

Chapter 2

The UCP and its Role in Facilitating the Reallocation of Risk

2.1 Introduction

This chapter explores the circumstances giving rise to the norms underpinning the letter of credit regime, and how these have led, through the development of the UCP and the dominance of banking interests in this process, and the virtual universal adoption of the UCP, to the marginalisation of alternative sources of “law” in respect of the letter of credit transaction. These features, together with the severe imbalance in bargaining power between the issuing bank and the applicant, generally facilitate the shifting of the burden to the applicant-buyer of those risks identified in Chapter 1.

2.2 Origins of Letters of Credit

2.2.1 Customary origins

The letter of credit is said to have been invented in the Middle Ages in connection with the trade of goods.¹ However, it generally is considered to have only actually developed in the 19th century and to

¹ E.P. Ellinger, *Documentary Letters of Credit - a Comparative Study*, University of Singapore Press; Singapore: 1970, at 106.

be used widely only after the first World War.²

Under the common law, the courts recognise that the law merchant is a body of commercial usages which has been built up under the pressure of the needs of commerce.³ Letters of credit law was said to have “descended from the law merchant (*lex mercatoria*) – an amalgam of commercial customs which developed independently of contract law for the convenience of merchants”,⁴ or “essentially a set of customary rules spontaneously used in the framework of international trade without reference to a particular system of law”.⁵ There exists a great amount of literature discussing the process by which scholars and courts recognise the documentary credit as a valid instrument.⁶ For instance, Trimble regards an irrevocable credit as a mercantile specialty which was binding “because it is so considered by the business world and because it is couched in a form recognized by the customs of merchants”.⁷

Such generalisations in respect of the nature of documentary credit face some objections. It has been argued that the mediaeval documentary

² Ibid.

³ Ibid., at 6.

⁴ M. Kurkela, *Letters of Credit Under International Trade Law: UCC, UCP and Law Merchant*, Oceana Publications. Inc; New York: 1984., at 321.

⁵ H. Veytia, “The Requirement of Justice and Equity in Contracts”, April, 1995, 68 *Tul. L. Rev.*, 1191 at 1197. Hight describes the *lex mercatoria* as “principles of the developing transnational or international law-merchant, capable of being applied by decision-makers (judges or arbitrators) as a source of legal rules, in order to give content to decisions, in much the same way that the decision-makers would apply a real legal system such as the *lex fori* or the *lex loci arbiters*.....”, K.. Hight, “The Enigma of the *Lex Mercatoria*”, Feb., 1989, 63 *Tul. Law Rev.* 613, 617-618.

⁶ E.P. Ellinger, *Documentary Letters of Credit - a Comparative Study*, University of Singapore Press, op. cit., Chap.5.

⁷ R.J. Trimble, “The Law Merchant and the Letter of Credit” (1948) 61 *Harv. L.R.* 981.

credit Trimble referred to might not be the same as the modern credit which developed only in the nineteenth century.⁸ Professor Ellinger has argued that the concept of the documentary credit that Trimble used should be merely regarded as a document requesting a third person to pay to a beneficiary and promise to repay to the payer, and not equivalent to the modern concept of documentary credit. He pointed out that a documentary credit:

“is no more than a promise to the seller (beneficiary) that drafts drawn by him will be accepted if accompanied by certain documents”.⁹ (emphasis added)

If banks and merchants referred to documents that merely evidenced the *existence* of a letter of credit as a documentary credit, as Trimble infers, it was then not a documentary credit in the modern sense. What we are dealing with here is a credit payable only if all accompanying documents requested by the buyer/applicant are accurate according to the conditions which are set out in the document called a letter of credit. Furthermore, it seems that historically, when referring to the mercantile nature of a letter of credit, it is arguable that the literature mainly focused on proving that the letter of credit was a payment instrument whose market acceptability derived from the customs of merchants. Endorsement of such mercantile theory is found in English and US cases alike. American courts also showed a strong tendency to treat documentary

⁸ Ellinger, *op.cit.*, at 106.

⁹ *Ibid.*, 107.

credits as instruments established by mercantile usage,¹⁰ as articulated by Lord Campbell in *Brandao v. Barnett*,¹¹ who stated that “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.”¹²

This raises serious questions as to whether such theory, which was limited to elaborating the process of accepting a letter of credit, by scholars and courts alike, as a valid payment instrument irrespective of a lack of consideration, has been exaggerated to include the assumption that the rights and duties incorporated under a letter of credit were the result of a collaboration of the “merchants” and were therefore beyond challenge. The distinction between the customary nature of the documentary credit as a commercial instrument and the question of the rights and duties of parties dealing with such documentary credit has never been before raised. It is submitted that comments such as that made by Lord Campbell have been used in an exaggerated manner by other scholars and courts to infer that any rules regarding the letter of credit transaction – including the risk allocation as well as the rights and duties of the relevant parties – should be treated as having been decided customarily. This could be said to be accountable for the confusion of the law dealing with such issues under the letter of credit and for the apparent disregard of the validity of the documents and the duty of the beneficiary providing such documents.

¹⁰ See *Moss v. Old Colony Trust Co.* 246 Mass. 139, 140 N. E. (1923) 803, at 807.

¹¹ (1846) 12 Cl & F. 787.

It is therefore not surprising to read that the leading commentator described letters of credit as:

“largely customary in its nature and many of its operative rules, regardless of geography or legal systems, have emerged from the customs of banks dealing with importers and exporters, and with shipping and insurance companies.”¹³

In the nineteenth century, courts of law had adopted the right of using letters of credit and their validity as settled law, with a view to the interests of trade and public convenience.¹⁴ From the perspective of the background of the operational rules under the UCP being mere usages, the way courts and scholars treated the letter of credit as a new instrument before the nineteenth century arguably is the reason why the law of letters of credit is in need of further development, because courts have not played an active role in perfecting the law of the rights and duties of the parties dealing with documentary credits.

Even in accepted usage, courts bear in mind whether “it was a claim founded upon general principles of universal justice”.¹⁵ It was so argued in the case of *Oppenheim v. Russell*, but Rooke J. refused to give effect to a usage which amounted to a certain class of people trying to establish a usage to the disadvantage of the rest of the

¹² Ibid., 805.

¹³ B. Kozolchyk, *International Encyclopaedia of Comparative Law*, 1979, at 10, cited by Kurkela, *op.cit.*, 335.

¹⁴ *Goodwin v. Roberts* (1875) L.R. 10 Ex. 337, at 346.

¹⁵ *Oppenheim v. Russell* (1802) 3 Bos. & P. 42, at 50.

world.¹⁶ This indicates that despite of the fact that certain practice can be proven to be universal and therefore might be called a usage, courts do not necessarily have to accept it as good law if accepting it will overrule a common law principle. Following the same line of reasoning, it might not necessarily be the case that courts will accept a certain practice just because it has been used on a broad scale.

Courts of law were clear about the unique nature of letters of credit and negotiable instruments.¹⁷ However, in the early 18th Century, the courts did not seem to be overwhelmed by a usage no matter how widely used. The judges were strong in guarding basic principles of the common law and were not hesitant to set aside a claim even by a strong industry. This was further indicated in *Taylor v. the Great Indian Peninsula Railway Co.*¹⁸ In this case, the London Stock Exchange alleged a usage which allowed blank transfers of stock. The court held that such usage was bad at law in recognising it would have meant overruling a common law principle.¹⁹

Thus, it is clear that although common law recognises the validity of negotiable instruments by recognising the usage which supported it, “the ‘mercantile usage theory’ has not, so far, been accepted by the courts” as far as irrevocable credits is concerned.²⁰ In *International*

¹⁶ Ibid., at 51.

¹⁷ Ellinger, *Documentary Letters of Credit*, op.cit., at 103.

¹⁸ *Taylor v. the Great Indian Peninsula Railway Co.* (1859) 4 De G. & J. 559.

¹⁹ See Professor Ellinger’s comment at note 30 of Ellinger, *Documentary Letters of Credit*, op.cit., at 111, Even though Professor Ellinger pointed out that such usage was only a local one, arguably it should not affect the significance of such ruling in the context of the argument in this paragraph - see also his distinction theory between local mercantile usages and universal usages at 118.

²⁰ Ibid., at 120.

Banking Corporation v. Barclays Bank Ltd.,²¹ Atkin L.J. pointed out clearly that “the mere existence of certain practices might not be sufficient to prove a commercial usage. It, when proved, will eventually determine the legal rights between the parties.”²²

It is submitted that mere proof that a practice is generally accepted by a industry should not be considered as demonstration of a usage with resulting entitlement to treatment as part of the law merchant. The certainty and uniformity of the practice should not be the only consideration. The parties should have to prove to the court the nature of the legal rights and duties in relation to the practice, and the court should consider whether accepting such practice is contradictory to general principles of law.

Arguably, under the pressure of big business and because of the confusing theory over the nature of documentary credits, particularly the doubt concerning the courts’ ability in dealing with such an “international “ instrument, courts generally have taken a “hands-off” attitude towards the development of documentary credit law. In *Kingdom of Sweden v. New York Trust Co.*,²³ Wasserfogel J. said: “commercial letters of credit have a long mercantile history and the principles which govern them are well established.”²⁴ In *Malas (Hamzeh) & Sons v. British Imex Industries Ltd.*,²⁵ Jenkins L.J.

²¹ *International Banking Corporation v. Barclays Bank Ltd.* (1925) 5 Legal Decisions Affecting Bankers 1 (C.A.).

²² *Ibid.*, at 4.

²³ *Kingdom of Sweden v. New York Trust Co.* 197 Misc. 431, 96 N. Y. S. 2d (1949) 779.

²⁴ *Ibid.*, at 787.

²⁵ [1952] 2 Q.B. 127, at 129.

indicated that the court was willing to recognise the customary basis of documentary credits and it would be wrong for the court to interfere with that established practice.²⁶

The practice of opening documentary credits is, in point of fact, uniform in England, the USA, France and Germany. Can, as Jenkins L.J. has stated, such practice be however considered as applicable universal law in respect of the letter of credit transaction? Lord Jenkin's *obiter* statement, made in *Malas (Hamzeh) & Sons v. British Imex industries Ltd.*, was that:

“...the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay.... An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice.”²⁷

It is submitted that such an *obiter* statement might have been wrongfully interpreted as meaning to apply generally to the letter of credit, therefore implying that a bank's duty to pay is too absolute to incorporate any other elements of rights and duties, which Jenkins L.J. did not have to deal with in the above case. Therefore, concluding under this line of reasoning that the legal problems

²⁶ Ibid. Also see Ellinger, *op. cit.*, at 121.

²⁷ *Malas (Hamzeh) & Sons v. British Imex Industries Ltd.* (1958) 2 O.B. 127 at 129.

concerning documentary credits are solved in a uniform manner in all jurisdictions could be considered a little premature. As indicated in the statement below, such legal problems are far from settled:

“Various legal problems arise in documentary credit transactions. Some arise in the relationship between the buyer and the seller, others in the relationship between the buyer and the banker, and still others in the relationship between the banker and the seller. Additional problems arise when a second bank, i.e. a correspondent, participates in the opening of a letter of credit.”²⁸

It is clear that such legal problems were not dealt with properly until a much later stage, and that the relevant rights and duties are now mostly derived from the UCP.

Another question to be considered is whether being a special type of instrument²⁹ justifies the courts’ reluctance to “interfere with” what is claimed to be established practice and the extent to which it could be said that the letter of credit is used as a device in international trade that “imposes a duty on courts to avoid application of strictly local rules to the device.”³⁰

John Dolan has stated that the courts, “in creating common law for

²⁸ Ellinger, *Documentary Letters of Credit*, op.cit., at 126.

²⁹ *Ibid.*, at 122. Also see Dolan, op.cit., 4-1 and 2. Letter of credit is considered as *sui generis* — *Bank of NS v. Angelica-Whitewear Ltd.*, 36 DLR 4th 161 (Can. 1987).

credits, have altered much of the law of general obligations to meet the unique nature of the credit”³¹ and “in fashioning credit rules, moreover, courts have demonstrated their willingness to resort not to local law but to the law merchant.”³² Dolan is referring to the law merchant as “an international body of law”, rather than local common law, which is, according to him, reflected in the UCP. He elaborates:

“By virtue of the fact that letters of credit are historically a bank product and of the fact that banks issue most of the credits ..., bank regulations contribute to the body of law governing most credits.”³³

2.2.2 The birth of the UCP

Because documentary credits were not in common usage before the end of the First World War,³⁴ it was not until after First World War that the need for seeking uniformity in documentary credit practice became urgent. The reason for the increasing use of documentary credits in the post-war period is given by Professor Ellinger as a lack of economic stability. Merchants prospered, and overnight became insolvent. The use of letters of credit as security became necessary.³⁵ Individuals and companies had found themselves dealing with partners of whom they knew little, who were located in distant countries often with insecure political and economic situations.

³⁰ J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, Warren, A.S. Pratt & Sons; Detroit: 2001 edition., at 4-3.

³¹ *Ibid.*, at 4-1.

³² *Ibid.*, at 4-4.

³³ *Ibid.*, at 4-5.

³⁴ Ellinger, *op. cit.*, at 37.

Therefore the principal and most important task of documentary transactions was to provide security to the parties with respect to the fulfillment of the reciprocal financial obligations.³⁶

This effort to introduce uniformity was evident in the New American Commercial Credit Conference in 1920 which set out regulations concerning documentary credits. Many Continental European law countries also issued standard forms and regulations concerning documentary credits.³⁷ However, the Uniform Customs and Practice for Documentary Credits (“the UCP”), issued by the Commission in Banking Technique and Practice of the International Chamber of Commerce (“ICC”), first in 1933 and with three subsequent versions in 1951, 1962 and 1974, a fifth version in 1983 and with the latest in 1993, is the one guideline that is the most important source of the law concerning documentary credits. Its popularity was reflected by the fact that banks in virtually all countries where credits are issued have signalled their adherence to the UCP.

On the surface, it seems that the UCP has played a role of unifying banking practices in dealing with the documentary credit. Reflecting this, it is said that “there could hardly be anything more international in the field of law than letters of credit.”³⁸

It is undeniable that the ICC has played and may continue to play an important role in its endeavour to achieve a greater degree of

³⁵ Ibid.

³⁶ Ibid., at 3.

³⁷ Ibid., at 37.

³⁸ M. Kurkela, *The Liability of Banks Under Letters of Credit*, Helsinki; The Union of Finnish Lawyers Publishing Company Limited; Helsinki: 1972, at 9.

uniformity by articulating the operational procedures of documentary credits and by distributing the explanations of articles of the UCP to all banks dealing with such credits. However, it is common knowledge that the banking practice in this area in fact is not unified at all. Different understandings and different practices exist around the world.³⁹ In fact, there might not exist as much uniformity as is being claimed by some scholars and banking community as far as banks' practice in the area is concerned.⁴⁰ Moreover, whatever has been achieved could also be due to the fact, as indicated by Ellinger, that the very purpose of using this mechanism by businessman is to provide finance for international commercial transactions,⁴¹ with the end result being some uniformity as to how documentary credits operate.

2.3 Drafting and Interpretation of the UCP

2.3.1 Drafting

The UCP is drafted by the Banking Commission of the ICC, which is

³⁹ See, for example, K. Iftikhar, Manager, Trade Services, Standard Chartered Bank, Dubai, in "Country Views: United Arab Emirates", Vol. 8, No. 4, *Insight*, Oct.-Dec. 2002, at 8. Such sentiments gave rise for the push to uniformity that recently crystallised in the acceptance of the International Standard Banking Practice from the Examination of Documents under Documentary Credits ("ISBP") in the Rome meeting of the ICC in October 2002.

⁴⁰ See discussion in Chapter 3 on ICC initiatives towards pushing forward codification of international bank practices and the difficulties involved in identifying such practices.

⁴¹ Ellinger, *op. cit.*, at 2.

formed by the representatives of the banking community. As the UCP has become ever more expansive and widespread in its application, questions have been raised over the constitution of the Working Group of the Banking Commission which prepares the drafts, and the fact that Group only represents banking interests. The working party for the 1971 revision, for instance, included bankers from 5 continents, with provision of some input from non-ICC United Nations members through the United Nations Commission on International Trade Law.⁴² The 1993 revision, included professors as drafting members for the first time, but those professors, in fact, were acting as high level consultants for the banking industry of the United States, UK, Germany, and so on.⁴³ As Professor Ross Buckley has pointed out, “the very parties that documentary credits are designed to serve, exporters and importers, were not directly represented at the drafting table.”⁴⁴ Therefore, there inevitably is some doubt about the neutrality of the Working Group during the drafting process in terms of its capability or indeed even its concern about balancing the interests of the banks and other parties involved. Such concern has given rise to calls for the UCP, “as is the duty of any system of law, to address issues of equity and fairness for all parties”.⁴⁵

The ICC Banking Commission Working Committee appears to illustrate all the hallmarks of what has been described by Schwartz

⁴² B.S. Wheble, “Uniform Customs and Practice for Documentary Credits 1971 Revision”, (1971) *Cornell International Law Journal*, v. 4, no. 2, 97., at 99-100.

⁴³ C. del Busto (ed.), International Chamber of Commerce, ICC Publication, No. 511, *Documentary Credits, UCP 500 & 400 Compared*, ICC Publications; Paris: 1993, at Preface, III.

⁴⁴ R.P. Buckley, “The 1993 Revision of the Uniform Customs and Practice for Documentary Credits”, *The George Washington Journal of International Law and Economics*, 1995, v.28, 265, at 267, citing J.A. Spanogle, Jr. “The Arrival of International Private Law”, (1991), 25 *Geo. Wash. J. Int’l L. & Econ.* 477, at 492.

and Scott as a “private legislature.”⁴⁶ Scott and Schwartz argue that such private legislatures have four characteristics that shape the kind of legislation that they produce: (a) the costs of logrolling, that is, the fact that they are selected for particular task forces on a particular project for which they work exclusively, thereby hindering their capacity to make deals across projects, (b) members of both the task forces and broader legislative body act as individuals and have no political power that they can wield in the lawmaking process (c) information asymmetries exist between task forces and the broader legislative body and (d) members have a stronger preference for moving away from the status quo than does the median member of the larger body. Where a single interest group (such as banks) brings pressure to bear on a project and no other group participates, the group has an advantage in shaping the project to benefit its members. Rules that are precise and constrain decision-makers will largely reflect the preferences of the interest group, and as interest groups will have considerable success in blocking rules that encroach on their particular preferences, the rules as a whole will not represent a departure from the status quo.⁴⁷ Accordingly, efforts at unification through a private legislature such as the ICC may “generate advantages for some discrete group at the expense of overall public good” as “less benign forces come into play when experts, seeking the reduction from legal risk, law reform, and the strengthening of the role of specialist advisors, set off to develop unified and harmonised

⁴⁵ Ibid.

⁴⁶ A. Schwartz and R.E. Scott, “The Political Economy of Private Legislatures”, 1995, 143 *U. Pa. L. Rev.* 595, espec. from 608.

⁴⁷ P.B. Stephan, “The Futility of Unification and Harmonisation in International Commercial Law”, 1999, 39 *Va. J. Int’l L.* 743, at 759-760.

rules of international commerce”⁴⁸.

The dominance of banks and banking experts in UCP drafting seems to strongly suggest that in the drafting of the UCP, the ICC is acting as a private legislature. Not surprisingly, and as elaborated in chapters 3 and 4, the UCP contains precise rules that benefit banks, leaving little opportunity for judiciaries to “intrude” by crafting innovative solutions to compensate customers for overly formalistic or careless conduct by banks. Sweeping immunities from liabilities that would ordinarily be imposed by local law is one category of provision that favours banks,⁴⁹ with the result that banks have the discretion to determine whether or not they pay out against documents, with little potential for liability for the consequences for wrongful rejection or mistaken acceptance.

One would expect a bank to be exposed to a greater number of letter of credit transactions than either sellers or buyers, and therefore to be able to more readily detect indicators of faulty documents, i.e., “red flags”, including indicators arising outside the documents themselves. If banks were to undertake this function, it is possible that they would find a way to cash in on the overall welfare gains of

⁴⁸ Ibid., at 751.

⁴⁹ See for example Article 14(c) which gives the bank sole discretion as to whether to approach the customer to obtain a waiver of discrepancies in documents presented on behalf of the beneficiary; Article 15 which relieves banks of liability for the “form, efficiency, accuracy, genuineness, falsification or legal effect” of the documents accepted without payment, and for the bad faith, acts or omissions of “the consignors., the carriers, the forwarders, the consignees, or the insurers of the goods, or any other person whomsoever”. Article 16 releases the banks for responsibility for delays or mistransmission of any message, including telecommunications, and permits banks to transmit documents without translating them. Article 17 absolves banks from responsibility for any untoward consequences arising from their use of another banks “for the purpose of giving effect to the instructions of the [customer]”.

the other parties.⁵⁰ Even without going this far, greater indeterminacy in the UCP may allow local courts to respond to extreme cases of bank negligence.⁵¹

Even in application of their “structure induced equilibrium theory”⁵² to the private lawmaking groups of legal practitioners — the American Law Institute and the National Conference of Commissioners on Uniform State Laws — drafters of the UCC in the United States,⁵³ Schwartz and Scott identified that both groups demonstrate strong status quo bias and are vulnerable to capture by powerful interest groups.⁵⁴ This may be particularly significant in respect of the 1995 revision to Article 5, which deals with letters of credit, as the working committee appears to have been comprised entirely of banking law experts, with the result that UCC Article 5 was to a great degree brought in line with the provisions of the UCP.

As Stephan points out, identifying pro-bank rules and the dominance of banks over drafting does not necessarily mean that the ultimate effect of the UCP is to favour banks over other parties to the letter of credit transaction. However, a “reasonable suspicion” exists that the effect of the UCP is to obtain economic rents for banks by assigning obligations to the party that cannot perform them most efficiently:

⁵⁰ Stephan suggests that banks have tended to exploit their relative position in which they receive a certain degree of protection in many markets to prefer more leisure and less risk, and that the benefits derived from standardisation of contractual terms may mean the costs of modification are greater than any potential welfare gains: Stephan, *op. cit.*, 784-785.

⁵¹ E.L. Symons Jr, “Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief” (1979-80) 54 *Tulane L.R.*, 338, at 381.

⁵² Schwartz and Scott, *op.cit.*, 597.

⁵³ UCC Article 5, most recently amended in 1995, governs letter of credit transactions in the US.

“What seems clear is that the international standard for bank-issued documentary credits seems to favour banks, that banks had the dominant role in drafting the standard, and that the clear gains in legal certainty achieved by the standard come with unwanted baggage of potentially redistributive outcomes. As with the Warsaw Convention and the Hague Rules, we must worry about the costs of legal risk reductions and the seeming inevitability of interest group influence over clear and specific international rules.”⁵⁵

2.3.2 Interpretation

The ICC’s Commission on Banking Technique and Practice, has the authority to interpret the UCP and apply these interpretations to answer questions arising from particular problems. The wide publicity and distribution of their answers mean that these can be regarded as official interpretations of the UCP, complementing, interpreting, and sometimes amending, its provisions. These are followed by banks dealing with letters of credit. To the extent that the Commission staff are only in theory accountable to ICC members, the risk of challenge to such interpretations is low, further amplifying the suspicions raised by the drafting process applied by the ICC.

2.4 UCP Exclusion of Other Sources of Law

⁵⁴ Schwartz and Scott, *op.cit.*

⁵⁵ Stephan, *op.cit.*, at 783.

2.4.1 Status as reflecting *lex mercatoria*

It is commonly asserted that the rules that generally govern letters of credit arose out of practices of all parties in the international sale of goods.⁵⁶ It is submitted, however, that such an assertion is misleading. The present documentary credit system is conducted almost exclusively under the umbrella of the UCP⁵⁷ which, as will be demonstrated, is merely a codification of the practices of banks without taking into account the practices of other parties to such transactions. In this manner, the UCP has in effect minimised the possible intrusion of all other sources of law. Furthermore by expanding the customary nature of this payment mechanism to say that the UCP is the manifestation of a law merchant or *lex mercatoria*⁵⁸ through codifying customs and practice and by being accepted universally, the UCP has been accorded an almost mythical status that has enabled it to become applicable to almost all documentary credits.

Prior to the UCP 500, the UCP was applicable to all credits under the theory that the UCP reflected custom and usage.⁵⁹ By limiting its applicability to only those credits which had expressly incorporated its provisions, the UCP 500 might no longer be considered as custom and usage and rather as incorporated contractual terms.⁶⁰ Arguably

⁵⁶ Dolan, *op.cit.*, at 1-1.

⁵⁷ For example, letter of credit expert, Kozolchyk, has noted that the UCP is "the most influential source of commercial letters of credit law in the world," B. Kozolchyk, "Letters of Credit" , *Int. Ency. Comp.*, 1979, Vol. IX, Ch. 5.

⁵⁸ Kurkela, *The Liability of Banks Under Letters of Credit*, *op.cit.*, at 1.

⁵⁹ J.F. Dolan & P. van Huizen. "International Rules for Letters of Credit: The UCP: A Final Report", 1993-1994, 9 *Banking and Finance Law Review* 173, at 175.

⁶⁰ *Ibid.*

this provides the applicant with the choice of choosing other rules or laws rather than subjecting the letter of credit to the UCP 500. In *Mannesman's Case*,⁶¹ the credit was subject to the law of the Switzerland and the court was therefore able to apply the principle of good faith, which is not available under the UCP. On the other hand, arguably, the bank's stronger bargaining power would probably still lead to the result of the application of the UCP in most documentary credits.

Interestingly, such a change of role of the UCP is not well accepted by the recent revised Article 5 of the UCC.⁶² The UCP is treated as reflecting custom and usage and also as contended by the United States Council on International Banking (USCIB), "the UCP is not only partly standard contract language but is also 'de facto law'".⁶³

In the Official Comment on Article 5 of the Uniform Customs and Credits (1962), the only comprehensive body of domestic legislation that specifically addresses the regulation of documentary credits, it was clearly indicated that the source of law regarding letters of credit was the law of contract "with occasional unfortunate excursions into the law of guaranty".⁶⁴ It was, from then, an "independent theoretical frame for the further development of letters of credit".⁶⁵ The events of 1962, including the UCP (1962), could be considered as a turning

⁶¹ *Mannesman Handel AG v Kaunlaran Shipping Corporation and Others (Third Parties)* [1993] 1 Lloyd's Rep. 89.

⁶² See UCC Article 5, 1995.

⁶³ J.F. Dolan & P. van Huizen., op.cit., at 175.

⁶⁴ Official Comment on §5-101 (62'), in American Law Institute, Official Comment of Article 5 (1962 Version) Letters of Credit, 1995, in J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*. Warren, A.S. Pratt & Sons, Detroit: 2001 edition, Appendix B.

⁶⁵ Ibid, Official Comment on §5-101 (62').

point in the development of the law of the letters of credit. It might not be wrong to assume the possibility of contract law playing a very important role in dealing with the rights and duties of all parties involving in letters of credit transactions. Clearly, however, the goal of the banking industry — to establish a totally independent theory — was so successful that the law of letters of credit totally departed from contract law and therefore from the influence of hundreds of years of development in this area.

As a result of assertions that it represents a codification of customs and practice, and by being accepted universally, the UCP is seen as belonging to an autonomous legal system, with its doctrine regarded as the first manifestation of a law merchant or *lex mercatoria*⁶⁶ in the sense that its principles have been applied not only to almost all letters of credit transactions (even though an incorporation in the contract is necessary), but also in the inter-bank relationship even in the absence of specific reference to it.⁶⁷

Despite the UCP's intention of trying to establish a brand new theory that differs from the traditional way of looking at letters of credit, Article 5-102 (62') of the UCC, in contrast, stated that it "deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop... the fact that this Article states that a rule does not by itself require, imply or negate application of the same or converse rule to a

⁶⁶ Ibid.

⁶⁷ Ibid.

situation not provided for or to a person not specified by this Article”.⁶⁸ This in effect allowed application of rules and principles beyond the UCC '62 and allowed space for developing new rules any time a transaction required.

2.4.2 *Sui generis and UCP's perceived international nature*

The mythical status of the UCP as being derived from the *lex mercatoria* has been enhanced by its perceived “international nature”. The documentary credit, by virtue of their international roots and role, is a part not of local law, but of the *jus gentium*. Its international nature has been used as a factor which “imposes a duty on courts to avoid application of strictly local rules to the device”⁶⁹ and therefore courts, rather than resorting to local laws, have been applying the UCP as if it represents an international body of law in dealing with issues under letters of credit.

It has been argued that the rules governing irrevocable letters of credit was a deviation from the established rules of the common law and if “common law rules were to be strictly observed there would be no room left for commercial usage at all”.⁷⁰ Such argument may have arisen out of the difficulty of courts and scholars in accepting the letter of credit as an instrument for payment because it lacked the consideration that the common law required. The *sui generis* of the documentary credit has been overstated so successfully that the laws of other areas have never been able to play any role in the letter of

⁶⁸ Ibid.

⁶⁹ Dolan, *op.cit.*, at 4-3.

credit field, to the extent of even limiting application of the basic principle of good faith.⁷¹ Courts have been facing great pressure from the banking industry not to interfere with banking practice established by the UCP, and court intervention is considered as disturbance to the mercantile practice of treating rights thereunder as being equivalent to cash in hand, except in a situation of fraud.⁷² James Barnes has gone so far as saying that courts should always make law by reflecting the real banking practice, and that it is simply not acceptable for a court to use the law of contract, or agency or even bill of exchange to interpret the law of the letter of credit. He further insists on the concept of *sui generis* and urged that the letter of credit should be left alone without being interpreted by the courts, which he would consider a real intrusion on banking commercial practice.⁷³

These views are also articulated by Dolan, who advocates that the good faith requirement of Article 5 should be read with regard to that body of law, “which makes allowance for the independent nature of the obligation, for the exigencies of the document examination process, and for the low cost of letters of credit”.⁷⁴ He further stated that “it is not helpful for courts to succumb, for instance, to the temptation to second-guess bank document examiners, clerks who must make decisions on short notice and without benefit of legal

⁷⁰ Ellinger, *Documentary Letters of Credit*, op.cit., at 109.

⁷¹ Note that in the US, the UCC emphasises the concept of good faith to resolve confrontations between parties to commercial transactions, and is frequently elaborated in the context of Articles 2, 9 and 7, and explicitly mentioned in Article 5-109, and that further, under the *lex mercatoria*, good faith is considered a fundamental tenet of international transactions — H. Veytia, “The Requirement of Justice and Equity in Contracts”, April 1995, 69 *Tul.L. Rev.* 1191, 1198.

⁷² See *Intraco Ltd v. Notis Shipping Corporation of Liberia; The Bhoja Trader*, [1981] 2 Lloyd’s Rep. 256, at 257.

⁷³ Interview with James G. Barnes at the Letter of Credit Annual Survey 2001 Conference in Hong Kong, June, 2001.

briefs and oral arguments.”⁷⁵

It is difficult to be convinced by arguments that generic contractual principles should be excluded from assessment of letters of credit because of *sui generis* or because of a supposed adverse impact on document examiner efficiency. As Symons has pointed out, there should be nothing strange about applying generic contract concepts such as good faith to the law of letters of credit:

“Just as the law of commercial paper is specialty contract law, that is to say, contract law with special doctrines superimposed to enhance special commercial needs, so the law of letters of credit is contract law with special doctrines superimposed to enhance other special commercial needs. To the extent there is no resulting detriment to the special commercial needs of the letter of credit transaction, application of generic contract principles assuring basic honesty in commercial dealings should be acknowledged. Therefore, the legal isolation of the bank’s undertaking in the letter of credit transaction should not be emphasised blindly, with the concomitant danger of disregarding the relevance of ordinary rules of contract law, such as good faith,

⁷⁴ Dolan, *op.cit.*, at 4-9.

⁷⁵ *Ibid.*

embodied in the UCC.”⁷⁶

The perceived international nature of the UCP as opposed to local law maybe explains why such a system has been able to exist devoid of the generally applicable principle of good faith. Both “good faith”, as well as “fraud unravels all” — a fundamental principle of the common law famously reiterated by Lord Diplock — consequently have found it difficult to penetrate the UCP regime which has resisted the intrusion of any norms extraneous to it. It is therefore submitted that dominance of the UCP and the exclusion of the application by judges of other legal norms has hindered the possible development of documentary credit case law.

2.4.3 Court reluctance to intervene

In *Discount Records Ltd. v. Barclay Bank Ltd.*,⁷⁷ the judge was hesitant to “interfere with bankers’ irrevocable credit, and not least in the sphere of international banking”.⁷⁸ This was a pattern followed in numerous other cases. It seems that judges are intimidated by banking experts threatening that the courts’ decision would have a gravely adverse affect on international trade. The pressure the court faces in bringing all parties involved in the letter of credit onto the track of behaving in good faith can be immense. To illustrate the types of arguments in this vein that are brought before the court by banks or banking experts, in *Mannesman Handel AG v. Kaunlaran*

⁷⁶ E.L. Symons, Jr, op.cit., at 340-341; There is also some judicial support that the letter of credit as “a well-known instrumentality of commerce” is governed under the same principles as contract law – see *J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda)*, 371 N.Y.S.2d 892: 897 (1975).

⁷⁷ *Discount Records Ltd. v. Barclay Bank Ltd.* [1975] 1 Lloyd’s Rep. 444; [1975] 1 All E.R. 1071.

Shipping Corporation,⁷⁹ the Swiss bank argued that it had rightfully rejected the presentation of the documents by the German company based on the independence principle and the discrepancies shown on the documents. The court was asked not to apply the good faith principle otherwise the court “would be calculated to undermine if not destroy the doctrine of strict compliance and to blur if not extinguish the distinction between transactions concerning goods and transactions concerning documents.” In *Santander*,⁸⁰ the court was threatened that never again would another confirmed deferred payment come into existence if the Court held against the confirming bank. The court identified a French case dealing with banks’ rights in the same situation and satisfied itself that there was little risk of such an eventuality.

Not surprisingly, as stated by Ellinger, the problem of provisions of the UCP conflicting with court decisions does not appear to occur. The judicial decisions on the legal aspects of documentary credits have usually been based on what the courts consider to be either the express intentions of the parties or established business practice which the parties are assumed to have had in mind when entering into the contractual relationship. In cases where the UCP provisions are different from business practice, a court will apply the UCP if the UCP is incorporated in the contract of the parties.⁸¹ Through such analysis, it is clear why the legal aspects of documentary credits have not over the years demonstrated significant advance.

⁷⁸ Ibid., final paragraph of the judgment (p 6 of the internet version).

⁷⁹ *Mannesman Handel AG v. Kaunlaran Shipping Corporation* [1993] 1 Lloyd's Rep. 89.

⁸⁰ *Banco Santander SA v. Banque Paribas*, [2000] 1 All ER (Comm) 776 [England].

⁸¹ *Soproma S.P.A. v. Marine & Animal By-Products Corporation*, [1966] 1 Lloyd's Rep. 367.

If courts ratify a system under which the rights and duties of all parties are determined, in effect, by the will of one party (the bank) by the application of an off-the-rack set of standard provisions, courts are permitting a system which inevitably lacks neutrality, transparency and equality.⁸² In doing so, courts have acquiesced to the entire documentary credit system being run by the banking industry which has further served to isolate the courts from the industry, thereby constraining courts in their ability to adjust the legal rights and duties between all parties. Thus, to the extent that the UCP is serving in practice as the only applicable “law” dealing with the rights and duties of all parties, and in the absence of application of common law contractual principles, the documentary credit system has become a little understood (outside banking circles) field of law impervious to the application of the rights and obligations inherent in contracts entered into by parties in other fields of activity.

⁸² As Chantayan rightly points out, in the context of reports that issuers typically require applicants to indemnify issuers against all risks (infra. n. 138), “it is difficult to reconcile that the issuer can obligate the applicant to effectively waive his right to seek a remedy from the issuer when the parties are of equal bargaining power. It is clear that these parties are not dealing at arms length”, Chantayan, op.cit., at 226 (n. 77). The inequality in bargaining power was also a source of concern for the New York State Law Revision Commission, as reflected in its report advocating adoption of the Revised Article 5 of the UCC to replace the form of Article 5 adopted by New York State in 1962. Adoption of the Revised UCC Article 5 would change the position under New York law (which at that time provided that Article 5 would not apply when the UCP was incorporated into the letter of credit) by restricting parties to a letter of credit from contracting out of certain compulsory provisions under Article 5 even when incorporating the UCP. The New York position was comparable to that in countries without specific legislation on letters of credit, such as England and Australia, in which the application of sui generis discouraged courts from applying general common law contract principles. Although not specifically stating that its concern related to the UCP, the New York State Law Revision Commission advocated adoption of Revised UCC Article 5 because of the ability of parties to freely select the applicable choice of law “will enable some stronger parties to obtain unfair and unexpected advantages” as the issuer can unilaterally declare the choice of law in the letter of credit when it is issued. The Commission stated that certain choice of law selections can “destroy ... rights [a] party might normally expect to have”, New York State Law Revision Commission, *Report on the Proposed Revised Article 5 – Letters of Credit – of the Uniform Commercial Code*, 42, 43.

2.4.4 Assumption of status of law in practice.

Should the UCP have the status of law? The US Council on International Banking refers to the UCP as a “de facto” law.⁸³ As Mugasha correctly pointed out in one of his early pieces of research, “whereas there is basic agreement that the UCP does not form part of the law of any country, it was not agreed upon by all users”,⁸⁴ leading scholar Professor Ross Buckley to hold that “originally, the UCP was neither designed nor intended to be law. It was prepared as a set of standard terms to be incorporated by reference into letters of credit by those parties who chose to do so.”⁸⁵ This seems to be confirmed by the UCP itself as the preface of UCP 500 clearly states that the UCP is not legislation but a compilation of rules fashioned by bankers for their own industry.⁸⁶

According to ICC Publication No. 511, *Documentary Credits, UCP 500 & 400 Compared* (1993),⁸⁷ edited by Charles del Busto, then chairman of the ICC, the banking commission has had as its goal the incorporation of new trade practices introduced by bankers, commercial parties, transport companies, as well as important recent

⁸³ “USCIB Study of Fundamental Problems with the Seventh Draft (March 31, 1993) Revision of the UCC Article 5”, in “Letter of Credit Law Revision: UCC, UCP and UNCITRAL”, 1993 *A.B.A. SEC. BUS. L.* 86, at 87.

⁸⁴ A. Mugasha, *Standby Letters of Credit in International Transactions*, L.L.M. Thesis, York University, [1988], at 29.

⁸⁵ R.P. Buckley, “The 1993 Revision of the Uniform Customs and Practice for Documentary Credits”, *The George Washington Journal of International Law and Economics*, 1995, v.28, 265, at 267.

⁸⁶ J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credit*, op.cit, at Appendix A-4.

⁸⁷ C. del Busto (ed.), *Documentary Credits, UCP 500 & 400 Compared*, Paris; ICC Publication, No. 511; International Chamber of Commerce: Paris: 1993.

decisions by court and tribunals.⁸⁸ However, there is some doubt as to whether this goal has been achieved. The UCP does not cover the above-mentioned areas comprehensively. Some issues are not covered by the UCP at all. One of the most important issues not covered is fraud, which was left to be dealt with by municipal law. It is believed that “the choice of the Working Group not to address the issues of fraud in the tendered documents and/or the sale of goods transaction reflects either an unwillingness to tackle a difficult but necessary issue, or an outdated view of the limited scope of the UCP as merely a codification of bankers’ practices rather than a dispositive regime of rules.”⁸⁹

There is therefore much controversy as to whether the UCP is a code of the law of letters of credit, or evidence of customary practices, or only ‘consensual regulation’ relating to letters of credit. There is also controversy on the question whether the individual provisions of the UCP have the same legal quality, that is, whether they are equally binding on all users of letters of credit.”⁹⁰ The New South Wales Supreme Court recently described the UCP as a “Code”, indicating that “it is not intended to be a legally enforceable code” but “to operate as a guide and code of behaviour”.⁹¹ Buckley believes that such a modest goal was appropriate in the early days of the UCP and the fact the UCP has acquired universal adoption requires the UCP, which “serves as law in practice” to address, as is the duty of any

⁸⁸ Ibid., at Preface, III.

⁸⁹ Buckley, op. cit., at 302.

⁹⁰ Mugasha, op.cit., at 28.

⁹¹ *St. George Bank Limited v. Salzberger* [2001] NSWCA. 67, at paragraph 12 of Stein JA’s judgment.

system of law, issues of equity and fairness for all parties.⁹²

2.4.5 Marginalisation of local law

(a) The Unified Commercial Code and increasing marginalisation of local law

The U.S. is the only country with an extensive and specific regulation for letters of credit – Article 5 of the UCC. Article 5 first made its appearance in the UCC in 1952. Even though most US states adopted the UCC (1950) without reservation,⁹³ most international letters of credit transactions of this nature would still incorporate the rules of the UCP rather than Article 5. In such case, the UCP rules, in effect, became the governing law.⁹⁴

The response of the State of New York, a jurisdiction in which banks occupy a key role in the economy and are a powerful interest group, to the enactment of Article 5, was instrumental in demonstrating the aversion of banking interests to the encroachment of national law on the application of the UCP, and is evidence of the primacy accorded by New York to the UCP. New York (together with the States of Alabama, Missouri and Arizona), in a non-conforming amendment to Article 102, rendered the UCC entirely inapplicable if the credit is made subject to the UCP.⁹⁵

⁹² Buckley, *op. cit.*, at 268.

⁹³ Except New York, Missouri and Alabama.

⁹⁴ D. W. Lee, "Letters of Credit: What does Revised Article 5 have to Offer to Issuers, Applicants, and Beneficiaries?", *Commercial Law Journal*, v.101, 1996 (Fall), 234, at 234.

⁹⁵ See ALA.CODE 7-5-102(4) (1993); ARIZ. REV. STAT. ANN. 47-5102(D) (1988); MO. ANN. STAT. 400.5-102(4) (Vernon 1994); N.Y. UCC.LAW 5-102(4) (McKinney1991). For background

After forty years of use, the American Law Institute and National Conference of Commissioners on Uniform State Laws claimed that some weaknesses in the regulatory regime and new developments in technology and shipping industries rendered revision of UCC Article 5 necessary. Therefore, in 1995, U.C.C. Revised Article 5 on Letters of Credit was promulgated.⁹⁶ Even though the Revised Article 5 is generally consistent with the UCP in principle and policy, it contains some provisions of great importance which are not dealt with in the UCP. Section 5-116(c) of the UCC provides that even if the UCP is incorporated by reference, it does not replace Revised Article 5 in total. The *non variable* provisions of the Revised Article 5⁹⁷ cannot be varied by agreement by a term in the letter of credit that waives a party's liability for negligence or limits remedies for failure to perform obligations.⁹⁸ In addition, as reflected by Article 5-109, the UCC is not as unequivocal as the UCP in separating the credit from the underlying transaction for which the credit serves as payment.

It is not clear, however, to what extent Article 5 of the UCC actually functions as the law to fill the gaps in the UCP. The issue here is whether courts perceive certain provisions in the UCP as a general waiver of the bank's liability for negligence and are prepared to bring Article 5 in to redress any unfairness. From the author's observations of how the UCP has actually operated in practice and the treatment it

as the rejection by New York, see C.W. Funk, "Letter of Credit: UCC Article 5 and the Uniform Customs and Practice", January 1966, 83, No. 1, *Banking Law Journal* 1 at 19-21.

⁹⁶ Because of the universal adoption of the UCP and the consistency of the Revised Article 5 with the UCP, my analysis throughout the thesis will focus mainly on the use of the UCP.

⁹⁷ UCC § 5-103(c) (1995).

⁹⁸ Lee, *op. cit.*, at 240.

has been accorded by the courts, it would appear that this is not the case.

The statement in the Prefatory Note to Article 5 ('95), that “the UCP is used in most international letters of credit”⁹⁹ indicates that Article 5 ('62) of the UCC often was not applied to international letters of credit. In fact, “virtually all credits issued within the United States in support of international trade are issued subject to the UCP and many of the credits issued for purely domestic transactions are likewise issued subject to its provisions.”¹⁰⁰ It also reflects the underlying intention that legal principles incorporated in Article 5 ('62), including the good faith principle, were not to be used by bankers. Therefore, the application of letters of credit *law*, even in the U.S., could be said to be actually the application of the *UCP*. This conclusion is confirmed by the statement in the Official Comment on Article 5 that “these international practices (referring to the UCP)¹⁰¹ are well known and employed by the major issuers and users of letter of credit”. Therefore, it is not surprising that the revision was to be made in accordance “with current international practice”, or in other words, in accordance with the banking culture to which bankers are accustomed. The end result of this is that “Article 5 is consistent with and was influenced by the rules in the existing version of the UCP”.¹⁰²

⁹⁹ Prefatory Note of Article 5 (95'), in J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credit*, op.cit, at Appendix A-4.

¹⁰⁰ Buckley, op. cit., at 266.

¹⁰¹ Added by the author.

¹⁰² Official Comment of 5-101, in American Law Institute, Official Comment of Article 5 (1962 Version) Letters of Credit, 1995, in J. Dolan, op.cit, Appendix B.

Therefore, the effect of the 1995 revisions was to give the UCP preeminence over the UCC's provisions except for "the non-variable provisions of Article 5".¹⁰³ The 1995 revisions therefore represent a significant step forward in the irrevocable process of marginalisation of local law that has accompanied the near universal adoption of the UCP.

(b) Impact of universal adoption of the UCP

The UCP is now used in most international letters of credit.¹⁰⁴ So widespread has the use of the UCP (and the bargaining power of banks *vis-à-vis* applicants) become, that applicants for letters of credit except perhaps in the largest or most lucrative transactions, in practice lack the ability to negotiate a choice of law or modifications to the terms of the credit as a standard document.

A credit such as the one which was the subject of *Mannesman Handel AG v Kaunlaran Shipping Corporation and others*, under which the governing law was Swiss law, is rare. *Mannesman* however demonstrates the impact that the application of local law and of accompanying generic contractual principles can potentially have on the outcome of a case. In applying Article 2 of the Swiss Civil Code which provides "(1) everyone is obliged to exercise their rights and to fulfill their obligations in accordance with the principles of good faith, and (2) the manifest abuse of a right is not protected by the law", Saville J on the Queens Bench questioned the possibility of

¹⁰³ Prefatory Note of Article 5 (95'), *op.cit.*, Appendix A-4, at A-9.

¹⁰⁴ *Ibid.*, at A-8.

ascertaining the significance of a discrepancy purely based on the independence principle and was of the view that unless “a letter of credit would itself stipulate or indicate what is to be regarded as significant or insignificant”, it is necessary for the court “to look outside the letter of credit at the surrounding circumstances” of the case. Ultimately, Saville J was able to proceed “to allocate responsibility on the basis of deciding what was fair and equitable in all the circumstances, taking into account the presence or absence of good faith as a relevant factor.”¹⁰⁵ Accordingly, the court held against the defendant Swiss Bank on the basis that, in the circumstances of the case, the bank had, in bad faith, attempted to take advantage of the doctrine of strict compliance in order to avoid paying out the proceeds of the credit to the German sellers.

There is no mention of a “good faith” requirement under the UCP, although there is under Article 5-109 of the UCC. If the credit was governed by English law, Fayers suggests that the courts could have reached the same result through the application of a species of estoppel,¹⁰⁶ although there is no such guarantee had the case been purely governed by the UCP, thereby demonstrating the potential significance of the choice of national law as the governing law of the credit and the application of generic contractual law principles.

Similarly, a decision of the Australian courts, *Contronics Distributors*,¹⁰⁷ which was extraordinary from the perspective of letter

¹⁰⁵ Mannesman, op.cit., at paragraph 24 of the judgment.

¹⁰⁶ R. Fayers, “Banks Are Not Always Shining Innocents”, *DCW*, June 2001, 28, at 30.

¹⁰⁷ *Contronics Distributors Pty Ltd v. Bank of New South Wales and others*, [1975] 3 NSWLR 110.

of credit law, was only possible due to the fact that the UCP did not govern the credit, and therefore the court was able to make its decision based not only on English and American authorities but also with reference to a wide range of scholarly work. This case is significant because it explicitly acknowledges the contractual relationship between the issuer and the applicant and entitled the applicant to a direct right against its issuer to restrain it from making payment over false documents.¹⁰⁸

2.4.6 Choice of law — what choice of law?

(a) Choice of Law under the UCP

Article 1 of UCP 500 reads:

“The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500, shall apply to all Documentary Credits (including to the extent to which they may be applicable, Standby Letter(s) of Credit) where they are incorporated into the text of the Credit. They are binding on all parties thereto unless otherwise expressly stipulated in the Credit.”

Article 1 of the UCP indicates that the UCP is only applicable when chosen by applicants. It is also considered by Professor Ellinger that “there is really no reason why the parties to each of the contracts in a

¹⁰⁸ See Chapters 3 and 5 for a discussion of *Contronics Distributors*.

documentary credit transaction should not be at liberty to agree on any lawful terms they choose...”¹⁰⁹ If the UCP is effective only when the parties have chosen to have their letter of credit subject to it, then it leaves open the theoretical possibility for the parties to choose, for example, the UNCITRAL Convention as the applicable law rather than the UCP, and also gives the parties the right to contract out of any provisions of the UCP if the UCP is the applicable law.

The reality, however, is such that banks only deal with other banks on the condition that the UCP is applicable. In order to give effect to this provision, documentary credits issued in most countries include a statement that the credit is governed by the provisions of the UCP.¹¹⁰ The sentence “subject to UCP for Documentary Credits 1993 (ICC Publication 500)” (with no attachment of the UCP to such documents) is incorporated in the standard application form.

This has rendered the UCP virtually applicable to all documentary credits — a virtual “off-the-rack” standard contract. As expressed by one commentator, “while the UCP is partly standard contract language, it is also recognized by the markets and the courts throughout the world as the *de facto* law which defines and regulates the interlocking relationships [involved in documentary credits].”¹¹¹

¹⁰⁹ Ellinger, *Documentary Letters of Credit*, op.cit, at 128.

¹¹⁰ Ellinger, op. cit., at 2.

¹¹¹ USCIB Study of Fundamental Problems with the Seventh Draft (March 31, 1993) Revision of UCC Article 5, in Letter of Credit Law Revision; UCC, UCP and UNCITRAL, 1993 A. B. A. Sec. Bus. L. 86:87, cited by Buckley, op. cit., at 268. See also Chantayan, who states accurately that “while the UCP is not the law, it has come to have the same binding effect as the law”, F. Chantayan, “Note: Choice of Law Under Revised Article 5 of the Uniform Commercial Code” – 5-116”, 1999, 14 *St. John’s J. L.Comm.* 199, at 206. See also *Calgarth Investments, Ltd. v. Bank Saderat Iran*, 1996 WL 204470, at 204477, denoting that the UCP is substantive law governing letters of credit; and A. D. Ronner, “Destructive Rules of Certainty and Efficiency: A Study in the

Such is the current popularity of the UCP amongst banks that the task of finding a bank willing to enter into a letters of credit transaction that does not nominate the UCP as the governing body of rules would be virtually impossible.¹¹² In fact, in the international arena, any applicant wanting a letter of credit not subject to the UCP would face a very difficult search to find a compliant bank.¹¹³ It is, therefore, evident that applicant-buyers do not have any say in terms of what contract they want and what law should be the applicable law in the letter of credit transaction. They have to take whatever is available.

If Article 1 expresses the spirit of the freedom of choice which is never in practice capable of being exercised under the UCP regime, Article 5 of the UCP further denies such spirit. Article 5 discourages the inclusion of any descriptive condition about the goods and services. That is to say, any conditions without the actual support of documents will be ignored by the bank.¹¹⁴ Article 5 of UCP 500 discourages the applicant from putting in “detailed” information. It seems that the ICC originally intended to include wording such as “banks should not issue credits”, or “banks should reject such instructions” if a letter of credit instruction is too detailed. However, owing to the fear of violating local laws that require the issuance of detailed instructions, credits or amendments,¹¹⁵ this article adopted wording that sounds mild but yet has basically the same effect. The

Context of Summary Judgment Procedure and the Uniform Customs and Practice for Documentary Credits”, 28 *Loy. L. Rev.* 619, at 626, indicating that the UCP is a source of law governing letters of credit.

¹¹² Buckley, *ibid.*, at 269.

¹¹³ *Ibid.*

¹¹⁴ Article 5(b) of UCP 500.

literal interpretation of this sentence is that the bank will still have the final say as to whether they will reject the issuance of detailed instructions, credits or amendments.

Even though it is considered that “the applicant is under no duty to acquaint himself with the UCP, and banks are better equipped to keep abreast of changes in commercial and banking practice”,¹¹⁶ applicants are expected to be familiar with their potential liabilities without being notified of the relevant provisions about the bank’s broad exemption of responsibilities. Even though Devlin J. points out the necessity of the applicants having a say regarding their rights¹¹⁷ and UCP Article 1 clearly indicates the UCP’s contractual nature, somehow these principles have been lost in the midst of the documentary credit transaction.

The reality is such that there has never been any right for applicants to have any say in the initial stage of the contract drafting. As a consequence, generally there has not been any perceived need for lawyers’ involvement on the part of buyers. Without seeking lawyers’ advice on how to redress the imbalance in the terms and conditions and without reading the articles of the UCP, it is doubtful that the majority of buyers are aware of their position under the UCP. It also could be said that the rights of applicants have rarely been insisted upon, as lawyers have been left outside the initial stage of the documentary credit transaction. It might not be untrue to say that

¹¹⁵ UCP 500 & UCP 400 Compared, op. cit., at 11.

¹¹⁶ M. Megrah, “Risk Aspects of the Irrevocable Documentary Credit”, *Arizona Law Review*, (1982), v.24, 255, at 257.

¹¹⁷ *Midland Bank, Ltd. v. Seymour* (1955) 2 Lloyd’s Rep. 147.

most applicants genuinely believe that the UCP is dispositive law and that they have no other choice. As a result, it is normal for applicants to simply sign any documents they are given. The applicant is usually given a standard form to fill out without adequate advice from the bank, which leaves the bank and courts free to interpret the intention of the applicant.¹¹⁸

Devlin J. commented on the nature of the application form in *Midland Bank, Ltd. v. Seymour*¹¹⁹ and said "... This is a printed document which shows the sort of thing that the bank wants, but it is left to the applicant for the credit to fill it up in what way he wants; and if he thinks there is some ambiguity in it there is no difficulty ... in his filling it up in a way to make it clear."¹²⁰ This seems to suggest that the buyers should, and should be able to under the law, incorporate specifications that the buyer thinks necessary in the application form. However, it is doubtful whether a buyer even knows or is ever advised by his bank as to how to fill a standard application form to include what he wants. In fact, further analysis of other UCP articles indicates that the chance of an applicant exercising any freedom of choice is minimal. This is suggested also by Professor Ellinger's analysis. "The judicial decisions on the legal aspects of documentary

¹¹⁸ Ibid. The more sophisticated users of letters of credit are established businesses that open letters of credit on a regular basis. Such users may see advantages in terms of speed, cost and efficiency by the use of standard documentation drafted by banks. Some users may even be vaguely aware that these perceived benefits come at the cost of increase risk to the buyer. This does not alter the fact that, except in the case of credits that involve extraordinarily large sums of money, there is in practice virtually no opportunity for buyers to contract out of the UCP, leaving them exposed to the full impact of the exclusions to bank liability under the UCP. The absence of suitable alternative forms of finance, and the extreme unlikelihood of banks entertaining any alternative governing law, serves to discourage buyers from undertaking a thorough analysis of the risks associated with opening letters of credit.

¹¹⁹ (1955) 2 Lloyd's Rep. 147.

¹²⁰ Ibid., at 153.

credits are usually based on what the courts consider to be either the express intentions of the parties or the established business practice which the parties are assumed to have had in mind when entering into the contractual relationship involved.”¹²¹

It is difficult to fathom why courts consider that the applicant opts for application of the UCP as an exercise of its freedom of choice. It would seem that such courts regard the UCP as being drafted with reasonable fairness and that that the rights and duties of all parties have been fairly considered. In this sense, it seems that they are ready to overlook the UCP’s omission of many rights and duties of applicants.

Regarding the buyer as choosing the UCP under the principle of autonomy provides the court with an opportunity to apply the UCP as though it is dispositive law. Meanwhile, the process of entering into letters of credit demonstrates that buyer autonomy has been denied. For other types of standard contract, public policy has been used to restrict the full freedom of autonomy. The private will and its effect are judged by the external and objective standards of the reasonable man, meaning, in effect, the judges.¹²² “Courts use the process of construction of the terms of the contract to restrict contracts which were oppressive or which exploit an imbalance of bargaining power between the parties.”¹²³

¹²¹ Ellinger, *Documentary Letters of Credit*, op.cit., at 127.

¹²² D. Allen, *Law of Contract in Australia*, Sydney: CCH Australia Ltd; Sydney and Melbourne: 1987, at 23.

¹²³ *Ibid.*, at 13.

The process of the court looking at the contractual relationship therefore should have as its starting point whether the contract is “fair” and whether there exist any elements of duress and unconscionability. “Freedom of contract referred to the principle of the autonomy of the private will, which provided the juristic basis of contract and the explanation of the source of the binding power of promises.”¹²⁴ The imbalance in bargaining power between applicants and banks therefore throws doubt upon the principle of freedom of contract in this context.

(b) Choice of UCP under the UCC

Choice and application of the UCP is legitimate under the UCC. Such reasoning appears in the Official Comment of Article 5-103, which states that terms of the UCP can be legitimately applied to a letter of credit transaction even though they may clearly conflict with Article 5 of the UCC under the excuse that such terms are “permissible contractual modifications” based on the agreement between the issuer and the applicant. This is irrespective of the fact that the agreement between the issuer and the applicant does not normally involve any process of negotiation. Although some UCP terms might not be permissible under the UCC, they will continue to be applicable to letter of credit transactions because of the theory that the applicant exercised free will in choosing UCP as governing the relationship.

Given that Article 5 was revised in 1995 to harmonise its content with

¹²⁴ Ibid.

the UCP, it is somewhat surprising that the Official Comment seemed to take such a lukewarm attitude toward the desirability of applying Article 5 in letter of credit transactions. Hence the statement in the Official Comment that “except by choosing the law of a jurisdiction that has not adopted the UCC, it is not possible to escape the UCC entirely. Since incorporation of the UCP avoids only the ‘conflicting’ Article 5 rules, parties who do not wish to be governed by the non-conflicting provisions of Article 5 must normally either adopt the law of a jurisdiction other than a State of the United States or state explicitly the rule that is to govern.”¹²⁵ When rules of custom and practice are incorporated by reference, they are considered to be explicit terms of the agreement or undertaking.

Needless to say, banking interests prefer the application of the UCP over national laws, not least because of the UCP’s sympathetic treatment of banks in its provisions. In advocating measures to avoid the applicability of Article 5 of the UCC and by continually taking advantage of courts’ lack of interest in the real process by which choice of law was made in nearly all credits, the banking industry can continue to benefit from the legal lacuna which the UCP has created while minimising the “interference “ of common law.

2.5 UCP Exclusion of Bankers’ Risk

2.5.1 *Disclaimers*

In the early sixties, there were serious discussions over the validity of

¹²⁵ Official Comment on §5-101 (95’), op.cit., at Appendix A-20.

the exemptions that the banks enjoy under the UCP.¹²⁶ A typical example of such a provision is Article 15 and 18 (b) of the UCP 500 (formerly Article 12 (a) and (b) of UCP 400), which limits the liability of the banks by making the letter of credit (with the aggregate effect of other relevant clauses) almost into a non-risk transaction to the banks.¹²⁷

Article 15 stipulates:

“Banks assume no liability to or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s) or for the general and/or particular conditions stipulated in the document(s) or superimposed thereon, nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any document(s) or for the good-faith or acts and/or omissions, solvency, performance or standing of the consignors, the carriers, the forwarders, the consignee or the insurers of the goods or any other person whomsoever.”

Article 18(b) further states:

“Banks assume no liability or responsibility should the

¹²⁶ Kurkela, *The Liability of Banks Under Letters of Credit*, op. cit., at 18.

¹²⁷ *Ibid.*, 28.

instructions they submit not be carried out, even if they have themselves taken the initiative in the choice of such other bank(s).”

The UCP 500 places the applicant-buyer in an absurdly vulnerable position through its disclaimer clauses.¹²⁸ There is a serious absence of meaningful duties on the part of the bank to check the authenticity of the documents; it is only necessary to ascertain that such documents comply with the terms of the credit on their face. Taking this into account, false documents may be used with comparative ease by the unscrupulous, leaving the defrauded buyer with little option but to indemnify the bank for making the payment.¹²⁹ Therefore, worldwide and increasing use of letters of credit does not mean that the UCP is fairly drafted.

2.5.2 Awareness by letter of credit users?

It is questionable whether business people, especially applicant-buyers to whom the exemption clauses are mainly applied, are aware of the existence of such disclaimers through, for example, being provided with a copy of the text of the UCP or by being given notice of these exemption clauses. Field research interviews with bankers of Australian banks which deal with letters of credit on a day-to-day basis indicates that the applicant-buyers are assumed to have the knowledge of the UCP and they are familiar with the provisions of

¹²⁸ H. Harfield, “Identity Crises in Letter of Credit Law”, *Arizona Law Review*, v. 24, (1982), 239, at 245; also see Article 15 to Article 18 of the UCP.

¹²⁹ D.G. Powles & S. J. Hazelwood, “Maritime Fraud – 1”, 1984, *Journal of Business Law*, 31, at 37.

UCP.¹³⁰ If such is the case, it cannot be expected that the applicant-buyers would be given due notice of the exemption clauses. Furthermore, as mentioned above, both an application for the issuance of a letter of credit and the letter of credit document itself only contain a simple sentence: “Subject to UCP for Documentary Credits 1993 (ICC Publication 500)”. There is no attachment of the UCP to such documents or information highlighting the existence of disclaimers.

It has been long held that exemption clauses do not take effect if the party who relies on them does not give the other party reasonable notice that the clauses exist.¹³¹ However, in the context of letter of credit, it is questionable whether courts look to whether reasonable notice has been given when judging the legal effect of these exemption clauses, which leads to the question whether courts should step in to balance the interests of the parties or whether applicant’s interests should be left to the mercy of bankers.

2.5.3 *Unconscionability*

In an early edition of their work *Law of Bankers’ Commercial Credits*, Gutteridge and Megrah have commented that Article 18 of the UCP, in the United Kingdom, could have been regarded as contrary to the Unfair Contract Terms Act.¹³² The provisions of the UCP which

¹³⁰ Interview by author with staff of Letters of Credit Department of St. George Bank, Sydney, Australia, on January 7th, 1999.

¹³¹ Ellinger, op. cit., at 129. Some of the earlier case authorities are *Parker v. South Eastern Ry.* (1877) 2 C.O.D. 416; *Richardson, Spence & Co. v. Rowntree* (1894) A. C. 217.

¹³² H.C. Gutteridge & M. Megrah, *The Law of Bankers’ Commercial Credits*, 4th ed., Europa; London and New York: 1968, at 36.

purport to favour the banks might be seen as the result of the leverage of the dominant party which behaves in an openly collusive manner in the oligopolistic market.¹³³

Even more disturbing, the UCP's failure to adequately address the rights of applicants and the obligations of issuers could be said to have led to, or even tacitly endorsed, certain practices that could be described as unconscionable, at least according to the definition of 'substantive unconscionability' suggested in *Bank of Indiana, Nat Ass'n v Holyfield*:

“Substantive unconscionability is present when there is a one-sided agreement whereby one party is deprived of all the benefits of agreement or left without a remedy for another party's non-performance or breach.”¹³⁴

Certainly, the revelation of James Barnes and James Byrne mentioned in Chapter 1,¹³⁵ that issuers are able to typically require applicants to enter into reimbursement agreements under which they agree to waive their rights and remedies against issuers and to indemnify the issuer against substantially all risks including beneficiary fraud, certainly suggests the proliferation of unconscionable-like practices under documentary credit transactions. The question should therefore be posed whether the continuance of

¹³³ *Ibid.*, at 28.

¹³⁴ 476 F. Supp. 104.

¹³⁵ 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.

such a situation is really in the interests of international trade.

For example, should courts go so far as to declare some of the provisions of such reimbursement contracts, or even of the UCP itself, illegal or invalid and unenforceable? The inherent difficulty in justifying the inherent imbalance of bargaining power seems to suggest that they should be prepared to take such action. However, it is doubtful whether courts could be willing or even capable of making such a judgment while they arguably lack the necessary expertise and understanding in this particular industry to do so – at least one noted scholar suggests courts are not armed with the expertise to fully understand the banking industry.¹³⁶

It would be unfortunate if the applicant could not rely on the UCP for fair dealings — its recourse would be to either sue the seller, or to choose to deal only with business people with whom he has a relationship or are already of sound reputation for payment purposes. Such suggestions are not realistic given the diversity of world trade activities and the circumstances under which letters of credit device is normally selected over other payment devices.¹³⁷ Further, the standing of business partners may change between the conclusion of a contract of sale and its implementation.

A loss occasioned by forged or fraudulent documents is borne by the applicant-buyer, which is normally the victim of the documentary

¹³⁶ Kurkela, *op.cit.*, at 26.

¹³⁷ Research by Ronald Mann indicates that letters of credit are used as a verification institution for the buyer's ability to pay. R.J. Mann, "Symposium Empirical Research in Commercial

letter of credit, and not by the issuing bank. While suing the seller for breach of contract or fraud could be a course for remedy, this is not an attractive proposition at any time because of the cost and uncertainty which could be involved.

2.6 Conclusion

The letter of credit instrument, which originally was governed by the law merchant, from the mid-nineteenth century has been increasingly governed by the UCP, whose drafting and interpretation is dominated by banking interests, which in turn suggests that the ICC is acting as a private legislature. Not surprisingly, the UCP leaves little opportunity for judiciaries to “intrude” by crafting innovative solutions to compensate customers for overly formalistic or careless conduct by banks. By expanding the customary nature of the letter of credit payment mechanism to say that the UCP is the manifestation of the law merchant through codifying customs and practice and by being accepted universally, commentators have accorded the UCP an almost mythical status that has enabled it to become applicable to almost all documentary credits while excluding other possible sources of law. The choice of the UCP however does not represent an exercise by the applicant of its freedom of choice. Courts believe that the buyer chose the UCP under the principle of autonomy. Yet the process clearly shows that the buyer’s autonomy has been denied. All these factors suggest that the way the letter of credit system has been contrived requires it to operate in ways that require

Transactions: II. Transactional Design: The Role of Letters of Credit in Payment Transactions”, 2000, 98 *Mich. L. Rev.* 2494, from 2521.

the applicant to bear a disproportionate portion of the error and negligence risk of the bank and the risk of intentional wrongdoing in respect of the documents and the underlying transaction.