

## Chapter 3

### *Operation of the Independence Principle and the Doctrine of Documentary Compliance*

#### 3.1 Introduction

The basic rules by which the letters of credit transactions operate are widely recognised. Underlying these rules is the principle that letters of credit are transactions autonomous or independent of the underlying contracts on which they are based. Under this principle, the issuer is not concerned with or bound by underlying contracts. It deals exclusively in documents and not in goods or services to which the documents may relate.<sup>1</sup>

Arguably there are questions as to the extent to which this principle should be applied. Focus on this principle under certain circumstances may bring injustice to applicant-buyers, and as mentioned in Chapter 1, entail the assumption of collusion risk by banks despite the operative protections of the UCP. Against the background of the respective apportionment of risks discussed in Chapter 1, this chapter will assess the position of banks and applicant-buyers under the letter of credit under the independence principle and the compliance principle derived from the independence principle.

It will be demonstrated that the UCP does not incorporate

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<sup>1</sup> See UCP, Articles 3 and 4.

adequate or clear enough duties to be exercised on the part of issuers toward applicants, and severely restricts the applicant's right to sue if the issuer has wrongfully honoured. The treatment of buyers is underlined by the 1995 amendments to Article 5 of the UCC. The 1962 version which was superseded by these amendments set forth a relatively balanced set of rights and duties that were, in certain key areas, adjusted in the 1995 amendments in ways that were not favourable to applicants, for the sake of uniformity with the UCP. The 1962 version will therefore be referred to where it provides a useful illustration of provisions that are relatively balanced in their approach.

### 3.2 The Independence Principle

The general understanding of the law of letter of credit is that it is essentially a contract between the issuer and the beneficiary and it is independent of the underlying contract between the applicant and the beneficiary.

The rule in relation to the independence principle is embodied in Article 3 and Article 4 of the UCP. Article 3 stipulates:

“Credits, by their nature, are separated transactions from the sales or other contract(s), even if any reference whatsoever to such contract(s) is included in the Credit.”

Article 4 further stipulates:

“In credit operations all parties concerned deal with documents and not with goods, services and/or other performances to which the documents may relate.”

In the United States the independence principle is recognised in similar provisions within the UCC('95), particularly at §5-103(d), which states that:

“rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of a contract or arrangement out which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary”.

Since its inception, the independence principle has governed letter of credit transactions. It declares that credits are by their nature transactions separate from their underlying transactions and that payment by the issuer is to be based solely on a determination of the conformity of the documents presented with the terms and conditions of the credit without reference to the beneficiary's performance of the underlying contract. Under the independence principle, usually the bank is under a duty to accept the tender of conforming documents and should not get involved in controversy between the buyer and seller. The bank is moreover not concerned about any debts or claims between the seller and the buyer, so the bank's undertaking to the seller is separated from the

undertaking between the seller and the buyer.

This separation of documents and goods has been considered essential to the continued utility of the letter of credit and is the basis upon which the banks enter into these transactions.<sup>2</sup> Most banks and many commentators have accepted the view that the continued utility and even the viability of the letter of credit as a payment mechanism depends upon the strictest observance of this principle. Therefore, this chapter will focus on how banks deal with documents and their relationship with other parties in the document transaction.

As Lord Justice Jenkins stated in *Malas (Hamzeh) & Sons v British Imex Industries Ltd*:

“It seems to me plain 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, irrespective of any dispute there may be between the parties on the question whether the goods are up to contract or not....”<sup>3</sup>

As suggested by Lord Justice Jenkins’ comment, the

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<sup>2</sup> S. H. Van Houten, “Letters of Credit and Fraud: A Revisionist View”, (1984) *The Canadian Bar Review*, vol. 64: 371, at 376.

<sup>3</sup> *Malas (Hamzeh) & Sons v. British Imex Industries Ltd*. [1958] 2 QB 127, [1958] 1 All ER 262, [1958] 2 WLR 100, [1957] 2 Lloyd’s Rep 549, 7 *Decisions Affecting Bankers* 168 [1957] (C.A.).

abovementioned sections of the UCC and UCP in effect recognise a “cash principle”, that is, that the issue of a letter of credit is equivalent to the payment of cash to the beneficiary under such letter of credit. The issuing bank is not concerned whether such beneficiaries have actually performed their duties of shipping the goods and therefore whether the documents actually represent any goods at all. The reason why the issuer can comfortably make payment without any of the above concerns is because its obligation is limited to ensuring that only the documents are compliant.

Is it sufficient to say that the banks cannot look beyond the documents themselves when making examination and payment? The absolute nature of the independence principle as expressed in the UCP strongly suggests that the letter of credit system has been established for and around the interests of the banking industry. Chapter 2 demonstrated that there is reason to question the absence of any balance of bargaining power between the applicant and the issuer in the context of the discussion about choice of governing law in the letter of credit. The lack of such balance is exacerbated by the uncertainty, as pointed out below, over whether applicant-buyers are even a party to the letters of credit transaction. This has effectively limited consideration of the interests of such parties and denied any contractual relationship between the issuer and the applicant-buyer, which has further stunted the development of the concept of bankers’ duties toward applicants, thereby facilitating the apparent trend, as suggested most recently by Mann’s research, of banks accepting discrepant and even forged documents without taking any responsibility for

such acceptance.<sup>4</sup> Consequently, the applicant has little right to challenge a bank for breach of duty or even a bank's bad faith in accepting documents which are obviously discrepant or even forged.

### 3.3 Status of the Applicant under the Letter of Credit

Article 1 of the UCP states that the UCP binds all parties to the credit unless provided otherwise. It however does not state who such parties are. It is therefore left ambiguous as to whether or not the applicant is a party to the UCP, and this is underlined by the virtual absence of provisions in the UCP stipulating the duties that the issuing bank owes toward the applicant. An opportunity to delineate the parties to the credit once and for all was missed in the 1993 amendments.

Various theories have been espoused in an attempt to reconcile the binding nature of the credit with contract law principles. The courts have indicated on occasions that the contract between the bank and the applicant is similar to a contract of agency.<sup>5</sup> However, as Ellinger asserts, the bank in this relationship is not a mere agent. There is between the bank and the buyer a

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<sup>4</sup> R. Mann, "Symposium Empirical Research in Commercial Transactions: II. Transactional Design: The Role of Letters of Credit in Payment Transactions", 98 *Mich. L. Rev.* 2494, espec. at 2505, and 2525. Also note that in evidence presented before the court in *Standard Chartered Bank v Pakistan National Shipping Corporation* [2000] 1 *Lloyds Rep.* 218, the Standard Chartered Bank document checkers' motivation in accepting clearly discrepant documents (a clearly late presentation) was "to speed up trade flows" and that the general approach was "to be lenient if there is no overriding reason to reject the presentation".

<sup>5</sup> See for example Devlin J. in *Midland Bank v. Seymour* [1955] 2 *Lloyd's Rep.* 147, at 168.

relationship of creditor and debtor.<sup>6</sup> The bank also acts as principal on its own behalf, and “though it does so on a mandate from the buyer, the agency relationship between bank and buyer is purely internal.”<sup>7</sup> Similarly, attempts to identify the existence of consideration under the credit in the form of “the seller’s agreement to present the shipping documents” and that the credit becomes binding as a result of the “buyer’s reliance on it” appear less convincing than Goode’s analysis in which he asserts that presentation is merely a non-promissory condition of the seller’s right to be paid”.<sup>8</sup> It is now accepted that the credit constitutes *sui generis* non-contractual engagement — a specialised commercial contract, which, in most matters, has its own rules,<sup>9</sup> and which has as the basis of its binding force the fact that it is so recognised as binding under mercantile usage subject to being reasonable in the sense that it has a commercial purpose which is not objectionable in terms of legal policy.<sup>10</sup>

The applicant’s status under the letter of credit is therefore somewhat equivocal. On the one hand, the letter of credit, as an obligation of the issuing bank to pay the seller, is created by virtue of the applicant’s instruction to the bank and the bank acting on such instruction to notify the seller (with whom the bank may previously have had no contact) that a letter of credit has been duly opened. On the other hand, the credit does not govern the relationship between the issuer and the applicant, the commonly

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<sup>6</sup> E.P. Ellinger, *Documentary Letters of Credit - a Comparative Study*, University of Singapore Press; Singapore: 1970, at 151.

<sup>7</sup> R. Goode, “Abstract Payment Undertakings”, in P.Cane and J. Stapleton, *Essays for Patrick Atiyah*, 1991: 209-236, at 218.

<sup>8</sup> *Ibid.*

<sup>9</sup> Ellinger, *op.cit.*, 152; Goode, *op.cit.*, at 219.

<sup>10</sup> Goode, *op.cit.*, at 224-225.

articulated view being that the applicant is not a party to the letter of credit at all.<sup>11</sup> Rather, when the buyer, based on the contract of sale, has procured and completed an application form from a bank for a letter of credit, this application form becomes a contract between the bank and the buyer when the bank acts upon it.<sup>12</sup> This document, the credit application agreement, which usually contains explicit language requiring the issuer to honour conforming documents, exclusively governs the issuer-applicant relationship.<sup>13</sup>

As mentioned above, the bank's obligation to pay the seller under the credit, as well as being completely independent of the underlying sales contract, is independent of the mandate between the applicant and the issuing bank. Thus no right to enjoin payment by the applicant arises from any breach of the instructions by the bank set out in its mandate — only a right to claim for damages from the bank. Accordingly, Article 3(a) of the UCP 500 states:

“The undertaking of a bank to pay, accept and pay draft(s) or negotiate and/or to fulfil any other obligation under the credit, is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank....”

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<sup>11</sup> J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, A.S Pratt & Sons; Detroit: 2001 edition, at 7-1. See also *Ocean Bank v. La Esquina Presidencial, Inc.*, 623 So. 2d 520 (Fla. Dist. Ct. App. 1993 (Ferguson J. dissenting)).

<sup>12</sup> E.P. Ellinger, *Documentary Letters of Credit - a Comparative Study*, op.cit., at 149.

<sup>13</sup> Dolan, op.cit., at 7-4.

It is illogical that an applicant should be obliged to reimburse or indemnify a bank that has paid out over the credit if the bank has not strictly followed instructions set out in the mandate or has not taken reasonable care in carrying out its functions as the buyer's agent and has provided the buyer with misleading information as a result.<sup>14</sup> In a relatively early case, *Midland Bank, Ltd. v. Seymour*,<sup>15</sup> for example, it was held that the bank was authorised to pay only in Hong Kong and that if the bank does not pay in Hong Kong and pays somewhere else, it exceeded its mandate and could not recover from the applicant.<sup>16</sup> However, instances in which it would be possible for an applicant to prove that a bank has actually deviated from its mandate are limited. In the absence of a degree of specificity in the application contract — an initiative that most banks are unlikely to tolerate for most types of clause<sup>17</sup> — it would be difficult for an applicant to convince a court that it is entitled not to reimburse or indemnify the bank on this basis.

The only generally accepted exception to the restriction on the applicant from enjoining a bank from payment is where fraud in the documents is established. As set out in Chapter 4, it will be seen that even though the thresholds for the applicant to invoke this

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<sup>14</sup> R. King, *Gutteridge and Megrah's Law of Bankers' Commercial Credits*, Europa; London and New York: 2001: 4-07 and 4-12 at pages 56 and 59 respectively. In conducting its enquiries with reasonable care, the bank is not obliged to undertake its enquiries with due diligence even though this may render the result of its enquiries misleading. *Midland Bank v. Seymour* [1955] 2 Lloyd's Rep. 147, at 157-158.

<sup>15</sup> *Midland Bank v. Seymour* [1955] 2 Lloyd's Rep. 147.

<sup>16</sup> *Ibid.*, at 168.

<sup>17</sup> Article 5 of the UCP states that credits must be complete and precise, and that banks should discourage any attempt to include "excessive detail".

exception are high, the assertion that the applicant is not a party to the letter of credit seems to fly in the face of the logic of having such a fraud exception. It is submitted that the creation of a fraud exception, that is the right of the applicants' to injunct payment under the letter of credit payment on the basis of fraud, serves to confirm the status of the applicant as a party to the credit transaction. If the theory is correct that the letter of credit is an engagement between only the issuing bank and the beneficiary, the court should never have rendered injunctive relief to the applicant and left the applicant's fate to the resort of the underlying sales contract. Therefore, it is illogical to assert that the applicant is not a party to the letter of credit while having a system of law under the fraud exception which tacitly acknowledges the applicant's position as a party to the letter of credit transaction.

The ability of applicants to enjoin banks is extremely limited. As mentioned above, applicants are restricted from making detailed stipulations or enumerating any conditions that would be considered as non-documentary conditions. So the ability of buyers even to seek redress from banks in the form of damages is limited. The feeble position of applicants is exacerbated by the absence or vagueness of the duties of banks and sellers under the credit relationship to buyers. The bank's obligation to pay the seller (and hence the applicant's obligation to reimburse banks) is triggered by the seller's presentation of complying documents. Banks are merely under a duty to exercise reasonable care in checking the documents so presented for compliance, to act in

good faith, and to observe any other banking usage.<sup>18</sup> The UCP does not specify the precise content of such duty apart from the obligation to exercise reasonable care in accordance with international standard business practice as reflected in the UCP articles,<sup>19</sup> and to whom such duty is owed. Such matters are however crucial to applicants as the obligation of the applicant-buyer to reimburse or indemnify the issuing bank is triggered by the outcome of the checking process. It is also unclear whether the seller owes the bank a duty to furnish complying and genuine documents. As such duties are unclear, the rights of the parties to whom such duties should be owed are also unclear.

It is submitted that the contractual relationship between the applicant and the issuing bank has never been accorded enough attention by the UCP and the courts. The rights of the applicant-buyers, and duties of banks and sellers towards them, have not been an object of serious consideration in the law of letters of credit.

This fact has subjected applicants to an unacceptable level of exposure of risk. This chapter advocates the incorporation of safeguards into the system by the delineation of duties of issuing

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<sup>18</sup> M. Kurkela, *The Liability of Banks Under Letters of Credit*, The Union of Finnish Lawyers Publishing Company Ltd; Finland: 1982, at 34. Other duties are to pay, and to strictly adhere to the mandate – Ellinger, op.cit., at 160 and Dolan, at 7-01.

<sup>19</sup> Article 15, UCP 500. A bank is not obliged to conduct its duty to exercise reasonable care with due diligence even though this might result in providing the buyer with misleading information. Note however that duty exists in the bank to examine the documents with greater care if the documents contain any unusual features, which should serve as “red flags” directing the bank to scrutinize carefully all accompanying documents for clues that would aid the banks in determining whether the terms of the credit had been met, Ellinger, op.cit., 161-162, citing as authority *Liberty National Bank & Trust Co. of Oklahoma v. Bank of America National Trust and Savings Association* 116 F. Supp. 233 at 240 (1953), affirmed 218 F. 2d 831 (1955).

banks to the applicant to exercise their checking functions in a manner that better ensures that they do not provide the buyer with a false impression that the seller has provided compliant and genuine documents.

We will proceed to analyse the lack of balance in the rights and duties in transactions involving bank, seller-beneficiary and buyer-applicant, the damaging effect of not fully delineating the banks' duties to buyer-applicants, and the necessity of banks acting fully within the mandate imposed by the contract between banks and applicants. We will emphasise the need for courts to insist on banks fully implementing their duty of exercising "reasonable care" in guarding the interests of the buyers (and indeed themselves), and for the explicit incorporation of the concept of "good faith" into the documentary system, which will help to crystallize the seller's duty of providing conforming and genuine documents.

### 3.4 The Principle of Documentary Compliance

#### *3.4.1 Banks' duties*

##### *(a) Duty to pay only over compliant documents*

A letter of credit is a written undertaking by a bank to pay to the beneficiary when a beneficiary delivers the documents agreed upon. At the same time the buyer knows the letter of credit amount will be released only upon delivery of the conforming documents in accordance with the terms and conditions of the credit. The documents represent the key element in the

functioning of the letter of credit transaction. Their availability in conformity with the conditions agreed upon between the seller-beneficiary and the buyer-applicant determines the enactment of the letter of credit, i.e., the payment of the amount promised. Documents that comply with the credit conditions, in all respects, make it possible for the credit to function. Under the terms of the credit system, “the implicit obligation of the bank is to pay against ‘genuine’ conforming documents; otherwise credits would be a sham and open to all sorts of chicanery,”<sup>20</sup> and that “by necessity, the letter of credit transaction, along with most other documentary credits, depends heavily on documents being correct at face value”.<sup>21</sup>

Article 13(a) of the UCP however provides:

“Banks must examine all documents stipulated in the Credit with *reasonable care* to ascertain whether or not they appear, *on their face*, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by *international standard banking practice as reflected in these Articles*. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.” (emphasis in

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<sup>20</sup> M. Megrah, “Risk Aspects of the Irrevocable Documentary Credit”, *Arizona Law Review*, (1982), vol.24, 255, at 257.

<sup>21</sup> *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, A Special Report prepared by the ICC International Maritime Bureau, ICC Publication No. 643; Paris: 2002, at 16.

italics added)

This provision, as demonstrated later in this chapter, does not provide a clear standard of care exercisable by banks.

In §5-102(a)(7) of the UCC, the issuing bank's obligations towards the applicant have been defined as follows: "an issuer's obligation to his applicant includes good faith and observance of a general banking usage." It continues to use the subjective definition of good faith: "honesty in fact in the conduct of the transaction concerned." The drafting committee refused to apply the objective requirement of "observance of reasonable commercial standards of fair dealing"<sup>22</sup> to the definition that was present in Article 5 ('62).

*(b) The obligation to pay the seller - the cash principle and separation of the documents with the underlying contract*

If the beneficiary breaches the underlying transaction, the bank does not care or at least does not care very much. As stated by J. F. Dolan & P. van Huizen, "the letter of credit thrives on that dynamic, because it fosters payment; the hallmark of the letter of credit is that it will yield payment even when the parties are contesting rights and liabilities in the underlying transaction. Bank issuers, moreover, are unlikely to risk their reputation as credit issuers in order to protect their customers."<sup>23</sup>

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<sup>22</sup> K.A. Barski, "An Analysis of the Recent Revision to Article Five of the Uniform Commercial Code: Letters of Credit", 1996 (Summer), *Commercial Law Journal*, vol. 101: 177, at 180.

<sup>23</sup> 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 177.

Such cash principle has been expressed in various authorities. Lord Justice Jenkins stated in *Hamzeh Malas v British Imex* that:

“It seems plain enough that the opening of a confirmed letter of credit constitutes a bargain between the bank and the vendor of the goods, which imposes upon the bank an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not....”<sup>24</sup>

Goode also states that:

“So it is no answer to a claim under a credit that the seller has shipped goods which are unmerchantable, do not correspond with the contract description, are short in quantity or otherwise fail to conform with the sale contract, nor is the bank affected by, or entitled to invoke, any set-off available to the buyer against the seller or to the bank itself against the buyer. Even the illegality or nullity of the contract of sale does not affect the enforceability of the letter of credit.”<sup>25</sup>

Here, the bank’s payment duty is singled out without mentioning the precondition which triggers such duty. i.e., beneficiary’s honesty in fulfilling its obligation of shipping contracted goods for which the letter of credit has been opened. It might be asked whether the concept of the letter of credit as stated here has been confused with a bill of exchange. A bill of exchange is defined

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<sup>24</sup> [1957] 1 Lloyd’s Rep. 549.

<sup>25</sup> R.M. Goode, “Reflections on Letters of Credit- 1”, [1980] *Journal of Business Law* 291, at 291.

under the English Bills of Exchange Act of 1882 as “an unconditional order in writing...requiring...to pay on demand at a fixed future time...”<sup>26</sup> A beneficiary under a credit is not like a holder in due course of a bill of exchange. A beneficiary is only entitled to be paid if the documents are in order, i.e., the payment is conditional, not unconditional like a bill of exchange.

One commentator<sup>27</sup> has suggested that although the letter of credit is a payment method, it does not constitute the payment itself. The bank’s obligation to pay stems only from the beneficiary’s fulfilment of its obligation by providing conforming documents before the expiry of the credit.

If the opening of a letter of credit does constitute an absolute payment, it should follow that the seller should not have had a right of recourse against the buyer at all. §2-325 of UCC provides:

“The delivery to the seller of a proper letter of credit suspends the buyer’s obligation to pay. If the letter of credit is dishonoured, the seller may on reasonable notification to the buyer require payment directly from him.”

This proposition has also been indicated in case law. Seller J., in *Newman Industries Ltd. v. Indo-British Industries Ltd (Govingdram Bros Ltd., Third Parties)* ruled that:

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<sup>26</sup> Article 3

<sup>27</sup> Van Houten, *op.cit.*, at 371.

“I do not think there is any evidence to establish, or any inference to be drawn, that the draft under the letter of credit was to be taken in absolute payment. I see no reason why the plaintiffs ... should not look to the defendants, as buyers, for payment.”<sup>28</sup>

The Official Comment on §5-114 ('62) used an irrevocable credit to try to explain an issuer's duty as regards payment to the beneficiary.<sup>29</sup> The Comment stated that the requirement that all documents must be satisfactory to the issuing bank is repugnant to the nature of an irrevocable credit and that such requirement should only be associated with the issue of a revocable credit. This suggests that by issuing an irrevocable credit, an issuing bank has already committed to pay and an issuer must proceed to payment even though some documents may not be to its satisfaction. Such an explanation does not appear to be compatible with the theory of warranty — that a beneficiary warrants that it has presented documents which it believes to be in compliance with the terms of the credit — stipulated under §111 ('62), as well as denying the issuer's duties to the applicant as stated under §5-109 ('62).

The letter of credit should not be considered as constituting payment — it is only a means of obtaining payment. Efficacy is not an excuse for banks to proceed to payment irrespective of conformity of the documents and to do so does not respect the basic nature of the letter of credit as a payment mechanism. Such

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<sup>28</sup> [1956] 2 Lloyd's Rep. 219.

<sup>29</sup> See Official Comment ('62) in Dolan, *op. cit.*, Appendix B-20-21.

attitudes could be said to have contributed to the present chaotic situation as suggested by Professor Mann's research which indicated that most letters of credit are ultimately paid out to sellers despite the high rate of discrepancies.<sup>30</sup>

Focusing on the mandate deriving from the contractual relationship between banks and applicants is the best approach. The mandate should impose liability and clear assumption of risk in the event that banks do not discharge their duties. As Allen has stated, "it is the function of law to give effect to the expectation of the parties."<sup>31</sup> In this case, it cannot be said to be unreasonable for applicants to expect that banks will discharge their duties in a professional manner.

*(c) The duty to exercise "reasonable care" as the standard*

In the context of the UCP being generally treated by courts as akin to an applicable "law" in determining the bank's rights and duties, with the actual meaning of a compliance being "on its face", we will now proceed to examine how the concept of "compliance" is understood in practice, whether a clear standard of reasonable care under the UCP is established and toward whom such care should be exercised, as well as the consequence of failure to exercise such care.

As mentioned above, sub-Article 13(a) of the UCP, which is set out under the title "Standard for Examination of Documents", provides

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<sup>30</sup> Mann, loc. cit.

<sup>31</sup> D. Allen, *Law of Contract in Australia*, CCH Australia; Sydney and Melbourne: 1987, at 14.

that the banks' duty is to examine the documents required by the applicant with "reasonable care" to ensure that such documents are complying with the terms and conditions of the letter of credit "on their face". According to Gutteridge and Megrah, examining with reasonable care in this context refers to "the duty of the banker to scrutinise the documents tendered ... and to check them carefully ... Any default in this respect will debar him from claiming reimbursement by the applicant of any amount which may be paid against the documents and will also cause him to forfeit his right to remuneration."<sup>32</sup>

The wording of "international standard banking practice" in sub-Article 13(a), for the purpose of determining documentary compliance, has caused some confusion as to its meaning. Even though it is followed by the phrase of "as reflected in these Articles", as one eminent scholar has pointed out, it is difficult for it to be convincing when there are no other articles in the UCP dealing with the standard of document examination.<sup>33</sup>

This standard does not provide predictability to the parties of the letters of credit transaction. Furthermore, all bankers know that

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<sup>32</sup> See R. King, *Gutteridge and Megrah 's Law of Bankers' Commercial Credits*, 8<sup>th</sup> Edition, Europa Publications; London and New York: 2001, 7-08, at 184.

<sup>33</sup> Work began in 2000 on the formulation of standard international letter of credit practices referred to in UCP 500, Article 13. It is widely admitted that that banking practices vary greatly throughout the world and at present, there is no consensus as to what constitutes international standard banking practice as referred to in the UCP. See O. Malmqvist, "How ICC Is Approaching Standard Banking Practice", *Insight*, Vol. 7, No. 4, Oct-Dec. 2001, 10, and "The Insight Interview: Donald Smith Explains the ICC Project on International Standard Banking Practices", *Insight*, Vol. 6, No. 3, Summer 2000, 3. This work culminated in the acceptance of the International Standard Banking Practice for the Examination of Documents under Documentary Credits ("ISBP") at the ICC Rome meeting in October 2002. This is an encouraging development that hopefully will have the desired impact over time in providing meaning to the term "international standard banking practice" as expressed in Article 13(a) of the UCP.

actual international standard banking practice varies and in fact a collection of such standard banking practices, the ISBP, in an attempt to address the problem of lack of uniformity in this area, were accepted by the ICC at the end of 2002 and will be ready for distribution in March 2003.

It is submitted that this provision is at the present time merely hortatory in its effect. Except where jurisdiction to give definitive rulings is conferred on a supranational body, such as the European Court of Justice as regards the interpretation of the 1968 Brussels Convention on jurisdiction and enforcement of judgments and the 1980 Rome Convention on the law applicable to contractual obligations, the risk of divergence among nations is inevitable.<sup>34</sup> The ICC Banking Commission's interpretations are not binding on courts. It is suggested that the intention behind this article is to discourage courts from being too ritualistic in treating documents as non-conforming when the discrepancies are trivial, and too liberal by involving considerations of good faith or lack of commercial significance of the discrepancy.<sup>35</sup> Thus the section raises more questions than it answers: for example, will the relevant standard of banks in non-financial centres or those without a vibrant banking industry be the same as the standard practiced by banks in international banking standards? Will all banks around the world be held to the standards of the banks with most expertise? The section's effect is probably merely to reinforce the interpretation of local courts that the local standard is the correct one. Hence the initiative for a definitive guide to

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<sup>34</sup> Goode, *Brook. J. Int'l Law*, op.cit., 7-8.

<sup>35</sup> *Ibid.* 8-9.

international banking standards that culminated in the recent adoption of the ISBP.<sup>36</sup> Reflecting this ambiguity, the court as a result normally requires expert witnesses to identify what the international banking practice is.

Because of the fact that such terms do not have the transparency needed for the parties to predict the outcome, the reasonable expectations of such parties can be frustrated by not knowing what such practice actually contains. The UCP, as well as the entire letter of credit system, does not clarify why such duty of care is imposed on the banks, towards whom banks' duty of care should be exercised and what risk a bank bears when not exercising such duty of care. This question is not answerable owing to the fact the applicant's rights are not addressed in the UCP, and the mandate within which a bank exercises its duty is not discussed because the payment duty toward the beneficiary is considered separate from the agreement an issuer has with the applicant. Even if there is any clause which imposes any duty on the issuer in respect of the applicant in the applicant's agreement with the bank, such clause is, in effect, not applicable as far as payment is concerned. It has also been claimed that the intention behind such wording was for it to restrict the scope within which "reasonable care" is to be applied by the courts.<sup>37</sup>

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<sup>36</sup> See R. Langerich, "Should We Trust a Banker's Commitment Given Under a Documentary Credit?", Sept 2000, *DCW* 27:29 and D.R. Smith, "Standard Banking Practice Approved", Vol. 8, No.4, *Insight*, Oct-Dec 2002: 1.

<sup>37</sup> C. del Busto (ed.), *Documentary Credits, UCP 500 & 400 Compared*, ICC Publication, No. 511, International Chamber of Commerce; Paris:1993, at 39.

(d) *The standard of “reasonable care” under the UCC*

Some courts have held that the issuer owes the account party a duty of care not to pay out on a credit if it is clear on the evidence available to the issuer that the demand by the beneficiary is fraudulent.<sup>38</sup> Ackner L.J. expressed the same view in *the United City Merchants Case*, stating that the issuer owes the applicant a duty of care. However, as discussed earlier in this chapter, the letter of credit system generally refuses to admit that the applicant is a party to the credit. Therefore, there is little basis, apart from a limited fraud exception discussed in Chapter 4, for the applicant to restrain the issuer from knowingly making payment on alleged fraudulent documents.

§5-108(a) of the UCC states that whether an issuer should honour a presentation depends on whether the documents appear on their face to strictly comply with the terms and conditions of the letter of credit. The standard based on which the compliance is going to be determined is said to be, under §5-108 (e), the “standard practice of financial institutions”. Clearly such “standard practice” is referring to the UCP standard.<sup>39</sup> Here the law’s intention seems to be to draw the court’s attention to such practice so that it can determine whether the issuer has discharged its duties, and provides the issuer with a reasonable opportunity to present

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<sup>38</sup> *United Trading Corporation S.A. and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Rep.554, at 560; *Hortico (Australia) Pty Ltd. v Energy Equipment Co (Australia) Pty Ltd.* (1985) 1 NSWLR 545, at 551-554.

<sup>39</sup> The concept of the standard practice includes (1) international practice set forth in or referenced by the UCP, (2) other practice rules published by associations of financial institutions. and (3) local and regional practice under the para. 8 of the Official Comments of §5-108, in American Law Institute, Official Comment of Article 5 (1962 Version) Letters of Credit, 1995, in Dolan, op. cit., at Appendix B.

evidence of such standard practice.

The Official Comment of §5-108 calls for the court rather than “unschooled layman”, to decide the question of banks’ compliance with standard practice because of the need for speedier resolution of disputes. The Comment requests the court to use the UCP for guidance for the determination of the performance of the banks’ duties. Even though judges undoubtedly already have the ability to decide what law is applicable for the purpose of judging whether all parties have exercised their duties properly when such issue is in dispute, the Comment attempts to dictate to the court to only use the UCP — a law drafted essentially by bankers. Failure to apply the UCP in such circumstances thus leaves judges open to allegations of being accused of trying to “destroy” letter of credit law. The knowledge that judges require, as implied by the Comment, is limited to what is stated in the UCP and by expert banking witnesses called to testify at the court in respect of standard letter of credit practice.

§5-108 of the UCC ('95), according to the Official Comment, has gone even further. Even though as a general rule, the duty of exercising due care may not be altered, Article 5 of the UCC recognises that an issuer and an applicant may agree that banks have no duty whatsoever to examine documents in certain circumstances, giving rise to the scenario that they can be released by agreement from having to exercise due care in examining documents submitted by the beneficiary.

Under §5-109 ('62), the obligation of examining documents with

due care could not be disclaimed. However, the standard of performance could be determined by agreement if not manifestly unreasonable.<sup>40</sup> It seemed that when Article 5 was drafted there was an expectation that communication between the issuing bank and the applicant should establish a mutual understanding in respect of specific situations, with the standard of performance in respect of such duty of care established through an agreement between such two parties. In contrast, the current situation under the UCP seems to merely provide for application of international banking practice as the standard for bank's performance without giving an opportunity to the applicant to define this in any meaningful respect. This of itself precludes the possibility of any bargaining that could give rise to an agreement between the issuer and the applicant. Courts have done little to clarify the standards applicable to banks in this process. The uncertainty surrounding the nature of the duty and the contract between applicant and bank is one of the reasons for the absence of an effective and concrete duty of care that is capable of application in respect of banks, and for the total separation of documents from the underlying goods.

If the system worked perfectly well, documents should comply when the beneficiary had performed as agreed and the documents would not comply when the beneficiary had not performed as agreed.<sup>41</sup> The traditional understanding of the payment system was through the letter of credit-based obligation of the beneficiary

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<sup>40</sup> Official Comment on §5-109 ('62), in American Law Institute, Official Comment of Article 5 (1962 Version) Letters of Credit, 1995, in Dolan, *ibid*.

<sup>41</sup> R. J. Mann, "The Role of Letters of Credit in Payment Transactions", in *Annual Survey of Letter of Credit Law & Practice 2001*, Institute of International Banking Law & Practice, Inc; Montgomery Village, MD: 2001: 117, at 124.

to present documents that conform to the requirements of the letter of credit, and the beneficiary's right to payment if the conforming documents are in order. Actual responsibility to perform the sales contract should arise only if the required documents are obtained that truly reflect the reality of the goods. Although it is expressed in the UCP that banks have to exercise "reasonable care" in examining the documents, it is unclear for whose benefit banks actually exercise this obligation. If banks actually are not concerned whether the goods are of the quality and in the quantities required and are shipped on time (which are the central concerns of the buyers), it is unclear what criteria should be applied by courts to ascertain whether the banks have actually discharged their obligation of checking the documents properly in order to give the concept of reasonable care some substance in this context.

*(e) Duty of confirming bank to applicant?*

Article 5 of the UCC ('95) does not contain any warranty that the banks, such as confirming banks, presenting banks and negotiating banks, make to the issuer. This might suggest, as pointed by Dolan, that such banks neither make warranties to the issuer that there is no forgery or fraud, nor to the applicant that presentation does not violate the underlying agreement between the beneficiary and the applicant.

“Absent a direct agreement between the applicant and a confirmer, normally the obligations of a confirmer are to the issuer not the applicant, but the applicant might

have a right to injunction against a confirmer under §5-109 or warranty claim under §5-117.”<sup>42</sup>

The reason why a letter of credit is confirmed is because confirmation gives the beneficiary greater confidence in the bank’s financial strength in paying the draft if it has fulfilled its obligation to provide documents which comply strictly with the terms of the credit. A confirming bank can be either the issuing bank’s division in the beneficiary’s jurisdiction or a bank with which the issuing bank has conducted business transactions. §5-107 states that a confirmer has all rights and obligations under §5-108.

A confirmer that has paid in accordance with the terms and conditions of the letter of credit is entitled to reimbursement by the issuer even if the beneficiary committed fraud. With this immunity clause, a confirmer has greater rights than the beneficiary against the issuer. It is open to question whether giving a confirmer greater rights by law is a breach of the mandate imposed on the issuer by the agreement between the issuer and the applicants. If an exercise of a duty of care by the issuer is expected from the applicant, what rights does the applicant have against the confirmer? Under such a clause, a confirmer can also be said to have the freedom to engage in the activity of either discounting the documents and obtaining a discounting fee (although the court in *Santander* took a different view – see below), or sitting tight and obtaining a confirmation commission even with the knowledge of existence of fraud.

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<sup>42</sup> J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, op. cit., at 8 - 21

The neutrality of a confirming bank's relationship with the beneficiary is of concern here as well. Both are located in the same jurisdiction and making payment is in both their interests. There is a great possibility of the confirming bank ignoring the applicant's interest and accepting documents with no concern as to whether they are forged or false.<sup>43</sup> Accordingly, in *the Santander Case*, the court clearly ruled that the confirming bank had to bear the risk of fraud and it did not have a greater right to obtain reimbursement from the issuing bank than the beneficiary.<sup>44</sup>

### 3.4.2 *The issue of document authenticity and validity*

Article 15 of the UCP protects the banks from being liable for the genuineness of the documents by stating that "banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents...". Banks can make payment without any concern whether these documents actually represent any goods, or whether all facts are honestly stated in the documents. Banks are permitted to operate, in effect, in a vacuum under which no responsibilities are attached.

A commercial letter of credit is a written undertaking by a bank to pay to the beneficiary when a beneficiary delivers the documents

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<sup>43</sup> Various commentators have suggested that an applicant should be able to bring an action directly against the confirming bank for breach of the duty of good faith, a duty that should be construed to run to the applicant – D. F. Dann, "Note: Confirming Bank Liability in Letter of Credit Transactions: Whose Bank is it Anyway?", May 1983, 51 *Fordham Law Review* 1219, especially at 1240; A. D. Ronner, "Destructive Rules of Certainty and Efficiency: A Study in the Context of Summary Judgment Procedure and the Uniform Customs and Practice for Documentary Credits", Winter 1995, 28 *Loy. L.A. L. Rev.* 619.

<sup>44</sup> *Banco Santander SA v Bayfern Limited and others* (1999) 2 Lloyd's Rep. 239. (Queen's Bench); *Banco Santander SA v Banque Paribas*, [2000] 1 All ER (Comm) 776. (Court of Appeal).

agreed upon. At the same time the buyer knows the letter of credit amount will be released only upon delivery of the conforming documents in accordance with the terms and conditions of the credit. The documents are the key element in the functioning of the letter of credit transaction. Their conformity with the conditions agreed upon enables the payment of the amount promised. Documents that comply in all respects with the credit conditions are necessary for the letter of credit to function.

Usually, in practice, a bank takes security for the advances it makes under the letter of credit transaction. This security is provided by the documents of title, which the bank receives, from the seller. Possession of these documents, especially when the goods are carried by sea, gives the bank control over the goods. The essence of the letter of credit transaction is therefore its documentary character, i.e., where goods are represented by a bill of lading, this document of title is used as a means of financing the transaction. Ellinger has described the principle involving the letters of credit transaction as “that of treating the documents of title as representing and passing the property in the goods.”<sup>45</sup> Banks only promise to place the seller in funds against the tender of certain documents of title.<sup>46</sup> The issuing bank has no obligation to pay unless the beneficiary has fulfilled his obligation by presenting complete documents conforming to the terms and conditions of the credit.<sup>47</sup>

If the documents tendered by the seller are false or forged, the

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<sup>45</sup> Ellinger, *op. cit.*, at 3.

<sup>46</sup> *Ibid.*, 15.

<sup>47</sup> Van Houten, *op. cit.*, at 376.

basis of the credit is gone. Without the security provided by the bill of lading (a document of title and carriage which indicates the delivery of the goods), and other documents which are evidence that the goods sent by the seller are what the buyer has bargained for, there would not be a letter of credit payment mechanism. Therefore, the documents stipulated in the credit are of material importance – the security on which the issuing bank relied to issue credit by obtaining the documents vanishes if the goods turn out to be garbage. Because such fraud affects the very validity of the credit documents, a bank should not pay a credit where a lack of documentary authenticity has been discovered.

Accordingly it could be said that “the commercial credit grows out of a contract for the sale of goods between a buyer and a seller.”<sup>48</sup> Rhetorically speaking, if the letter of credit is only the tree trunk, the letter of credit system cannot grow healthily if the root of the tree is ignored. It is therefore submitted that a precondition for document dealings is the reliability of the validity and accuracy of documents. As held by the court in *Siderius Inc. v. Wallace Co.*:

“The issuer of a documentary letter of credit, dealing in documents and not merchandise, must be able to rely on the accuracy and integrity of the documents presented by the beneficiary.”<sup>49</sup>

Documents required by the letter of credit must comprise valid documents and in order to be valid, a document must be effective

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<sup>48</sup> Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, op. cit., 3-8, 1-2.

<sup>49</sup> *Siderius Inc. v. Wallace Co.*, 583 SW 2d 852 (Tex. Civ. App. 1979), at 862.

and legal. It is obvious that an invalid document cannot be a good tender.<sup>50</sup> As far as the regularity of the documents is concerned, Greer J. in *Skandinaviska in Kreditaktiebolaget v. Barclays Bank* stated:

“It seems to me that documents of this sort tendered to a bank under a credit ought to be documents on which questions cannot be raised so far as the documents are concerned.”<sup>51</sup>

In an English case, *Establishment Esefka International Anstalt v Central Bank of Nigeria*, Lord Denning M.R., discussing the question of fraud, observed that:

“Documents ought to be correct and valid in respect of each parcel. If that condition is broken by forged or fraudulent documents being presented – in respect of any one parcel – the banks have a defence in point of law against being liable in respect of that parcel.”<sup>52</sup>

In *Old Colony Trust v Lawyer’s Title and Trust Co.*, Justice Mayer held that:

“an issuer may refuse payment when the document of title presented by the seller is false in the sense that it does not represent any goods. Obviously,

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<sup>50</sup> See *Midland Bank, Ltd. v. Seymour*, [1995] 2 Lloyd’s Rep. 147, at 152.

<sup>51</sup> (1925) 22 Lloyd’s List L. R. 523, at 525.

<sup>52</sup> *Establishment Esefka International Anstalt v Central Bank of Nigeria*, [1979] 1 Lloyd’s Rep. 445, at 447.

when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognise such a document as complying with the terms of a letter of credit...<sup>53</sup>

In *Old Colony Trust*, an action by the seller for payment was dismissed on the grounds that an issuer cannot be forced to recognise a document as complying with the terms of a letter of credit when it knows that a document, although correct in form, is, in point of fact, false or illegal.

It is apparent that some courts therefore do look beyond the documents into the facts to see whether the information provided in the documents is accurate. Documents, which, on their face, are correct in form but false or illegal, cannot be called documents which comply with the terms and conditions of the credits because their accuracy and integrity cannot be relied upon.

### *3.4.3 Required standard of compliance*

#### *(a) Controversy over the standard of compliance*

Questions concerning documentary compliance remain a frequent subject for litigation over letters of credit because of insufficient standardisation in international banking practice.<sup>54</sup>

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<sup>53</sup> *Old Colony Trust v Lawyer's Title and Trust Co.*, 297 F. 152 (2d. Cir. 1924), at 159.

<sup>54</sup> Dolan, op. cit., at 6.01.

Courts have exhibited two ways of dealing with documentary compliance, namely (1) strict compliance with the letters of credit terms, and (2) substantial compliance which is determined based on (a) the intent of the parties as reflected in contracts other than the credit itself and (b) the fundamental fairness of the parties' conduct.<sup>55</sup>

*(b) Strict compliance rule*

\* *The common law position*

Strict compliance requires that, first of all, all documents required by the letter of credit have to be tendered. Secondly, the documents must be of the exact type required by the credit. Thirdly, the description of the goods in the documents must be sufficient.<sup>56</sup> The strict compliance rule requires that the documents and their wording, descriptions and so on must strictly comply with what is stipulated in the letter of credit. When a beneficiary presents documents to the issuer and demands a payment of the credit, the issuer must examine the documents to determine whether they comply on their face with the requirements of the credit. If they do not comply, the issuer may dishonour the beneficiary's draft, and the beneficiary cannot complain.<sup>57</sup> As one U.S. court has reportedly explained, "compliance with the terms of the credit is not like pitching horseshoes. No points are awarded for being close."<sup>58</sup>

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<sup>55</sup> Ibid., at 6.02.

<sup>56</sup> Ellinger, op. cit., at 280.

<sup>57</sup> Ibid., at 385.

<sup>58</sup> Ronner, op.cit., at 630-631.

The advantage of the strict compliance rule to the applicant is most obvious in letters of credit transactions because the primary concern of the applicant-buyer is that the seller has shipped what was bargained for before the buyer becomes obligated to pay.<sup>59</sup>

Rugg J. held in *Moss v. Old Colony Trust Co.* that:

“If he [the seller] accepts it [the letter of credit] and acts under it, he is bound to conform to its requirements in every particular....There is no promise to pay unless drafts are in strict conformity to the authority conferred.”<sup>60</sup>

American practice is also in line with the strict compliance rule. If the bank accepts faulty documents from the seller, it does so at its own risk.<sup>61</sup> In *Liberty National Bank & Trust Co. of Oklahoma v. Bank of America National Trust & Savings Association*, it was held that the bank must scrutinise the documents with great care, checking that the documents, although complying with the terms of the letter of credit, do not contain any unusual features. Such features in a document, even if not sufficient for rejecting a tender, should serve as “a red flag” directing the bank to scrutinise carefully all accompanying documents for all clues which would aid the banks to determine whether the terms of the letter of credit had

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<sup>59</sup> 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 247.

<sup>60</sup> (1923) 246 Mass. 139, 140 N.E. 803, at 808.

<sup>61</sup> Ellinger, *op. cit.*, at 61.

been met.<sup>62</sup>

The duty to examine all documents is important because any discrepancies in the documents should debar the bank from claiming reimbursement from the applicant of any amount which has been paid against the documents. This is known as checking for 'compliance'. It has thus become the general rule in the letter of credit transaction that the issuer or the confirming bank should not honour documents presented by a beneficiary unless the documents comply strictly with the terms and conditions of the letter of credit.

\* *The UCP position*

Article 37(e) of the UCP states:

“The description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit.”

This standard reflects the standard as expressed in English cases. In *Midland Bank Ltd. v Seymour*, Devlin J stated:

“... it is sufficient that the description should be contained in the set of documents as a whole and that the documents should each one be valid in itself and

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<sup>62</sup> 116 F. Supp. 233 (1953), at 240.

each be consistent with the other, and accordingly, it would not matter for this purpose whether the description in the bill of lading is or is not negated by the clause in the bill of lading, since the description is sufficiently contained in the invoice, which is one of the documents.”<sup>63</sup>

Devlin J further stated that if the terms of the letter of credit require that the bill of lading contain a certain description, then such bill must contain that description, and it is not for the bank to ask what legal value such a description might have.<sup>64</sup>

\* *The UCC position*

§5-108 of the UCC has placed on banks the duty to examine documents with care so as to ascertain that on their face they appear to be strictly in compliance with the terms of the credit. It further expressly provides that banks are presumed not to have assumed any liability with respect to knowledge or lack of knowledge of any usage of any particular trade. The banks are, however, supposed to observe general banking usage, performing a banking rather than a trade function.

(c) *Substantial compliance*

In some rare situations, however, a question has been raised whether beneficiaries should be denied payment when they have,

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<sup>63</sup> *Midland Bank Ltd. v Seymour*, op. cit., at 155.

<sup>64</sup> *Ibid.*

in good conscience, made substantial, although not literal performance, for instance, where the document contained a typing error.

There therefore exist two theories. One is that the strict rule can sometimes lead to harsh results because the seller is not the issuer of the documents and therefore it is difficult for it to comply with all the terms of the credit. On the other hand, it is believed that insistence by banks on “word for word” strict compliance finds its justification and necessity, and grants to the parties maximum security combined with maximum efficiency. It is further claimed that although the standard of strict compliance gives maximum protection to the bank and to the applicant, the latter needs to have all guarantees that the goods are acceptable because it pays before being able to see the goods.<sup>65</sup> “Word for word” strict compliance undoubtedly provides considerable protection to the banks because banks are recognized as service providers operational only in the financial sector, therefore neither familiar with commercial practices nor the language.<sup>66</sup>

Courts have also developed a “substantial compliance” rule under which a document should be accepted, despite discrepancies, when such discrepancies are not misleading and when the inherent compliance is apparent. The concept of “substantial compliance” was inspired by the desire to promote the equity principle under which a document is deemed to comply with the letter of credit requirements even if it does not conform in every

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<sup>65</sup> Dolan, *op. cit.*, at 6.03 [1].

<sup>66</sup> *Ibid.*, at 6.03 [3].

formal respect. In other words, the bank is allowed to look beyond mere technical discrepancies in order to ascertain if the documents delivered comply with the letter of credit in every material respect, thus not limiting its intervention to the mere formal inquiry.<sup>67</sup>

(d) *Application of the strict and substantial standards*

It is true that most banks do not consider certain discrepancies, such as a typing error, for instance, replacing “l” with “i”, etc, substantial because one would not be likely to be misled by such defects. Therefore, typographical errors, unless they constitute a material misdescription, or otherwise affect the validity of a document, will not invalidate the promise. Evidence tendered in *Standard Chartered Bank v Pakistan National Shipping Corporation* suggested that the practice of document checkers was far more liberal than this, to the extent of routinely ignoring late shipment dates on the basis of “speeding up trade flows”.<sup>68</sup>

Singular versus plural creates challenges for the courts. Under the strict compliance rule, if a buyer wants the opinion of two experts, it becomes a condition of the letter of credit contract. The assertion,<sup>69</sup> for example, that the difference between a certificate of origin (or a certificate of quarantine) as issued by a single expert instead of the required experts was not substantial is highly questionable. It contradicts the old common law rule established

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<sup>67</sup> See Dolan, at 6.05, for a critique of this approach.

<sup>68</sup> Evidence given by Vincent Holley, document checker with Standard Chartered Bank's export-import department, in *Standard Chartered Bank v Pakistan National Shipping Corporation and Others (No. 2)* [1998] 1 Lloyd's Rep. 684, at 699.

<sup>69</sup> H. Harfield, “Identity Crises in L/C Law”, *Arizona Law Review*, v. 24, (1982), 239, at 242.

in *Equitable Trust Company of New York v Dawson Partners Ltd.*, where the letter of credit required “a certificate of quality to be issued by experts who are sworn brokers.” In communicating this information, the message was altered by the bank’s agent to the effect that a certificate issued by a single expert would satisfy the requirement. The alteration was due to the agent’s telegraphic code which used the same symbol for singular and plural words. The House of Lords held that the applicant was not obliged to reimburse the bank because the terms of the credit had not been complied with.<sup>70</sup> In *Bankers Trust Co., v State Bank of India*,<sup>71</sup> Lloyd L.J. described as trivial that the “telex number of the buyer’s office was given as 931319 instead of 981310”. A further example of a trivial defect was given in *Kredietbank Antwerp v. Midland Bank plc*<sup>72</sup> where Evans L.J. gave as an example an obvious typographical error, such as the possible misspelling of Smith as Smithh”. A case which extended the exception further was *Glencore International AG v Bank of China*,<sup>73</sup> under which the commercial invoice and certificate of origin both differed from the credit requirements. The letter of credit stated: “Origin: Any Western Brand.” The invoices described the goods as “any Western Brand-Indonesia (Inalum Brand)” and the certificate of origin certified that the goods were of “Indonesian origins (Inalum Brand)”. The Court of Appeal held that had these been the only defects, that the tender would have been good.

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<sup>70</sup> (1927) 27 Ll. L. R. 49, at 49.

<sup>71</sup> [1991] 2 Lloyd’s Rep. 443.

<sup>72</sup> Court of Appeal, 28 April, 1999.

<sup>73</sup> [1996] 1 Lloyd’s Rep. 135.

In another case, however,<sup>74</sup> the court held that the examiners could have easily identified the discrepancies as typing errors because the discrepancy in one presented document had been remedied by the contents of other presented documents. The court held that the papers would not have confused anyone if considered *as a whole and in context*.<sup>75</sup>

There are, however, serious questions as to what extent the issuers are expected to make “inter-document” searches to decide whether a discrepancy is immaterial or not. Is the “inter-document” search job an expectation of the bankers? Is it too much to expect the bankers to check the documents not only against the terms of a letter of credit but also to “keep combing through the entire presentment to see if the discrepancies encountered in a given paper were truly remedied by the contents of one or more other papers?”<sup>76</sup> If so in an ordinary documentary examination, what about a situation where 967 pages of documents are presented?<sup>77</sup>

Do courts have to use the general reasonableness standard to examine whether the same discrepancy would have confused other document examiners? One commentator believes that:

“if the discrepancy could not possibly mislead a reasonable document examiner as he checks the discrepant paper on its own against what the letter requires for that paper, then the discrepancy should be

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<sup>74</sup> *Exotic Traders Far East Buying Office v. Exotic Trading U.S.A., Inc.*, 717 F. Supp. 14, 9 U.C.C. Rep. Serv. 2d (Callaghan) 698 (D. Mass. 1989).

<sup>75</sup> *Ibid.*, at 17, 9 U.C.C. Rep. Serv. 2d (Callaghan) 702.

<sup>76</sup> A.J. Givray, “Letters of Credit”, *The Business Lawyer*, August 1991, v.44, 2381, at 2390.

<sup>77</sup> (1991) 2 Lloyd’s Rep. 443 (Eng. C.A.).

disregarded. But if it takes the contents of another paper to remedy the discrepancy, then the discrepancy should not be excused as a harmless error.... Enlarging the 'could not possibly mislead' notion may give undue protection to the beneficiary at the issuer's expense."<sup>78</sup>

Significantly, under the UCP, banks are exempted from being liable for any transmission errors, which to an extent undermines the protection provided by the strict compliance rule. Article 16 of the UCP states that:

"Banks assume no liability or responsibility for the consequences arising out of delay and/or loss in transit of any messages(s), letter(s) or documents(s); or for delay, mutilation or other error(s) arising in the transmission of any telecommunication. Banks assume no liability or responsibility for errors in translation and/or interpretation of technical terms, and reserve the right to transmit credit terms without translating them."

To permit a bank to claim reimbursement when care and skill are lacking in transmission of information seriously undermines one of the main objects of the parties in using letters of credit.<sup>79</sup>

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<sup>78</sup> Givray, *op.cit.*, at 2390.

<sup>79</sup> K. S. T. Kim, 'Updating "Living Law": Some Reflections on the Forthcoming Revision of the Uniform Customs and Practice for Documentary Credits', in *Current Problems of International Trade Finance*, 1983, 60, at 64.

(e) *Discouraging detailed credits*

Article 5(a) of the UCP stipulates that instructions for the issuance or an amendment of a credit must be complete and precise. Article 5 also discourages the inclusion of any descriptive condition about the goods and services. That is, the applicants have to state the precise documents in the credit against which the payments have to be made, and any conditions without actual support of documents will be ignored by the banks.<sup>80</sup> Further, in order to guard against confusion and misunderstanding, banks discourage any attempt to include excessive detail in the credit or any amendment thereto.

When dealing with Article 5 of UCP 500, it seemed that the drafting group actually intended 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,<sup>81</sup> this article has adopted a wording that sounds mild but yet has basically the same effect. The literal interpretation of this sentence is that the bank will still have the final say as to whether they will reject the issuance of a detailed instruction, credit or amendment. The only difference here is that a bank might have been given the opportunity to accept an instruction if the fee from the issuance is high enough for the bank to consider taking the risk.

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<sup>80</sup> Article 5(b) of UCP 500.

<sup>81</sup> del Busto, *op. cit.*, at 11.

(f) *Bank obligations upon detecting a discrepancy*

Under §5-108(b)(3) of the UCC and Article 14(d) of the UCP, an issuer must give prompt notice to beneficiaries of defects in documents. Old common law principles regarding this rule were however much stricter in terms of the security a bill of lading can provide. In *International Banking Corporation v. Irving National Bank*, for example, the bank had accepted bills of lading for “general merchandise contents unknown” instead of a bill of lading for “Manila hemp” called for by the credit. Later on it was discovered that only part of the consignment consisted of “Manila hemp”, and the bank was entitled to indemnify against its applicant to the extent that there actually was Manila hemp in the consignment.<sup>82</sup> This case indicated that a bank had to follow the instruction of the applicant and accept the documents which strictly comply with the terms and conditions of the letter of credit issued by the bank.

As indicated in sub-Article 9(b) of the UCP, the confirming bank commits itself to honour the beneficiary's documents provided they comply with the terms and conditions of the letter of credit. In case discrepancies are found, the first responsibility of the confirming bank is to notify the beneficiary of discrepancies found, assuming the documents are presented directly by the beneficiary. If the discrepancies can be corrected, such as wrong description of goods on invoice, the beneficiary will correct those discrepancies

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<sup>82</sup> *International Banking Corporation v. Irving National Bank*, 283 F. 103; 1922 U.S. App., LEXIS 2249; 274 F. 122; 1921 U.S. Dist., LEXIS 1145.

and re-present them to the confirming bank. If the discrepancies cannot be corrected, such as late shipment and late presentation, the beneficiary must provide instruction to the confirming bank how he wishes the documents to be handled — to send them to the issuing bank for payment, or cable the issuing bank for authority to pay despite the discrepancies.

A confirming bank should not take it upon itself to accept discrepant documents. If it does, it will be taking a risk of the documents being rejected by the issuing bank. By the same token, an issuing bank should not take it upon itself to accept discrepant documents. If it does, it will be taking a risk of not being reimbursed by the applicant. The applicants agree to reimburse the issuing bank only if conforming documents are presented. The definite undertaking for the issuing bank and confirming bank to pay becomes null and void where the beneficiary does not comply with the terms and conditions of the letter of credit, by presenting discrepant documents.

*(g) Obligation for banks to exercise duties in good faith*

The concept of good faith has long been a tenet of Civil Law and is spreading rapidly to other legal families.<sup>83</sup> Meanwhile, under the *lex mercatoria*, good faith is considered a fundamental tenet of

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<sup>83</sup> R. Goode, "Abstract Payment Undertakings in International Transactions", (1996) 22 *Brook. Int'l Law J.*, No. 1: 1, at 9. See for example, under the Swiss Code and the German Code ("Das Buergerliche Gesetzbuch"), letters of credit are treated as subject to contract law and the efficiency requirement of letters of credit is not allowed to violate the fundamental principle of good faith. A. Grassi, "Letters of Credit Transactions: the Banks' Position in Determining Documentary Compliance. A Comparative Evaluation Under U.S., Swiss and German Law", (1995) 7 *Pace International Law Review* 81. Westlaw version, at 23.

international transactions.<sup>84</sup> It is featured in the UCC,<sup>85</sup> Vienna Sales Convention,<sup>86</sup> the EC Directive on Self-Employed Commercial Agents<sup>87</sup> and Unfair Terms in Consumer Contracts,<sup>88</sup> the UNCITRAL Convention,<sup>89</sup> and the UNIDROIT Conventions on International Factoring<sup>90</sup> and International Financial Leasing,<sup>91</sup> as well as in the UNIDROIT Principles for International Commercial Contracts<sup>92</sup> and the separate Principles of European Contract Law issued by the Commission on European Contract Law.<sup>93</sup>

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 §5-109.

In contrast to US law, English law does not yet possess any clear concept of good faith in contracts as traditionally courts have been wary of open-textured concepts and the degree of unpredictability that they represent. This was despite a bold attempt by Lord Mansfield to introduce the concept, which was subsequently limited to insurance contracts.<sup>94</sup> It is likely that this aversion will dissipate as the courts become accustomed to applying the EC

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<sup>84</sup> H. Veytia, "The Requirement of Justice and Equity in Contracts", April, 1995, 69 *Tul.L. Rev.* 1191, at 1199.

<sup>85</sup> Article 1-203, UCC.

<sup>86</sup> United Nations Convention on Contracts for the International Sale of Goods, Article 7(1).

<sup>87</sup> Council Directive 86/653, Art. 3(1), 4(1), 1986 O.J. (L 382) 17.

<sup>88</sup> Council Directive 93/13, Art. 3(1), 1993 O.J. (L 95) 29, at 31.

<sup>89</sup> Articles 5, 19.

<sup>90</sup> Article 4(1).

<sup>91</sup> Article 6(1).

<sup>92</sup> Article 1.7(1), 1994.

<sup>93</sup> Article 1.106(1).

<sup>94</sup> *Carter v Boehm*, 97 Eng. Rep. 1162, 1164 (K.B. 1766).

<sup>95</sup> Goode, (1996), *op. cit.* at 10.

Directive on Unfair Terms in Consumer Contracts.<sup>95</sup>

Certain cases in Australia have suggested the existence of good faith. In 1896, Griffith CJ in the Supreme Court of Queensland stated a principle — the duty to cooperate — that could approximate the principle of good faith.<sup>96</sup> Justice Finn in the Federal Court of Australia,<sup>97</sup> following the earlier decision of Justice Priestly in *Renard Constructions Ltd v. Minister for Public Works*,<sup>98</sup> also concluded that such a duty existed in Australia. Mugasha reports that the UCC has been a major source of inspiration for Australian courts, tribunals and academics in the trend toward implying the duty of good faith.<sup>99</sup> The content of the obligation, though vague, is practically, to “do the right thing”.<sup>100</sup>

The issue of the incorporation of the obligation to exercise obligations in good faith will be further discussed in Chapter 4.

### 3.4.4 Nature of the documents examined

#### (a) Documents subject to examination

The letter of credit has been described by Burton as follows:

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<sup>96</sup> *Butt v. McDonald* (1896) 7 Q.L.J. & R. 68, 70-71 as discussed in A. Mugasha, “Evolving Standards of Conduct (Fiduciary Duty, Good Faith and Reasonableness) and Commercial Certainty in Multi-Lender Contracts”, 2000, 45 *Wayne L. Rev.* 1789, at 1879-1800.

<sup>97</sup> *Ibid.*, citing *Hughs Aircraft Systems International v. Airservices Australia* (1997) 146 A.L.R. 1, at 37. However Justice Gummow in *Service Station Association v. Berg Bennett & Associates Ltd.*, (1993) 117 A.L.R. 393: 406 and Justice Ormiston in *News Limited v. Australian Rugby League Ltd.*, (1996) 139 A.L.R. 193, at 285 were not in favour of acknowledging a general duty of good faith.

<sup>98</sup> (1992) 26 N.S.W.L.R. 234.

<sup>99</sup> Mugasha, *op.cit.*, at 1800.

<sup>100</sup> *Ibid.*, at 1802, citing N. Se, “Contract Law: Maelstrom or Measured Mutation (1994) 7 J. Cont. L. 93, at 95.

“A letter of credit is a document containing a promise to pay ‘against’ specified documents. Those documents are the shipping documents in a cif or fob contract which evidence the consignment of the goods whose purchase price the letter of credit is issued to cover, such as the consignment note or invoice, bill of lading, marine insurance certificate, relevant export licences and inspection certificates, etc.”<sup>101</sup>

Each bank in the letter of credit transaction therefore has a duty to examine the documents as to their conformity with the conditions specified and to make payment against conforming documents. The main documents are the bill of lading, the invoice, which generally has to contain exactly the same description of the goods as contained in the letter of credit itself, the bill of exchange, the transport document, the certificate of origin, and the certificate of weight, etc, depending on the condition of the letter of credit.

*(b) The documents specified*

*(i) Bill of lading*

The bill of lading is one of the most important documents under the letter of credit. The bill represents the goods themselves and permits those to whom the bill is negotiated to treat it as the equivalent of the goods. The bill gives the issuer, in the event of its applicant’s insolvency or default, an interest in the goods.

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<sup>101</sup> G. Burton, *Australian Financial Transactions Law*, Butterworths; Sydney: 1991, at 275.

\* Absence of description and misdescription - deterioration in value of the bill of lading

The bill of lading is like a certificate of quality in that one of its functions is to evidence receipt by the carrier of goods of a certain description, in practice such evidence is hardly reliable since carriers are not qualified to check the goods received for shipment. The *Sztejn Case* is a typical example of a case which involves a false bill of lading in that the bill of lading and invoice described rubbish as bristles.<sup>102</sup>

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. However, as discussed in Chapter 1, the real value of this notion could have been changed by container shipping practice because carriers no longer have to inspect the goods shipped. In most cases, carriers use such language as “shipper’s load and count” to disclaim the warranty that the seller has shipped conforming goods. Such disclaimers, under the law of transport, are proper and do not render the bill of lading defective under the credit.<sup>103</sup> However, this disclaimer takes away the real value of this document as a title document because with such notion on the bill, it might no longer be considered as equivalent to the goods.

Even though modern transportation makes it impractical for the carriers to check the goods received for shipment, it does not

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<sup>102</sup> *Sztejn v. J Henry Schroeder Banking Corporation* 31 N.Y.S. 2d 631 (1941), at 632.

<sup>103</sup> UCP, Article 15.

disqualify a bill of lading as the title document under the law of carriage of goods and letters of credit. However, one has to admit that such method of transportation does provide ample opportunities for dishonest sellers to pack rubbish in the containers while being able to obtain bills of lading which described, e.g., rubbish as bristles as indicated in the *Sztejn Case*.<sup>104</sup> It is submitted therefore that such practice can be easily taken advantage of by a fraudster.

Maybe payment against the bill of lading should not be considered as payment against the goods, but rather as payment against the beneficiary's representation that it shipped the goods. This reasoning might well be considered as a realistic approach to the present theoretical problem. However, this theory is meaningless without the support of a legal system which recognises a bank's cause of action against a beneficiary for misrepresentation if the contracted goods are not shipped, while noting that the under UCC §5-111(1) at least, if the beneficiary presents a draft and documents and obtains payment from the issuer and if the documents are defective, the issuer can recover from the beneficiary.

According to Purvis and Darvas, the documents are false when there existed misdescription of the goods.<sup>105</sup> This provides a clear foundation for an understanding of the fundamental duty of the seller, that is, to provide genuine documents which contain an

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<sup>104</sup> *Sztejn*, op.cit., at 632.

<sup>105</sup> R.N. Purvis and R. Darvas, *The Law and Practice of Commercial Letters of Credit, Shipping Documents and Termination of Disputes in International Trade*, Butterworths; Sydney: 1975, at 37, at 38.

honest description of the underlying contract. By the same token, it undoubtedly sets the basis from which the bank's duty to pay derives. Unfortunately, under the independence principle, letter of credit practice creates a total separation between underlying performance and the documentary compliance, and the issue of the validity of the documents has been ignored.

Thus it is submitted that the law of letters of credit has to impose more stringent requirements for seller/beneficiary's honesty in its performance of the underlying sales of goods contract in order to compensate for the carrier's inability to check the goods actually shipped. As the title document, a bill of lading has to represent the goods shipped and evidence the actual shipment. If there are no goods or an inadequate amount of goods shipped, the quality of the title document will be undermined.

\* The nature of common bills of lading discrepancies

Bills of lading are a frequent source of error in the documents that a beneficiary presents under the credit.<sup>106</sup> "Under letter of credit law, issuers must give complete notice to beneficiaries of defects in documents. Unfortunately, many beneficiaries cannot correct a curable defect in bills of lading (such as a missing "on board" stamp or a missing date or signature) in time to resubmit the bill prior to the credit's expiry. Amended bills of lading are difficult to obtain when a container ship is in the Pacific."<sup>107</sup>

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<sup>106</sup> Dolan, *op.cit.*, at 3-26, 1-40.

<sup>107</sup> "An Introduction to Letters of Credit", *Letters of Credit Web Report*, at 17. Retrieved 19 June 2001 at [www.lettersofcreditonline.com/understanding.htm](http://www.lettersofcreditonline.com/understanding.htm).

The common problems in respect of bills of lading are:<sup>108</sup>

(i) The issuing bank, receiving a full set of bills of lading indicating the shipment from Port A to Port B, discovers that the shipment did not stop at Port B at all;

(ii) The issuing bank, after receiving a full set of seemingly faultless bills of lading, was told by the shipping company on “whose original stationery the bills of lading were issued” that this set of documents has not been issued by the company at all;

If a set of blank paper on the company’s letterhead can be issued in such a manner, if banks are really concerned about security, one is compelled to query why banks do not make an effort to check the truthfulness of the beneficiary’s claims, especially if there is an easy way to check, such as checking a transportation schedule.

(iii) A full set of bills of lading is submitted in which it is hard to make out whether the signature in black ink is original or a photocopy;

(iv) The beneficiary submits to the freight forwarder bills of lading instead of the real liner bills of lading in the hope that it could control the delivery of the goods until the buyer has paid;

(v) The “on board date” on the face of the original bills of lading has been altered “cleverly using chemicals it was impossible for

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<sup>108</sup> L. Sankaran, “Reliability of Bills of Lading”, *Documentary Credit World*, March 2001, at 9.

the naked eye to detect and beyond the scope of checking documents by a bank”; and

(vi) Shippers (beneficiaries) make unauthorised amendments to the ‘On board bills of lading dates’ in order to meet letter of credit expiry dates.<sup>109</sup>

\* Falsely dating the bill of lading

Correctly dating the bill of lading is a matter of great importance. Letters of credit will normally have a term stating that shipment must take place before a specified date. A bill of lading issued after this date will not be acceptable under the letter of credit. However, as described in a recent report by the International Maritime Bureau,

“if goods are loaded after the final date of shipment permitted under the letter of credit, and the bills of lading correctly reflect this date, the seller will have to request that this buyer extend the final date of shipment in the letter of credit. Such a request could result in the buyers renegotiating the price or other terms of the contract. An easier option for the unscrupulous seller is not to disturb the letter of credit,

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<sup>109</sup> The safest bill of lading is one which is issued by the shipowner as carrier. If the shipowner defaults under the bill of lading contract, the buyer has the right to take action against the shipowner and possibly arrest the vessel as security for his claim. However, if a bill of lading is issued by Non-Vessel Owning Common Carriers (“NVOCCs”) and if wrongful delivery or fraud did occur, “the buyer has no claim against the physical carrier of the vessel as he has no contract with them. Many NVOCCs are inadequately capitalized and do not have proper insurances in place to cover their liabilities” - *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op.cit., at 33.

but to exert pressure on the shipping agent to pre-date the bill of lading,<sup>110</sup> thus ensuring that his documents comply with the terms of the credit.”<sup>111</sup>

Indeed, “so concerned are sellers to ensure that bills of lading are issued with an acceptable shipment date that they sometimes make it a condition of the charter party that owners provide bill of lading with an on-board notation before a specified date. Such arrangements often go wrong and cannot be relied upon.”<sup>112</sup>

In *Merchants Corp. of America v Chase Manhattan Bank*,<sup>113</sup> a U.S. bank issued a letter of credit undertaking to pay against shipping documents showing that the goods were placed on board a ship in Korea no later than January 31, 1968. The applicants alleged that the documents were fraudulent since the ship had apparently docked for loading in the Korean port only on February 13, 1968. The court was satisfied that the dispute did not amount to a breach of contract between the buyer and the seller, but amounted to a dispute as to the terms of the letter of credit. The court regarded the case at hand to be similar to *Sztejn* and granted an injunction.<sup>114</sup> In another similar case, *Siderius Inc. v Wallace Co., Inc.*,<sup>115</sup> the jury found that the seller knowingly and intentionally

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<sup>110</sup> Goods that are insured under a marine policy usually cover the risk to a cargo from ship's rail to ship's rail, i.e. when the goods are at sea when a loss occurred. Pre-dating is done when the cargo was not at sea when the loss occurred, the underwriters are unlikely to pay out. Therefore, it raises question as to the prospect of the buyer bringing a lawsuit against the carrier for issuing a pre-dated bill of lading for recovering the purchase price from the sellers. If goods never existed in the first place, the insurance policy will not come into effect - *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op.cit., at 14.

<sup>111</sup> *Ibid.*, at 13.

<sup>112</sup> *Ibid.*

<sup>113</sup> *Merchants Corp. of America v Chase Manhattan Bank*, 5 UCC Rep. Serv. 196 (N.T. Supp. Ct. 1968).

<sup>114</sup> *Ibid.*

<sup>115</sup> 583 S.W. 2d Tax. Cir. App.1979.

represented a false date when a pipe was loaded on board the ship. The issuer refused the seller's payment demand under the credit.

It has been pointed out by at least one eminent scholar that an issuer of a bill of lading which deliberately backdates it in order to bring it within the shipping time in the credit acts fraudulently.<sup>116</sup> Consequently, as far as the issuer of the bill is concerned, there is no difference between a forged bill and a deliberately backdated bill.

Bills of lading presented often show alterations not correctly approved by the carrier or his agent, but simply made by the beneficiary or his bank or another unauthorised person. According to Kozolchyk, banks will not accept documents on which insertions and/or corrections appear to have been made unless such insertions and/or corrections are duly signed by a person who has introduced such an alteration.<sup>117</sup>

In *Merchants Corp. of America v. Chase Manhattan Bank, N. A.*,<sup>118</sup> the courts granted a temporary injunction on the claim of the applicant that the on-board bills of lading were falsely dated January 31, 1968, when the specified vessel was not in port until February 13, 1968. It was considered that in the United States, such a beneficiary would have breached the warranties of the UCC ('62).

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<sup>116</sup> L. D'Arcy, C. Murray, and B. Cleave, *Schmitthoff's Export Trade: The Law and Practice of International Trade*, 10th Ed., Sweet and Maxwell; London: 2000, at 206.

<sup>117</sup> Kozolchyk, *op. cit.*, at 228.

<sup>118</sup> *Merchants Corp. of America v. Chase Manhattan Bank, N. A.*, 5 UCC Rep. Serv.(Callaghan) 196 (NY Sup. Ct. 1968).

\* “Clean” bills of lading

In *Tiposan Hart v. Matbaa Gerecleri A.S. v. Masonite Corporation et al.*,<sup>119</sup> the Fourth Circuit US Court of Appeals declared that “according to industry practice”, a “clean” bill of lading indicates in this case that the goods to be shipped are below deck and not on deck. A clean bill of lading should not have been issued for the shipment which stored part of the goods on the deck and, as a result, this part of goods sustained water damage en route to Turkey. The buyer, Tiposan, sued Masonite alleging several claims including breach of the terms of the letter of credit by allowing a clean bill of lading to be issued. This court clearly stated that a clean bill of lading means that “the goods are to be safely and properly stowed under deck”.<sup>120</sup> Traditionally a bill of lading with no clauses or notations of damage is considered a clean bill of lading and is *prima facie* evidence of the good condition of the cargo at loading. This decision has added another meaning to this traditional concept. This is that a shipping company has no authority to issue a “clean” bill of lading for goods shipped on deck, and that therefore the issuing bank should not pay if proven that the goods are not shipped properly.

This decision in *Tiposan* has injected flesh and blood into the letters of credit system by requiring that documents must have particular functions to exist. As Justice Goh suggested in *Lambias*, documents should never be looked upon as meaningless

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<sup>119</sup> 1998 U.S. App. Lexis 18560 (4th Cir. 1998)

<sup>120</sup> *Ibid.*, at para. 3, citing *The Delaware* 81 U.S. (14 Wall) 579, 602, 20L. Ed. 779 (1871).

paper which exist merely for the purpose of being processed by a bank checking system that has no interest in the goods whatsoever. Each document must have its reason to exist. Their existence is reflected by the very goods they represent and without the actual goods, the documents are meaningless.<sup>121</sup>

*Tiposan Hart* will hopefully have the effect of deterring the negligent practice and indifferent attitude of certain shipping companies towards the quality of the goods when they arrive. In order for the realization of the effect of a letter of credit, the shipping company has to assist the beneficiary in a positive way in assuring the compliance of the documents with the conditions of the letter of credit. This decision therefore reinforces the responsibility of beneficiaries obtaining documents from the shipping companies which are truly complying, and further protects the interests of the buyer-applicants, implicitly giving the applicants the power to request in a letter of credit a clean bill of lading to be issued only based on the satisfaction of the requirement that the goods are stored properly according to the nature of the particular goods.

(ii) *Commercial invoice*

The commercial invoice is a document prepared by the seller that describes the goods, presents that the amount of the draft is justified, and that the amount of insurance coverage is adequate. It sets out the price of the goods and the insurance and shipping

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<sup>121</sup> *Lambias (Importers and Exporters) Co Pte Ltd v Hongkong & Shanghai Banking Corporation*, 1993-2 SLR 751; 1993 SLR LEXIS 554., at 787.

costs. Although not required by the UCP, the price also should be for the same amount and in the same currency as in the letter of credit. The description of the goods also serves as a benchmark for the more general descriptions of the goods in other documents. The purpose of the invoice which complies with the terms and conditions of the credit is to “give the bank an express warranty from the seller that it has complied with the credit....”<sup>122</sup>

If the seller falsifies the invoice, the bank and the applicant may sue the seller for a breach of warranty.<sup>123</sup> Under §5-110 ('95) of the UCC, the accurate description of the goods has been considered as an express warranty that the seller has complied with the credit, and that if the seller falsifies such description, the bank and the applicant may sue the seller.<sup>124</sup> This might entitle the issuing bank and the applicant to sue the beneficiary for fraud or misrepresentation because the seller was in complete control of the documents in question. It should be easy to detect deceit if such documents contain false information.

### *(iii) Certificate of inspection*

There are two types of certificate of inspection. When their issuance and content are under the control of an independent third party, the certificates provide documentary proof of the seller's compliance with the underlying contract. When the beneficiary controls their issuance or content, they serve to create warranties

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<sup>122</sup> “An Introduction to Letters of Credit”, *Letters of Credit Web Report*, op. cit., at 16.

<sup>123</sup> Ibid.

<sup>124</sup> See UCC § 5 -110 (a) (1995) which extends beneficiary warranty to applicant and UCC §5 - 111 (1962) which extends warranty to all interested parties.

from the beneficiary.<sup>125</sup> This position seems to be reflected in *Commercial Banking Company of Sydney Ltd. v. Jalsard Pty Ltd.*,<sup>126</sup> in which the Privy Council had to decide what particulars were required in a “Certificate of Inspection”.

In *Commercial Banking Company of Sydney Ltd. v. Jalsard Pty Ltd.*, the buyer’s letter of credit required a certificate of inspection to be tendered in relation to the goods, a quantity of battery-operated Christmas lights sold by a seller in Taiwan. Certificates were tendered stating that the surveyors had supervised the packing of the goods, implying that there were no apparent defects in the goods or in the manner of their packing. When the goods arrived in Sydney, they were found to be of defective quality and substantially unsaleable. The buyer claimed that the bank had wrongly accepted the documents. However, Lord Diplock stated<sup>127</sup> that the term “Certificate of Inspection” normally requires that the person issuing the certificate inspect the goods visually. The use of the term “Certificate of Inspection” did not implicitly require another particular method of inspection (such as electrical testing) or other particular information (for instance, as to the quality of the goods) to be recorded.

(iv) *The certificate of origin and phytosanitary certificate*

The certificate of origin, and phytosanitary certificate, in addition to bills of lading and commercial invoices, are other documents that have been traditionally relied upon by the applicant-buyers for as

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<sup>125</sup> Ibid.

<sup>126</sup> [1972] 3 W.L.R. 566.

<sup>127</sup> Ibid., at 570.

long as letters of credit has existed as essential for their protection before the issuer sends funds to the seller-beneficiary. Such certificate usually has no special features that prevent forgery. In fact, in many countries, one could get a genuinely issued certificate of origin for a non-existent cargo.<sup>128</sup>

(v) *The bill of exchange*

The bill of exchange must be compliance in accordance with the law of the country in which it is drawn. It must specify all clauses and notations specified in the letter of credit, and, if made out to the order of the beneficiary, carry all the necessary signatures and endorsements. Banks also tend to require it to be drawn up in the language of the credit.<sup>129</sup>

(vi) *The insurance documents*

Where required, the insurance documents must state that the goods are insured, usually for their CIF value plus 10% starting no later than the shipping date. They should be made out in the currency of the credit and state the risk covered. Where necessary, they must be endorsed.<sup>130</sup>

### *3.4.5 Sellers' duties to submit valid and compliant documents*

(a) *Seller's "empty" warranty of genuineness to the issuing bank*

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<sup>128</sup> *Trade Finance Fraud - Understanding the Threats and Reducing the Risk, A Special Report prepared by the ICC International Maritime Bureau*, op.cit., at 15.

<sup>129</sup> Grassi, op.cit., at 88

<sup>130</sup> *Ibid.*, at 89.

As already mentioned, in *Lambias (Import & Exporters) Co. Pty Ltd. v. HongKong & Shanghai Banking Corporation*, Goh Phai Cheng J pointed out that it is a surprise that a bank can be compelled to purchase worthless paper which passes down the credit chain to the buyer who is left to sue the seller on the contract of sale if it can.<sup>131</sup>

As suggested by Justice Goh, allowing a seller to enforce payment when it has tendered forged documents would be to allow it to escape the responsibilities placed on it in an international trade transaction.<sup>132</sup> Sellers are under a duty in the credit transaction, just as they are in the sales context, to tender documents which conform on their face to the credit requirements and which are genuine and valid. The fact that the UCP and UCC enumerate the bank's obligation to guarantee genuineness does not give the seller-beneficiary any excuse not to do so. It is submitted that the bank's obligation to pay should stem only from the seller-beneficiary's fulfilment of its obligation of submitting conforming documents which banks know contain *true information* about the shipment and that it is against the principle underlying letter of credit law that a court can require payment to be honoured when it is clear that the abovementioned documents, and especially the bills of lading, contain false information.

In the Prefatory Note of Article 5 of the UCC ('95), the purpose of the revision of Article 5 and the insertion of the warranty clause in

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<sup>131</sup> *Lambias*, loc. cit.  
<sup>132</sup> *Ibid.*

§5-110 was stated to be for the benefit of the applicant. This was explained as giving “the applicant on a letter of credit which has been honoured a direct cause of action if a drawing is fraudulent or forged or if a drawing violates any agreement augmented by a letter of credit (*italics added*)”. The Official Comment, commenting on the warranties in the relevant section in the UCC, §5-110(a) given by the beneficiary “if its presentation is honored”, stated that:

“Since the warranties in subsection (a) are not given *unless a letter of credit has been honored*, no breach of warranty under this subsection can be a defense to dishonor by the issuer....Also breach of the warranties by the beneficiary in subsection (a) cannot excuse the applicant’s duty to reimburse.”<sup>133</sup>

The motivation behind the inclusion of the offending phrase “unless a letter of credit has been honored” seems questionable when the effect of such words is properly understood.<sup>134</sup> While stating that the beneficiary warrants to the issuing bank and the applicant that there is no fraud or forgery of the kind described in §5-109(a), the Official Comment immediately denies such warranty by stating that “the payment under the letter of credit is final.”

The warranties provision under §5-110 appears to recognise that a letter of credit is not a two party engagement between a beneficiary and a bank. It could be said to recognise that an

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<sup>133</sup> Official Comment of §5-110 (1995 Version) of the UCC in Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, op. cit., at Appendix A, at App. A-37.

<sup>134</sup> See the Official Comment of §5-108 for the use of such wording, in American Law Institute, Official Comment of Article 5 (1962 Version) of the UCC, in Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, op. cit., at Appendix B.

applicant is a party to the letter of credit and therefore “gives the applicant on a letter of credit which has been honoured a direct cause of action if a drawing is fraudulent or forged or if a drawing violates any agreement augmented by a letter of credit.”<sup>135</sup> If it does give the applicant the right to a direct cause of action, does this mean that the applicant can sue the beneficiary on the letter of credit or it does have the effect of directing the applicant back to its right under the underlying contract?

This warranty is given only *after* the letter of credit has been honoured, which means there does not exist any possibility of the beneficiary breaching its warranty to the issuer. The Official Comment further states that the warranty does not run to the issuer, only to the applicant, and that no breach of warranty under this sub-section can be a defence to dishonour by the issuer. Therefore, the first part of the warranty, which is supposedly to the issuer, is denied. Secondly, the Comment further reveals that this warranty is not actually a warranty under the letter of credit. “It is not a warranty that the statements made on the presentation of the documents presented are truthful nor is it a warranty that the documents strictly comply under §5-108(a).”<sup>136</sup> If there is any warranty element, it is only a warranty that the beneficiaries have performed all the acts expressly and implicitly necessary under any underlying agreement to entitle the beneficiary to be honoured.

It is questionable, if the warranty is not given in respect of the

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<sup>135</sup> Prefatory Note of Article 5, in Dolan, *ibid.*, at Appendix A-4.

<sup>136</sup> Official Comment on §5-110('95), in App. A-38 in Dolan, *op. cit.*

truthfulness of the documents and only concerns the performance of the underlying contract, whether it should be stipulated here in Article 5, which supposedly, under the independence principle, should only be dealing with the documents and not the underlying contract. Secondly, if it is a warranty only to the applicant on the performance of its contract with the beneficiary, why does §5-110(a)(1) state a warranty “to the issuer”? The Official Comment of §5-110 explains that a breach of the warranties by the beneficiary in subsection (a) cannot excuse the applicant’s duty to reimburse. So the issuer has to honour and the applicant has to reimburse and the letter of credit business is finished. The drafting committee has in effect condemned the applicant to its usual fate of resort to the seller under the underlying transaction, thereby upholding the payment mechanism without regard to actual breach of the warranties by the beneficiary.

If, as stipulated in §5-110(b) of the UCC, this warranty is in addition to warranties arising under Articles 3, 4, 7, and 8, one is obliged to question whether the warranty actually adds value to the warranties specified in the above-mentioned articles or only has some cosmetic value which is designed to give Article 5 greater legitimacy within the entire scheme of the UCC.

It is therefore submitted that a real warranty has to be established for the letter of credit system to be justifiable. That is, the very action of the beneficiary’s presentation of the documents should constitute a warranty to the issuer and the applicant that the statements made on the presented documents are truthful, and that the documents are complete, i.e., all documents which

represent the shipped goods have been submitted. In such circumstances, only where the seller has performed its underlying contract will it be entitled to be the presenter of the relevant documents. Recognising otherwise is to permit the beneficiary or shipping companies as well as freight forwarders to forge documents or to allow the beneficiary to present documents which contain false information about the goods. Without a system to safeguard the reliability of the documents, which are too easily forged or subject to insertion of false information, the letter of credit system is legitimising deception.

Recognising such a warranty system would mean the issuer would have a right of dishonour arising out of breach of warranty. This is consistent with the theory where the bank should have no greater right than the beneficiary to be paid by the applicant. That is, if the issuer has made payment to the beneficiary and after the payment a fraud is discovered, this should give immediate rise to a right of recourse against the confirming bank, which should have a right of recourse against the beneficiary. This could be effectively and efficiently done as demonstrated in *Santander*. The confirming bank in this case had a recourse agreement with the beneficiary and it also had a credit check done on the credibility of the beneficiary. Upon being informed of fraud by the beneficiary, the confirming bank took immediate action and successfully froze the beneficiary's account. Such a system could conceivably curtail fraudulent activities.

In circumstances where the issuer has already made payment to a confirming bank or other bank and the fraud is discovered, the

applicant should not be forced to reimburse the issuer. The system should recognise the applicant's right under the letter of credit and the issuer's subrogation of the applicant's right to sue the beneficiary for recovery. Naturally, issuers may take time to warm to such an idea because it may be perceived to affect business efficiency. Therefore the only way to achieve this is for courts or legislatures or even the ICC to step in to impose necessary rules in order for the letter of credit system to grow in a healthy direction.

*(b) Actual high level of non-compliance by sellers*

The problem of documentary discrepancy in the context of the letter of credit is not new. The Preface to UCP 500 identified reducing such problem as one of the reasons for the revision. It has been recorded that the percentage of documents that are discrepant is 50%-60% and according to some estimates, even as high as 70%.<sup>137</sup>

The letter of credit regime, however, has been successful in persuading courts to look only at the face of the documents, without exercising any concern over the actual performance of the contract, or to distinguish those discrepancies that are significant from those which are not. Yet, according to a survey undertaken recently by Ronald J. Mann, sellers do not normally present documents that conform to the requirements of the letter of credit.<sup>138</sup> In practice, the indications are that the system is

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<sup>137</sup> *Insight*, Vol. 5, No 2, Spring 1999, at 11.

<sup>138</sup> Mann, "The Role of Letters of Credit in Payment Transactions", *loc. cit.*

operating without satisfaction of the precondition that sellers provide the required conforming documents.

There are several reasons why a high percentage of documents presented are discrepant. One cause of the problem is the fact that the documents are prepared by the freight forwarder. Freight forwarders are not familiar with the letter of credit process and therefore very often prepare documents that are not in conformity with the letter of credit terms. A further cause is that, very often, the different people from different departments within the beneficiary's organization who are responsible for producing certain documents required under the letter of credit are not fully aware of the letter of credit terms, thereby causing the documents being produced to not be in compliance with the letter of credit terms. Another is when the shipping department is not aware that the goods must be shipped at the latest by the date specified in the letter of credit, thus, creating late shipment discrepancy.

Entities which are responsible for issuing shipping documents are not as reliable as they once were. Shipping companies are backdating bills of lading; issuers of certificates of origin issue the certificates depending on the shipper's assertions without conducting any independent verification; and sometimes they conceal the truth in order to get business.<sup>139</sup>

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<sup>139</sup> "How Reliable Are Certificates of Compliance?", July 2000., *Letters of Credit Web Report*. Retrieved 24 June 2001, from [www.lettersofcreditonline.com/reports/archive/200007\\_casesinbrief.htm](http://www.lettersofcreditonline.com/reports/archive/200007_casesinbrief.htm).

(c) *Extending the duty of the seller to provide genuine rather than merely “complying” documents.*

Whether a document is regular or not is always a question of fact. As a general rule it can only be stated that a document is irregular either if it does not include that which is regularly included in it or includes something which is not regularly found in that type of document.<sup>140</sup>

Irregularities can be of different types. First, any document, which is not valid or legal on its face, is irregular. Secondly, the irregularity can be a matter of form or appearance. An acknowledgement of dispatch or a parcel receipt, written by hand, without being properly stamped and headed, was irregular. A document might further be considered to be irregular if the circumstances of its presentation gives rise to suspicions.<sup>141</sup>

The question that should be raised here is, is it right, when the question of genuineness is raised, that courts and banks should take an attitude towards that fact that completely neglects the applicant's interest? After all, it is not just the buyer-applicant that expects a presentation of genuine and valid documents by the beneficiary in accordance with the terms and conditions of the credit, but the whole letter of credit system operates on the assumption that this is what will happen. It would be a pity if the function of courts is reduced to only facilitating banking practice by

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<sup>140</sup> Ellinger, op. cit., at 297.

<sup>141</sup> Ibid., at 299.

following the UCP,<sup>142</sup> when following the UCP involves turning a blind eye to concepts of equity and justice and overlooking the applicant's rights in general. Courts should generally take a view without being heavily affected by so-called "banking practice".

As Ellinger has stated, any error is incompatible with the main object of the contract.<sup>143</sup> Further, Ellinger also wisely points out "a tender including non-conforming documents is a different commodity from the one bargained for and its tender is, therefore, contrary to the main object of the transaction or contract."<sup>144</sup> Accordingly, the cardinal feature of a letter of credit transaction is the performance by the tender of the documents specified by the buyer in the application form and by the bank in the letter of credit.<sup>145</sup> The object of the bank's letter of credit is to ensure that the seller-beneficiary of the credit gets paid for the goods he sells and the buyer receives, in the shape of the relative documents of title and other required documents, the goods that the seller has contracted to deliver to it.

The system requires the beneficiary to provide true documents. This is the beneficiary's sole responsibility and the basis for the whole transaction of the letter of credit. Illustrating this, §5-114(2) of the UCC carefully delineates the issuer's obligations upon the presentation of documents, which appeared on their face to

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<sup>142</sup> See, for example, *Standard Chartered Bank v Pakistan National Shipping Corporation*, op.cit., and discussion by R. Sayers, "Banks are Not Always Shining Innocents", *DCW*, June 2001, 28, at 34, in which he poses the question after reviewing the case: "Can it realistically be supposed that courts should readily give effect to practice at the expense of distorting the law, particularly that governing fraud or falsity?"

<sup>143</sup> Ellinger, op.cit., at 169.

<sup>144</sup> Ibid.

<sup>145</sup> Ibid., at 189.

conform to the terms of the credit. But where a required document does not in fact conform to the warranties made on negotiation or transfer (if a document of title were forged or fraudulent, or if there was fraud in the transaction), the issuer is not obliged to honour but could still honour the credit if acting in good faith, despite notification from the applicant of fraud, forgery or other defect not apparent on the face of the documents. Under this section, if a document does not conform to the warranties that the law infers from its presentation, the issuer may dishonour. These warranties are derived from §7-507 of the UCC, which “includes a warranty to the issuer that the document is genuine, that the presenting party has no knowledge of any fact that would impair its validity or worth, and that negotiation or transfer is rightful and fully effective.”<sup>146</sup>

The beneficiary should have the burden to prove the genuineness of the documents under the UCP; it would be much easier for the beneficiary to discharge such a burden than for the applicant-buyer. The seller could either provide evidence to demonstrate his innocence or, in the absence of such evidence, resort to the underlying contract for recovery. This is in conformity with the letter of credit system and is fair and will not assist fraud.

*Rayner v. Hambros Bank*<sup>147</sup> provides some support for this approach by advocating that the provision of documents precisely in accordance with the terms and conditions of the letter of credit and the sale contract will enhance the speed of credit transaction

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<sup>146</sup> Dolan, *op.cit.*, at 7-60.

<sup>147</sup> *Rayner (JH) & Co. Ltd v. Hambros Bank Ltd* [1943] 1 K.B. 37.

as well as protecting the interest of the buyers.

### *3.4.6 Investigating “red flags”*

This section examines the obligation of banks to ensure that letter of credit documents are strictly compliant with the letter of credit. The matters discussed below suggest that, at least in the context of actual implementation, the doctrine of documentary compliance under the independence principle is an artificial concept with little actual substance. The system imposes on the banks the duty to check documents by looking at their facial compliance without any requirements in respect of the validity of such documents. As a result, the system gives rise to a total separation of documents from goods and denies the importance of the genuineness of the information included in the documents. Because banks bear no risk in respect of the non-performance of the underlying contract, the system demonstrates a total lack of interest in the validity of the documents. Meanwhile, fraudulent activities have been booming.<sup>148</sup>

Despite the fact that a bank’s liability is limited to dealing with documents on the basis of their facial appearance, and even though a bank can turn a blind eye to the genuineness of the documents under Article 15 of the UCP, in this section it is submitted that a bank should not ignore a ‘red flag’, e.g., obliterations in a bill of lading or any unusual signs of abnormalities. If bankers are aware of the fraud of the seller, they

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<sup>148</sup> See references to the IMB reports mentioned in Chapter 1 at note 17 et al.

should not be obliged to take up the documents.<sup>149</sup>

In the process of examining the documents required by the applicants, under Article 13 of the UCP, banks can determine the standard of compliance by adopting “international standard banking practice” as the standard. It does not seem logical for the banks to set up such a standard to judge their own duty of care. This gives rise to a problem of neutrality, and suggests that a more objective standard applicable for such assessment should be applied in circumstances where the issuer and the applicant have a genuine disagreement on the relevant standard. It is questionable that saying that a bank’s action is judged by a special banking practice standard is fair to all parties, as the role assumed by banks could easily give rise to an impression of possible partiality. Naturally, as a result, questions should be asked whether one or other parties’ interests suffer.

The drafting committee has commented upon the meaning of “on their face” under Article 13 of the UCP. Their comment was that the decision as to whether the documents comply with the terms and conditions of the credit and are consistent with one another is based exclusively upon the banker’s examination of the document, and not upon someone else’s understanding.<sup>150</sup> In other words, there is a method for examination of documents under the letter of credit which is peculiar to bankers. This notion also does not help with the problem of transparency of the UCP because it is hard for other parties of the documentary transaction to predict what the outcome of such examination would be.

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<sup>149</sup> Ellinger, *op.cit.*, at 166.

<sup>150</sup> 116 F. Supp. 233 (1953), at 240.

The general principle of good faith has been difficult to realise under general banking practice because of a lack of a substantial requirement of reasonable care and clear standard concerning the performance of such duty of care. For instance, both the UCC and the UCP do not impose on banks a duty to look into obvious “red flags” and to raise any suspicion of fraud. Naturally banks have the excuse of not “noticing” any obvious forgery or raising any suspicion because, after all, the risk of fraud has been habitually shifted to applicants with no need for banks to be concerned with the genuineness of the documents. This also could be one of the reasons explaining why the practice of multi-tender by beneficiaries of “badly altered” documents has been continuing without any apparent restriction. It has furthermore been admitted by banks that “banks,... are not concerned with the *bona fides* of the beneficiary”.<sup>151</sup> In other words, banks can afford to be indifferent to whether or not there is fraud penetrating into either the underlying contract or into the documentary transaction.

As early as 1923, however, in an American case, *Brown v. C. Rosenstein Co*,<sup>152</sup> it was established that while the plaintiff banks should not be responsible for the correctness or genuineness of the documents, a bank should, at the same time, not ignore a ‘red flag’. Moreover, if the bank was aware of the fraud of the seller, it was not obliged to take up the documents. This standard has been upheld in a recent case, *Standard Bank v. Bank of Tokyo*, where the court used an objective test to define clear notice. It

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<sup>151</sup> *Banco Santander SA v. Banque Paribas*, [1999] 2 Lloyd’s Rep. 239, at 14 of the LEXIS version. Retrieved 22 October 2001.

<sup>152</sup> 120 Misc. 787, 200 N. Y.S. 491 (1923), affirmed (no Opinion) 202 N.Y.S. 922 (1924).

held that a person would be deemed to have had notice of any fact to which it can be shown that the person deliberately turned "a blind eye". The court held that when facing the question of knowledge, the party has to establish (a) actual knowledge of the fraud, (b) turning a blind eye to the obvious or (c) wilfully and recklessly failing to make such inquiry as an honest and reasonable man would make.<sup>153</sup>

This case instilled some substance into the concept of the duty of care banks have to exercise. A bank has to exercise reasonable care in examining all documents, which includes paying attention to any 'red flag' or in other words, any suspicion of fraud by the seller. It is a basic duty for a bank to refuse payment under such circumstances because it owes a duty to accept only those documents which are genuine.

Banks should not ignore any suspicious alterations or obliterations in a bill of lading. According to the American case of *Liberty National Bank & Trust Co. of Oklahoma v. Bank of America National Trust and Saving Association*, banks should, in such a case, treat such anomalies as a "red flag" and then scrutinise carefully all accompanying documents for clues which will aid the bank in determining whether the terms of the credit have been met.<sup>154</sup> The case of *Liberty National Bank* sets a different standard of reasonable care from that espoused by the House of Lords in *United City Merchants* which decided that banks should not be allowed to look into anything more than the presented documents

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<sup>153</sup> [1995] 2 Lloyd's L. Rep. 169, at 8-10 of the LEXIS version. Retrieved 24 June 2001.

<sup>154</sup> *Liberty National Bank & Trust Co of Oklahoma v Bank of America National Trust and Savings Association*, 116 F. Supp. 233, at 240 (1953).

on their face even though the date of shipment on the bill of lading was clearly altered awkwardly at least twice.

The traditional way of looking at the banks' right to pay over an allegation of fraud deserves reconsideration judging from recently established law. Whether a bank is willing to accept the consequences of paying over possibly false documents and not getting paid by the applicant is open to question. Courts, at least in England, are now less willing to uphold banks' payment purely based on facial compliance. Therefore, banks should now consider what the result would be if an applicant subsequently proves actual fraud. When the court applies the rule of "fraud unravels all", banks are not necessarily protected from fraud, and the only way that a bank that has already paid out on the credit can recover is to sue the beneficiary which has acted in bad faith for misrepresentation or deceit. As a result of such reasoning, the courts in England now on occasion support suspension of payment pending the result of the applicant's application for injunction.

Even though §5-109 of the UCC requires banks to act in good faith, this duty has been used by banks as a defence for the payment over false documents. Under the UCP, there is no express requirement for the banks to act in good faith. It is hoped that the impact of the recent cases extends far enough so that that good faith becomes the test against which dealings of all parties will be measured, and that the independence principle will not assist when doubts in respect of good faith are raised in respect of one of the letter of credit parties, so that those acting in bad faith will be restrained from benefiting from the letter of credit system.

In respect of the exercise of good faith, it should be noted that in *Commonwealth Bank v. White (No. 2)*,<sup>155</sup> the court has recognised that the information the bank acquires from other sources, which might prove bank's knowledge of the fraud, can be introduced into the court in dealing with the bank's duty under the letter of credit.

§5-108 of the UCC states that the standard of strict compliance applies not only to the issuer's obligation to the beneficiary but also the issuer's obligation to the applicant:

“Except as otherwise provided in Section 5-113 and unless otherwise agreed with the applicant, an issuer shall dishonour a presentation that does not appear to comply.”

The real effect of this section, which is not apparent on its face, as the Official Comment reveals, is that the issuer enjoys a broader right of reimbursement than a beneficiary's right to honour. Although not obvious from the reading of §5-108 (a) and (e), the word “elsewhere “ appears to be the basis from which such right of the issuer is actually derived. As mentioned in the Official Comment, “issuers can and often do contract with their applicants for expanded rights of reimbursement.” This may not be an isolated occurrence. It indicates actual banking practice, as demonstrated by Mann, in which it appears the applicants often accept documents with serious discrepancies even though such discrepancies show clear and sometimes severe breaches of the

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<sup>155</sup> [1999] VSC 400 (22 October 1999).

underlying contract by beneficiaries.<sup>156</sup>

Under general letter of credit law, the issuer's duty is to only honour if the documents strictly comply with the terms of credit, and to not honour if the documents are discrepant. However, given such "expanded right for reimbursement", the issuer is able to obtain reimbursement without having to follow the strict compliance rule in the examination of the presented documents by the beneficiary.

Judging from Ronald Mann's research into actual banking practice,<sup>157</sup> such practice has been disturbingly successful in allowing banks to pressure applicants to accept discrepant documents under threat of possibly being labelled as having bad creditworthiness and being refused letters of credit services in future by the banking community. Furthermore, without exercising their strict duty to applicants of accepting only conforming documents, issuers do not have to insist that beneficiaries comply with their duty of presenting conforming documents. This is where the fraudster can step in, thereby providing a cogent and persuasive explanation as to why fraud has been able to increase.

Even though §4-302 of the UCC requires the physical return of dishonoured documentary drafts, the Official Comment of §5-112 ('62) clearly indicates a distinct lack of enthusiasm for following such a requirement by stating that such practice would cause

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<sup>156</sup> Mann, loc. cit.

<sup>157</sup> With over 60 - 70% of presentations with discrepancies in the documents, there existed only 1% dishonour, R. Mann, "Discrepancies in Presentations Against Commercial Letters of Credit", *Documentary Credit World*, Nov./Dec. 2000: 21, at 24 and onwards, and at notes 27 and 42.

“hardship on the mercantile parties to the transaction” because “resale of the goods might be more difficult if the controlling documents of title were not available at the place of arrival of the goods”.

The above seems to suggest that, at least as far as banks are concerned, discrepant documents are acceptable. This is in clear contradiction to the provisions under the UCP. Even more serious is the implication that banks are unconcerned or oblivious to the fact that the discrepant documents actually indicate non-performance of the underlying contract and, secondly, that banks have the power to legitimise the obvious dishonesty and bad faith action of the beneficiary, thereby indirectly encouraging fraud, which diminishes the importance and the creditability of the specified documents in international sales of goods.

### *3.4.7 Preclusion clauses*

#### *(a) Strict time limitation on banks for documentary examination*

The clause in the UCP referred to as the “preclusion clause” provides an indication of the banking industry’s attitude towards documentary compliance under the law of documentary credit. Under Article 14(d) and (e) of the UCP, banks are required to examine all documents within 7 working days and notify the beneficiary of all discrepancies together. If a bank fails to act in accordance with this provision, it will be precluded from claiming that the documents are not in compliance with the terms and conditions of the credit. This was considered an applaudable

change to the provisions of UCP 400.<sup>158</sup>

It is difficult to discern the reasoning behind the practice of, on one hand, providing a beneficiary with an unlimited opportunity to take required documents back and forth in order, finally, for the beneficiary to represent conforming documents,<sup>159</sup> and on the other hand, allowing the bank only one bite of the cherry with no further opportunity to even correct its mistake if it finds further discrepancies after having been given the first notice of discrepancies. In such circumstances, a bank will have to pay out even though it knows that there are other discrepancies of which it could not notify the beneficiary.

This practice seems to contradict the principle in the UCP that banks should only pay against conforming documents. Would a bank breach its duty to the applicant to make payment despite the discrepancies? If so, this may mean that the applicant has to bear the consequences of the bank's legitimate acceptance of the nonconforming documents. The bank's right of reimbursement from the applicant could conceivably be put into question if the bank pays out over discrepant documents. It does not exist without reason that "under Anglo-Australian common law, discrepancies not realised upon the rejection of the documents may **not** later be introduced as grounds for that rejection unless the failure to raise the discrepancies in a timely fashion denies the beneficiary the opportunity to cure the defects in the documents".<sup>160</sup> Therefore, the certainty of the beneficiary's receipt of payment has

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<sup>158</sup> Buckley, *op.cit.*, at 271.

<sup>159</sup> See discussion of multiple tender of documents further below in this section

<sup>160</sup> Buckley, *op. cit.*, at 269.

been enhanced by the change in UCP 500 at the expense of the increase in uncertainty in respect of the degree of conformity of the documents.

Even though it is the bank's duty to check all documents, applicants should be aware that the employees of a bank who deal with letters of credit on a day-to-day basis are normally not armed with the knowledge of specific industries.<sup>161</sup> The only responsibility they are capable of carrying out is to check whether the conditions described in the letter of credit are met by the documents provided by the seller. The decision whether or not the documents are compliant is based on their commonsense, not any special knowledge of law or industries. Reflecting this, normally a letter of credit checker has little time to check and approve an outgoing letter of credit or examine a set of documents. The reason for this is efficiency. The shorter the turnaround time of transactions, the higher the rating for operational efficiency.

It is submitted that the time needed by the bank to exercise reasonable care should be the standard upon which the time required for examination is determined. Banks normally desire, and clerks are compelled, to examine documents in an expedient

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<sup>161</sup> Where document checkers do have knowledge and experience in respect of the specific industry in which the transaction is taking place, they are able to spot "red flags" far more easily. For example, where a government trading organization was involved in the purchase of 20,000 metric tones of sugar, which was to be financed through a letter of credit negotiated by a bank in Jordan, the bank staff had rich experience in dealing with shipments of sugar and knew how the letterheads and signatures on the documents should look. The letter of credit misspelled the name of the surveyors who were to attest to the quality and quantity of the sugar loaded on board. The fraudsters knew that in order to get paid, they needed to produce documents which exactly complied with the terms of the letter of credit. When the documents with misspelled names of the surveying company were produced, the staff was immediately alerted. It was discovered that the goods were not loaded on the vessel at all. The bank therefore refused payment - *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op.cit., at 11.

manner.<sup>162</sup> Promoting such banking efficiency without at the same time imposing stringent standards in respect of banks' reasonable care can result in legitimised negligence by the issuer in exercising its duty of care which should not be justifiable.

The limitation of time for examination of documents under §5-108(a) of the UCC could be said for the purpose of avoiding the possibility that the examiner (at the urging of the applicant or for fear that it will not be reimbursed) will take excessive time to search for defects. This preclusion clause is new to the UCC and taken from the provisions of the UCP. Does this rule suggest that in a case where the examiner does require more time for examination, the issuer can be excused for not checking all documents properly to identify discrepancies for reason of such time restriction? If the issuer is allowed to pay over such documents which have discrepancies, then the strict compliance rule is breached.

In contrast to §5-108(a)('95), under §5-112('62) of the UCC, although banks were allowed only 3 days for examination of documents, it did not really take away the bank's discretion to extend the examination period if necessary. §5-112('62) clearly indicated the possibility of banks communicating with the beneficiaries and that the banks had a right of dishonour after the examination was finished. It is submitted such process encapsulated the very essence of "reasonable care" that banks should exercise in examination of documents — it allows banks to avoid the possibility of making payment without checking the

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<sup>162</sup> See discussion above on pressure put on bank letter of credit document checkers.

documents properly. It recognised the power of banks to exercise their discretion to decide, based on each individual case, how long a proper examination should require and discouraged banks from being hasty when executing their duty of examination.

*(b) Allowing beneficiaries the opportunity to cure discrepancies*

The preclusion clause insists that the issuer has to notify beneficiaries of the discrepancies that the beneficiaries have to cure. If banks allow documents to be taken back by the beneficiaries after first submission and altered in order to make them into conforming documents<sup>163</sup> they are, in effect, being given an opportunity to perfect what could be a fraudulent transaction. In such cases a bank which subsequently receives firm evidence external to the documents of fraud by a third party does not have the option of refusing to honour the credit.

It is submitted that such practice has placed the duty of ensuring conforming documents wrongfully on the issuer. By allowing the beneficiary to change the discrepant facts to meet the terms and conditions of the credit, the system implicitly permits forgery or false information in the absence of a system to guarantee that the curing process is done by a legitimate entity or that the new facts are true. Furthermore, because there is no substantial standard to judge whether the issuer has exercised “reasonable care” and there is no requirement for the issuer to accept documents based on “good faith”, banks can easily turn a blind eye to forgery or false documents under the protection of the disclaimer under UCP

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<sup>163</sup> Buckley, op.cit., at 267 and 274.

Article 15 that the issuer is not responsible for the genuineness or falsity of the documents.

It is submitted, therefore, that such a system can be too easily taken advantage of by a fraudster without (a) imposing a clear duty on the beneficiary to provide conforming documents which truly represent the contractual goods the beneficiary has shipped; (b) clearly stating that by presenting the documents, the beneficiary warrants that it has performed its underlying contract to entitle the payment; (c) imposing a system whereby both the issuer and the applicant will have recourse to the beneficiary on breach of warranty and/or on misrepresentation and/or on documentary discrepancies or on fraud, and (d) imposing on the issuer a duty to exercise “reasonable care” with good faith.

#### *3.4.8 The waiver problem*

As mentioned above, it has become standard practice for banks to obtain a waiver from the applicant in respect of documentary discrepancies so that the lack of documentary compliance does not become an issue.<sup>164</sup> The result of the provision of a waiver by the applicant is that discrepant or invalid documents are made acceptable. This practice in effect denies the strict compliance rule, giving the fraudsters the opportunity to receive payment under the letter of credit without fulfilling any legal obligation under the sales contract with the buyer, thereby shifting risk to the buyer.

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<sup>164</sup> R. Mann, “Symposium Empirical Research in Commercial Transactions: II”, *op. cit.*, at 2523-2530,

The obligation of the beneficiary to abide by the terms and conditions of the credit is a condition precedent to the issuing bank's obligation to make payment. In theory, the duty to examine all documents is so important that any discrepancies in the documents should debar the bank from claiming reimbursement from the applicant of any amount which has been paid against the documents. As expressed to the author by an experienced banker of the Trade Services section of Citicorp,<sup>165</sup> the responsibility of the issuing bank/confirming bank is to ensure that the terms and conditions of the letter of credit are complied with before honouring the drawing (presentation). If the documents are discrepant, the bank's definite undertaking under the letter of credit or confirmation becomes null and void. Vincent Maulella, an experienced and renowned banker, reported in his recent article<sup>166</sup> that the applicant waives discrepancies in 99.9% of cases. According to Ronald J. Mann's study, out of the 343 discrepant files he reviewed, 36 (11%) were for expired letters of credit. This provides an indication of the frequency in which documents were presented on expired letters of credit.

The reality of the applicant's acceptance of faulty documents is a reflection of a lack of bargaining power, as well as indicating the great pressure brought by banks (in a position of great bargaining power) on applicants. The result of such practice is that discrepant documents are rendered acceptable and the importance of the validity of documents blurred. Therefore, applicants assume a

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<sup>165</sup> A senior banker of Citicorp Trade Services (M) Sdn. Bhd. when attending the Annual Survey of Letter of Credit Law & Practice Conference in Hong Kong, June, 2001.

<sup>166</sup> V.M. Maulella, "A Decade Later: A New UCP, and a 'White Paper' But Has Anything Really Changed?", *Documentary Credit World*, Nov./Dec 2001, 24, at 25.

disproportionate amount of risk not only because of the separation of documents and goods under the independence principle, but also through having to accept discrepant documents.

Article 14(c) of the UCP seemingly gives buyers the choice to decide whether they are willing to take up non-conforming documents. This feature, however, as suggested by Mann's research, appears to be exploited by banks to manipulate the buyer into authorising the issuer to pay under the letter of credit on the basis that the buyers have waived the discrepancies. One would assume that Article 14(c) was intended to counter the potential injustice that the strict compliance doctrine might cause to beneficiaries in cases of minor or legally insignificant discrepancies, such as typographical or spelling mistakes. The existence of discrepancies gives rise to doubts about the actual performance of the underlying contract based on which the letter of credit is issued. Yet, under the guise of the independence principle, banks expect buyers to waive such discrepancies despite their obligation to exercise reasonable care in their examination of documents in the context of their relationship with the buyer.

### 3.5 Conclusion

The contractual relationship between the applicant and the issuing bank has never been given enough attention by the UCP or the courts. Therefore, the rights and duties of the parties can be said to have been treated as if they were only the rights and duties of the banks and the sellers. Such a defect in the letter of credit

system, it is submitted, has contributed to a situation where banks do not exercise true reasonable care towards the buyers, and sellers submit discrepant and even non-genuine documents at an alarmingly high rate. There is a need for a clear standard to be articulated under which banks owe a specific duty to buyers to exercise their duty of “reasonable care”, including an obligation to investigate “red flags”. The importance of the seller's duty of providing conforming and genuine documents should also be clarified by placing all parties under the obligation to exercise good faith in the discharge of their respective responsibilities under the credit. In the context of the deterioration in the reliability of bills of lading, and the reallocation of risks under the letter of credit that has occurred as a result, including the unsavoury practices of providing the beneficiary with multiple opportunities to “rectify” the documents and of the extraction of waivers in respect of discrepancies from applicants, the argument in support of the articulation of such duties and obligations has become, over time, increasingly compelling.