Chapter 5

Prescription for Reform

5.1 Introduction

The letter of credit is the most commonly used method of payment for goods in export trade,[1] to the extent that it is commonly referred to as the "lifeblood" of international commerce.[2] As a result of the effort of the ICC in codifying the law and practice of documentary credits, the current letter of credit system has become almost exclusively governed by the UCP which is now considered as "the most influential source of commercial letter of credit law in the world."[3] In fact, the UCP is so dominant that in the international arena, any applicant wanting a letter of credit not subject to the UCP would face a very difficult task to find a compliant bank.[4]

The UCP, however, "was neither designed nor intended to be law."[5] Despite consultations with non-bank bodies, the UCP has been drafted by banks and for the interests of the banking industry without, in a meaningful way, incorporating the interests of

[1] L. D'Arcy, C. Murray and B. Cleave, *Schmitthoff's Export Trade*, 10th ed., Steven & Sons; London: 2000: 186.
[2] Stephenson L. J. in *United City Merchants (Investments) Ltd v. Royal Bank of Canada* [1982] Q.B. 208, at 222.
[3] B. Kozolchyk, "Letters of Credit", *Int. Ency. Comp L* ,1979, Vol. IX, Ch. 5.
[4] R.P. Buckley, "The 1993 Revision of the Uniform Customs and Practice for Documentary Credits", *The George Washington Journal of International Law and Economics*, 1995, v.28, 265, at 269.
[5] Ibid.

applicants. Applicants do not have any say here in terms of what contract they want and what law should be the applicable law in the letter of credit transaction; they have to take whatever is available even though there are extensive disclaimers about the bank's liabilities. In the terms expressed by Professor Edward Rubin,[6] the agreement for the issuance of the letter of credit could be categorised as an "adaptable" contract[7] bordering on a contract of adhesion.[8]

Having demonstrated in this thesis the inequities existing under the UCP, one is compelled to agree with Buckley's assertion that the UCP, in acquiring universal adoption and serving, in effect, as the "law in practice", should address, as is the duty of any system of law, issues of equity and fairness for all parties.[9] As will be suggested below, there is also an argument that the merits of a reallocation of risk under the UCP on the basis that the efficiencies obtained from the extreme standardisation[10] represented by the UCP and "off-the rack" contracts imposed by banks on applicants

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[6] E.L. Rubin, "Types of Contracts, Interventions of Law", Winter 2000, 45 *Wayne L. Rev.* 1903.

[7] "Adaptable" contracts include a limited number of negotiated terms and a large number of standardised terms that are beyond the scope of negotiation, with the source of standardisation being either a form contract established by the particular seller, a form contract in a given industry, a set of rules adopted by a trade association, or a set of permissive statutory rules, ibid., at 1907.

[8] A contract of adhesion is defined as one that is offered to the other party on a "take-it-or-leave-it" basis, without an opportunity to vary the terms, ibid., at 1906.

[9] Buckley, op.cit., at 268. See also *St. George Bank Limited v. Salzberger* [2001] N.S.W.C.A. 67, in which the UCP was described as "Code" which was not intended to be legally enforceable but to operate as a guide and a code of behaviour.

[10] The argument in respect of standard contracts is that they offer general social benefits by reducing transaction costs, that is, the cost of negotiating and drafting the initial contract, the cost of resolving disputes between the parties, and the cost of litigation should the parties fail to resolve their differences, Rubin, op.cit., at 1917.

are undermined to a significant extent by market failures.[11] Market failures arising from both information asymmetry between banks and other parties to the letter of credit transaction[12] as well as from the absence of the opportunity for applicants to identify banks that offer contracts with terms that are different in substance.

5.2 *The Rationale Underpinning the Current Distribution of Liabilities and Costs under the Letter of Credit*

In *Angelica-Whitewear,*[13] Justice Le Dain asserted that it is important to maintain the principle that an issuing bank must decide promptly on the basis of what appears on the face of the documents whether or not to accept them and to pay the draft.[14] The backbone principle on which this standard is established is not fairness or justice to all parties, but the 'efficacy' that the banking industry demands be accorded undue weight.

Banks strive to achieve premium efficiency under the forces of

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[11] In respect of contracts, 'market failures' are events that produce inefficiencies, such as an event of information asymmetry under which the non-drafting party will lack adequate knowledge to suggest or search for shop of a contract with more advantageous terms, or a situation under which a contract with terms different in substance cannot be obtained elsewhere in the market, Rubin, op.cit., at 1915.

[12] Economists generally believe that business-merchants are not subject to information asymmetry as it is assumed that as repeat players they know as much as the party with whom they are dealing, or can hire knowledgeable experts at low transaction cost, Rubin, op.cit., 1912. However, there are many mid-sized enterprises that, despite using letters of credit, do not have staff with expertise in the UCP, and are not able to contract for advice in this respect because of the relatively high transaction cost, resulting in the possibility of being "blind sided". For an analysis that deals with this issue in the context of standby credits, see J. Dolan, "Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)", (2000) 45 *Wayne L. Rev.* 1865.

[13] *Bank of NS v. Angelica-Whitewear Ltd.,* 36 DLR 4th 161 (Can 1987), at 165.

[14] Ibid.

competition in order to win business.[15] The beneficiary's interest is in getting payment as early as possible. However, no matter how urgent is a bank's need to reduce costs and to earn more profit, or how desperate a beneficiary's need to obtain assurance of payment, neither should be achieved at the cost of justice. That is, efficacy should not be the only factor considered when dealing with the rights and duties of all parties involved in the letter of credit transaction. Fairness and justice should be the underlying principle borne in mind by judges, drafters and commentators. In the absence of this principle, it is submitted that blind reverence for certain and efficient outcomes can engender unfair results under which less than culpable parties are forced to bear substantial losses, as well as an environment which facilitates fraud.[16]

Some commentators have been advocating the importance of prompt payment,[17] suggesting that the letter of credit system will weaken in the absence of more effective application of the efficiency principle. While acknowledging the importance of prompt payment for the efficacy of the system, this dissertation further asserts that however important the concept of prompt payment, it should not be compromised by failure to provide complying (including genuine) documents, and that the payment mechanism should only be triggered by the beneficiary submitting

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[15] Buckley, op.cit., at 277.

[16] 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", 28 Loy. *L.A.L.Rev*. 619, at 629.

[17] See, for example, J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, Warren, A.S. Pratt & Sons; Detroit: 2001 edition, Update No. 2, 3.07(7) for his views on the importance of prompt payment to the letter of credit system.

strictly complying documents. Further, as will be argued below, efficiency is not an absolute concept, and the extent to which efficiency can be tolerably compromised before the utility of letters of credit is brought into question really depends on the attitude of actual customers. Simply put, it is a question of balance, and it is submitted that up until now, against the backdrop of the dominant role of banks in the drafting of the UCP, that the question of where such balance lies, and whether customers are prepared to assume more costs for the purpose of incorporating some justice and equity into the system at the possible expense of efficiency, has never been adequately addressed — not surprising given that it has never been placed on the agenda for discussion between banks and letters of credit users.

5.3 Economic Rationale for a Reallocation of Liabilities

The UCP represents an attempt by the banking community through the ICC to provide predictability, stability and efficiency in the operations of letters of credit worldwide. It serves to reduce legal risks and transaction costs[18] for banks, which in turn should increase the value of transactions. However, precise rules and exclusion of bank liabilities increases the probabilities that application of the UCP may lead to outcomes that parties to a transaction would like to avoid. As Professor Paul Stephan of University of Virginia Law School suggests, forcing business

[18] The letter of credit transaction costs include the bank's cost of operating the letter of credit system, which the bank will generally pass to the users, the user's costs of using the instrument, and the costs imposed by fraud, forgery and error losses, R.D. Cooter and E.L. Rubin, "A Theory of Loss Allocation for Consumer Payments", (1987) *Texas L. Rev*. 63, at 64.

people to tailor their transactions through the application of off-the-rack contractual formulations such as the UCP only works if such contracts do not cramp the relationships that they set out to govern. It could be added that they only can work to the extent that users are comfortable that their own risks do not outweigh the benefits of using this device (if they are indeed aware of such risks, which, it is suggested, is unlikely for unsophisticated users of letters of credit). Bank attempts, through the UCP, to reduce their own risk to the maximum extent in the letters of credit transactions, have not come without costs to users. Hence, Stephan's comment that the optimal level of legal risk for banks may well be higher than it is at present,[19] suggesting that awareness of such risks would lead to user willingness to pay more for the use of the letter of credit device in return for increased assumption of risk by the bank.

Intervention and adjustment in respect of the allocation of risk is justified when existing regulation or the market fails to produce efficiency, which is evidenced by a high rate of market failure.[20] The resistance of banks to allow deviation from standard form agreements, evidencing high potential negotiation costs compared to the potential benefits, the virtual impossibility of applicants successfully identifying banks that are willing to offer standard term contracts any different in substance from that of the banks initially approached, and the problem of asymmetric information for the

[19] P.B. Stephan, "The Futility of Unification and Harmonisation in International Commercial Law", (1999) 39 *Va. J. Int'l L.* 743, at 783.
[20] Rubin and Cooter, op.cit., at 69.

huge numbers of less sophisticated letter of credit users, which limits the effectiveness of "bank shopping" for contracts with advantageous terms[21] — all suggests a rate of market failure which is too high too ignore. As discussed in Chapters 2 and 3, the UCP largely insulates banks (and sellers) from the increased transactional costs arising from fraud and forgery, with the result that, by and large, buyers are saddled with such costs. The market failures described above, which, presumably, to the extent that they do not result in bank transactional costs do not become a bank concern, contribute to a perpetuation of a situation under which buyers must, unconsciously or otherwise, acquiesce to bearing such potential costs.

This dissertation has also put forward several other reasons suggesting the necessity for a readjustment of the risk as currently reflected by the UCP. One of these was the shift of risk from the beneficiary/seller to the banks and in turn to the buyer/applicant arising out of the proliferation of bulk and containerised cargo and the concomitant reduction in value and reliability of the bill of lading as a title document. The other was the inequitable nature of many of the provisions of the UCP, and particularly the disclaimers of liability, which serve to reduce bank liability to a minimum at the cost of the applicant, combined with the "off-the-rack" nature of UCP-governed agreements for opening the letters of credit, which generally preclude the applicants from any opportunity to negotiate such one-sided provisions.

[21] This is not to suggest that banks do not universally compete on price – although this may well be the case in many jurisdictions – but the opportunity to negotiate other terms is, by all

The limited nature of consultation with non-banking parties in the drafting of the UCP is one reason why the UCP predominately reflects banking interests. The problems summarised immediately above could be addressed in the context of the drafting of the next version of the UCP if the drafting process is structured in a manner that renders efficient results more likely.[22] As Stephan sets out so poignantly, up until now the UCP represents a case of private regulators from the same mercantile interest group (banks) who, borrowing the words of Rubin who was speaking more generally, "have the most to gain from network externalities and the greatest capacity to organise themselves...likely to select provisions that favour their own interests at the expense of non-merchant firms" with "results that are likely to create market failures that undercut and perhaps vitiate the benefits for the network externalities that have been achieved."[23]

The result is a code, the UCP, universally applicable, under which there is an over-emphasis on protection of the interests of one party — the banks — while being applied in a manner that, in effect, is giving rise to information asymmetries and other market failures that are being justified in the name of efficiency. Equity can only be assured through a more balanced process of drafting under which more interests are represented. There is still time for such a process to be instituted for the purposes of drafting UCP

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accounts, minimal.

[22] Dolan suggests the same in the context of standby letters of credit, J. Dolan, "Analysing Bank Drafted Standby Letter of Credit Rules", op. cit.

[23] Rubin, op.cit., at 1924.

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5.4 Limitations of the Independence Principle

5.4.1 Should banks bear a duty to investigate the authenticity (rather than merely checking for facial conformity) of the documents?

Under the basic rule of the independence principle, issuers are not concerned with or bound by underlying contracts. They deal exclusively in documents and not in goods or services to which the documents may relate. The fact of payment by the issuing bank therefore does not ensure that the buyer gets the goods it wants and for which it has contracted. The security the beneficiary enjoys does not reflect the buyer's absence of security for the procurement of the contracted goods. The buyer-applicant may get the documents, which on their face justify the issuing bank in paying, but if the documents do not represent the goods the buyer-applicants want, their recourse is to the seller, not the buyer's bank. Therefore, scholars and courts have been struggling for the solution to the question as to how strictly this rule of autonomy should be applied.

The principle of independence of the letter of credit in relation to the underlying contract dictates that the issuer is obliged to make payment upon presentation of conforming documents without regard to any defenses or claims which the applicant may have against the beneficiary or the issuer. Further, whether the

documents are genuine or not is not a matter which the bank is obliged to investigate. This is indicated clearly in Article 15 of the UCP 500, which states: "banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents..."

Because the bank's duty is limited to examining documents for compliance only on their face, whether the documents in fact represent the contracted goods or any goods at all is not the banks' concern. As a result, the banks tend not to be proactive in regard to identifying "red flags" that could indicate problems in sufficiency, accuracy, genuineness, falsification or legal effect of any documents, while the vagueness of general standards of documentary examination, and the absence of explicitly duties of the bank to the applicant under the UCP, means the bank (with the exception of situations of buyer-seller collusion) bears little actual risk for making payments under documentary credits which are tainted with underlying fraud.

It is of great concern if such attitude towards the validity of the required documents should be shared by the seller/beneficiary and for it to be permitted to treat documents in the same manner. However, as Mann's research strongly indicates, it is precisely this situation that characterizes presentations by sellers under letters of credit at the present time.[24]

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[24] See R. J. Mann, "Discrepancies in Presentation Against Commercial Letters of Credit", *Documentary Credit World*, November/December 2000; and R.J. Mann, "Symposium Empirical Research in Commercial Transactions: II. Transactional Design: The Role of Letters of Credit in Payment Transactions", 2000, 98 *Mich. L. Rev.* 2494.

This trend is so worrying that bankers are reportedly in two minds as to whether they should look into the underlying transaction. "On one hand he would like to remain isolated from the physical transaction and have his payment responsibilities circumscribed merely to the documents presented to him. On the other, as he is often taking a much larger risk in the transaction, he would like to have access to greater information regarding the transaction, so that he can better assess the risk and hopefully avoid fraudulent transactions."[25]

As mentioned in Chapters 1 and 3, "an important piece of collateral within the trade transaction may be the bill of lading consigned to the bank. The bank, if all else fails, wishes that through the bill of lading it would be able to get its hands on the cargo and thus recover some of its losses. However, if that document itself is false, it may have no collateral and hence be financing a transaction worth millions of dollars based upon non-existent cargo."[26] Thus the need for banks, irrespective of whether they have taken other security, to check whether or not the documents presented are genuine.

Other bankers have questioned whether limiting examination to the

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[25] P. Mukundan, (Director of ICC International Maritime Bureau), cited in Foreword of *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, A Special Report prepared by the ICC International Maritime Bureau, ICC Commercial Crime Services, ICC Publication No 643; Paris: 2002, at 4. Mukundan, in his reference to the "much larger risk" of the banks, presumably had "collusion risk" in mind when making this statement and bank concern that the bill of lading, as the bank's collateral, represented goods of the value indicated on the face of the bills of lading.

[26] Ibid., at 29.

documents on their face is good banking practice. They suggest bankers are not acting in good faith when they refrain from questioning the beneficiary about "red flags".[27] It is submitted, therefore, that banks should be required to check and to question the authenticity and correctness of documents tendered under the letter of credit transaction, not only as "best practice", but also as part of the exercise of their duty of care.

5.4.2 Lowering applicable thresholds of proof to invoke the fraud exception

Fraud has long been a source of major concern in commercial law. Hapless buyers only discover the fraud when they go to collect their cargo (or lack of it) weeks or months after the fraud has been perpetrated, during which time the fraudster has spirited away his ill-gotten gains and melted into the shadows.[28] Complex international frauds are costly to investigate and are generally given a low priority by under-resourced (and often unenthusiastic) law enforcement bodies, and even when they lend assistance, the investigation tends to proceed at an inordinately slow pace, with requests for judicial assistance from authorities in another country taking many months to be answered; and with trials only taking place (if at all) after several years, by which time the seller has usually disappeared without trace.[29]

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[27] R. Langerich (Vice-President of the Trade Finance Division of Unibank), "UCP Should Not Deal with Fraud. Right? Wrong Says Reinhard Langerich", *DCW*, Vol. I. 6, No. 3. Summer 2000, 9, at 10.

[28] P. Lowe, "Fraud and the Documentary Credit", Report of the ICC International Maritime Bureau, ICC Publications: Paris: 1994, at 8.

[29] Ibid., at 9 .

Under the general circumstances of banking practice of issuance of a letter of credit, if, on their face, the documents conform to the credit, the bank is under a contractual obligation to the seller to honour the credit. This is irrespective of whether the bank has knowledge that the seller, at the time of presenting the conforming documents, is alleged by the buyer to have fraudulently breached the underlying sales contract. The commercial purpose of the system of documentary credits is to give the seller an assured right of payment before it parts with control of its goods. Therefore the performance of the contract of sale is not permitted to become a ground for non-payment or deferment of payment under the credit.

Therefore, the independence principle should not be applied too rigidly. If special circumstances arise, this general principle should give way to a fraud exception. The fraud exception should be considered as a deterrent which assists the healthy movement of letters of credit. If the independence principle can be described as the motor pushing the letter of credit to move efficiently, the fraud exception is what the transaction needs to clean the motor (and indeed the whole vehicle) in order for the whole apparatus to operate soundly. For the fraud exception to assume such a role, however, it must be made easier to invoke through a lowering of the applicable thresholds of proof in applications for interlocutory injunctions.

The application of the independence principle must not be allowed to encourage or facilitate fraud in such transactions. The fraud

exception represents a departure from the independence principle. Only by looking behind the face of presented documents can a fraud be detected. However, a narrow interpretation of the fraud exception provides unscrupulous seller-beneficiaries a no-risk opportunity to take advantage of the system because if there is fraud, applicants only have the right to seek an injunction before the bank has made the payment against the presented documents, not after the honour. This narrowly tailored option between honour and dishonour, combined with the high threshold of demonstrating "established fraud", greatly reduces the applicant's chances of applying for injunction (as mentioned in Chapter 4, in England, *there are only 2 instances* on record of an interlocutory injunction being granted in such circumstances) and leaves the suit against the beneficiary-seller the only option. In Chapter 4, this dissertation, while acknowledging that banks should only be obliged to refrain from payment under a credit if they determine that fraud has been "established" by the time of payment, advocates that courts should apply a lower standard of proof — a "real chance of success" standard — for the purpose of granting interlocutory injunctions under the fraud exception. Such a reform would render interlocutory injunctions achievable in the context of the extremely short time frame within which an application for such an injunction must be brought prior to payment under the credit to a beneficiary who, in all likelihood, will disappear with his booty upon receipt of the credit proceeds.[30]

[30] Even though law has established a fraud exception, some scholars over-emphasise its effect in respect of the prompt payment feature by asserting that this exception might be abused by applicants in order to delay payment by making unfounded charges of fraud and, therefore, weaken or even destroy the mechanism of the letter of credit. There are however

While a document is correct in form, yet false or illegal, the issuer should not be called upon to recognise such a document as complying with the terms of the letter of credit under the guise of the independence rule.[31] Irrespective of the business pressures auguring toward efficiency, there should be clearly defined circumstances under which banks may refrain from paying under a letter of credit. Currently, however, as "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," knowledge or suspicion of fraud only gives the bank the option "to honour or dishonour,"[32] or to inform the buyer of its concern, with the buyer left to make a quick decision (as much financial risk and under extreme pressure) as to whether to seek an injunction.

The Australian case of *Contronics Distributor* suggests a basis upon which a requirement can be developed that restrains banks from payment where a suspicion of fraud exists, thereby according applicants more time to gather evidence for the purpose of an interlocutory injunction application. In *Contronics Distributors*, the court reasoned that a bank is bound not to pay if it has knowledge of the circumstances such as those that are disclosed here, or it

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elements which will prevent the abuse of the exception. For example, the plaintiff could be required to pay the amount which is the subject of the dispute into court. It is submitted that such a practical restraint would be sufficient to prevent a flood of fraud allegations and injunctions and that the onus should therefore be placed on the applicant to seek an attachment order or injunction. This would seem a sensible course of action in order to avoid the risk of burdening the letter of credit system in any way that would reduce incentive to give full play to its utilisation.

[31] *Old Colony Trust v. Lawyer's Title and Trust Co* 297F.152 (2d Cir 1924) at 158.

may be that if it pays it is liable to face an action.[33] The bank in the facts of the case took a neutral position, leaving the court to make a determination in respect of the fraud:

> "The Bank has taken up a neutral position. Fortunately for it, it has not had to make a decision as to whether it will pay against the letter of credit or not, and a decision will now be made for it."[34]

It is therefore submitted that banks, if they detect the possibility or are informed of fraud but are unable to make a determination themselves of established fraud, should be able to take up a neutral position for a period of time sufficient to allow an interlocutory injunction application to proceed even if this means delaying payment under the credit. The buyer-applicant should be able to bring an application for an injunction to the court during which time the bank's obligation to pay under the credit is automatically suspended. The court would then have the opportunity to consider whether the applicant has "a real chance of success", i.e., where it has set forth a strong *prima facie* case.[35] This should help to address an imbalance in the rights of the parties involved in the letter of credit and provide courts with a strong basis upon which they can provide some sorely needed relief. Such an approach, it is submitted, should enable the courts

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[32] *Siderius Inc*., op. cit., at 862.
[33] *Contronics Distributors Pty Ltd v. Bank of New South Wales and others*, [1975] 3 NSWLR 110, at 116.
[34] Ibid., at 114.
[35] Van Houten, op.cit., at 384.

to realise their elusive yet fundamental "duty of guaranteeing that the beneficiary of a letter of credit will not be allowed to take unconscientious advantage of the situation and run off with (the money)".[36]

The UCP has left the fraud issue outside its purview. In fact, Article 15 of the UCP goes so far as to disclaim any bank from liability for third party falsification of documents. It is therefore submitted that there is inadequate protection against fraud under the present system. It is suggested that "the choice of the Working Group not to address the issues of fraud in the tendered documents and/or the sale of goods transaction reflects either an unwillingness to tackle a difficult but necessary issue, or an outdated view of the limited scope of the UCP as merely a codification of bankers' practices rather than a dispositive regime of rules."[37]

5.5 *Towards a More Equitable Allocation of Risk — Indemnification for Losses Arising from Fraud, and Use of Deferred Credits*

5.5.1 Availability of recourse of confirmer to beneficiary

As indicated in the *Santander Case*, the confirming bank had

[36] *In Intraworld Industries v. Girrd Trust Bank* 336 A. 2d 316 (Pa.1975], 17 U.C.C. Rep.191.
[37] Buckley, op. cit., at 302.

entered into a recourse agreement which included the beneficiary's bank information; such information helped the confirming bank to act immediately, after it was informed by the issuer of the fraud, which allowed it to successfully freeze the beneficiary's account and thereby protect its interests.[38] This raises another issue as to whether the creditworthiness of the beneficiary is such that the confirming bank can rely on the recourse agreement, and therefore whether a confirming or nominating bank[39] should as a matter of course conduct a thorough credit check on the beneficiary/seller, particularly in circumstances where a confirming bank is accepting a deferred credit undertaking.[40] As previously mentioned in Chapter 4, the International Maritime Bureau is strongly of the view that banks should routinely carry out such credit checks.[41] The confirming bank is usually in the best position to undertake such checks on the seller, as it is usually located within the seller's jurisdiction. In most jurisdictions, such checks can be undertaken relatively inexpensively through specialist credit checking agencies, the cost for which would be ideally charged to the account of the seller, where practicable. Such information should be made available to all relevant banks as well as the applicant/buyer.

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[38] *Banco Santander SA v. Bayfern Limited and others* (1999) 2 Lloyd's Rep 239, retrieved on 17 February 2001 at http://www.lexis.com, and heard by the Court of Appeal as *Banco Santander SA v. Banque Paribas*, [2000] 1 All ER (Comm) 776, retrieved on 17 February 2001 at http://www.lexis.com.

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

[40] Given the risks to the nominating bank under these circumstances as confirmed by the decision of *Santander*, taking an indemnity as a precondition for the transfer and undertaking a credit check should be standard practice in such circumstances.

[41] *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op.cit., at 28; Such checks can even be undertaken free of charge by an organisation such as the CCS Bureaux for their banking members, at 29.

Confirming banks, which are considering discounting a credit, should, as a matter of practice, enter into a recourse agreement with the beneficiary which could be called upon in the event of fraud, thereby:

(a) causing banks that want to discount the credit for profit to at least look into beneficiaries' creditworthiness. As indicated by the expert evidence in the *Santander Case*, banks often assess the integrity of the beneficiaries. Santander obtained a bank reference on Bayfern from the Royal Bank of Scotland: "it is obvious that any bank contemplating discounting is in a position at least to seek to know who it is dealing with."[42] Such efforts would be rewarded by establishing a client information database, which will assist banks to avoid the possibility of suffering the loss that Santander suffered, as well as secure bank profit on the discounting market;

(b) establishing a contractual obligation for the beneficiary not to commit a fraudulent act on the bank.[43] Such a contract could be enforced through a local court. In any case if the beneficiary was

[42] *Banco Santander v. Bayfern*, at 10 of the Lexis version.

[43] *Contronics Distributors,* cited above, suggests that, firstly, the beneficiary has a contractual duty of presenting documents which provides true information of the underlying performance. If the beneficiary did not send as many goods as the draft had indicated, the beneficiary had breached its contract with the bank. The decision appeared to recognise the obligation for the seller to provide the bank with documents that correspond with the underlying contract. This approach could be considered pioneering because any attempt to look beyond documents themselves on their face has been condemned as an effort to destroy the independence principle and even the usefulness of the letters of credit in the international sale of goods. *Contronics* also suggested that the bank had a right to refrain from paying to the beneficiaries when documents on their face are regular yet contain information contrary to what reality revealed.

to try to escape from its liability, the bank should be able to freeze the beneficiary's account or seize its property; and

(c) reducing the issuing bank's concern of not being able to easily find a bank to confirm any deferred letters of credit. If a confirming bank knows that in any case, if fraud is discovered before the credit is mature, the beneficiary has to return the money paid out by the confirming bank, the issuing bank will not be the target for such reimbursement as contended by Santander against Paribas. This should be acceptable to the parties concerned as the discounting is at the request and for the benefit of the beneficiary, with the confirming bank also deriving profit. The issuing bank should not be liable for any risk arising as a result.

In the context of these arrangements, the issuing bank should be extremely careful in sending instructions to the confirming bank. In any event, as was the case with Paribas in *Santander*, there should not be any communication that could be interpreted to be an authorisation from the issuing bank for the confirming bank to make early payment, thereby saddling the issuing bank with liability for reimbursement of the confirming bank.

5.5.2 Indemnification by confirming bank

In this thesis, reference has been made from time to time to the 1962 version of the UCC. The 1962 version of the UCC, in the author's view, is a valuable document in that it represented a more balanced treatment of the rights and duties of the parties under a

letter of credit than does the current version of the UCC amended in 1995, or, needless to say, the UCP. Subsequent revisions to the UCC were made with the object of harmonising it with the UCP, which inevitably skewed the UCC in favour of the interests of the banking industry.

At this juncture, it is useful to make reference to §5-113(1) of the UCC ('62), under which a bank seeking to obtain (whether for itself or another) honour, negotiation or reimbursement under credit could give an indemnity to induce such honour, negotiation or reimbursement if "a draft and an accompanying document may almost comply with the terms of the credit, but fail in some particular."[44] This meant that "issuer was then not obligated to honour the draft, but it may be willing to do so if properly indemnified against the particular defect".[45] Even though the wording here seemed to be referring to only the issuer, from the actual transaction it was clear that this article also applied to other banks including negotiating banks and confirming banks.

§5-113(2)('62) incorporated the concept of waiver into this arrangement and made the indemnity so provided temporary subject to notice of objection by the applicant. It gave the applicants the right to decide whether they were willing to take up the defective documents before the expiry of ten business days following receipt of the documents or longer, if explicitly agreed.

[44] Official Comment of 5-113 (62'), in American Law Institute, Official Comment of Article 5 (1962 Version) Letters of Credit,1995, in J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, op. cit., Appendix B.
[45] Ibid.

The result of the applicant objecting to the discrepancies, was, as indicated in this section, either the confirming bank deciding not to take up the documents or the perpetuation of the term of the indemnity.

It is submitted that there is merit in adapting and applying the ideas encapsulated in §5-113('62). It would further interrelate well with the other proposals made in this chapter. The re-introduction of such an arrangement would provide an extra safeguard to buyers and issuing banks as the recipients of such an indemnity from banks seeking payment, acceptance, or negotiation under the credit. Underlying the §5-113(2)('62) construct is an assumption that the confirmer has detected documentary discrepancies but wishes to proceed with the confirmation irrespective of such discrepancies. However, it is submitted under a slightly altered version of this approach, that the relevant bank should in any event provide an indemnity to give the applicant and issuing bank comfort regarding the fulfillment its obligations to assiduously check the documents. If such a bank, in most cases a confirming bank, has entered into a recourse agreement under which it is already indemnified by the beneficiary, it may well not proffer any objection to providing an indemnity of identical scope to the issuer and applicant. Such a structure will, in effect, constitute a back-to-back indemnity arrangement between the respective parties.

5.5.3 Merit of using deferred payment letters of credit

As alluded to above, applicants would be well advised to opt for

the deferred payment credit in preference to other forms of letters of credit. *Santander* [46] demonstrated that where the letter of credit in question is a deferred letter of credit, use of the deferred payment letter of credit provides the applicant with certain safeguards. Under a deferred payment letter of credit, the issuing bank is not to pay out on the credit until the maturity date. In the interim, the confirming bank may pay out the beneficiary, and discount the credit at its own risk.[47]

Use of a deferred payment credit means that the applicant, because of the period of time between when the issuing bank issues the credit and when it is obliged to pay out on the credit to the confirming bank, has greater opportunity to gather evidence in relation to fraud, therefore increasing its chances to enjoin the issuing bank from payment prior to the maturity date. Such an approach will leave the confirming bank "holding the baby", which is appropriate as it is the confirming bank which is in the best position to enter into a recourse agreement with the seller, as suggested above. The dual strategy of use of deferred payment credits and requiring confirming banks to enter into recourse arrangements with sellers helps to shift some the risk under the letters of credit transaction from the applicant to the confirming bank and subsequently to the seller, thereby injecting a measure of justice and equity into the system.

5.6 Lifeblood of International Commerce Not Threatened

[46] See discussion of *Santander* in Chapter 4.
[47] *Santander*, op.cit.

When redrafting the UCP, it would be wise for drafters to apply one or more of the three principles that Rubin and Cooter have put forward — the loss-spreading principle,[48] the loss reduction principle,[49] and the loss imposition principle,[50] in settling upon a more appropriate risk allocation for bank error, bank negligence and fraud in the documents and in the transaction under future versions than currently in place. Given the capability of the banks to spread risk among their customers, and their resulting ability to bear risk at a lower cost than applicants or beneficiaries, in the area of letters of credit, application of the loss spreading principle would appear to be the most suitable method to determine the appropriate level of risk allocation. Banks should be under the obligation to inform customers of the risks involved in the use of letters of credit, and to offer customers who are risk averse (most customers are normally risk averse) the opportunity to pay more for letters of credit services[51] in return for the banks' assumption of a commensurate amount of risk, such payment being used to cover the cost of insurance. In turn, as suggested above, confirming banks should put into place recourse agreements to shift risk to seller/beneficiaries. The confirming banks' relationships with sellers, their ability to secure recourse from

[48] The loss-spreading principle involves assigning liability for a loss to the party that can achieve risk neutrality at the lowest cost, Cooter and Rubin, op.cit., at 71.
[49] The loss-reduction principle involves assigning liability to the party that can reduce losses at the lowest cost, Cooter and Rubin, op.cit., at 73.
[50] The loss imposition principle involves the enforcement of payment rules that can efficiently assign liability, Cooter and Rubin, op.cit., at 78.
[51] Generally, total fees for the banks issuing and processing the letter of credit amount to about 0.25% of the amount of the letter of credit, R.J. Mann, "Symposium Empirical Research in Commercial Transactions: II", op. cit., at 2499.

sellers, to spread risk, and to take out insurance constitute a persuasive rationale in support of a reallocation of risk from applicants to banks under the letters of credit transaction.

In the past it was regularly argued before courts on behalf of banks that any reallocation of risk under the letters of credit system would threaten the viability of letters of credit as “the lifeblood of international commerce”.[52] Mann’s research however indicates that assurance of payment is not a driving reason behind the use of the letters of credit.[53] Following this reasoning, such a change would not have a great impact on beneficiaries’ or banks’ readiness to use the letters of credit. High discrepancy rates suggest that sellers pay little attention to the question of documentary compliance,[54] thereby destroying the unconditional nature of the transaction and their assurance of payment. Sellers do not need assurance of payment to part company with their goods. Similarly, banks do not appear unduly concerned about the high rates of discrepancies because of their effectiveness in extracting waivers from applicant customers in respect of such discrepancies.[55] Mann’s research indicates that sellers utilize letters of credit as a mechanism of verifying buyers’ capacity to pay,[56] as protection against bogus remittances,[57] and to take advantage of the fact that there would be reputational implications

[52] See *Solo*, op.cit., para. 6 at 4 of the Lexis version.
[53] Mann, “Symposium Empirical Research”, op.cit, at 2499.
[54] Ibid., at 2502-2513.
[55] Ibid., at 2518-2519, 2524-2530.
[56] Ibid., at 2521-2530.
[57] Ibid., at 2530-2533.

for banks not to pay,[58] and that subsequently, letters of credit are only used in those 20% or so of international transactions where the relationship between buyer and seller is weak.[59] This rationale for the use of letters of credit would remain unaffected by the proposed reallocation of risk.

5.7 Treatment of Lawmakers Without Accountability

In Chapter Two, one of the issues examined was the dominance of banking interests over the drafting of the UCP and the limited nature of consultation with non-banking groups with a vested interest in the content of the UCP. Irrespective of these limitations, the application of the UCP by banks has become so universal that it has virtually assumed the status of law and most courts treat it as legislation.[60] As Stephan argues so cogently, there is reason to question an international lawmaking process under which one interest group can influence the process both to defeat rules that it finds threatening, and to foist upon business partners rules that distribute wealth in its own favour,[61] in effect, as demonstrated in Chapter Two, forcing its business partners to submit to the law it has shaped.[62] Stephan describes such a situation as "the worst possible outcome", as it makes evasion of rent seeking "even more

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58 Ibid., at 2525.

59 Ibid., at 2518. Ranging from the most favourable to the seller to the most favourable to the buyer, payment options include prepayment, payment by letter of credit, payment by documentary collection, and open account.

60 Ronner, op.cit., at 626.

61 P.B. Stephan, "The Futility of Unification and Harmonisation in International Commercial Law", (1999) 39 *Va. J. Int'l L.* 743, at 793.

62 Ibid., at 794.

difficult".[63] Moreover, the international lawmaker, unlike the domestic bureaucrat, is not made accountable for his choices.[64] One would not expect the courts to give an instrument created by drafters without accountability the benefit of the doubt, but for the UCP, court treatment of the letter of credit as a special species of contract and reluctance to apply general contractual and equitable principles suggests that the opposite is the case.

To the extent that its drafting process remains cloistered and closed, and as long as its drafters lack the sort of accountability that drafters of legislation assume at the national level in democratic environments, the UCP lacks key features that laws should possess. Courts should not treat it as a *de facto* law, and should only treat it as a code for reference that does not preclude the application of general principles of contract and equity where doubt exists.[65] There is a case for reversing the trend towards obligatory application of the UCP and for legislating for the mandatory application of freedom of contract principles for the purpose of enabling relief for applicants from the UCP straitjacket.

5.8 Conclusion

The documentary credit is an institution of international commercial

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[63] Ibid.

[64] P.B. Stephan, "Institutions for International Economic Integration: Accountability and International Lawmaking: Rules, Rents and Legitimacy", (1996) 17 *J. Intl. L. Bus* 681, at 691.

[65] Such an approach appears to have gained some credence in the English courts which, while treating letters of credit as a valuable piece of property recognised by the law, remains "no more than a bundle of contractual rights and obligations ultimately capable of being enforced only be legal action", with ordinary principles of law applying in any such action – per Moore-Bick J in *Jaks (UK) Ltd v. Cera Investment Bank SA* [1998] 2 Lloyd's Rep. 94.

law recognised almost universally as having performed an important service in international commerce. However, as pointed out by Stoufflet, and as demonstrated in this thesis, the independence principle cannot be allowed to run roughshod over the general law of obligation in dealing with frauds which are implicated in letter of credit transactions — principles that are recognised by the legal systems of all nations. The fraud exception, as a carve-out from the independence principle, has represented an attempt to at least acknowledge, albeit in a token manner thus far, such principles. This thesis, in demonstrating the severe deficiencies of the UCP in its role as the *de facto* law of credits, the untenable imbalance in the rights and obligations of the parties participating in the credit, and the system's shortcomings in failing to adequately address fundamental issues of justice and equity, has highlighted the need for reform and set out some ways in which such reforms can be incorporated into the system with minimal surgery.

If such principles are applied, and the UCP is improved so that it represents the interests of all parties, a basis for the healthy development of documentary credit law will be created, thereby making the future of the system relatively secure.[66] Failure to apply such principle and to take such measures, however, may lead to the gradual erosion of documentary credits, with eventual concomitant adverse consequences for the world trading system.

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[66] J. Stoufflet, "Payment and Transfer in Documentary Letters of Credit: Interaction Between the French General Law of Obligations and the Uniform Customs and Practice", 1982, 24 *Arizona Law Review* 267, at 276.