill of lading

A bill of lading stands for the goods and it gives the issuer an interest in the goods in the event of default in the applicant. “It is this document that transfers title to the buyers and against endorsement of which the purchase price is usually paid.”⁷⁴ Use of a bill of lading carries with it certain safeguards — when cargoes are loaded on board and the shipmaster discovers such cargoes in damaged condition the master has to put a clause on the bill of lading to reflect this fact.

Prior to container shipping, one of the main risks in respect of bills of lading concerned the false issue of a clean bill of lading irrespective of the damage detected by the master. Some shipper/sellers, knowing that a bill of lading reflecting that the goods are in a damaged condition is no use to them under the letter of credit, would insist that the master issue a clean bill of lading.⁷⁵ The shipper/seller will make such promise that should any claim be made arising from the condition of the cargo by the buyer, the shipper would indemnify the ship-owner.⁷⁶ Such practice is illegal. “Under the principle of English law and most other legal systems that such a letter of indemnity is tantamount to a conspiracy to defraud the buyer into paying the full value of goods, based upon the clean bill of lading,

⁷³ Ibid.

⁷⁴ *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op.cit., at 10.

⁷⁵ The definition of a clean bill of lading is universally accepted and is almost identical to that of Salmon J. in *British Imex Industries Ltd v. Midland Bank Ltd* [1958] 1 Q.B. 542, 551: “A clean bill of lading is one which does not contain any reservation as to apparent good order and conditions of the goods or packing”.

although the shipowner knew that the cargo was not in that condition. The owner has been prevented from exercising his rights under the letter of indemnity against the shipper on the grounds that it is an illegal contract.”⁷⁷

The safeguard of inspection by the shipmaster and reflection of the state of the goods on the bill of lading has been removed by container shipping. This change in shipping practice could even be said to go so far as to undermine the notion of the bill of lading as a document of title. As a result, the bill often is blank or contains such language as “shipper’s load and count”.⁷⁸ The disclaimer “shipper’s load and count” takes away the real value of this document as a title document because with such notation on the bill, it might no longer be considered as equivalent to the goods.

Such practice can be easily taken advantage of by a fraudster. A bill of lading is a relatively simple document, which can be reproduced without great difficulty. Furthermore, there is little physical control over blank books of bills of lading. They are given away to the freight forwarders and other sub-contractors and the fraudulent seller does not need to go back to the liner for stamp and signature. Banks have no way to verify the stamp or signature of a bill of lading. This also applies to the documents required under an average letter of credit.⁷⁹

⁷⁶ *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op.cit., at 42.

⁷⁷ *Ibid.*

⁷⁸ The legal effect of “shipper’s load and count” is that the bill of lading holder still has to prove the particulars of the cargo, save to the extent that these relate to its apparent order and condition.

⁷⁹ It has been suggested by the International Maritime Bureau that banks and buyers can protect themselves to a certain extent by identifying with liner companies, which have established

As the secretary-general of the ICC has stated, “it is unfortunately the case that fraud, like other forms of crime, is encouraged in an environment that remains unaware and hence lacks effective deterrence”.⁸⁰ In reality:

“blank bills of lading can be bought over the counter, and no questions asked, from stationers in the City of London for five pence a form ... It is fertile ground for the criminal who sets himself up as a trader and offers nonexistent goods ... This is how it works – the fraudster agrees to supply and ship goods. Usually, there is an exchange of sample contracts or a pro-forma invoice. Then the buyer instructs his own bank to open a letter of credit in favour of the seller, which is forwarded through an advising bank in the seller’s country. With the letter of credit in his hands, all the fraudster needs is the backing documents to obtain money from his bank.”⁸¹

Consequently, frauds net their perpetrators hundreds of millions of dollars each year.⁸²

The resulting situation has been succinctly summarised by Powles

databases, whether or not a particular container has been shipped on board a vessel. However, even these rudimentary efforts are rare - *Trade Finance Fraud*, op.cit., at 17.

⁸⁰ Maria Livanos Cattai, (Secretary General of ICC), cited in Preface of *Trade Finance Fraud*, op.cit., at 3.

⁸¹ See *ICC Business World*, Vol. 1, Autumn, 1983: 9 (at note 4).

⁸² P. Lowe, “Fraud and the Documentary Credit”, Report of the ICC International Maritime Bureau, ICC Publications; Paris: 1994., at 8.

and Hazelwood:

“Documentary Credits are used as the basis of many frauds. The ease whereby they are thus utilised is largely facilitated by the divorcing of the documents from the goods as the basis of the credit, the bank’s duty to pay the seller on presentation of the documents which comply strictly with the terms of the credit (even though the contractual basis of this duty is obscure, to say the least) *which puts the seller into almost as secure position as if he had been paid in cash* (italics added).⁸³

Therefore, because a bank does not ensure that the buyer receives the goods he wants and has contracted for, the buyer may obtain documents which on their face justify the issuing bank’s payment, but documents which do not represent the goods the buyer wants. Such ill correspondence of documents with the actual fact has developed to such extent that some bankers have started worrying about the worth of a document of title that may not be strictly accurate in its content. A banker confessed that when:

“we received a bill of lading which has been altered or sometimes been altered more than once, we are concerned because if we check up on the vessel’s departure date, we often find that the on board date is not accurate. (We are sure that everyone is aware that

⁸³ D.G. Powles & S.J. Hazelwood, “Maritime Fraud – 1”, 1984 *Journal of Business Law* 31, at 37.

this could also apply where the date has not been altered).”⁸⁴

This statement clearly indicates the lack of confidence that maybe many bankers have in the accuracy or even legality of the bills of lading.⁸⁵ Reflecting this concern, Bank Leumi (UK) plc, London has initiated an effort to stop such practice. In their letter of credit there is a clause prohibiting the use of correction fluid. However, “this will not stop any other alterations.”⁸⁶ Consequently, even “some of the world’s largest traders, banks and insurance companies, with very sophisticated trading practices, have fallen victim to fraud.”⁸⁷ Indeed, “in most cases of documentary fraud the banks lose in one way or another” — “at the very least the fraud will strain relations between the bank and its customers or the correspondent banks in the letter of credit chain.”⁸⁸

1.8.2 Risk implications of diminution in reliability of the bill of lading for banks and bank countermeasures

While the bill of lading can be described as the most important document in international sale of goods involving carriage by sea and its transfer gives the holder title, not only to the document itself, but also to the goods, as a result of the developments in container shipping, the bill of lading has gradually lost its legal effect as a document of title in the sense that banks no longer consider it as

⁸⁴ C. Eden, “Country Correspondent Reports”, *Insight* V. 7 No 3, July-September 2001: 16.

⁸⁵ See also L. Sankaran, “Reliability of Bills of Lading”, *DCW*, March 2001: 9.

⁸⁶ Eden, *op. cit.*

⁸⁷ *Trade Finance Fraud*, *op.cit.*, at 9.

good security. Under the traditional scenario, a bill of lading functioning as the document of title and representing the goods actually shipped was a matter of life and death to the bank's business. If the goods shipped actually were garbage or other worthless merchandise, the bank, which had paid out and accepted the documents would have no way to redress its loss. Maybe it could sue the beneficiary. However, the difficulties of getting money back this way would often be too great to be even worth trying, reflecting the reality that "in most cases, once a fraud has occurred the chances of recovery are small and the costs of investigation and litigation high."⁸⁹

The banks face their greatest danger when they are financing a transaction where the buyers and sellers are in collusion.⁹⁰ They can start with a few transactions with genuine documents. Then, "as the volume of the transactions increase, the banks extend even better facilities to the buyers/sellers. The contribution of these trades to the fees earned by the letter of credit department of the bank becomes significant and bank staff hesitate to examine the transactions with the care and detachment that might be prudent in the light of the sums advanced."⁹¹

The consequences of the traditional reliance on the bill of lading as collateral was poignantly illustrated in a case reported by the International Maritime Bureau where the fraudster managed to reap

⁸⁸ Ibid., at 25.

⁸⁹ P. Mukundan, (Director of ICC International Maritime Bureau), cited in Foreword of *Trade Finance Fraud*, op.cit., at 4.

⁹⁰ Ibid., at 25.

over US\$400 million from 26 international banks. Through gaining the confidence of banks firstly through a series of legitimate transactions, they were unlikely to question transactions that the fraudster had brought to them later that involved producing documents indicting they were shipping high value metals. Such documents were presented to different banks, “each unaware that similar documents in respect of the same containers were being presented to other banks”.⁹² This case indicates that had the banks’ staff looked into the documents more carefully rather than having such a “collateral illusion”⁹³ they may have detected that what had previously seemed liked a reputable customer was actually dishonest.⁹⁴

The result of such experiences is the present system under which the banks try to shift this burden to the applicant-buyer as much as possible. Nowadays rarely a letter of credit will be issued to an applicant who has not got credit with the issuing bank. Banks will have an applicant’s “credit checked” before issuing a credit.⁹⁵ In the event that an applicant defaults, an issuing bank has direct access to the applicant’s money rather than having to take the goods to the open market in order to get the money back.

⁹¹ Ibid., at 26.

⁹² Ibid., at 27.

⁹³ Ibid., at 26.

⁹⁴ Banks often have their own insurance policies, which are intended to protect them against unforeseen loses and fraud. However, such insurance doesn’t cover situations where the bill of lading itself has been fraudulently issued or a genuinely issued bills of lading contains wrong description of the contents, date of shipment, and name of vessel. In a recent case of letter of letters of credit fraud, where tens of millions of dollars had been lost by a bank, the bank sought to recover under such an insurance policy, but found that the terms of the policy were such that it did not cover the presentation of fraudulent bills of lading - *Trade Finance Fraud*, op.cit, at 32.

⁹⁵ Interview by author with staff of Letters of Credit Department of St. George Bank, Sydney, Australia, on January 7th, 1999.

Such credit checks can take substantial amounts of time. N.D. George, the head of trade finance at the National Bank of Fujairah, Dubai, has stated that it seemed paradoxical that establishing credit limits take considerable time but the actual giving away of money takes such little time. The assessment of the credibility of a new customer-applicant involves a thorough study of the financial condition of the applicant, visits to the applicant's premises, several face-to-face sessions with the applicant, obtaining of credit reports etc. Then a proposal is furnished for approval by several officials, with the process taking weeks or even months to complete.⁹⁶

In addition, it is now common practice for issuers to obligate the applicant to effectively waive its rights to seek a remedy from the issuer. As James Barnes and James Byrne have stated, "issuers typically require a LC applicant to sign a reimbursement agreement limiting the applicant's rights and remedies against the issuer for honor of a non-complying presentation, and obligating the applicant to indemnify the issuer against substantially all risks, such as the risk of beneficiary fraud".⁹⁷

Banks therefore probably consider that they can afford to ignore underlying performance because of their thorough research into the applicants' financial strength, their elaborate method of obtaining security with collateral,⁹⁸ and their ability to obligate the applicant to

⁹⁶ *Insight*, Vol. 7, No 3, July-September 2001, at 10.

⁹⁷ J.G. Barnes and J.E. Byrne, "Survey Uniform Commercial Code: - Revision of U.C.C. Article 5", (1995) 50 *Bus. Law.* 1449, at 1454.

⁹⁸ See Mann, "Symposium Empirical Research in Commercial Transactions: II", *op. cit.*, at 2526-2529.

reimburse the issuer against all risks. As already mentioned, reflecting the importance ascribed by issuers to obtaining collateral in the context of letters of credit transactions, banks reduced their issuance of credits to those customers who were hit by the crash in land prices in Hong Kong by 50%.⁹⁹ Even so, it would appear that “it is not possible for financiers to seek one hundred percent collateral on every transaction.”¹⁰⁰

In the context of widespread bank practice that allows sellers multiple opportunities to amend documentation for the purpose of making underlying transactional documents compliant with the letter of credit, ease of forgery through the application of technological advances is significant. The UCP Article 15 disclaimer of responsibility for genuineness means that the resulting increased risk of forgery is borne by the buyer. There was a time when telexes were considered to be reliable and used in preference to letters and other forms of communication. Now, “documents used in a trade finance transaction have few security measures built into them. None of these documents are immune from forgery, especially given the sophistication of scanners, colour copiers and laser printers today.”¹⁰¹ Even though “[s]ome inspection companies have security water marks and background patterns on their certificates”,¹⁰² it is not enough to stop the fraudster, who does not have to forge the document to satisfy examination by the issuer of the document, for instance, the inspection company. As long as he can satisfy

⁹⁹ Information collected from interviews conducted with bankers in HK.

¹⁰⁰ P. Mukundan, (Director of ICC International Maritime Bureau), cited in Foreword of *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op. cit., at 4.

¹⁰¹ *Ibid.*, at 15.

examination by the trade finance department of a bank, “whose obligation is to ensure that the document complies with the terms of the letter of the credit, not to ensure that the document is genuine and properly issued by the inspection company”.¹⁰³

As discussed in Chapter 3, Banks also attempt to shift risk associated with their payment over discrepant documents by their use of waiver, expressed in the UCP as a right of the buyers¹⁰⁴ yet used by banks’ as means of facilitate payment irrespective of discrepancies of documents and non-performance of the sale contract. Mann’s research persuaded him that banks effectively vouch for their customers when they issue letters of credit for them, and consider that the bank’s reputation is at risk whenever their customers refused to waive discrepancies that might undermine the bank’s obligation to pay the seller for the shipper, with certain bankers admitting that they “persuaded” or “pressured” their customers to waive discrepancies, at least where the seller’s performance was not seriously defective and especially where the bank considered that discrepancies would normally be waived in the industry in question, under threat of the bank (or even perhaps other banks in the jurisdiction) not dealing with the customer again.¹⁰⁵

The consequence of the banks’ ability to secure their position and to ignore underlying performance is that honest buyers are, in effect, having to bear the risk of paying for goods for which they had not

¹⁰² Ibid.

¹⁰³ Ibid.

¹⁰⁴ UCP Article 14c.

contracted.

1.9 Conclusion

This chapter has introduced the reader to the underlying dynamic – the shift in the burden of risk associated with the development of container cargo – which underpins the justification for the writing of a thesis focusing on the position of the buyer-applicant under the letter of credit. It will become apparent in Chapters 2-5 the extent to which reform is necessary to inject some semblance of balance and equity into a system that for too long, in terms of governance, rulemaking and administration, has been dominated by banking interests and effectively insulated from non-banking influences, including that of the judiciary. This thesis is not meant to be anti-banking, and indeed identifies areas in the letter of credit system where bank interests are particularly vulnerable. However, the focus of the thesis will predominately be on identifying institutionalised inequities in the way the system operates, and how these might be addressed without, in the process, undermining the system itself.

¹⁰⁵ R.J. Mann, “Symposium Empirical Research in Commercial Transactions: II”, *op. cit.*, 2494, at 2524-2530.