DOCUMENTARY CREDIT LAW: AN INDIAN PERSPECTIVE

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By

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DECLARATION

I do hereby declare that my thesis "**DOCUMENTARY CREDIT LAW: AN INDIAN PERSPECTIVE**" is the record of the original research work carried out by me under the guidance and supervision of Dr.A.M.Varkey, Reader, School of Legal Studies, Cochin University of Science and Technology. This work has not previously formed the basis for the award of any degree, diploma, associateship, fellowship or other similar title or recognition.

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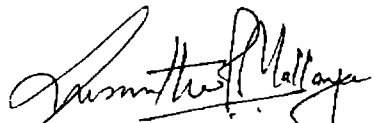

Susmitha P Mallaya.

CERTIFICATE

This is to certify that this thesis **"Documentary Credit Law : An Indian Perspective"** submitted by Susmitha P Mallaya for the Degree of Doctor of Philosophy is the record of bonafide research work pursued by her as full –time research scholar, School of Legal Studies, Cochin University of Science and Technology under my guidance and supervision. This thesis or any part thereof has not been submitted elsewhere for any degree.

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Dr.A.M.Varkey
Supervising Guide

PREFACE

This is a study in international trade law. Documentary credits are the most common method of payment for goods in international trade. In India also these instruments are used both in national and international trade. The law governing these transactions remains haphazard. This study identifies the deficiencies in the regulatory framework for documentary credits in India. It primarily focuses on those areas which exhibits a lack of equality and justice in its operation. An attempt has also been made to identify the rights and duties of parties involved in the transaction. The reasons for the increase of fraudulent activities associated with the documents executed in the documentary credit transactions are also examined. How far the law in India is sufficient to ensure fair business practice in international trade financing is also examined. Methodology adopted for the study is analytical. The statutory provisions, rules and case laws under these provisions have been examined. An empirical study by personal interview with the bankers is also made to ascertain the practice of bankers in India.

The study is divided into nine chapters. Each chapter deals with specific areas connected with the documentary credit law. Major areas chosen are legal nature of documentary credit, principles of autonomy and its exceptions, transfer and assignment of rights under letter of credit and rights and obligation of bankers involved in the transactions.

The evolution of the documentary credit is examined in the first chapter. It also enumerates different forms of documentary credits used in the trade. In the second chapter, the autonomy principle of documentary credit and its ramifications are examined. The concept of strict compliance and its importance in documentary credits are analysed in the third chapter. The fourth chapter discusses the fraud exception to autonomy principle and its impact on the documentary credit practice. The effect of the transfer of rights and obligations under documentary credit is discussed in the fifth chapter. The sixth chapter identifies the rights of the issuing bank and the problems it encounters while transacting documentary credits. In the seventh chapter, the duties of correspondent banks are considered. Administrative control over documentary credit and the practice followed by banks in India are discussed in the eighth chapter. The final chapter presents the major findings of the study and the proposals for reforms of the law in this area.

In the empirical study, I have made a random choice of banks mainly based on accessibility. Strict random sampling method could not be followed since many of the bankers are reluctant to disclose the practice followed by them. The method of citation followed is the one suggested by Enid Campbell et.al, in *Legal Research Materials and Methods,* The Law Books Company Limited, Mellbourne (1979).

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CONTENTS

LIST OF ABBREVIATIONS

A.C.	:	Appeal Cases
A.I.R.	:	All India Reporter
A.L.J.R.	:	Australian Law Journal Reports
All.E.R.	:	All England Reporter
All.	:	Allahabad
Aus.L.J.		Australian Law Journal
Bom.	:	Bombay
Cal.	:	Calcutta
C.A.		Court of Appeal
Com.Cas.	:	Company Cases
Com.L.J.	:	Company Law Journal
Ch.D.	:	Chancery Division
C.B.	:	Common Bench Reports
E.R.	:	English Reports
E.C.C.	:	European Economic - Community
Georgia.L.R.	:	Georgia Law Review
H.L.	:	House of Lords
I.C.L.Q.	:	International Comparative-Law Quarterly
J.B.L.	:	Journal of Business Laws
K.B.	:	Kings Bench
Ker.	:	Kerala
L.Q.R.	:	Law Quarterly Review
Lloyd's. Rep.:		Lloyds Reports

P.C.	:	Privy Council
Q.B.	:	Queens Bench
QBD		Queens Bench Division
R.B.I.	:	Reserve Bank of India
S.C.	:	Supreme Court
S.C.C.	:	Supreme Court Cases
Tul.L.Rev	:	Tulane Law Review
U.C.P	:	Uniform Customs and Practice for Documentary Credits
U.C.C.	:	Uniform Commercial Code
UNCITRAL	:	United Nations Commission on International Trade Law
W.L.R.	:	Weekly Law Reports
Smu.L.Rev.	:	Southern Methodist University Law Review
J.I.B.L.	:	Journal of International-Banking Law
Ariz.L.Rev.	:	Arizona Law Review
Am. Bus. L. J.	:	American Business Law-Journal
Yale J. Int'l. L	:	Yale Journal of International-Law
Col. L.R.	:	Columbia Law Review
Law &Pol'y Int'l Bus	:	Law and Policy International-Business
Fordham Int'l. L. J.	:	Fordham International Law-Journal
Stan. L. Rev.	:	Standford Law Review

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- *Vinitec Electronics Pvt Ltd. v. HCL Infosystems Ltd.*, A.I.R. 2005 Del.314.
- *Virgo Steels v. Bank of Rajasthan*, A.I.R. 1998 Bom. 82.
- *Voest-Alpine International Corporation v. Chase Manhattan Bank*, 707 F.2d 680 (1983).
- *W.J. Alan & Co Ltd v. ElNasr Export and Import Co.*, [1972]2 Q.B.189.
- *Walibe,Tamari & Sons Ltd v. 'Calprogela' Sociedada de Fibras.*, [1969]2 Lloyd's Rep.18.

- *Wells Fargo Nevada National Bank v. Corn Exchange National Bank*, (1927) 23 F. 2d.1

- *Westpac Banking Corporation v. Commonwealth Steel Co Ltd.*, [1983] N.S.W.L.R.735.

- *Westpac Banking Corporation v. South Carolina National Bank*, [1986] 1 Lloyd's Rep.311.

- *Wood Hall Ltd v. Pipeline Authority*, (1979) 141 CLR 443.

CHAPTER-1

INTRODUCTION

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Documentary credits are highly sophisticated tools for financing international commercial transactions. They help to reduce the risk of both buyers and sellers. In a sale of goods context the seller beneficiary use this instrument as collateral to finance production. In a contract of sale of goods, the seller generally faces the risk of prompt payment by the buyer and on the other hand the buyer faces the risk of getting goods with the specified quality and quantity. By using documentary credit, once the goods are shipped the seller is assured of prompt payment upon presentation of complying documents before the bank. The buyer on the other hand avoids prepaying the entire amount of the purchase prior to its shipment without any assurance of satisfactory performance of basic sales contract. During early times its use was limited to domestic trade[1]and was also used as an instrument for social relations in the form of circular letter of credit to tourists[2].

The new international economic order which promoted liberalization of international trade resulted in the frequent use of documentary credit in the international trade. Now they are relied upon by industries as supporting debt instruments such as commercial paper or industrial revenue bonds[3].

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[1] Richard King (Ed.),*Gutteridge and Megrah's Law of Bankers'Commercial Credits*, Europa Publications, United Kingdom (2001),p.4.
[2] A.G.Davis, *The Law Relating to Commercial Letters of Credit*, Sir Issac Pitman and Sons Ltd., London (1963),p.1.
[3] Read H Ryan,Jr and Charles W. Mooney Jr (Eds.), *Letters of Credit Supporting Debt Instruments*, Practicing Law Institute, U.S. (1986),p.1.

Documentary credit used in sales transactions are known as "commercial letters of credit" and those used to guarantee other types of performance are known as "standby" or "guarantee letters of credit". Bank Guarantee and performance bonds[4] are also treated as guarantee instruments for payment. All these instruments are essentially used in conjunction with documentary credit. Letters of credit are the most commonly used forms of documentary credit[5]. The rapid growth of industrialization and liberalization of trade has increased the importance of this mercantile instrument in the present day society.

In international trade buyer and seller reside in different countries. They are exposed to various major risks. Banks provides an undertaking to act as their intermediaries and help them to mitigate the risks involved in the transaction. Generally letters of credit are taken as a contract under which the issuing bank agrees with the buyer customer to pay on his behalf to the seller beneficiary. This is paid through a confirming bank on presenting the required documents mentioned in the letter of credit. There will be an underlying agreement between the buyer and the seller for the sale transaction. The legal issues in these contracts are often complicated. The validity of this underlying contract and its performance are major issues.

Letters of credit are based on commercial policy and efficiency considerations that demand the prompt honour of the instrument by banks. The transaction involves huge amount of money. Nation's reputation may also get

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[4] Leslie King O'Neal, "They're Back: Letters of Credit provided in lieu of Surety Bonds", 13 *Construction Law* 3. They are neither surety bonds nor guaranties though letters of credit are used in lieu of surety bonds. *Ibid.*

[5] The terms 'letters of credit' and 'documentary credit' are used interchangeably according to practice in different countries. See William Hedly and Richard Hedley, *Bills of Exchange and Banker's Documentary Credits*, LLP, London (2000), p.1.

jeopardized if delay in payment occurs. On the other hand this has also resulted in increasing instances of international commercial fraud[6]. It is done either by practice of fraud in collusion with banks or shipping agents. Its rampant growth threatens the financial security of a nation. Government intervention and control in this area are very limited. The speed with which today's financial markets move and the absence of adequate regulations have resulted in the increase of professional commercial criminals. It is believed that the letters of credit transactions can also indirectly assist the enforcement of currency controls and laws against money laundering.

International Commercial transactions now involve use of traditional as well as electronic payment system. Electronic transactions may even replace the traditional payment methods[7]. E-commerce and internet banking have paved the way for transforming traditional letters of credit to electronic letters of credit[8]. This in turn has created new dimensions.

Thus recent developments in commercial transport practices resulting from speedier movement, multimodal transport, changes in sale and payment terms and various measures to facilitate trade have necessitated changes in traditional documentary trade procedures. The present study is intended to analyse the Indian laws on documentary credit as developed by courts, administrative agencies and merchants. It is also proposed to examine whether the Indian law on the subject is in consonance with the practice followed in developed countries world over.

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[6] Catty Gunn, "Financial Fraud", *Banking World* 21 (1984).
[7] Duncan Bentley and Patric Quirk, "A Proposal for Electronic Transactions Tax Collection in the Context of Tax-Driven Reform of Banking Laws", 14 *Journal of International Banking Law*.327.
[8] R.David Whitaker, "Electonic Documentary Credits", 46 *Business Law*.1781 (1991).

Meaning and Definition of Documentary Credit

A documentary credit is generally understood to be one in which the issuing bank undertakes to honour the bills drawn under credit if they are attached with certain documents which the issuer can hold by way of security for advances made by him. It is a conditional promise issued by the issuing bank[9]. In other words letters of credit are essentially conditional promises to pay for goods or services made by one bank to another, substituting the credibility of the bank's promise for the buyer's promise to pay. Documentary credit can be considered as a risk-mitigation tool[10].

The most striking element in documentary credit is the difficulty to define it in a precise manner. They are devised by the commercial community to meet different circumstances and their meaning depends on its functions. It can be seen that the meaning attributed to letters of credit transaction needs to be wider. A narrow understanding of the term may affect the transaction. The obligations of the banker will vary because of the different ingredients and agreements followed by different countries. This has resulted in the formulation of various definitions to this commercial instrument in different places. A brief analysis of these definitions will help to formulate a comprehensive definition.

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[9] Peter Gillies and Gabriel Moens, *International Trade and Business: Law, Policy and Ethics*, Cavendish Publishing, London (1998), p. 387.

[10] Janet Koven Levit, "A Bottom-up Approach to International Law Making: The Tale of Three Trade Finance Instruments', 30 Yale J. Int'l. L. 125(2005).

In an early period Story had defined the letter of credit as:[11]

> "An open letter of request, whereby one person (usually a merchant or a banker) requests some other person or persons to advance moneys or give credit to a third person named therein, for a certain amount, and promises that he will repay the same to the person advancing the same, or accept bills drawn upon himself, for the like amount. It is called a general letter of credit when it is addressed to all merchants or other persons in general, requesting such advance to a third person; and it is called a special letter of credit when it is addressed to a particular person by name requesting him to make such advance to a third person."

According to this definition the sole purpose of this instrument is to extend the credit to one person on the promise of another who will be a banker. The banker will act as a paymaster to the person extending the credit. Many English writers have adopted this definition.[12]

Hart[13] refers to a documentary letter of credit as follows:

> "Where the undertaking on the part of the bank is to accept drafts against documents of title to goods, particulars of the merchandise in respect of which the bills are to be drawn being stated, it is a "documentary Credit"[14].

However these definitions fail to fulfill the function of modern commercial letters of credit. Therefore a modified definition was formulated by Davis.[15] He defines it as follows,

> "A letter whereby one person (usually a merchant or banker) promises another person (who is either named in the letter, or to whom it is intended that the letter shall be shown and who is

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[11] A. G. Davis, *The Law Relating to Commercial Letters of Credit*, Sir Isaac Pitman & Sons Ltd., London (1963), p.1.
[12] *Ibid.*
[13] Herbert L.Hart, *Law of Banking*, Stevens & Sons Ltd., London (1931).
[14] *Id.*,650.
[15] *Supra* n.11.

known as the "beneficiary") that he will reimburse the beneficiary any amounts for which he may give credit to a third person (usually a customer of the person giving the letter), either by the shipment of goods or payment of money, in respect of a commercial transaction into which the beneficiary has entered or intends to enter with the third party."

This definition is also considered as unsatisfactory. It does not mention the documents to be presented. So Gutteridge[16] renamed the document as documentary credit and defined it as

"one which provides that the banker's liability to pay or accept the seller's drafts is conditional on his being furnished with certain documents (generally a bill of lading, policy of insurance and an invoice) which are to be pledged to him as security for an advance."

This is a definition which brings the liability of the bank under its purview. But it does not mention the role of the bank as a confirming or a negotiating bank.

Another general definition can be found in *Halsbury's Laws of England.*[17] It reads,

"A letter of credit is in principle an undertaking by a banker to meet drafts drawn under the credit by the beneficiary of the credit in accordance with the conditions laid down therein."

In Blacks Law Dictionary[18], letters of credit is an engagement by a bank or other person made at the request of a customer that the issuer will honour drafts or other demands for payment upon compliance with the conditions specified in the credit.

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[16] H. C. Gutteridge and Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), p.5.
[17] 3 *Halsbury's Laws of England*, Butterworths, London (1989), p.209.
[18] Henry Campbell Black (Ed.), *Black's Law Dictionary*, St. Paul Minn. West Publishing Co., U.S.A. (1990), p.903.

An attempt to describe a letter of credit can be seen in *Voest-Alpine International Corporation* v. *Chase Manhattan Bank*.[19]

> "A typical letter of credit transaction ... involves three separate and independent relationships – an underlying sale of goods contract between the buyer and the seller, an agreement between a bank and its customer (buyer) in which the bank undertakes to issue a letter of credit, and the bank's resulting engagement to pay the beneficiary (seller) providing that certain documents presented to the bank conform with the terms and conditions of the credit issued on is customer's behalf. Significantly, the bank's payment obligation to the beneficiary is primary, direct and completely independent of any claims which may arise in the underlying sale of goods transaction."

In order to overcome the problems in the above definitions the International banking and business community formulated the Uniform Customs and Practice for Documentary Credits[20] which contains an elaborate definition. It reads as follows:[21]

> "For the purposes of these articles, the expressions "Documentary Credit(s)" and "standby letter(s) of credit" (herein after referred to as "credit(s)") mean any arrangement, however named or described, whereby a bank (the "issuing bank") acting at the request and on the instructions of a customer (the "applicant") or on its own behalf –
>
> (i) Is to make a payment to or the order of a third party (the "Beneficiary") or is to accept and pay bills of Exchange (Draft(s)) drawn by the Beneficiary,
>
> or

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[19] 707 F.2d 680 (1983) at p. 682 cited in *supra* n.9. Reading of this aspect reflects that a documentary credit transaction is separate and independent of the underlying contract for the sale of goods.

[20] This has become a universally accepted code by most of the banks with a high degree of uniformity, though it fails to get legal status. Hereinafter referred to as U.C.P., current version is U.C.P. 600.

[21] See the U.C.P. 500, Article 2. Present U.C.P. 600 made this definition precise.

(ii) Authorizes another bank to effect such payment, or to accept and pay such bills of Exchange (Draft(s))

or

(iii) Authorises another bank to negotiate, against stipulated documents, provided that the terms and conditions of the credit are complied with."

This definition also fails to cover all the ingredients of a documentary credit. Moreover, it is limited to the presentation of bill of exchange which is somewhat in tune with the definition given by R. R. Pennington,[22] who describes it as:

> "An undertaking by a bank to pay a sum of money to the person to whom the credit is addressed, or to accept or purchase a bill of exchange drawn or held by that person, and the undertaking is either absolute or, more usually, is given on condition that [*sic* that] person fulfils the requirements set out in the credit."

The present U.C.P.600 contains a brief definition. It states:

> "...Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation...."[23]

This new definition is also not free of problems, as it favours irrevocable letter of credit over revocable credits. Apart from this there is no equivalent of the old Article 6 which expressly gave buyers the choice of applying for a revocable credit. It is argued that the delimitation of the word "credit" by Article

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[22] R. R. Pennington and A. H. Hudson, *Commercial Banking Law*, Macdonald and Evans, Plymouth (1978), p. 309.

[23] The U.C.P.600, Article 2 is a comprehensive definition clause.

2 of U.C.P. 600 to irrevocable letters of credit would make it impossible to apply this rule to a revocable letter of credit[24].

In India also there is no authoritative definition for the term "documentary letter of credit". But there have been some attempts. G. S. Lall,[25] defines it

> "as a document issued by an issuing banker by which the banker undertakes either to pay the beneficiary, or to accept usance drafts of the beneficiary drawn upon the banker provided that certain conditions are complied with".

However he has not elaborated on what will constitute the conditions which may be laid down by the buyer.

From the above discussions it can be seen that there is no comprehensive definition for documentary letters of credit. The difficulty may be due to the lack of clear understanding of the functioning of letters of credit transactions especially in the field of international trade. It is suggested that defining documentary credit in a comprehensive manner may result in curtailing the growth of this instrument in international trade. Apart from the buyer and the seller the obligations of the banker are different and vary from one transaction to another. There is no proper law governing these transactions.

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[24] Charles Debattista, "The New UCP 600-Changes to the Tender of the Seller's Shipping documents under Letters of Credit", [2007] J.B.L.329.

[25] G. S. Lall, "A Short Note on Commercial Letters of Credit", 34 *The Journal of the Indian Institute of Bankers* 91 (1963).

Functions of Documentary Credit

In normal situations letters of credit involves a chain of transactions involving four parties having separate contractual relationships. The parties involved are the buyer[26], the seller[27], the bank issuing the credit[28], and the bank which makes payment[29]. Therefore in order to carry forward the function there will be a buyer who will be an applicant for the credit for importing goods. His banker will issue the letter of credit to the seller who will be a beneficiary residing in other country. It is known as the issuing bank. The seller, presenting the documents specified in the letter is known as the beneficiary who will export the goods to the buyer's country. Banker in the beneficiary's country is known as the advising bank who will intimate the beneficiary of the credit received. When the bank adds its confirmation to the credit it will become a confirming bank which will pay the beneficiary on fulfilling its terms.[30]

Therefore the obligations of the bank will be determined based on the particular situation. Apart from this, the terms and phrases used in different countries in the letter of credit in their native languages also cause difficulties of comprehension.

Lord Wright describes the function of letters of credit in the following words,

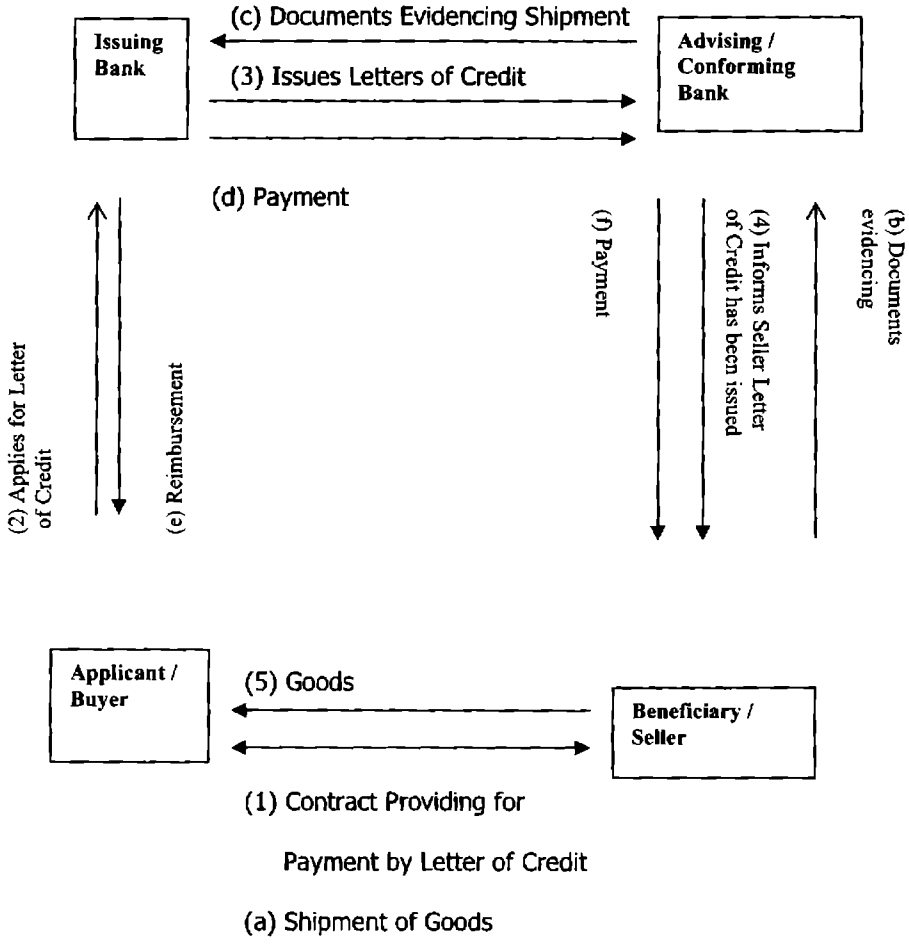
> "The general course of international commerce involves the practice of raising money on the documents so as to bridge the

[26] The applicant for the credit.
[27] The beneficiary under the credit.
[28] The issuing bank
[29] The intermediary bank or paying bank
[30] It is to be noted that the branches of a bank in different countries are treated as separate bank. See the U.C.P. 600, Article 2.

period between the shipment and the time of obtaining payment against the documents"[31].

A brief summary of the function can be expressed in the following chart:

Issuing and Payment under Letters of Credit[32]



[31] *T. D. Bailey Son & Co.* v. *Ross T. Smyth & Co. Ltd.*, (1940) 56 T.L.R. 825 as cited in Leo D'Arcy, Carole Murray *et.al.* (Eds.), *Schmithoff's Export Trade: The Law and Practice of International Trade,* Sweet & Maxwell, London (2000), p.167.

[32] Items represented in the numerical represent the issuance of credit and in the alphabets constitute payment of credit under letters of credit transaction.

It can be seen that the banks at importer's and exporter's countries have different roles to play. It has become a settled position in law that banks obligation under letters of credit is separate from the contractual obligations of the underlying transaction between the buyer and the seller.[33] Similarly the buyer is also under an obligation to reimburse the payment made on his behalf under the credit. The beneficiary stands on a different footing. He hopes to receive the funds offered by the letter of credit as payment for the anticipated shipment when the issuing bank issues the credit, the beneficiary's bank forwards the documents presented by the beneficiary and seeks payment from them. In ordinary practice its role is processing of the documents. However if it confirms the credit, it is liable to pay directly to the beneficiary and get reimbursed[34] later.

On analysis of the definition given in U.C.P.,[35] it can be seen that it envisages three methods by which the obligation of the issuing bank to make payment arise. First is the undertaking by the bank to pay cash against the tender of documents. Secondly the bank undertakes to accept a bill of exchange for the amount to be drawn on it by the seller. It should be accompanied by the stipulated documents. Thirdly the bank may undertake to negotiate with another bank a bill of exchange.

Therefore a simple definition containing the function of the letters of credit is hard to frame in legal terms because of the complexities in legal relationship between the parties involved. Apart from this, codification of the

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[33] See the U.C.P. 600, Article 4. This was incorporated in this code after the famous case of *Sztejn v. J. Henry Schroder Banking Corp.* 31 N.Y.S. 2d. 631 (1941) as cited in Richard Schaffer et.al., *International Business Law and its Environment*, West Educational Publishing Co., U.S.A. (1999), 257.

[34] M. G. Bridge, *The Sale of Goods*, Clarendon Press, Oxford (1997), p. 255.

[35] *Supra* n.21.

term will curtail the development of the concept of letter of credit. However a proper understanding of the functions will help to solve the problem.

Classification of Documentary Credit

In earlier times there were two basic forms of documentary credit. One was the revocable letter of credit and the other the irrevocable letter of credit.[36] Earlier the revocable credits were incorporated in the U.C.P.[37]. However there was an increased realization by the international banks of the need for specialisation of their letter of credit functions. This necessitated distinguishing between different types of letters of credit in order to facilitate the most convenient type of letter of credit to be cited in international trade. Davis has remarked,[38]

> "one of the most striking examples of commercial communities' contribution towards course of business is the various types of letters of credit which are devised to meet differing circumstances."

Story[39] tried to classify letters of credit into two categories. One is the general letter of credit addressed to the world and the other is the special letter of credit addressed to the specified person. The essential feature of this credit is that it is given before the merchant refers to any particular transaction.

Later various classifications of letters of credit were made. The liabilities and obligations of banker differ from one to the other.

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[36] J. C. T. Chuah, *Law of International Trade,* Sweet & Maxwell, London (1998), p. 328.
[37] The U.C.P.500, Article 6.
[38] *Supra* n.11.
[39] *Ibid.* This classification is of little importance because modern letters of credit aims to assist a merchant to carryout a contract which he has already entered.

Revocable and Unconfirmed Letters of Credit

In revocable credit there is an indirect notification to the beneficiary that the right of modification or cancellation is reserved by the banker.[40] Thus a bank is not liable to the beneficiary for revocation of the revocable credit before the transaction is complete. It is unconfirmed because the advising bank will also advise this limitation to the beneficiary. It is because this credit is subject to cancellation or modification at any time without notice.[41] The standard form of instruction by the buyer usually contains an express provision to the effect that the bank may revoke the credit at any time during its currency. According to Davis a revocable credit is merely an advice to the addressee of the credit that he is authorized to draw on the banker issuing it. However it contains no undertaking on the part of the banker that bills drawn in conformity with the credit will be met. The banker reserves to himself notice.[42] The revocable letter of credit is well illustrated in *Cape Asbestos* v. *Lloyd's Bank*.[43] If the letter indicates opening of revocable letter of credit which is not confirmed, there is no obligation on the part of the bank to give notice to the beneficiary if the credit was cancelled. This is applicable even if the bank as a matter of practice used to give notice. It is because it is solely a matter of grace and no legal liability will arise. In the *Cape Asbestos* case the bank refused to pay a company. The company sued the bank alleging that it was the duty of the bank to give

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[40] *Infra* n.42.

[41] It is to be noted that if the bank confirms such type of credit it will become liable to the beneficiary and is obliged to pay irrespective of modification.

[42] A. G. Davis, *The Law Relating to Commercial Letters of Credit*, Sir Isaac Pitman & Sons Ltd., London (1963), p. 33.

[43] [1921] W.N. 274 as cited in Gutteridge, Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), p. 17. It is to be noted that the revocable nature of the credit is reflected in the advice sent by the advising bank to the beneficiary which also states that the credit is not confirmed.

reasonable notice of the cancellation of the credit.[44] Gutteridge and Megrah[45] are of the opinion that a mere statement that credit is revocable is sufficient to allow the bank to cancel it without notice.

Thus in case of revocable letters of credit parties cannot rely on the practice of banks since giving of notice is merely an act of courtesy and no liability is imposed on the banker. The U.C.P.500 also supported this stand.[46] It is useful to quote the following observation of the learned Judge Bailhache in *Cape Asbestos Co.* case[47]

> "an unconfirmed credit is practically worthless. If it is followed for the sake of classification then it should at least insert a "notice clause".

However the U.C.P.600 removed the revocable letter of credit from its parlance. Now it deals only with irrevocable letters of credit. But there is nothing in the new rules which prevents the opening of a revocable letter of credit. There are two related but different issues here. One is that an applicant and an issuing bank are free to open a revocable letter of credit on the basis of general principle of freedom of contract. Another point is that although U.C.P. calls them as "rules" they are simply a set of terms available for contractual incorporation. Therefore in practice these types of credits are not widely used. This is really an unsatisfactory method of finance. The standard documentary credit forms do not

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[44] *Ibid.*
[45] *Supra* n.16.
[46] The U.C.P. 500, Article 8 states: (a) a revocable credit may be amended or cancelled by the Issuing Bank at any moment and without prior notice to the beneficiary.
[47] *Supra* n.43. See also Lord Denning M. R., in *W. J. Alan & Co. Ltd.* v. *El Nasr Export and Import Co.*, [1972] 2 Q.B. 189.

contain forms for revocable credit.[48] This has become outdated in the present competitive market economy.

Irrevocable Letters of Credit

In this type of credit there will be legally binding undertaking by the issuing bank to pay the beneficiary. This credit cannot be amended or cancelled without the consent of the beneficiary or the issuing bank.[49] If the beneficiary wishes to amend any of the provision of the credit he must request the buyer. Buyer will instruct the issuing bank to consider the seller's request. The meaning of an irrevocable credit was stated in Article 5 of the U.C.P. in 1951 revision.[50] It says:

> "Irrevocable credits are definite undertaking by an issuing bank and constitute the engagement of that bank to the beneficiary or as the case may be, to the beneficiary and bonafide holders of drafts drawn there under that the provisions for payment, acceptance or negotiations contained in the credits will be duly fulfilled provided that the documents or, as the case may be, the documents and the drafts drawn thereunder comply with the terms and conditions of the credit."

In *Urquhart Lindsay & Co. Ltd.* v. *Eastern Bank Ltd.*,[51] the court held that a binding contract arises between the issuing bank and the beneficiary when the beneficiary ships the goods covered by the credit in reliance on an irrevocable

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[48] See International Chamber of Commerce Document No. 416. This was published in April 1986. It is based on the United Nations layout key proposed by the UN Economic Commission for Europe and this aligns with export documentation.

[49] The U.C.P. 500, Article 9(d) (i) states, that an irrevocable credit can neither be amended nor cancelled without the agreement of the Issuing Bank and the Beneficiary.

[50] The U.C.P. 500 does not contain meaning in an elaborate manner. It is discussed in Article 9(a) of the code and a detailed guideline is provided under sections. Similarly if the issuing bank instructs another bank to confirm its irrevocable credit that confirmation will be deemed as a definite undertaking of the confirming bank from the date of confirmation and cannot be modified without the agreement of all concerned parties.

[51] [1922] 1 K.B.318.

credit notified to him. Later the court in other cases[52] went further to add that the beneficiary may turn an irrevocable credit into a binding contract by merely informing the issuing bank that he accepts its offer to honour his drafts. He can do this by presenting bills for acceptance by the bank accompanied by the documents called for by the credit.

However even this credit is associated with two notable practical risks[53]. One is related to the strength of the issuing bank. If the bank is small with a purely domestic orientation and has small assets in relation to the amount stated in letter of credit it is difficult for seller to recover the value in case of failure to meet the credit. It is to be noted that the seller's country's advising bank may not be offering an undertaking that the credit will be honoured. It may merely advice beneficiary of the opening of the letter of credit. Secondly governmental intervention may defeat the irrevocable credits.[54]

Therefore in order to overcome these results irrevocable credits are again classified as confirmed and unconfirmed. Confirmation is the fact of the seller's own bank adding its undertaking that the documents will be paid within the terms of the letter of credit issued by the buyer's bank. However confirmation is construed strictly. Thus any ambiguity will be construed as confirmed which will constitute a definite undertaking of the confirming bank.

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[52] See *Midland Bank Ltd.* v. *Seymour*, [1955] 2 Lloyd's Rep. 147, *Elder Dempster Lines Ltd.* v. *Ionic Shipping Agency Inc.*, [1968] 1 Lloyd's Rep. 529.
[53] J.C.T. Chuah, *Law of International Trade*, Sweet and Maxwell, London (1998), p. 329.
[54] *Ibid.* An off-cited example is the freezing of Egyptian assets and funds by the U.K. government in 1950. As a result the sellers failed to encash on the basis of letters of credit.

The effect of a confirmed credit has been described as constituting "a direct undertaking by the banker that the seller, if he presents the documents as required in the required time, will receive payment"[55]. This is an absolute undertaking. Hence the bank cannot withdraw from liability to the beneficiary even if instructed by the buyer to cancel the credit.

When an irrevocable letter of credit is confirmed by the advising it is termed as confirmed letter of credit. It is to be noted that only the irrevocable letter of credit can be confirmed.[56] Similarly if the advising bank does no enter into its own obligation to make payment under the credit, it will be an irrevocable and unconfirmed credit.

The use of word "confirmed" along with irrevocable credit is a matter to be analysed. This was the result of the practice of bankers of different countries. The main disadvantage of unconfirmed letter of credit is the non performance of the contract of sale in the seller's country. In this situation the advising bank would refuse to pay on tender of documents and the seller might be compelled to institute proceedings. This will defeat the main purpose of this commercial credit to make prompt payment.

English bankers adopted the word "confirmed" and made a new expression.[57] The term "confirmation" originally had been used to indicate the formal notification of assent to the credit transaction conveyed by the bank to

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[55] *Ian Stach Ltd.* v. *Baker Bosley Ltd.*, [1958] 1 All. E.R. (Q.B.D) 542 *per* by Diplock J., at p.546.
[56] *Ibid.* A revocable letter of credit cannot be confirmed as the confirming bank will be liable without having any recourse to the issuing bank in case the letter of credit is cancelled. Also see *Discount Records Ltd.* v. *Barclays Bank Ltd.*, [1975] 1 W.L.R. 315. *Trendtex Trading Corporation* v. *Central Bank of Nigeria*, [1977] 2 W.L.R. 356.
[57] *Supra* n.11.

the seller in connection with the sale contract.[58] The use of such credit paved way for the corresponding use of terms in different countries. In France it is termed as "confirmed credit."[59] In America banks named it as irrevocable and avoided the terminology of confirmed or unconfirmed. Thus it can be seen that there is no uniformity in nomenclature of the terms and they do not necessarily mean the same things to all banks even within a country. However the term "irrevocable" and "confirmed" are accepted in the meaning attached to them though earlier they were taken as synonymous. In an earlier case *M. A. Sassoon & Sons Ltd.* v. *International Banking Corporation*[60] Lord Summer[61] said that there was no distinction from a legal point of view between an irrevocable credit and a confirmed credit and that both were concluded contracts. Therefore in actual practice irrevocable credit is also invariably confirmed, which makes the distinction little practical importance.

Another feature of the confirmed credit is that the paying bank does not have a right of recourse against the seller. However if the banker reserves to himself a right of recourse against the seller his undertaking does not constitute a confirmation.[62] This resulted in further classification of "with recourse" and "without recourse."

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[58] Philip W. Thayer, "Irrevocable Credits in International Commerce: Their Legal Nature", 36 Col. L.R. 1031 (1936).
[59] *Ibid.* It is termed as '*Credit Confirme*'
[60] [1927] A.C. 711.
[61] *Id.* at p.724.
[62] *Walibe, Tamari & Sons Ltd.* v. *"Calprogela" Sociedade de Fibras etc.*, [1969] 2 Lloyd's Rep. 18. It is to be noted that if the confirming bank pays the beneficiary under reserve but the issuing bank retain the documents beyond a reasonable time it will become liable to reimburse the confirming bank.

It is a confirmed irrevocable credit which is more beneficial to the parties. It imposes on the confirming bank an absolute obligation to pay and provides the seller with an absolute assurance of payment. The following passage of Jenkins L. J., in *Hamzeh Malas and Sons* v. *British Imex Ltd*,[63] describes the situation effectively,

> "It seems to be plain enough 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 as to whether the goods are up to the contract or not... A vendor of the goods selling against a confirmed letter of credit is selling under the assurance that nothing will prevent him from receiving the price. That is no mean advantage when goods manufactured in one country are being sold in another."

This is the most commonly used instrument by all the parties concerned. It is advantageous to all. The beneficiary is assured of getting his money. The buyer is assured of getting the goods ordered and the bank is assured of obtaining reimbursement. Thus an irrevocable credit gives increased security to the seller.

Sight Credit

This type of credit provides for the drawing of sight or demand draft. The terms of credit call for presentation of a sight draft. The beneficiary presents the draft and documents to his local bank relying upon the promise of the issuing bank. This bank makes payment to the beneficiary immediately after verifying documents tendered. It will be based on the condition that the submitted

[63] [1958] 2 Q.B. 127. It is to be noted that this is a case in which it was held that the bank cannot withdraw from its liability to the exporter even if instructed by the buyer to cancel the credit.

documents comply with the terms and conditions of the letters of credit. The issuing bank carefully examines the documents and on satisfactory examination of the documents releases them to the importer against a receipt. It is simply a process of payment against documents[64].

Deferred Payment Credit

Deferred payment credits were developed in the continent to avoid payment of stamp duty on accepted bills of exchange. Under this type of credit a provision is made in the letter of credit itself for the payment to be made by the bank at a future and determinable time.[65] Buyer has advantages as he can make payment for goods after obtaining the presented documents. The time available to the buyer to make payment could be used by him to resell the goods and use the proceeds for paying. However seller will be in difficult position if he needs immediate money. He can obtain cash by negotiating the letters of credit.[66]

Acceptance Credit

In acceptance credit payment is provided on the date on which the bill of exchange matures. Beneficiary draws a bill of exchange either on the banks or the buyer on tendering of conforming documents, in accordance with the terms and conditions of the credit the bill of exchange in accepted by the bank.[67] The purpose of this type of credit is to give buyer sufficient time to make payment.

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[64] *Supra* n.9 at p.391.
[65] *Ibid.*
[66] See E. P. Ellinger, "Document of Letter of Credit", [1984] J.B.L. 379.
[67] Clive M. Schmithoff, *Schmithoff's Export Trade The Law and Practice of International Trade,* Sweet & Maxwell, London (1993),p. 442.

The bill accepted by the advising bank provides the seller with a considerable degree of security.

Negotiation Credit

This credit empowers the beneficiary to draw a bill of exchange on the issuing bank. The seller can then present the bill to a bank for negotiation together with the original letter of credit and the documents stipulated therein.[68] The main advantage of a negotiation credit lies in the fact that the beneficiary is not limited to receive payment of the credit from the advising bank but may obtain payment from any bank of his choice by drawing a bill of exchange which is guaranteed by the issuing bank.

Back to Back Credit

This type of credit is useful for the beneficiary to receive financial assistance for another sale transaction which he had committed without any difficulty. There will be three banks involved in this credit (a) Bank issuing the original credit to the beneficiary (b) Advising bank through which the credit has been advised (c) Bank which issues an ancillary credit against the security of the original credit.[69]

This type of credit is used to pay the ultimate supplier. The first letter of credit service as collateral for the second credit.

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[68] *Id.*, 423.

[69] S. N. Gupta, *Banking Law and Practice*, Modern Law Publications, Allahabad (2004), p.785

Revolving Credit

This type of credit is used commonly where the buyer is a regular customer of the seller. This is also in cases where the buyer receives goods from the exporter in installments at specified intervals.[70] The main advantage of this credit is that it avoids bank charges and clerical costs to the importer. The meaning of this term was a matter of dispute in *Nordskog* v. *National Bank*.[71] A joint general manager of Lloyd's Bank was called as an expert witness to decide the meaning of the term "revolving credit". During the course of examination it was said that, a revolving credit technically means a credit for a certain sum at any one time outstanding, which is automatically renewed by putting on at the bottom what you have taken off at the top. Therefore it is automatic in its operation and does not need any renewal.

Thus with a revolving letter of credit the issuing bank restores the credit to its original amount once it has been used. Usually these arrangements limit the number of times the buyer may draw down its line over a predetermined period.

Red-clause Credit

Under this credit the seller is able to obtain an advance from the advising bank prior to the presentation of the prescribed documents by the seller.[72] It

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[70] *Supra* n.9 at p. 393.
[71] (1922) 10 Lloyd's Rep. 662.
[72] Hans Van Houtte, *The Law of International Trade*, Sweet & Maxwell, London (2002), p.282. The intention of this credit is to finance the manufacturer.

derives its name from the fact that it was formerly written in red ink. It authorizes the advising bank to advance payment.

The problem with regard to this credit is the risk factor to the buyer. If the seller fails to present the prescribed documents in time and fails to refund the advance, the advising bank will debit the issuing bank with the amount of the advance along with the interest. The issuing bank will take recourse against the buyer. Thus it can be said that in this credit the buyer by extending finance to the seller incurs the risk for all advance credit.

Transferable Credit

This is a common financing tactic for middleman. This credit allows the seller to transfer all or part of the proceeds of the original letter of credit to a second beneficiary. Under this the first beneficiary does not supply the goods himself but act as a middleman and transfers the credit to a third party who will actually ship the goods. It should be specifically stated as "transferable credit".[73] However it is not negotiable like a bill of exchange.

Standby Letters of Credit

This type of credit is similar to guarantee payment. The economic boom after the Second World War produced huge and complex transactions that required the trading community to demand security to ensure that goods and services for which they had paid would be provided in accordance with the

[73] The U.C.P.500, Article 48(b). A detailed discussion of this credit and also obligations of banker will be made in a separate chapter along with the general transfer of credit. Also see the U.C.P.600, Article 38(b).

contract. Often the traders were paid by means of documentary credits and requested guarantees from the producers for which they approached their banks. In response to this need, American, English and European banking system developed the standby letter of credit[74].

In the United States according to the federal law and the laws of some states national banking associates were prohibited from issuing guarantees. To overcome the difficulty caused to the buyer, expression 'letter of credit' was made to include standby credit also.[75] It is a security device where the bank issuing the letter of credit agrees to pay on letter of credit if the beneficiary present document of default.[76] They are often called as non-performing letters of credit because they are used as a backup in the event buyer fails to pay. Even a statement by beneficiary that the other party is in default is enough. Therefore it is functionally similar to that of a bank guarantee[77].

However the principles relating to ordinary letters of credit are applied to standby credit also. In this credit the customer has to establish a rapport with the seller by showing that he can fulfill his payment commitments. They are less complicated and entail a less documentation requirement than irrevocable letters of credit.

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[74] Emmanuel T Laryea, "Payment for Paperless Trade: Are there viable alternatives to the Documentary Credit?", 33 Law &Pol'y Int'l Bus.3 (2001).
[75] D. C. Gardner, *Bonds & Guarantees*, Euromoney, London (1995), p. 16.
[76] Bruce S. Nathan, "Standby Letter of Credit and Strict Compliance Standard: the Case of the Overstated Sight Draft", in http://findarticles.com/p/articles/mi-go1480/is_200410/ai_n7334062. visited on 1st June 2005.
[77] *Supra* n.11.

Since there are various classes of letters of credit, it is necessary to have a clear idea about the type of transaction entered between the parties in order to understand their liabilities in case of failure to perform the obligations.

Evolution of the Law on Documentary Credits

Documentary credits are said to have been invented in the middle ages in connection with the trade of goods[78]. However generally it is considered to have actually developed only in the nineteenth centaury. It was widely used only after the First World War[79]. There is evidence that letter of credit were used in Renaissance Europe, Imperial Rome, ancient Greece, Phoenicia and even in early Egypt.[80] Originally they were used in international trade to reduce the risk of extending credit to unknown buyers. According to Richard Schaffer they evolved as a mercantile specialty entirely separate from common law contract concepts.[81]

The letter of credit was first used to fulfill the purpose of providing a person abroad with money similar to the bill of exchange which excluded the necessity of carrying money for trade. In their earliest forms they were also used by Popes, Princes and other rulers who wished to procure advances for their servants. To understand the origin of the modern documentary credit, one has to start with traditional letter of credit. The salient feature of a traditional letter of credit is as under:

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[78] E.P.Ellinger, *Documentary Letters of Credit- A Comparative Study*, University of Singapore Press, Singapore (1970) p.106.
[79] *Ibid.*
[80] Rufus James Trimble, "The Law Merchant and the Letter of Credit", 61 Harv. L. Rev. 981(1948).
[81] Richard Schaffer, Beverley Earle et.al. (Eds.) *International Business Law and its Environment*, West Educational Publishing Co., Ohio (1999), p.254.

> "The letter of credit is a contract. The issuing authority usually a bank—promises to pay the 'beneficiary'—traditionally a seller of goods—on demand if the beneficiary presents whatever documents may be required by the letter. There are normally the only two parties involved in the contract. The bank which issues a letter of credit acts as a principal, not as agent for its customer, and engages its own credit. The letter of credit thus evidences—irrevocable obligation to honour the draft presented by the beneficiary upon compliance with the terms of the credit"[82].

Apart from this letters of credit was said to have "descended from the law merchant (*lex mercatoria*)-an amalgam of commercial customs which developed independently of contract law for the convenience of merchants"[83]. They are essentially a set of customary rules spontaneously used in the framework of international trade without reference to a particular system of law[84]. There exists a great amount of literature discussing the process by which scholars and courts recognize the documentary credit as a valid instrument. For instance, Trimble regards an irrevocable credit as a mercantile specialty which was binding "because it is so considered by the business world and because it is couched in a form of recognized by the customs of merchants"[85].

During a period of more than a century the letter of credit has developed because of geographically distant parties and the changing needs of the market. They were used as a method of guaranteeing performance of other types of

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[82] Paul R.Verkuil, "Bank Solvency and Guaranty Letters of Credit", 25 Stan.L.Rev.716 (1972-73) at p.719.
[83] M.Kurkela, *Letters of Credit under International Trade Law: U.C.C. U.C.P. and Law Merchant*, Oceana Publications Inc., New York (1984) p.321.See also, Janak De Silva, "The New Law Merchant: Fact or Fiction?", 17 *Sri Lanka Journal of International Law*167 (2005).
[84] H.Veytia, "The Requirement of Justice and Equity in Contracts", 68 Tul.L.Rev.1191 (1995) p.1197.
[85] *Supra* n.74.

obligations. Therefore the traditional commercial letter of credit paved way for "standby" or "guarantee letter of credit.[86]

Common Law Developments

The development of letters of credit in common law was the result of a long struggle culminating in an Act of Parliament to induce the common law to recognize the written instruments of the law merchants.[87] Courts treated them as part of simple contracts. It is generally assumed that the letter of credit is an offer made into a contract by extension of a credit according to its terms. However the development of the instrument of law merchant along liberal lines and its free absorption was stopped by the constructive judges in the earlier times.

Fraud exception also developed in common law as part of letter of credit transaction. As can be seen in famous decision *Derry* v. *Peek*[88] a false act or a false statement done knowingly or without belief in its truth or recklessly, not caring whether it is true or false. Thus in the context of letters of credit in common law, fraud would involve dishonestly making a demand or asserting other than a bonafide demand. In documentary credits, consideration which is an essential element of contract was discarded. However the widespread use of the irrevocable commercial letter of credit after the First World War forced the

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[86] Kozolchyk, "The Emerging Law of Standby Letters of Credit and Bank Guarantees", 24 Ariz. L. Rev. 319 (1982) p. 320.
[87] Omer F. Hershey, "Letters of Credit", 32 Harv. L. R. 1 (1918-19) at p. 10. Also see Davis A. G., *The Law Relating to Commercial Letters of Credit*, Sir Isaac Pitman & Sons Ltd., London (1963), pp. 2-4.
[88] (1889) 14 App. Cas. 337.

common law writers to resort to a rationale that would obviate the nullifying effects of lack of consideration.[89]

Another development in letter of credit was the strict compliance doctrine as against the extreme independence of the bank's duty from the commercial setting. Thus independence and strict compliance as embodied in the letter of credit were one of the law's few working examples of viable "bright line" rules.[90]

Thus it can be seen that earlier "buyer's credit" developed and banker's credit was evolved from common law. The peculiarity of the banker's credit lay in the issue of the letter of credit by a bank instead of by the buyer.

Evolution of Law in the United Kingdom

In United Kingdom commercial letter of credit has a long mercantile history. They got its recognition based on common law principles. Earlier banks in U.K. refused to accept the commercial code formulated by the international chamber of commerce. One of the reasons might have been their desire to retain their independence in dealing with any particular letter of credit. Apart from this the U.K. did not accept it on the basis that it did not conform to the time honoured practices of banks. Later when the code was revised in 1962 there was an active collaboration of British banks which followed their practice.[91] In course

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[89] Boris Kozolchyk, "The Legal Nature of the Irrevocable Commercial Letter of Credit", 14 *American Journal of Comparative Law* 395 (1965-66), at p. 403.
[90] See Comments on, "*Bank of Cochin Ltd.* v. *Manufacturers Hanover Trust*: "Quasi-Strict" Compliance of Documents, Issuer's "Supervisory Curve" and "Reasonable Delay" under Letters of Credit", 18 *University of Miami Inter American Law Review* 539 (1986-87).
[91] *Supra* n.11 at p. 7.

of time courts become familiar with the commercial code and frequently tried to interpret them.[92] However there is no specific legislation in this regard so far.

Developments in Australia

In Australia, law on letter of credit was developed as part of judicial interpretations of contractual principles. When the indigenous banking in many countries of commonwealth mushroomed, they realized the need to adopt a standard code.[93] Thus in 1962, when the revision of International Code was revised, they accepted it. Later High Courts in Australia started referring to the provisions of U.C.P. while deciding cases.[94] In Australia commonly used letters of credit are guarantee based. Banks will undertake to accept a bill of exchange for the amount to be drawn on it by the seller to be accompanied by the stipulated documents. However in this regard there is no special legislation.

Developments in the United States of America

The United States of America is perhaps the only country where law governing letters of credit are developed to the stage of legislation. It was in the nineteen-twenties that, American banks began a more serious campaign to develop letter of credit financing. Apart from this the American courts also showed a strong tendency to treat documentary credits as instruments

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[92] *Banque de l'Indoschine et de Suez* v. *J. H. Rayner (Mincing Lane) Ltd.*, [1983] Q.B. 711, *Forestal Mimosa* v. *Oriental Credit Ltd.*, [1986] 1 W.L.R. 631.

[93] V. V. Keshkamat, *Documentary Letters of Credit – Uniform Customs and Practice,* Vivek Publications, Bombay (1976), p. 55.

[94] *Singer & Friedlander* v. *Creditanstalt-Bankverein*, 17 cg 72180 (1980) as cited in Rolf Eberth and E. P. Ellinger, "Assignment and Presentation of Documents in Commercial Credit Transaction", 24 Ariz. L. Rev. 277 (1982), p. 285.

established by mercantile usage[95]. Lord Campbell articulated this aspect in *Brandao* v. *Barnett*[96]. He stated, "when a general usage has been judicially ascertained and established, it becomes a part of the law merchant, which courts of justice are bound to know and recognize". The Uniform Commercial Code[97] is the legislation governing letters of credit.[98] It is a joint product of the American Law Institute and the conference of commissions on Uniform State Laws.[99] Similarly a number of cases arose in the courts and judges added their profound and often contradictory opinions on these financial instrument.[100] Article 5 of the code deals with letters of credit. It covers some of the rules and principles of letters of credit. Inspite of statutory enactment it gives power to vary the terms of agreement by excluding statutory terms. By the late 1950s and early 1960s, states began to adopt the U.C.C.[101] they were drafted to alleviate state jurisdictional differences.

The original Article 5 was based on a limited body of existing law governing letters of credit at earlier times and made no attempts to expand. The revision of Article 5 of the U.C.C. took place in 1995. This revised Article 5 of the U.C.C. suggests a clear recognition of the U.C.P. as the source for many of the formal requirements and details of letters of credit[102]. The revised provision confirms the rules to current customs and practice and accommodates new forms

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[95] See *Moss* v. *Old Colony Trust Co.*, 140 N.E. 803 as cited in *Supra*.n.16
[96] (1846) 12 Cl. &F 787, *Ibid.*
[97] Hereinafter referred to as U.C.C.
[98] The Uniform Commercial Code, Article 5.
[99] Walter D. Malcolm, "The Uniform Commercial Code in the United States", 12 *International Comparative Law Quarterly* 226 (1963).
[100] Henry Harfield, "Secondary uses of Commercial Credits", 44 Col. L.R. 899 (1944).
[101] Mark S.Blodgett and Donald O.Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud", 35 Am.Bus.L.J.443.
[102] U.C.C.§ 5-116(c) (1995).See also Carlyle C.Ring,Jr., "Key U.C.C. Changes on Letters of Credit are in the works", 13 Banking Poly. Rep.7 (1994). This article provides an interpretation of the changes made in the revised Article 5.

of letters of credit as well as evolving technology[103]. Presently Article 5 covers virtually all letters of credit transaction arising in the commercial context[104]. However the article expressly recognizes other sources of law by stating that "the effect of this article may be varied by agreement or by a provision stated or incorporated by reference in an undertaking"[105]. Section 1-102 codifies "the continued expansion of commercial practices through custom, usage and agreement of the parties".[106] The effect of usage does not permit the parties to vary certain obligations by agreement, such as the obligations of good faith, diligence, reasonableness and care.[107] Another development with regard to letters of credit is the standby letters of credit to overcome the increased risk of security of payment. This resulted in the standby letter of credit used as an instrument to reduce the risk associated with non performance of a contract.

Section 5-102 of the revised Article 5 contains several new provisions. The revision authorizes the use of electronic technology in letter of credit transactions.[108] In addition, deferred payment letters of credit and two-party letter of credit are expressly permitted. Under a deferred payment letter of

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[103] The revised U.C.C., Article 5 on Letters of Credit has received approval from both the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI). The revision process began in 1990 and was completed in 1994. After approval in August 1994 by NCCUSL, the final draft was approved with amendment by the ALI in May 1995.In August 1995,the amended final draft received approval. *Ibid.*

[104] Original Article 5 was drafted before the standby letter of credit became a common commercial device. See John F. Dolan, *The Law of Letters of Credit*, A.S.Pratt&Sons, Washington (1984), p.86.

[105] See U.C.C. § 5-103(c) (1995); See also *Id.* § 5-103 Cmt. 2 "Even within letter of credit law, the article is far from comprehensive .... [I]t is appropriate for the parties and the courts to turn to customs and practice such as the Uniform Customs and Practice for Documentary Credits ...."

[106] *Id.* § 1-102(2) b. More generally, revised Article 5 provides that "[a]n issuer shall observe standard practice of financial institutions that regularly issue of letters of credit. Determination of the issuer's observance of the standard practice is a matter of interpretation for the Court". *Id.* § 5-108 (c). The original Article 5 assumed that standards of practice would be expressly provided for the contract between the parties to a letter of credit. In revised Article 5, the standards apply unless the contract otherwise specifies. *Id.*

[107] *Id.*, § 1-102.

[108] *Supra* n.97.

credit, the letter of credit may be honoured before the beneficiary receives payment because the issuer incurs an unconditional obligation to make payment at some future date.[109] It also codifies rules developed through American case law.[110] Apart from this fraud exception is also the contribution of the United States to the development of law of letter of credit and autonomy principle.[111]

Therefore U.C.C. recognized the need for instrumental uniformity and responded by coordinating the Article 5 rules with current custom and practice and provides solid standards for the governance of letters of credit transaction. It contributed much to the development of the law governing letters of credit in other countries also.

International Initiatives

Letters of credit devices developed by mercantile community, International business community and organizations contributed much to the development of law on letters of credit. Customary rules are followed by merchants in trade. These rules are mostly formulated by the association of merchants involved in international business. These are termed as International Chamber of Commerce rules, generally followed and recognized by courts of most of the countries.

The Uniform Customs and Practice for Documentary Credits provides a set of transnational rules that commercial banks uniformly follow in their letters

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[109] *Ibid.*
[110] *Ibid.*
[111] *Sztejn* v. *J. Henry Schroder Banking Corporation,* 31 N.Y.S. 2d. 631 (1941) as cited in Richard Schaffer et.al, *International Business Law and its Environment*, West Educational Publishing Co., U.S.A. (1999), p. 257.

of credit practice. These rules are not the work of policy makers. They are the creation of private bankers who congregate under the auspices of the Commission on Banking Technique and Practice[112] of the International Chamber of Commerce[113] to draft the rules and offer practice-based interpretations of their meaning. While the U.C.P. is not technically law, courts in the countries frequently use it to decide letter of credit disputes.

The letter of credit ascended to prominence in the United States which was capturing an increasingly large share of the export market. In 1933, the I.C.C. approved and published the first set of rules[114]mainly based on the U.S. lobbying. But this did not gain widespread acceptance until 1951[115]. Thus I.C.C. brought the rules into line with the developments which had taken place in trade[116]. Every decade thereafter, the I.C.C. had kept on revising the U.C.P. to maintain its consonance with banking practice in every decade. The latest revised U.C.P 600 came into effect in 2007.

Another contribution made by the I.C.C. in the area of documentary credit relates to the deciding of rights and responsibilities of banks. They formulated the Uniform Rules for Bank to Bank Reimbursement under documentary credits[117]. These rules have been made in amplification of the U.C.P[118].They have been framed to meet the needs for an international standards which will help the banks while transacting in documentary credit business. These rules are

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[112] Hereinafter referred to as Banking Commission.
[113] Hereinafter referred to as I.C.C.
[114] Clive M. Schmithoff, "The New Uniform Customs for Letters of Credit", [1983] J.B.L. 193.
[115] *Supra* n.93.
[116] *Ibid.*
[117] Published as I.C.C. Brochure 525. Hereinafter referred to as U.R.R.525.
[118] See, the U.C.P.500, Article 19.

applicable to all bank to bank reimbursements once they re incorporated. Accordingly there will be a 'Re-imbursement Authorisation' which stands as an independent term of credit[119]. The reimbursing bank will act on the instructions issued by the issuing bank. These rules are not intended to override the provisions of the U.C.P. In India Foreign Exchange Dealers Association of India has advised member banks that all letters of credit established by them should contain a clause regarding the incorporation of U.R.R.525 in the letters of credit issued[120].

The Documentary Instruments Disputes Resolution Expertise System has been launched by the I.C.C[121]. They are rapid, cost effective and an expert based dispute resolution mechanism for resolving the letters of credit disputes. Bank to Bank reimbursement cases are also included under this purview. Under the DOCDEX any dispute relating to the U.C.P., U.R.R. can be submitted for an expert decision. The verdict given by them is known as DOCDEX decision. There will be a panel of three experts appointed from the list maintained by the Banking Commission. Their service is available for a fee. But the decision is devoid of any legal sanctity. It is usually left to the discretion of the parties whether to adhere or not.

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[119] The U.R.R.525 Article 2(c) states; "Reimbursement Authorisation" shall mean an instruction and 'or authorization, independent of the credit, issued by an Issuing Bank to a Reimbursing Bank to reimburse a claiming Bank, or, if so requested by the Issuing Bank, to accept and pay a time draft(s)drawn on the Reimbursing Bank".

[120] *Documentary Credits & Standby Credits*, Foreign Exchange Dealers Association of India, Mumbai (2004) p.213.

[121] Published as I.C.C. Brochure No.811. Hereinafter referred to as DOCDEX.

Apart from this, I.C.C. has published *International Standard Banking Practice for the Examination of Documents*[122] in 2002. Uncertainities left unanswered by the U.C.P. 500 were filled in this. However it cannot be regarded as comprising standard terms governing the contractual relationships created in the documentary credit. Another development is eU.C.P. It has been created to meet the demands of the market for the presentation of electronic documents. It validates the electronically transmitted documents as regards their tender under the documentary credit. They do not combat the commercial risks involved. They protect banks and pass the risk of fraud to the applicant.[123]However they remained as paper work. Therefore in order to make eU.C.P. effective they have now added as a supplement to the U.C.P.600. Thus read together, the U.C.P and the eU.C.P. provide the necessary rules for electronic presentation of documents in documentary credit transactions.

The recently revised U.C.P.600 rule on documentary credit[124] contains substantive changes to the existing rules[125]. One of the main purposes of the revision of the U.C.P was to enhance the reputation of the rules as a payment mechanism. The new U.C.P.600 contains within the text the 12 articles of the eU.C.P.[126]The major changes are as follows:

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[122] Published as I.C.C. Brochure 645.
[123] Notes, "Use of I.C.C. Guidelines", [2004] J.B.L. 704.
[124] The U.C.P. revision 2007, U.C.P.600 came in force from July 1, 2007. Gary Collyer was the head of the drafting group that developed the rules. He cites the obvious advantages of the new U.C.P as an easier to read text and a simplified structure among others. He also cites some of the issues that were not completely addressed, including Corporate-issued letters of credit and how to deal with inconsistent data among documents in a presentation.
[125] *Ibid.*
[126] *Ibid.* It is to be noted that I.C.C.'s supplement to the U.C.P governs presentation of documents in electronic or part-electronic form. In this discussion 170 participants from 40 countries were present.

(a) A leaner set of rules with 39 articles rather than 49 articles of U.C.P.500.

(b) A new section of definitions containing terms such as "honour" and "negotiation".

(c) Replacement of the term "reasonable time" with a definite number of days for examining and determining compliance of documents.

(d) A new provision concerning addresses of the beneficiary and the applicant.

(e) An expanded discussion of "original documents".

(f) Re-drafted transport articles aimed at resolving confusion over the identification of carriers and agents.

However the U.C.P.600 is not adequate to decide all the issues raised by banks and parties. This difficulty is due to the peculiar nature of these instruments and the different trade practices.

UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit

The United Nations Commission on International Trade Law[127] also works for harmonization of letter of credit laws at the international level. Within UNCITRAL, the I.C.C. presents the views of international banks.[128] They initiated the U.N. Convention on Independent Guarantees and Standby Letters of Credit. They differ from the U.C.P. While U.C.P. is considered as private law, the convention is public law. Apart from this UNCITRAL also provides for injunctive relief to thwart fraudulent demands.[129]

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[127] Hereinafter referred to as UNCITRAL.

[128] Charles Del Busto, *I.C.C. Guide to Documentary Credit Operations*, I.C.C.Publications,Paris (1994) p. 3.

[129] Mark S. Blodgett and Donald O. Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud", 35 Am. Bus. L. J. 443 (1998).

UNCITRAL has a long standing involvement with the I.C.C. on issues relating to documentary credits and guarantees. In 1992 UNCITRAL's working group on international contract practices proposed a convention on guarantee letters. It states,

> "to bring the language in line with the commonly used in letter of credit decisional law and to elaborate on the meaning of fraud in this context, i.e., in identifying hidden defects in the presentation that are so serious as to permit the issuer (or a court) to ignore the independence of the undertaking".[130]

The Convention on Independent Guarantees and Standby Letters of Credit has been approved by the United Nations General Assembly. Later the convention was adopted at 28th UNCITRAL Session in 1995.[131] It contains rules on independent undertakings made by banks in order to support payment of goods. However this convention applies to an international undertaking if the place of business of the guarantor or issuer is in a state that has adopted the convention. This will not apply if the undertaking excludes the application of convention. The convention also applies if it expressly states that it applies to an international letter of credit.[132]

The difficulty is that being a convention, it needs to be ratified by different countries to get legal sanction.

Later with an intention to bring compatibility with the UNCITRAL Convention the Institute of International Banking Law and Practice and the I.C.C.

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[130] UNCITRAL, Independent Guarantees and Stand-by Letters of Credit, 18th Sess. at 17, U.N. Doc. A/C N.9/WG II/WP.76 (1992).
[131] Adopted by Resolution of the General Assembly on December 11, 1995.
[132] An undertaking is said to be international if any two of the issuer, the applicant, the confirmer and the beneficiary are located in different states.

designed International Standby Practice in 1998[133]. ISP 98 reflects the generally accepted practice, customs and usage of standby letters of credit. They simplify, standardize and streamline the drafting of standby letters of credit. Apart from this they also help to provide clear and widely accepted answers to common problems found with these instruments. These rules can be made applicable by incorporating an undertaking in the contract that they have been made subject to these provisions. This will in turn help to avoid many disputes and unnecessary litigation. They can also be used in arbitration as well as judicial proceedings[134].

Therefore ISP 98 and the UNCITRAL Convention supplement each other in an ideal manner and together lay the necessary basis for a smooth functioning of standby letter of credit practice world wide.

Evolution of Documentary Credit Law in India

In India also documentary credits are extensively used for import and export of goods. Documentary credit are used in international trade transactions. In domestic transactions bank guarantees are prevalent. In contracts where government is a party, bank guarantees are insisted upon as a measure of assurance of performance of contracts[135]. There is no special legislation governing documentary credit in India. Therefore courts in India

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[133] International Standby Practices (ISP 98) came into effect on January 1, 1999.Hereinafter referred to as ISP 98.

[134] Here arbitration refers to the expert based letter of credit arbitration system developed by the International Center for Letter of Credit Arbitratio of I.C.C. See, Isabella Chung, "Developing a Documnetary Credit Dispute Resolution System: An ICC Perspective", Fordham Int'l. L. J. 1349 (1996).

[135] T.S.Venkatesa Iyer, *The Law of Contacts and Tender*, S.Gogia&Co., Hyderabad (1999), p.521.

apply the common law principles of contract[136], special rules of indemnity and suretyship[137] apart from the rules formulated by association of merchants and trade practices[138].

The judicial decision relating to documentary credit demonstrates that courts interfere and grant interim injunction only under exceptional circumstances. Most of the cases that came before courts were adjudicated under the Contract Act, 1872[139]. The courts determine the obligations of the parties under the instrument depending on the precise terms of the contract they have entered into. In *Texmaco* v. *State Bank of India,* [140]the terms of the guarantee were wide. The bank undertook to pay the beneficiary on demand. It also agreed that the beneficiary's decision as to the banks liability under the guarantee would be final and binding. The Calcutta High Court refused to grant injunction restraining the bank from making payment to the beneficiary. The court held that the terms of the bank guarantee determine its enforceability by the beneficiary. The guarantor bank cannot be restrained from fulfilling the obligations it has undertaken under the guarantee.

The importance given by courts in India to the terms of guarantee can be seen in a decision rendered by the Delhi High Court[141] also. The court refused to restrain the bank from making payment to the beneficiary on the basis of non

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[136] *U.P.Co-operative Federation Ltd.* v. *Singh Consultants and Engineers (P) Ltd,* (1988)1S.C.C. 174.
[137] *Texmaco Ltd* v. *State Bank of India,* A.I.R. 1979 Cal. 44.
[138] For example Uniform Customs and Practice for Documentary Credits formulated by International Chamber of Commerce.
[139] The Contract Act 1872, s. 126 deals with Contract of Guarantee.
[140] *Supra* n.137.
[141] *Banwarilal Radha Mohan* v. *Punjab State Co-operative Supply &Marketing Federation Ltd,* A.I.R. 1982 Del. 357. Also see *Crown Maritime Co.* v. *ECON Engineering Pvt Ltd,* A.I.R.2003 Bom. 163., *Daewoo Motors India Ltd* v. *Union of India,* A.I.R. 2003 S.C.1786.

compliance with the terms of guarantee. In this case bank guarantee contained an undertaking `to pay without any demur` on demand from the beneficiary stating that the amount claimed was due and payable by way of loss or damage caused to or would be caused to or suffered by him due to breach of supply contract by the seller. The bank agreed that any demand made shall be conclusive as regards the amount due and payable by the bank under the guarantee. However, the learned judge opined that the beneficiary should make out a *prima facie* case in support of his demand[142].Therefore if the beneficiary complies with the terms of the guarantee the bank is under an obligation to pay. The courts refused to infer the principle of *audi alteram partem* in the contractual terms. The court observed that the doctrine has no application to contractual relationship particularly where the parties have themselves entered into the arrangement and the banker as a party is bound to pay without demur to the other on mere demand[143]. The Gujarat High Court also gave importance to the terms of the contract of guarantee in *Amrok Logistics Trading Pvt Ltd.* v. *Digvijay Cement Company Ltd* [144]. In this case an injunction was sought against encashment of the bank guarantee. The court refused to grant the injunction as there was no clause in the bank guarantee which made it conditional or subject to certain clause that may be part of the principal agreement between the parties. On the contrary the bank guarantees unequivocally stated that it was unconditional and unequivocal and the bank agreed to pay on demand without any demur on demand made by the beneficiary. The Bombay High Court treated bank guarantee as a special contract that could be enforced according to its

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[142] See in this connection, the observations of a Division Bench of Delhi High Court in *Harprasad &Co Ltd* v. *Sudarshan Steel Rolling Mills*, A.I.R. 1980 Del. 174 and of D.K.Sen J., in *Road Machines(India)Ltd Projects and Equipment Corporation of India Ltd.*, A.I.R.1983 Cal. 91.
[143] *Supra* n.137.
[144] A.I.R.2001 Guj. 299.

terms. Thus in *Union Bank of India*[145] case it was observed that if the bank guarantee is unconditional and payment was to be made on demand, the bank was under no obligation to find out whether any default was committed. Once the beneficiary invoked the guarantee and made a demand the bank was obliged to make the payment. A similar view was expressed by the Kerala High court[146] when condition for invoking guarantee was only a demand from the beneficiary.

The Supreme Court went to the extent of stating that pendency of arbitration proceeding for adjudication of inter se disputes between the parties is not a ground for preventing the beneficiary from invoking the guarantee[147]. In *Hindustan Construction Co. Ltd* v. *State of Bihar* [148]there was a specific term in the bank guarantee that the guarantee could be invoked only upon the breach of that particular term. It was held that invocation of bank guarantee had to be in accordance with the terms of the guarantee, otherwise the invocation would be untenable.

Courts grant injunctions only if contracts are concluded and not when they are in negotiating stage. Thus the Gujarat High Court in *Adani Exports Ltd.*,[149]case observed that if there was no concluded contract between the parties and the matter was at offer and negotiation stage injunction could be granted. However any amendment in the condition of the concluded underlying

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[145] *Union Bank of India* v. *J.B.Khanna &Co*, A.I.R.1996 Bom. 409.
[146] *S.A.Sattar* v. *Kuruvilla* A.I.R.1998 Ker. 292.
[147] *National Thermal Power Corporation Ltd* v. *Flowmore Pvt Ltd*, (1995) 4 S.C.C.515, also see *Association of Corporation and Apex Societies of Handlooms* v. *State of Bihar*, A.I.R.2000 Del.106., *Pesticides India,Props Mewar Oil &General Mills Ltd* v. *State Chemicals &Pharmaceuticals Corporation of India*, A.I.R.1998 Del. 78.
[148] A.I.R.1999 S.C. 3710. For a similar view see, *Maharastra State Electric Board* v *Official Liquidator, High Court*, A.I.R. 1982 S.C. 1497.
[149] *Adani Export Ltd* v. *Hindustan Organic Chemical*, (2003) 3 Guj. L.R.2759.

contract would not affect the bank guarantee[150]. In *Intercontinental (India)*[151] case it was held that injunction against invocation of bank guarantee cannot be ordered on the ground that there was no concluded contract. When bank guarantee was unconditional and irrevocable and there was a covenant in the bank guarantee that change in terms and condition of the contract would not affect the bank guarantee then even if some changes were made it would not affect the bank guarantee once parties acted upon it.

The principle of indemnity is applied in documentary credit case also. It is considered that the bank acts as a surety and promise to the beneficiary that in case of default of principal debtor specified amounts will be paid to him on presentation of documents specified in the guarantee. The Andra Pradesh High Court tried to point out the difference between contract of guarantee and contracts of indemnity, in *Nagpur Nagarik Sahakari Bank Ltd* v. *Union of India*[152]. In this case there were two agreements. One was between the sole advertising agent and the government and the other was between the bank and the government. It found that the second agreement contained the features of guarantee. The court held that the two documents had to be read in conjunction and a valid contract of guarantee could be found. The court pointed out that while a contract of indemnity is bilateral, a contract of guarantee is trilateral. Here also the terms incorporated in the guarantee document determine whether the obligation of the bank is similar to that arising under a contract of indemnity or suretyship contract. Thus if the terms of bank guarantee provide that the

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[150] *Vinitec Electronics Pvt Ltd* v. *HCL Infosystems Ltd*, A.I.R.2005 Del. 314.
[151] *Intercontinental (India)* v. *Indian Sugar & General Industries Export Import Corpn.*, A.I.R. 2001 Guj. 227.
[152] A.I.R. 1981 A.P.153.

bank would be liable only if its customer committed default of the underlying contract, the bankers obligation would be the same as that of a surety under a contract of guarantee. If, on the other hand, it is stipulated that the liability of the bank will be independent of the underlying contract between the parties, the banker's obligation can be equated to that arising under a contract of indemnity. Here the bank will be directly bound by the demand made under the guarantee irrespective of whether its customer had committed a breach of underlying contract. The learned judge in *Premier Tyres Ltd* v. *State Trading Corporation of India* [153], expressed the view that a bank guarantee was not to be treated as a guarantee under the Indian Contract Act,1872. It is a contract of indemnity because the provisions dealing with guarantee speak of three persons whereas an indemnity is between two persons. In this case the bank undertook to pay State Trading Corporation in case of default to observe certain conditions by the Premier Tyre Limited. Hence the banks obligation to pay was contingent upon the default of Premier Tyers.

In *Centax (India) Ltd*[154] case, a letter of credit was issued by a bank. However the applicant failed to receive the original bill of lading from the seller beneficiary. In order to claim the goods, the applicant received letters of guarantee in favour of the shipping company for release of the goods in lieu of the original documents. When a demand was made by the shipping company to honor the letter of indemnity, the applicant filed a suit to restrain the bank from making payment to the shipping company in terms of the letter of indemnity.

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[153] (1981) 51 Com. Cas. 316 (Del.).
[154] *Centax (India)Ltd* v. *Vinmar Impex Inc & Others*, (1986) 4 S.C.C.136.

The Supreme court upheld the letter of indemnity and refused to restrain the bank from making payment[155].

If there is term which stipulates that the bank guarantee is encashable only if it is proved that there is breach of contract by the supplier of goods, then the arbitral award or court decree to that effect will have to be produced[156]. Therefore courts interpret the terms of document either as part of the contract of indemnity or as part of contract of guarantee.

The courts in India have also tried to introduce the concept of equity while dealing with letters of credit or bank guarantee cases. The High Court of Delhi in *Harprashad &Co Ltd* v. *Sudarshan Steel Polling Mills* [157],observed that while the law as generally stated is that liability arising out of the unilateral contracts of commercial credits, such as letters of credit, bank guarantee and performance bonds is absolute, the intention of the parties as gathered from a reasonable construction of the language of the particular contract must ultimately govern the decision of the court regarding the liability. The term of a particular document may even constitute an exception to the general rule. The bench agreed that it was just and fair that the buyer should not be allowed to recover the amount of guarantee. The court said,

> "...The (buyer) is simply seeking to grab the amount of the bank guarantee without any equity or justice in its favor merely as a means of unjust enrichment. However, the bank is not concerned with the equities involved and it will have to pay if the term of the

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[155] For similar view see *Damodar Paints Pvt Ltd* v. *Indian Oil Corporation Ltd.*, (1983) 54 Com.Cas. 114 (Del.).
[156] For example see *Bhushan Industrial Company (P)Ltd* v. *Cimmco International*, (1983)54 Com. Cas. 157 (Del.), *Larsen & Tourbo Ltd* v. *Maharastra State Electricity Board*, (1995) 4 Comp.L.J.476 (S.C.).
[157] A.I.R. 1980 Del. 174.

guarantee is fulfilled except where the beneficiaries demand is fraudulent"[158].

The above analysis shows that courts in India equate letters of credit, bank guarantees and performance guarantee on an equal footing. The observations in this regard can be seen in decisions of various high courts and the Supreme Court. The Delhi High Court in *Pesticides India* v. *State Chemicals &Pharmaceuticals Corporation of India Ltd*,[159] said,

> "This performance guarantee, as it is called, is very much like a confirmed letters of credit. It stands on the same footing as an irrevocable documentary credit. It has many similarities to a letter of credit. It has been long established that when a letter of credit is issued and confirmed by a bank, the bank must pay if the documents are in order and the terms of the credit are satisfied. As in the case of irrevocable letters of credit the bank is not concerned to see whether one party has committed the breach or the other, so in the case of this performance guarantees the bank agree to pay the amount on the happening of a specified event"[160].

In *A.V.N.Tubes Ltd* v. *Steel Authority of India*[161], the Madhya Pradesh High Court observed,

> "....In modern commercial transactions, various devices are used to ensure performance by the contracting parties. The traditional letters of credit has taken a new meaning. They are also known as stand-by letters of credit, performance bond and guarantee bonds are other devices increasingly adopted in commercial transaction. The courts have treated such documents as analogous to letters of credit"[162]...."

However Calcutta High Court examined the distinction between irrevocable letters of credit and bank guarantee in *State Bank of India* v.

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[158] *Id.* at p.180.
[159] A.I.R.1982 Del. 78.
[160] *Id.* at p.81.
[161] A.I.R.1996 M.P.53.
[162] *Id.* at p.60.

Economic Trading Corporation[163] and *Minerals and Metals Trading Corporation of India* v. *Suryaballav Seth*[164]. The court opined that a bank guarantee does not enjoy the autonomy of an irrevocable letter of credit since it depends upon a contract between the beneficiary and a third party. Unless there is some act of commission or omission on the part of the third party, payment under the guarantee does not become due. Similarly, in granting an injunction there seems to be a difference. In case of letter of credit there is no need for the beneficiary to show that he suffered some loss. Any dispute between him and the other party is not a basis. However, in case of guarantee it is necessary to show evidence leading to the prima facie conclusion that the beneficiary had suffered a loss which gave him a right to enforce the guarantee. The court however reiterated that the payment under a bank guarantee is like payment under letter of credit and becomes due only on compliance with the terms on which the bank was to pay under the respective documents. It can be seen that courts have tried to draw a parallel between letters of credit and bank guarantees as regards their independence from the underlying sale of other contracts. The Supreme Court emphasized the need to follow and apply the law laid down by it to examine the terms of the bank guarantee and letters of credit and cautioned the lower courts from creating judicial adventurism by deviating from the propositions laid down by it[165].

In India letters of credit are treated like credit notes which are freely encashable. This can be seen from the decision of the Rajasthan High court in *Basant Rlymers, Alwar* v. *State Chemical and Pharmaceuticals Corporation of*

[163] A.I.R.1975 Cal. 145.
[164] (1970)74 Cal W.N.991.
[165] *Dwarikesh Sugar Industries Ltd* v. *Prem Heavy Engg.Works (P) Ltd.*, A.I.R.1997 S.C.2477.

India[166]. The court said that bank guarantees are encashable like credit notes and courts will not normally interfere with it. If there is an impediment in encashing the bank guarantee, the whole foundation of banking system will collapse and people will lose faith in it. In *Road Machines(India)Pvt.Ltd.* v. *The Projects &Equipment Corpn. of India Ltd.*[167], it was stated that bank guarantee is a commercial document.

Indian courts also follow the mercantile rules of practice which are universally accepted in dealing with documentary credit transactions. For example the Supreme Court in *Tarapore & Co.* v. *Tractors Export Moscow*[168], upheld the importance of the Uniform Customs &Practice for Documentary Credits issued by the International Chamber of Commerce[169]. Again the question of applicability of U.C.P. was raised in *United Commercial Bank* v. *Bank of India*[170] with regard to a dispute based on liability of the banker arising out of a contract of letter of credit. The court observed,

> "Banker's commercial credits are almost without exception everywhere made subject to the code entitled the 'Uniform Customs and Practices for Documentary Credits', by which the General Provisions and Definitions and the Articles following are to "apply to all documentary credit and binding upon all parties thereto unless expressly agreed". A banker issuing or confirming an irrevocable credit usually undertakes to honour drafts negotiated or to reimburse in respect of drafts paid by the paying or negotiating intermediate banker and the credit is thus in the hands of the beneficiary binding against the banker...".[171]

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[166] A.I.R.1986 Raj. 1.
[167] A.I.R 1980 Del. 174 D.B.
[168] 1969(1) S.C.C.233.
[169] hereinafter referred to as U.C.P.
[170] A.I.R.1981 S.C 1426. Also see *Hindustan Zinc Ltd* v. *Punjab National Bank*, A.I.R.2002 Del.398.
[171] *Id.*at p.1435.

The Supreme Court in *Federal Bank Ltd* v. *V.M.Jog Engineering Ltd.* [172]also analysed the application of the code of practice of merchants. The court observed that in the absence of incorporation, the UCP will not apply. But it can be taken into account as part of the mercantile customs and practices. Most of them are treated as part of common law.

It can be seen from the above discussion that in various cases the Supreme Court has tried to reiterate the law on the shape of judicial interference with the invocation of letters of credit and bank guarantees. India does not admit any debate or doubt with regard to legal principles in documentary credits. The Courts refuse to interfere with the invocation of these instruments. They rely on foreign precedents which lay down wider propositions. However the Supreme Court in *BSES Ltd* v *Fenner India Ltd.*[173], refused to incorporate the wider proposition of fraud exception in India. The case related to the granting of injunction against enforcement of a bank guarantee.

Reserve Bank of India also regulates the letter of credit transactions in India. It issues circulars from time to time regulating these transactions. The Banking Regulation Act, 1949, empowers the banks to carry on "every kind of letters of credit, guarantees and indemnity business"[174]. According to the Reserve Bank guidelines, banks should confine themselves to the provisions of letters of credit and exercise due care with regard to honoring these instruments. The Reserve Bank also issues directives to banks issuing letters of credit keeping the

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[172] A.I.R 2000 S.C.3166.
[173] A.I.R.2006 S.C.1148.
[174] The Banking Regulation Act, 1949, s.6.

spirit of UCP principles[175]. Apart from this, the Foreign Exchange Dealers Association of India, a voluntary trade association has advised its member banks that all letters of credit opened by them with effect from 1st January, 1994 should contain the following clause,

> "Except as otherwise expressly stated, this Documentary Credit is subject to the Uniform Customs and Practice for Documentary Credits (1993 Revision) International Chamber of Commerce Publication No.500"[176].

The revised U.C.P.600[177] is yet to be implemented in India. It is necessary to incorporate the changes brought at International level.

Bank Solvency and Documentary Credit

The creation of new uses for the letter of credit is the result of the "ingenuity of bankers" and the elastic nature of the letters of credit.[178] These new uses entail new risks and different assumptions from those associated with the traditional letter of credit in the sale of goods context. In acquiring the functions of guaranties and acceptances, the letter of credit transaction unavoidably has become subject to a whole series of charged calculations.

Solvency of bank issuing letter of credit is important because it undertakes to pay the beneficiary on presentation of the required documents. The beneficiary will receive timely payment notwithstanding the bankruptcy filing

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[175] For instance, the Master Circular DBOD No.Dir.BC 7/13.03/00 2002-2003 dated 26 July 2002 issued by the R.B.I. contains guidelines regulating the guarantee business.
[176] Circular letter 1992/UCP/500/SPL-71/93 dated 3.11.1993.
[177] ICC Uniform Customs and Practice for Documentary Practice, 2007 Revision, ICC Publication No.600, ISBN 92-842-1257-X, http/www.iccbooks.com, visited cite on 28.07.2007.
[178] W. Ward & H. Harfield, *Bank Credits and Acceptances*, Ronald Press Co., New York (1958). Also Weistart, "Consumer Protection in the Credit Card Industry: Federal Legislative Control", 70 Mich. L. Rev. 1476 (1972).

by the issuing bank[179]. Therefore how the bank places the letter of credit in their books is important. Traditionally, letters of credit have been considered as "contingent liabilities" which are not reflected in the bank's balance sheet.[180] The bank's balance sheet is the basis for determining whether it has exceeded the lending limits established to assure bank solvency. There will always be regulation regarding the lending limit.[181] Now the functional aspect of letters of credit is changing. The question is whether the same result is justified with respect of guaranty letter of credit. Earlier the letter of credit did not seek to insure performance by the beneficiary once payment is made. The bank is less exposed because its interest in the goods is represented by the title documents transferred. But with a guaranty letter of credit, the bank does seek to insure performance of the underlying agreement and receives no security upon payment to the beneficiary. The account receivable from its customer which the bank enters on its balance sheet after payment is almost always worthless, since it is receivable from a party that has already defaulted on its principal obligation. Thus, the liability created by the guaranty letter of credit is not contingent in the same way as the liability created by the traditional letter of credit.[182]

Therefore if a bank continues to treat guaranty letter of credit as traditional letters of credit the risk of bank insolvency is a real one. This will itself be a reason for a bank to become insolvent. The solvency problem is inherent in the reckless issuance of guaranty letter of credit by a bank. So long as the

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[179] Stanley F. Farrar, "Survey on Letters of Credit", 39 Bus. Law 1319 (1984), also see, *In re Twist Cap Inc.*, 1 Bankr. 284 (Bankr. D. Fla. 1979) as cited in *Ibid.*

[180] Paul R. Verkuil, "Bank Solvency and Guaranty Letters of Credit", 25 Stan. L. Rev. 716.

[181] For instance *The National Bank Act* 1864 of U.S. establishes liability limits by requiring that a national bank shall nor "at any time be indebted, or in any way liable, to an amount exceeding the amount of its capital stock ... plus 50 percent of the amount of its unimpaired surplus fund. In additional, no national bank may lend more than ten percent of its capital funds to one customer.

[182] *Supra* n.180.

issuing bank remains solvent, the character of asset and liabilities is not in issue, nor will arise the question whether the bank's credit is super imposed upon or substituted for that of the buyer.[183] But when issuing bank becomes insolvent the nature of asset and liability and the relation of the parties become the chief problem.

Hence the solvency of bank needs to be analysed in the modern letter of credit function than in the traditional form. Sound banking practice requires more caution in the issuance of guaranty letters for credit than in the issuance of the traditional variety. If such caution is not employed there is a serious threat to bank solvency that could well lead to a series of bank failures.[184]

Electronic Documentary Credits

The documentary credit mechanism can operate electronically without major problems. Moreover, electronic documentary credits remain the best option in the current age. Much trade credit related informations are electronically transmitted now a days[185]. The major hindrance to a complete electronic trade credit system is not the digitization of the credit transaction itself but the absence of a generally accepted electronic bill of lading system.[186] For credits to operate electronically, the creation, communications and documentary exchanges under the various arrangements must be capable of electronic

[183] From the inception of letter of credit transaction by issuing the bank's books reflect the buyer's obligation to the bank and the bank's obligation to the seller as an asset and liability of the bank respectively. See for details Julius L. Neidle and Walter Bishop, "Commercial Letter of Credit: Effect of Suspension of Issuing Bank", 32 Col. L. R. I (1932).

[184] In India these changes in letter of credit function are hardly felt. However to meet the international competition in banking sector there is likelihood of performances and wide use of these forum of letter of credit.

[185] R David Whitaker, "Electronic Documentary Credits", 46 *Business Lawyer*.1781 (1991).

[186] *Ibid.* at p.1782.

operation. An electronically concluded contract for the issue of a credit will have all the legal qualities of its paper counterpart in many jurisdictions. It would constitute a binding contract between parties and legal evidence in the event of dispute.[187]

In view of the enormous benefits electronic processes offer,[188] banks in developed countries now encourage electronic applications for credits[189] to which importers with the relevant equipments have been positively responding. Some banks have open systems for credit applications on the internet,[190] while others maintain closed systems that connect the banks and their customers. The system enables customers to check the progress of credits online.[191]

Electronic Variant of the Documentary Credit Procedure

Inter-bank communication of credit instructions and credit-related information has long been electronic mainly through the society for world wide Inter-bank Financial Tele-communication.[192]The procedure is vividly described by Samuel Newman as follows,

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[187] For the evidential status of electronic data as evidence, See Christopher Nicoll, "Should Computers be Trusted? Hearsay and Authentication with Special Performance to Electronic Commerce", [1999] J.B.L. 332. Also C. C. Nicoll, "Can Computers Make Contracts", [1998] J.B.L. 35, Emmanuel T. Laryea, "The Evidential Status of Electronic Data", 3 Nat'l. L. Rev. (May 1999) at http://www.nlr.com., visited on 12.05.07.

[188] Electronic processes are quick and save time and costs. They are also amenable to automation, which further hastens the processing of applications and reduces data re-entry and the associated potential for errors. See Christopher Nicoll, "E.D.I. Evidence and the Vienna Contention", [1995] J.B.L. 21 at p.22.

[189] Michael Rowe, "Automating International Trade Payments - - Legal and Regulatory Issues", 4 *Journal of International Business Law.* 234 (1987), p.235.

[190] See, e.g. *West Pac Banking Corp., Imex Trade Banking Online,* at http://www.westpac.com.au/internat/publish.nsf/content/CB+HomePage (last visited Jan. 8, 2002).

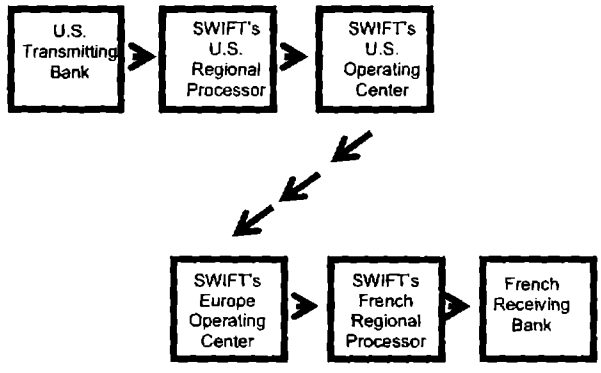
[191] *Supra* n.185.

[192] Hereinafter referred to SWIFT. It is a computerized telecommunication network for transmitting messages, connects the world's major banks. It has functioned across different legal systems without problems.

> "A Swift message originates from a network user ... for example, the issuing bank ... and is communicated to the nearest SWIFT access point, one of which is located within most member countries. From the access point the message is routed to the Regional Processor, "the gateway to SWIFT system", where validation of the message is performed, after which the message is routed to the main switching or operating center."[193]

From the operating center, the message is routed to the receiving bank through the Regional Processor in its region and the SWIFT access point in the receiving bank's country[194] Electronic messaging of credits through SWIFT is effective. The following chart will illustrate the SWIFT mechanisms[195] and process of electronic collection:

Routing of Financial message through SWIFT



Legend:

(1) Arrows indicate the routing of financial messages from a United States bank to a French bank.

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[193] See Samuel Newman, Society for Worldwide Inter-bank Financial Telecommunication (SWIFT), in Robert C Effros (Ed.), *Payment Systems of the World*, Oceana Publications, New York (1994), at p.396.

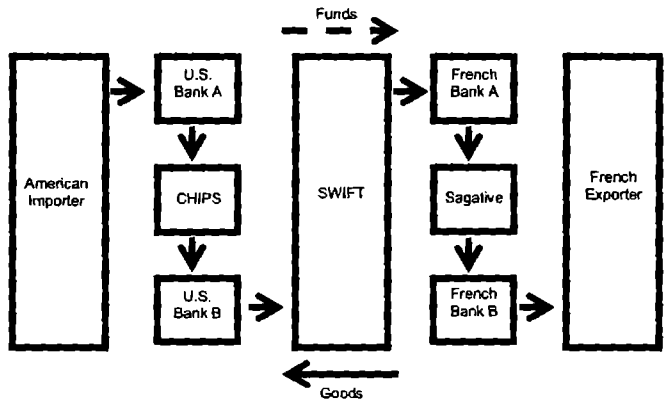
[194] *Id.*

[195] Adapted from Samuel O. Maduegbuna, "The Effects of Electronic Banking Techniques on the use of Paper-based Payment Mechanisms in International Trade", [1994] J.B.L. 338 at p.354.

(2) SWIFT has two operating centers in the Netherlands and in the United States.

(3) Messages from the United States to France thus pass first through the respective countries' regional processors and then through the operating centers to the bank in France.

Electronic Trade Payment Through SWIFT



Legend:

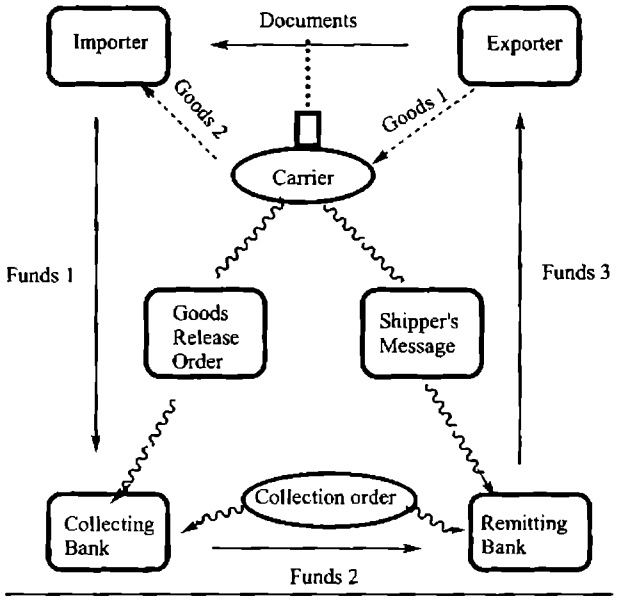
(1) Arrows indicate the movement of funds tele-transmitted from the American importer through its bank and ultimately to the French importer.

(2) It is assumed that U.S. Bank A does not have a correspondent relationship with banks in France, so through CHIPS (the New York automated clearing house) it transfers the responsibility for the transmission of the funds to U.S. Bank B that correspondent relationship with French Bank A.

(3) U.S. Bank B then through SWIFT remits the money to French Bank A

(4) French Bank A through SAGITTAIRE (the automated clearing house for French banks) sends the money to the exporter's bank (French Bank B) which then credits its account.

Flowchart of the Process of Electronic Collection[196]



Legend:

Arrows indicate flow of responsibility from party to party.

Wire message from Carrier to Banks ensure that Goods are released as per Exporter's instructions.

Wire message between Remitting bank and Collecting Bank transmits the collection instructions.

[196] Adapted from M. Rowe, *Electronic Trade Payments: A Practical Guide to Electronic Banking and International Trade*, IBC Ltd., London (1981), at p.346.

Thus considered separately from the other autonomous but inter connecting contracts of an international sale transaction, the documentary credit as a payment mechanism is capable of electronically operations. However traditional paper method remains dominant[197].

A Critical Appraisal of Documentary Credit Law

The documentary letters of credit transaction is the most common method of payment for goods in international trade. Banks, manufacturers and those indulged in commerce all over the world have relied upon the documentary credits from time immemorial. Originally it was conceived as a method of reducing the uncertainties such as doubt as to the buyer's intentions, reliability, or good faith, and difficulties of foreign litigation that occur when some one sells goods and services to a buyer in a foreign land[198], it has now become a basic tool for a fully developed banking business.

In letters of credit law, banker's obligation is based on the principle of autonomy. It helps the business communities dealing in international trade. The seller is assured of payment on tender of documents mentioned in the letter of credit. However sometimes abuse of this power has taken place in collusion with persons involved in this transaction. Buyer is often put to hardships. It is for the concerned states to take care of this abuse.

Although documentary credit has served international commerce well, they are not without problems. The main operative problems of documentary credit are delay, cost and fraud. The procedure for letter of credit takes too long

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[197] Emmanuel T. Laryea, "Payment for Paperless Trade: Are There Viable Alternatives To The Documentary Credit?", 33 Law & Policy Int'l. Bus. 3 (2001).
[198] Wiley, "How to use Letters of Credit in Financing the Sale of Goods", 20 *Business Lawyer* 495 (1965).

as its mechanism involves the movement to issue and transmit paper documents.[199] By the time the exporter gathers and presents the stipulated documents for payment, considerable time may have elapsed. Another cause of delay is that documents tendered are often discrepant with credit terms. Discrepancy in tendered documents causes delays because of the fundamental principle of documentary credit law that documents must strictly comply with the terms of the credit.[200] Apart from this if the discrepancies are minor, banks often used to inquire from their customers whether they wish to waive their right to reject the discrepant documents. The process of consultation with customers on discrepant documents causes further delays.

Along with the increased use of letter of credit it has become an area for growing volume of litigation, particularly litigation over fraud. As the triggering event for payment under trade credits is the presentation of specified documents, crooked sellers may ship rubbish or send no goods at all and forge all the documents to obtain payment.[201] As a result fraud exception is recognized as part of onerous duty of bank.[202] In case of real fraud there is no effective remedy. Therefore to what extent fraud helps promotion and scope of fraudulent activities of beneficiary requires detailed examination. Along with this there is a need to limit autonomy principle and regulation of fraud. Fraud exception should be accepted to the minimum possible level. A detailed study is required in this area.

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[199] Leonard W. Krouner, "Profile on Indorsements in Letters of Indemnity", 14 *Journal of International Business Law* 271 (1986), at p.275.
[200] Roy Goode, "Abstract Payment Undertaking and the Rules of the International Chamber of Commerce", 39 *St. Louis University Law Journal* 725 (1995), p.740.
[201] See Note, "Fraud in the Transaction: Enjoining Letters of Credit during the Iranian Revolution", 93 Harv. L. Rev. 992 (1980).
[202] E. P. Ellinger, "Fraud in Documentary Credit Transaction", [1981] J.B.L. 258.

In certain circumstances bank can avoid absolute liability. Non-compliance of terms by the seller is sometimes excused by the banker on the ground of technicalities with an option to recourse. Therefore the extent of requirements and circumstances under which bank can avoid payment requires detailed analysis.

Another area is transfer of rights under letters of credit. There is an increase in transfer by negotiation and other methods. However the position is not clear. Conditions of transfer are laid down by law. Thus rights and obligations of the parties needs in depth analysis.

Under letter of credit transactions various rights and obligations will arise to the parties concerned. Thus, if the beneficiaries' bank pays to the beneficiary under its obligation, the remedies available against applicant need evaluation. Therefore the scope and extent of obligation of the banks involved in the transaction also need to be examined.

It is seen that buyer always undertakes major risks. Sometimes remedies are available against bank for breach of obligation. In usual practice banker avoids this obligation on the basis of rejection of documents with recourse against buyer. Sometimes, there are also attempts to restore the balance of equities between buyer and seller. It may result in inefficiency and inequity if priority is given to holders and like persons[203]. Therefore it is essential to find out how far a banker is justified in avoiding buyer's valid claims.

Apart from this there are technological advancements in the field of banking in electronic banking being a striking example of this. The contractual

[203] Razeen Sappideen, "International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency", [2006] J.B.L.133.

agreements through online are governed by different laws. There is no law to regulate electronic letter of credit contracts. Hence how far law can regulate electronic letters of credit is relevant in the letters of credit transaction. This study aims to evaluate these issues.

CHAPTER-2

NATURE OF DOCUMENTARY CREDIT

CHAPTER 2

NATURE OF DOCUMENTARY CREDIT

In documentary credit transactions the obligations undertaken by the parties are mutually dependent. Each party undertakes an obligation to the other in expectation of a benefit to be conferred by the other[1]. There are several underlying contractual rights and obligations in this transaction between the parties and the documentary credit is independent from other contracts, arrangements and relationships involved. From the beneficiary's point of view the independence of documentary credit relieves him from the concern that the buyer applicant may be unwilling to perform his engagement to pay. Moreover documentary credit provides considerable assurance that payment will not be withheld pending resolution of commercial disputes.

This independence rule of the documentary credit is based on two policy considerations[2]. One is that the issuing bank does not assume any liability for the performance of the underlying contract between the buyer and the seller as the banker does not have control over making the underlying contract. Another consideration is that if the issuing bank look beyond the terms of the credit to the underlying contractual controversy between its customer and the beneficiary the commercial utility of documentary credit will get eroded. Therefore the issuing bank deals exclusively in documents and not in goods to which the documents may relate. This situation sometimes brings injustice to the buyer applicant. There can be situations where the seller has breached the obligation

[1] Keith A. Rowley, "Anticipatory Repudiation of Letters of Credit", 56 Smu.L. Rev.2235 (2003).
[2] *Ibid.*

under the basic contractual terms. The goods might have been actually shipped by the seller and documents may also be in conformity. However the goods may not confirm with those of contracted on actual verification[3]. In this context the validity and enforceability of letters of credit will get questioned. Whether the bank is justified in paying the beneficiary by ignoring the underlying contract or not needs to be evaluated. This can be determined on the basis of the legal nature of the documentary credit. The initiatives of the Uniform Customs and Practice for Documentary Credit,[4] and the UNCITRAL,[5] are in different lines. It is necessary to examine the legal effects of these principles also in documentary credit transaction.

Similarly the obligation of the issuing bank under the independence principle is limited to honour a draft on a credit when it is accompanied by documents which on their face are in accordance with the terms and conditions of the credit. Therefore obligations of the issuing bank to the beneficiary are independent of the contract between the issuing bank and the applicant buyer and between the applicant buyer and the beneficiary. The bank cannot normally refuse payment to the beneficiary when the required documents are tendered. Apart from this, the payment is made in consideration of the assurance that the banker will get indemnified against loss by the buyer. How actually this works in international trade process is to be examined by taking into account rights of the buyer, the seller and the banks involved in the credit.

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[3] *Sztejn* v. *J. Henry Schroder Banking Corporation*, 31 N.Y.S. 2d 631 (1941) as cited in Mark S. Blodgett and Donald O'Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud", 35 Am. Bus. L. J. 443.

[4] Hereinafter referred to as the U.C.P.

[5] The United Nations Commission on International Trade Law.

While it is argued that contract of sale and contractual undertaking by the banker to pay the beneficiary constitute two separate and distinct contract, they cannot be termed altogether distinct as and independent. It is also not reasonable to assume that the parties intended them to be so[6]. The UNCITRAL and the U.C.P. states the nature of documentary credits[7]. Judicial approach to these definitions is to be examined.

In one of the earlier cases[8] the Chancery Appeal court tried to explain the legal nature of letters of credit by applying contractual principles. It was treated as a unilateral offer. It is acted upon and the seller part with his goods. So it gets the contractual nature. Once there is separate contract, offer theory is not followed. This is to be explained in order to understand the legal relationship between the advising banks and the beneficiary.

It is pertinent to note that there are at least three separate contracts involved in this. The underlying sales contract between the buyer and the seller, contract between the buyer and the issuing bank and a contract between the issuing bank and the seller. Apart from this it is also stated that there is a fourth contractual relationship[9]. It is when the correspondent bank undertakes the obligations of the issuing bank to the seller by acting as confirming bank.

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[6] Peter Gillies, Gabriel Moens (Eds.), *International Trade and Business: Law Policy and Ethics*, Cavendish Publishing (Australia) Pty Ltd., London (1998), p.410.

[7] See the U.C.P.600, Article 4. Also see Eric E. Bergsten, "A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters", 27 *International Law Review.*, 859 (1993).

[8] *Re Agra and Masterman's Bank, Ex Parte Asiatic Banking Corporation*, (1867) 2 Ch. App. 391

[9] Stephen J. Leacock, "Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions", 17 Vand. J. Trans. Nat'l. L. 885 (1984).

Autonomy Concept: An Analysis

Autonomy principle is the basis of documentary credits. It evolved through peculiar nature of transaction between the banks and the parties involved in the transaction. Megrah has stated[10],

> "...banks are not concerned with the sales contract or the goods, if it were otherwise, credit business would be impossible. In law, the credit contract stands by itself and "is not to be interpreted to the point of amendment or augmentation by reference to the contract of sale."

Hirst J explained the autonomous nature of letters of credit in *Tukan Timber Ltd* v. *Barclays Bank Plc.*[11],

> "It is of course very clearly established by the authorities that a letter of credit is autonomous, that the bank is not concerned in any way with the merits or demerits of the underlying transaction, and only in the most extremely exceptional circumstances should the Court interfere with the paying bank honouring a letter of credit in accordance with its terms bearing in mind the importance of the free and unrestricted flow of normal commercial dealings".

The rule in relation to the independence principle is embodied in Article 4 and Article 5 of the U.C.P. Article 4 stipulates:

> "A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate 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 or the beneficiary"[12].

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[10] H. C. Gutteridge and M. Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), at p.62.
[11] [1987] 1 Lloyd's Rep. 171 at p.174.
[12] The U.C.P. 600.

Article 5 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 U.C.C. It is stated as follows[13],

> "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 nonperformance 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".

Apart from this there have been discussions from earlier period itself regarding the legal basis of letters of credit transactions. One such early case is *Re Agra and Masterman's Bank, Ex parte Asiatic Banking Corporation,*[14] where the court applied the principles of contract law and tried to establish contractual relationship between bank and beneficiary. The court put forward the offer theory in this case. Accordingly the bank's liability was determined by treating a letter of credit as an offer made by it to anyone who purchased bills and purchaser having accepted the offer and paid cash to the beneficiary. However in a later case, *Union Bank of Canada* v. *Cole*[15], the Court of Appeal gave importance to the intention of the parties. Therefore in order to determine the liability of bank the terms of credit should show such an intention. But these

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[13] See the U.C.C. §5-103(d).

[14] (1867) 2 Ch. Appl. 391. One of the Judges Cairns, L. J. added the reason by applying assignment principle. Thus buyer becomes assignee of the beneficiary which gives him contractual rights against the bank.

[15] (1877) 47 L.J. (C.P.) 100 as cited in R.R. Pennington and Hudson, *Commercial Banking Law*, Macdonald and Evans, Plymouth (1978), p.315.

cases failed to explain the true nature of letters of credit transactions. The most complicated relationship is between the banker and the beneficiary. It is on this basis the autonomy principle originated.

Similarly, the distinction between the customary nature of the documentary credit as a commercial instrument and the question of the rights and duties of parties dealing with such documentary credit has never been before raised. As described by the leading commentator[16]:

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

The rules under the UCP being mere usages the courts need to play an active role in perfecting the law of the rights and duties of the parties dealing with documentary credits. Even in accepted usage, courts should bear in mind whether "it was a claim founded upon general principles of universal justice"[17]. The certainty and uniformity of the practice should not be the only consideration. The parties should have to prove to the court the nature of the legal rights and duties in relation to the practice, and the court should consider whether accepting such practice is contradictory to general principles of law. Jenkins L.J. has altered much of the law of general obligations to meet the unique nature of the credit and in fashioning credit rules[18]. Moreover, courts have demonstrated

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[16] B. Kozolchyk, *International Encyclopaedia of Comparative Law* ,at p. 10, cited by M. Kurkela, *Letters of Credit Under International Trade Law: UCC, UCP and Law Merchant*, Oceana Publications. Inc, New York (1984).

[17] *Oppenheim v. Russell* (1802) 3 Bos. & P. 42 as quoted in M.Kurkela, *Letters of Credit Under International Trade Law : UCC,UCP and Law Merchant, Ibid.*

[18] *Malas (Hamzeh) & Sons* v. *British Imex Industries Ltd.*, [1952] 2 Q.B. 127.

their willingness to resort not to municipal law but to the 'law merchant'. Dolan is referring to the law merchant as "an international body of law". He elaborates:

> "By virtue of the fact that letters of credit are historically a bank product and of the fact that banks issue most of the credits ..., bank regulations contribute to the body of law governing most credits[19]."

Thus the independence principle governs letter of credit transactions since its inception. It declares that credits are by their nature transactions separate from their underlying transactions and that payment need 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. 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. Moreover, the bank is not concerned about any debts or claims between the seller and the buyer. The bank's undertaking to the seller is diferent 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. This is accepted by banks and many commentators[20].

Nature of Relationship between the Seller and the Issuing Bank

It is the seller who is the direct beneficiary of credit. The bank may refuse to honour the drafts presented by the seller in three situations[21]. Firstly on the ground that seller failed to observe to rely on collateral. Secondly when the bank

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[19] *Infra* n.60.
[20] S. H. Van Houten, "Letters of Credit and Fraud: A Revisionist View", 64 *The Canadian Bar Review* 371 (1984), p. 376.
[21] Philip W. Thayer, "Irrevocable Credits in International Commerce: Their Legal Effects", 37 Col. L. Rev.1326 (1937).

attempts to rely on collateral circumstances in justification and finally because of the seller's own conduct in the performance of the contract which relieves the bank.

It is obvious that the seller is required to comply meticulously with the conditions mentioned in the letter of credit. However in order to protect the interest of buyer this requirement is essential. In *Lamborn & Co.* v. *Lake Shore Banking and Trust Co.*,[22] Smith J. said:

> "A party who is entitled to draw against a letter of credit must strictly observe the terms and conditions under which the credit is to become available, and if he does not, and if the bank refuses to honour his draft, he has no cause of action against the bank."

It is based on the underlying transaction between the buyer and the seller, the relations between the issuing bank and the seller is established. The chief object of the seller who insists for opening of letter of credit is to avoid the ordinary risks associated in dealing with the buyer. His interest is secured by the direct assurance of a bank that he will be paid. This shows that the expectations of the parties are to get an absolute and self-sufficient undertaking from bank to pay the seller. This view is supported by an English decision, in which Rowlatt J. said,[23]

> "The obligation of the bank is absolute and is meant to be absolute, that when the documents are presented they have to accept the bill. That is the commercial meaning of it."

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[22] 196 App. Div. 504, at p. 507, as cited in H. C. Gutteridge and Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), p.88. In this case it was held that a letter of credit which calls for bill of lading to the order of the bank is not satisfied by the production of bill of lading to the order of the seller.

[23] *Stein* v. *Hambro's Bank of Northern Commerce*, (1921) 9 Ll.L.Rep.507. (K.B.D.) at p.529.

Thus courts do not refer to the underlying differences on legal theory. Instead they accept the mercantile view. The statement of an American judge[24] that the contract between the bank and the seller is "entirely separate, distinct and independent" is recognized in almost all the countries. In England, in *Urquihart, Lindsay & Co.* v. *Eastern Bank*[25], Rowlatt, J., ruled that "the position of the banker under an irrevocable credit is in law the same as that of a person who has contracted to buy the shipping documents representing goods shipped, or to be shipped under the contract between the beneficiary and the person at whose instance the credit has been issued". He held that in such a case the banker must accept and pay for the documents irrespective of any defense. Such defense is solely a matter to be fought out between the buyer and the seller. In 1958, the Court of Appeal[26] went even further by holding that a credit imposes a binding contractual obligation on the issuing bank from the moment it is notifies to the beneficiary regarding issuing of documentary credit. Lord Jenkins stated,[27]

> "It seems to be plain enough 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 as to whether the goods are up to contract or not..."

Another instance which establishes the distinct contractual relationship between the banker and the seller is to be found in *American Steel Co.* v. *Irving*

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[24] Hough, J., in *International Banking Corporation* v. *Irving National Bank*, 283 Fed. 103 (1922)
[25] [1922] 1 K.B. 318. Similarly in *Midland Bank Ltd.* v. *Seymour* [1955] 2 Lloyd's Rep. 147 and *Elder Dempster Lines Ltd.* v. *Ionic Shipping Agency Inc.*, [1968] 1 Lloyd's Rep. 529, the court added that the beneficiary may turn an irrevocable credit into a binding contract by merely informing the issuing bank that he accepts its offer to honour the drafts.
[26] See *Hamzeh Malas & Sons* v. *British Imex Industries Ltd.*, [1958] 2 Q.B. 127.
[27] *Id.* at p.129.

National Bank[28]. The court held that the contract between the seller and the bank was distinct from and independent of the contract between the buyer and the seller. Therefore non performance of the contract between the buyer and the seller will not effect the bank's undertaking to pay beneficiary. In this case the facts relates to the procurement of the letter of credit from bank in favour of the seller beneficiary. However the statement of facts mentioned that acceptance of draft cannot be possible owing to the prohibition of the export of tin plates from the United States. The export regulations were changed. Even then the bank was held liable to accept the document. Rogers, J. said[29],

> "The law is that a bank issuing a letter of credit ... cannot justify its refusal to honour its obligations by reason of the contract relations existing between the bank and its deposition (the buyer)."

Thus the court here approved the decision in *Sovereign Bank of Canada* v. *Bellhouse,Dillon&Co*[30]. Similarly the beneficiaries' bank performs two roles depending on the nature of the credit. Sometimes it will only "advise" the beneficiary of the issuance of the letter of credit. In this case it will just process the documents and assumes no direct liability on letters of credit. But if it "confirms" the letters of credit the liability will arise.[31]

On an analysis of the above positions, it can be seen that there is no certainty as to whether any legal relationship exist. If so the nature of

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[28] (1920) 266 Fed. 41.Also see *Dulien Steel Products Inc.* v. *Banker's Trust Co.*, (1960) 189 F. Supp. 922, *supra* n.10. The court said, "Neither the issuing nor confirming banks have ... any obligation to go behind the terms of letter and documents which are required to be presented and enter controversies between the beneficiary and the party for whose account the letter was opened."

[29] *Ibid.*

[30] [1911] 23 Q.R. (K.B.) 413.

[31] Ronald J. Mann, "The Role of Letters of Credit in Payment Transactions", 98 *Michigan Law Review* 2494 (2000), p.2501.

relationship whether based on contractual principle or not is uncertain. In this transaction beneficiary wants a promise from the bank that he will be paid. It is true that when a credit is issued to finance the purchase of goods, the beneficiary may promise to deliver the goods to the buyer. But as far as banker is concerned there is no consideration for the service from the beneficiary. The promise made by the issuing bank to the beneficiary in a letter of credit is purely unilateral one and hence House of Lords concluded in *Morgan and Gooch* v. *Lariviere*[32] that the beneficiary has no claim in contract against the bank if it refuses to honour the bills of exchange presented by him. Therefore it is not contractual principles that constitute the absolute payment to the beneficiary. There are of course various theories which support the legal validity of the bankers promise.[33]

Accordingly Gutteridge and Megrah[34] favoured a contractual analysis of the relationship and reject the offer and acceptance theory. He also rejected guarantee theory and estoppel or trustee theory advanced by American writers[35]. Prof. Ellinger on the other hand preferred a theory based on mercantile usage. He argued that none of the contractual analysis gives sufficient weight to the business nature of a commercial credit.[36] It can be seen that other systems of law have not found it as difficult as English law to place commercial credits in a recognized category of enforceable legal transactions.

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[32] (1875) L.R. 7 (H.L.) 423.
[33] Boris Kozolchyk, "The Legal Nature of the Irrevocable Commercial Letter of Credit", 14 *American Journal of Comparative Law* 395 (1965-66).
[34] *Supra* n.10.
[35] A.G.Davis, "The Relationship between Banker and Seller under a Confirmed Credit", 52 L.Q.R. 225 (1936), p.227.
[36] Mark Williams, "Documentary Credits and Fraud: English and Chinese Law Compared", [2004] J.B.L. 155 at p.159.

Advising Bank and Beneficiary

An advising bank will only inform the beneficiary that a documentary credit has been issued and does not promise to pay beneficiary. Therefore there will not be any contractual relationship between them. The advising bank is considered as an agent for the issuing bank which becomes responsible for acts or omissions. Therefore the advising bank is not liable to honour the drafts if the beneficiary or the issuing bank fails to do so. In *Cape Asbestos Co. Ltd.* v. *Lloyds Bank Ltd.*[37], it was observed that there was no contractual relationship between the advising bank and the beneficiary. Therefore any failure on the part of advising bank towards beneficiary will not make them liable for breach.

The U.C.P. 600 relieves the advising bank from liability if it merely advises the beneficiary of the credit, as it makes no promise to pay the seller[38]. It is only a means to provide banking service by transmitting the letter of credit to the seller. However the bank is responsible for not using reasonable care to authenticate the letter of credit. It is often done by comparing the signature on the credit with the authorized signature kept on the file in the bank's signature books. Further, the U.C.P.[39] states that letter of credit can be transmitted from issuing bank to the advising bank electronically and that no mail confirmation needs to be sent.

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[37] [1921] W.N. 274 as cited in A. G. Davis, *The Law Relating to Commercial Letters of Credit*, Sir Isaac Pitman & Sons Ltd., London (1963), p.34.

[38] See the U.C.P.600, Article 9.

[39] *Id.*, Article 11. It says about tele-transmitted and pre-advised credits. It makes clear that even if mail confirmation is sent advising bank will not have obligation to check such mail confirmation against the operative credit instrument.

Therefore it can be seen that the obligations between the advising bank and the beneficiary is established based on the general guidelines which govern the letters of credit transaction.

Intermediary Bank and Beneficiary

The contract between the intermediary banker and the beneficiary depends upon the terms agreed between them.[40] It becomes binding when confirmed. The purpose of confirmation is to enable the beneficiary to obtain the promise of payment of a banker in his own country.[41]

Gutteridge[42] says that the relationship between the intermediary banker and the seller depends on the agency principle. Thus if the intermediary acts as an agent of the issuing banker he must do according to the instructions. Though intermediary banker acts as agent initially, it may also act as principal in relation to him. The intermediary bank in this case may negotiate with the seller with regard to the drafts drawn on the issuing banker. Then it will be acting as principal of the issuing banker.[43]

Similarly, in case of confirmed credit the paying bank does not have a right of recourse against the seller. In *Maran Road* v. *Austin Taylor & Co.*,[44] it was held that even if the credit is only a negotiation credit banker is liable if the

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[40] *Supra* n.10. at p.70.
[41] Maurice Megrah and F.R. Ryder (Eds.), *Pagets Law of Banking*, Butterworth, London (1982), p. 546.
[42] *Supra* n.10.
[43] *Supra* n.31. If the intermediary bank negotiates in accordance with the conditions of credit, he is an agent.
[44] [1975] 1 Lloyd's Rep. 156. Under negotiation credit the advising bank is only authorized to negotiate a bill of exchange drawn by the seller on the buyer or the issuing bank.

credit is confirmed. However if the bank pays under reserve or has obtained an indemnity from the seller it will get a right of recourse against the seller[45]. Similarly according to U.C.P. provisions the confirming bank will get right to reimburse from the issuing bank if it pays the seller in accordance with the terms of the credit[46]. But in the Canadian case *Michael Doyle and Associates Ltd.* v. *Bank of Montreal,*[47] the Court of Appeal of British Columbia held that the advising bank could not take recourse on the sellers because the advising bank accepted a draft drawn on it by the sellers although the documents showed a discrepancy. This case was concerned with an irrevocable but unconfirmed credit.

The time factor also plays an important role if the confirming bank pays under reserve. In *Co-operative Centrale Raiffersen-Boereleenbank B. A. (Rabobank Nederland)* v. *Sumitomo Bank Ltd. The Rayan,*[48] it was held that the issuing bank which waived the right to rely on the discrepancies had to reimburse the confirming bank for the financing charges which will include interest which arise from the late acceptance. In this case the confirming bank paid the beneficiary under reserve but the issuing bank retained the documents beyond a reasonable time without electing whether to accept or reject them.

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[45] *Ibid.*

[46] See the U.C.P.600, Article 8.

[47] [1982] 6 W.W.R. 24 as cited in Leo D'Arcy, Carole Murray *et.al.* (Eds.), *Schmithoff's Export Trade, The Law and Practice of International Trade,* Sweet and Maxwell, London (2000) p.198.

[48] [1987] 1 Lloyd's Rep. 345. In this case Taylor J. observed,"[t]he actual letter of credit appears to be an instrument which has achieved a status so legendary in the world of international credit transactions as to render it wholly mythical ..." See also *Micheal Doyle & Associates Ltd.* v. *Bank of Montreal* (1982) 140 D.L.R. (3d) 596. cited in Stephen Van Houten, "Letters Of Credit And Fraud: A Revisionist View", 62 *Canadian Bar Review* 371 (1984).

Status of the Buyer- Applicant under Documentary Credit

Documentary credit transaction begins from the buyer applicant who approaches the banker with a request to issue letter of credit. The revised U.C.P. contains definition of 'applicant'[49]. Accordingly applicant means the party on whose request the credit is issued. This recognition of applicant in the U.C.P. provision is remarkable. The term 'party' used is neutral in character[50]. Hence it can include private individuals, corporate entities and banks. Meanwhile, it is not clear how far they can effectively reduce the sham transactions in case of bogus corporate firms. Moreover there is virtual absence of provisions in the U.C.P. stipulating the duties that the issuing bank owes toward the applicant. The courts have indicated on occasions that the contract between the bank and the applicant is similar to a contract of agency[51]. This agency relationship is rejected by some writers who argue that the banker merely issues the letter of credit for the use of the seller[52]. As Ellinger asserts, the bank in this relationship is not a mere agent. There is a relationship between the bank and the buyer as that of creditor and debtor[53]. An agency relation is created as the bank acts as agent on a mandate from the buyer which is purely an internal arrangement[54].

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[49] The U.C.P.600, Article 2.
[50] Janet Ulph, "The UCP 600: Documentary Credits in the Twenty-first Century", [2007] J.B.L.355.
[51] See for example Devlin J. in *Midland Bank v. Seymour* [1955] 2 Lloyd's Rep. 147.Also see, William E. McCurdy, "Commercial Letters of Credit", 35 Harv. L. R. 539 (1921-22).
[52] Herman N.Finkelstein, "Performance of Conditions Under A Letter of Credit",25 Col. L. R.724 (1935).
[53] E.P. Ellinger, *Documentary Letters of Credit - A Comparative Study*, University of Singapore Press, Singapore (1970), p. 151.
[54] R. Goode, "Abstract Payment Undertakings", in P.Cane and J. Stapleton, *Essays for Patrick Atiyah*, OUP (1991) p. 218.

Similarly, attempts had been made to identify the existence of consideration under the credit. This is 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". It is generally accepted that the credit constitutes *sui generis* non-contractual engagement[55]. It is a specialised commercial contract having its own rules which has binding force 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[56]. The relationship between the buyer and the issuing bank can be analysed from the following statement,

> "When a client induces a bank to give a letter of credit to a third party, he cannot, of his own will, compel the bank to cancel the letter, for the contract does not exist between the client and the bank but between the bank and the third party"[57].

Apart from this the revised U.C.P.600 in a subtle way created a feeble position for the buyer. Earlier as a matter of practice the buyers were allowed to ask for copies of sales contract and proforma invoice. This to a certain extent protected him from the fraudulent seller. Now Article 4 (b) of the U.C.P. 600 stipulates as follows,

> "An issuing bank should discourage any attempt by the applicant to include, as an internal part of the credit, copies of the underlying contract, proforma invoice and the like".

Moreover, the U.C.P. precisely states that it is the 'banks' that deal in documents and excludes the applicant and beneficiary from the term[58]. It further made clear

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[55] *Ibid.*
[56] *Ibid.*
[57] *Supra* n.26.
[58] The U.C.P.600, Article 5.

that the bank's undertaking to honour the credit is not affected by any defences which may be available to the applicant in relation to the underlying contract[59].

The applicant's status under the letter of credit is therefore somewhat equivocal. In letter of credit transaction an obligation on the issuing bank to pay the seller is created by virtue of the applicant's instruction to the bank. The bank acting on such instruction will notify the seller that a letter of credit has been duly opened. The credit does not govern the relationship between the issuing bank and the applicant[60]. Based on the contract of sale the buyer completes an application form from a bank which results in formation of contract under a documentary credit. The application form becomes a contract between the bank and the buyer when the bank acts upon it. This document exclusively governs the issuer-applicant relationship. The applicant is usually given a standard form to fill out without adequate advice from the bank, which leaves the bank and courts free to interpret the intention of the applicant[61]. Devlin J. commented on the nature of the application form and said "... This is a printed document which shows the sort of thing that the bank wants, but it is left to the applicant for the credit to fill it up in what way he wants; and if he thinks there is some ambiguity in it there is no difficulty ... in his filling it up in a way to make it clear[62]. This seems to suggest that the buyer is at the liberty to incorporate specifications which he thinks necessary in the application form. However, it is doubtful whether a buyer even knows or is ever advised by his bank as to how to fill a standard application form to include what he wants. In fact, further analysis of

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[59] The U.C.P.600, Article 4.
[60] J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, A.S Pratt & Sons, Detoit (2001), p.7.
[61] *Midland Bank, Ltd. v. Seymour* (1955) 2 Lloyd's Rep. 147.
[62] *Ibid.*

other UCP articles indicates that the chance of an applicant exercising any freedom of choice is minimal. This is suggested also by Professor Ellinger's analysis.

> "The judicial decisions on the legal aspects of documentary credits are usually based on what the courts consider to be either the express intentions of the parties or the established business practice which the parties are assumed to have had in mind when entering into the contractual relationship involved.[63]"

Therefore the contractual relationship between the applicant and the issuing bank has never been accorded enough attention by the U.C.P. 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.

Effect of Laws Governing Documentary Credits

In documentary credit transactions parties involved will be conducting business in more than one jurisdiction. The laws governing the contract will be varied from country to country. This will result in conflict of laws governing documentary credits. Usually the parties leave the issue of governing law of their relationships to the determination of courts as contract of documentary credit does not normally state what their governing law is[64]. To overcome this problem while issuing letters of credit bank will insist to include a provision that the credit will be governed by the U.C.P. Therefore the transactions are mostly governed by the U.C.P. This will result in the inequality of bargaining power between banks and the applicants.

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[63] Ellinger, *Documentary Letters of Credit, supra* n.53.
[64] Nicholas Creed, "The Governing Law of Letter of Credit Transaction", 16 J.I.B.L.41 (2001).

Halsbury's Law of England[65] summarized the law pertaining to letters of credit as:

> "It is often made a condition of a mercantile contract that the buyer shall pay for the goods by means of a confirmed credit, and it is then the duty of the buyer to procure his bank, known as the issuing bank, to issue an irrevocable credit in favour of the seller by which the bank undertakes to the seller, either directly or through another bank in the seller's country known as the correspondent or negotiating bank, to accept drafts drawn upon it for the price of the goods, against tender by the seller of the shipping documents. The contractual relationship between the issuing bank and the buyer is defined by the terms of the agreement between them under which the letter opening the credit is issued; and as between the seller and the bank, the issue of the credit duly notified to the seller creates a new contractual nexus and tenders the bank, the issue of the credit duly notified to the seller creates a new contractual nexus and renders the bank directly liable to the seller to pay the purchase price or to accept the bill of exchange upon tender of the documents. The contract thus created between the seller and the bank is separate from, although ancillary to, the original contract between the buyer and the seller, by reason of the bank's undertaking to the seller, which is absolute. Thus the bank is not entitled to rely upon the terms of the contract between the buyer and the seller which might permit the buyer to reject the goods and to refuse payment therefore; and, conversely, the buyer is not entitled to an injunction restraining the seller from dealing with the letter of credit if the goods are defective."

This contains an elaborate discussion regarding the law relating to documentary credit. Apart from this the relationship between each parties need to be analysed based on the applicable law governing them. Eventhough the U.C.P. is applied when incorporated into the contract by the parties, it is not a body of law. Therefore when disputes concerning its application and interpretation arise they must be determined in accordance with the system of law that governs the contract in respect of which the dispute arises. Moreover the U.C.P. does not contain any provision as to how the system of law governing such contract is to be determined and also the place where disputes can be adjudicated upon.

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[65] 3 *Halsbury's Law of England*, Butterworths, London (1989), at p. 212.

Usually disputes involving letters of credit arise from the obligation of parties involved in the credit.

Under a letter of credit the place of performance of the obligation of an issuing or confirming bank need to be determined from the terms of the credit itself. Generally, it is the place at which the documents need to be presented. In case of a credit which is confirmed by a bank in a jurisdiction where the issuing bank carries on business, the letter of credit will be governed by the laws of the jurisdiction where the confirming bank carries on business. Whereas if the letter of credit is merely advised, and not confirmed, the governing law will be the law of the place of business of the issuing bank at which the credit is payable against presentation of documents[66].

Therefore if the letter of credit does not contain express choice of law the courts will decide. As stated by Gutteridge and Maurice Megrah[67],

> "Men of business do not, perhaps, often express their choice of law either openly or by interference and very frequently it becomes the duty of the Court to ascertain, not what the parties intended to be the proper law of the contract, but what law would be selected by reasonable men of business in all the circumstances of any particular transaction. In this event it is submitted that the presumption must be that matters connected with the performance by the banker of his contract under a commercial credit are to be regulated by the law prevailing at the place of performance, i.e. the law of the territory in which the seller's draft is presented to the Bank for acceptance or payment".

There will be different contractual situations between the parties. Firstly there will be a contract between the issuing bank and the seller, secondly a

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[66] *Westpac Banking Corporation* v. *Commonwealth Steel Co. Ltd.*, [1983] N.S.W.L.R.735. Also see, *Offshore International SA* v. *Banco Central SA*, [1976] 2 Lloyd's Rep.402, *Power Curber International Ltd.* v. *National Bank of Kuwait SAK*, [1981] 1 W.L.R. 1233.
[67] *Supra* n.10 at p.196.

contract between the confirming bank and the seller embodied in the confirmation, thirdly there will be a contract between the issuing bank and the confirming bank arising from the confirming bank acting on the issuing bank's instruction to confirm. The laws applicable to each contract need to be determined separately. But the courts approached the question of the law governing each contract according to two guiding principles[68]. One is the commercial purpose of the transaction. The purpose of the transaction is to provide the beneficiary with the right to receive payment in a particular country. Accordingly his rights under the credit should be determined in accordance with the law of that country. The other principle followed is that each of the contracts should be governed by the same law which is the law of the place where the issuing bank is situated as the confirming bank[69].

Documentary Credit: A Trite law

The legal aspects governing letters of credit are both difficult and obscure because of the complicated nature of the transaction. It is considered as "trite law".[70] There are four autonomous though interconnected contractual relationships involved. They are;

(1) The underlying contract for the sale of goods where the buyer and the seller are the only parties.

2) The contract between the buyer and the issuing bank under which the bank agrees to issue credit and make payment to the seller against presentation of the stipulated documents.

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[68] See, *European Asian Bank AG* v. *Punjab and Sind Bank*, [1981] 2 Lloyd's Rep 651.
[69] See, *Bank of Credit & Commerce Hong Kong Ltd (in liquidation)* v. *Sonali Bank*, [1995]1 Lloyd's Rep 227. Also see, *Bank of Baroda* v. *Vysya Bank Ltd*, [1994] 2 Lloyd's Rep 87.
[70] See *United City Merchants (Investments) Ltd.* v. *Royal Bank of Canada*, [1982] 2 W.L.R. 1039, H.L., *Per* Lord Diplock J., at p.1044.

3) The contract between the issuing bank and the confirming bank if the payment is made through confirming bank. In this the issuing bank agrees to reimburse the confirming bank for the payment made under credit.

4) The contract between the confirming bank and the seller under which the confirming bank undertakes to pay to the seller up to the amount of the credit against presentation of the stipulated documents.

Of these it is trite law governing relationship between confirming bank and the seller which became the basis for the development of legal principles of letters of credit.

Autonomy Principle in Standby Letters of Credit

The validity of the rules applied in traditional letter of credit may not suit cases in which standby letters of credit are used. In this type of transaction, the beneficiary gets the guarantee of payment when the third party commits default. It is similar to a bank guarantee[71]. The rule of autonomy prohibits the bank from inquiring into the truth of the beneficiary's assertion in standby letters of credit[72]. Thus sometimes bank will be compelled to pay the beneficiary on unjustifiable demand. Banker is also put to peril because it will not receive bill of lading which give the bank title to the goods[73]. However there are arguments which state that an absolute rule of independence may promote the interests of contracting parties[74]. Beneficiary benefits from this autonomy rule because he is assured that the customer will not be able to hold up payment on the standby letter of credit.

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[71] Hans Van Houtte, *The Law of International Trade*, Sweet and Maxwell, London (2002), p.282.
[72] In standby letter of credit transaction a mere written statement that default is made in underlying transaction is enough to get payment.
[73] In case of bill of lading, if the customer refuses to reimburse the bank, it can claim on the goods.
[74] Michael Stern, "The Independence Rule in Standby Letters of Credit", 52 *University of Chicago Law Review* 218 (1985), p. 233.

The customer cannot allege that a good faith demand was in fact made in bad faith because he presents his claim only when the customer defaults. Customer is also benefited from the use of a standby letter of credit under the autonomy principle. Customer will agree to use standby letter of credit only on the assurance from beneficiary that he will compensate the risk of unjustified demand.

Nonetheless, the principle of autonomy in standby letter of credit is inserted by UNCITRAL Convention on independent guarantees and standby letters of credit[75]. Thus it has made a strict duty on the part of the bank to pay when default is alleged. Later specific rules were formulated for standby letter of credit[76]. Accordingly a standby letter of credit is irrevocable and binding from the time it is issued.

Autonomy Principle in Performance Bond

Performance bonds are used to guarantee obligations arising under international sale of goods contracts. They are treated equivalent to letter of credit transaction by courts of law. In *Edward Owen Engineering Ltd.* v. *Barclays Bank International Ltd.*,[77] Lord Denning M. R, stated,

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[75] See Article 4 of convention. This convention excludes documentary credits from its scope.

[76] *The International Standby Practices* (ISP 98) was adopted by the International Chamber of Commerce in 1998.

[77] [1978] Q.B. 159. There is a contrary view also expressed by Eveleigh L. J. in *Potton Homes Ltd.* v. *Coleman Contractors Ltd,* [1984] 28 Build. L.R. 19. as cited in Charles Debattista, "Performance Bonds and Letters of Credit: A Cracked Mirror Image", [1997] J.B.L. 289 He says: "In attributing to the bond many similarities to a letter of credit, I do not regard Lord Denning is saying that one should approach every case upon the basis that the bond is a letter of credit and to have no regard to the circumstances which brought it into existence". *Id.* at p.302

> "The performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with relations between the supplier and the customs, nor with the question whether the supplier has performed his contractual obligations or not; nor with the question whether the supplier is in default or not[78]."

Similarly the principle of autonomy is made cardinal in performance bond also. Thus the issuer of the performance bond undertakes an absolute undertaking to pay the beneficiary according to the tenor of the bond. However the purpose of the performance bonds is to guarantee performance of the underlying contract of sale. Thus depending upon breach of the underlying contract a performance bond generates a primary liability on its issuer. The strength of the autonomy principle was demonstrated in *Power Curber International Ltd.* v. *National Bank of Kuwait S.A.K.*[79] Griffiths L. J. stated that such credits,

> "are regarded by merchants the world over as equivalent to cash, they have rightly been described ... as they are life blood of international commerce ... the whole purpose of this form of payment is that a seller by litigation against him at the suit of the buyer."

Limitations on Autonomy

In dealing with cases on letters of credit law courts have uniformly held that the issuer's obligation under letter of credit is independent of any defense the customer may have against payment on the underlying contract. However it was found that this absolute rule sometimes paves way for the development of

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[78] *Id.* at p.171.

[79] [1981] 2 Lloyd's Rep. 394 at p.400. Also refer *Burleigh Forest* v. *Cigna Insurance.* [1992] 2 Qd. R. 54 as cited in Howard N. Bennett, "Performance Bonds and the Principle of autonomy", [1994] J.B.L. 574 court upheld the beneficiary's right to claim on the bond, reaffirming the independence of the bond from the underlying contract.

commercial frauds. This is done sometimes in collusion with shipping agents by the parties concerned. Therefore courts have attempted to strike a balance between the commercial utility of letters of credit and the rule of autonomy principle against the inequitable results arising from fraudulent misrepresentations. The position is explained in the following words,

> "... in cases of beneficiary fraud in which an action by the account party on the underlying contract would be ineffectual, the rule of independent contract would operate to unjustly enrich an unscrupulous beneficiary."[80]

Hence the following limitations are applied to the autonomy principle:

The doctrine of strict compliance which is a limitation to the autonomy principle seeks to protect the interests of the buyer and of the paying bank. When a bank receives the documents for payment, the bank is under a duty to check the documents for discrepancies. The documents should comply strictly with the terms of the credit. No reliance is to be placed on trade customs as these may differ from place to place. It would be unreasonable to expect banks in one jurisdiction to be aware of what are customary practices in another[81]. Letters of credit may contain instructions to be followed by beneficiary in order to receive payment. If the documents thus presented vary with that mentioned in the letter of credit, the banker is justified in avoiding the autonomy principle. Similarly bank is not required to make inquiries as to any ambiguities or

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[80] Anonymous, "Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114", (1979) 63 *Minnesota Law Review* 487 at p.490 as cited in Jeffrey J. Browne, "The Fraud Exception to Standby Letters of Credit in Australia: Does it Embrace Statutory Unconscionability?", 11 *Bond Law Review* 98 (1999), at p.100.

[81] Razeen Sappideen, "International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency", [2006] J.B.L.133 at p.135.

discrepancy.[82] The strict application of the rule is found in performance bonds also. In this case, seller will be getting greater protection against the risks of unfair calls.

Fraud is the most trumpeted exception to the autonomy principle with respect to both performance bonds and documentary credits. It has become an accepted exception to autonomy principle in almost all countries. However the universally accepted U.C.P. does not contain fraud exception. Therefore it is always the judicial intervention in the disputes that paved way for the development of fraud exception. However this exception is applied in wholly exceptional cases. There too, fraud is construed narrowly. In fraud application two issues are vital. One is whether fraud is perpetrated by the seller or with his knowledge and secondly the level of proof of fraud.[83] Sometimes infringement of international obligation[84] is also treated as an exception to autonomy principle.

Another limitation on principle of autonomy is the invalidity of underlying contract. This has not however, merged in the main stream of case laws which determine the disputes. It is recognized as an exception to the principle of autonomy. Therefore if the underlying contract is illegal, the court can restrain payment[85]. However, courts need to be cautious in dealing with the defense of

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[82] See *Seaconsar Far East Ltd.* v. *Bank Markazi Jombouri Islami Iran*, [1993] 3 W.L.R.756 (H.L.) It was observed in this case that nothing is trivial because the banks are not expected to test the materiality of the particulars required under the credit.

[83] Mark Williams, "Documentary Credits and Fraud: English and Chinese Law Compared", [2004] J.B.L. 155. For a detailed discussion on fraud exception see *infra* chapter 4.

[84] Howard N. Bennett, "Performance Bonds and Principle of Autonomy", [1994] J.B.L. 574.

[85] See *Deutsche Ruckveersicherung A. G.* v. *Walbrook Insurance Co. Ltd.*, [1996] Lloyd's Rep.345 (C.A.). Also see Agasha Mugasha, "Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee", [2004] J.B.L. 515 at p.523.

illegality of the underlying contract because it will restrain the use of letter of credit transaction in international trade law.

Apart from this autonomy principle creates an imbalance of bargaining power between applicants and banks and throws doubt upon the principle of freedom of contract. Although it seems that applicant is provided with freedom of choice of law, it is hardly exercised[86]. The buyer by choosing the U.C.P. under the principle of autonomy provides the court with an opportunity to apply the U.C.P although it is a *defacto* law[87]. The strict application of the U.C.P. principles denies an opportunity for the court to analyse whether the contract in dispute is oppressive and leads to an imbalance of bargaining power between the parties. Therefore the courts need to look at the contractual relationship and see whether the contract is "fair" and whether there exist any elements of duress and unconscionability.

Application of Autonomy Principle in India

The courts in India have established that the opening of a confirmed letter of credit constitutes a bargain between the banker and the seller of the goods which imposes on the banker an absolute obligation to pay[88]. Letters of credit constitute the sole contract with the banker. The bank issuing or confirming a letter of credit is not concerned with the underlying contract between the buyer and the seller. This gives rise to the concept of autonomy principle which is applied in dealing with documentary credit transactions in

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[86] M. Megrah, "Risk Aspects of the Irrevocable Documentary Credit", 24 Ariz. L. Rev.255 (1982).
[87] *Ibid.*
[88] *United Commercial Bank* v. *Bank of India*, (1981) 2 S.C.C. 766.

Indian context also. The courts have emphasized the need for autonomy principle[89]. The apex court in India refused to grant an injunction restraining the issuing bank from making payment under its letter of credit on the ground that the letter of credit was independent and unqualified by the contract of sale.[90] The court held,

> "An irrevocable letter of credit is mechanism of great importance in international trade and so the autonomy of an irrevocable letter of credit is entitled to protection. Any interference with that mechanism is bound to have serious repercussions on the international trade of the country and the courts ought not to interfere with that mechanism except under very exceptional circumstances."[91]

The courts in India treat the concept of autonomy of the credit as one of the fundamental principles relating to letter of credit[92].The principles are applied in bank guarantees also. In *Pesticides India (Mewar Oil & General Mills Ltd)* v. *State Chemicals and Pharmaceuticals Corporation of India*[93], the pesticides raised a dispute regarding breach of contract by the corporation in supplying the goods according to contract terms. The court held that a guarantor bank is not concerned with the performance of the obligation undertaken in the guarantee. If the terms of guarantee imposed an absolute obligation to pay, the bank is liable to pay. Any dispute between the beneficiary and the bank's client may be settled through arbitration or appropriate legal methods.

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[89] *U. P. Co-operative Federation Ltd.* v. *Singh Consultants and Engineers (P) Ltd.*, (1988) 1 S.C.C. 174.
[90] *Tarapore &Co.* v. *V/O.Tractors Export, Moscow*, (1969)1 S.C.C. 233.
[91] *Id.*, p. 234.
[92] *Swiss Bank Corporation* v. *Jai Hind Oil Mills&Co.*, (1989) 66 Com.Cas.241 (Bom.).
[93] A.I.R.1982 Del. 78.

Earlier the Delhi High court refused to restrain the bank from making payment under the terms of bank guarantee[94]. The nature of guarantee in this case was performance guarantee. The court observed that the performance guarantee is an "autonomous contract". It imposes an absolute obligation on the bank in its terms. As such the existence of disputes between the parties under the primary contract or the possibility of a reference of these disputes to arbitration or of the pendency of proceedings on such a reference have absolutely no relevance to the obligation of the bank under the guarantee. Banks are bound to pay without demur irrespective of the pendency of any arbitration proceedings[95] in relation to primary contract between the parties. Even in case of the company on whose behalf the letter of credit is issued becomes a sick company, the autonomy principle of bank guarantee[96]is not affected.

In *Hindustan Steel Works Construction Ltd.* v. *Tarapore and Company*[97], the High Court issued an injunction restraining the beneficiary from encashing the guarantee stating that the guarantee would be encashable only if the arbitrators decide that the contractor had committed a breach of contract. The facts of this case relates to a civil work contract. As per the terms of this contract the contractor furnished a performance guarantee. The work was not completed within the stipulated time and dispute arose between the parties. To resolve the dispute an arbitrator was appointed. Meanwhile the beneficiary party called upon the bank to pay the amount it. Though the high court allowed injunction petition

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[94] *Banwarilal Radhe Mohan* v. *Punjab State Co-operative Supply &Marketing Federation Ltd.*, A.I.R.1982 Del. 357.
[95] See also, *Interior's India* v. *Balmer Lawrie & Co Ltd.*, A.I.R 2007 Del. 16.
[96] *AVN Tubes Ltd* v. *Steel Authority of India*, A.I.R. 1996 M.P.53.
[97] A.I.R. 1996 S.C.2268.

the same was set aside by the Supreme Court. On appeal the Supreme Court said,

> "A bank guarantee is an independent and distinct contract between the bank and the beneficiary and is not qualified by the underlying transaction and the primary contract between the person at whose instance the bank guarantee is given and the beneficiary. In case of unconditional bank guarantee the nature of the obligation of the bank is absolute and not dependent upon any dispute or proceeding between the party at whose instance the bank guarantee is given and the beneficiary. Whether the bank guarantee is towards security deposit or mobilization advance or working funds or for due performance of the contract, if the same is unconditional and if there is stipulation that the bank should pay on demand without any demur and that the beneficiary shall be the sole judge not only on the question of breach of contract but also with respect to the amount of loss or damages, the obligation of the bank could remain the same and that obligation has to be discharged in the manner provided in the bank guarantee"[98].

In *Ansal Engineering Project Ltd.* v. *Tehri Hydro Development Corporation Ltd.*[99], the contractor failed to complete the construction within the stipulated period. The Corporation issued letter of invocation calling upon the bank to pay the amount in terms of the bank guarantee. The contractor sought for an injunction to restrain the Corporation from invoking the guarantee. It was contended that unless the amount due and payable was determined by a competent court or tribunal, the guarantee could not be encashed. Repelling the contention, the Supreme Court said,

> "Bank guarantee is an independent and distinct contract between the bank and the beneficiary and is not qualified by the underlying transaction and the validity of the primary contract between the person at whose instance the bank guarantee was given and the beneficiary. ... The bank unconditionally and irrevocably promised to pay on demand, the amount of liability undertaken in the

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[98] *Id.*, p.2272.
[99] (1996) 5 S.C.C.450.

> guarantee without any demur or dispute in terms of the bank guarantee. The object behind is to inculcate respect for free flow of commerce and trade and faith in the commercial banking transactions unhedged by pending disputes between beneficiary and the contractor"[100].

In *Minerals &Metals Trading Corporation of India Ltd* v. *Surajbalaram Sethi*[101], a division bench of the Calcutta High Court opined that a bank guarantee does not enjoy the autonomy of an irrevocable letter of credit since it depends upon a contract between the beneficiary and a third party and unless there is some act of commission or omission on the part of the third party payment under guarantee should not be invoked. In this case two bank guarantees were executed. One bank guarantee contained a stipulation that the dispute between the parties would not be a ground for withholding the payment by the bank. But in respect of other guarantee there was no such express stipulation. Therefore when the dispute arose between the parties, the question before the court was to decide whether the injunction restraining bank from enforcing bank guarantee can be granted in respect of both guarantees. The Division Bench upheld the order of the trial court which granted the injunction only in respect of that bank guarantee which did not contain the term that irrespective of the dispute between the parties and held that the bank would be obliged to pay. The court made the distinction between an irrevocable letter of credit and a bank guarantee. It observed that for payment under an irrevocable letter of credit it is not necessary on the part of seller to perform obligation apart from those expressly imposed in letter of credit. There is no role for any third party. However in case of a bank guarantee default by the third party is a need.

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[100] *Id.*, p.454 *per* Nanavathi J.
[101] (1970)74 Cal WN 991.

There was always the question of a contingency on the occurrence of which the guarantee became enforceable.

In applying the autonomy principle emphasis is given to the documents involved in the transactions. The obligation on the bank is based on documents. This aspect is illustrated by the Supreme Court in *State of Maharashtra* v. *National Construction Co.*[102] the court said,

> "The rule is well established that a bank issuing a guarantee is not concerned with the underlying contract between the parties to the contract. The duty of the bank under a performance guarantee is created by the document itself. Once the documents are in order, the bank giving the guarantee must honour the same and make payment. Ordinarily, unless there is an allegation of fraud or the like, the courts will not interfere, directly or indirectly, to withhold payment, otherwise trust in commerce, internal and international, would be irreparably damaged. But that does not mean that the parties to the underlying contract cannot settle their disputes with respect to allegations of breach by resorting to litigation or arbitration as stipulated in the contract. The remedy arising *ex contractu* is not barred and the cause of action for the same is independent of enforcement of the guarantee"[103].

Similarly, in *Hiralall &Sons* v. *Lakshmi Commercial Bank*[104] the Supreme Court said,

> "....The settled legal position is that a letter of credit constitutes sole contract with the banker and its authorizing the bank issuing letter of credit has not concern with any question that may arise between the seller and the purchaser of the goods in respect of the purchase price; that there should, however, be strict compliance both by the customer at whose instance letter of credit was issued and by the banker, with his instructions; that in a claim on letter of credit, defence of fraud or apprehension of irretrievable injustice or non compliance with instructions could also be raised. All such defences could be urged or agitated

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[102] (1996)1 S.C.C.735. Also see *Roshanlal Anand* v. *Mercantile Bank Ltd.*, (1975) 45 Com. Cas. 519 (Del.).
[103] *Id.* at p.741.
[104] (2002) 6 S.C.C.389.

before the Tribunal by the petitioner and on a decision by it, an appeal also could be filed[105]."

Again in *Centax (India) Ltd* v. *Vinmar Impex Inc.*,[106] it was held that the obligation of bank under letter of indemnity was absolute. Hence upon a demand being made by the beneficiary the bank is bound to honour the same regardless of any controversy between the parties. In this case the allegation was that inferior qualities of goods were supplied. Hence the petition was for restraining the bank from making any payment in the term of letters of credit.

Analysis of the above cases shows that courts have succinctly condensed the law relating to documentary credits in which the principle of autonomy plays a pivotal role[107]. The autonomy of documentary credit is entitled to protection and the court refrain from interfering with the autonomy of irrevocable credit[108]. It can be seen that the principle underlying the independence rule is that invocation of letter of credit cannot be mixed up with other disputes between the parties regarding underlying contract. Bank has a duty to honour the letter of credit as and when the demand is made. If there is any claim on account of short supply or quality of goods the parties have the right to take action in proper

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[105] *Id.* at p.392.
[106] (1986) 4 S.C.C. 136.
[107] *National Thermal Power Corporation Ltd.* v. *Flowmore,* (1995) 3 Comp. L.J. 23 (S.C.), *Delon India (P)Ltd* v. *Bharat Heavy Electricals*, (1998) 1 Comp. L J 504 (Del.), *Dwariesh Sugar Industries Ltd.* v. *Prem Heavy Engineering Works (P) Ltd,* (1997) 5 J.T.417 (S.C.), *General Electric Technical Services Inc* v. *Punj Sons Private Ltd.,* (1991) 3 Comp.L. J. 95 (S.C.), *State of Maharastra* v. *National Construction Company,* (1996) 1 S.C.C. 735, *U.P.Co operative Federation Ltd* v. *Singh Consultants &Engineering (P) Ltd.,* (1988) 1 S.C.C. 174., *U.P.State Sugar Corporation* v. *Sumac International Ltd.*, (1997)1 S.C.C. 568.
[108] *Interdas Advertising P Ltd* v. *Bentrax & Co,* (1983) 53 Com. Cas. 646 (Del.).

proceedings. It cannot act as a special equity to enable the court to deviate from the autonomy principle[109].

Legal Nature of Documentary Credit: An Evaluation

A key component for the development of an efficient financial device is the establishment of a well-developed legal and regulatory regime that governs it. The autonomous character of the letter of credit is the main reason which made it the lifeblood of commerce. The whole commercial purpose for which the system of confirmed irrevocable documentary credit developed is to give the seller an assured right to be paid before he parts with the control of the goods on one hand and assuring buyer the delivery of the goods on strict compliance of the terms of credit. However when the bank issues the letters of credit, that contract becomes independent from the underlying contract between the buyer and the seller and the principle of autonomy of credit steps in.

There are many instances where sellers successfully secured payment from banks on the basis of documents eventhough actual goods were different[110]. The confirming bank is under an absolute obligation to pay out against tender of the documents specified in the letter of credit, having undertaken a reasonable inspection to insure that they comply.[111] The bank must

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[109] *Kamini Ferrous Ltd* v. *Neelam International Pte Ltd*, A.I.R.2006 Cal. 244., *Svenska Handelsbaken* v. *Indian Charge Chrome*, A.I.R.1994 S.C. 626., *Larsen &Tourbo Ltd* v. *Maharasta SEB*, A.I.R.1996 S.C. 334.,*Hindustan Steel Workers Construction Ltd* v. *G.S.Atwal &Co (Engineers) P Ltd*, A.I.R.1998 S.C.1314., *U.P.State Sugar Corpn* v.*Sunmac International Ltd*, A.I.R 1997 S.C.1644, *National Building Construction Corporation Ltd* v. *State Bank of Patiala*, A.I.R.1993 Del. 89., *Lloyds Steel Industries Ltd* v. *Indian Oil Corporation Ltd.*, A.I.R.1999 Del. 248, *Man Industries India Ltd* v. *Kharote Engineer & Contractors*, A.I.R.2005 Bom. 311, *Mak Impex Chemicals(P) Ltd* v. *Union of India*, A.I.R.2003 Bom. 88.

[110] *Supra* n.19.

[111] See for instance *Tarapore & Co.* v. *V/O Tractoroexport.*, (1969) 1 S.C.C. 233.

ignore deficiencies in the goods or documentation which although possibly giving rise to a cause of action under the sale or carriage contracts, do not constitute non-compliance with the description in the letter of credit[112]. It will get reimbursed by the buyer only if it carries out these requirements in exchange for the shipping documents. The shipping documents will allow the buyer either access to the goods or a means of raising funds by pledging them with a bank.

Similarly, documentary credits which were originally governed by the law merchant, from the mid-nineteenth century have been increasingly governed by the U.C.P. However it is dominated by the interest of bankers and acts as a private legislature. The U.C.P leaves little opportunity for judiciaries to "intrude" by crafting innovative solutions to compensate customers for careless conduct by banks. The commentators have accorded the U.C.P an almost mythical status and are universally accepted. It enabled to become applicable to almost all documentary credits transactions while excluding other possible sources of law. The choice of the U.C.P however does not represent an exercise by the applicant of its freedom of choice. Courts believe that the buyer chose the U.C.P under the principle of autonomy. Yet the process clearly shows that the buyer's autonomy has been denied.

The mercantile practice is to treat rights under documentary credits as equivalent to cash in hand.[113] This is accepted by many countries. Thus in

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[112] On the meaning of a "*mere error of the draftsman*", see *Bank of Montreal*, 622 F. Supp. 6 (1986), Also see P. S. Atiyah, J. N. Adams and Hector MacQueen (Eds.), *The Sale of Goods*, Taxman Publications, New Delhi (2002), pp. 418-424.

[113] Kerr L. J. in *R. D. Harbottle (Mercantile) Ltd.* v. *Westminister Bank Ltd.*, [1978] Q.B. 146 at p.155.

leading Australian case *Wood Hall Ltd.* v. *Pipeline Authority,*[114] Stephen, J indicated that the autonomy principle is necessary to ensure that letters of credit remain as good as cash. Similarly analysis of the U.C.P. provisions also leads to the effect of a "cash principle". It is recognized 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. The reason why the issuer can comfortably make payment without any of the above concerns is because of the limited obligation to the compliance of the documents alone. The absolute nature of the independence principle as expressed in the U.C.P strongly suggests that the letter of credit system has been established for and around the interests of the banking industry. Moreover there is absence of any balance of bargaining power between the applicant and the issuer in the context of the choice of law

A strict application of the autonomy principle can be justified to a certain extent. It has become a ground for unjustified activities. So there is a need to control it. Apart from this there seems to be no reason why the terms of underlying contract should not be incorporated in the letter of credit in accordance with ordinary contractual principle. The Prompt payment concept under documentary credit is not fully satisfactory because law should balance the interests of both parties. Hence there are chances where seller with fraudulent intentions receives payment from the bank by presenting forged documents.

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[114] (1979) 141 CLR 443. *Ibid.* at p.457.

CHAPTER-3

DOCTRINE OF STRICT COMPLIANCE - AN EXCEPTION TO AUTONOMY PRINCIPLES

CHAPTER 3

DOCTRINE OF STRICT COMPLIANCE – AN EXCEPTION TO AUTONOMY PRINCIPLE

In documentary credits, payment is effectuated on the presentation of confirming documents before the confirming banker[1]. The power of negotiation of documents offered by the buyer's banker in his letters of credit will be subject to the condition that documents are drawn by the seller in strict conformity with the terms of the letters of credit. This task of determination of the accuracy of document by banker is very difficult as banker spend a lot of time checking the document for compliance. These documents are checked by two banks including the negotiating bank and the issuing bank.

A large number of documents are relied on by the buyer and the seller beneficiary in letter of credit. Therefore there are chances of discrepancies while documents are prepared by the parties. The discrepancies in documents can be in a wide variety of ways including typographical errors and simple mistakes.[2] In usual practice the negotiating bank has to contact the beneficiary to explain the discrepancies and to correct it to the possible extent. But if the discrepancies are major, negotiating bank is expected to consult the issuing bank in order to make payment. Apart from this the documents are prepared from different directions so they may not be in an orderly form. Therefore the chances of missing any one of the documents presented for payment are high. In these situations if the bank

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[1] Usually confirming banker is one who provides a guarantee of payment to the seller beneficiary. Sometimes this bank itself will be negotiating banker who advices the seller regarding tendering of documents. See generally, H. C. Gutteridge and Maurice Megrah, *The Law of Bankers' Commercial Credits*, Europa Publications, Ltd., London (1979).

[2] Ray August, *International Business Law*, Prentice Hall, New Jersey (1997), p.633.

neglects the missing document and makes payment, a question may arise whether banker is entitled to avoid its liability with a right of recourse against its payee. How far such rights are dealt under international rules governing credit transactions also needs examination. This is essential from buyer's point of view because he can invoke his remedies against seller in cases of breach of contract on the basis of these documents. Therefore, the strict compliance prevails in all the contracts which occur under documentary credits[3]. The circumstances where applicant refuses to reimburse the bank when non-conforming documents are presented are also to be analysed. The problems intractable nature of documentary non-conformity and the standards of compliance are other matters of significance.

Strict Compliance: Meaning

Generally it is accepted by judicial pronouncements that bank deal in documents and not with the goods and services to which the documents relate.[4] Therefore the duty of a bank to make payment to the beneficiary is only against documents which comply strictly with the terms of a letter of credit. Both banks involved in letter of credit are expected to comply with this principle. Thus the issuing bank perform its obligation to the buyer by complying strictly with the terms entered between them, so also the paying bank who acts at the issuing bank's request to pay beneficiary is placed with a heavy responsibility to check the documents and pass those documents to the issuing bank.

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[3] R. R. Pennington & H. H, Hudson, *Commerical Banking Law,* Macdonald and Evans, Plymouth (1978), p.367. Strict compliance is essential in the contract between buyer and banker, the contract between banker and seller and between issuing and correspondent banks.

[4] *Equitable Trust Co. of New York* v. *Dawson Partners Ltd.*, (1927) 27 Ll.L.Rep.49. Also see *Moralice* v. *E. D. & F. Man* (1954) 2 Ll.L.Rep.526. *Soproma* v. *Marine and Animal Byproducts Corpn.*, (1966) 1 Ll.L.Rep.367, *Gian Singh & Co.* v. *Banque de Indochine*, (1974) 1 W.L.R. 1234.

It is a very complicated task to determine the meaning of strict compliance. Its meaning is explained by different authorities in different manner. It stands as an exception to the autonomy principle[5]. It is the legal principle that the bank is entitled to reject documents which do not strictly conform to the terms of the credit. This principle is expressed in the classic statement of Lord Summer in *Equitable Trust Co. of New York* v. *Dawson Partners Ltd.*:[6]

> "It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorized to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same or which will do just as well. Business could not proceed surely on any other lines. The bank's branch abroad, which knows nothing officially of the detail of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk."

This definition is developed by the English Courts. The "*de mininis non curat lex*"[7] rule does not apply to letters of credit transactions. Although the bank's duty is limited to check the documents "on their face", they have to fulfill that obligation strictly so that the buyer can enjoy the protection of the documents which he has instructed the bank to collect. "On their face" means that a bank need not ask itself whether the documents may perhaps be false or whether the document may have become worthless. The actual situation does not concern the bank. Thus in *Maurice O' Meara Co.* v. *National Park Bank*,[8] the banker was suspicious regarding the quality of goods and therefore refused to

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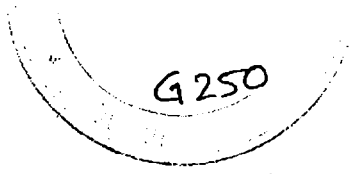
[5] For a detailed discussion on autonomy principles see *supra*. Chapter 2.

[6] *Supra* n.4 at p.52. See also Greer J. in *Scandinaviska Akt* v. *Barclays Bank*, (1925) 22 Ll.L.Rep.523, and *Kydon Compania Naviera S.A.* v. *National Westminster Bank Ltd.*, [1981] 1 Lloyd's Rep.68.

[7] It means usually law does not care trifling matters.

[8] (1924) 239 N.Y.386 as cited in "Case Notes on Letters of Credit – Defences Available to Bank", 25 Col.L.R.829 (1925).



pay beneficiary even though the documents presented were in good order. The court emphasised the documentary character of transaction and held that the bank was liable. It is not necessary for banks to verify the goods but should verify documents only and those documents must confirm strictly to the terms[9]. It was argued in the *Maurice O' Meara Co.*[10], that if the bank were given the privilege of litigating the quality of the goods, it would be compelled by business considerations to assert this privilege for the convenience of its customer. The whole purpose of letter of credit instrument will get defeated. Apart from this another line of argument advanced by the dissenting judges in that case[11] was that the issuing bank often issues the letter of credit relying on the goods as collateral security for credit extended to the buyer. It is therefore a question of importance as to how can they be expected to pay out the money on inadequate security.

The doctrine of strict compliance is applied even to the terms used in the documents. Thus in *J. H. Rayner & Co. Ltd.* v. *Hambros Bank Ltd.*[12] Court of Appeal upheld the bank's refusal to pay on the ground that there was literal difference in the product mentioned in the letter of credit and the document presented by the beneficiary. In this case the letter of credit called for documents covering a shipment of coromandel ground nuts, but the bill of lading presented by the beneficiary stated it is "shelled ground nut kernels" with the letters "C. R. S." written in the margin, which indicated to anyone who knew the trade that the

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[9] Clive M. Schmithhoff, *Schmithoffs Export Trade: The Law and Practice of International Trade*, Sweet and Maxwell, London (1993), p.406.
[10] *Supra* n.8. This case is considered as the classic case and the basis of documentary credit.
[11] *Ibid.*
[12] [1943] 1 K.B. 37. This decision raised a problem in which English and American law differed. This decision was much criticized in the United States. See Harfield, *Bank Credits and Acceptance*, 5th Ed. 1974, pp 76-8 cited in *Supra* n.9

groundnuts were coromandel. The court was of the opinion that the banker cannot be expected to have knowledge of the customs and customary terms of every one of the thousands of traders for whose dealing letter of credit may be issued[13]. However the meaning of strict compliance to which Lord Summer drew[14] attention does not extend to obvious typographical errors either in the credit or the documents. There is chance for the wide variation in language to be found in both the documents used and it is impossible to be dogmatic. Therefore the meaning attributed to the strict compliance is to consider on the merits of each case. Sometimes in the absence of any instructions in the banker's mandate the documents must be such as are usual in the trade in question, and which the customer could in turn require a sub-purchaser to accept in satisfaction of a contract of resale. Lord Summer in *Hansson* v. *Hamel & Horley,*[15] explained this as follows,

> "The documents have to be handled by banks; they have to be taken up or rejected promptly and without any opportunity for prolonged inquiry; they have to be such as can be re-tendered to sub-purchasers, and it is essential that they should so conform to the accustomed shipping documents as to be reasonably and readily fit to pass current in commerce."

However the strict compliance regarding the terms used and the conflict regarding the terms used in credit and the terms used in document were given different meaning in *Midland Bank Ltd.* v. *Seymour.*[16] The court held that the

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[13] *Ibid.* Goddard, L. J. was of the opinion that "for all the bank knows the customer may have a particular reason for wanting 'coromandel groundnuts in the bill of lading'.

[14] See for discussion, H. C. Gutteridge and Maurice Megrah, *The Law of Banker's Commercial Credits,* Europa Publications Ltd., London (1979), p. 90.

[15] [1922] 2 A.C. 36 at p.46. Also see in *Borthwick* v. *Bank of NewZealand,* [1900] 6 Com. Cas. 1, the bank was instructed to pay against 'usual documents', it was held that this meant documents which by usage of the trade in question must be tendered to a seller under a contract on c.i.f. terms or the equivalent where it is usual in the trade to tender all three of the set of bills of lading, this must be done.

[16] [1952] 2 Lloyd's Rep.147. A contrary view was taken in *J. H. Rayner & Co. Ltd., supra* n.12.

shipping documents could be looked at together and no need to consider in an individual document aspect. Devlin, J., said:

> "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 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 not negatived by the clause in the bill of lading, since the description is sufficiently contained in the invoice, which is one of the documents."

The meaning of strict compliance is difficult to state in narrow terms. It is given different meaning according to circumstances of each case. However the basic principle is that banker is under obligation towards the customer to follow the mandate given to it under the letter of credit in strict order and not to deviate from it according to his own judgment.

Strict Compliance and Discrepancies

Strict compliance rule is closely associated with the discrepancy aspect. It is the discrepancies which promote bank to apply doctrine of strict compliance. Hence a bank is justified in rejecting a document submitted by a beneficiary seeking to obtain payment on a letter of credit when the document does not exactly comply with the description stated in the credit. American court[17] went to the extent that the misspelled name of the person entitled to notice of the arrival of the goods being shipped was a material discrepancy that relieved a confirming bank from its duty to honor a letter of credit. The basis of strict compliance may be the reason that banks are not experts regarding the industries and do not

[17] *Beyene* v. *Irving Trust Co.* Federal Reporter, Second Series, Vol. 762, p.4 (Second Circuit Ct. of Appeals 1985) as cited in *supra* n.2. In this case, the name mentioned was 'Soran' instead of 'Sofan'.

have the knowledge to judge about goods and therefore cannot overview the terms and conditions between the applicant and the beneficiary.

However if this view is followed, it will result in a dangerous situations that even discrepancies that appear insignificant will cause big damage to the beneficiary and the purpose of letters of credit will get defeated.

In order to avail benefit of credit the beneficiary has to tender to the bank documents specified under letter of credit. If these documents do not agree with those listed by the bank in its advice in every respect, discrepancy of document will arise. It is stated that discrepancies in tendered documents are an everyday occurrence. Mann has estimated that documents presented under letters of credit comply in only 27 per cent of cases.[18] Banks are the most affected group by these discrepancies. The discrepancy point was summed up by Sir John Donaldson M. R. in *Banque de Indochine et de Suez S.A.* case[19]. He observed[20],

> "....that the banker is not concerned with why the buyer has called for particular documents, that there is no room for documents which are almost the same, or which will do just as well, as those specified, that whilst the bank is entitled to put a reasonable construction upon any ambiguity in its mandate, if the compliance with that mandate, that documents have to be taken up or rejected promptly and without opportunity for prolonged inquiry, and that a tender of documents which properly read and understand calls for further inquiry or is, such as to initiate litigation is a bad tender."

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[18] See Ronald. J. Mann, "The Role of Letters of Credit in Payment Transactions", 98 *Michigan Law Review* 2494 (2000), at p.2502 and statistical appendix at p.2534.
[19] *Banque de Indochine et de Suez S. A.* v. *J. H. Rayner (Mincing Lane) Ltd.* [1983] Q.B.711. See also *Shamsher Jute Ltd.* v. *Sethia (London) Ltd.*, [1987] 1 Lloyd's. Rep.388.
[20] *Id.*,at pp.729-730.

There can be two different types of discrepancies. Firstly there may be an ambiguity in the mandate and secondly there may be ambiguity with respect to the tendered documents.

Classification of Discrepancies

Most common discrepancies faced by banks under letters of credit are related to discrepancies in invoices, discrepancies in transport documentation, discrepancies in insurance documentation and other discrepancies. Schmithoff arranges the discrepancies under two situations[21]. He was of the opinion that the variants of irregular documents are the result of inexperience and inattention and it is impossible to device an all-embracing categorization of discrepancy situations.

Similarly in case of ambiguity with respect to tendered documents bank should not insist on the rigid and meticulous fulfillment of the precise wording. It was said by the Banking Commission of the ICC that,

> "Banks could not act like robots, but had to check each case individually and use their judgment."[22]

(1) Irrelevant Irregularities of Documents

In this type of discrepancies the documents tendered by the beneficiary do not correspond to the specification in the credit. Thus in *Bank Melli Iran* v.

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[21] Clive M. Schmithoff, "Discrepancy of Documents in Letter of Credit Transactions", [1987] J.B.L. 94.
[22] Opinions (1980-1981) of the I.C.C. Banking Commission (I.C.C. Publications No. 399), p.35.

Barclays Bank D. C. O. Ltd.[23], the court held that the defendant bank should have rejected the documents tendered because "as good as new" trucks were obviously not the same thing as new trucks. In this case the defendant bank issued a credit to cover "100 new Chevrolet trucks" on the instructions of the customer and paid to the beneficiary on the basis of document which stated, "28 packages said to contain lorries" and delivery notes for "100 new-good [i.e., as good as new] trucks". Similarly, in *Seaconsar Far East Ltd.* v. *Bank Markazi Jomhouri Islami Iran*[24], the letter of credit stipulated that all documents presented to the bank should carry the credit number and the buyers' name. However one of the documents tendered omitted to state the credit number and the buyers' name. It was held that it was a discrepancy. The court observed that obvious typographical errors in names may not constitute a discrepancy. But the misspelling of a name that is not obviously misspelt is a discrepancy a may be the insertion of the word "Pty" in the name of a company.

Mostly banks do not consider certain discrepancies as substantial. It is because they may not get misled by such defects and that will not affect the validity of a document. Such includes typing errors and typographical errors[25]. A variation found in the telex number of the buyer's office was considered as trivial[26]. Another example of a trivial defect was given in *Kredietbank Antwerp v. Midland Bank plc*[27], where Evans L.J. gave as an example an obvious typographical error, such as the possible misspelling of Smith as "Smithh". In

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[23] [1951] 2 Lloyd's Rep.367. Also see *J. H. Rayner & Co. Ltd.* v. *Hambros Bank Ltd.*, [1943] 1. K.B. 37.
[24] [1993] 3 W.L.R. 756 (H.L.).
[25] *Standard Chartered Bank v Pakistan National Shipping Corporation (No. 2)*, [1998] 1 Lloyd's Rep. 684, at 699
[26] *Bankers Trust Co., v State Bank of India*, [1991] 2 Lloyd's Rep. 443.In this case telex number of the buyers office was given as 931319 instead of 981310.
[27] [1999] Lloyd's.Rep.219.

Glencore International AG v Bank of China,[28] both commercial invoice and certificate of origin 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 they are only defects that can be ignored.

According to the U.C.P. principles[29], bank is allowed to disregard certain minor variations subject to the express provisions of the credit. It also states that the quantity specified in the documents may be 5 per cent more or less than that specified in the credit as long as the credit does not refer to the quantity in terms of a stated number of packing units or individual items. Thus if the credit refers to 1000kg and documents tendered specifies 1005 kg that document will not become discrepant and banker can accept.

(b) Irrelevant Variations in the Document

There may be irregularities relating to commercial invoices that cause problems. The commercial invoice must contain the description of the goods with some particularity and allow linkage[30] with the other tendered documents relating to transport, insurance, pre-shipment inspections and so on.[31]

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[28] [1996] 1 Lloyd's Rep. 135.
[29]The U.C.P.600, Article 30.
[30] Linkage of documents means that some latitude is allowed in the description of the goods in the documents other than invoice. The question of identification of the goods is different from that of their description in the documents. If the documents are not linked by an unambiguous reference to the same goods, the tender is bad. For details see *supra* n.21.
[31] The U.C.P.600, Article 18.

Sometimes it happens that the description of the goods in the credit and in the invoice does not agree literally but that it is clear that both descriptions relate to the same goods.[32] This irregularity can be avoided. Schmithoff[33] states,

> "If the tendered documents, should not insist on the rigid meticulous fulfillment of the precise wording in all cases. If 'properly read and understood',[34] the words in the instructions and in the tendered documents have the same meaning if they correspond though not being identical, the bank should not reject the documents."

(c) Irregularities Irrelevant According to Court Decisions

Eventhough irregularities exist in one or two documents, courts may consider such irregularities irrelevant. In *Westpac Banking Corporation* v. *South Carolina National Bank.*[35], the letter of credit required presentation of "shipped" bills of lading. However the bills tendering by seller were in the form "received for shipment." On the face of the each of the bills were the words "shipped on board" and "freight pre-paid". The intended vessel was stated to be "Columbus America". The issuing bank rejected the bills of lading as there were irregularities in the document. The court distinguished between mere technical or irrelevant discrepancies and discrepancies that go to the substance of the document and held that the technical discrepancies should be avoided.

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[32] For instance, if a letter of credit stipulates "10 cm pipe-cutting machinery" and the invoice relate to "two 10 cm pipe-cutting machines". This irregularity can be accepted but if the letter of credit refers to "two machines" and the invoice specifies only "machinery" this discrepancy should not be avoided because "machinery" may cover only one machine.

[33] *Supra* n.9. at pp. 346-347.

[34] The words 'properly read and understood' are taken for the judgment of John Donaldson M. R. in *Banque de l'Indochine et de Suez* v. *J. H. Rayner (Mixing Lane) Ltd.*, [1983] Q.B. 711.

[35] [1986] 1 Lloyd's Rep.311. This was decided by the Privy Council on appeal from the Court of Appeal in New South Wales.

Courts distinguished terms as requiring literal compliance and substantial compliance. Technical objections and technical irregularities should not be a ground for rejecting.

In *Soproma* case,[36] the document required a bill of lading marked "freight prepaid" and an analysis certificate stating that the "goods had a content of minimum 70 per cent protein". However the tendered document included a bill of lading marked "collect freight" and an analysis certificate showing "a protein content of 67 per cent". The court held that it was a genuine discrepancy. In *Panchaud Freres S. A.* v. *Et. General Grain Co.*[37], there was contradiction in the documents presented. The bill of lading document and the loading certificate were dated in different situations. The bill of lading purports to show loading within the shipping time but the superintendent's certificate showed that it took place out of time. This was considered by court as a genuine discrepancy.

Effect of Discrepancies in the Documents

Genuine discrepancies may affect the buyer, the seller and the banker. When a discrepancy is found out by a negotiating bank, beneficiary will be called to explain the discrepancies and will be allowed to correct the documents to the possible extent. If the discrepancies cannot be corrected the negotiating bank will prepare a list of the discrepancies and request the issuing bank for permission to pay. On receiving the permission, issuing bank will contact the applicant with a request of waiver and it will be informed to the negotiating bank.

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[36] *Soprama S.P.A.* v. *Marine & Annual Byproducts Corporation* [1996] 1 Lloyd's Rep.367.
[37] [1970] 1 Lloyd's Rep.53.

However if the bank decides to reject the documents it must inform the presenter without delay. The U.C.P.600 states[38],

a. When a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate.

b. When a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank decides to refuse to honour or negotiate, it must give a single notice to that effect to the presenter.

c. The notice must state:

i. that the bank is refusing to honour or negotiate; and

ii. each discrepancy in respect of which the bank refuses to honour or negotiate; and

iii. a) that the bank is holding the documents pending further instructions from the presenter; or

b) that the issuing bank is holding the documents until it receives a waiver from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver; or

c) that the bank is returning the documents; or

d) that the bank is acting in accordance with instructions previously received from the presentor.

d. The notice required in sub-article 16© must be given by telecommunication or, if that is not possible, by other expeditious means no later than the close of the fifth banking day following the day of presentation.

[38] The U.C.P.600, Article 16.

e. A nominated bank acting on its nomination, a confirming bank, if any, or the issuing bankmay, after providing notice required by sub-article 16 (c) (iii) (a) or (b), return the documents to the presenter at any time."

Role of Banks in Discrepancy

If the documents presented are not in order, the banker can follow any of the three alternatives.

(A) Refuse Payment

(B) Pay and take an indemnity from the beneficiary in respect of any loss or damage resulting from the deficiency in the documentation

(C) Pay the beneficiary "under reserve".[39]

Once the bank decides to reject the document a notice of refusal is required to be sent by expeditious means. In *Banque de l'Indochine ed de Suez S. A.* v. *J. H. Rayner (Mincing Lane) Ltd.*[40] a notice of refusal, setting out the discrepancies with precision in four distinct paragraphs was issued by the bank. There was inconsistency between the documents presented. Hence the court upheld the action of the bank.

In some situations after informing the discrepancy and getting instructions of the applicant, the bank may again raise another objection. Whether this is possible was the issue raised in *Skandinaviska Aktiebdaget* v. *Barclays Bank Ltd.*[41]. It was held that such a supplementation of reasons for

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[39] William Hedley & Richard Hedley, *Bills of Exchange and Bankers Documentary Credits*, L.L.P., London (2001), p.337

[40] *Supra* n.19.

[41] (1925) 22 Ll.L.Rep.523. Only very rarely can the rejection notice of the bank be interpreted as a representation that in all other aspects the documents are in order, so that a question of estoppel or waiver arises. See *supra* n.2.

rejection was perfectly valid. This is in harmony with the general principle of contract law. In case of sale of goods, a new ground for rejection of defective goods is possible[42]. However it is not permissible for the issuing bank to supplement the stipulations in the mandate by further conditions after the advising bank has confirmed the credit to the beneficiary. Similarly in doubtful cases bank has two options, either to reject the documents or to accept them under a protective mechanism.

(A) Refusal of Payment

The first option is to reject the document by refusing to pay. However rejection of the documents invariably causes difficulty to the beneficiary of the credit.[43] Once it decides to reject, speedy decision must be taken. Failure will amount to ratification of the documents and the banks may lose their right of rejection. Lord Diplock explained the position in *Commercial Banking Co. of Sydney* v. *Jalsard Pty.*[44]

> "Both the issuing banker and his correspondent bank have to make quick decisions as to whether a document which has been tendered by the seller complies with the requirements of the credit at the risk of incurring liability to one or other of the parties to the transaction if the decision is wrong."

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[42] This general principle is stated in Benjamin's Sale of Goods as follows: "It is a general principle of the law of contract and gives a ground which does not justify the refusal, or no ground at all, may nevertheless subsequently rely on another ground, which does justify the refusal to perform, provided that other ground in fact existed at the time of the refusal".

[43] See *Equitable Trust Co.* v. *Dawson*, (1927) 27 LL.L1.R.49; *Gian Singh & Co. Ltd.* v. *Banque de l'Indochine*, [1974] 1 W.L.R. 1234. *Suproma S.P.A.* v. *Marine & Animal By-products Corporation*, [1966] 1 Lloyd's Rep.367.

[44] [1973] A.C. 279 at p.286

(B) Pay and Take an Indemnity Option

According to this option banker can pay the beneficiary instead of rejecting discrepant document by taking an indemnity from him. The indemnity should state in which circumstances the bank may hold the indemnor liable. It should be able to protect the banker's interest. However before giving an indemnity, the beneficiary should satisfy himself that the discrepancies can be explained and corrected immediately[45].

Another question arose before an American court in *Dixon, Irmaos & Cia Ltd.* v. *Chase National Bank of the City of New York,*[46] whether the issuing banker need accept an indemnity. It was decided that a bank may not refuse an indemnity if offered by a reputable bank in respect of a missing bill of lading. However the proposition that an indemnity avails only for the benefit of the banker to whom it is given is not universally accepted.[47]

(C) Pay "Under Reserve"

In order to overcome the difficulties in discrepant documents banks pay "under reserve". This payment is made on the condition that if the documents are rejected by any subsequent recipient, the bank will be entitled to reimbursement by beneficiary of the amount paid by the bank under reserve.

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[45] See *Moralice (London) Ltd.* v. *E.D. & F Man*, [1954] 2 Lloyd's Rep.526.
[46] 144 F. 2d. 759 (1944) cited in Richard King (Ed), *Gutteridge & Megrah's Law of Bankers' Commercial Credits*, Europa Publications Limited, London (2001) at p.154 The ground for the decision was that there was a general and uniform custom among New York banks to accept indemnity in lieu of missing bill of lading and therefore relates only to it.
[47] See H.C.Gutteride and Maurice Megrah, *The Law of Bankers' Commercial Credits*, *supra* n.1. This proposition is followed in U.K.

However the expression "payment under reserve" has not been defined in any comprehensive manner. Therefore meaning of such expression may vary from case to case depending on the parties' intention. Payment under reserve was made by the bank in *Banque de l'Indochine case*[48]. The court examined the meaning of the expression "under reserve". Parker J. considered that in the absence of any established custom the meaning of such expression had to be determined in the light of the surrounding circumstances or 'the factual matrix'.[49] This payment is made on the basis that documents will be accepted by the buyer. In the view of the court the proper approach is,

> "What the parties meant, I think, was that payment was to be made under reserve in the sense that the beneficiary would be bound to repay the money on demand if the issuing bank should reject the documents, whether on its own initiative or on the buyer's instructions. I would regard this as a binding agreement made between the confirming bank and the beneficiary by way of a compromise to resolve the impasse created by the uncertainty of their respective legal obligations and rights."[50]

The bank will invoke this provision if it considers that the beneficiary is of good standing and is able to make repayment if a difficulty arises. Also there should be a genuine dispute regarding the documents. However from the beneficiary point of view this is the worst arrangement the bank can make as it completely defeats the purpose of the letter of credit.

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[48] *Supra* n.19.

[49] *Ibid* 'Factual matrix' here means that the remitting bank genuinely believed that there were one or more discrepancies justifying non payment, that the beneficiary believed that the bank was wrong and that it was entitled to payment under the credit and that both parties hoped that notwithstanding the alleged discrepancies which were disputed by the beneficiary, the issuing bank would take up the documents and reimburse the remitting bank.

[50] *Ibid. Per.* Kerr L. J. at p.733. It is not clear whether the advising bank could recover its money only if the issuing bank rejected the documents on the same grounds or some of them.

The Waiver Problem

In the mechanism of letter of credit, discrepancies get cleared if such discrepancies are waived. Though strict compliance is an important element in documentary credit, its ambiguity brings problem. Advising bank of course will notify the beneficiary within a reasonable time of the alleged discrepancies and the beneficiary can rectify it. The discrepancies can be waived. In practice it was found that applicant buyer almost always waive the discrepancies and permit full payment to the beneficiaries under the letter of credit.[51] Mostly the buyer wants to get his goods and the beneficiary his payment. The result of this waiver by the applicant is that discrepant documents are made acceptable. Mostly the documents will be invalid. This practice in effect denies the strict compliance rule, giving the fraudsters an opportunity to receive payment under the letter of credit without fulfilling any legal obligation under the sales contract. The risk is shifted to the buyer.

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 buyer. When the documents are discrepant, the bank's definite undertaking under the credit becomes null and void[52].

This practice by the buyer to accept faulty documents reflects a lack of bargaining power. It indicates the great pressure brought by banks on the buyer.

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[51] *Supra* n.18. This article gives the Empirical Research Data at p.2514.
[52] *Ibid.*

Ultimately discrepant documents rendered are accepted and the validity of documents is ignored. The buyer assumes a disproportionate amount of risk not only because of the separation of documents and goods under the independence principle, but also his compulsions to accept discrepant documents.

Documentary Compliance: Its Legal Effect

In letters of credit transaction proper documents stipulated, need to be presented by the beneficiary to get payment. The law governing the sufficiency of shipping documents tendered under credit in respect of technical matters and the modification of standard clauses is highly complex. These rules are derived from the rules governing C.I.F. contracts.[53] These documents need to be precise and banks accept them as original documents.[54] The U.C.P. also contains general rules on documents and deals more in detail with the invoice, the transport documents and the insurance documents. The documentary requirements are strictly interpreted by courts[55]. Banks always find themselves saddled with the onerous task of dealing with all detail of these documents. In America,[56] the U.C.C. provides that:

> "In order to guard against confusion and misunderstanding, banks should discourage any attempt to include excessive detail in the credit or in any amendment thereto".

In *Credit Agrocole Indosuez* v. *Muslim Commercial Bank*[57], it was held by the Court of Appeal that when there was a genuine doubt as to whether

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[53] *Supra* n.3, at p.343.
[54] *Halsbury's Law of England,* Butterworths, London (1989), p.221.
[55] *Glencore International A. G.* v. *Bank of China* [1996] 1 Lloyd's. Rep.135.
[56] In America, The U.C.C. Article 5 deals the documentary credit in America.
[57] [2000] 1 All E.R.172. (Com).

documents were essential to the operation of the credit, it should be constructed against the issuing bank. Sir Christopher Staughton explained:

> "...in terms of commerce the confirming bank is the correspondent of the issuing bank in order to do what the issuing bank is not present to do for itself. That is ... sufficient to attract the rule that an agent is to be excused for acting on a reasonable, even if ultimately wrong, interpretation of his principal's instructions."[58]

Therefore bankers should examine the documents as to their conformity with the conditions specified under the credit and to make payment against conforming documents. The main documents used 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. Apart from this, depending on the condition of the letter of credit, the bill of exchange, the transport document, the certificate of origin, and the certificate of weight are also used.

Transport Documents

These are the documents which evidence that the goods are in the hands of a carrier for transportation to the buyer. The most commonly required transport document is a bill of lading. It is a vital document which a bank will need to have in its possession. It entitles its lawful holder to claim the goods against the carrier[59]. Bills of lading are a frequent source of error in the documents that a beneficiary presents under the credit[60]. Therefore, if any discrepancy is there in the document presented it will make the whole transaction in trouble. If the letter of credit calls for tender of a bill of lading

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[58] *Ibid.* p.177

[59] Caslav Pejovic, "Documents of Title in carriage of Goods by Sea: Present Status and Possible Future Directions", [2001] J.B.L. 461 at p.475.

[60] Dolan, *The Law of Letters of Credit: Commercial and Standby Credits, infra.* n.110

without specifying its form or contents, the general law requires the bill to be signed on behalf of the carrier and to be an "on board" bill. So also there should not be a qualification in the description of the goods in bill of lading showing that they may not be in sound condition when delivered at the arrival port.[61] It means that bill of lading must be clean.

Similarly bill of lading must state "shipped" and not "received for shipment". In *Diamond Alkali Export Corpn.* v. *Bourgeous*[62], the court held that tender of a forwarding agent's or shipping lines bill of lading stating that goods have been received for shipment on a named ship or another ship of the same line is not sufficient. It does not show that the goods are on board of a particular vessel from which they can be collected on arrival.

In an American decision, *Liberty National Bank and Trust Co.* v. *Bank of America National Trust and Savings Association*[63] it was held that the deletion in a bill of lading of the standard wordings as to the apparent good order and condition of the goods shipped and the substitution of words "exoneration the ship owner from liability for their condition", entitled the issuing bank to refuse to take the bill, even though there was nothing in the bill to indicate that the goods were actually defective. Similarly, when the letter of credit required the beneficiary to present a "full set" of bills of lading in respect of the goods in question, tendering of one copy of a bill issued in a set[64] by beneficiary is not enough.

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[61] *Golodtz & Co. Inc* v. *Czarnikow-Reonda Co.Inc. The Galatia*, [1980] 1 W.L.R.495.
[62] [1921] 3 K.B. 443
[63] (1955) 218 F. 2d. 831.
[64] See *Sanders* v. *Maclean & Co.*, (1883) 11 Q.B.D.327. However there are chances of risk that other set can be used to collect the goods from ship.

The problem created by these discrepancies in the bill of lading is that of giving notice of defects in documents to the buyer. The banks are expected to give a complete notice to beneficiaries of defects in documents[65]. However many of the discrepancies in bill of lading cannot be cured by beneficiaries. Apart from this amended bill of lading are difficult to obtain from the carriers.

Commercial Invoice

This is one of the most important documents which a seller must provide. It should contain the description of the goods. The description must correspond with the description in the letters of credit[66]. If the description does not correspond the bank is entitled to reject the documents. It should also contain the name of buyer and the price of the goods. Banks may refuse commercial invoices issued for amounts in excess of the amount stipulated in the credit unless other arrangements are made.[67] Davis is of the opinion that commercial invoice is not so important as either the bill of lading or the insurance documents[68]. But the purpose of commercial invoice which comply with the terms of the credit is to give an express warranty to be bank by the beneficiary that he has complied with the terms of the credit. Therefore banks can sue against the beneficiary for the breach of warranty.

The issuing bank is justified in refusing to pay the seller's draft when it was accompanied by an invoice showing that part of the merchandise belonged

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[65] The U.C.P.600, Article 16 (c).
[66] *Id.*, Article 18 (c) reads; "The description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit".
[67] *Ibid.* Article 18 (b). Also see *Glencore International A.G.* v. *Bank of China*, [1996] 1 Lloyd's Rep.135 at p.154.
[68] A. G. Davis, *The Law Relating to Commercial Letter of Credit,* Sir Isaac Pitman & Sons Ltd., London (1963), at p.142.

to one person and part to another[69]. So the importance of commercial invoice cannot be overlooked. Similarly the invoice should agree with the bill of lading, showing particularly that the quantity on one is the same as the quantity in the other. Therefore failure to comply with the terms on the face of document will make it irregular document. Therefore banker will be justified in refusing to accept[70].

Insurance Documents

In documentary credit, insurance document will include insurance policy, an insurance certificate or a declaration under an open cover[71]. They should comply strictly with the terms of credit. They must be issued and signed by insurance companies. It can be signed by an underwriter or their agents or proxies. However any signature by an agent or proxy must indicate whether they signed on behalf of the insurance company or underwriter[72]. The cover notes will not be accepted as insurance documents[73].

Similarly if the credit indicates that it has been issued in more than one original, all the originals must be presented. Thus in *Glencore International A.G.* case[74] the issuing bank rejected documents on the ground of non marking of "original" in the certificate. The document was originally been generated on a word-processing system, printed and then photocopied. One of the photocopies was signed by the beneficiary with an original signature in blue ink. The Court of

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[69] *Wells Fargo Nevada National Bank* v. *Corn Exchange National Bank*, (1927) 23 F. 2d.1 cited in *ibid.*
[70] C. T. Le Quesne, "Letters of Credit", 57 *Journal of the Institute of Bankers* 174 (1936).
[71] The U.C.P.600, Article 28.
[72] *Ibid.*
[73] *Id.*,Article 28 (c).
[74] *Supra* n.55.

Appeal held that original signature was not enough to make the document an original. However this decision is no more relevant in the context of the revised U.C.P.

The U.C.P. 600 tried to clarify the problem of original documents and copies. It states[75];

"a. At least one original of each document stipulated in the credit must be presented.

b. A bank shall treat as an original any document bearing an apparently original signature, mark, stamp, or label of the issuer of the document, unless the document itself indicates that it is not an original.

c. Unless a document indicates otherwise, a bank will also accept a document as original if it:

i. appears to be written, typed, perforated or stamped by the document issuer's hand; or

ii. appears to be on the document issuer's original stationery; or

iii. states that it is original, unless the statement appears not to apply to the document presented.

d. If a credit requires presentation of copies of documents, presentation of either originals or copies is permitted.

e. If a credit requires presentation of multiple documents by using terms such as "in duplicate", "in two fold" or "in two copies", this will be satisfied by the presentation of at least one original and the remaining number in copies, except when the document itself indicate otherwise."

[75] The U.C.P.600, Article 17.

Similarly when the credit calls for an insurance policy, but instead of it a cover note is tendered it would not be sufficient to meet the requirement under documentary credit[76]. Scrutton L. J. in the course of his judgment in *Scott* v. *Barclays Bank Ltd.*[77] stated that he was not prepared to hold that all such certificates would be a bad tender under a banker's commercial credit.

Apart from this the insurance should be for the full value and expressed in the same currency as the credit. The effective date of the cover must be atleast, the day of "loading on board", "taking in charge" or "dispatch" and banks will refuse documents showing a later date unless there are other provisions stipulated in the credit. Thus discrepancies in this document also become a problem in letter of credit transaction. The strict compliance principle upholds its accuracy as these documents are needed to overcome the disadvantage that may arise because of the independence rule to the buyer as well as the banker.

Other Documents

In the letter of credit in addition to above documents other documents may also be required. They may include documents like certificates of quality and inspection, certificate of weight and quantity and certificate of origin. Discrepancies in these documents are also to be looked into. Combination of these documents however will not amount to discrepancy. In *Netherlands Trading Society* v. *Wayne & Haylett Co.*[78] the credit called for "original weight

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[76] *Donald H. Scott & Co.* v. *Barclays Bank Ltd.*, [1923] 2 K.B.1. Cover notes and certificates are not equivalent to a policy. See *Diamond Alkali Export Corporation* v. *Bourgeous*, [1921] 3.K.B. 443

[77] *Ibid.* However the decision in this case was in banker's favour and the rejection of certificate was held valid.

[78] (1952) 6 L.D.B. 320 as cited in *Supra* n.1.

certificate" and "original jute mills certificate". The bank accepted a combined jute mill and weight certificate. This was upheld by the court.

In *Re Reinhold & Co. v. Hansloh*[79], a C.I.F. contract called for "legalized" Chamber of Commerce certificate. The seller tendered his bills of lading describing the goods as in bags "marked and numbered as in the margin", with the letter F. The accompanying Chamber of Commerce certificate did not state that the bags referred to in the certificate were those marked F. It was held that this was a discrepancy in document and was liable to be rejected. This shows that document demanded[80] in the letter of credit and the document tendered should agree.

Strict Compliance and Banks Reimbursement

The issuing bank should reimburse the correspondent bank if they comply with strict compliance rule while making payment to the seller. However if there is non compliance, issuing bank can reject the documents even though the beneficiary is paid by the correspondent bank. In *Co-operative Centrale Raiffeisen-Boerenleen Bank B.A.* v. *Sumitomo Bank Ltd.*,[81] it was accepted by all parties that, in the absence of contrary agreement, the issuing bank's obligation is to reimburse the confirming bank with funds of the same value. Banks are not

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[79] (1896) 12 T.L.R. 422. *Ibid.*

[80] A demand must be made for a document. It is not sufficient to qualify the word denoting quality in the description of the goods if the buyer or the banker wishes the quality to be certified by a separate document.

[81] [1987] 1 Lloyd's Rep.345 at p.345, varied on appeal without affecting this point. [1981] 2 Lloyd's Rep.250.

liable for effectiveness of documents. So also banks are not liable for transmission of messages[82].

In examining the documents under the documentary credits the banks are expected to comply with international standard practice[83]. It is a very elusive concept. However International Chamber of Commerce has published a guide to international banking practice,[84] which stabilizes the question of compliance to a certain extent. In case of trivial discrepancies banker will get right of recourse against applicant.[85] Paying bank is entitled to recover from the applicant the amount paid by them. If the confirming bank accepts non-confirming documents and pays, it could not get reimbursement.

In *Beyerische Vereinsbank Aktiengesellschaft* v. *National Bank of Pakistan*[86], the confirming bank after payment to the beneficiary on document passed them to the issuing bank. The issuing bank refused to accept the documents on grounds of discrepancies. On analysis of the situations it was found that issuing bank had not objected to the discrepancies. The notice sent by the bank had been delivered by courier instead of by telecommunication. Mance J., considered that they have not acted "without delay" as required by the U.C.P.500. The court considered the fact that the issuing bank had disposed fax and telex access but had chosen not to use them. Therefore issuing bank was

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[82] The U.C.P.600, Article 35.
[83] *Id.*, Article 14 (d).
[84] *International Standard Banking Practice*, I.C.C. No. 645 (2003)
[85] *Seaconsar Far East* v. *Bank Markagi*, [1993] 1 Lloyd's Rep.236. However the Court of Appeal was unwilling to define trivial discrepancies.
[86] [1997] 1 Lloyd's Rep.59

not entitled to refuse payment.[87] Hence discrepancies in the documents should be scrutinized clearly by banks. They should pay careful attention while payment is made.

The U.C.P.600 tried to clarify the above issues. It states for bank to bank reimbursement arrangements[88]. It states;

a. If a credit states that reimbursement is to be obtained by a nominated bank("claiming bank") claiming on another party ("reimbursing bank"), the credit must state if the reimbursements in effect on the date of issuance of the credit".

b. If a credit does not state that reimbursement is subject to the ICC rules for bank-to-bank reimbursements, the following apply:

   i. An issuing bank must provide a reimbursing bank with a reimbursement authorization that conforms with the availability stated in the credit. The reimbursement authorization should not be subject to an expiry date.

   ii. A claiming bank shall not be required to supply a reimbursing bank with a certificate of compliance with the terms and conditions of the credit.

   iii. An issuing bank will be responsible for any loss of interest, together with any expenses incurred, if reimbursement is not provided on first demand by a reimbursing bank in accordance with the terms and conditions of the credit.

   iv. A reimbursing bank's charges are for the account of the issuing bank. However, if the charges are for the account of the beneficiary, it is the responsibility of an issuing bank to so indicate in the credit and in the reimbursement authorization. If a reimbursing bank's charges are for the account of the beneficiary, they shall be deducted from the amount due to a claiming bank when reimbursement is made. If no reimbursement is made, the reimbursing bank's charges remain the obligation of the issuing bank.

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[87] However more liberal approach to article 14(d) was taken in *Seaconsar Far East* v. *Bank Markazi Jombouri Islami Iran,* [1997] 3 All E.R.628.

[88] The U.C.P.600, Article 13.

c. An issuing bank is not relieved of any of its obligations to provide reimbursement if reimbursement is not made by a reimbursing bank on first demand.

Discrepancy of the Documents: Duty of the Beneficiary

Doctrine of strict compliance enjoins that the beneficiary's performance has to comply precisely with the terms and conditions contained in the letter of credit. The bank is not required to make any judgment as to the adequacy of performance of the beneficiary, or importance of any particular term in the letter of credit. This is clear from the decision in *Hamzeh Malas* v. *British Imex Industries Ltd.*[89]. A bank cannot refuse to accept or purchase a bill of exchange drawn by the beneficiary of a credit merely because the beneficiary has broken the underlying contract. American courts have gone to a further extent by holding that the bank cannot refuse to accept the beneficiary's draft even if the bank's customer has rescinded the underlying contract.[90]

Thus it can be seen that the duty of the beneficiary is to present the required documents in strict compliance before the confirming banker so that payment can be received.

Doctrine of Strict Compliance: An Indian Perspective

Strict compliance doctrine is applied in India based on the English precedents and common law principles. Accordingly banks are entitled to reject documents which do not strictly conform to the terms of the credit. The bank

[89] [1958] 2 Q.B.157

[90] *Frey* v. *Sherburne*, (1920) 184 N.Y. Supp. 661. In this case the applicant buyer was the customer of the bank. Fundamental breach of the underlying contract was made by beneficiary and that fact was known to the bank. The court held that it will not prevent bank from paying in terms of the letter of credit.

must examine all documents with reasonable care to ascertain whether or not they appear on their face to be in compliance with the terms of the credit. The banks may refuse to accept discrepant documents. The bank which operates the credit has to ascertain whether the documents tendered by the seller correspond to those specified in the instructions under the letter of credit. The strict compliance rule is limited to the documents. In *Roshan Lal Anand* v. *Mercantile Bank Ltd*[91], the importance of strict compliance of documents in letter of credit transaction was mentioned. This case related to the discrepancy in import license. It was held that import license was an integral part of the contract relating to the opening of the letter of credit. Here the bill of lading and other papers presented to the bank by the beneficiary were not in conformity with the import license. The invoice also did not tally with the import license. However the bank accepted these documents and paid the beneficiary. The buyer refused to reimburse the bank. The bank sued the buyer for recovery of bill amount. The Delhi High Court allowed the bank's claim and held that bank was not liable to the buyer on the ground of autonomy principle. But the court observed that in order to recover from the person who had opened the letter of credit, the banker must show that it had carried out, in all their strictness its instructions as notified to it by the buyer. In *Ellerman and Bucknall Steamship Co. Ltd.*[92], the question of regularity of documents tendered was raised. In this case, in pursuance of the contract with a company in New York the bank opened a letter of credit in favour of the seller. One of the documents mentioned that the letter of credit was for a clean bill of lading. The seller delivered to the shipping company certain consignments in "re-used fiber drums". The mates receipts issued to the seller

[91] (1975) 45 Com. Cas. 519 (Del.).
[92] A.I.R.1966 S. C. 1892.

mentioned that the consignments were packed in "re-used drums". At the request of the seller the shipping company used bill of lading stating that the goods were received in drums in apparent good order and condition and did not mentioned that the drums were "re-used". The company obtained an indemnity from the seller for the loss that might occur. By presenting the document the seller obtained payment. When the buyer took delivery of drums, he found that they contained coal dust and factory shavings. He sued the shipping company for making misrepresentation and breach of duty by not disclosing in the bill of lading the drums were re-used. If it was mentioned, the bill of lading would not have been clean and the seller could not have obtained the money under the letter of credit. It was held that there was a breach of duty by the shipping company in not disclosing the word "re-used" which would have affected the negotiations of bill of lading. In the course of judgment the court made a reference to the doctrine of strict compliance. It observed that when the documents are tendered by the beneficiary, bank should scrutinize the documents and see whether the instructions given by its constituent had been strictly complied with. It is bound to refuse the documents if they are not strictly in conformity with the instructions. This strict compliance of documents was again accepted by the Madras High Court in *Indian Overseas Bank Ltd* v. *S.K. Ramalingam Chettiar* [93], where both the bill of lading and insurance policy documents were not in conformity with the instructions given under the letter of credit. It was held that the bill of lading was not clean because of the special note therein regarding the condition of packing of the goods. The letter of credit

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[93] (1970)2 M.L.J.288. Also see *United Commercial Bank* v. *Bank of India*, A.I.R.1981 S.C. 1426, *National Oils and Chemicals Industries Ltd* v. *Punjab & Sind Bank Ltd.*, (1980) 50 Com. Cas. 390 (Del.)

had called for a clean bill of lading. The insurance policy was also defective since it did not cover the risk of theft and pilferage.

The Delhi High court applied this principle in *Interdas Advertising (P) Ltd.* v. *Palmex Enterprises* [94]. Here the bill of lading contained a rubber stamp "shipped on board". It was neither signed nor initialed. The word "Singapore" was printed against the column "freight payable at". There is also a rubber stamp "freight prepaid". It appeared that the bill of lading was not in conformity with the letter of credit. The letter of credit also required a certificate of weight and quality issued by an independent surveyor. It did not disclose who conducted the survey and whether the surveyor was a qualified person. All these showed that the documents were not strictly in conformity with the documents mentioned in the credit. In the course of judgment the court remarked that the words "as tendered" in article 33 of the U.C.P.400 cannot be stretched to mean that whatever document is tendered by the beneficiary styled as certificate of quality, that has to be accepted by the bank. It must be a certificate of quality in essence and not in name only[95].

Similarly, in *Hindustan Zinc* v. *Punjab National Bank* [96], the plaintiff presented documents with sight draft to the advising bank. It was not accompanied by transport documents and was not submitted within the stipulated time. It was held that the bank was not bound to honour the bill of

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[94] (1983) 53 Com. Case. 550 (Del.). For similar case also see, *Interdas Advertising P Ltd* v. *Bentrex & Co.*, (1983) 53 Com. Cas. 646 (Del.)

[95] For the inconformity of the quality certificare also see *B.S.Aujila Co Pvt Ltd* v. *Kaluram Mahadeo Prasad*, A.I.R.1983 Cal.106, *State Bank of India* v. *Manganese Ore (India) Ltd*, (1997)4 Comp. L. J. 57 (S.C.)

[96] A.I.R.2002 Del. 398.

exchange drawn by the seller unless the accompanied documents are in exact compliance with the terms of credit.

According to courts, the strict compliance doctrine is based on the contractual relationship and the terms agreed between the parties. This document is of great importance to the commercial world. In *Swiss Bank Corporation* v. *Jai Hind Oil Mills Company*[97], the Bombay High Court stated that the doctrine of strict performance is one to the fundamental principles relating to letter of credit. The court remarked that the bank is entitled to reject the documents which do not strictly conform to the terms of the credit. According to the court the advising bank is a special agent of the issuing bank. Such agent has only limited authority to act. But every discrepancy would not lead to the conclusion that the documents are not in accordance with the letter of credit[98].

In *Jindal Stainless Ltd.*,case[99], the Delhi High Court said[100],

> " ... The bank is to honour the demand for encashment if the seller prima facie complies with the terms of bank guarantee or the letter of credit, namely, if the seller produces the documents enumerated in the bank guarantee or the letter of credit. If the bank is satisfied on the face of the documents that they are in conformity with the list of documents mentioned in the bank guarantee or the letter of credit and there is no discrepancy, it is bound to honour the demand of the seller for encashment...."

Strictly compliance means that the documents are same and exactly same documents mentioned in the credit. In *AVN Tubes Ltd v. Steel Authority of India*[101], it was stated that the documents must be those called for and not

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[97] (1989) 66 Com.Cas.241(Bom.).
[98] *Emmsons International Ltd* v.*State Bank of India*, A.I.R. 2007 (N.O.C.) 832 (M.P.).
[99] *Jindal Stainless Ltd* v. *ICICI Banking Corporation Ltd*, A.I.R. 2005 Del. 53
[100] *Id.*,64.
[101] A.I.R 1996 M.P.53.

similar documents. The banker is not expected to know or interpret trade customs and terms. Thus if the goods are described in identical terms, the name, the description mentioned in the document is important. The Supreme Court in the *United Commercial Bank*[102] case said,

> "...The banker owes a duty to the buyer to ensure that the documents tendered by the sellers under a credit are complied with those for which the credit calls and which are embodied in terms of paying or negotiating bank. The description of the goods in the relative bill of exchange must be the same description in the letter of credit, that it, the goods themselves must in each be described in identical terms, even though the goods differently described in the two documents are, in fact, the same. It is the description of the goods that is all important and if the description is not identical it is the paying bank's duty to refuse payment"[103].

The paying bank should scrutinize the documents. Acceptance of documents with insignificant and technical defects might make the bank liable. This aspect was considered by the Delhi High court in *Harparshad &Co Ltd. v. Sudarshan Steel Rolling Mills*[104]. In this case, HCL entered into a contract with an Iranian buyer for supply of railway track components. On behalf of HCL, Punjab National Bank issued a performance guarantee to the importer. A sub contract was entered with SSRM to facilitate HCL's performance of the export contract and in terms of the subcontract SSRM had undertaken to indemnify HCL if any amount was paid or become payable to the importer under the performance guarantee owing to the fault of SSRM. Subsequently HCL called upon PNB to pay. SSRM obtained a temporary injunction against the payment. HCL appealed. HCL contented that there was a failure on the part of SSRM in the performance of the subcontract since in a bill of lading furnished by SSRM the name of the

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[102] (1981)2 S.C.C. 766.
[103] *Ibid.*
[104] (1980) 50 Com.Cas.709 (Del.)

exporter was mentioned as "M/s.Harprasad & Co" without the word "Ltd". As a result of this the documents including the bill of lading presented by HCL under a letter of credit was negotiated under reserve. The court dismissed the appeal and held that the liability of the bank was not absolute.

The above discussion shows that the law relating to strict compliance is well recognized in India also. It is considered as a fundamental principle of the letter of credit transactions.

A Critical Appraisal of the Compliance Standards

In order to protect the integrity of the documentary credit strict compliance rule need to be applied. The primary concern of the buyer in international sale of goods is that the seller would ship the goods bargained before the buyer becomes obligated to pay. Although the doctrine does not totally guarantee the sellers' compliance, it is evidence as to the performance of the seller. On the other hand the beneficiary is helped by ensuring that banks will be able to act quickly. Banker is also relieved from tension for he has to verify the documents only on their face and not to go in depth of its legal characteristics. The strict compliance rule requires that the documents and their wording, and the descriptions must strictly comply with the stipulations in the documentary credit[105].

However the liability of banks to make payment to the beneficiary under documentary credit is contingent upon the proper presentation of documents by

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[105] E.P. Ellinger, *Documentary Letters of Credit - A Comparative Study*, University of Singapore Press, Singapore (1970), p.167.

the beneficiary. The documents tendered must be in compliance with the terms and conditions of the documentary credit. An issuing bank is not entitled to reimbursement unless this condition is satisfied. Any payment without such compliance is a breach of contract between the issuing bank and the buyer[106].The standard that guides the issuing bank while examining the documents tendered under the letter of credit is a mere *prima facie* determination of inconsistency[107]. So if the documents are on the face of it found to be inconsistent with the strict terms and conditions of the documentary letter of credit, banks are justified to repudiate such discrepancies. So also the banker is justified in refusing the documents as defective if any word is added as different from the original name in the invoice. Here the beneficiary, whose correct style of reference was 'P.S. (Pte) Ltd' was issued in the beneficiary's full name, the documents were taken as discrepant by the issuing bank and refused to pay. The court said that on the facts and evidence, the issuing bank could not be certain that the issuer of the invoice was the very same person as the beneficiary named in the letter of credit[108].

Another aspect regarding the strict compliance principle is the 'international standard banking practice'[109]. The standardization of international banking practice is insufficient[110]. Therefore the questions concerning documentary

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[106] *South African Reserve Bank* v. *Samuel & Co. Ltd.,* (1931) 40 Lloyd's. Rep. 291.
[107] The U.C.P.600, Article 14 states, "A nominated bank acting on its nomination, a conforming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation".
[108] *United Bank Ltd.* v. *Banque Nationale de Paris*, [1992] 2 S.L.R. 64.
[109] The U.C.P.600, Article 14 (d) reads; "Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit".
[110] J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits,* A.S Pratt & Sons; Detoit (2001),p.85.

compliance remain a frequent subject for litigation over documentary credits. Courts have exhibited two ways of dealing with documentary compliance. One view is the strict compliance with the letters of credit terms. Another view is that there must be substantial compliance based on the intention of the parties as reflected in contracts other than the credit itself and the fundamental fairness of the parties' conduct. The U.C.P.600 contains only general rules rather than detailed guidelines, therefore banks should make reference to generally accepted banking procedures.

The fundamental rationale behind the strict compliance rule is the need to ensure that the buyer is able to acquire proper documents so that he may obtain delivery of the consignment from the carrier. The letter of credit explains in detail the exact nature of the documents required to be furnished by the seller. Apart from this banks deal with a vast multitude of documentary credit transactions from all parts of the world. The decision must be rapid. In case of doubt the safest course for the bank is to reject the documents. As a consequence, the very purpose of the letter of credit will render Infructuous. It is true that independence principle should be the basis of letters of credit. But protective measures should be there to the buyer as well as the beneficiary to get prompt payment.

The study reveals the inconsistency and uncertainties regarding discrepancy and trivial ones. Therefore there is a need to adopt clear and simple rules in this regard.

CHAPTER-4

FRAUD EXCEPTION IN DOCUMENTARY CREDIT

CHAPTER 4

FRAUD EXCEPTION IN DOCUMENTARY CREDIT

Autonomy of letters of credit is a settled principle. Banks engaged in this transaction are not concerned with any dispute arising between the parties to the underlying contract. It is vital that every bank which issues letter of credit should honour its obligation to pay on presentation of the required documents. The banks are thus concerned only with the documents. There is no obligation on banks to check the factual authencity of the documents which are presented to them[1]. This position of certainty of payment raises various difficult situations.

The documents required under a documentary credit normally originate from the seller. Therefore if he chooses, he can make a forged document. Unless the forgery is obvious, the bank is entitled to pay. Similarly documents usually indicate dispatch of the goods. In some situations documents may be presented for a non-existent cargo.[2] By the time when the buyer came to know about this, he might have lost his money. The insurers generally do not pay for a non existing cargo. So fraud is recognized as an exception to the absolute payment principle in letters of credit. Banks are exempted from paying if it knows that the tendered document is false or contains a forged signature.[3]

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[1] *Maurice O'Meara Co.* v. *National Park Bank of New York* 239 N.Y. 386, 146 N.E. 636 (1925) cited in Richard Schaffer *et.al.*, *International Business Law and its Environment,* West Educational Publishing Co., U.S.A. (1999),p.255.

[2] Leo O'Arcy, Carole Murray (Eds.), *Schmithoff's Export Trade,* Sweet and Maxwell, London (2000), p.210. It is to be noted that courts appears to not draw distinction between forged and fraudulently false bill of lading.

[3] *Gian Singh Ltd.* v. *Banque de l'Indochine,* [1974] 2 All E.R. 754.

In documentary letters of credit, fraud occurs in various forms. Therefore banks are expected to act in a reasonable manner in case of allegation of fraud in relation to the commercial documents. However a mere allegation of fraud is insufficient to affect the bank's obligation to make payment.[4] Evidence of fraud is required for the refusal of payment by banks. But it is not clear as to the degree of evidence of fraud required. Similarly, it is not clear whether knowledge of such fraud to the beneficiary and the bank is necessary to invoke fraud exception. Therefore it is necessary to analyse the fraud rule in order to find out how it helps to minimize the risk undertaken by the concerned parties. Since the U.C.P. principles remain silent regarding the fraud it is essential to find out the legal basis of this rule. Increase in fraud exception application will result in diminution in the commercial utility of this instrument. Therefore a critical evaluation of fraud exception in modern scenario is needed.

Effect of Fraud in Documentary Credit

It is a fundamental principle of letters of credit law that a bank's undertaking to pay beneficiary on presentation of stipulated documents is separate from any underlying contract.[5] The only exception to this principle apart from strict compliance[6] is fraud.

Sometimes the documents will be genuine but the beneficiary perpetrates a fraud which the issuing bank comes to know afterwards. The fraud exception remains too narrow and the banker is liable to pay irrespective of fraud. Thus in

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[4] Hans Van Houtte, *The Law of International Trade,* Sweet and Maxwell, London (2002),p.279.
[5] Ross Cranston, *Principles of Banking Law*, Oxford University Press, New York (2002), p.387
[6] Under strict compliance doctrine the documents presented for payment must exactly comply with the documents stipulated in letters of credit. For a detailed discussion, see, *supra*, Chapter 3.

Discount Records Ltd. v. *Barclays Bank Ltd.,*[7] Megarry J., refused to grant injunction on an allegation of fraud. He observed:[8]

> "I would be slow to interfere with banker's irrevocable credits, and not least in the sphere of international banking, unless a sufficiently good cause is shown; for interventions by the court that are too ready or too frequent might gravely impair the reliance which, quite properly, is placed on such credits."

The buyers failed to establish the evidence of the alleged fraud in this case. When they opened the cartoons they found that it contained only a small quantity of goods ordered. Some of the cartoons were empty and contained goods which were not ordered. But the bank in this case accepted the draft which was in order.

The facts of this case show that the buyer communicated to the bank that fraud had occurred. But on enquiry the bank found that the alleged discrepancies were insignificant. The beneficiary was not a party to such fraud.

Meaning of Fraud

The term 'fraud' in letter of credit is not defined and courts have tried to interpret and give meaning to that. In *Beauman* v. *A.R.T.S. Ltd.,*[9] it was observed that the term "fraud" connotes dishonesty or deceit but may be of far wider application. The burden of proof required to establish dishonesty leading to fraud is different. Fraudulent misrepresentation or deceit which will be the basis of

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[7] [1975] 1 All. E.R. 1071 (C. D.)
[8] *Ibid.* at p. 1075.
[9] [1949] 1 K.B. 550

many types of fraud was exhaustively defined by Lord Herschell in *Derry* v. *Peek*[10]. He said,

> "…. in order to sustain an action of deceit, there must be proof of fraud and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, (2) without belief in its truth, or (3) recklessly, careless whether it is true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second for one who makes a statement under such circumstances can have no real belief in the truth to what he states."

This statement is however the general classification of fraud. Frauds in relation to letters of credit are frauds involving documents and also or fraud in relation to goods. However frauds in relation to goods are difficult to establish. If such an allegation arises before the payment is made, payment cannot be withheld by the bank unless there is proof that the seller has committed the fraud[11].

Courts have given a very narrow meaning to the term 'fraud'. Only outrageous conduct which shocks the conscience of the courts are treated as fraud[12]. This narrow interpretation is justified on the ground that a broader rule would defeat the certainty of letter of credit transaction. However there are two wider interpretations of the term 'fraud'. One is breach of standard contract and the other is intentional fraud standard[13]. In case of breach of contract standard, the customer would be allowed to obtain an injunction against payment by showing that it has a valid defense in an action for breach of the underlying

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[10] (1889) 14 App. Cas. 337 at p.376

[11] So long as the documents satisfy the requirement of credit, fraud in relation to goods will not stand.

[12] Harfield, "Enjoining Letter of Credit Transactions", 95 *Banking Law Journal* 596 (1978).

[13] Michael Stern, "The Independence Rule in Standby Letters of Credit", 52 *University of Chicago Law Review* 218 (1985).

contract[14]. But the intentional fraud standard follows the traditional "egregious fraud" standard. According to that a beneficiary who presents confirming documents under a letter of credit should be prevented from receiving payment only when his own wrongdoing has led to the creation of these documents.[15] Later broader definition of "wrong doing" was adopted to include a false representation[16]. However courts are reluctant to broaden the definition and narrow definition is insisted. In *Roman Ceramics Corpn.* v. *Peoples National Bank,* [17] the district court enjoined payment by finding that the beneficiary knew that the invoices covered by letter of credit had been paid. But misrepresenting this fact to the issuing bank has attempted to get payment. While applying the definitions of fraud in the transaction, the court observed:[18]

> "[We] think that the circumstances which will justify an injunction against honour must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligations would no longer be served."

It can be seen that the "egregious fraud" standard is traditionally followed in letter of credit transaction.

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[14] Note, "Fraud in the Transaction Enjoining Letter of Credit during The Iranian Revolution", 93 Harv. L. Rev. 992 (1980).
[15] Stephan H. Van Houten, "Letters of Credit and Fraud: A Revisionist View", 62 *Canadian Bar Review* 371 (1984).
[16] Agasha Mugasha, "Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee", [2004] J.B.L. 515
[17] 714 F. 2d. 1207 (3d Cir. 1983) cited in Mark S. Blodgett and Donald O Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud", Am.Bus.L.J.443 (1998).
[18] *Ibid* at pp.1212-13.

Development of Fraud Rule in the *Szejn* case[19]

This is perhaps the most important case law relating to fraud universally followed in case of documentary credits as an exception to autonomy principle. The seller in this case shipped rubbish materials under a contract of sale. He obtained a bill of lading from the carrier fraudulently stating that the goods shipped in the container are in good condition. However on suspecting fraud buyer refused to accept the documents and filed an injunction restraining the issuing bank from accepting this documents and making payment to the seller. The court held that the principle of autonomy is the important element of documentary credit however in case of fraud the autonomy principle cannot be upheld. Shientag J., said,

> "...where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.[20]"

However in this case certain questions left unanswered. One is the degree of knowledge of fraud that is necessary to justify the issuing bank in refusing to pay. The other question is whether the payment without knowledge of fraud is protected. Apart from this it does not address the position of the negotiating banker.

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[19] *Sztejn* v. *Henry Schroder Banking Corpn*,(1941) 31 N.Y.Supp.2d 631 cited in Richard Schaffer et.al., *International Business Law and its Environment*, *Supra* n.1

[20] *Ibid.*

Documentary Credit Frauds

Documentary credit system is wholly dependent on the integrity of the documents. The volume of documents used in documentary credits is often high. There are documents of different nature. The parties are at the liberty to include the documents of their choice. This will pave way for an increased fraudulent activity by the parties as the payment obligation undertaken by the banks is purely based on documents. Fraudsters use documents to perpetuate the fraudulent activities by using forged documents.

Frauds in Relation to Bill of Lading

One of the important documents used in letters of credit is the bill of lading. The long standing recognition that it may pass both title in the goods and all rights to sue under the contract of carriage has made it a vital document in letters of credit[21]. There can be fraud in relation to this document on various ways.

(i) Non shipment of goods

This is a simple method fraud committed through bill of lading of a known shipping company without actual shipping of goods. Sometimes bill is made by using imaginary names for the carrier and ship. In such cases the carrying vessel named in the bill may not even exist.

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[21] For a discussion, see T. K. Thommen, *Bills of Lading in International Law and Practice*, Eastern Book Company, Lucknow (1986).

In *Hindley & Co.* v. *East Indian Produce Co. Ltd.*,[22] Kerr J., remarked that

> "If no goods had in fact been shipped, the sellers had not performed their obligation."

The argument that seller was not a party to the non shipment is irrelevant and he cannot avoid his liability to the buyer. The seller has to ship goods of the contractual description and tender the sales, shipping and insurance documents to the buyer. Of course the seller is not concerned with the safe arrival of goods and their subsequent delivery to the buyer.[23] But during initial stage, he should be vigilant. However when a bill of lading document comes into the hands of a banker as part of the letter of credit transaction, the banker will verify only authencity of the document presented. Actual inspection is beyond the scope of the duty of banker. This increases the scope for committing fraud through bill of lading.

(ii) Short Shipment of Goods

Fraud can be committed through bill of lading by shipping lesser quantity of goods than actually contracted. The bill of lading is the prima facie evidence that the goods referred to has been shipped and the onus is clearly on the carrier to show that it had not in fact been shipped.[24] This requires very satisfactory evidence and proof of extreme probability. Any removal of goods during transit is not sufficient.[25]

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[22] [1973] 2 Lloyd's Rep.515 at p. 518.
[23] *Biddle Bros.* v. *Clemsens Horst Co.*, [1911] 1 K.B. 214.
[24] *Smith* v. *Bedouin S. N. Co.*, [1896] A.C. 70.
[25] See the decision of House of Lords in *Hain S. S. Co.* v. *Herdman & MacDougall*, (1922) 11 Ll.L.Rep.58.

Here also the banker cannot deny payment to beneficiary since the bill of lading presented will be in terms with those mentioned in letters of credit. It is the buyer who is put into trouble when he receives lesser quantity of goods. As fraud is not proved, he cannot raise any claims against the banks.

(ii) Falsification of a Bill of Lading

In this situation a bill of lading is altered after it has been issued. It is most commonly used when goods are shipped late. The date is often altered to show that shipment had been made in time. In *Kwei Tek Chao* v. *British Traders and Shippers Ltd.*[26] it was held that the bill of lading was a forgery when it showed the goods in question as having been loaded on the ship named in the credit within the time limit specified therein whereas in fact the loading had taken place after that time. However in that case fraud was that of the forwarding agent and not that of the seller. Even then the court held that the banker could reject the document as the beneficiariy's blamelessness will not be a concern when fraud is proved beyond any doubt.

Apart from this in *Bank Russo Iran* v. *Gordon, Woodroffe & Co. Ltd.*[27] Browne J. said that a fraudulent beneficiary would be liable to repay money paid by mistake of fact. The U.C.P. frees banks from liability or responsibility for the falsification or legal effect of documents[28]. This relief may not be enough to avoid all the consequences of fraud.

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[26] [1954] 2 Q.B. 459.
[27] The Times (London) Oct. 4, 1972, at 16 Col. 5 cited in *Sztejn* v. *J. Henry Schroder Supra* n.19
[28] The U.C.P.600, Article 34.

In an earlier case, one U.S. Court[29] refused to invoke the fraud exception. They believed that issuing bank's liability relates only to the verification of documents and checking whether they are on the face complies with credit only. A mere doubt regarding the quality of goods will not amount to fraud. Hence banks cannot refuse payment. Justice Cardozo dissented and took a different version for fraud.[30] He held that fraud means misrepresentation. This view can be ascertained from the following :

> "We have to bear in mind that this controversy...arises between the bank and a seller who has misrepresented the security upon which advances are demanded... I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face."

According to Cardozo's statement, in order to invoke the fraud rule, a misrepresentation should amount to complete non performance of the contract. Although in *Maurice's Case* a breach of warranty was involved when the seller shipped newsprint paper of inferior quality whereas in *Sztejn case* fraud in the translations by presenting the documents covering goods and the shipment of bales of worthless rubbish materials was involved. However according to Richard Schaffer, *Maurice O'Meara*[31] and *Sztejn Case*[32] presents clear distinction between a mere breach of warranty and fraud.[33]

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[29] *Maurice O'Meara Co.* v. *National Park Bank,* 239 N.Y. 386, 146 N.E. 636 (1925) cited in Richard Schaffer et.al., International Law and its Environment, *supra* n.1
[30] *Ibid.*
[31] *Ibid.*
[32] *Supra* n.19
[33] *Ibid.*

However whenever the question of fraud comes, the courts looks into the *Sztejn* rule. This rule has been expressly adopted in English decisions. In *American Accord* case[34], the sellers were unaware of the fraud committed by the shipping agent by fraudulently dating the bill of lading in order to convey the impression that the goods had been shipped before the expiry of the period specified in the documentary credit. Referring to *Sztejn's* case, Macatta J. observed,

> "the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment."

In another case[35], the bank paid against a set document including a bill of lading and a certificate of origin. Bill of lading was a forgery and certificate of origin included fraudulent misstatements. The bank refused payment and the seller sued. Lord Denning M. R. observed,

> "documents ought to be correct and valid in respect of each parcel. If that condition is brooked by forged or fraudulent documents being presented – in respect of any one parcel – the [bankers] have a defense in point of law against being liable in respect of that parcel"[36].

Thus fraud rule gives a different version to the autonomy of the letter of credit. Only condition is that the fraud must have been perpetrated by the seller or his agent. However this should be contrasted with forgery as a defense. There is some suggestion in *The American Accord* that banks should pay against forged documents where the seller is not privity to the forgery. Chuah says that the

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[34] [1979] 2 Lloyd's Rep.267.
[35] *Establissement Esefka International Anstalt* v. *Central Bank of Nigeria* [1979] 1 Lloyd's Rep.445
[36] *Ibid.*

suggestion of payment where seller is not party to forgery is not correct because forged documents could never be conforming documents. Hence the beneficiary has no right to demand payment by presenting a forged document.[37]

Fraud rule of *Sztejn* case has influenced and shaped the fraud exception in all jurisdictions world wide. In the United States this rule has been adopted in the Uniform Commercial Code. It states that if the letter of credit is fraudulent, forged or fraud in the translations exists in the underlying sales contract buyer can restrain banker from making payment.[38] This Code specifies certain factors which the court must consider in order to determine the applicability of fraud exception. These factors include the effect of injunction on the beneficiary, the prohibition of injunction by another law and the availability of a remedy for fraud or forgery against the responsible party.[39] Therefore it can be concluded that fraud has been interpreted in *Sztejn* case to give an effective legal meaning.

Forged Documents

Apart from the bill of lading, various other documents are also used for the payment under letter of credit. There are situations where fraud had been committed and the documents appear on their face as fraudulent. There is no certainty to this position in municipal laws. The U.C.P. 600 also does not attempt to set out the position. The intention of the U.C.P. 600 may be to leave the questions of fraud to the relevant municipal courts.

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[37] J.C.T. Chuah, *Law of International Trade,* Sweet & Maxwell, London (1998), p.338
[38] The U.C.C.Article 5, s. 109.
[39] *Ibid.*

Limitations to the Fraud Rule

Though fraud as an exception to autonomy principle is established in *Sztejn*[40], it applies within narrow confines. There are three limitations which are frequently discussed.[41] One limitation is that it is difficult to determine whether an alleged discrepancy between the description of goods in the documents and their actual nature is indicative of fraud. It has been held that unless there is a blatant fraud, the banker cannot assert the deficiency of goods against the seller.[42] Second limitation shows that fraud is difficult to prove. In majority of cases, the letter of credit would be realized before the buyer succeeds in obtaining evidence of fraud. Moreover mere suspicion cannot establish fraud. In *Dulien's* case[43] the learned judge indicated that when an injunction is sought to restrain the bank from paying on an allegation of fraud, it must be closely connected with the letter of credit. A mere contention that the behavior of the beneficiary is a fraud upon the buyer might not be sufficient.

The third situation is that fraud can effectively be raised only against the party who has committed it. This point is made clear in many decisions.[44] Therefore if the fraud is committed by a third party, fraud exception cannot be raised to restrain payment under letter of credit.

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[40] *Supra* n.19.
[41] E. P. Ellinger, "Fraud in Documentary Credit Transactions", [1981] J.B.L. 258
[42] *Supra* n.7
[43] *Dulien Steel Products Inc. of Washington* v. *Banker's Trust Co.* 298 F. 2d 836 (1962) cited Gutteridge and Maurice Megrah, *The Law of Bankers' Commercial Credit*, Europa Publications, London (1979),p.24.
[44] See *Discount Records Ltd.* v. *Barclays Bank Ltd. Supra* n.7, *American Accord* case, *Supra* n.314

Effect of Fraud by Third Party

Another question relating to documentary credit fraud is that, if a document tendered by the third party is a "nullity" whether the bank can refuse to pay the beneficiary. This issue was addressed by the House of Lords in *United City Merchants (Investments) Ltd* v. *Royal Bank of Canada*.[45] Hence the sellers were unaware of the inaccuracy of the notation in the bill of lading. Believing it to be true they presented it for payment and the confirming bank refused to pay on the ground that they had information suggesting the fraud committed in the bill of lading. The court was of the opinion that if seller is not a party to fraud then fraud exception cannot be invoked. The argument that to render a transaction a nullity, knowledge on the part of the seller is not required was rejected by the court. Lord Diplock said that such a proposition would seriously undermine the whole system of financing international trade by means of documentary credit. Though the nullity question was reserved by Lord Diplock in this case, it was answered by the Court of Appeal in *Montrod Ltd.* v. *Grundkotter Fleischvertriebs Gmb H.*[46]. It was held that there is no general nullity exception under English law. The beneficiary may have presented documents that are not genuine and have no commercial value, but he is entitled to payment under the credit unless he was fraudulent.

The Court of Appeal stressed that there were "sound policy reasons" for rejecting the general nullity exception. Potter L. J., delivering the judgment of the

[45] [1983] 1 A.C. 168. See also, Note, "Fraud and Letters of Credit: Is there a Nullity Exception", 61 *Cambridge Law Journal* 279 (2002).
[46] [2002] 1 All E.R.257(Comm.).

Court,[47] considered that a general nullity exception would be incapable of precise definition. This case involved a document presented under "the letter of credit, which was signed by the beneficiary believing that it was authorized to do so by the applicant, while in fact there was a dispute on the validity of the authority for so signing. Though there was no allegation that beneficiary was fraudulent, it was alleged that document tendered was nullity and fraud.

However Richard Hooley[48] points out three reasons for criticising this view point.[49] Firstly the bank's undertaking in the credit is to pay against conforming document and not against those that appear to conform.[50] So if the document is fraudulent but confirms with the letter of credit, payment made by the bank will lead to injustice. Secondly, a document which is a nullity is a worthless piece of paper. It offers no security to the bank which has paid out under the credit. It is to be noted that the principle of autonomy works only because the bank's obligation to pay has some value[51]. Third criticism is that there is a chance for circulation of forged documents in international trade undermining the trust in trade. Cresswell J. described antedated and false dated bills of lading as "a cancer in international trade."[52] This is true in case of a nullity document.

The ultimate result of these decisions seems to protect the beneficiary in case of fraud committed by a third party. But the applicant is made to suffer.

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[47] *Ibid.*
[48] Note, "Fraud and Letter of Credit: Is there a Nullity Exception", 61 *Cambridge Law Journal* 279 (2002).
[49] *Ibid.*
[50] Professor Goods has pointed out that a forged document is not a conforming document.
[51] C. Debattista, "Performance Bonds and Letters of Credit: a Cracked Mirror Image," [1997] J.B.L. 289 at pp. 303-304.
[52] *Standard Charted Bank* v. *Pakistan National Shipping Corpn.* (No. 2) [1998] 1 Lloyd's Rep.684. at p. 686.

This may be the reason why Potter L. J. in *Montrod* case did not decide the issue. He suggested that a non-fraudulent beneficiary might be refused payment on tender of apparently confirming documents when he acts recklessly in haste[53].

Thus though nullity of document was treated as a separate exception to the autonomy principle, it is related and should be treated as part of fraud exception. The reason for giving protection to beneficiary in case of third party fraud is that it is not only the bank and the buyers who will get it affected, but also the sellers who are deceived due to the fraud committed by the third party. This reasoning makes the legal position unclear as it will affect the international trade since no protection is available to the parties for their investments. If beneficiary in collision with third party commits fraud, it is difficult to prove and he can escape.

A fraudulent misrepresentation made by an agent of seller without the knowledge of the seller will not be sufficient to invoke fraud exception. The question, what will constitute material misrepresentation in document, is to be decided according to the circumstances. "material misrepresentation" is a standard of fraud in the United Kingdom[54]. The word misrepresentation is very close to a statement of the elements of fraudulent misrepresentation which constitute the tort of deceit.[55]

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[53] *Supra* n.46. This suggestion is only *Obiter dictum* of this case. It is to be noted that nullity exception was not accepted as it would erode the autonomy principle but various observations were made by the judge will arising at a decision.

[54] See the U.C.C. Article 5.

[55] For fraud of deceit there must be three elements (i) knowing the representation to be false (ii) without belief in its truth or (iii) recklessly, careless whether it be true or false.

This shows that in England, third party fraud is narrowly construed. However in Canada, intentional fraud and prima facie evidence is given importance[56]. Thus in *Henderson* v. *Canadian Imperial Bank of Commerce*[57] Berger J. expressly rejected Lord Diplock's conclusion that a bank must pay against apparently confirming documents even if it knows that the seller has committed a breach of contract. His Lordship's thought that Lord Diplock's restriction of fraud exception to cases of material misrepresentation known to the bank would render the exception "illusory" and "narrow".

It appears from the above discussion that different countries follow different views with regard to payment to beneficiary in case of fraud by third party. Though the legal proposition is unjustifiable and detrimentally affects the applicant, it is necessary for not disturbing the worth of documentary credit transaction. The peculiar feature of such transaction is the prompt payment.

Documentary Fraud: Role of Banks

In making payment to the beneficiary, the obligation of the issuing banks rests solely upon the presentation of correct documents. Problem arises when the documents are correct on their face but actually fraudulent. Placing an absolute duty on the bank to defend against the fraudulent presentation of shipping document based on notice of fraud by buyer will create hardships. Such a step would force the bank to stop payment upon unfounded fears by the buyer. In that case the bank was made a party to litigations. The bank was

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[56] *Supra* n.19.

[57] (1982) 40 B.C.L.R. 318 (B.C.S.C.) cited in Stephen H. Van Houten, "Letters of Credit and Fraud: A Revisionist View", 62 *Canadian Bar Review* 371 (1984), at p.383.

required to take reasonable care to ascertain whether fraud was present on allegation of fraud by the buyer[58]. However, this requirement would greatly enhance the obligations of the bank unless strict standard are not imposed on them. The approach of courts seems to protect the interest of bankers in cases of fraud.

Standard of Proof

The bank is not obliged to ascertain whether the alleged fraud can be proved. It may adopt a passive attitude and evaluate the evidence placed before it. However evidence of fraud must be clear to the bank's knowledge. Then only banker is justified to refuse payment to beneficiary. This was stated by the Court of Appeal in *Boliventer Oil S.A* v. *Chase Manhattan Bank NA* [59]

> "The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will be clearly fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge. It would certainly not normally be sufficient that this rests upon the uncorroborated statement of the customer, for irreparable damage can be done to a bank's credit in the relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged."

The evidentiary requirement was further elaborated in *Tukan Timber Ltd.* v. *Barclays Bank Plc* [60] where the court stated;[61]

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[58] Notes, "Buyer may Enjoin Payment of Seller's Drafts on Ground of Fraud", 42 *Columbia Law Review* 149 (1942), Also see Philip W. Thayer, "Irrevocable Credits in International Commerce: Their Legal Effects", 37 Col. L. R. 1326 (1937).
[59] [1984] 1 W.L.R. 392 at p.393.
[60] [1987] 1 Lloyd's Rep.171.
[61] *Ibid.* at p.175.

> "We would expect the court to require strong corroborative evidence of the allegation, usually in the form of contemporaneous documents, particularly those emanating from the seller. In general, for the evidence of fraud to be clear, we would also expect the seller to have been given an opportunity to answer the allegation and to have failed to provide any, or adequate answer in circumstances where one could properly be expected."

If the bank receives corroborative evidence of fraud which includes some contemporaneous documents emanating from the buyer and on enquiry seller fails to give satisfactory answer to the allegation, banker can refuse payment. Thus solid proof must be furnished to the bank in case of fraud. In *Edward Owen Engineering Ltd.* v. *Barclays Bank International Ltd.*,[62] the unanimous opinion of the court was,

> "... it is certainly not enough to allege fraud: it must be 'established', and in such circumstances I should say very clearly established"[63].

In this case, Lord Denning M. R. stated:

> "That case shows that there is this exception to the strict rule; the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment."

Hence it would appear that the major regard to the alleged fraud is one of proof. If the bank has real knowledge, it can reject the document and refuse payment.

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[62] [1978] 1 All E.R. 976 (C.A.).
[63] *Id.*, at p.984 *per* Lord Denning M. R.

The Bank's Duty of Care

In most cases the bank would accept the forged or fraudulent tender before the true facts were discovered. Here bank is not liable so long as it has acted in good faith. However buyer will try to establish that in the initial stages of the transaction there had been a breach of a duty of care on the part of the bank. In order to succeed he must show that the bank had failed to give him the necessary guidance as regards the nature of the documents to be demanded in the letter of credit. The basic question that arises is whether the bank owes any such duty of care to its customer.

In *Midland Bank* v. *Seymour*,[64] Devlin J., found on the facts that no request for information had been made and that the bank had not been negligent. His observation was that in any event the bank's duty was confined to its not supplying misleading information whether bank was under a duty to "prosecute enquiries with due diligence" is a doubtful aspect. The facts related to the shipment of rubbish materials instead of 'Hong Kong duck feathers' by the exporter which resulted into the refusal by the buyer to reimburse the bank against the fraudulent documents presented. Some information received by the issuing bank about the exporter was not conveyed to the buyer[65]. Apart from this, the issue of reasonable practice of accepting documents was also considered by the court. It was held that the banker is not under a duty to verify the authenticity or the legal nature of the document presented. In the second case, *Commercial Banking Co. of Sydney Ltd.* v. *Jalsard Pty Ltd.*,[66] the plea that

[64] [1955] 2 Lloyd's Rep.147 at p.155.
[65] *Ibid.*
[66] [1973] A.C. 279.

the bank had broken a duty of care was rejected by the Privy Council on the facts. It was established that the buyer had specifically instructed the bank to call for a certificate of inspection issued by a firm selected by him. Here it was a consignment of christmas lights manufactured in Taiwan. When collected the buyer found that they were unusable although a "certificate of inspection" certified that the goods appeared to be in good condition. The buyer refused to reimburse the bank alleging that the bank should have advised him to stipulate for a certificate confirming that the goods had been subjected to an electrical test.

The above two cases discusses the question of duty of care. But the question involved is really a difficult one. The U.C.P. guidelines provide that banks have no liability to check the authencity of credit[67]. However if it elects to advice the customer it should take reasonable care to check the apparent authencity of the credit. But the degree of care to be taken is not mentioned. E. P. Ellinger states that,[68]

> "It would appear unwarranted to impose on banks a general duty of care to advise their clients in respect of documentary credit transactions as the experienced importer will be familiar with such transactions. However when a new customer who is not familiar with such transaction comes the bank may owe a duty of care to him."

If an allegation of fraud in relation to the commercial documents is involved, banks are expected to act in a reasonable manner. They must act to

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[67] The U.C.P.600, Article 34.
[68] E. P. Ellinger, "Fraud in Documentary Credit Transactions", [1981] J.B.L. 258.

prevent and detect possible fraud. They are not liable if the fraud cannot be detected even after the exercise of due diligence.[69]

Suspicious Circumstances

Sometimes bank may suspect documents without instigation by the buyer. The question regarding banker's obligation in this situation was raised in *Maurice O'Meara Co* case[70]. The question was whether the refusal of issuing bank to pay on a letter of credit on the basis of a reasonable doubt regarding the quality of goods was justified. It was held that a suspicion if not proved will not justify the refusal to pay. This should be distinguished from the situation of suspicion on documents. The suspicions regarding goods are part of the underlying contract. It is not the obligation of the bank to enquire into those issues and refuse to pay. If the banker is suspicious regarding the document presented, its obligation was not discussed. It is true that a suspicion cannot lead to a refusal to pay. But if it lead to proved fraud, banker should not be made liable for the refusal to pay.

Effect of Customers Instruction

If the customer informs the bank regarding fraud, whether the banker is under an obligation to reject the document or to make payment is a difficult question. It is argued that bank is bound by the instructions given to it, when the

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[69] J.C.T. Chuah, *Law of International Trade*, Sweet & Maxwell, London (1998), p.337.
[70] *Maurice O'Meara Co.* v. *National Park Bank of New York, supra* n.1. See also *Discount Records Ltd.* V. *Barclays Bank Ltd.* [1975] 1. W.L.R. 315.

bank enters into a contractual relationship with parties[71]. However, the right to give instructions is limited to the agency agreement in which the buyer gave his instructions.[72] Therefore buyer's right to give further instructions after opening of the letter of credit is restricted because a new instruction on a concluded contract will call for reconsideration of the earlier contract.

Nonetheless, the banker cannot deny taking into consideration the instruction given by the buyer regarding fraud. If clear evidence is given, bank should take it into consideration. The decision to reject or accept the document can be made by the bank alone. Thus if it ignores a clear evidence of fraud, the bank will be liable.

Effect of Fraud on Discounted Deferred Letters of Credit

Sometimes letters of credit provide for deferred payment. This enables the bank to pay on the maturity date stipulated in the credit. There are situations where the beneficiary approaches the confirming bank and request for discounting the deferred letters of credit. On the basis of the terms of credit it may undertake payment. If fraud committed comes to the knowledge of bank after discounting and making payment but before the maturity date, the question of risk allocation will arise. Is it the issuing bank who instructs the confirming bank which acts under the instruction or the confirming bank though acts in terms with instruction, but discounts according to its own discretion will become liable.

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[71] Richard King (Ed.), *Gutteridge & Megrah's Law of Bankers' Commercial Credits*, Europa Publications, London (2001).
[72] Todd, "Sellers and Documentary Credits", [1983] J.B.L. 468 at p.470

These questions were analysed by the court in *Banco Santander S.A.* v. *Bayfern Ltd.*[73]. In this case the letters of credit stipulated payment as deferred and expressed it to be paid 180 days from the bill of lading date. Meanwhile he presented the documents under the credit before confirming banker. The banker examined and found that the documents were conforming. They discounted the letter of credit and payment was made before the maturity date by following the standard operational procedure. But after a week it was discovered that some of the documents were false and the issuing bank refused reimbursement to the confirming bank. The moot question was which bank is liable to bear the risk. The court held that the confirming bank should bear this risk. Langley J., held that the obligation to reimburse a party which has incurred a deferred payment obligation arises only when that deferred payment obligation has been discharged at maturity. He put the matter as follows:[74]

> "The basic authority given by the issuing bank to the confirming bank in a deferred payment letter of credit is to pay at maturity. The consequent obligation to reimburse is to reimburse on payment being made at maturity. If at that time there is established fraud, there is no obligation on the confirming bank to pay or on the issuing bank to reimburse."

The U.C.P.600 fails to address the question of allocation of risk of fraud in relation to deferred payment adequately. Therefore the opinion of Langley J., is the guiding legal principle in this matter.

This decision is to be distinguished from the position under a negotiation credit. In situations of negotiation credit, courts have held that the issuing bank

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[73] [1999] 2 All E.R. 18 (Comm.). This decision was upheld and endorsed by the Court of Appeal. [2000] 1 All E.R.776 (C.A.)
[74] *Id.*, at p.31(a)

must bear the risk of fraud discovered after the date of payment of the discounted value but prior to the maturity date.[75] This is because discounting of the negotiation credit was expressly authorized by the issuing bank on terms that it would be liable at the maturity date for the undiscounted sum of the credit. This position reflects the meaning of "negotiation" in the U.C.P.[76]

Fraud will affect the right of reimbursement of the confirming bank. It is difficult for a confirming bank to protect itself against this type of fraud. But the ruling is not harsh. It was the consequence of confirming banker acting itself to make payment before it was bound to do so[77]. Thus as a matter of legal reasoning the judge's approach in this case is sound. It accords with logic and with the well-established role of the fraud exception to the autonomy of credit. The banks must deal carefully with the discounted deferred letter of credit situation.

Effect of International Convention

The U.C.P. 600 does not address the issue of fraud. The problems relating to fraud are left at the discretion of the municipal laws of the concerned countries. This will generate problems as the municipal laws vary from country to country. To overcome this problem to an extent generally international communities refer the United Nations Convention of Independent Guarantees and Standby Letters of Credit. However the meaning accorded to the term 'fraud' has taken different views. This provision is not exhaustive. It has taken an

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[75] See *European Asian Bank A.G.* v. *Punjab and Sind Bank*, [1983] 1 Lloyd's Rep.611 (C.A.).
[76] The U.C.P.600, Article 2.
[77] Daniel Aharoni and Adam Johnson, "Fraud and Discounted Deferred Payment Documentary Credit: The Banco Santander Case", 15 J.I.B.L.22 (2000).

impressive and encouraging way to define fraud as the kind of misconduct[78]. The provision clarifies the misconduct that may bring the fraud rule into play. To a certain extend they provide good guidance for the courts to decide fraud cases. This position was accepted as 'clear and narrow' in scope and provide and excellent international standard with regard to fraud exception[79]. However while this convention required "manifest and clear" evidence to invoke the fraud rule, it does not mention that the wrongdoer's intention should be proven. Reading the text of the convention it seems to emphasize more the nature of the misconduct rather than the fraudster's state of mind.

Similarly International Standby Practices[80] expressly states that it does not provide for defenses based on fraud, abuse or similar matters.[81] These issues are left to the discretion of municipal law.

Fraud Exception: A Comparative Analysis

A large number of letter of credit fraud cases have been decided by courts in the United States. It is perhaps the only country which contains a

[78] Article 19, United Nations Convention on Independent Guarantees and Standby Letters of Credit reads: Any document is not genuine or has been falsified; no payment is due on the basis asserted in the demand and the supporting documents; or judging by the type and purpose of the undertaking, the demand has no conceivable basis. Article 19(2) further refined "no conceivable basis", as; The Contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized. The undertaking obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking; The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary; fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary.

[79] Comment 1, *Letigation Digest: Agritrade Int'l Pte Ltd.* v. *Industrial & Commercial Bank of China*, [1998] 3 S.L.R. (Singapore), *4Documentary Credit World* 8 (2000) cited in Gaoxiang & Ross Buckley, "A Comparative Analysis of the Standard of fraud required under the fraud rule in letters of credit", 13 *Duke Journal of Comparative & International Law* 293.

[80] Hereinafter referred to as I.S.P. 98. This governs international standby letters of credit. It is published by Institute of International Banking Law and Practice, Inc. in the United States.

[81] See rule 1.05(c) of I.S.P. 98.

codified legislation in this regard[82]. It contains a state of the art provisions with respect to fraud rule.[83] *Sztejn* case[84] laid down the basis of fraud rule in the U.S.A. It is codified in U.C.C.[85] However neither the code nor its comments gave any hint as to what type of fraud gave the bank an option to pay. This resulted in formulation of a number of standard frauds. Some courts struck to a strict and restrictive approach and adopted an egregious standard of fraud[86]. Other courts adopted a constructive standard of fraud. There is no certainty in fraud standard eventhough it is recognized statutorily. Later a task force was formed to study the previous case laws and make recommendations for the revision. The task force made several observations regarding the issue of fraud. Thus after extensive discussion and consultation of the recommendations a standard of fraud for letters of credit was set forth in the revised U.C.C.[87]. It adopted "material fraud" as the standard of fraud[88].

Fraud rule adopted in England is relatively rigid and narrow. It requires a high standard of proof. Accordingly it is very difficult to establish fraud. There have been only a limited number of cases in which the fraud rule is applied. *R. D. Harbottle (Mercantile) Ltd.* v. *National Westminster Bank Ltd.*[89], is perhaps the

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[82] Uniform Commercial Code is the legislation hereinafter referred to as U.C.C.
[83] The U.C.C. Article 5.
[84] *Supra* n.19
[85] *Ibid.* Also see the U.C.C. Article 5, s. 114(2).
[86] See *International Industries* v. *Girard Trust Bank* 336 A.2d 316 (Pa.1975) as cited in Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London, (1979), at p.144.
[87] The U.C.C., Article 5, section 109 reads: If ..... a required document is forged or materially fraudulent, or honor of the presentation would felicitate a material fraud by the beneficiary on the issuer of applicant, ... the issuer, acting in good faith, may honor or dishonor the presentation ..... if an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would felicitate a material of fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons".
[88] The article does not define material fraud.
[89] [1977] 2 All E.R. 862.

first decision which discusses the fraud rule. Though this case was not a case of established fraud, a restrictive view was taken to enable the circumstances in issuing bank to justify refusal to pay.

In the United Kingdom "material misrepresentation" is the standard of fraud in the law governing letters of credit[90]. The English position is close to that of the United States[91]. However courts in the U.S. will "look more on the severity of the effect of the fraud on the transaction rather than the sate of fraud of the beneficiary, whilst courts in the U.K. will require proof of the state of the mind of the fraudster.

Canadian courts have generally focused on standard of proof rather than standard of fraud when considering the application of the fraud rule[92]. They had considered whether the rule is confined to cases of forged or fraudulent documents or extend it to fraud in the underlying transaction[93]. The issue is normally addressed in a very simple way. For instance, in *CDN Research and Development Ltd.* v. *Bank of Nova Scotia,*[94] the court said,

> "It is my opinion; in this case, an injunction ought to be granted. In my view, it ought to be granted for at least two reasons. The first is that the plaintiff has made out a strong prima facie case that the demand made by the agent of the Ministry of War is fraudulent. Delivering has clearly been made and claim for a payment of delivery guarantee necessarily implying that delivery was not made is clearly untrue and false. Smith J. said that "[i]t may well be that the test of "clear fraud" is too high ...." and that

[90] See *United City Merchants (Investments) Ltd.* v. *Royal Bank of Canada, supra* n. 45.
[91] "Material fraud" is the term used in U.C.C.also.
[92] Stephen Van Houten, "Letters of Credit and Fraud: A Revisionist view", 62 *Canadian Bar Review* 371 (1984)
[93] See *Bank of Nova Scotia* v. *Angelina Whitewear.*, (1987) 36 Jeffrey J.Browne, "The Fraud Exception to Standby Letters of Credit in Australia", 11 *Bond Law Review* 98 (1999).
[94] 18 C.P.C. 62 (Ont. High Ct. of Justice 1980) cited in Stephen Van Houten, "Letters of Credit and Fraud: A Revisionist view", 62 *Canadian Bar Review* 371 (1984) at p.383.

> "[t]he test applied to be more apt and is less onerous than that of Lord Denning in *Owen* of clear or established fraud."[95]

Later in *Henderson* v. *Canadian Imperial Bank of Commerce*,[96] Berger J., expressly rejected Lord Diplock's conclusion that a bank must pay against apparently confirming documents where the bank knows that the seller has committed a breach of contract.

It can be said that the Canadian position on standard of fraud is somewhat confusing or contradictory. Fraud in Canada means something of "dishonesty or deceit or clearly untrue or false". Being a country of English tradition, the Canadian Courts traditionally follow the approach of their English counterparts. They adopted the standard of common law fraud. But the influence of the U.S. position in the area of letter of credit law can be seen in many cases[97].

In Australia, the fraud rule was considered only in a small number of cases. Intentional fraud and gross equitable fraud are the two kinds of standard of fraud there. However the idea that only gross equitable fraud may invoke the rule was rejected by Justice Batt of the Supreme Court of Victoria in *Olex Focas Pty Ltd.* v. *Skoda Export Co.*[98] He stated:

> "Now in Victoria, as in England, that law is clear. The principle is clearly established that payment by a bank and a demand therefore by a beneficiary under an unconditional performance

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[95] *Ibid.*
[96] *Supra* n.58.
[97] It is to be noted that fraud in Canada means something of "dishonesty or deceit or clearly untrue or false" similar to common law fraud requiring intention of the fraudulent party but on other hand, it means "utterly without justification" or "where it is apparent there is no right to payment" can also mean fraud which is similar to American position looking more to the sharpness of the fraudulent conduct, See *Ibid.*
[98] (1996) 13 4 F.L.R. 331, in Jeffrey J Browne, "The Fraud Exception to Standby Letters of Credit in Australia", *supra* n.93.

> bond or guarantee, as under a confined irrevocable letter of credit, will not be restrained except in a clear case of fraud of which the bank is clearly aware at the time of, probably the proposed payment, or in the case of forgery of documents (which is probably applicable only to letters of credit) or perhaps, in the case of illegality of the underlying contract...."[99]

The judge considered a number of English cases and said that only clear fraud could activate the fraud rule.

Therefore in Australia only "intentional fraud" has been applied. Gross equitable fraud, eventhough mentioned twice by the justice Batt was not applied in any case[100].

Application of Fraud Rule in India

Documentary credit is usually honoured free from interference by courts in India[101]. But the courts recognise two exceptions to this principle. One is the fraud exception and the other is irretrievable injustice. Courts have observed that these principles need not be treated as sacrosanct or sacred. When there is any serious dispute and a good prima facie case of fraud or special equities causing irretrievable injustice courts can interfere[102]. Fraud and irretrievable injury are recognized as exceptions in India also by following English precedents. The

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[99] *Id.*, at p.108.
[100] See *Inflatable Toy Co.* v. *State Bank of New S. Wales*, (1994) 34 N.S.W.L.R. 243; *Hortico (Ausralia) Pty Ltd.* v. *Energy Equip. Co. (Australia) Pty. Ltd.* (1985) 1 N.S.W.L.R. 545.
[101] *United Commercial Bank* v. *Bank of India*, (1981) 2 S.C.C. 766, *U.P.Co-op Federation Ltd* v. *Singh Consultants and Engineers (P) Ltd.*, (1988)1 S.C.C. 174, *Hindustan Steelworks Construction Ltd* v. *Tarapoe &Co.*, (1996)5 S.C.C. 34.
[102] *Ashim Ganguly* v. *Indian Oxygen Ltd*, A.I.R.1989 Cal. 150 (D.B.), see also *Union of India* v. *Philips Construction*, A.I.R.1989 Ker. 152.,*National Oils and Chemicals Industries Ltd* v. *Punjab & Sind Bank Ltd.*, (1980) 50 Com. Cas.390 (Del.)

observations made by Mukherji., J in *U.P.Co-op Federation Ltd.* case[103], throws light in this regard. He observed,

> "...An irrevocable commitment either in the form of confirmed bank guarantee or irrevocable letter of credit cannot be interfered with except in case of fraud or in case of question of apprehension of irretrievable injustice has been made out. This is well- settled principle of the law in England. This is also a well settled principle of law in India...."

Therefore most of the fraud cases decided in India are in tune with English cases. The courts in India are not inclined to move away from the fraud rule. As a result they insist that fraud has to be an established fraud and not a mere allegation of fraud[104]. Irretrievable injustice also must be genuine, established, immediate and irreversible[105]. The declaration of law in this regard is made in *Svenska Handelsbanken* v. *Indian Charge Chrome*[106]. It state,

> "in a case of confirmed bank guarantee or irrevocable letter of credit it cannot be interfered with unless there is fraud and irretrievable injustice involved in the case and fraud has to be an established fraud. There should be prima facie case of fraud and special equities in the form of preventing irretrievable injustice between the parties. Mere irretrievable injustice without prima facie case of established fraud is of no consequence in restraining the encashment of bank guarantee. Only in the even of fraud or irretrievable injustice the court would be entitled to interfere in a transaction involving a bank guarantee and under no other circumstances".

Courts also try to adopt the meaning for "fraud" in documentary credit by referring to the definition of fraud in the Indian Contract Act, 1882[107]. This can

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[103] (1988)1 S.C.C.174.
[104] *Saw Pipes Ltd.* v. *Gas Authority of India*, A.I.R.1999 Del. 30.
[105] *General Electric Technical Services Company Inc.* v. *Punj Sons (P) Ltd.*, A.I.R. 1991 S.C.1994.
[106] (1994)1 S.C.C. 502
[107] The Contract Act,1872, s.17 states, 'Fraud' means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract-

be seen in the decision of the Supreme Court in *State Trading Corporation of India Ltd* v. *Jainsons Clothing Corporation*[108] . However on analysis of the facts of this case, the court said that none of the conditions of fraud as set out in the definition under section 17 of the Contract Act are satisfied or applicable to the facts. But in another case[109] the court said,

> "Fraud as is well known vitiates every solemn act. Fraud and justice never dwell together. Fraud is a conduct either by letter or words, which induces the other person or authority to take a definite determinative stand as a response to the conduct of the former either by word or letter. It is also well settled that misrepresentation itself amounts to fraud. Indeed, innocent misrepresentation may also give reason to claim relief from fraud. A fraudulent misrepresentation is called deceit and consists in leading a man into damage by willfully or recklessly causing him to believe and act on falsehood. It is a fraud in law if a party makes representations which he knows to be false, and injury ensues there from although the motive from which the representations proceeded may not have been bad. An act of fraud on court is always viewed seriously. A collusion or conspiracy with a view to deprive the rights of others in relation to a property would render the transaction void *ab initio....*"

In *Ram Preeti Yadav* v. *U.P.Board of High Schools and Intermediate Education*[110], it was held that "fraud is a conduct either by letter or words, which induces the other person or authority to take a definite determinative stand as a response to the conduct of the former either by words or letter and that although negligence is not fraud, but it can be evidence on fraud". It was also held that once fraud is proved, it would deprive the person of all advantages or benefits

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(1) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
(2) the active concealment of a fact by one having knowledge or belief of the fact;
(3) a promise made without any intention of performing it;
(4) any other act fitted to deceive;
(5) any such act or omission as the law specially declares to be fraudulent".

[108] (1994) 6 S.C.C.597
[109] *Ram Chandra Singh* v. *Savitri Devi*, (2003)8 S.C.C. 319
[110] A.I.R. 2003 S.C. 4268

obtained thereby. This meaning of fraud was applied by the Gujarat high court[111] in letter of credit case. In this case fraud was played by defendant by preponing date of lodging of goods to obtain benefit of early payment as per conditions of letters of credit. The goods of approved quality were not supplied within the specified time and those goods supplied were less than those contracted for. The Bombay High court[112] considered the meaning of the word "fraud" while examining whether a strong prima case was made out.

According to courts fraud should be against the beneficiary and of an egregious nature. This is made clear in various cases. For example in *U.P.Co operative Case*[113] the Supreme Court said,

> ".... Since the bank pledges its own credit involving its reputation, it has no defence except in the case of fraud. The bank's obligations of course should not be extended to protect the unscrupulous seller, that is, the seller who is responsible for the fraud. But, the banker must be sure of his ground before declining to pay. The nature of the fraud that the courts talk about is fraud of an "egregious nature as to vitiate the entire underlying transaction". It is fraud of the beneficiary, not the fraud of somebody else."[114].

Thus a fraud must be established beyond reasonable doubt[115]. A finding as to fraud cannot be based on suspicions and conjunctures[116]. Similarly mere non supply of goods will not result in fraud[117].

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[111] *Adani Exports Ltd* v. *Marketing Service Incorporated*, A.I.R.2005 Guj. 257.
[112] *Dai-ichi Karkaria Pvt Ltd.* v. *Oil& Natural Gas Commission*, A.I.R.1992 Bom.309 at p 329.
[113] *Supra* n.3. See also *Association of Corporation and Apex Societies of Handlooms* v. *State of Bihar*, A.I.R. 2000 Del.106.
[114] *Id.*,197.
[115] *A.V.N.Tubes Ltd* v. *Steel Authority of India Ltd*, A.I.R. 1996 M. P. 53
[116] *Sree Narayanan Chettiyar* v. *Official Assignee, High Court Rangoon*, A.I.R. 1941 P.C. 93, *GEC Tech Services Co. Inc's case*, A.I.R.1991 S.C.1994, *Texmaco Ltd* v. *State Bank of India*, A.I.R. 1979 Cal. 44.
[117] *I.T.C.Limited* v. *Debts Recovery Appellate Tribunal*, (1998) 2 S.C.C. 70.

The fraud rule is applied in bank guarantee also. In *Svenska case*[118], ICCL issued a global tender for setting up a captive power plant. The tender indicated that credit by the suppliers will be preferred. The suppliers submitted their tenders in this regard. The supplier approached a foreign lender to finance the project. Contracts were entered into between the borrower and the supplier. The foreign lender entered into credit agreements with the borrower. The liability of the borrower to effect payment under the agreement was secured by a demand guarantee. The take-over certificate was issued. Later the borrower filed a suit for a decree of perpetual injunction restraining the bank from making payment. The case of the borrower was that the foreign lender had made fraudulent representations to persuade him to enter into contract. The suppliers were not competent enough to manufacture the plant. The borrower decided to go ahead with the contract relying on the representation and advice given b the defendants. He argued that the agreements between the supplier and the borrower and that of the borrower and the tender were interconnected and constituted one transaction and were vitiated by fraud. Repelling the contention, the Supreme Court took the view that allegation of fraud was made on suspicion could not be accepted.

In *Dwarikesh Sugar Industries Ltd.*, v. *Prem Heavy Engineering Works (P) Ltd.*[119], the Supreme Court reiterated the principle that if fraud is involved which would vitiate the very foundation of the bank guarantee and the beneficiary can be restrained from encashing it. But the fraud has to be an established fraud. The principle of unjust enrichment is not applicable to encashment of bank

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[118] *Supra* n.106
[119] (1997) 6 S.C.C.450.

guarantee. Encashment of guarantee can be restrained only in circumstances where it will result in irreparable harm or injustice to one of the parties concerned. The resulting of irretrievable injury should be decisively established. It must be proved to the satisfaction of the court that there would be possibility whatsoever of the recovery of the amount from the beneficiary by way of restitution.

In *Arul Murugan Traders* v. *Rashtriya Chemicals and Fertilisers*[120], the plaintiff was a dealer for the sale and distribution of products manufactured by the defendant. The plaintiff furnished a bank guarantee to assure prompt payment of invoices. Clandestine undertaking was adopted by the defendant and the plaintiff refused to pay. The defendant invoked the guarantee. Plaintiff brought to the notice of the court many discrepancies in the invoices supplied by the defendant. Some of the delivery challans were forged. The Madras High Court granted injunction interdicting the enforcement of the guarantee.

In *Dai-ichi Karkaria Pvt Ltd* v. *Oil & Natural Gas Commission*[121], plaintiff was supplying goods to the defendant. Customs duty was payable on the raw materials imported by the plaintiff which was required to be used for the manufacture of goods. The defendant agreed to make payment of certain amount to the plaintiff provided the plaintiff would undertake to repay the said amount on receipt of refund of the customs duty. The plaintiff furnished a demand guarantee to secure the amount. The terms of the bargain were re-negotiated to the complete prejudice of the plaintiff. The plaintiff agreed to

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[120] A.I.R.1986 Mad.161
[121] A.I.R.1992 Bom.309

incorporate under duress, the stipulation in the guarantee to provide the liability of the bank to pay even if refund of customs duty was not received by the plaintiff. Extensions of the bank guarantee were also given by the plaintiff out of fear. The defendant invoked the guarantee. The plaintiff field a suit for a declaration that the demand was fraudulent. The court found that the plaintiff had made out a prime facie case establishing economic duress, fraud and coercion and granted injunction. Dispute relating to breach of contract or pending arbitration would not amount to an exceptional case justifying interference by courts[122].

It can be seen that courts generally permit dishonor of letter of credit only on the fraud of the beneficiary[123]. This principle is a reflection of the American approach[124]. A circular was issued by the Reserve Bank of India in this regard[125]. Thus in *Arul Murugan*[126]case an irrevocable letter of credit was issued by the UCO Bank. The documents sent to it by the paying bank were confirmed by it. As a result, the Bank of Rajasthan who was acting as the paying bank paid the amount to the beneficiary and claimed reimbursement from the UCO Bank. The UCO bank refused to pay on the ground of fraud by some officers of the Rajasthan Bank. The court refused to accept the contention of fraud or conspiracy. The court further stated that as per the Reserve Bank circular, even if there is some allegation of fraud the liability of UCO bank to reimburse the

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[122] *Supra* n.101. Also see *Jindal Stainless Ltd* v. *ICICI Banking Corporation Ltd.*, A.I.R.2005 Del. 53

[123] *Virgo Steels* v. *Bank of Rajasthan* ,A.I.R.1998 Bom. 82 at p.86.

[124] *Sztejin* v *J Henry Schrodar Banking Corporation* (31 NYS 2d 631),*supra* n.19.

[125] Circular dated 1st April 1992 issued by the Reserve Bank of India.

[126] *Supra* n.120. See also *Federal Bank Ltd* v. *V.M.Jog Engineering Ltd.*, (2001)1 S.C.C. 663.

paying bank cannot be denied. The salient portion of the Reserve Bank Circular is as under:

> "... that banks should honour their commitments/letters of credit and make payments promptly leaving the opportunity for any complaints in this regard".

In *Synthetic Foams Ltd* v. *Simplex Concrete Piles (India) Pvt Ltd.*[127], The Delhi High Court said stated that misrepresentation, suppression of material facts and violation of the terms of the guarantee could be regarded as species of as fraud which would disentitle a beneficiary to enforce the bank guarantee.

However in most of the cases the courts had refused to accept the existence of fraud on the ground that prima facie case of fraud or irretrievable injustice was not made out[128]. But there are cases where fraud exception was allowed. In *Banerjee &Banerjee* v. *Hindustan Steel Works Construction Ltd.*[129], the court said,

> "Even if in the petition there is no allegation of fraud, if there is a willful false representation by the beneficiary that the entire guaranteed amount has become due and payable by suppressing the facts of recoveries already made, it is a factor which must be treated on the same footing as 'fraud' giving rise to special equity and must be treated as an exception to the general rule that the court should not interfere in these matters".

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[127] A.I.R.1988 Del. 207, See also *National Aluminium Co.Ltd* v. *R.S.Builders (India) Ltd*, A.I.R. 1991 Ori. 314.

[128] *Larsen&Tourbo Ltd* v. *Maharastra State Electricity Board*, (1995) 6 S.C.C. 68,*Ansal Properties &Industries (P) Ltd* v. *Engineering Projects (India) Ltd*, A.I.R. 1998 Del. 176,*J.T.Mobiles Ltd* v. *Deutsche Bank Ltd*, A.I.R. 1999 Del. 358, *Coronation Construction Pvt Ltd* v. *Indian Oil Corporation Ltd*, A.I.R. 1999 Del. 268,*Oil & Natural Gas Corporation* v. *SBI Overseas Branch Bombay*, (2000) 6 S.C.C.385, *EMCO Pressmaster Pvt Ltd* v. *Union Of India*, A.I.R. 2000 Del. 37, *Interior's India* v. *Balmer Lawrie &Co*, A.I.R. 2007 Del. 16, *Harcharan Dass Gupta* v. *Delhi Development Authority*, A.I.R. 2007 Del. 75.

[129] A.I.R.1986 Cal. 374. The facts are not relevant for the discussion here.

Similarly in *Rigoss Exports International (P) Ltd.* v. *Tartan Infomark Ltd.*[130], injunction against encashment of guarantee was granted. In this case petitioner was doing exporting business through an agency. All the letters of credit transactions were induced by the agency. There was fraud and a document relating to shipment procured by the agent was found to be forged.In *D.S.Constructions Ltd* v. *Rites Ltd*[131], also the fraud rule was applied. Here the defendant was invoking bank guarantee despite the knowledge that he had no right to this amount as the plaintiffs offer had lapsed.

The courts are not inclined to add additional grounds to the fraud exception. This can been seen in *BSES Ltd* v. *Fenner India Ltd*[132]. The court in this case declined to accept the averment that "lack of goodfaith" or "enforcing with an oblique purpose" constitutes further exceptions to the general rule of fraud application.

Thus it can be seen that the court would examine each case in order to find out whether the case falls within any of the classes relating to fraud rule. It can be seen that major hurdle faced in India is regarding the difficulty to produce solid proof of fraud and the rigid approach of courts.

Remedies and Claims in Fraud Situations

The fraud exception gives rise to a difficult situation. On the one hand the beneficiary is affected if he is denied payment on the basis of fraud which may

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[130] A.I.R.2002 Del. 235.
[131] A.I.R.2006 Del. 98. See also, *Easter Industries Ltd* v. *J.K.Corporation Ltd.*, (1997) 4 Comp. L. J. 78(Cal); *S.M.S.Demag A.G.* v. *Neelachal Ispat Nigam Ltd*, A.I.R. 2004 Ori. 89.
[132] A.I.R.2006 S.C.1148

ultimately prove to be false. On the other hand if the bank pays the buyer is left with no remedies

Remedies of Beneficiary

The essence of fraud is that the person perpetrating it is conscious that he is acting wrongfully. Obviously there would be fraud if a beneficiary knowingly present forged document under a credit. But in the case of forgery, the law is less concerned with the beneficiary's state of mind[133]. Therefore if the banker rejects documents where beneficiary is not a party, banker will be liable to compensate the beneficiary. Thus in *Urquhart, Lindsay & Co. Ltd.* v. *Eastern Bank Ltd.*[134] it was held that the beneficiary can recover general damages from bank if the issuing or confirming bank refuses to accept or purchase drafts from the beneficiary under a letter of credit without lawful excuse. However these damages will usually be the difference between the amount payable under credit and the lower market value of the goods covered by the credit.

The beneficiary cannot recover from the bank additional special damages which could be claimed from the other party to the underlying contract. This is because of the special knowledge of the circumstances known to the beneficiary only[135]. Apart from this as an alternative to suing the issuing or confirming bank for damages the beneficiary may sue the bank for the actual amount of the credit on the basis of shipping documents[136].

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[133] *Supra* n.45.
[134] [1922] 1 K. B. 318
[135] R. R. Pennigton & H. H. Hudson, *Commercial Banking Law*, Macdonald and Evans, Plymouth (1978), at p.360
[136] See *Belgian Grain and Produce Co.* v. *Cox & Co.*, (1919) 1 Lloyd's L.R.256, *Larious* v. *Bonany Y. Gurity*, (1873) L.R. 5 P.C.346 as cited in *Ibid.*

Buyer's Claim

Buyer is the ultimate party to suffer if the fraud occurs. Though the buyer can enjoin payment of the seller on the ground of fraud the burden of proof is high[137]. It is highly desirable that the buyer be protected against fraud of the seller. But to pressure the acceptability letter of credit, the grant of a remedy to the buyer should be limited. Only on reasonable ground, payment under the letter of credit is delayed.

It is believed that injunctive relief appears to be the most adaptable remedy which provides adequate protection for the buyer without placing undue hardship upon the issuing bank[138].

Fraud: Effect of Electronic Transaction

In documentary credit transaction paper based documents are used. Now electronic letters of credit are used where the parties can open letter of credit from terminals of their desktops directly to their bank's branch on the other side.[139] There is ample scope for fraudulent activity as the transactions are conducted through online[140]. Several attempts have already been made to create a new legal framework for the use of electronic transport documents. The attempts to create electronic transport documents are aimed at developing methods for claiming transferability of right and liabilities electronically with the

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[137] Notes, "Letters of Credit - Buyer may Enjoin Payment of Sellers Drafts on Ground of Fraud", 42 Col. L. Rev.149 (1942)
[138] See, Agasha Mugasha, "Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee," [2004] J.B.L. 515
[139] Notes, "Electronic Letters of Credit", *Banking World* 80 (1985).
[140] Susan Barkehall Thomas, "Electronic Funds Transfer and Fiduciary Fraud", [2005] J.B.L. 48

objective of creating electronic documents which will be able to perform all functions of paper documents.[141]

This shows that electronic documentary fraud will evolve as there is difficulty to prove the legal authencity of the electronic documents presented. It is said that the use of digital signatures can prevent a fraudster from impersonating either a carrier or legitimate trader, or tampering with the contents of an electronic document.[142] But it is doubtful how far they will alleviate fraud possibilities at payment and at delivery. Though eU.C.P. makes provision for the electronic transmission of documents tendered it is silent regarding the fraud aspect. The eU.C.P. validate the electronically transmitted documents as regards their tender under the documentary credit. They do not combat the commercial risks involved. They protect the bank and effectively pass the risk of fraud to the applicant[143].

Need For Arbitral Alternatives

The standards by which courts adjudge a seller's fraud as sufficient to enjoin payment have been discussed. The courts have preferred injunctive relief when the seller's fraud has "vitiated the transaction",[144] or is "intentional"[145] or

[141] Caslav Pejovic, "Documents of title in Carriage of goods by Sea: Present Status and Possible future directions", [2001] J.B.L. 461.
[142] Paul Todd, *Maritime Fraud*, LLP, London (2003), at p.144
[143] See the eU.C.P. Article.12.
[144] See, e.g. *Roman Ceramics Corp.* v. *Peoples Nat'l Bank*, 517 F. Supp. 526 (M.D. Pa. 1981) as cited in Mark S Blodgett and Donald O Mayer, "International Letter of Credit: Arbital Alternatives to Litigating Fraud", 35 Am.Bus.L.J.443 (1998).
[145] See, e.g. *Takes Co.* v. *Mead Paper* 611 N.Y.S. 2d 543 (1994). See also *Hohenberg Co.* v. *Comitex Knitters Ltd.* 428 N.Y.S. 2d 156 (1980) cited in *Ibid.*

"egregious",[146] or where there is "no conceivable basis"[147] for the demand. The concepts are developed through court verdicts in different situations of fraud. However these injunction requests have generated extensive litigation[148]. This injunctive relief will be appropriate only where the court has jurisdiction and there is irreparable injury. In these situations arbitration settlement will be a helpful device to solve these types of cases. International Commercial Arbitration has become the primary method for dispute resolution of transnational contract.[149] There are no legal or contractual barriers to the increased use of international commercial arbitration in letters of credit disputes.[150] However James Byrne is of the opinion that the arbitration measures are not really been successful with respect to letters of credit disputes[151]. It may be one of the reasons for increasing the court litigation than arbitral awards.

Modern Trends in Fraud Exception: A Critical Evaluation

The fraud rule is the most controversial and confused area in the law governing documentary credits. Fraud exception to the principle of autonomy arises in the case of established fraud. Except in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration. Courts are not concerned with the enforcement of such claims. It is believed that these must be free from

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[146] Di Sabatino, "What Constitutes Fraud of Forgery Justifying Refusal to Honor or Injunction against Honoring, Letters of Credit under U.C.C. § 5-114 (1) (2)", 25 *American Law Review* 239 (1983) at pp. 247-48.

[147] This test is proposed in Article 19 of UNCITRAL'S Convention on Independent Guarantees and Standby Credits.

[148] *Supra* n.94.

[149] Margaret Pedrick Sullivan, "The Scope of Modern Arbitral Awards", 62 TUL.L.REV. 1113 (1988).

[150] Mark S. Blodgett and Donald O'Mayer, "International Letters of Credit: Arbitral Alternatives to Litigating Fraud", 35 Am. Bus. L. J. 443

[151] *Ibid.* at p.446

interference by the courts. The judicial decisions of the past have indicated a move away from the courts reluctance to grant injunctions restraining payment under letters of credit in the face of allegation of fraud[152]. Now courts are signaling a move bank towards the classical position[153].

There is sensitivity towards the letters of credit instrument. If fraud is defined too narrowly it will encourage the growth of fraudulent conduct by the beneficiary. Similarly its liberal interpretation will erode the principal of autonomy and affect the use of letters of credit in trade.

Various tests are discussed by courts in different countries in order to arrive at fraud situation. It is always difficult to lay down the standard of fraud[154]. The U.C.P. remains silent regarding fraud situations and the banker faces difficulties in arriving at a decision.

There were only very few cases which established fraud as an exception to autonomy principle. Courts were reluctant to interfere with autonomy principles. Slowly there is a trend to increase the grounds of exception. Some commentators say that this trend is inevitable because it would afford parties involved in documentary transactions some protection against sharp practices.[155] But each of the newer grounds is uncertain.

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[152] See *Themehelp Ltd.* v. *West* [1996] Q.B. 84, *Kvaerner John Brown* v. *Midland Bank Plc.*, [1998] C.L.C. 446

[153] See *Czarnikow-Rionda Sugar Trading Inc.* v. *Standard Bank London Ltd.* as cited in 16 J.I.B.L.37 (2001).

[154] For discussion see *Ibid.* See also, Notes, "Letters of Credit", [2000] J.B.L. 623.

[155] *Supra* n.16.

As the question of fraud exception remains the matter to be decided by municipal laws there is uncertainty and inconsistency. The U.C.P. does not deny the existence of fraud in the transaction. The American legislation provides measure to tackle fraud situations.[156] So also the UNCITRAL convention contains provisions to deal with fraud situations. It is suggested that a combination of both these provisions may provide the limits of the fraud exception.[157]

Apart from this there is a need to reform the law in this area to meet the technological documentary fraud which may be crept in[158]. The existing provisions in municipal laws are inadequate. The U.C.P. also needs a revision to include provisions on fraud exception and the principle of autonomy. It may be argued that the fraud exception should be seen as an attempt to restore the balance of equities between the buyer and the seller.[159]

Protection given to buyer on the ground of fraud may sometimes result in increase in litigations. Buyer may approach courts on mere suspicion. If unnecessary delay occurs, the beneficiary will suffer loss. Hence adopting a balanced view is neDocumentarycessary.

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[156] See the U.C.C., Article 5. S.109.
[157] See the UNCITRAL, Article 19.
[158] Samuel O Maduegbuna, "The Effects of Electronic Banking Techniques on the Use of Paper-based Payment Mechanisms in International Trade", [1994] J.B.L. 338
[159] Razeen Sappideen, "International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency", [2006] J.B.L. 133

CHAPTER-5

TRANSFER OF RIGHTS AND OBLIGATIONS UNDER DOCUMENTARY CREDIT

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Transfer of documentary credits is essential in international trade. It is beneficial for the beneficiary who is in need of immediate finance. Sometimes the beneficiary may not be in a position to supply the contracted goods to the buyer by himself. Then by transferring the documentary credit to a third party the beneficiary will arrange for the supply of goods to the buyer and receive payment for contract goods. In this respect the buyer will arrange with the bank to issue documentary credit which can be transferred by the beneficiary to the third party. Usually the beneficiary will transfer a fraction of credit in favour of the third party who will be supplying the underlying goods on behalf of the beneficiary to the buyer. The third party will be permitted to draw on before the seller draws on the documentary credit for the balance. This provides the third party with a reliable source of payment and relieves the seller from making payment to the third party before the seller had himself been paid under the credit.

The rights created under documentary credit are contractual rights. Such rights can be transferred subject to the rules governing transfer of contractual rights. However the rules governing rights under documentary credit are different from the ordinary contractual rights. The rights of the beneficiary under letter of credit are termed as chose-in-action[1]. Traditionally rights under

[1] *Trans Trust SPRL* v. *Danubian Trading Co. Ltd.*, [1952] 2 Q.B. 297 at p. 305 *Per* Denning L. J.

documentary credit cannot be ordinarily transferred in order to protect the applicant's reliance on the designated beneficiary[2]. This approach created difficulties. Therefore separate rules and regulations are developed for this purpose. In the U.S.A., rules were codified to include letters of credit as non-transferable unless expressly provided in the contract between the parties[3]. The non governmental guidelines and conventions also deal with transfer of rights[4].

However parties engaged in documentary credit transaction may face some risks. The buyer is under risk if the beneficiary engages in the transfer of rights beyond his means. The banker is also faced with the genuineness of the documents furnished as substitute of the original documents mentioned in the original letter of credit[5]. These problems need detailed analysis.

The fact that the credit is not stated to be transferable may not affect the beneficiary's right to assign any proceeds he may be entitled to receive. This must however be made in accordance with the applicable law. Here too all rights of the beneficiary are not assignable. It is only the payment right that can be assigned. So there is a need for the classification of the right which the beneficiary possesses. The legal basis for the distinction between "transfer" and "assignment" in the context of the letters of credit also need to be identified. The contribution made by the judiciary in the development of legal principles dealing with transfer and assignment of rights is another area for study.

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[2] Katherine A. Barski, Comment on "Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits" 41 *Loyola Law Review*.735 (1996), p.755.
[3] See for example the U.C.C. Article 5, s. 5-112(a).
[4] See the U.C.P. 600.
[5] Jean Stoufflet, "Payment and Transfer in Documentary Letters of Credit: Interaction between the French General Law of Obligations and the Uniform Customs and Practice", 24 Ariz.L.Rev. 267.

Meaning of Transferability

The meaning of transferability under letter of credit is difficult to understand. They are termed as "tights which are locked up in a document to the extent that the document is considered to represent the right"[6]. This right is peculiar from ordinary rights because the beneficiary has the right to give instructions to the bank to make the credit available to third parties. But the bank has no obligation to comply with such instructions. In other words, consent in express terms by the bank regarding transfer is required[7]. There is no precise definition for transfer under letter of credit. For the purpose of getting a clear picture, it can be compared with the transfer of other instruments. It is not having the meaning "transfer" as applied in negotiable instruments[8] though it is similar to a bill of exchange[9] which can ordinarily be transferred with necessary indorsement.

The meaning of the word "transfer" describes the procedure that takes place and is an inaccurate description of the legal nature of the operation[10]. The word "transfer" in letter of credit suggests an amended form of the credit issued which reflects different conditions regarding the transferee's documents.[11]

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[6] R.M.Goode, "Reflections on Letters of Credit – V", [1981] J.B.L. 150.

[7] See the U.C.P.600, Article 38. Apart from this, this is notion of a right on one side unaccompanied by a duty on the other.

[8] A letter of credit is not considered as a negotiable instrument though it possess the characteristics of negotiable instrument. See Notes, "Letters of Credit – Negotiable Instruments", 36 *Yale Law Journal* 245 (1926-27) p. 249.Also see William E. McCurdy, "Commercial Letters of Credit", 35 Har. L. Rev. 539 (1921-22).

[9] *Power Cuber International Ltd.* v. *National Bank of Kuwait S.A.R.*, [1981]1W.L.R.1233. Lord Denning M. R. compared the letter of credit with a bill of exchange.

[10] See R. M. Goode, *Commercial Law*, Penguin Books Ltd, U.K. (1995), p. 1016.

[11] Typically, for example, the commercial invoice.

The process of transfer can be described as follows:

The issuing bank issues a transferable credit to the beneficiary. He may wish to transfer this to X. The beneficiary returns the letter of credit to the issuing bank[12]. Then at the beneficiary's request it issues a new version of the credit to X for part of the amount of original credit. There is thus, no physical transfer of the original credit to X. X is entitled to payment under the terms of the new form of credit by furnishing his own documents. The original credit remains available for the original beneficiary.[13] Therefore transfer of letter of credit has a different meaning. In order to ascertain the clear meaning it is essential to analyse the process in detail. The fact is that if the credit is not stated to be transferable it does not affect the beneficiary's right to assign[14].

Distinction between Transfer and Assignment

The legal basis for the distinction between "transfer" and "assignment" in the context of documentary credits lies in the nature of the commercial and banking relationships involved. It is well-settled law that the right to present documents under a non-transferable credit is personal to the beneficiary. In an Austrian case[15] court reasoned that the only right the beneficiary had assigned was the right to proceeds. English authority in this proposition is *Cleveland Manufacturing Co. Ltd.* v. *Muslim Commercial Bank Ltd*[16]. In this case, the plaintiff as beneficiary of a credit authorized a firm of shipping agents to prepare

[12] See the U.C.P. 600, Article. 38 (b).
[13] It is available only for the balance remaining after the transferee's drawing.
[14] See the U.C.P. 600, Article 39.
[15] *Singer & Friedlander Ltd.* v. *Creditanstalt-Bankverein*, 17 Cg. 72180 (Vienna Commercial Ct. 1980), cited in Maurice Megrah Q. C., "Risk Aspects of the Irrevocable Documentary Credit", 24 Ariz. L. Rev. 255 (1982).
[16] [1981] 2 Lloyd's Rep. 646.

the documents required by the credit. The agents presented the documents and received payment from the bank. The beneficiary sued against the bank when the agent became insolvent and went into liquidation. They argued that the agents they authorized were not entitled to receive payment their behalf. The court held that the bank is liable for not paying the beneficiary of the credit. The bank's obligation of payment to the beneficiary is discharged only on payment to the named beneficiary[17].

The letter of credit practice has long recognized a fundamental distinction between the third party's ability to submit documents under the terms of the credit and of the right to receive the proceeds thereof[18]. This distinction is maintained in the U.C.P. 600[19] which provides for assignment of the proceeds under separate provision. This distinction in terms of commercial practice largely reflects the legal position.

Another distinction regarding the use of terms of 'assignment' and 'transfer' is with regard to its nature. The process characterized in transfer[20] resembles a novation or partial assignment. Under the U.C.P.[21] transfer requires the consent of the bank. As a matter of general legal principle assignment does not need the consent of the bank and the beneficiary is free to assign at his

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[17] Gerry McCormack and Alan Ward, "Assignment and Documentary Credits", 16 J.I.B.L.138 (2001).
[18] *Ibid.*
[19] The U.C.P.600, Article 39 states: "The fact that a credit is not stated to be transferable shall not affect the Beneficiary's right to assign any proceeds to which he may be, or may become entitled under such credit, in accordance with the provisions of the applicable law. This Article relates only to the assignment of the proceeds and not to the assignment of the right to perform under the credit itself."
[20] *Ibid.* It is a unilateral undertaking. The beneficiary is under no obligation towards the issuing or confirming bank.
[21] The U.C.P. 600, Article 38 (a) states: "A bank is under no obligation to transfer a credit except to the extent and in the manner expressly consented to by that bank".

discretion. A novation occurs where two contracting parties agree that a third shall take the place of one of them. The consent of both the original contracting parties is necessary before this procedure can be completed. "Transfer" therefore seems more consistent with novation than assignment. This is certainly the view of Professor Goode who argues:

> "In view of the procedure adopted for transfer, by which the original documentary credit is taken back and a new credit or credits are issued to one or more second beneficiaries, it would seem more accurate to treat the partial transfer of a credit as a novation in relation to the part transferred, so that in effect, at the request of [the] first beneficiary, the original contract between [issuing bank and first beneficiary] becomes divided, remaining in force as regards the untransferred part of the credit, while being novated as regards the transferred part"[22].

The transfer of a credit is a conveyance of the right to draw drafts under the credit. But an 'assignment' of the credit proceeds is the transfer only of the right to payment without altering the requirement that the assignor, not the assignee, comply with the terms of the credit[23]. Accordingly, under the U.C.C.[24] a beneficiary may assign its rights to part or to all of the proceeds of a letter of credit[25]. It conforms to the existing practice by requiring the consent of the issuer to an assignment of proceeds.[26] However, an issuer may not unreasonably withhold consent "if the assignee possesses and exhibits the letter of credit and presentation of the letter of credit is a condition to honour."[27] It also provides for a more orderly procedure for recording assignments by consent of the issuer or

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[22] *Supra* n. 10 at p. 1021.
[23] See, John F. Dolan, *The Law of Letters of Credit*, A.S.Pratt&Sons, Washington (1984), p.68.
[24] The U.C.C. §5-114.
[25] *Id.*, §5-114(a), (b).
[26] *Id.*, §5-114(c).
[27] *Id.*, §5-114(d).

nominated person.[28] In contrast, the U.C.P.'s treatment of assignment of proceeds is brief. It states only that the assignment of proceeds is permissible.[29] Many bankers expressed concern with the continuing presence in the U.C.P. of the provision addressing assignment of proceeds[30]. In some countries the assignment of proceeds is characterized as a secured transaction thereby placing the burden of adjudicating payment priorities on the issuing banks.[31] However, the drafters accepted the practice as a "very traditional, common and helpful transaction under Documentary Credits."[32]

It can be seen that transfer and assignment are different. The assignment is necessary to meet the requirements of the beneficiary without affecting transfer of the credit[33].

Assignment and Negotiation

The word assignable has an altogether different meaning from that of the word negotiable.[34] Negotiation means the giving of value for Draft(s) or documents by the bank authorized to negotiate. In negotiation the issuer does not give a payment undertaking direct to the beneficiary but rather undertaken to reimburse a nominated bank if that bank "negotiates" the beneficiary's

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[28] *Id.*, §5-114(f).
[29] The U.C.P. 600 Article. 39.
[30] *Supra* n.2.
[31] Charles del Busto (Ed.), *International Chamber of Commerce, Documentary Credits: U.C.P. 500 & 400 Compared,* I.C.C. Pub. No. 511 at p. 30.
[32] *Ibid.* Also see Grant Gilmore, "The Commercial Doctrine of Good Faith Purchase", 63 *Yale Law Journal* 1057 (1953-54), p.1108.
[33] H. C. Gutteridge and Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), p.172.
[34] George B. McGowan, "Assignability of Documentary Credits", 13 *Law and Contemporary Problems* 678 (1948),p.680

documents in accordance with the credit's terms.[35] Therefore negotiation is done by the banker with the beneficiary unlike assignment and transfer. It is a form of credit issued by the bank in order to make payment to the beneficiary.

Negotiation credit may be issued in one of the two forms. It may be freely negotiable or negotiation may be restricted to one or more banks named in the credit. Similarly the act of negotiation is voluntary on the part of the nominated bank whether the credit is restricted or freely negotiable.[36]

The rights under letters of credit are thus transferred, assigned and negotiated according to the nature and undertaking of credit by the bank. The right to transfer a credit may be vital. Denning, L. J. in *Trans Trust S.P.R.L.* v. *Danubian Trading Co. Ltd.*[37] explained as follows;

> "[A banker's confirmed credit] is irrevocable by the banker; and it is often expressly made transferable by the seller. The seller may be relying on it to get the goods himself. If it is not provided, the seller may be prevented from getting the goods at all."

Legal Effect of Transfer and Assignment

The legal effect of the transfer and assignment can be understood through the analysis of judicial pronouncements. It is difficult to legally categorise the transfer and assignment of credit under documentary credits. Mostly it is derived from the credit itself. The request of the first beneficiary to transfer the credit to the second beneficiary will also pave way to determine the

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[35] See the U.C.P.600, Article 2.
[36] See for the details, Alan Ward, "The Nature of Negotiation under Documentary Credits",14 J.1.B.L.292 (1999).
[37] [1952] 1 Lloyd's. Rep.348 at p. 356.

effect of transfer. Apart from this the nature of relationship between the several parties under the transfer of credit are taken. Therefore one view is that the act of the beneficiary in transferring documentary credit amounts to an equitable assignment by him of the benefit of the credit[38]. The second approach is that the beneficiary drops out altogether and there is a novation in favour of the transferee[39]. A letter of credit is not an assignment of the money which it undertakes to pay in given circumstances,[40] nor is it a negotiable instrument. Transfer of the letter of credit by way of endorsement and delivery will be inoperative so far as the vesting of any rights in the transferee is concerned.[41] Transfer without authority is therefore an assignment of the benefit of the credit with the consequences that naturally follow.[42] In *Linden Gardens Trust* v. *Lenesta Sludge Disposals*[43] , Lord Brown-Wilkinsoin stated the basic principle of the law relating to assignment as,

> "It is trite law that it is, in any event, impossible to assign "the contract" as a whole, i.e. including both burden and benefit. The burden of a contract can never be assigned without the consent of the other party in which event such consent will give rise to a novation meantime protected by equity." The attempt to assign the right to present documents therefore includes the benefit of payment also.[44]

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[38] *Supra* n.6.
[39] See *Singer & Frindlander Ltd.* v. *Credutanstalt-Bankverin*, *Supra.*n.15
[40] *Morgan* v. *Lariviere*, (1875) L.R.7.H.L. 423
[41] Davis, *The Law Relating to Commercial Letters of Credit*, Sir Isaac Pitman & Sons Ltd., London (1963), p. 110.
[42] See for details, Rolf Eberth and E. P. Ellinger, "Assignment and Presentation of Documents in Commercial Credit Transactions", 24 Ariz. L. Rev. 277 (1982), at p. 279.
[43] [1994] 1. A.C. 85 at 103.
[44] Per Windeyer J. in *Norman* v. *Federal Commisioner of Taxation* (1963) 109 C.L.R.9 at 24 citing *Holroyd* v. *Marshall* (1862) 10 H.L.Cas.191. *Colyer* v. *Isaacs* (1981) 19 Ch. D. 342, *Tailby* v. *Official Receiver* (1888) 13 App. Cas. 523 and *Re Lind, Industrials Finance Syndicate* v. *Lind* [1915] 2 Ch. 345.

Governing Law on Transfer of Documentary Credit

Once the documentary credits are made transferable to determine the governing law is difficult. The credits will be often transferred in favour of a second beneficiary in a country different from that of the first beneficiary. The U.C.P. provision states that the first beneficiary may request that payment or negotiation be effected to the second beneficiary at the place to which the credit has been transferred[45]. Accordingly the place of performance of the issuing bank's obligation will be in a different country from that of the country where documentary credit is originally issued[46].

However as the U.C.P. regulates the conditions upon which transfer can take place and the parties agree with abide by the provisions of it is unlikely that any issue will arise. If any issue arise question between the transferee and the issuing or confirming bank would be determinable according to the law that governs the obligations of the bank under the credit.

Effect on Transferee's Right

In usual practice the first beneficiary will not be the actual supplier of the goods. So he may wish to transfer the credit to a second beneficiary who will be

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[45] The U.C.P.600,Article 38 (j).

[46] *Bank of Credit & Commerce Hong Kong Ltd (in liquidation)* v. *Sonali Bank* , [1995] 1 Lloyd's Rep 227. Cresswell J., stated: "In my view the governing law is the law of Hong Kong (a) whether or not the beneficiary presented direct or through a presenting bank; and (b) whether or not a presenting bank negotiated/discounted the documents; and (c) whether or not the documents presented to the confirming bank conformed with the credit or did not confirm...".

the supplier of goods.[47] Under this transaction the first beneficiary is acting as the agent of the principal supplier. However transfer can be made only once. Once it is transferred second beneficiary will become the transferee and is entitled to certain rights. Then a question may arise whether the second beneficiary's right to payment is subject to equities available against the first beneficiary. Another question is whether any express or implied warranties by the first beneficiary are to be treated as continuing in relation to the second credit.

As regards the first question it can be seen that the right to tender documents against payment of the price would get transferred from the first beneficiary to the transferee. The transferee's right to payment depends on the strict compliance with the terms of the credit issued to him. The intermediary banker and the transferee are in privity as a result of the former's promise as given in the substituted credit.[48] Hence the effect of the transfer of credit is that there is no assignment of right of the first beneficiary to payment. Apart from this, the first beneficiary is not authorized to delegate tender or replace a payment undertaking in favour of the first beneficiary, in favour of the second beneficiary. Therefore if the second beneficiary fulfils the conditions of payment specified in the second credit he is entitled to get paid by the bank. Moreover a bank cannot withhold payment to the second beneficiary on the ground of any

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[47] The first beneficiary will take a portion of the amount to be transferred as the profit on the transaction. See D. C. Gardner, *International Trade Finance Collections and Documentary Credits*, Euro money, London (1995), p. 24.

[48] Mark Hapgood (Ed.), *Paget's Law of Banking*, Butterworths, London (1983), p.629.

mistakes or omissions on the part of the first beneficiary[49]. Hence the second beneficiary is not affected by equities available against the first beneficiary.

Similarly since the transfer will entitle the second beneficiary to open a new credit which is completely independent of the original credit issued in favour of first beneficiary, there is no continuity in relation with the implied warranties by first beneficiary.[50] Therefore if there is any fraud on the part of the second beneficiary he alone is responsible. Even if the first beneficiary procured the documents in goodfaith payment can be denied.

Effect of Rights under Assignment

The U.C.P. provides that, "the fact that a credit is not stated to be transferable shall not affect the beneficiary's right to assign any proceeds to which he may be, or may become, entitled under such credit, in accordance with the provisions of the applicable law"[51]. This article relates only to the assignment of proceeds and not to the assignment of the right to perform under the credit[52].

Even in the case of a non-transferable credit the first beneficiary is entitled to assign his right of payment to a second beneficiary.[53] However, in case of assignment the second beneficiary is only an authorized negotiator. Therefore the documents must be tendered only on behalf of the first beneficiary. He cannot use his own name. Similarly a tender by the second

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[49] *Supra* n.6.
[50] For instance, a confirmation of a credit in favour of first beneficiary would not ensure benefit to second beneficiary.
[51] See the U.C.P.600, Article 39.
[52] *Ibid.*
[53] Assignment may be a statutory assignment or a pure equitable assignment. See Clive M. Schmithoff, "The Transferable Credit", [1988] J.B.L. 49.

beneficiary on his own account would not comply with the conditions of payment. Therefore the assigned debt continues to be conditional and the condition can only be discharged by the seller[54]. This view is stated by Zahn as,

> "The tender of the documents remains the beneficiary's duty even after an assignment has taken place. The assignment relates soley to the proceeds of the credit. When the beneficiary has assigned the amount due to him, the proceeds are paid to the assignee after the tender of the required documents by the beneficiary."[55]

Therefore assignee receives nothing if the original beneficiary fails to perform all the conditions of the credit. Thus the position of a second beneficiary is that he is entitled to enforce the rights transferred to him against the tender of documents procured by him. But an assignee of the proceeds of a credit is entitled to payment against documents obtained by the first beneficiary is clear in common law systems.

Similarly without authority of the buyer and the paying bank the seller can assign the benefit accruing to him under the credit in favour of the third party[56]. He must comply with the requirement laid down for the assignment under national laws. According to English law[57] the assignment has to be absolute and not in part. It has to be in writing under the hand of the assignor. There must be notice in writing of the assignment, given to the bank. The condition mentioned in the assignment constitutes a liability which cannot be

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[54] Clive M. Schmithoff, *Schmithoff's Export Trade, The Law and Practice of International Trade*, Sweet & Maxwell, London, (1998),p.434.

[55] It is to be noted that Zahn polarized the transfer of the credit and the assignment of the proceeds, See Rolf Eberth and E. P. Ellinger, "Assignment and Presentation of Documents in Commercial Credit Transactions", *Supra* n. 42.

[56] See the U.C.P.600, Article 39.

[57] See Leo D'Arcy, Carole Murray et.al. (Eds.), *Schmithoff's Export Trade*, Sweet & Maxwell, London (2000) at p. 203.

assigned without the consent of the paying bank according to general principles of law. However in India there is no specific rule to govern this aspect. The banks in India apply the provisions of the U.C.P.[58].

Apart from the transfer of the credit under the U.C.P. and the assignment of the proceeds, there can be other transaction where the beneficiary would be able to confer two separate rights on the assignee[59]. The scope of this was discussed by the commercial court of Vienna in *Singer & Frielander* v. *Creditanstalt-Banvereinf*[60]. The court held that the beneficiary's right to the proceeds of the credit was assignable[61]. However, the court emphasized that the right to present the documents was retained by the beneficiary and he alone was entitled to perform the condition stated in the commercial credit. The court said,

> "It would contradict the nature of a non transferable credit, if, in addition to the proceeds, the beneficiary could also transfer the right to realize the claim by presentation of documents in conformity with the letter of credit or to impede the paying out of the proceeds by not presenting the documents"[62].

The court added that if the right to present the documents is treated as assignable it would become difficult to draw a rational distinction between transferable and non-transferable credit. It can be seen that the right of the beneficiary in assignment is limited to the proceeds of credit only.

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[58] See the manual of instructions on Foreign Exchange Business, issued by various banks.
[59] The two rights are the right to the proceeds of the credit and the right to present in the assignee's own name a set of documents furnished by the beneficiary.
[60] 17 Cg. 72/80, *supra* n.15.
[61] *Ibid. per se* Zahn's J.,
[62] *Ibid.*

The effect of an assignment of the benefit of a letter of credit has been judicially considered in the United Kingdom in *The American Accord*[63] case. In this case, the credit was not made transferable but the whole benefit was assigned. The proposition seems to state that the beneficiary may not convert a non-transferable credit to transferable credit by alienating such rights and benefits. The benefit of a credit may mean something more than the proceeds of credit. Earlier the moot question before the Austrian Court[64] was whether Creditanstalt were justified in refusing to pay. Several arguments were placed. One argument was that the U.C.P. provides for the transfer of credit. Therefore no other method of transfer other than that set out in the article[65] can be valid. The Austrain court held that Creditanstalt was justified in refusing to pay Singer & Frielander who is a third party as the credit issued was non-transferable.

Thus it can be seen that the effect of assignment on the rights of beneficiaries is complicated. The tender of documents and the fulfillment of other stipulations in the credit are not a right at all. Instead it is a burden. The only right of the second beneficiary in case of assignment of proceeds is to get paid[66].

Procedure for Transfer

According to Gutteridge,[67] transfer takes place under the U.C.P. in two forms. According to one method the original credit is advised to the beneficiary by the intermediary bank on the basis of a request for transaction. The

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[63] [1979] 1 Lloyd's L.R. 267. Also see *United City Merchants (Investments) Ltd.* v. *Royal Bank of Canada*, [1981] 1 Lloyd's L.R. 604.
[64] *Singer & Frielander* v. *Creditanstalt-Banverein*, *Supra* n.15.
[65] See the U.C.P.600, Article 38 and 39.
[66] *Schmithoff*, *op.cit.* at p.434.
[67] H.C.Gutteridge and Maurice Megrah, *Supra* n.33 at p. 164.

beneficiary will request for transfer and return the credit to intermediary bank. The intermediary bank will notify the named transferee of the credit and state the terms on which transfer is permitted. In the second method the intermediary bank passes the original credit to the transferee under cover of a letter setting out the terms on which the intermediary will give effect to the proposed transfer[68].

However Peter Gabriel describes the procedure for transfer as follows[69]: The beneficiary require as a term of his contract with his own buyer to provide an irrevocable transferable credit in favour of the seller. When the beneficiary receives confirmation of the issuance of the transferable credit he can instruct the bank to transfer the credit to his own supplier as the second beneficiary. Then transfer is by issuing of a fresh credit separate from original letter of credit[70]. Later, following notification of such transfer, the suppliers will dispatch the goods to the first beneficiary and present the prescribed documents to receive payment from confirming bank. The transferee bank will debit the beneficiary's account on receipt of this document. The beneficiary then delivers to the transferring bank his own invoice of his supplier and the amount is credited in his own invoice. Finally the transferring bank forwards to the issuing bank all the prescribed documents including the beneficiary's invoice[71].

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[68] *Ibid.* Gutteridge favours the second method. In the first method it is difficult to tally both the credits issued except for the differences allowed by the U.C.P. Article 48(b).

[69] Peter Gillies & Gabriel Moens (Eds.), *International Trade and Business: Law Policy and Ethics*, Cavendish Publishing (Australia) Pty. Ltd., London (1998), p. 394.

[70] *Ibid.* In commercial parlance it is termed as back to back credit. However U.C.P. does not provide specific rules for back to back credit.

[71] *Ibid.*

Schmithoff points out that the operation of a transferable credit raises three problems which are inter-related[72]. The first problem is that the seller may wish to keep the source of supply confidential because if disclosed the buyer can place future orders for the goods directly with the supplier. However to overcome this problem the middleman will require his supplier that none of the prescribed documents contain any indication of the buyer's identity. The beneficiary will ensure that the transferable letter of credit does not stipulate any documents that contain the buyer's name. The second problem is that the seller may want to transfer the credit only for the amount which he has to pay the supplier. So he may wish to make the credit divisible. The third problem raised is regarding the person who has to tender the documents in order to make the credit operative. Thus when the credit is transferred, the tender of the documents should in principle be done by the second beneficiary. The principle is stated as follows,[73]

> "A transferable credit is one in which the seller can transfer the credit to a third party. The third party will, then, ship the goods and tender the documents, including his own invoice."

From the legal point of view, the transfer confers on the transferee not only the benefit of the credit, but also places him under the obligation to discharge the condition on which the operation of the credit depends[74].

The above problems are not settled. The procedure for the transfer of credit seems complex and lengthy. There is no uniformity in legal principle as different national laws are reliedin to affect transfer. However the present

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[72] Clive M. Schmithoff, "The Transferable Credit", [1988] J.B.L.49.
[73] E. P. Ellinger, *Documentary Letters of Credit*, Oxford University Press, London (1970), p.17.
[74] *Ibid.*

U.C.P.600 made an attempt to clarify the procedure of transfer by simplifying its wordings. It states[75],

> "....A credit may be transferred in part to more than one second beneficiary provided partial drawings or shipments are allowed.
>
> A transferred credit cannot be transferred at the request of a second beneficiary to any subsequent beneficiary. The first beneficiary is not considered to be a subsequent beneficiary.
>
> Any request for transfer must indicate if and under what conditions amendments may be advised to the second beneficiary. The transferred credit must clearly indicate those conditions.
>
> If a credit is transferred to more than one second beneficiary, rejection of an amendment by one or more second beneficiary does not invalidate the acceptance by any other second beneficiary, with respect to which the transferred credit will be amended accordingly. For any second beneficiary that rejected the amendment, the transferred credit will remain unamended.
>
> The transferred credit must accurately reflect the terms and conditions of the credit, including confirmation, if any, with the exception of:
>
> . the amount of the credit,
>
> . any unit price stated therein,
>
> . the expiry date,
>
> . the period for presentation, or
>
> . the latest shipment date or given period for shipment, any or all of which may be reduced or curtailed.

[75] The U.C.P.600, Article 38.

> The percentage for which insurance cover must be effected may be increased to provide the amount of cover stipulate in the credit or these articles.
>
> The name of the first beneficiary may be substituted for that of the applicant in the credit.
>
> If the name of the applicant is specifically required by the credit to appear in any document other than the invoice, such requirement must be reflected in the transferred credit...".

This provision avoided the 'deferred payment undertaking' from the purview of transfer procedure[76]. So also, where partial drawings and shipments are allowed a credit may be transferred in part to more than one beneficiary. However the element of risk involved for banks is not properly addressed.

The practice followed by bankers when a request for transfer of letter of credit is received from the first beneficiary is as follows;

Usually the bank will act upon the request by sending a SWIFT[77] or telex to the second beneficiary's bank. The terms and conditions for transfer will be stated in the direction issued by the transferring bank. Therefore the document sent by the paying bank to the second beneficiary's bank will contain the terms in which the credit is made available to the second beneficiary and expressly state

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[76] The U.C.P.500, Article 48 (a) and (b) states; "(a) A transferable credit is a credit under which the Beneficiary (First Beneficiary) may request the bank authorized to pay, incur a deferred payment undertaking, accept the bank authorized to pay, incur a deferred payment undertaking, accept or negotiate ("the Transferring Bank") or in the case of a freely negotiable credit, the bank specifically authorized in the credit as a Transferring Bank, to make the Credit available in whole or in part to one or more other Beneficiary(ies) (Second Beneficiary(ies)).
(b) A credit can be transferred only if it expressly designated as "transferable" by the Issuing Bank. Terms such as "divisible", "fractionable", "assignable", and "transmissible" do not render the Credit transferable. If such terms are used they shall be disregarded".

[77] Society for Worldwide Interbank Financial Telecomunication. For details see H.F.Lingl,"Risk Allocation in International Interbank Electronic Fund Transfers: CHIPS & SWIFT", 22 *Harward International Law Journal* 621(1981).

that it is a transfer of credit. It will also incorporate any changes in the terms requested by the first beneficiary. Whether the transferring bank has confirmed the credit or not will also be indicated. Later the second beneficiary will present the documents called for by the credit within the time and at the place stipulated in the transferred credit in order to receive payment.

Mechanism of Assignment

Assignment may be used where a buyer intends to utilize a credit in his favour opened by one bank as security for the issue of a letter of credit with a different bank[78]. However for the beneficiary also there is a right to assign the proceeds of credit. Its availability is crucial where the beneficiary does not have any other asset to be utilized for the financing of the underlying contract between himself and the applicant for the credit.

Some authors suggest that there is no reason for an assignment of the proceeds and that the only method available in commercial letters of credit is transfer under the procedure set out in the U.C.P.[79]. However in the light of modern practice this position is not true. The transfer of credit differs altogether with regard to mechanism and object from an assignment of its proceeds.

The mechanisms of assignment depend firstly upon what is being assigned. If the assignment is merely of the proceeds, any clear intention to transmit will be sufficient. However assignee should notify the bank which makes payment. Secondly, the assignment will depend on the terms on which the credit

[78] *Mannesmam Handel A.G.* v. *Kannalaren Shipping Corp.*, [1993] 1 Lloyd's Rep. 89.
[79] See H. Gutteridge & Megrah, *op.cit.* at p.178.

is payable. These terms are regulated by the applicable provisions of the law of obligation or of contract[80].Notice of assignment should be clear and unequivocal. The bank immediately on receipt of notice verify the assignment by reference to the beneficiary[81].

Similarly an assignment can arise only in respect of moneys which may become payable to the beneficiary when he fulfils his part of the undertaking. If the terms of the sale between the beneficiary and the assignee are the same except as to price, the procedure is filling the credit with the same bank that issued credit in favour of beneficiary. When the drafts and documents are presented, the bank notifies the original beneficiary. The bank attaches that draft to the shipping documents which came attached to the assignee's draft and charges to the letter of the credit the amount of the beneficiaries' draft. By this procedure the seller-beneficiary of an assignable credit is enabled to use the credit to finance his purchase of the goods[82].

Therefore in case of assignment the procedure followed depend on the terms agreed between the parties. In usual practice the purpose of an assignment of the proceeds of commercial credit is to facilitate the extension of credit.

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[80] Wheble, "Documentary Credits – Uniform Customs 1974 Revision", *Journal of Institute of Bankers* 226 (1975).
[81] H.Gutteridge & Megrah, *op.cit.*
[82] *Supra* n. 34.

Bankers Obligations in Transfer and Assignment of Rights

The banks obligation in transfer of credit is conditional upon the beneficiary's presentation of the required documents. In transfer transaction bank acts as an agent for the customer[83]. Therefore the banker is not burdened with additional duties. He is obliged to act according to the terms mentioned in the transfer undertaking. But as per the U.C.P. when a request to effect the transfer is received by the bank is under no obligation to make such transfer[84]. This provision is really surprising because on the one side beneficiary has the right to give instructions to the bank to transfer the credit but on the other side there is no duty to fulfill the request. In otherwords, an instruction to the bank to transfer the credit is not binding on the bank unless within the limits and in conformity with the procedures prescribed by the bank[85]. The U.C.P. however does not prescribe what those limits are.

A question whether the unconfirmed credit payable at the counters of the issuing bank could be a transferable credit under the provisions of the U.C.P. was considered by the Privy Council in *Bank Negara Indonesia 1946* v. *Lariza (Singapore) Pte.Ltd*[86]. In this case the bank opened an irrevocable transferable letter of credit in favour of a beneficiary. The beneficiary instructed the bank to transfer part of the credit to the third party but the bank refused to do so. The court held that the consent of the issuing bank to the transfer of credit was required after a request for the transfer was made. Lord Brandon said:

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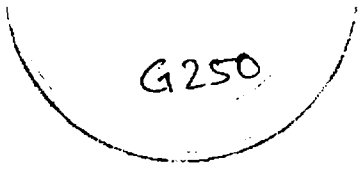
[83] *The Brimnes,* [1975] Q.B. 929.
[84] The U.C.P.600, Article38 (a) states: "The transferring bank shall not be under an obligation to effect such transfer except to the extent and the manner expressly consented to by such bank."
[85] *Supra* n.6.
[86] [1988] 2 W.L.R.374. The U.C.P. provisions referred were the U.C.P.1974, Article 46.



> "Such consent cannot be given in blanket form in advance, so as to apply to any request for transfer which may subsequently be made, whatever its extent or manner may be. It has to be an express consent made after the request and it has to cover both the extent and the manner of the transfer requested."

Earlier the Singapore Court of Appeal had held that the issuing bank was obliged to effect transfer. The leading judgment was given by Thean J. He said:[87]

> "In the instant case, the respondents had issued an irrevocable letter of credit and had designated it as transferable; that being so it must be taken to have consented to a transfer of the letter of credit in accordance with the terms thereof."

The Privy Council reversed the judgment of the Court of Appeal. It dealt with two points. First it considered the argument of the seller that the words in the U.C.P.500 "whether it has confirmed the credit or not"[88] and held that the provision referred only to the position of the advising bank and not to that of the issuing bank. Though the court recognized the strength of this argument it refused to express any opinion. The court said that it could not express any opinion "without the assistance of expert evidence on relevant banking practice." Secondly it considered and decided on the basis of literal interpretation of the U.C.P. provision[89].

The argument raised by the bank that merely by designating a credit transferable a bank comes under no obligation to effect a transfer of the credit appears to be right because it is issued based on certain conditions[90].

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[87] Schmithoff, "The Transferable Credit", *op.cit* at p. 53.
[88] The U.C.P.500, Article 46 (b).
[89] This decision is criticized by Schmithoff mainly because the court required expert evidence on banking practice on a question of law such as the interpretation of a document.
[90] William Godwin, "Transferable Letters of Credit – The Effect of Lariza", [1990] J.B.L. 48.

The arguments considered in the *Bank Negara Indonesia* case lost their force on the revision of the U.C.P. provisions. The new provision[91] states that transferring bank means a nominated bank that transfers the credit or a bank that is specifically authorized by the issuing bank to transfer and that transfers the credit. An issuing bank may also be a transferring bank. Apart from this the transferring bank has a right to accept the documents received from the second beneficiary if the first beneficiary fails to present its own invoice and draft on first demand[92].

The intermediary banker is clearly under no duty to question the transfer. Once it is authorized the intermediary banker is free to act on the prime beneficiary's instructions. However in transfer, the second beneficiary is given a fresh credit which is independent of original. So there will be breach of his contract with the first beneficiary. It would however appear that so long as there is no breach of his mandate as embodied in the credit, the intermediary banker is impliedly indemnified as an agent for any loss which may be suffered as a result of his acting on the authority to transfer[93].

Banker must take care to see that the authorization relates specifically to transfer of the letter of credit with all its conditions and not merely to transfer of benefits accruing thereunder after performance by the prime beneficiary.[94] If the banker fails to exercise reasonable care it will increase the credit risk for bank. In

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[91] The U.C.P.600, Article 38 (b).
[92] The U.C.P.600, Article 38 (i).
[93] Maurice Megrah and F. R. Ryder (Eds.), *Pagets Law of Banking*, Butterworths, London (1982), p. 540.
[94] Henry Harfield, "Secondary Uses of Commercial Credits", 44 Col.L.R. 899 (1944), at p. 902.

cases of fractional transfer also the bank must be careful to see that the whole is at least as great as the sum of the parts transferred.[95]

The banker's obligations were discussed by the committee constituted for drafting of the U.C.P. It said,

> "According to the nature and terms of a credit, the bank offers or undertakes, as instructed by its client, to pay or have paid to a named person a certain amount, after that person has fulfilled certain specified formalities. It follows that the only person who can legally be recognized in regard to the payment by the bank is the person so named. If the person in question is unable to comply with the necessary conditions, the bank cannot be obliged to pay a third person. In order that the bank should do so, the intervention and agreement of the principal (buyer) are necessary, for the transfer constitutes the substitution of a party specified by name in the agreement concluded between the principal and the bank which consented to open the credit. No credit may therefore be transferred without the agreement of the principal. The committee decided along those lines and added that, even when transfer was authorized, the credit could only be transferred once. This decision seems to give security against any abuse of the right to transfer credit."[96]

Therefore an express authority of opening bank is essential for transfer. Sometimes a bank will pay in spite of some irregularities in documents on the basis of indemnity.[97]

In case of assignment of proceeds, it will be valid against the bank only on the basis of consent of the bank. The distinction between an assignment to a bank and an assignment against a bank is easier for a banker to understand. Hence it can be seen that obligation of bank is determined according to the

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[95] *Ibid.*

[96] International Chamber of Commerce, Brochure No. 82 (1933), p.12 as quoted in A. G. Davis, *The Law Relating to Commercial Letters of Credit*, Sir Isaac Pitman & Sons Ltd., London (1963), at p.111.

[97] H. O. Nash, "Transferrable Credits", 73 *Journal of the Institute of Bankers* 24 (1952).

circumstances of each case and the guidelines provided are protecting the interest of the bank. There is no much authorities available to analyse the situation in case of transfer and assignment. The law is scattered at national and international level.

National and International Measures

The problem that arises in transfer and assignment of the rights are dealt with by national and international legal principles. Earlier the question regarding the distinction between the assignment of the proceeds subject to tender and an assignment of the accrued proceeds was considered by the Banking Commission of the International Chamber of Commerce in collaboration with the United Nations Commission on International Trade Law[98]. An attempt to regulate the details of the assignment of the proceeds of commercial credits could lead to conflicts between the U.C.P. and individual national legal systems. Hence the commission left open the issue to the national laws.

In the United States the Uniform Commercial Code regulates the transferability. It provides for the right to transfer documentary credit if the credit expressly provide as transferable or assignable[99]. The transfer is allowed by operation of law[100]. Therefore a successor to a beneficiary is allowed by operation of law to make presentation and receive payment or

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[98] Hereinafter referred to as UNCITRAL. See the *Guide To Documentary Credit Operations*, I.C.C. Publication. No. 305, (1978).
[99] See the U.C.C., S. 5-116(1).
[100] See *Pastor* v. *National Republic Bank*, 390 N.E. 2d 894 (III.1979) and *Federal Deposit Ins. Co.* v. *Bank of Boulder* 911 F.2d 1466 (10th Cir. 1990) as quoted in Katherine A Barski, *Supra* n.2.

acceptance[101].However the U.C.C. does not provide detailed rules to govern the basic transfer of credits.

In the United Kingdom the original credit should authorize transfer abroad in accordance with the Bank of England notice E.C.68. They follow the U.C.P. provisions. The bankers in the U.K. formulates rule based on their banking practice. This rule is followed by them with regard to acceptance of payment. Similarly the rights of a beneficiary under a contact are assignable as they are chose in action. This is under the U.K. Law of Property Act, 1925 or by way of equitable assignment[102].

Transfer of Rights and Obligations: An Indian Outlook

The transfer of rights and obligations under documentary credits are allowed in India also if permitted under the terms of documentary credit. The documentary credit should mention it to be 'transferable'. In India bankers will not effect transfer of letter of credit until bank charges are paid[103]. These charges are paid by the first beneficiary unless otherwise specified[104]. Apart from this the U.C.P procedures are also followed[105]. However transfer of export letter of credits to any party outside India requires prior clearance from the Reserve Bank of India[106].

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[101] *Ibid.* Also see the U.C.C. §5-102(a).
[102] Richard King (Ed.), *Gutteridge & Megrah's Law of Bankers' Commercial Credits*, Europa Publications, London (2001), p.129.
[103]The booklet *Documentary Credits & Standby Credits*, Foreign Exchange Dealers' Association of India, Mumbai (2004) p.139.
[104] *Ibid.*
[105] See the manual of instructions on foreign exchange business, issued by different banks.
[106] *Ibid.*

The courts also try to incorporate strictly the provisions of article the U.C.P 600[107]. The court usually looks for literal applications of the provisions and is reluctant to examine the real factual situations which may some times have element of fraud. There are been few cases where courts had to examine the issues relating to transfer of documentary credits. The only case reported in India relating to transferable credit is *Jindal Stainless Ltd* v. *ICICI Banking Corporation Ltd*[108]. In this case Jindal entered into a sale agreement with Surya Impex for the supply of steel scrap. As per the terms of sale, 90% of the payment was to be made through an irrevocable, transferable and confirmed usuance letter of credit payable after 180 days of the receipt of bills of lading. The remaining 10% is to be released within ten working days after the receipt of goods and satisfactory trial of materials by Jindal. Accordingly transferable letters of credit was opened by the ICICI bank who was the issuing bank in favour of Surya Impex. KBCV Bank was the negotiating bank. It transferred the letter of credit in favour of another company at the request of Surya Impex who was the first beneficiary. However the first beneficiary did not arrange for the supply of ordered goods and the transfer made was in collusion with the second beneficiary to defraud the buyer applicant. The buyer filed a suit for passing of a decree of permanent injunction restraining ICICI Banking Corporation from remitting any amount under the letter of credit to the defendant bank. The court held in favour of the defendent bank and dismissed the suit. The reason stated was the failure of the buyer to make out a *prima-facie* case. Here the payment had been already released by the negotiating bank according the terms of letters of credit.

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[107] The U.C.P.600, Article 38.
[108] A.I.R.2005 Del. 53.

However the nature of the instrument in this case needs to be analysed. Whether this instrument would amount to a letter of credit was a moot problem. The first condition was payment was based on completion of certain days and the other part payment which was based on physical verification of goods. The essence of documentary credit is prompt payment to the beneficiary on presentation of stipulated documents in compliance with the letter of credit. Therefore if physical verification of goods is also contained in the instrument, it is against the basic principle of documentary credit. But the Courts in failed to examine this aspect and applied the U.C.P. provisions.

Conclusion

When the sellers act as middlemen buying goods from the suppliers to sell it to the buyers abroad, they might require credits that are transferable so that their suppliers could be paid in the same manner. Therefore the letters of credit are also made transferable. The above discussion shows that there is no specific law governing transfer of rights under letters of credit. The provisions contained in the U.C.P. are complex[109]. The universally accepted principle fails to establish the nature of rights transferred. National laws also failed to give clarity on this point. Apart from this in some countries the assignment of proceeds is characterized as a secured transaction. This will place the burden of adjudicating payment priorities upon the issuing, confirming or paying Banks[110]. Long back the working group on the revision of U.C.P 400 felt that this characterization was not generalized enough to warrant the exclusion of a traditional, common and helpful

[109] See the U.C.P.600, Article 38.

[110] See for details on secured transactions, Penina Mbinya Machoka, "Towards Financial Sector Development – The Role of the UNCITRAL Guide on Secured Transactions", 21 J.I.B.L.529 (2006).

transaction under documentary credits[111]. In the revised Article[112], it is reinstated that nothing precludes the beneficiary from assigning the proceeds due to him under the credit. Yet it should be understood that there is a clear distinction between the beneficiaries' right to assign proceeds due to him under the credit and the assignment of his rights to the credit[113].

Another problem is that when a credit is transferred to a third party by the beneficiary it may result in another autonomous credit for the banker with second beneficiary. Hence the banker has to pay the second beneficiary irrespective of the relationship with the first beneficiary. This will affect the primary letter of credit transaction. The rights of the transferee are not defined.

The transfer of rights under letter of credit can be effected only once[114]. This limitation distinguishes transferability in letters of credit from ordinary transfers. Therefore in cases of conflicts, national laws regarding transfer cannot be applied as it will invite difficulties. However now the U.C.P.600 does not contain any limitation on effecting the number of times the transfer can be effected. Moreover it again complicated the matter. The present provision reads[115];

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[111] See Guide to *Documentary Letters of Credit & UCP 500*, Nabhi Publications, New Delhi (1994), p. 228.
[112] *Ibid.*
[113] The last sentence in the U.C.P.600, Article 39 reads; "This Article relates only to the assignment of proceeds and not to the assignment of the right to perform under the credit."
[114] See the U.C.P.500, Article 48 (g).
[115] The U.C.P.600, Article 38 (d).

> "A credit may be transferred in part to more than one second beneficiary provided partial drawings or shipments are allowed.
>
> A transferred credit cannot be transferred at the request of a second beneficiary to any subsequent beneficiary. The first beneficiary is not considered to be a subsequent beneficiary."

Though it is assumed that the bank is less exposed to risks in relation to transferability and assignability, there are situations which will make the banker answerable to the buyer and the first beneficiary. This will arise when he fails to take reasonable care to examine the authenticity of the documents presented by the second beneficiary. Therefore the practical distinction between the assignability of the right to draw under the documentary credit and the proceeds of the credit reflects the well-established general principle of contract law. On the other hand while the benefit of a contract can be assigned, its burden cannot be assigned. When the presentation of documents is involved, the process of transfer becomes a novation. This is reinforced, in the specific context of the banker-customer relationship, by the doctrine of mandate which requires the banker to comply strictly with the applicant's instructions.

CHAPTER-6

RIGHTS OF ISSUING BANK

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RIGHTS OF ISSUING BANK

The bank issues a letter if credit on the basis of an application made by its customer. The undertaking of the bank is to arrange payment to the beneficiary on compliance of the terms and conditions set out in the letter of credit. A contractual obligation is formed in this transaction[1]. The bank's undertaking is under an assurance of indemnity by the customer. The rights arising from this undertaking in favour of the issuing bank depends on the contractual relationship between parties involved in this credit. The letter of credit can be compared with the ordinary credit provided by banks. In such transactions bank adopts several methods to realise the loan advanced to the customer. Similar methods are adopted in letter of credit transaction also.

The rights of the issuing bank against correspondent bank are another aspect. The relationship between the issuing bank and the correspondent bank is that of principal and agent[2]. When the issuing bank instructs the correspondent bank to pay the beneficiary the amount mentioned in the credit on behalf of it, the correspondent bank acts an agent of the issuing bank. As an agent of the issuing bank it has to observe the directions given to it by the issuing bank. The correspondent banker will get protection only if it comply strictly with the mandate given to it so that the issuing banker can invoke right of recourse against the customer. It is necessary to analyse the scope and ambit of the

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[1] H. C. Gutteridge and Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), p.5

[2] *Id.*, p.68

functions of issuing bank and correspondent bank resulting in the invocation of these rights.

The undertaking of the issuing bank is absolute so long as the documents of title to goods which the sellers tender to the banker to receive payment are in order[3]. Sometimes problem may arise when beneficiary tenders non-confirming documents which go unnoticed by the issuing banker. In such situations the interest of issuing bank will get jeopardized. A detailed examination is required to identify remedy left to the issuing bank to make good the loss.

If there is a doubt regarding non-conformity of documents presented by the beneficiary, the banker will be ready to make payment on the basis of an indemnity given by the beneficiary. In that situations bank may have recourse against him and may hold him liable on indemnity[4]. The scope of this right is also to be examined.

Issuing banks' consent is required in order to effect the transfer of letters of credit. The transferee may be put to difficulties if the issuing bank refuses to effect a transfer of the credit at the request of the transferor beneficiary. The discretion given to the bank is accepted by the practice of trade[5]. Even if it consents to transfer, the extent and manner should also be accepted by the bank[6]. It is essential to analyse how far these rights are regulated by national and international systems.

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[3] For example, see the observations of bankers, L. J. in *Belgian Grain Co.* v. *Cox* (1919), 1 Ll.L. Rep. 256. This undertaking cannot be termed as absolute. It is subject to certain exception recognized by courts though applied in limited situations like fraud.
[4] *Moralice (London) Ltd.*, v. *E. D. & F. Man*, [1954] 2 Lloyd's. Rep. 526
[5] See the U.C.P.600, Article 38 (a).
[6] *Ibid.*

Rights of the Issuing Bank

The written agreement between the issuing bank and the applicant for the letter of credit is the basis of the rights of the issuing bank[7]. If the bank acts in accordance with terms agreed, it has a right to be indemnified by the customer. The contractual right can be exercised by the issuing banker only if it strictly follows the terms and conditions agreed in the credit. If there is any deviation from any terms agreed it will loss its claim. The observations made by Lord Summer can be noted:

> "It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorized to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same, or which do just as well..."[8].

If the corresponding bank which negotiates and pays the beneficiary believing that the documents are irregular, it should pass the documents to the issuing bank. Issuing bank should determine whether it will honor or refuse them. It must be done only on the basis of documents alone. The issuing bank is concerned itself to see that the documents appear regular on their face. But the legality of the documents presented is not to be examined by the issuing banker.

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[7] In usual practice the written request form is available with bank and it is termed as contract for the parties to transact. See for discussion, A. G. Davis, *The Law Relating to Commercial Letters of Credit,* Sir Isaac Pitman & Sons Ltd., London (1963), p.58

[8] *Equitable Trust Co. of New York* v. *Dawson Partners Ltd,* (1927) 27 Lloyd's. Rep.49 at p.52.

If the applicant fails to give clear and complete instructions regarding issue of the documentary credit, the issuing bank has different options. The U.C.P.600 reads[9],

> "Banks assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance represented by any document, or for the goodfaith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person".

Effect of Ambiguous Instructions given by Customer

In letters of credit transaction the issuing bank is not concerned with the efficacy of any documents stipulated by parties. In *Midland Bank* v. *Seymour*[10], the instructions given by the buyer were ambiguous. Even then bank paid the beneficiary. Later when buyer refused to reimburse the bank, it took the plea that it acted upon the terms and conditions agreed between them. The court held that the bank was not in default as the instructions given were not clear. The facts of the case relate to shipping of rubbish materials by the seller. The buyer sued the bank on several issues. One of the issues related to the unauthorized acceptance of draft presented by the seller[11]. It can be seen that this decision was designed to protect the interest of the bank. The law always tries to protect the decision of the bank when the buyer gives unclear and

[9] The U.C.P.600, Article 34.
[10] [1955] 2 Lloyd's Rep. 147.
[11] *Ibid.* Here the issuing bank accepted the draft after the expiry date though they argued that the buyer has accepted it.

imprecise instructions[12]. The U.C.P.600 contains a special provision which disclaims for acts of an instructed party. It states[13],

> "A bank utilizing the services of another bank for the purpose of giving effect to the instructions of the applicant does so for the account and at the risk of the applicant.
>
> An issuing bank or advising bank assumes no liability or responsibility should the instructions it transmits to another bank not be carried out, even if it has taken the initiative in the choice of that other bank.
>
> A bank instructing another bank to perform services is liable for any commissions, fees, costs or expenses ("charges") incurred by that bank in connection with its instructions.
>
> If a credit states that charges are for the account of the beneficiary and charges cannot be collected or deducted from proceeds, the issuing bank remains liable for payment of charges.
>
> A credit or amendment should not stipulate that the advising to a beneficiary is conditional upon the receipt by the advising bank or second advising bank of its charges.
>
> The applicant shall be bound by and liable to indemnify a bank against all obligations and responsibilities imposed by foreign laws and usages.".

It is a well established principle that if the instructions given by the customer to the issuing banker regarding the document tendered by the beneficiary are ambiguous, the banker is not in default if he acts upon a reasonable meaning of the ambiguous instructions[14]. But what is reasonable is a flexible concept and there is no specific law to determine its meaning.

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[12] For instance, see the U.C.P.500, Articles 12 and 16.
[13] The U.C.P.600, Article 37.
[14] *Supra* n.9.

In the United States, the law seems to deny a right to the issuing bank to test the quality of goods. It tries to protect the interest of bank in case of unclear instructions. In *Maurice O'Meara Co.* v. *National Park Bank of New York*,[15] the seller presented the documents describing the newsprint paper as required in the letters of credit. In fact the letter of credit did not require that a certificate from an independent laboratory should accompany the documents. The bank refused to pay on the ground that it had not got any opportunity to test the tensile strength of the paper. The seller argued that the issuing bank had no right to test the same. Though the decision was in favour of the seller denying such right to the issuing banker on the ground of independence principle, it raised several issues regarding the rights of issuing bank.

If the issuing bank is not having such right on the basis of its own interest and on the assurance of prompt payment against documents. The judgement delivered by McLauglin[16] contains the following observation.

> "It has never been held so far as I am able to discover, that a bank has the right or is under an obligation to see that the description of the merchandise contained in the documents presented is correct. A provision giving it such right, or imposing such obligations, might, of course, be provided for in the letter of credit ...."[17]

But if the letter of credit contained such provision, the banker will have such right according to the above observations. It is pertinent to inquire the scope of that right if the bank had such right to determine. This will put the

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[15] 239 N.Y. 386, 146 N.E.636(1925). The Court of Appeals of New York as cited in Ray August, *International Business Law*, Prentice Hall, New Jersey (1997), p.631.
[16] *Ibid.*
[17] *Id.* at p.633.

banker in troubles. It will be time consuming and there will be need for expert opinion. In such a situation the banker's will be unenvious.

In a decision of the Court of Appeals for the ninth circuit[18], it was held that the issuing bank was under a duty to verify the buyers complaint that the goods did not conform to contract specifications. However, jurists[19] criticised this decision. It said[20]:

> "If banks were required to undertake their obligation, the result would be a destruction of the certainty of the promise embodied in the letters of credit. The seller's risk of non payment would be increased and the buyer would be denied the assurance that the seller would not receive payment until he has presented to the bank the documents required in the credit letter".

If the proposition that in an irrevocable letter of credit the bank is under a legal obligation to inquire into the terms of sales is accepted the result would be destruction of the certainty of the promise embodied in the letter of credit. It is logical to assume that a bank may feel compelled to honor a customer's request to engage in various communications with the seller-beneficiary. The bank's conduct in the instant case may well represent common practice rather than an isolated incident.

However, the Uniform Commercial Code contains provision which protect the interest of bank issuing credit for the applicant if it honours a presentation as

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[18] *Associacio'n de Azucareros de Guatemala* v. *United States National Bank of Oregon*, 423 F.2d 638 (9th Cir.1970) as quoted in Clark L.Derrick, "An Issuing Bank's Duty of Payment under an Irrevocable Letter of Credit: Associacion De Azucareros De Guatemala v. United States National Bank of Oregon", 12 Ariz.L.Rev.835.

[19] Clark L Derrick, "An Issuing Bank's Duty of Payment under an Irrevocable Letter of Credit: *Associacio De Azucareros De Guatemala* v. *United States National Bank of Oregon*", 12 Ariz.L.Rev.835 (1970).

[20] *Id.*, at p.844.

required by the law on letter of credit[21]. Therefore, if the instructions that the applicant gives are clear and precise, the issuing bank has to act strictly with it. In cases of ambiguous instruction it is a matter to be decided through interpretations of courts.

Issuing Banks Right against Correspondent Bank

In normal situations correspondent bank pays the beneficiary and receives the document mentioned in letter of credit. There is no liability to pay if it only advises the beneficiary and its obligations are to ensure that the beneficiary is advised and the credit is delivered. The U.C.P.600 reads[22],

> "If a bank is requested to advise a credit or amendment but cannot satisfy itself as to the apparent authenticity of the credit, the amendment or the advice, it must so inform, without delay, the bank from which the instructions appear to have been received. If the advising bank or second advising bank elects nonetheless to advise the credit or amendment, it must inform the beneficiary or second advising bank that it has not been able to satisfy itself as to the apparent authenticity of the credit, the amendment or the advice".

Therefore the advising bank will take reasonable care to check the apparent authenticity of the credit which it advises. This is usually done by comparing the signature on the credit with the authorized signatures it maintains on file. Once the advising bank confirms the letter of credit the rights and liabilities will be changed. Apart from this the issuing bank has the right against correspondent banker to supervise. The correspondent banker must obey strictly

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[21] The U.C.C. Article 5-108 (i) provides, "An issuer that has honoured a presentation as permitted or required by this article: (1) is entitled to be reimbursed by the applicant in immediately available funds not later than the date of its payment of funds...".
[22] The U.C.P.600, Article 9(f).

the instructions he receives as an agent. When the bank acts accordingly the contractual principles govern their relationship[23].

The correspondent bank must take reasonable care to ensure that the document received appear on its face consistent with the terms of credit. Then only they can claim reimbursement from the issuing bank. Issuing bank has got the right to reject the documents if they are inconsistent with the terms agreed by the correspondent bank. It is immaterial whether the correspondent bank paid to the beneficiary or not.

The difficulties that arise in this arrangement are due to receiving the instructions which are not clear. The term understood will be something which is not intended by the issuing bank. The U.C.P. tried to overcome this difficulty. It provides,[24]

> "If incomplete or unclear instructions are received to advise, confirm or amend a credit, the bank requested to act on such instructions may give preliminary notification to the beneficiary for information only and without responsibility. This preliminary notification is provided for information only and without the responsibility of the Advisory bank. In any event, the Advising Bank must inform the Issuing Bank of the action taken and request it to provide the necessary information.The issuing bank must provide the necessary information without delay. The credit will be advised, confirmed or amended, only when complete and clear instructions have been received and the advising bank is then prepared to act on the instructions."

But the provision is not clear regarding the element of time. It says "without delay"[25]. However to decide the "delay" was once subject to litigation.

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[23] Mark Hapgood (Ed.), *Pagets Law of Banking*, Butterworths, London (1983), p.624

[24] The U.C.P.500, Article 12. However the U.C.P.600 does not contain this provision.

[25] *Ibid.*

In *Bank Melli Iran* v. *Barclays Bank (Dominion, Colonial and Overseas)*[26], the correspondent bank paid against documents which did not comply with the terms of credit. When they forwarded these documents to the issuing bank to receive the reimbursement they remained silent. There was a delay on the part of the issuing bank to reject the document. This inadvertent delay was taken as ratification by the correspondent bank. It was held that the inaction on the part of issuing bank amounted to ratification.

Justice M. C. Nair said,

> "There was considerable debate before me as to whether or not mere inaction or silence can amount to ratification. In my judgment, it is plain that mere inaction or silence may be evidence from which a jury might infer an intention to ratify.[27]"

Gutteridge criticizes this judgment and says that it deprives the issuing bank the right to complain of the payment against unsatisfactory documents[28]. It was evidenced by the issuing bank that such delay was owing to pressure of work in the documentary credit department. These observations cannot be accepted in the light of modern letter of credit transaction. The provision should be clear as to the time limit for informing the correspondent bank regarding irregular document. Then only they can get reimbursement from customer. Therefore the U.C.P. 600 tried to clarify these difficulties by limiting the reasonable time to a maximum of five banking days[29].

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[26] [1951] 2 Lloyd's Rep. 367
[27] *Ibid.*
[28] *Supra* n.1.
[29] The U.C.P.600, Article 14 (b) reads, " A nominated bank acting on its nomination, confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurance on or after the date of presentation of any expiry date or last day of presentation".

The legal principle which determines the right of reimbursement is contained in the rules adopted by non-governmental agencies. They are given binding effect by incorporating them into the contract. The International Chamber of Commerce has published a number of rules dealing with the bank to bank reimbursement[30]. It is for the issuing bank to initiate the reimbursement procedure[31]. However these are inter-bank arrangements and these rules are not intended to override or change the provisions of the U.C.P. Moreover, the U.C.P.600 specifically incorporated bank to bank reimbursement arrangements. It provides certain guidelines to be followed by the banks in case if a credit fails to state that reimbursement is subject to the I.C.C. rules for bank-to-bank reimbursements[32]. Accordingly it states,

> "...i. An issuing bank must provide a reimbursing bank with a reimbursement authorization that conforms with the availability stated in the credit. The reimbursement authorization should not be subject to an expiry date.
>
> ii. A claiming bank shall not be required to supply a reimbursing bank with a certificate of compliance with the terms and conditions of the credit.
>
> iii. An issuing bank will be responsible for any loss of interest, together with any expenses incurred, if reimbursement is not provided on first demand by a reimbursing bank in accordance with the terms and conditions of the credit.
>
> iv. A reimbursing bank's charges are for the account of the issuing bank. However, if the charges are for the account of the beneficiary, it is the responsibility of an issuing bank to so indicate in the credit and in the reimbursement authorization. If a reimbursing bank's charges are for the account of the beneficiary, they shall be deducted from the amount due to a claiming bank when reimbursement is

[30] See the Uniform Rules for Bank to Bank Reimbursements under Documentary Credits, ICC Publication No. 525. It came into force on 1st July 1996.
[31] *Id.*, Article 2 (a).
[32] The U.C.P.600, Article 13.

made. If no reimbursement is made, the reimbursing bank's charges remain the obligation of the issuing bank..."[33].

Issuing Bank's Obligation under a Negotiation Credit

The negotiation credit[34] may be issued in one of two forms. In the first one it may be freely negotiable and in the other negotiation may be restricted to one or more banks named in the credit. In either case the issuing bank's primary obligation is to reimburse the negotiating bank if the negotiating bank has complied with the terms of the credit.

It is the issuing bank that authorizes the negotiating bank[35] to negotiate against documents. The bank's undertakings are clearly predicated on the assumption that the draft and documents will have been presented to the negotiating bank and negotiated by that bank before presentation to the issuer for payment. This raises the alarming possibility that the credit may fail to provide payment despite the beneficiary's compliance with its documentary stipulations. This possibility arises because the act of negotiation is voluntary on the part of the nominated bank to decide whether the credit is restricted or freely negotiable[36]. If the beneficiary is unable to persuade a bank to negotiate, despite the documents are being in conformity with the credit, it appears that he

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[33] *Id.*, Article 13 (b).

[34] Negotiation means the purchase by the nominated bank of drafts or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank. See the U.C.P.600, Article 2.

[35] The bank which negotiates the bills or drafts under letters of credit is also known as nominated bank or paying bank, see R.K.Gupta, *Banking Law and Practice*, Modern Law Publishers, Allahabad (2004), p.783.

[36] *Maran Road Saw Mill* v. *Austin Taylor & Co. Ltd*, [1975] 1 Lloyd's Rep.156,at p.161

is unable to operate the credit. This disturbing conclusion derives judicial support from the decision of the Singapore Court of Appeal in the *Indian Bank* case[37]. Here the court ruled that since the presentation to the nominated bank was for collection, there had been no negotiation under the credit and the issuer thus incurred no liability thereunder. Unless, the nominated bank is the conforming bank, nomination by the issuing bank does not constitute any undertaking by the nominated bank to negotiate. The nominated bank's receipt for examination and forwarding of the documents does not make the nominated bank liable to negotiate. However the issuing bank is under an obligation to make necessary arrangements to pay the beneficiary if he tenders required valid documents under credit.

Another question that may arise is whether the nominated bank can claim a right of reimbursement from issuing bank if it does not actually pay beneficiary. The following arguments are advanced by some jurists[38].

Thus if value is given by the nominated banks on assumption of a risk, the issuer might not pay on documentary grounds. It might not be able to pay on insolvency or political grounds also. Then reimbursement should logically be available in respect of the negotiating bank despite the fact that the negotiating bank has not been paid.

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[37] *Chinsim Trading (Pte) Ltd v. Indian Bank*, 1993-2 S.L.R.144, as cited in Alan Ward, "The Nature of Negotiation Under Documentary Credits", 14 J.I.B.L.292 (1999), at p.296

[38] Alan Ward, "The Nature of Negotiation under Documentary Credits", 14 J.I.B.L. 292 (1999).

Correspondent Bank's Right against Seller

The rights of the correspondent bank are evolved through judicial decisions. There may be provisions in the governing rules accepted by parties also. In case of inconsistent documents received from the seller, the correspondent banker can exercise the following rights:

a) Right to refuse payment

b) Pay and take an indemnity from the seller in respect of any loss or damage resulting from the deficiency in the documentation

c) Pay the beneficiary "under reserve".[39]

These rights can be exercised by the correspondent bank in order to meet the immediate situation and to protect the interest of parties to the letters of credit. The position of the correspondent bank becomes more complex when the issuing bank subsequently rejects the document. The corresponsdent bank can claim repayment of money from the beneficiary if it has paid the beneficiary "under reserve". But there is no exact meaning of the words "under reserve".[40]

This provision was used is *Banque De L'Indochine Et De Suez S.A.* v. *J. H. Rayner (Mincing Lane) Ltd.*[41] In this case the confirming bank pursuant to a telephone discussion with the parties paid the beneficiary even though they had a doubt regarding the effectiveness of the document tendered. They paid "under reserve". Later the buyer refused to lift the conditions and accept the document. The confirming bank sued the beneficiary for return of money paid to him "under

[39] William Hedley and Richard Hedley, *Bills of Exchange and Bankers' Documentary Credits*, LLP, London (2001),p.338.
[40] See *Credit Agricole Indo Suez* v. *Muslim Commercial Bank*, [2000] 1 All E.R.172(Com).
[41] [1983] Q.B. 711.

reserve". The beneficiary contended that they could not reserve their rights as done by the confirming bank and that the documents were not defective as found by the buyer. The decision of the court favoured the stand of the correspondent bank. It was held that they were entitled to get repayment from the beneficiary. The expression "under reserve" is not having any precise meaning and when that is used. Therefore the court must look to the intention of the parties. Kerr L. J.,[42] said, the

> "that payment was to be made .... in the sense that the beneficiary would be bound to repay the money [to the Confirming Bank] on demand if the issuing bank should reject the documents, whether on its own initiative or on the buyer's instructions. I would regard this as a binding agreement made between the confirming bank and the beneficiary by way of a compromise to resolve the impasse created by the uncertainty of their respective legal obligations and rights."

There is no provision to pay "under reserve" in the U.C.P. The bank must give notice stating the discrepancies in respect to which it refuses the documents[43]. The legal principles are based on the terms agreed between the correspondent bank and the seller. The contractual relationship comes into existence when the correspondent bank pays. This principle is well established in *United City Merchants*[44] case. In this case the contractual obligations of the parties were accepted in order to determine the dispute between them. However the seller did not have any right to sue anyone other than the correspondent bank. He could not intervene in the contract between the buyer and the issuing

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[42] *Id.*, p.734.
[43] See *Bayerische Vereins Bank Aktiengesellschaft* v. *NationalBank of Pakistan*, [1997] 1 Lloyd's Rep. 59, *SeaconsarFarEast* v. *BankMarkazi Jombouri Islam's Iran* [1997] 3 All E.R. 623
[44] *United City Merchants (Investments) Ltd.* v. *Royal Bank of Canada*, [1983] 1 A.C. 168.

bank[45]. So this right can be exercised by the correspondent banker with utmost care against the beneficiary. There will not be direct connection between the issuing bank and the beneficiary.

Another view is that by confirming a credit by the correspondent banker does not guarantee the fulfillment of terms by the issuing banker. The undertaking given by the correspondent bank is independent. So the seller can turn against both banks in case of any breach. This can be inferred from the following provision of the U.C.P.500[46].

> "A confirmation of an irrevocable credit by another bank (the "Confirming Bank") upon the authorization or request of the Issuing Bank, constitutes a definite undertaking of the Confirming Bank, in addition to that of the Issuing Bank, provided that the stipulated documents are presented to the Confirming Bank or to any other National Bank and that the terms and conditions of the credit are complied with:
>
> (i) If the credit provides for sight payment to pay at sight
>
> (ii) If the credit provides for deferred payment to pay on the maturity date(s) determinable in accordance with the stipulations of the credit
>
> (iii) If the credit provides for acceptance
>
> (a) by the Confirming Bank to accept Draft(s) drawn by the Beneficiary on the Confirming Bank and pay them at maturity
>
> or
>
> (b) by another drawer bank to accept and pay at maturity Draft(s) drawn by the Beneficiary on the Confirming Bank, in the event the drawer bank

[45] The U.C.P.500, Article 3(b) provides, "A beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the applicant and the issuing bank.
[46] *Id.*, Article 9(b).

stipulated in the credit does not accept Draft(s) drawn on it, or to pay Draft(s) accepted but not paid by such drawer bank at maturity.

(iv) If the credit provides for negotiations to negotiate without recourse to drawers and/or bonafide holders, Draft(s) drawn by the beneficiary and/or document(s) presented under the credit. A credit should not be issued available by Draft(s) on the Applicant. If the credit nevertheless calls for Draft(s) on the Applicant, banks will consider such Draft(s) as an additional document(s)".

From the plain reading of this provision it can be inferred that the confirmation given by the correspondent bank is only additional to that of the original undertaking by the issuing bank.

However the U.C.P. 600 confined the undertaking of the correspondent bank in a very precise manner. It reads[47],

"...A confirming bank is irrevocably bound to honour or negotiate as of the time it adds its confirmation to the credit[48].

A confirming bank undertakes to reimburse another nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the confirming bank. Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred pyment is due at maturity, whether or not another nominated bank prepaid or purchased before maturity. A confirming bank's undertaking to reimburse another nominated bank is independent of the confirming bank's undertaking to the beneficiary[49].

If a bank is authorized or requested by the issuing bank to confirm a credit but is not prepared to do so, it must inform the issuing bank without delay and may advise the credit without confirmation[50]".

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[47] The U.C.P.600, Article 8
[48] *Id.*,Article 8(b).
[49] *Id.*, Article 8 (c).
[50] *Id.*, Article 8 (d).

Apart from this the issuing bank needs to have clear assessment of the document tendered by the beneficiary, when received from the correspondent bank. This will help the bank to exercise its rights in an effective manner. The right of the corresponding bank against the seller to insist for documents mentioned in the letter of credit should be reasonable and clear. Whether this right should include right of recourse to the seller beneficiary in the event of the issuing bank's right against seller is to be determined.

Issuing Bank and the Seller

So long as the issuing bank is solvent and does not dispute the intermediary's acceptance of the tender of documents the right of recourse can be exercised by the issuing bank against beneficiary. The undertaking to pay by the issuing bank is independent. The correspondent bank only acts on the instruction of the issuing bank. When the documents are presented by the seller, the correspondent bank pays him after the verification of the documents. These documents are then forwarded to the issuing bank to get reimbursement of the amount paid[51]. There again the issuing bank has got the right to examine the document. Problem will arise if the issuing bank finds out any inconsistency with the documents which were not found by the correspondent bank. It can be argued that unless there is a deliberate breach on the part of the seller for inconsistency of documents, it is impracticable for the correspondent bank to deny payment even if any discrepancy exists. It will be time consuming to detect minor errors and to get confirmation. In this situation the banker can invoke a

[51] See Notes, "The Letter of Credit as Protection for a Performer", 66 *Yale Law Journal* 903 (1956-57).

right of recovery from the seller against the payment made under mistake. Here again issuing bank can also invoke right, in the absence of the confirming banker after making the reimbursement to them. Similarly if there is a mutual mistake on the part of the seller and the bank which leads to make payment under the documentary credit the issuing banker has got the right to refuse payment[52]. But if there is a mistake of banker and the seller is aware of the mistake he can't recover[53].

Effect of Right of Waiver

The bank is under a duty to examine the documents. When they are accepted by them in due course, the seller has the right to presume that the set is regular[54]. He is entitled to claim that the bank has waived inquiry. Waiver is based on a decision by the bank to pay regardless of the state of the documents[55]. The issuing bank has the right to waive discrepancies and pay regardless if they have the approval of the applicant[56]. In order to waive a right, the waiver must be aware of the existence of the right to be waived. The issuing bank pays on the basis that the documents are goods. It does not realize that it has a right to recover the money paid. In common law it cannot both accept the documents and retain the right to reject them later. However this depends on the banks knowledge of its initial entitlement to reject the documents.

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[52] *Supra* n. 1. at p.66
[53] See *Riverlate Properties Ltd* v. *Paul* [1974] 3 W.L.R. 564(C.A.).
[54] J.D.Murphy, "Documentary Credits and Rejected Documents", [1992]L.M.C.L.Q.26 at p.29
[55] S.Arrowsmith, "Mistake and the Role of the Submission to an Honest Claim", in A.S.Burrows (Ed.), *Essays on the Law of Restitution*, Oxford Press, London (1991), p.17.
[56] The U.C.P.600, Article 16 (b).

Right of Recourse

When a bank makes a payment in error the effect of its recourse from the payee needs to be examined in straight credit transactions and payment on a bill of exchange. It is also necessary to examine whether its rights are barred under international rules governing credit transactions.

Straight Credit Transactions

A straight documentary credit is essentially a bank's guarantee of payment against specified document.[57] Its duty is to pay when the beneficiary presents the documents to it. Once the bank undertakes payment in non-confirming documents a question will arise against whom the right of recourse can be exercised, is it against the beneficiary who present the non-confirming document or is it against the applicant of credit needs to be analyised.

In practice usually the payment in discharge of debt of applicant is made by the bank. But the documents must be non-confirming on their face[58]. Nonetheless there are cases where for commercial reasons applicant cannot be sued. This is where the applicant is bankrupt. Here the bank is forced to pursue its remedies against the payee or beneficiary.

[57] ICC Guide to Documentary Credit Operations (ICC) No.515 (1994). It provides a summary of the parties objections in choosing to effect payment by documentary credit.
[58] The U.C.P.600, Article 14 (a).

Payment under Bill of Exchange

When the issuing bank accepts and pays a bill of exchange under letter of credit, three situations need to be considered. In situation where the draft is drawn on the issuing bank, the issuing bank has no right of recourse against the seller[59]. The issuing bank acts as a holder when seller is the drawer and the buyer is the drawee. In these circumstances tight of recourse is automatically excluded[60]. The third situation is drawing the bill on the issuing bank by the applicant and the payee is the beneficiary. In *Barclays Bank* v. *W. J. Simms Son & Cooke (Southern) Ltd.*,[61] it was held that right of recourse is available to the issuing bank. This is because of the common law position that payment made under a mistake can be recovered under right of recourse by the bank. The facts of this case though different from letter of credit transaction, principle is applied in credit transactions also.

The payment by mistake is a case of unjust enrichment. In cases of unjust enrichment the bank can avail the subrogation remedy.[62] It is an established principle of subrogation law that the purpose of subrogation is to provide restitution when the absence of restitutionary relief would yield unjust enrichment[63].

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[59] See the Bills of Exchange Act, 1882, s.60

[60] Duncan Sheehan, "Rights of Recourse in Documentary (and other) Credit Transactions", [2005] J.B.L. 326.

[61] [1980] Q.B. 677

[62] This is a statutory provision under the Uniform Commercial Code. See§ U.C.C. 5-117.

[63] John F. Dolan, "A Study of Subrogation Mostly in Letter of Credit and other Abstract Obligation Transaction", 64 *Missouri Law Review* 789 (1999).

However Benjamin says that if the issuing bank commits mistake, right to recourse should not be made available to it[64]. There is no reason why a right of recourse should not to be made available against the issuing bank if has made a genuine liability mistake subject to the standard of restitutionary defences. In most of case of the letter of credit, the U.C.P. will prevent recovery[65].

Thus the issuing bank can exercise right of recourse in letters of credit transaction subject to the rules of practice followed by them.

Rights under Fraud Situations

The issuing bank can exercise its right to refuse payment to the seller in case of fraud committed by seller. The fraud takes place in two situations mainly in relation to the goods and the other in relation to the documents. The issuing banker is more concerned in relation to documentary fraud. The bank has the right to reject for inconsistent document.[66] Similarly, if the bank exercised "reasonable care", it has got the right to get indemnified by the seller. In case the bank pays money under mistake of fact and the beneficiary is responsible for such fraud, the issuing bank can recover the money from the beneficiary. Such a right of recourse against beneficiary is based on the principle of implied warranty[67]. When the defects in the document are latent, the beneficiary

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[64] A.G.Guest, (Ed.), *Benjamin's Sale of Goods*, Sweet and Maxwell, London (2002), p. 160
[65] See the U.C.P.600, Art. 16(b).
[66] *United City Merchants (Investments) Ltd* v. *Royal Bank of Canada*, [1982] 2 All E.R. 720.
[67] *Bank Russo-Iran* v. *Gordon Woodroffe & Co. Ltd.*, (1972) 116 S.J.921 as cited in *Supra* n.1. at p.138

assumes that the documents are genuine and contain no latent defects. However banker can exercise this right only on a clear proof of fraud by the seller[68].

Right of Constructive Possession

The documents received from the confirming bank changes the character of issuing bank. It can hold the documents under pledge. It is a kind of security where reimbursement is refused by its principal customer. When the bank acts as a pledgee, the document of title[69] gives the bank the right to constructive possession. Once the bank gets possession and when reimbursement is refused, issuing bank can take delivery of the goods from the carrier. It has also got the right to sell.

It may be argued that the bank's interest in the goods as pledgee is a proprietary which can be enforced against third parties[70]. As a pledgee, the bank can repledge the goods without the pledgor's consent because the bank has a right to immediate possession of the goods as pledgee of the bill of lading. The bank has also got the right to recover damages in the tort of conversion from the carrier if the goods are delivered to someone else at the port of discharge[71].

It is to be noted that this right as pledgee of the goods can be invoked only in cases of documents of title to the goods. If the letter of credit does not

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[68] *Discount Records Ltd.* v. *Barclays Bank Ltd*, [1975] 1 W.L.R. 315, *Bolivinter* v. *Chase Manhattan Bank*, [1984] 1 All E.R.351, *Edward Owen Engineering Ltd* v. *Barclays Bank International Ltd.*, [1978] 1 All E.R.976

[69] Bill of Lading is an example of document of title

[70] *Law of International Trade in Practice*, Inns of Court School of Law, Blackstone Press Ltd., London (1998) at p.90

[71] See *Chabbra Corporation Pte Ltd.* v. *Jag Shakti (owners) (The Jag Shakti)*, [1986] A.C. 337.

include a bill of lading, the bank will not get proprietary rights.[72] In case of other documents bank will not be assured of any security. Hence if a seaway bill is tendered by the seller as per the letter of credit, the banker will not be able to demand the goods from the ship. Even when the bank insist in the credit that seaway bill should contain name of the bank as the consignee, it is not possible to get a proprietary right. This document lacks negotiability[73]. Hence in case of tendering of seaway bill, the bank will only be able to demand the goods from the ship in its own right if it can be shown that it is the party to whom the seller has instructed delivery to be made. The bank acquires contractual rights against the carrier merely on the basis of the fact that they are identified as consignee in the document. The possession of document may be relevant only to evidence the terms of the contract and not for acquiring rights under the contract.[74]

In the case of multi-model transport document[75] similar problems of seaway bill is encountered. But the endorsement of the document to the bank will enable them to demand delivery from ship. It is argued that when the U.C.P. authorizes bank to accept these documents, they are recognized as documents of title by mercantile customs. Banks would not accept a document which is not capable of being the subject of an effective pledge.[76] Even if the letter of credit prohibits trans-shipment, banks will accept a multi-model transport document

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[72] *Supra* n.70. Also see Alexander Von Ziegler and Jette H. Ronoe (Eds), *Transfer of Ownership in International Trade,* Kluwer Law International, London (1999), p.30.
[73] Caslov Pejovic, "Documents of Title in Carriage of Goods By Sea: Present Status and Possible Future Directions", [2001] J.B.L.461 at p. 481
[74] *Ibid.*
[75] See the U.C.P.600, Article 17.
[76] *Supra* n. 73 at p.480

which indicates that shipment will take place[77]. How far this is practicable is an unsettled question.

Rights of Issuing Bank against Transferee

Letters of credit can be transferred only after obtaining consent from the issuing bank. The U.C.P. provides that "A credit can be transferred only if it is expressly designated as "transferable" by the issuing bank. Terms such as "divisible", "fractionable", "assignable" and "transmissible" do not render the credit transferable. If such terms are used they are to be disregarded[78]. The discretionary power is given to the bank by the accepted practice of trade. Even when it decides to transfer, it can be transferred only on the terms and conditions specified in the original credits with limited exceptions mentioned in the U.C.P.[79].

One of the arguments raised in a case relating to transferable letter of credit[80] was that an issuing bank has got a right to withhold consent to effect a transfer. This view is supported by the U.C.P. provisions. The issuing bank is not concerned with the transferee of credit.[81] It is more concerned with the first beneficiary to get the required documents.

Issuing bank has got the right to insist indemnity from the transferee if payment is to be made on irregular documents tendered[82]. Issuing bank has got

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[77] *Supra*.n.75.
[78] *Ibid.*
[79] The U.C.P.600, Article 38(g).
[80] *Bank Negara Indonesia 1946* v. *Lariza (Singapore) Pte. Ltd.* ,[1988] 2 W.L.R.374
[81] *Supra* n.1.at p.168
[82] *Ibid.*

right to get commission fees and expenses from the transferee[83]. So also if the transferee tries to transfer the credit to a second beneficiary, the issuing bank has got the right to restrict such transfer. If transfer had already taken place, the issuing bank can refuse to accept it.

Rights of the Issuing Bank: Indian Perspective

The rights of the issuing bank in India depend upon the compliance with the terms of letters of credit they issue on an application from the buyer-applicant. While issuing an import letter of credit, banks in India should ensure not merely that the terms of the credit are in conformity with what the customer has asked for but also that they do not go against the current import and exchange control regulations[84]. The issuing banks have right of recourse against the customer if they comply with the terms of credit they issue.

Similarly, the issuing bank has right to pay under reserve. If the documents presented under a credit are not entirely in conformity with its terms, instead of rejecting them the issuing bank can accept them on the strength of an indemnity from the intermediary bank and make payment. The issuing banks claim for refund of such a conditional payment on the documents when it is rejected by the buyer was considered by the Supreme Court in *United Commercial Bank* v. *Bank of India*[85].In this case the sale agreement was for the supply of 'Sizola Brand Pure Mustard Oil'. Accordingly beneficiary presented the

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[83] The U.C.P.600, Article 38 (c).
[84] *Roshan Lal Anand* v. *Mercantile Bank Ltd*, (1975) 45 Com. Cas.519 (Del.).
[85] A.I.R. 1981 S.C.1426. In earlier decision the Supreme Court had emphasized the principle that letters of credit are independent of the underlying transaction and the issuing banks obligation is not affected by a dispute between the buyer and the seller. See *Tarapore &Co.* v. *Tractoro Export, Moscow*, (1969)1 S.C.C. 233.

agreed documents before appellant bank to receive payment. On examination of the documents it was found that the railway receipt covering the dispatch of goods described the goods as 'Sizola Brand Pure Mustard Oil unrefined'. Then the appellant bank refused to accept the document and agreed to make the payment to the respondent bank[86] under reserve. Later the buyer refused to accept the discrepant document. Hence the appellant bank made a demand on the respondent bank to pay back the amount paid under reserve[87]. The beneficiary also approached the court to restrain the respondent bank from making payment. The court held that unless documents tendered under a credit were in accordance with those for which the credit calls for the beneficiary cannot claim against him and it is the banker's duty to refuse payment. The court further emphasized that "the documents must be those called for and not documents which are almost the same or which seemed to do just as well". In the course of judgment the court made the following observations[88],

> "The appellant presumably knew little or nothing about mustard oil. Banks are not dealers in mustard oil in such a case as this, but dealers in documents only. The appellant as the issuing bank was presented with documents and asked to pay a very large sum of money in exchange for them. Its duty was not to go out and determine the physical examination of the consignments, or employment of experts, whether the goods actually conformed to the contract between the buyer and the seller, nor even determine either from its own or expert advice whether the documents called for the goods which the buyer would be bound to accept. The banker knows only the letter of credit which is the only authority to act, and the documents which are presented under it. If these documents conform to the letter of credit [,]. He is bound to pay. If not, he is equally not bound to pay....".

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[86] Here respondent bank was the bank which ultimately makes payment to the beneficiary.
[87] A payment under reserve is understood in banking transaction to mean that the recipient of money may not deem it as his own but must be prepared to return it on demand. See *Japson International* v. *State Bank of India*, A.I.R. 1989 P&H 289.
[88] *Supra* n.86. at p.1439

Therefore the issuing bank has the right to refuse payment if the documents tendered are not in conformity with those agreed[89].

The issuing bank has right to claim reimbursement of the amount it paid to the beneficiary irrespective of any insurance coverage. In *Lakshmi Commercial Bank Ltd* v. *Hiralall &Sons*[90], the bank opened a letter of credit in favour of a foreign seller at the request of the Indian buyer. The letter of credit was transmitted through negotiating banker in foreign country. The seller shipped the goods and presented the stipulated documents. The negotiating bank scrutinized the documents and found that they were in conformity with the credit and made payment. Later, the issuing bank claimed reimbursement of the amount it paid from the buyer. The buyer refused to pay on the ground that the ship carrying goods had sunk and the issuing bank should claim the amount from the insurance company. The Delhi High Court held that the buyer should pay the amount to the issuing banker. It emphasized that whether the ship sunk or sailed was not the concern of the issuing banker. If the ship sank, it was the buyer's business to pursue the claim against the insurance company even though the policy of insurance was in the name of the buyers as well as the issuing bank. The insurance policy was only a means of security in the hands of the banker. Though the bank had lodged a claim against the insurance company, that did not mean that the primary obligation of the buyer to pay the amount to the bank ceased.

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[89] Also see *AVN Tubes Limited* v *Steel Authority of India Ltd*, A.I.R. 1996 M.P.53.
[90] (1983) 54 Com. Cas.313 (Del.).Also see *Hiralall&Sons* v. *Lakshmi Commercial Bank*, (2002) 6 S.C.C.389.

Whether the issuing banks can be restrained from paying against similar documents tendered under letter of credit was considered by the Delhi High Court in two different cases. In one case, the court refused to grant injunction[91]. But in the other the court confirmed the already granted injunction[92]. The refusal in the first one was based on the obligation of an issuing bank. It was stated that it was for the bank to decide whether or not to pay against the documents tendered under the credit. If the bank wrongfully rejected documents that met the requirements of the credit, the bank would be answerable to the beneficiary. The court observed,

> "...Needless to say that where the irregularity is obvious, the banker takes the document with his eyes open and should pay, if at all, only under indemnity or recourse, for he cannot look to his principal for re-imbursement if the latter refuses to accept the documents. Surely, the bank cannot be dictated by the plaintiff in this behalf although there may be a lot of common sense on its part to consider the objections raised by the plaintiff before accepting or rejecting the documents on the ground of discrepancies...".

On the other hand the decision which confirmed injunction was based on reason that the documents tendered were not consistent with the terms of the credit. The court in this regard was more concerned with the interest of parties than in the issuing banks obligation to the seller. In both the cases the certificates of weight and quality were held to be not what the credit called for. The documents did not expressly state how the surveyors assessed the quality of the goods or satisfied themselves as to the quality. Jain J.,[93] remarked

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[91] *Interadas Advertising (P) Ltd* v. *Bentrex & Co*, (1983) 53 Com. Cas. 646 (Del.).
[92] *Interdas Advertising (P) Ltd* v. *Palmex Enterprises* ,(1983) 53 Com. Cas. 550 (Del.).
[93] *Supra* n.92.

> " the words "as tendered" in art 33 of the U.C.P. cannot be stretched to mean that whatever documents is tendered by the seller-beneficiary styled as a certificate of quality has to be accepted by the issuing or negotiating bank.... It must be a certificate of quality in essence and not in name only".

From the above discussion, it can be seen that courts in India expect banks to ensure the documents apparently meet the description with what they are in the letter of credit.

The rights of the issuing bank to claim reimbursement from the buyer depends upon compliance with the terms. In *Indian Overseas Bank Ltd* v. *S.K.Ramalingam Chettiar*[94], the Madras High Court discussed this aspect. In this case the issuing bank made payment to the seller on defective documents. The bill of lading tendered by the seller was defective. The letter of credit called for a clean bill of lading. But the bill of lading produced contained a special note which stated that the condition of packing of the goods was not clean. Apart from this the insurance polity was also defective since it did not cover the risk of theft and pilferage[95].

If the issuing bank has any objection to the acceptance of the documents it must inform the negotiating or confirming bank immediately before the negotiating bank made payment to the seller. Otherwise the issuing bank cannot refuse to accept the documents. This was made clear by the Delhi High Court in *National Oils and Chemical Industries Ltd.* v. *Punjab & Sind Bank Ltd*[96]. This was a suit for injunction restraining the negotiating bank from making payment on

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[94] (1970) 2 M.L.J. 288.
[95] The court pointed out that these risks were not automatically covered by a policy which covers perils against "pirates, rovers and thieves".
[96] (1980) 50 Com. Cas. 390 (Del.)

the ground of non conformity with the terms of credit. The issuing bank had not raised any objection to the documents. Instead it informed the negotiating bank that the documents had been accepted by the buyer. The issuing bank sought to reject the documents only when the carrying vessel had sunk. The court observed that the issuing bank was estopped from claiming the amount. Similar view was taken by the Calcutta High Court in *B.S.Aujila Co Pvt Ltd* v. *Kaluram Mahadeo Prasad* [97]. In this case the issuing bank failed to communicate the discrepancies in the documents to the negotiating bank within a reasonable time. It was held that irrespective of the question as to the conformity or otherwise of the documents with the terms of the credit, the issuing bank had forfeited the right to reject the documents since there was delay in communicating the same.

The importance given to the terms of the letter of credit by courts sometimes go against the basic nature of letters of credit. For example the Supreme Court in *State Bank of India v. Manganese Ore (India) Ltd.*[98] went to the extent of holding that the obligation of a bank to honour letter of credit is conditional upon the supply of quality goods in conformity with condition of the letters of credit. In this case the goods supplied were not of the specification and standard required under the letters of credit. So the bank refused to make payment against documents presented by the seller. The Bombay High Court directed the issuing Bank to make payment to the seller. The Supreme Court allowed the appeal filed by the issuing bank and held that it had no liability to honour the documents.

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[97] A.I.R. 1983 Cal.106, also see, *Federal Bank Ltd* v. *V.M.Jog Engineering Ltd*, A.I.R. 2000 S.C.3166.
[98] (1997) 4 Comp L. J.57 (S.C.)

The issuing bank is also liable to accept the bills of exchange if it adds confirmation on it. Once it agrees with the negotiating bank to honour the bills of exchange and accept that payment will be made on due date it cannot refuse payment even on the ground of fraud played by officers of the bank. Thus in *Virgo Steels* v. *Bank of Rajasthan*[99] suit was for an unconditional leave to defend payment of the of bill of exchange negotiatied on the basis of an irrevocable letter of credit. The negotiating bank after receipt of the bills of exchange with documents sought confirmation from the issuing bank. The issuing bank confirmed the same. Later reimbursement was claimed from the issuing bank when the amount was paid by the negotiating bank. The issuing bank refused to pay. They alleged that some officers of another bank were involved in fraud and conspiracy. The court refused to accept this allegation. The court held that the issuing bank was bound by its own confirmation and if the documents were in order payment had to be made. The Supreme Court[100] also made it clear that the issuing bank is not concerned with the disputes between the opener of the letter of credit and the beneficiary thereof. Its liability is solely based on the letter of credit terms.

A Critical Evaluation of Rights of the Issuing Bank

The issuing bank's right to reimbursement is dependent on complying strictly to the instructions given by the buyer. To enforce this right it may realise any security interest it has in the shipping or other documents received from the beneficiary. Even though the bank may deliver these shipping documents to the

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[99] A.I.R.1998 Bom. 82.
[100] *Fargo Freight Ltd* v. *Commodities Exchange Corporation*, (2004) 7 S.C.C.203.

applicant, it is only for the purpose of processing the goods. Once the bank is put with funds by the applicant, it becomes his exclusive property[101]. The right of reimbursement becomes effective only if the beneficiary is paid by the bank. Even a slight variation from the mandate given by the customer will defeat this right of the issuing bank. This influence can be drawn from *South African Reserve Bank* v. *Samuel &_Co. Ltd*,[102] where the bank took up warehouse receipts which simply stated that they were for certain quantities of maize without identifying the source from which they had been acquired. The Court of Appeal held that it was necessary for the bank to ensure that the maize for which warehouse receipts were delivered was represented by shipping documents. The bank lost its right to get reimbursement. Apart from this the U.C.P. does not incorporate adequate duties to be exercised on the part of the issuing bank towards the buyer applicant and restricts the buyer applicant's right to sue if the issuing bank acts contrary to its undertaking under documentary credits.

However there is no decided case on the question with regard to the right of reimbursement by the bank from the buyer if the bank pays against the shipping documents which are not mentioned in the credit. If the bank is negligent in not making adequate inquiries before concluding that the conditions have been fulfilled, it will lose its right to reimbursement. If the parties follow the U.C.P provisions, bank will lose its right to reimbursement only when it is negligent[103]. But if the rules are not mentioned, it is an open question for litigation.

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[101] *Sale Continuation Ltd* v. *Austin Taylor & Co. Ltd.*, [1968] 2 Q.B.849
[102] (1931) 40 Ll. L. R. 291
[103] See the U.C.P. 600 Articles 13.

It can be ascertained from the case laws dealing with this aspect that the right of the issuing bank depends on its fulfillment of the agreed terms. These terms may vary from case to case. Determining the clear boundary describing the rights of the issuing bank is a difficult task. On the other hand if they are not specifically enumerated, a lot of uncertain situation will be crept in. Therefore it is necessary to harmonise the interest of parties.

The role of the corresponding banker also needs careful examination. The obligations they have to the issuing bank as well as other concerned parties are to be clearly mentioned. The task of the corresponding bank is very crucial when it acts as confirming banker.

CHAPTER-7

OBLIGATIONS OF CORRESPONDING BANK

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The corresponding bank plays a pivotal role in the documentary credit transactions. Its obligations vary according to the nature of the function it agrees to undertake. The role of corresponding bank can be viewed from two different angles. One view is that they agree merely to advise the beneficiary. In this situation the obligation of corresponding bank is limited. It is not under binding contractual relationship with the beneficiary.[1] Another view is that it agrees to confirm the credit. Then it undertakes an independent contractual obligation to pay the beneficiary apart from the issuing bank. The obligation towards the beneficiary initiates at the moment the beneficiary tenders the documents specified in the letter of credit and demands payment[2].

In practice, difficulties arise due to the fact that the instructions are not clear and are intended to mean something different from what they actually convey. The consequences of wrong compliance of instructions are different and needs detailed evaluation. Similarly, once the bank agrees to pay to the beneficiary, the primary scrutiny of the documents needs to be done by them. This task is very complicated as there are different types of documents[3] the parties require under documentary credit.

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[1] Mark Hapgood (Ed.), *Pagets Law of Banking*, Butterworths, London (1983), p.623
[2] Richard King (Ed.), *Law of Bankers' Commercial Credits*, Europa Publications Ltd, London (2001), p.100.
[3] See Charles Debattista, "The New UCP 600---Changes to the Tender of the Seller's Shipping Documents under Letters of Credit", [2007] J.B.L.329.

Obligations of Corresponding Banker

The services of a corresponding banker are availed to facilitate the payment under documentary credit. The beneficiary is likely to rely on the corresponding banker placed in his country. Therefore the issuing banker approaches the corresponding banker with an option of either acting as a mere advisor of credit or to confirm the credit. The corresponding banker is having an option either to accept the offer or to reject it. In case it decides to act as mere advisor of credit, it should be intimated to the issuing bank immediately.[4] Some writers have criticised this position[5]. They observed that the correspondent bank should not accept the instructions to advise unless it is prepared to give effect to the credit. This argument is favourable for the beneficiary who does not know anything about the issuing bank. He may prefer to have the obligations on a bank in his own country[6].

The obligations of a correspondent banker towards the beneficiary depend on the terms in which it gives its confirmation. The most important aspect of the obligation of corresponding banker is that it does not guarantee the fulfillment of its obligations by the issuing banker. This obligation is an additional obligation given by the correspondent banker. It is apart from the original obligation undertaken by the issuing bank. Gutteridge is, of the opinion that every confirmation given by the correspondent banker will not result in an additional

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[4] The U.C.P.600, Article 9 (e).
[5] Epschtein et Bontoux: *Reflexions sur le credit Documentaire Irrevocable non Confirme*, as cited in H. C. Guteridge and Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd, London (1979), p.70.
[6] *Ibid.*

obligation[7]. The reason is that in case the correspondent bank issues its own credit which states that the credit is given pursuant to the irrevocable credit of another bank, the direct relationship is formed between the beneficiary and the issuing bank. This is reflected in the U.C.P.600 also[8].

Inspite of different arguments the position of a confirming bank can be considered as the bank which undertakes the risk of accepting documents from beneficiary when he makes payment[9]. If the documents are in the order, the correspondent bank can escape from the liability. On the other hand if there is any irregularity the correspondent bank will have to face the consequences. This is because the correspondent banker's rights and obligations are governed by the instructions received from the issuing bank. They cannot use any discretion in this transaction though sometimes they act independently. The correspondent bank gives as an independent undertaking to pay to the beneficiary in terms of instructions received from the issuing bank. Apart from this, the peculiar feature of the obligation is to take reasonable care to ensure that the documents received must appear on their face to be in consistent with the terms of the credit[10].

Corresponding Banker and Seller

Once the correspondent banker agrees to pay the seller beneficiary, a contractual relationship comes into existence between them[11]. This relationship gives rise to certain obligation for the correspondent bank towards the seller. As

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[7] H.C.Gutteridge and Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), p.72.
[8] See the U.C.P.600, Article 8 (c).
[9] Ray August, *International Business Law*, Prentice Hall, New Jersey (1997), p.631.
[10] Supra n. 1. at p. 624.
[11] For the detailed discussion on the legal nature of relationship between correspondent banker and seller. See *supra* Chapter 2.

the banker deals with documents only and not with goods[12] the basis of the obligation can be confined to the authenticity of documents. The obligation to honour the credit is accepted by courts in general terms. The observation of the court is general with wide dimensions as letter of credit is used as a means to supply goods world over. They always treat the obligation to honour the credit as vital[13].

The object of confirmation of credit by the correspondent banker is different from payment to beneficiary on tendering of documents. This view is supported by the decision in *Trans Trust S. P. R. L.* v. *Danubian Trading Co. Ltd.*[14]. Denning L.S., said[15],

> "A Banker's confirmed credit is a different thing from payment. It is an assurance in advance that the seller will get paid. It is even more than that. It is a chose in action which is of immediate benefit to the seller."

This distinction however will not relieve the correspondent bank from its duty to pay the seller when he presents the documents.

One of the important obligations of the correspondent bank is to take quick decision regarding the acceptance of documents presented by the seller. This aspect is clear from the following observations made by Lord Diplock in *Commercial Banking Co. of Sydney Ltd.* v. *Jalsard Pty Ltd,*[16]

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[12] The U.C.P.600, Article5 reads, " Banks deal with documents and not with goods, services or performance to which the documents may relate".
[13] *Edward Owen Engineering Ltd* v. *Barclays Bank International Ltd,* (1978) 1 All E.R. 976 (C.A.).
[14] [1952] 2 Q.B.297.
[15] *Id.*, at p. 305.
[16] [1973] A.C.279.

> "Both the issuing banker and his correspondent bank have to make quick decisions as to whether a document which has been tendered by the seller complies with the requirements of the credit at the risk of incurring liability to one or other of the parties to the transaction if the decision is wrong. Delay in deciding may in itself result in a breach of his contractual obligations to the buyer or to the seller. This is the reason for the rule that where the banker's instructions from his customer are ambiguous or unclear he commits no breach of his contract with the buyer if he has constructed them in a reasonable sense, even though upon closer consideration which can be given to questions of construction in an action in a court of law, it is possible to say that some other meaning is to be preferred."[17]

This shows that any breach of this obligation by the correspondent bank will give rise to liabilities.

Apart from this the U.C.P.600 has also made an attempt to clarify the obligation of the correspondent bank under two categories of confirming bank undertaking and advising banks undertaking[18]. It has also provided nominated bank's obligation[19]. It reads[20];

> "a. Provided that the stipulated documents are presented to the confirming bank or to any other nominated bank and that they constitute a complying presentation, the confirming bank must:
>
> i. honour, if the credit is available by
>
> a) sight payment, deferred payment or acceptance with the confirming bank;
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> b) sight payment with another nominated bank and that nominated band does not pay;
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> c) deferred payment with another nominated bank and that nominated bank does not incur its deferred

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[17] *Ibid.* Also see *European Asian Bank A.G.* v. *Punjab and Sind Bank (No.2)*, (1983) 2 All E.R.508 (C.A.).
[18] The U.C.P.600, Article 8 and 9.
[19] *Id.*, Article 12.
[20] *Id.*, Article 8.

payment undertaking or, having incurred its deferred payment undertaking, does not pay at maturity;

d) acceptance with another nominated bank and that nominated bank does not accept a draft drawn on it or, having accepted a draft drawn on it, does not pay at maturity;

e) negotiation with another nominated bank and that nominated bank does not negotiate.

ii. negotiate, without recourse, if the credit is available by negotiation with the confirming bank.

b. A confirming bank is irrevocably bound to honour or negotiate as of the time it adds its confirmation to the credit.

c. A confirming bank undertakes to reimburse another nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the confirming bank. Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not another nominated bank prepaid or purchased before maturity. A confirming bank's undertaking to reimburse another nominated bank is independent of the confirming bank's undertaking to the beneficiary."

This shows that the correspondent banker is under an obligation towards the seller to make payment by examining the documents tendered. A breach of these obligations that causes loss to the beneficiary is actionable by the seller[21].

Duties of Correspondent Banks

When the correspondent bank agrees to act as confirming bank and given an undertaking in the terms as the issuing bank, it owes precisely the same duties to the beneficiary. One of the important obligations of the correspondent bank is

[21] *Supra* n.2. at p.99.

to take reasonable care to ensure that the document received appear on its face to be consistent with the terms of the credit. Gutteridge comments[22]:

> "It is the duty of the banker to scrutinize the documents tendered to him by the beneficiary under the credit and check them carefully with the instructions which he has received from his customer. Any default in this respect will debar the banker from claiming reimbursement by the customer of any amount which may be paid against the documents and also cause him to forfeit his right to get remuneration."

Therefore scrutiny of the documents needs to be done by correspondent bank when it agrees to make payment to the beneficiary. It must make certain that the documents tendered by the seller are exactly the same documents required by the credit. As it is an accepted principle that credits are by their nature separate from the sales contract between the parties[23] the correspondent bank is not concerned with any such contracts even if any reference is included in the credit. This shows that corresponding banker's obligation is concerned only with the accuracy of documents produced before it. If a minor mistake in examining the document is occurred, the banker will be held liable for the breach of its obligation[24]. Any relaxation permitted by the bank on the documents tendered will cause serious embarrassment. As Lord Summer has rightly pointed out:

> "There is no room for documents which are almost the same, or which will do just as well."[25]

Therefore the correspondent banker cannot be compelled to honour the credit unless the beneficiary pursues and confirms the document in every l

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[22] *Supra* n.7. at p.89.
[23] The U.C.P.600, Article 4.
[24] *Equitable Trust Co. of New York* v. *Dawson Partners Ltd.*, (1927) 27 Ll.L.Rep. 49
[25] *Id.*, at p.52

respect[26]. The correspondent banker's obligations are obviously be most difficult to pinpoint. It is because each case will be different from one another. As different documents are used their obligation varies from one to another. Therefore in case of bill of lading document, the banker must ensure the literal compliance with the terms mentioned in the bill of lading[27]. He is not concerned with the legal interpretation of the clauses in a bill of lading.

Similarly the extent of obligation of the correspondent banker to acquaint himself with the terms of the documents has not been analysed by courts. This situation was discussed in a case[28] by Scrutton, L. J. He said[29],

> "In some cases the obligation of a banker, under such a credit, may need very careful examination. I only say at present that to assume that for one-sixteenth percent of the amount he advances, a bank is bound carefully to read through all bills of lading presented to it in ridiculously minute type and full of exception, to read through the policies and exercise a judgment as to whether the legal effect of the bill of lading and the policy is, on the whole, favourable to their clients, is an obligation which I should require to investigate considerably before I accepted it in that unhesitating form....."

Salmon, J., shared the doubt expressed by Scrutton, L. J. He said[30],

> "I doubt whether they [the bank] are under any greater duty to their correspondents than to satisfy themselves that the correct documents are presented to them, and that the bills of lading bear no endorsement or clausing ... which could reasonably mean that

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[26] *Moss* v. *Old Colony Trust Co.*, 140 N.E.803 as cited in H. C. Gutteridge and Maurice Megrah, *The Law of Banker's Commercial Credits*, Europa Publications Ltd., London (1979), p.92.
[27] See *Bank Melli Iran* v. *Barclays Bank D.C.O. Ltd.*, [1951]2 Lloyd's Rep.367. Midland Bank Ltd. v. Seymour, [1995] 2 Lloyd's Rep. 147. *Laudisi* v.*Americn Exchange Bank*, (1924) 239 N.Y.234 as cited in R.R.Pennington and H.H.Hudson, Commercial Banking Law, MacDonald & Evans, Plymouth (1978),at p.339.
[28] *National Bank of Egypt* v. *Hannevig's Bank*, (1919) 1 Ll.L. Rep. 69
[29] *Id.*, p.75.
[30] *British Imex Industries Ltd.*, v. *Midland Bank Ltd.*, [1957] 2 Lloyd's Rep. 591 at p.597

there was or might be some defect in the goods, or in their packing."

He also expressed concern regarding the purpose of letter of credit if a bank is made obliged to read through the clauses in minute print and consider their legal effect. This will consume time for verification so there will be delay in the payment as there will be large number of clauses in the document tendered. Apart from this the clause in the document relating to defect in the goods will also create difficulty for the corresponding bank.

Correspondent banker is also under an obligation to verify the charter party bill of lading. In this situation the banker is not expected to examine charter party contract even if the credit requires them to do so[31]. In *Enrico Furst & Co.* v. *W. E. Fischer Ltd.,*[32] the correspondent banker was held to be entitled to reject a bill of lading which was not clean. Here a bill of lading was issued by a forwarding agent and expressed it to be subject to the charter party. However it was found that the bill of lading contained qualifying words inconsistent with the common practice followed when bill of lading is issued. Diplock J said,

> "...on the evidence of banking witnesses, the banking practice is that, where the credit is for payment against bills of lading, banks, whether in London or Switzerland or in Italy, do not treat as good tender either bills of lading signed by forwarding agents or bills of lading claused to incorporate the terms of a charter party."

The obligation of the correspondent banker relating to the bill of lading document is confined to reasonable examination of document tendered by the beneficiary. Once it is in conformity with the terms of credit, he is bound to make payment.

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[31] The U.C.P.600, Article 22(b) reads, "A bank will not examine charter party contracts, even if they are required to be presented by the terms of the credit".
[32] [1960] 2 Lloyd's Rep. 340.

If the goods are to be transported by land or air involving the letter of credit, it will require an air transport document and other documents including the insurance cover. The law relating to the sufficiency and accuracy of other documents which must be tendered to the correspondent bank is not as complex as the rules relating to bills of lading.

Duty of Care in Insurance Documents

The correspondent banker is expected to take reasonable care to examine insurance document. He must be able to distinguish between a certificate of insurance and policies of insurance. In *Diamond Alkali*[33], it was held that a certificate of insurance could not be regarded as equivalent to policies of insurance. In *Scott* v. *Barclays Bank Ltd.*[34], the documents tendered by beneficiary included a certificate of an American insurance company. It merely stated that a policy had been issued but was silent as to the nature of the insurance and its terms and conditions. The correspondent bank rejected this document. The letter of credit stated that drafts would be honoured against documents including "an approved insurance policy." The court justified the refusal. Scrutton, L. J., said:[35]

> "In my view they have a right to see a document or documents which contain the terms of the insurance which is offered to them as security for the loss of the goods, and if the document tendered to them does not show them what the terms of that insurance are, they are, from a commercial point of view, reasonable in refusing to approve it or accept it as a policy."

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[33] *Diamond Alkali Export Corporation* v. *Bourgeio's*, [1921] 3 K.B. 443.
[34] [1923] 2 K.B. 1
[35] *Id.* at p.15.

Moreover regarding what will constitute an approved insurance policy, a good definition for an "approved" bill can be found in *Hodgson* v. *Davies*[36]. ATKIN, L. J., said,

> ".... an "approved policy" indicates, in my view .... an objective standard. That is to say, it does not mean a policy which may or may not be approved by the person to whom it is tendered, but it means a policy such that no reasonable objection could be taken to it by commercial men."

The correspondent banker can accept insurance certificate or a declaration under an open cover in lieu of an insurance policy[37]. However an insurance policy or certificate must cover all the risks specified in the letter of credit. In *Borthwick* v. *Bank of New Zealand*[38], the policy contained exclusion clauses which exempted the insurer from liability in certain circumstances and allowed him to limit the amount. It was held that the confirming bank could reject the documents tendered.

Similarly the term "all risks" does not have a clear meaning. The U.C.P.600 states[39],

> "When a credit requires insurance against "all risks" and an insurance document is presented containing any "all risks" notation or clause, whether or not bearing the heading "all risks", the insurance document will be accepted without regard to any risks stated to be excluded".

There are some risks which cannot be included under this "all risk". For instance, the risk of unlimited transshipment or delay cannot be covered under all

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[36] (1810) 2 Camp 530 at p.532 as cited in Gutteridge, *Supra* n.7 at p.127.
[37] The U.C.P.600, Article 28 (d).
[38] (1900) 6 Com. Cas. 1 cited in R. R. Pennington and H. H. Hudson, *Commercial Banking, supra* n.27.
[39] The U.C.P.600, Article 28 (h).

risks[40]. Therefore it is impossible to visualize all the possibilities of loss which would be excluded from "all risks" insurance. Moreover lack of a universal meaning to such a term will invite difficulties to understand the exact meaning.

The corresponding banker is only having an obligation to take reasonable care while examining the insurance document. He should also have a clear understanding of the terms contained in it.

Duty of Care under Other Documents

In addition to a bill of lading and insurance document, letters of credit may require tendering of other documents like commercial invoice, certificates of weight, quantity or analysis or expert's certificate or opinions. The corresponding banker is under an obligation to verify the correctness of each document. In *Equitable Trust Co. of New York* v. *Dawson Partners Ltd.*[41] the letter of credit called for a quality certificate by experts. The certificate tendered contained the opinion by one expert only. The court held that the banker's obligation was to verify whether the certificate contained more than one expert's opinion. In *Basse and Selve* v. *Bank of Australia*[42] it was held that the banker was not under an obligation to insist that the beneficiary should prove that the expert's quality report was based on a sample of the goods delivered to him for testing and was accurate. The banker had only an obligation to verify whether sufficient detail to show that sample delivered to the expert was a sample of the bulk which was shipped.

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[40] *F. W. Berk & Co. Ltd* v. *Style,* [1955] 2 Lloyd's Rep. 382.
[41] (1926) 25 Ll.L. Rep. 90.
[42] (1904) 20 T.L.R. 431 cited in R. R. Pennington and H. H. Hudson, *Commercial Banking Law, Supra* n. 27.

The banker is under an obligation to accept documents tendered provided that they are the usual documents used in that particular trade. However if they failed to provide the expected information, documents become invalid. In *Old Colony Trust Co.* v. *Lawyer's Title and Trust Co.*[43], the "certificate of analysis" was tendered. It was found that though it was labeled as such, it did not provide the information which it was intended to give. It was held that the banker should take reasonable care to verify the genuineness of the document tendered.

The corresponding bank has to see that the document received appear on their face to be consistent with the term of the credit. Similarly, it has an obligation towards issuing bank to forward these documents.

Correspondent Banker's Obligation Towards Issuing Bank

Once the documents are accepted by the correspondent bank from the seller, it has to transmit them to the issuing bank. This obligation should be carried out promptly and failing which, the correspondent bank will not get the eligible reimbursement[44].

The corresponding banker is having an obligation to take utmost care. If any doubt arises as to the validity of any document, it should enquire and clear it with the issuing bank. However in a Court of Appeal decision[45], it was held that if the issuing bank acknowledged the receipt of the documents without making any objection to them, it cannot reject the same. It was bound to reimburse the

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[43] 297 F 152 (2nd Cir 1924) as cited *Ibid.*
[44] Richard Schaffer and Beverely Earle (Eds), *International Business Law and its Environment*, West Educational Publishing Co., Ohio (1999), at p. 266.
[45] *Supra.*n.28.

correspondent bank. Similarly, in *Bank Melli Iran* v. *Barclays Bank D. C. O. Ltd.*[46], it was held that by taking unreasonable length of time to reject the shipping documents received from the confirming bank, the issuing bank waived its right of rejection.

If the issuing bank request the correspondent bank to confirm a credit and the correspondent bank is not prepared to do it, it must inform the issuing bank without any delay[47]. It can undertake to advise the credit without confirmation. In case of acting as an advising bank, the obligation can be inferred from the following. The U.C.P.600, states[48],

> "A credit and any amendment may be advised to a beneficiary through an advising bank. An advising bank that is not a confirming bank advises the credit and any amendment without any undertaking to honour or negotiate.
>
> By advising the credit or amendment, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit or amendment and that the advice accurately reflects the terms and conditions of the credit or amendment received.
>
> An advising bank may utilize the services of another bank ("second advising bank") to advise the credit and any amendment to the beneficiary. By advising the credit or amendment, the second advising bank signifies that it has satisfied itself as to the apparent authenticity of the advice it has received and that the advice accurately reflects the terms and conditions of the credit or amendment received.
>
> A bank utilizing the services of an advising bank or second advising bank to advise a credit must use the same bank to advise any amendment thereto.

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[46] [1952] 2 Lloyd's Rep. 367.
[47] The U.C.P.600, Article 8 (d).
[48] *Id.*,Article 9.

If a bank is requested to advise a credit or amendment but elects not to do so, it must so inform, without delay, the bank from which the credit, amendment or advice has been received.

If a bank is requested to advise a credit or amendment but cannot satisfy itself as to the apparent authenticity of the credit, the amendment or the advice, it must so inform, without delay, the bank from which the instructions appear to have been received. If the advising bank or second advising bank elects nonetheless to advise the credit or amendment, it must inform the beneficiary or second advising bank that it has not been able to satisfy itself as to the apparent authenticity of the credit, the amendment or the advice".

The obligation of the correspondent bank towards the issuing bank in case if it agrees to act as a nominated bank is different. The U.C.P.600 states[49],

"a. Unless a nominated bank is the confirming bank, an authorization to honour or negotiate does not impose any obligation on that nominated bank to honour or negotiate, except when expressly agreed to by that nominated bank and so communicated to the beneficiary.

b. By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorizes that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank.

c. Receipt or examination and forwarding of documents by a nominated bank that is not a confirming bank does not make that nominated bank liable to honour or negotiate, nor does it constitute honour or negotiation.

Therefore the obligation towards the issuing bank depends upon the terms it has agreed with the issuing bank.

[49] *Id.*, Article 12.

Correspondent Bank's Obligation towards Buyer

The correspondent banker is not having any obligation towards the buyer as there is no direct relationship between them. In *Calico Printers Association* v. *Barclays Bank Ltd.*[50], it was observed that a confirming bank owes no duty of care to the applicant. However if the confirming bank knowingly permits the beneficiary to draw under letter of credit by any unauthorized means, it becomes liable[51]. So the correspondent bank is having an obligation not to permit any unauthorized transactions. But there is no supporting case law which justifies this obligation. In *Auto Servicio San Ignacio* v. *Compania Anonima Venezolana de Navigation,*[52] Schwarz J., dismissed the complaint filed by the buyer alleging negligence in verifying the authencity of a bill of lading. The judge observed that the confirming bank was having duty only to the issuing bank and not to the issuing bank's customer. Similarly in *Orr and Barber* v. *Union Bank of Scotland,*[53] the House of Lords held that the applicant could not sue the confirming bank when it had paid a forged draft and subsequently refused to honour a genuine draft presented by the beneficiary.

Breach of Obligation by Correspondent Banks

The correspondent bank should examine the documents with reasonable care. If it acts negligently or omits to take reasonable care it will lead to breach of duty. The bank will be liable to the concerned parties. They may have to pay

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[50] (1930) 36 Com. Cas. 71 as cited in R. R. Pennington and H. H. Hudson, *Commercial Banking Law*, *Supra* n. 27.
[51] See for instance, *Oelbermann* v. *National City Bank of New York*, (1935) 79 F. 2d 534. *Ibid.*
[52] Federal Supplement, Vol 586, p. 259 (Dist. Ct. for E. Dist. Of Louisiana, (1984),*supra* n.9.
[53] (1854) 1 Macq. H. L. Cas. 512 as cited in *ibid.*

damages for such breach. However damages are determined in the ordinary way[54]. The banker will not be liable to pay any special damages. In *Urquhart, Lindsay & Co. Ltd.* v. *Eastern Bank Ltd.*[55], it was observed that if a confirming bank refuses to accept or purchase drafts presented by the beneficiary under a credit without lawful excuse, the beneficiary can recover general damages. However, the beneficiary cannot recover any special damages.

Instead of damages, the beneficiary can claim the actual amount of the letter of credit in some cases. In *Belgian Grain and Produce Co.* v. *Cox & Co.*[56] ,the Court of Appeal held that the beneficiary can sue the bank for the actual amount of the credit without proving loss. The same view was taken by the Privy Council in *Larios* v. *Bonany y Gurity*[57].The question whether the damages are to be computed with reference to the loss suffered by the beneficiary by the non-acceptance of shipping documents or solely on the basis of the banker's failure to pay was considered. In this regard, Bankes, L. J., said,

> "The object of letters of credit in this form.... is to secure payment of the purchase price of the goods or of the actual amount named in a letter of credit in exchange for the particular documents named therein, and one of the objects is to avoid any controversy in reference to the amount of damage and to secure that as against the documents if they are in order the amount of money named in the letter of credit should be paid over."

Thus it is a settled that if there is a breach of obligation towards the beneficiary by the correspondent banker, he is entitled to get damages. In case of

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[54] Damages are given meaning of the rule laid down in *Hadley* v. *Baxendale* (1854) 9 Ex. 341 as cited in *supra* n. 7
[55] [1922] 1 K.B. 318.
[56] (1919) 1 Ll.L. Rep. 256.
[57] (1873) L.R. 5 P.C. 346.

the buyer, the correspondent bank has no obligation and hence cannot be sued[58]. Similarly the question of damages will not arise as there is no privity between them. In case of breach of obligation towards issuing bank, the correspondent bank has to face the consequences. They cannot get reimbursement from the issuing bank.

Correspondent Bank and Exclusion Clauses

Correspondent bank is liable to perform its obligation to the extent mentioned under the credit. The U.C.P.600 contains provision which excludes liability of the banks for the inevitable risks of inaccuracy connected with the transmission of instruction[59]and acts of an instructed party[60]. Another exclusion clause is related to force majeure[61]. However the clause does not expressly mention about negligence on the part of banks. It is reasonable to assume that the clause merely clarifies the position of a bank while acting as intermediaries[62]. It fails to perform their functions correctly on time. Such an interpretation is

[58] *Courteen Seed Co.* v. *Hong Kong & Shanghai Banking Corporation*, 245 N.Y. 377 as cited in Philip W. Thayer, "Irrecoverable Credits in International Commerce: Their Legal Effects", 37 Col. L.R. 1326 (1937), at p. 1358

[59] The U.C.P.600, Article 35 covers two distinct issues: (a) errors or delays which occur during the transmission of communications either by post or using telecommunications (b) errors arising in the translation or interpretation of technical terms.

[60] *Id.*, Article 37 reads, Disclaimer for Acts of an Instructed Party

(a) A bank utilizing the services of another bank for the purpose of giving effect to the instructions of the applicant does so for the account and at the risk of the applicant.

(b) An issuing bank or advising bank assumes no liability or responsibility should the instructions it transmit to another bank not be carried out, even if it has taken the initiative in the choice of that other banks.

(c) A bank instructing another bank to perform services is liable for any commissions, fees, costs or expenses ("charges") incurred by that bank in connection with its instructions.

If a credit states that charges are for the account of the beneficiary and charges cannot be collected or deducted from proceeds, the issuing bank remains liable for payment of charges.

A credit or amendment should not stipulate that the advising to a beneficiary is conditional upon the receipt by the advising bank or second advising bank of its charges.

(d) The applicant shall be bound by and liable to indemnify a bank against all obligations and responsibilities imposed by foreign laws and usages.

[61] *Id.*,Article 36.

[62] Post office can be intermediary.

neither fanciful nor remote and would not absolve banks from their obligation to exercise reasonable care when operating the documentary credit[63].

In case of errors in interpretation of technical terms are concerned, it is applicable only among bankers themselves and not of the third party. Again the framing of the provision in broad terms will allow banks to escape liability even if they are negligent. If this is followed it will result in paying a seller under the terms of an erroneously advised credit and claiming reimbursement from the buyer even though the documents obtained did not confirm to his instructions. This will result in contradiction with the doctrine of strict compliance[64]. The U.C.P. states[65],

> "A bank assumes no liability or responsibility for the consequences arising out of delay, loss in transit, mutilation or other errors arising in the transmission of any messages or delivery of letters of documents, when such messages, letters or documents are transmitted or sent according to the requirements stated in the credit, or when the bank may have taken the initiative in the choice of the delivery service in the absence of such instructions in the credit.
>
> If a nominated bank determines that a presentation is complying and forwards the documents to the issuing bank or confirming bank, whether or not the nominated bank has honoured or negotiated, an issuing bank or confirming bank must honour or negotiate, or reimburse that nominated bank, even when the documents have been lost in transit between the nominated bank and the issuing bank or confirming bank, or between the confirming bank and the issuing bank".

However its exclusion of terms are very precise and does not include any error made in translating a non-technical term. It is confined solely to the situation

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[63] *Suisse Atlantique Société d'Armement Martine S.A.* v. *N.V. Rotterdamsche Kolen Centrole*, [1967] 1 A.C. 361. See also *Hollier* v. *Rambler Motors*, [1972] 2 Q.B. 71.
[64] For details, see *supra* chap.3.
[65] The U.C.P.600, Article 35.

where instructions expressed in one language require to be translated into another in order to operate the credit successfully. Where the bank provides such a service, the effect of the clause is merely to ensure that it does so at the risk of the applicant. Any such error in translation could result in confusion and delay.

Before considering the efficacy of the exclusion clauses, it is necessary to recall the background against which attempts are made by banks to exclude liability. Although the U.C.P have been accepted by banks worldwide and seen as a clear reflection of international banking custom and practice, they do not solve all questions arising from documentary credits. They are essentially contractual in nature and are subject to municipal law. Under English law also there is no prohibition on disclaiming liability[66].

The common law, on the other hand developed strict requirements regarding the incorporation of disclaimer clauses into a contract. In *Spurling* v. *Bradshaw*[67], it was held that the more onerous an exclusion clause, the greater is the burden upon those seeking to rely on it to bring it to the counter party's attention.

Therefore, generally a banker cannot incorporate more stringent exclusion clause into the contract with the applicant. Courts have also developed strict rules of construction to restrict the scope of exclusion clauses. In order to avoid liability banks should define the exclusion in precise terms. The bank can avail of the exemption only if a clause to that affect is expressly mentioned in the contract in clear and unambiguous terms.

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[66] See *Photo Productions* v. *Securicor*, [1980] A.C. 827.
[67] [1956] 2 All E.R. 121 (C.A.).

In the U.K., the Unfair Contract Terms Act, 1977[68] is applied to all documentary credit transactions with regard to exclusion clause. Any attempt to exclude liability for the negligent performance of a contract is controlled by it[69]. In order to exclude any liability, it has to satisfy the test of "reasonableness" provided under the UCTAct, 1977[70]. Therefore in the U.K. the disclaimer clauses of the U.C.P. must satisfy the test of reasonableness set out in the UCTAct, 1977.

Courts in the U.K. are using broad discretion in applying the test of reasonableness although they are not under any obligation to consider them[71]. They will consider other matters including the difficulty of the task undertaken by the parties apart from the practical consequences of the decision on reasonableness[72]. The discretion given to the courts in applying the concept of reasonableness in documentary credit is really debatable.

A problem will arise in case, the validity of exclusion clause under documentary credit is challenged. Can the exclusion clauses set out as standard terms of the U.C.P. be challenged on the ground of lack of reasonableness is the moot question to be decided. Although there is no English authority on the point, it would appear that where standard terms have been formulated by an

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[68] Hereinafter referred to as UCT Act, 1977.
[69] The UCT Act, 1977, s. 2(2) provides that any type of loss or damage arising from the negligent performance of a contract other that death or personal injury is effective only in so far as the clause satisfies the "requirement of reasonableness".
[70] *Id.*, s. 11 provides that a term is reasonable if it has been a reasonable one to be included having regard to the circumstances.
[71] The Unfair Contract Terms Act, 1977, schedule II provides number of guidelines to decide the case.
[72] *Smith* v. *Bush*, [1990] 1 A.C. 831.

independent body, generally the court would consider whether that body is neutral in order to decide the validity of such exclusion clause[73].

Apart from this, the U.C.P. 600 does not allow an issuing bank to disclaim all responsibility for acts or omissions by an advising bank. It does not deprive the applicant of any effective remedy. This would be the case even where the issuing bank uses the services of its own overseas branch.[74] The question will arise whether a provision which excludes the issuing bank's liability not only for the negligent performance of an instructed bank but even where that bank fails to act at all, can be treated as reasonable under UCTA[75]. It would not be reasonable because it would enable the bank to avoid liability, no matter how egregious was the misconduct of the instructed bank and no matter how grave were the consequences for the applicant. It will leave the applicant at the mercy of issuing banks if their instructions were not implemented by correspondent banks and they suffer resultant economic losses. Apart from this the Uniform Rules for Demand Guarantees also does not allow banks to rely upon the disclaimer clauses if they fail to act in good faith and with reasonable care[76].

Thus it can be seen that if the test of reasonableness provided in the UCTAct, 1977 is applied to the U.C.P provision, will not protect the interest of the applicant. It is stated that "the UCP 500 places the applicant-buyer in an absurdly

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[73] See *McCrone* v. *Boots Farm Sales Ltd.*, (1981) S.L.T. 103 as cited in Alan Ward and Robert Wight, "The Liability of Banks in Documentary Credit Transactions Under English Law," 13 J.1.B.L.387 (1998).

[74] Branches of a bank in different countries are considered as another bank", Art. 2 of U.C.P 500.

[75] S. 3.(2)(b) UCTA applies to any contractual term by virtue of which a party claims to be entitled (i) to render a contractual performance substantially different from that which was reasonably to be expected of him, or (ii) in respect of the whole or any part of his contractual obligation, to render no performance at all.

[76] See ICC Publication No. 458, Article 15.

vulnerable position through its disclaimer clauses"[77]. Moreover there is a serious absence of meaningful duties on the part of the bank to check the authenticity of the documents. The duty of the correspondent banker remains only to ascertain that such documents comply with the terms of the credit on their face. Therefore if false documents are used by unscrupulous seller, the buyer is left with little options. He should nonetheless, indemnify the bank for making the payment[78]. It is questionable whether buyers to whom the exemption clauses are mainly applied are aware of the existence of disclaimer clauses. Though the documentary credit issued contains that the credit is subject to the U.C.P.600 there will not be any information highlighting the existence of disclaimers.

The correspondent banker is in a safer position if they took shelter under exclusion provision of the U.C.P. Hence this needs redrafting. The litigations in these areas are limited. In other countries where UCTAct, 1977 is not followed, the U.C.P is followed. Hence it is necessary to apply the disclaimer clauses conditional on the bank's acting in good faith and taking reasonable care.

Corresponding Bankers Obligation in India

In India the corresponding banker's obligation is similar to that of the English position. It depends mainly upon the nature of its undertaking regarding the documentary credit. In case of mere intimation to the beneficiary by the correspondent bank that the documentary credit has been issued, then it will only be liable for the accuracy of the information which it has conveyed. It is not required to make any payment to the beneficiary in this situation. This position

[77] H. Harfield, "Identity Crises in Letter of Credit Law", 24 Ariz. L. Rev. 239 (1982), p.245.
[78] D.G. Powles & S. J. Hazelwood, "Maritime Fraud – 1", [1984] J. B. L. 31, at p.37.

was accepted by the Calcutta High Court in *United Bank of India Ltd* v. *Nederlandsche Standard Bank*[79]. In this case the information regarding the opening of letter of credit was not clear. The undertaking of the bank which sent the information also was not satisfactory to decide the liability for restraining payment to the beneficiary on the basis of expiry of letter of credit. The court pointed out the need for care on the part of an advising bank while advising the beneficiary of a letter of credit. The advise should make it clear that the credit is that of the issuing bank and that the advising bank is merely advising or transmitting it to the beneficiary.

On the other hand if the corresponding bank confirms the letter of credit, it becomes liable to make payment on presentation of the stipulated documents. The risk of nonpayment by the issuing bank is shifted from the beneficiary to the confirming bank. The advising bank is a special agent of the issuing bank and the later is a special agent of the buyer. On presentation of documents for negotiation, the bank can either accept the document or reject the same. But it must take reasonable care to examine the documents and ensure that they comply strictly with the terms of credit. The Bombay High Court distinguished the terms "Presentation" and "Negotiation" and held that negotiation means acceptance of documents by the bank. In *Swiss Bank Corporation* v. *Jai Hind Oil Mills Company*[80] the court dismissed the case filed by the negotiating bank on the sole reason the documents were negotiated beyond the date prescribed under the letter of credit. The court pointed out that the negotiating bank made payment on its own risk and was not entitled to realize amount from the issuing

[79] (1963) 33 Com.Cas. 1 (Cal.)
[80] (1989) 66 Com. Cas.241 (Bom.).

bank. This decision highlights the extent of care that the corresponding bank is bound to take. Reasonable care is expected from corresponding bank while examining the documents. The obligation of corresponding bank and the standard of care in examining documents are based on the provisions of the U.C.P. in India also. The Supreme Court explained this position in *Federal Bank Ltd* v. *V.M.Jog Engineering Ltd*[81]. In this case, the negotiating bank received documents from the seller. It got the documents confirmed by the issuing bank and made payment to the beneficiary. Meanwhile the buyer obtained a temporary injunction against the issuing bank from honoring the letter of credit on the ground of fraud. Later when the negotiating bank made claim to get reimbursement of the amount, the issuing bank refused to pay. It was held that the temporary injunction granted in favour of the buyer and against the issuing bank does not preclude the issuing bank to reimburse the negotiating bank. The court relied on Article 11(d) of the U.C.P.500. The court said that if the negotiating bank is satisfied that the documents appear on their face to be in accordance with the terms and conditions of the credit and makes payment the issuing bank is bound to reimburse the negotiating bank. The court said[82],

> "The contract between the issuing banker and the paying or negotiating (intermediary) banker may partake of a dual nature. The relationship is mainly that of principal and agent, mandator and mandatory. In order that he may claim reimbursement for any payment he makes under the credit or the indemnity of an agent, the intermediary banker must obey strictly, the instructions he receives, for by acting on them, he accepts then and thus enters into contractual relations with the issuing [b]ank. The instructions may take the form of an authority either to pay against documents or drafts accompanied by document, or to negotiate drafts drawn either on the issuing banker or on the buyer. The authority may be accompanied by instructions to the intermediary banker to

[81] A.I.R.2000 S.C.3166.
[82] *Id.*, p.3181

> confirm the credit, that is, to place himself in binding contractual relationship with the beneficiary. There is ordinarily no privity between the intermediary banker and the buyer. But the intermediary banker, though initially the agent of the issuing [b]ank, may also act as principal in relation to him."

When corresponding bank pays in compliance with the documentary credit, it is entitled to receive reimbursement for the same from the issuing bank. This principle is affirmed by the Supreme Court in *UBS AC* v. *State Bank of Patiala*[83].In this case, the letter of credit issued contained a request to the confirming bank to inform the beneficiary that an irrevocable letter of credit had been established and to make payment on negotiation of documents by beneficiary. As per the instructions the confirming bank after verification of the documents paid and claimed reimbursement from the issuing bank. The issuing bank refused to reimburse on the ground of fraud perpetrated by the beneficiary. It was held that if the fraud had been detected earlier and informed the confirming bank or put on caution prior to making payment, the issuing bank might have had a triable issue and was justified in refusal to pay. But in this case the fraud was detected after the letter of credit had been negotiated. So the court held that the issuing bank was liable to make reimbursement.

This analysis shows that the obligations of the corresponding bank in India are determined on the basis of contractual principles, English precedents and the U.C.P. provisions.

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[83] A.I.R. 2006 S.C.2250

Correspondent Banker's Obligation: A Critique

The correspondent banks obligation is unilateral. It is bound to accept the documents only when the beneficiary tenders them before it. There is no contractual duty for the beneficiary towards the bank to act on terms. But he will lose his right to get payment if he fails to submit the required documents under credit. The bank is entitled to insist that the documents presented correspond exactly to the requirements of the credit. It can refuse to accept if they are inconsistent.

The obligation towards the beneficiary by the correspondent bank is treated as an additional one. So naturally they should be more cautious when accepting the documents. So far, there is no law which pinpoints the true obligations of the correspondent banker. Instead, there is only a general idea to take "reasonable care". Hence when the instructions are ambiguous the bank is expected to adopt what would be reasonable in the circumstances[84]. However the standard to determine the "reasonable care" is not developed. So the circumstances determine the reasonableness which may create ambiguities. The heart of the problem is the limited discretion available to bank in matching the terms and conditions of credit against the documents presented. This is important to judge the obligation of the banker.

The correspondent bank looks to the issuing bank alone for reimbursement. Therefore prima facie it is unlikely that it owes no duty to the

[84] Razeen Sappideen,"International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency", [2006] J.B.L.133.at p.137

applicant even if he is paying the confirmation fee[85]. Banks attempt to exclude their liability by relying on the provisions of uniform customs principles[86]. The judicial trend is liberal[87]. Moreover it is questionable whether courts examine if reasonable notice has been given when judging the legal effect of these exemption clauses. This leads to the question whether courts should balance the interests of the parties or whether applicant's interests should be protected. The banks have the right to waive discrepancies and pay regardless of the approval of the applicant[88]. On the other hand the applicant is liable to indemnify a bank against all obligations and responsibilities imposed by foreign laws and usages[89]. Therefore the applicant has to bear a disproportionate portion of the error and negligence risk of the bank and he is left at the mercy of the bankers. The applicant will be the most affected party. As there is no contractual relationship with the correspondent bank, he cannot sue or claim damages for any breach. Therefore it is necessary to define in clear terms the obligations of corresponding bank. The interest of both the banker and the account party should be taken into account.

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[85] See *United Trading Corp.* v. *Allied Arab Bank,* [1985]2 Lloyd's Rep. 554. *GKN Contractors* v. *Lloyds Bank Plc.*, (1985) B.L.R.48 as cited in Alan Ward, "The Liability of Banks in Documentary Credit Transactions under English Law", 13 J.I.B.L.387 (1998), p.390

[86] The U.C.P.600, Article 37.

[87] Except in cases of fraud courts are reluctant to interfere.

[88] Duncan Sheehan, "Rights of Recourse in Documentary (And Other) Credit Transactions", [2005] J.B.L.326.

[89] The U.C.P.600, Article 37(d).

CHAPTER-8

ADMINISTRATIVE CONTROL AND BANKING PRACTICE RELATING TO DOCUMENTARY CREDIT

CHAPTER 8

ADMINISTRATIVE CONTROL AND BANKING PRACTICE RELATING TO DOCUMENTARY CREDIT

Documentary credit is a non fund based lending activity. Banker is undertaking a substantial liability without making any immediate payment. There have been several national and international efforts to make this activity fair and uniform[1]. In India the Reserve Bank of India has issued several instructions to regulate this activity. Very often these instructions are in conformity with the practice recommended by the International Chamber of Commerce[2]. These guidelines have not been formally adopted in India. However banks in India are following these guidelines and have issued several instructions to their branches in conformity with these guidelines.

In this context it is necessary to examine how far the instructions given by individual banks and the regulatory scheme on lending activities issued by the Reserve Bank of India go in tune with the Uniform Customs practice provisions. The code of ethics formulated by bankers and practice directions issued by individual banks are collected for this purpose. Several Indian banks have issued internal directions relating to administration of letters of credit transactions. Many of these instructions have been collected through personal interviews and verification of circulars from individual banks. These are critically evaluated.

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[1] For a detailed discussion on the international attempts for the unification the of law relating to letter of credit, see James E. Byrne, "Fundamental Issues in the Unification and Harmonization of Letter of Credit law", 37 *Loyola Law Review* 1 (1991).

[2] Hereinafter referred to as I.C.C. The Uniform Customs and Practice on Documentary Credits, 2007, U.C.P.600 is the latest result of these efforts.

Obligation of Bankers in Non-fund Lending and Need for Control

Non-fund lending does not involve actual deployment of funds by banks. In this form of lending, banks help the obligants to obtain certain facilities from third parties[3]. The risks undertaken by the bank in granting such facilities is almost the same as in granting loans and advances. In fact non-fund based facilities are generally not granted in isolation and are linked with other facilities granted to a customer[4]. Therefore banks employ the same appraisal techniques used for lending activities while granting letters of credit.

The issuing bank must take utmost care while issuing letters of credit. If it fails to exercise reasonable care it may lead to insolvency of the bank itself [5]. The banking regulation has been concerned mainly with solvency and liquidity of banks. To protect the interest of banks, insurance policies are introduced[6] against such risks. Apart from this the regulatory theory shows that the liability of banks in case of issuance of irrevocable letter of credit is contingent upon the beneficiaries' compliance with the credit terms. Therefore there may not be much threat to bank solvency[7] if the banks comply with the terms of the documentary credits.

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[3] R.K.Gupta, *Banking Law and Practice*, Modern Law Publication, Allahabad (2004), p.646.
[4] Nabhi's Board of Editors, *How to Borrow from Banking and Financial Institutions*, Nabhi Publications, New Delhi (1997), p.285.
[5] Ross Cranston, *Principles of Banking Law*, Clarendon Press, Oxford (1997), p.237.
[6] For instance the Federal Deposit Insurance Corporation gives insurance coverage for banks issuing letters of credit in America. In India, the Export Credit Guarantee Corporation of India tries to cover the risk of financial loss of banks.
[7] Philip W Thayer, "Irrevocable Credit in International Commerce: Their Legal Nature", 36 Col.L.R.1056 (1936).

Issuing Bank and Financial Risks

The most obvious risk that may arise from documentary credits is the inability of the issuing bank to pay when it is called upon to perform its obligation to pay. In the U.S.A, The Federal Deposit Insurance Corporation[8] had stated that almost 15 per cent of insured banks were on its "problem bank list"[9]. Further, the lending bank cannot rely on recovering the amount of the letter of credit from FDIC insurance in the event of issuing banks failure. Even in the case of standby letter of credit, the same principle is applied. The Supreme Court of America had held that standby letters of credit are not insured deposits under the rules of FDIC[10]. As a consequence of this decision, a standby letter of credit issued by a financially unstable bank is a risk for the bank that relies on that letters of credit. A letter of credit presented after the issuing bank becoming insolvent cannot be enforced[11]. Similarly problem may arise when the payment obligation exceed maximum lending limit. An issuing bank in Albama was successful in making this argument in *International Dairy Queen* v. *Bank of Wadley*[12]. The plaintiff in this case brought a suit against the issuing bank for breach of the terms of an irrevocable letter of credit. The issuing bank's defense was that the payment of the letter of credit would obligate it to lend a sum of money beyond the maximum lending limits as established by Alabama law.

In India, normally banks open letters of credit for their own customers who enjoy credit facilities with them. Only those customers who are maintaining

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[8] Hereinafter referred to as FDIC in the U.S.A.
[9] Many bank failures led to the creation of FDIC. For details, see *supra* n.5 at p.100.
[10] *FDIC* v. *Philadelphia Gear Corporation*, 106 S.Ct.1931 (1986) cited in *infra* n.19.
[11] It is to be noted that according to the principles of equitable receivership the insolvent banks receiver is bound to recognize only claims that are due and owing as on the date of insolvency.
[12] 407 F.Supp.1270 (M.D.Ala.1976) as cited in *Ibid.*

current account are granted with letter of credit facility. The banks usually treat payment undertaking under letters of credit as an extension of credit on behalf of the applicant within the credit norms of the Reserve Bank of India[13]. There is no restriction for the banks in opening letters of credit for import of essential items[14]. Apart from this banks are given liberty to fix the lending rates according to the performance rate of its customers. Therefore in case of the customer who is rated as excellent, the banker will not stipulate any margin on the letters of the credit[15]. In usual practice the banker will retain a cash margin ranging from 10% to 25% of the value of the obligation undertaken by them in issuing letters of credit[16]. Though a letter of credit facility is a non-fund based facility, it has the potential to turn to be a funded facility when the applicant fails to reimburse the bank at appropriate time. Therefore element of risk is involved in these transactions. This risk is eliminated by imposing legal restrictions on the issuing bank. Therefore cash margins as per the R.B.I. rules are stipulated while issuing letters of credit. Apart from this additional securities to cover the risk are taken from the applicant and the margin is fixed at the time of establishing the letters of credit[17].

Another risks associated with documentary credit is the risk of good faith[18]. In this case the applicant will exploit a close and substantial relationship

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[13] The booklet *Documentary Credits & Standby Credits*, Foreign Exchange Dealers' Association of India, Mumbai (2004) p.95.
[14] Master Circular UBD.BPD (PCB).MC.No.1/09.27.000/2006-07 dated July 3, 2006 issued by the Reserve Bank of India.
[15] M.L.Tannan, *Tannan's Banking Law and Practice in India*, Wadhwa & Co, New Delhi (2005), p.944.
[16] *Ibid.*
[17] *Supra* n.13.
[18] For a detailed discussion on this aspect, see Joyce Furfero, "Seven Good Reasons for Retaining the Narrow Definition of Good faith In Letter of Credit Law: The Case of Wrongful Dishonor", http//www.drfurfero.com/articles/art03/art03.html.visited on 18.01.2005.

with the issuing bank by pressuring the issuing bank to refuse to reimburse the correspondent bank that had made payment to the beneficiary. Apart from this sometimes unnecessary legal conflict over the letter of credit is created which will compel the correspondent bank to compromise its claim. This is usually done by the issuing bank which is relatively small and is not concerned about the future risk in the acceptability of its letters of credit. However if the issuing bank is a reputed one it will not refuse to pay as its reputation will be lost in the trading scenario[19].

Obligation to Maintain Liquidity

Another aspect relating to the documentary credit transaction is the importance given to them in relation to accounting standards. The financial solvency of a banking company can be ascertained from its balance sheet. A balance sheet will consist of the assets and liabilities of the banks. Therefore serious consequences can follow if letters of credit are not treated as asset[20]. However they are not shown in the balance sheet. They are shown only in the footnote to the balance sheet[21]. In order to ascertain the solvency of banking institution, liquidity ratio plays a pivotal role. Liquidity ratio is determined based on the relationship between current assets and current liabilities. Therefore if a bank undertakes to act as a confirming banker in documentary credit transaction, liquidity ratio need to be maintained considering the commitments it has undertaken. Bank failures may occur if they fail to consider its payment

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[19] Ford Barrett, "Bank Regulatory Aspects of Letters of Credit and Guaranties", 450 *Practising Law Institute*.139 (1988). In India at the time of field survey some bankers pointed out that this possibility is due to lack of proper regulation governing letter of credit transactions.

[20] *Supra* n.4.

[21] *Supra* n.3 at p.590. Contingent liabilities are those liabilities which do not exist at the time of preparation of balance sheet but which may arise in future.

obligation. Therefore the banker cannot afford to ignore these liabilities while considering the balance sheet. They need to be assessed in relation to the financial resources.

Apart from this, the banks are required to study its liquidity position in order to meet the outside liabilities[22]. The relevance of asset classification of the bank becomes operative. In this context when the letter of credit comes under asset classification norms[23], the obligation of the bank under the same need to be evaluated.

The classification of assets of the banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms. The provisioning for assets is made on the basis of assets classification in trade. Mainly it is ascertained on the basis of the period for which the asset has remained non-performing. Apart from this availability of security and the realizable value of the security are also considered[24]. However in case of letters of credit it is not an asset having realizable value but only generating income on the basis of commissions for the risk the banker has undertaken to pay. Hence the debit arising out of letters of credit are given in a separate account. They are treated as facility granted by the bank to a borrower. The balance outstanding in that account is treated as part of the borrower's principal operating account. This is for the purpose of the application of prudential norms on income recognition, asset classification and provisioning so as to classify and

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[22] Liquidity here relates to solvency of the firm.

[23] In tune with the international practices and as per the recommendations by the Committee on the Financial System asset classification is introduced so as to move towards greater consistency and transparency in the published accounts.

[24] *Supra* n.3 at p.1072.

consider the non-performing asset of the bank[25]. The obligation of the bank in this situation is to evaluate the balance outstanding as receivable and payable. Prudential norms are the guidelines issued by Reserve Bank of India to protect the risk undertaken by bankers[26].

Banks are dealing with these issues independently according to their own discretion. There is no control over this, except a few circulars which are directory in nature. Most of the problems go unnoticed by the authorities[27]. Therefore there is a need to control these non-fund lending activities.

Capital Adequacy Norms and Documentary Credit

The adequacy of capital of banks has traditionally been regarded as a sign of banking strength. Letters of credit are treated as risk based. Therefore under the Basle Accord it was agreed by its members to constrain banks from issuing large number of undertaking under letters of credit[28]. According to Basle Accord, off-balance sheet items are first assigned on the basis of conversion factors with their perceived credit risk[29]. This converted amount need to be further weighted

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[25] It is to be noted that asset classification in this situations is borrower-wise and not facility wise. See Master Circular No.DBOD.BP.BC.1/21.04.048/2002-2003 dated 4.7.2002 issued by Reserve Bank of India.

[26] See for details, Recommendations of the Working Group on Lenders Liability Law, DBOD.No.Leg.BC./09.07.007/2002-03 dated 19.12.2002 issued by Reserve Bank of India.

[27] See R.Vishwanthan, "Letter of Credit: A Scam in the Making?" Hindu Business Line (internet edition) dated 30th January,2002 ,www.blonnet.com/2002/08/29/stories/2002082901571000.htm, visited site on 19.01.2005, also see Kumara Swamy, "Misuse of (L/Cs) Banker Receipts (BRs) And Cheque(Check) Fraud Leads to Financial Distress: Formulation of a New Approach to Ethnic-Based Financial Analysis", 18 *Journal of Financial Management and Analysis* 57 (2005)

[28] Risk based capital adequacy guidelines issued by the Basle Supervisors Group of the Bank of International Settlement in July 1988 is discussed in Hal S.Scott, "The Competitive Implications of the Basle Capital Accord", 39 *St.Louis University Law Journal* 885 (1995).

[29] *Ibid.*

by a ratio based on the creditworthiness of the counterparty[30]. The amount of undertaking instruments offered by the bank will get limited. This will result in charging higher fees for issuing these instruments.

The governments and business community around the world are making efforts to legalise these transactions by framing regulations in this regard. In India, the committee on Financial System while appreciating the importance of setting out minimum capital adequacy norms suggested that Indian banks should reach the Basle Standards in a phased manner[31]. It was observed by the committee that the greater exposure of Indian banks to international environment have the potential for increasing the risk associated with banking business[32].

The Reserve Bank of India introduced a risk asset ratio system for banks in India as a capital adequacy measure with a view to adopt the Basle Committee framework on capital adequacy norms[33]. Accordingly, the balance sheet assets, non-funded items and other off-balance sheet exposures are assigned with weights according to the prescribed risk weights. Banks should maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis.

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[30] See Robert W.Williams, "Assessing the Treatment of Letters of Credit Under the Risk-Based Capital Guidelines", 10 Ann.Rev.Banking L.271 (1991).
[31] See Narasimham Committee Report on the Financial System and Progress of Financial Sector Reform, hereinafter referred to Narasimham Committee Report.
[32] *Ibid.*
[33] Master Circular DBOD No.BP.BC.28/21.01.002/2002-03,dated 5th July, 2002 issued by the Department of Banking Operations and Development, R.B.I. Central Office, Mumbai.

Thus risk weights for calculation of capital to risk- weighted assets ratio[34]is calculated for non-fund items including letters of credit. The credit risk exposure attached to off-balance sheet items has to be first calculated by multiplying the face value of each of the off-balance sheet items by "Credit Conversion Factor"[35]. This will then have to be again multiplied by the weights attributable to the relevant counter-party. In case of non-bank counter party's transactions[36], the risk weight is 20% and will be treated as claims on banks. In this the banks should be fully satisfied that the risk exposure is in fact on the other bank. It is also provided that Indian banks having branches abroad should report information relating to off balance sheet items in separate formats using the appropriate conversion factor and risk weights[37].

The above discussion shows that the letter of credit obligation is reflected in capital adequacy provisions. It is a threat to the existence of banks though they are treated as non-fund based lending and shown in the foot note of the balance sheet. The balance sheet of banks is the basis for determining whether it has exceeded the lending limits. Moreover the items indicated by way of a footnote in the balance sheet are not *prima-facie* crystallized liabilities affecting the overall liability position[38]. Hence very often sufficient attention is not paid to

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[34] This means the minimum percentage of capital to be maintained by banks in order to cover the risk factors. For a detailed analysis of risk management and capital adequacy measures see *supra* n.3.

[35] According to the credit conversion factor, the percentage is 100 in case of standby letters of credit and 50 percent in letters of credit relating to a particular transaction and 20 percent for short term self liquidating trade related contingencies such as documentary credits collateralized by underlying shipments. See *supra* n.3.

[36] This will include (a) guarantees issued by banks against the counter guarantees of other banks (b) re-discounting of documentary bills accepted by banks. Bills discounted by banks which have been accepted by another bank will be treated as a funded claim on the bank.

[37] *Ibid.*

[38] *Supra* n.3.

study them carefully. However a closer look at these items may reveal that they often include liabilities with serious financial implications.

Effect of Administrative Guidelines on Documentary Credit

The banking community has fought hard in the past to defend the sanctity of the documentary credit as a reliable instrument[39]. It will continue to be "as good as cash" only so long as banks continue to treat it as such. However under the shelter of its sanctity it is used by unscrupulous traders to indulge in illegal activities[40]. This paved way for money- laundering activities[41]also. The law and practice relating to these instruments are rule oriented and based on commercial policy. Therefore bank's willingness to issue the letters of credit suggests the legitimacy of the transaction. Thus the letter of credit indirectly assists in the enforcement of currency controls and laws against money laundering[42].

Legislative Provisions

The Banking Regulation Act, 1949 is the major legislation to regulate banking activities in India. The nature of business that a banking company carries on is prescribed in the Act. The permitted activities include issuing and

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[39] M. Kurkela, *The Liability of Banks Under Letters of Credit*, The Union of Finnish Lawyers Publishing Company Limited, Helsinki (1972), p.9.

[40] D.G. Powles and S. J. Hazelwood, "Maritime Fraud – 1", [1984] J.B.L.37.

[41] Money laundering means making the illegal money into legal money through the process of laundering. They are the generation of unaccounted funds and cross border transfer thereof in circumvention of monetary control legislation. The letter of credit transaction is also one of the areas where illicit transfers of funds through the channel of bogus sale of goods take place. For a detailed discussion see *infra* n.42.

[42] Ronald J.Mann, "The Role of Letters of Credit in Payment Transactions", 98 *Michigan Law Review* 2530 (2000), p.2498.

granting of letters of credit[43]. Further, the Act gives power to the Reserve Bank of India to issue directions to the banks for various purposes including matters of letter of credit[44]. These directions may be issued in the interest of public as well as in the interest of banking policy. They are binding on the banks[45]. Apart from this, the Reserve Bank of India is empowered under the act to determine the policy in relation to advances to be followed by banking companies[46]. The directions issued by the Reserve Bank to banks under this provision are statutory in nature and are binding on banks[47]. The powers are wide enough to exercise effective control over all banks. If any bank commits a breach of the directives, it is liable to be penalised[48].

Another legislation dealing with the letter of credit facility for export of goods from India is Foreign Exchange Management (Guarantees) Regulations, 2000[49]. It provides that a person resident in India can avail credit facility including letters of credit from a bank or a financial institution outside India also in connection with the execution of an export project[50]. The exporter should comply with the condition for payment of the goods including software covered by an irrevocable letter of credit prior to the export[51].

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[43] The Banking Regulation Act, 1949, s.6 (a).
[44] *Id.*, s.35 (A).
[45] *BOI Finance Ltd* v. *Custodian*, A.I.R. 1997 S.C.1952. It was held that the direction issued by the Reserve Bank under Section 36 of the Banking Regulation Act, 1949 would be binding on the banks and has to be complied with.
[46] The Banking Regulation Act, 1949, s. 21.
[47] *Jameela Beevi* v. *State Bank of Travancore*, (1991) Bank.J.427 (Kant).
[48] *Corporation Bank* v. *D.S.Gowda*, (1994) 5 S.C.C.213.
[49] Notification No.GSR39 (E), dated 3.5.2000, published in the Gazette of India, Extraordinary No.249, dated 4.5.2000, Part II, section 3(1).
[50] *Id.*, s.5 (a).
[51] See the Foreign Exchange Management (Export of Goods and Services) Regulations, 2000, rule 17(a).

The Reserve Bank of India Act, 1934, mandates that every scheduled bank should send to the Reserve Bank of India a return showing the amount of its demand and time liabilities at the close of business on each alternative Friday[52] Every such return should be sent not later than seven days after the date to which it relates. The time and demand liabilities include letters of credit. In this category margins held against letters of credit will also be included. The margins held against letters of credit which are not payable on demand will come under time liability as they are payable otherwise than on demand[53].

The above discussion shows that, in India statutory provisions dealing with letters of credit are very few. So the guidelines issued by the Reserve Bank of India govern the business relating to letters of credit.

Reserve Bank Guidelines

Opening of a letter of credit is an undertaking of a payment commitment on behalf of the applicant. Hence, it amounts to extension of credit to the applicant. So it is within the credit norm of Reserve Bank of India. Though a letter of credit is a non-funded credit facility, it has the potential to turn to funded facility if the applicant does not reimburse the bank at the appropriate time. Further as per the credit norms, extending usuance letters of credit facility tantamount to substitution of funded facilities. In the light of this, the Reserve Bank of India has advised banks to assess the facilities of import letters of credit requirements

[52] The Reserve Bank of India Act, 1934, s.42 (2).
[53] *Supra* n. 3 at p.77.

like any other normal credit assessment[54]. In the absence of specific regulations, banks are governed by normal trade practices. But they have to adhere to the 'Know Your Customer Guidelines' issued by the Reserve Bank of India[55]. The following principles are followed in India in this regard[56]:

1. Banks will open letters of credit for their own customers enjoying credit facilities with them.

2. Customers maintaining current account only are eligible.

3. The request of such customer for sanctioning and opening of letters of credit should be properly scrutinised to establish the genuine need of the customer.

4. Where a customer enjoys credit facilities with some other bank, His reasons for approaching the bank for the same should be investigated.

5. Once the bank opens letter of credit on behalf of such customer it should invariably make a reference to the existing banker of the customer.

6. In all cases of opening of letters of credit, the bank has to ensure that the customer is able to retire the bills drawn under letters of credit as per the financial arrangement already finalised.

The circular governing import of goods and services to India contains regulations for the issue of letters of credit[57] in relation to that. Accordingly the authorized dealer banks[58] can open letters of credit and allow remittances for

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[54] See the circular DBOD.Dir.BC.62/13.07.09/2002-03 dated 24.1.2003 issued by Reserve Bank of India. It directs that banks in India should not open letters of credit bearing clause 'without recourse' and the letters of credit should be opened only in respect of genuine commercial and trade transactions.

[55] Circular No. DBOD.BP.BC.114/C.469 (81)91, dated April 19, 1991 issued by the Reserve Bank of India.

[56] See Nabhis Board of Editors (Eds.), *How to Borrow from Banking and Financial Institutions*, New Delhi (1997), p.626.

[57] Master Circular No. /08/2006-07 dated July 1, 2006 issued by the Reserve Bank of India

[58] Authorized dealer banks are notified under Foreign Exchange Management Act, 1999 and the notification No.GSR 381 (E) dated May 3, 2000.

import of goods unless they are included in the negative list requiring license under the Foreign Trade Policy in force. Licenses marked for exchange control purposes should be called for in such cases. Apart from this if any special conditions are attached to such licenses they should adhere to Exchange Control Regulations. A copy of the import license should be submitted by the importer for opening a letter of credit. It should be preserved by authorized dealers of bank till its scrutiny by the internal auditors and inspectors is completed[59]. The obligations of banks are mentioned in case of export also[60]. It provides that banks can handle them without prior approval of the Reserve Bank of India if the bank is satisfied with the delay for submission of shipping documents by exporter[61]. A checklist for scrutiny of forms presented is also given[62]. Authorized dealer banks are normally bound to dispatch shipping documents to the overseas correspondent bank expeditiously.

Apart from this it says that[63] a letter of credit should be opened only in favor of overseas supplier, manufacturer or shipper of goods and not in favor of applicant himself or his nominee. They should be opened based on the underlying sale contract. In the absence of sale contract, purchase order or performa invoice, indent or offer is acceptable. Such document should have the conformation and acceptance of the overseas supplier and the importer. In respect of transferable letters of credit, transfer is restricted to specified second

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[59] The authorized dealer's bank may allow advance remittance for import of goods without any ceiling. They may frame their own internal guidelines to deal with such cases as per a suitable policy framed by the banks Board of Directors.

[60] Master Circular No.09/2006-07, dated July 1,2006 issued by the Reserve Bank of India

[61] *Ibid.*

[62] It says that number on the duplicate copy of a G/R form presented to them is the same as that of the original which is usually recorded o the bill of lading and the duplicate has been duly verified and authenticated by appropriate customers authorities.

[63] Regulatory Requirements under FEMA, 1999, published by Foreign Exchange Dealers Association of India, Mumbai (2005), p.74.

beneficiaries within the country of first beneficiary or another country which conforms to the prescribed manner of payment. Revolving letters of credit are to be opened with adequate safeguards with reference to aggregate drawings.

Guidelines on Bills Drawn as Part of Letters of Credit

Sometimes as part of the terms of the letter of credit the parties may insist for drawing of bills under credit. Under the U.C.P. provisions drawing of bill of exchange on letters of credit by opening bank is not mandatory. If a bill of exchange is drawn, it will be treated as an additional document[64]. Usually bills are drawn in case of usance letter of credit[65]. Earlier the bills negotiated under usance letters of credit were assessed as receivables for assessment of working capital credit limits[66]. Now, the norms for bank lending for working capital are changed[67]. As per the revised guidelines the precautions taken by banker negotiating a bill under a letters of credit are the following:

1. The letter of credit is genuine and that he should satisfy himself that the signature of the officer signing the letter on behalf of the issuing bank corresponds to the specimen signature in the possession of the negotiating bank.

2. The period of its validity has not expired.

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[64] See Cir.No.ID/01/SP/01/2005 dated January 7, 2005 issued by the Reserve Bank of India.
[65] In this type of letter of credit , in addition to presenting the documents, the beneficiary is required to draw a time draft on a specific bank(issuing, advising, or a third bank). After the documents have been found to be in order, the exporter receives the draft back after it has been accepted by the drawee bank. So the draft can be cashed in immediately by the seller while the buyer will be charged with the draft amount only upon maturity.
[66] Circular IECD No.44/08.10.01/93-94 dated 20.5.94 issued by the Reserve Bank of India.
[67] This change is on the basis of the Report of the In-house Group appointed by the Reserve Bank of India under the Chair Person ship of Ms.I.T.Vaz, Executive Director, the Reserve Bank of India, see http:/ www.rbi.org., visited on 20.9.2005.

3. The amount of the bill to be negotiated is within the unavailed balance of the amount given in the letters of credit[68].

4. The terms of the letters of credit are satisfied. If the negotiating banker fails to satisfy himself in this respect he may have no claim against the bank which issued the letter of credit.

5. The party whose bill the banker is asked to negotiate is the same as given in the letter of credit. The banker can satisfy himself in this respect by comparing the signature of the party issuing the bills with those given in the letter of indication or in any other manner he likes.

Effect Of Restrictive Clauses In Letters Of Credit

Some foreign commercial banks operating in India insert clauses in letters of credit which restricts the obligation to make payment under the letter of credit. The usual provision[69] permits to open letters of credit and make remittances under them in respect of imports made in compliance with import trade control regulations. The Reserve Bank of India directed that they should not stipulate such restrictive clauses in letter of credit opened by them for bonafide imports under the prevailing Import Trade Control Policy[70].

Apart from this, the Reserve Bank has instructed banks to follow country risk management. In this respect the bank usually trade with countries based on the risk factor[71]. This should also be considered while issuing letter of credit to the applicant. Accordingly banks make provisions on the net funded country exposures on a graded scale ranging from 0.25 to 100 percent according to risk

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[68] According to the terms of the letters of credit every bank negotiating bills under the said credit has to make on the letter of credit the necessary entry regarding the amount of the bills negotiated and its date, it is not difficult to ascertain the balance if any for which the letter of credit hold good.

[69] See the Exchange Control Manual, issued by various banks in India.

[70] See A.D. (G.P.Series) Circular No.19 dated 17.12.1990 issued by the Reserve Bank of India.

[71] Circular No. ID/156/CBD/15 2006 dated 10.04.2006 and Ref.No.ID/CBD/PSS/2006 dated September 8, 2006 issued by an Indian. (The name of the bank cannot be mentioned due to the undertaking made to it by the researcher).

categories. Countries like Figi, Senegal are brought under very high risk categories whereas countries like Columbia, Peru, Srilanka, Maldives, and Indonesia come under high risk categories[72]. India is categorized as a moderate risk country. The United States and the United Kingdom is having insignificant risk. France, Italy, New Zealand are having low risk factor.

Effect of Co-acceptance Facility on Letters of Credit

Co-acceptance facility is acceptance of bills by a buyer's bank either singly or jointly with the buyer on the demand made by the seller's bank[73]. Some banks co-accept bills of their customers and also discount bills co-accepted by other banks in a casual manner[74]. Apart from this some banks open letters of credit on behalf of their constituents and also co-accept the bills drawn under such letters of credit. If a bank co-accepts a bill drawn under its own letter of credit, the bill so co-accepted becomes an independent document and the special rules applicable to commercial credits do not apply to such bills. The negotiating bank of such a bill is not under an obligation to check the particulars of the bill with reference to the terms of the letter of credit.

This practice is will defeat the purpose of issuing of letters of credit. Hence the discounting banks should first ascertain from co-accepting banks the reasons for such co-acceptance of bills drawn under its own letters of credit. They may consider discounting such bills only after satisfying themselves of the genuine nature of such transaction.

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[72] This came into effect from 31.3.2003.
[73] *Supra* n.3, p.648.
[74] See Master Circular No.DBOD.Dir.BC.07/13.03.00/2002-03 dated 26th July 2002 issued by the Reserve Bank of India.

In order to regulate this problem, the Reserve Bank of India has issued instructions regarding co-acceptance facility[75]. These instructions should be adhered by bank officials at the time of co-acceptance of bills. Clear accountability in this respect should be determined.

Regulation of Letters of Credit by Audit Mechanism

Misuse of letters of credit is checked by auditing of the books of accounts of banks. In some type audit letters of credit transactions are also monitored.

(a) Concurrent Audit[76]

The concurrent audit system is regarded as part of a banks early warning system to ensure timely detection of irregularities and lapses. It also helps in preventing fraudulent transactions at branches. This is essentially a management process, integral to the establishment of a sound internal accounting function. The activities covered under concurrent audit includes off balance sheet items which includes letters of credit. The duty of concurrent auditor can be summarised as follows[77]:

The auditor should scrutinize and ensure that the bills paid on the previous day under letters of credit are strictly as per the

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[75] *Ibid.*

[76] It is an examination which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. For the definition of the term 'concurrent audit', see Circular DBS.No.BC.16/08-91-021/96 dated 14th August, 1996 issued by the Reserve Bank of India.

[77] *Ibid.* The auditor should see whether the transactions are within the policy laid down by the Head Office, and they do not violate the instructions or policy prescriptions of the Reserve Bank of India.

terms of the letters of credit. He should check whether the reimbursement of letter of credit is promptly obtained and also issue of letters of credit is within the delegated powers of the branch and they have been issued for genuine trade transactions[78]. The auditor should check that the correct entries have been passed on issue, expiry, and cancellation of letters of credit issued[79]. It should also be ensured that the allowance of packing credit is under proper sanction and backed by letters of credit of approved bank and also related conditions are complied with[80]. The foreign documents purchased and negotiated under letter of credit and over detention of import bills and debit of import bills to company's account should also be checked[81].

(b) Statutory Audit

Statutory audit is provided under the Banking Regulations Act, 1949[82]. This provides checklist for audit. Profit and loss account needs to be verified under this audit. Therefore auditor should check whether the commissions charged on letters of credit are in terms of the policy implemented.

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[78] *Supra* n.3. Also see DBOD No.BC.182/16.13.100/93-94 dated 11th October 1993 issued by the Reserve Bank of India.
[79] *Ibid.*
[80] *Ibid.*
[81] *Ibid.*
[82] The Banking Regulation Act, 1949, s. 30.

(c) Revenue Audit

Revenue audit[83] is undertaken on monthly, quarterly, half yearly or yearly basis. In this type of audit, the auditor checks the following[84]:-

1. Whether the opening charges, re-instatement charges and the commitment charges, as the case may be, have been charged as specified for opening or restoring or non revolving letters of credit.

2. Whether the commission has been charged as per agreement.

Other Regulatory Measures

Apart from the statutory provisions and the Reserve Bank of India guidelines certain schemes are formulated by the Reserve Bank. These schemes also contain provision relating to letters of credit transactions.

Banking Ombudsman Scheme

In order to redress the grievances in banking services concerning loans and advances, the Banking Ombudsman Scheme was introduced in India[85]. According to this mechanism, the Banking Ombudsman has the duty to consider complaints received relating to banking service. He also has power to settle disputes by agreement or by making recommendation or award in accordance with the scheme[86]. The scheme mentions certain matter on which he has the

[83] This audit deals with audit of income and expenditure.
[84] *Id.*, p.1420.
[85] It is framed by the Reserve Bank of India under section 35-A of the Banking Regulation Act, 1949 in public interest and in the interest of banking policy.
[86] See the Banking Ombudsman Scheme, 2005, clause 12.

authority to consider complaints. These matters include failure to honour letters of credit commitment by banks[87]. The ombudsman has power to impose penalty for deficiencies relating to letters of credit services.

Remedies under Consumer Protection Act, 1986

The disputes pertaining to letter of credit can also be brought under the Consumer Protection Act, 1986.

In *Pardes Dehydration Co.* v. *State Bank of India*[88] the question was whether the loss of letters of credit from the bank would constitute deficiency in service. In this case a consumer claimed compensation for loss and injury suffered by him.

The Gujarat State Consumer Dispute Redressel Commission held that the complainant was not a consumer and there was no privity of contract between the complainant and the bank. But the National Commission held that he was a beneficiary of the service rendered by the bank. The Commission said,

> "We are not prepared to accept the findings of the State Commission that the complainant is not a consumer though the Letters of Credit was issued by a foreign bank but it was transmitted to the State Bank of India. The complainant was the beneficiary under that Letters of Credit. Thus the complainant becomes 'consumer' as defined in Section 2 (1) (d) (ii) of the Consumer Protection Act"[89].

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[87] The Banking Ombudsman Scheme, 2006. clause V.
[88] As quoted in S.N.Gupta, *Banks and the Consumer Protection Law*, Universal Law Publishing Co.Pvt. Ltd., New Delhi (2000), p.91.
[89] *ibid.* at pp. 92-93.

So the bank was held deficient and negligent in rendering services. However, in this case, the complainant failed to prove that he had suffered any loss or injury due to the deficiency. Hence no compensation was granted.

Role of Export Financing and Guarantee Corporation Schemes

Banks are undertaking various risks in issuing letters of credit. When a bank in India adds its confirmation to a foreign letters of credit, it binds itself to honour the drafts drawn by the beneficiary of the letters of credit without any recourse to him on the basis of strict compliance principle. The confirming bank will suffer a loss if the foreign bank fails to reimburse the amount paid to the exporter. This may happen either due to the insolvency or default of the issuing bank or due to certain political risks such as war, transfer, delays or moratorium which may prevent the transfer of funds to banks in India. In order to protect the interest of banks the Export Credit Guarantee Corporation has evolved various schemes[90]. For example, the transfer guarantee scheme seeks to safeguard banks in India against losses arising out of such risks. This is issued either to cover the political risk alone or both political and commercial risks. Loss due to political risks is covered upto 90% and loss due to commercial risks upto 75%[91].

Apart from this there are short term specific shipment policies[92]. This policy usually covers the following aspects:

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[90] See the booklet on Export Credit Guarantee Corporation Services, published by the Export Credit Corporation of India Ltd. as cited in *supra* n.3 at p.894.
[91] For this premium is charged at rates normally applicable to insurance policy of the ECGC covering export of goods.
[92] See Booklet on Specific Shipment Policies (short-term) published by the Export Credit Guarantee Corporation of India Ltd.

(1) Insolvency of the letter of credit opening bank.

(2) Failure of the letter of credit opening bank to make the payment due within a specified period, normally four months from the due date.

(3) Failure to accept the bill drawn on it under the letter of credit opened by it.

However, the following risk will not be covered by the Shipment Policy,

1. Commercial disputes including quality disputes raised by the buyer, unless the exporter obtains a decree from a competent court of law in the buyers country in his favour.

2. Causes inherent in the nature of goods.

3. Buyers failure to obtain necessary import or exchange authorization form authorities in his favour.

4. Insolvency or default of any agent of the exporter or of the collecting bank.

5. Loss or damage to goods.

6. Exchange rate fluctuation

7. Failure of the exporter to fulfill the terms of the export contract or negligence on his part.

8. Non-payment under a letter of credit due to any discrepancy pointed out by the letters of credit opening bank.

All these regulations are trying to control the issue of letters of credit and also to protect the interest of bankers.

American Position

In the United States, letter of credit transactions are strictly controlled by the National Bank Act, 1864. It is the oldest legislation to control all banking functions in the United States. The power to issue letters of credit by the National Bank is recognized as in implied power[93]. This implied power is derived from the practice of banks prior to 1863. The National Bank Act, 1864 gives the Comptroller of Currency the power to examine, supervise and regulate all national banks and to protect the interests of national banks[94]. According to the provisions of the Act national bank could not lend more than ten percent of its capital funds to one customer[95]. Apart from this state banking laws also impose similar restrictions on the lending limits of banks[96]. Moreover, the traditional definition of letters of credit as contingent liabilities was accepted by the Federal and State law however contingent liabilities are not included within the limitations on lending[97].

In America at present the law relating to letters of credit is contained in the Uniform Commercial Code[98]. It regulates the issue and lending limits of letters of credit in America. Most of the states either follow this or include this provision in their local banking laws[99]. In 1996, the New Jersey Law Revision

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[93] Rufus J Trimble, "The Implied Power of National Bank to Issue Letters of Credit and Accept Bills", 58 *Yale Law Journal* 713 (1948-49).
[94] Mark Furletti, "The Debate over the National Bank Act and the Pre-emption of State Efforts to Regulate Credit Cards", www.philadelphia fed.org/PCC/discussion/National Bank Act 032001.pdf.visited on 16-12-2006.
[95] 12 U.S.C.A § 84 (1970) as cited in *Ibid.*
[96] Paul R Verkuil, "Bank Solvency and Guaranty Letters of Credit", 25 Stan. L. Rev. 716 (1973).
[97] *Ibid.*
[98] See, the U.C.C. Article 5.
[99] Read H.Ryan, "Letters of Credit Supporting Debt Instruments", 399 *Practicing Law Institute* 467 (1986).

Commission reviewed and revised this provision[100]. The revised provision which are in tune with the U.C.P.600 states that letters of credit should be issued in conformity with the following principles[101]:

(a) Each letter of credit should conspicuously state that it is a letter of credit.

(b) The banks undertaking should contain a specified expiration date or be for a definite term:

(c) The bank's undertaking should be limited in amount:

(d) The bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit. The bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary;

(e) The banks customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit.

Regulation on Standby Letters Of Credit

A standby letter of credit is often used to cover the "non performance" situation. The U.C.P.600 also permits issuance of standby letter of credit. However the International Chamber of Commerce had formulated a separate set of rules relating to this in 1998[102]. This has been adopted in India also. Hence the banker[103] can issue standby letter of credit either under ISP 98 or UCP 600 as agreed upon mutually by parties concerned. Thus the authorized dealers in India

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[100] See the New Jersey Law Revision Commission, www.http://www.lawrev.State.nj.us, visited on 12.10.2006.

[101] See Comptroller of the Currency's Interpretative Rulings as cited in Reade H. Ryan, *op.cit.*at p. 468.

[102] International Standby Practices, I.C.C. Publication No.590, came into force on 1st January 1999. I.S.P.98 reflects the generally accepted practice, custom and usage of standby letters of credit.

[103] Banker is termed as 'authorised dealer' in this provision.

are now permitted by Reserve Bank of India to issue standby letters credit[104]. Prior permission of the Reserve Bank of India is not required for a bank to issue standby letters of credit in favour of foreign banks[105]. The guidelines in this regard are issued by the Foreign Exchange Dealers Association of India[106]. It contains the following conditions.

1. Satisfactory credit report of the overseas supplier should be obtained by the issuing bank before issuing standby letter of credit.

2. Invocation of the commercial standby by the beneficiary of the credit should furnish a declaration to the effect that the claim is made on account of failure of the importer to abide by his contractual obligations, along with the following documents.

   (a) a copy of invoice.

   (b) Non-negotiable set of documents including a copy of non-negotiable bill of lading or transport document.

   (c) A copy of Lloyds or SGS inspection certificate whenever provided for as per the underlying contract.

   (d) Incorporation of suitable clauses to the effect that in the event of such invoice or shipping document has been paid by the authorized dealer earlier provision to dishonor the claim quoting the date or manner of earlier payment of such documents[107].

Another regulation fixes limit for standby undertaking is issued by the FEDAI. The following matters need to be considered by the bank[108],

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[104] Circular No.84 vide (Dir Series) dated 03.03.2003 issued by the Reserve Bank of India.
[105] Notifications, http://www.bankingindiaupdate.com, visited on 18/01/05. Earlier banks were exempted from prior clearance of the Exchange Control Department of the Reserve Bank of India for opening of letter of credit. See the Reserve Bank of India press release 1990-91/225 dated 26.3.1991.
[106] Hereinafter referred to as FEDAI.
[107] The facility of issuing commercial standby is extended on selective basis and only to certain categories of importers only. *Supra* n.13.
[108] *Id.*, p.227.

1. Bank must assess the credit risk in relation to standby and explain to the importer customer the interest risk in a standby covering importation of goods.

2. Discretionary power for sanctioning standby letter of credit limit for import of guides may be delegated to the controlling office or zonal office only.

3. A separate limit for establishment of standby letter of credit is desirable rather than permitting it under the regular documentary letter of credit limit.

4. Due diligence on the importer as well as beneficiary is essential.

5. Unlike documentary credits, banks do not hold original negotiable documents[109] of titles to goods [such as original bill of lading]. Hence while assessing and fixing credit limits for standbys, banks do not treat such limits as clean for the purpose of discretionary lending powers.

6. The importer should give an undertaking that he would not raise any dispute regarding the payment made by the bank in standby letter of credit at any point of time, and will be liable to the bank for all the amount paid therein. He should also indemnify the bank from any loss, claim, counter claims and damages which the bank may incur on account of making payment under the standby letter of credit.

Apart from this the issuing bank should report payment made under standby letters of credit to the Reserve Bank of India. Similarly if there is any provision in the ISP 98 which conflict with Indian law such provision would not be applicable in India[110].

[109] The bill of lading belongs to the restricted class of documents which possess some of the qualities of a negotiable instrument but it is not a fully negotiable instrument like bill of exchange. *Ibid.*

[110] *Ibid.*

Practice of Bankers in the United States of America and the United Kingdom: A Comparative View

In the United States of America and the United Kingdom, the law on letters of credit is well developed. Still the studies and surveys conducted there reveal that in practice different problems are encountered there also.

An empirical study conducted by Ronald J Mann in America[111] revealed that in many countries the export side bank transmitting goods to the United States will not even bother to examine the documents before forwarding them. In those cases the bank makes no effort at all to cure the discrepancies[112]. The data presented suggested that applicants almost always waive the discrepancies and permit full payment to the beneficiaries under the credit. In this study, 365 files with discrepancies were found. The applicants waived the discrepancies and permitted full payments in every file except one. And in that file the applicant did not refuse payment but permitted payment of 94% of the agreed amount. Thus in the 500 letters of credit transactions examined and it was revealed that the applicant never refused to accept the discrepant document. It is suggested that bank does not undertake or encourage the buyer to waive any discrepancies that might undermine the bank's obligation to pay the seller for the shipment. However the truth is that banks effectively vouch for their customers when they issue letters of credit for them. The result of deeper examination of practices of bankers gives a different picture. Some bankers stated that they were very sensitive to their credibility. To quote the words of one:

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[111] He is a Research Professor of Law in the University of Michigan. He presented these views at Michigan Law Review Symposium on Empirical Research in Commercial Transactions. *Supra* n.42.

[112] In Asia, banks offer a standard product in which the seller agrees that its bank will not examine the documents, instead will forward them immediately to the issuer without determining whether they comply. *Ibid.*

> "[B] anks are very sensitive to their credibility. It doesn't mean that they won't reject documents when documents are presented that do not conform to the letter of credit. They'll do that but they're very sensitive about having the letters of credit not paid why they are supposed to be paid"[113].

Similarly regarding the governmental regulations and requirements, strict controls are there only in transactions that involves imports into less economically stable countries. The study suggested that there might be significant variations between letters of credit practices in domestic and international transactions. Apart from this the value of the letters of credit in assuring beneficiaries of payment does not lie primarily on their legal significance but rather in their practical significance. His findings of the purpose of letter of credit shows that in majority of transactions, the parties do not actually use this method to secure payment instead prefer to rely on informal methods backed up by reputational sanctions[114].

In U.K. also there is an organisation which facilitates trade changes through identification and promotion of best trading practices. The SITPRO[115] has carried out numerous surveys in the field of letters of credit. Although much work had been carried out, rejection rates seem to remain static. Accordingly SITPRO had presented a report on the use of export letters of credit[116]. The review estimates that in the year 2000, the UK lost $113 million through non-compliant documents being presented under letters of credit. This is merely the

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[113] *Id.*, p.2525.
[114] This view is based on the actual practice followed by banks. He suggested that parties were interested in verifying the buyer's reliability to the seller, not in legal liability per se. But this suggestion was criticized by Avery Katz stating that it was unconvincing. See Avery Wiener Katz, "Informality as a Bilateral Assurance Mechanism",98 *Michigan Law Review* 2554 (2000).
[115] This is the U.K.Government's trade facilitation organisation supported by the Department of Trade & Industry.
[116] SITPRO Report on the Use of Export Letters of Credit, 2000/2002.

amount that can be measured and does not include other factors such as lost opportunity and cash flow problems[117]. A number of banks were consulted during the course of this research. It was found that majority of the discrepancies was with the exporter. Although there were times when events beyond an exporter's control may cause documents to be presented late a shortfall can be seen from the lack of a planned strategy[118].

Practice of Bankers In India: An Evaluation

In India actual practices followed by bankers relating to documentary credits are different. The bankers are given liberty to formulate their own internal procedures subject to the Reserve Bank Supervision[119]. Therefore banks are implementing their own customer-friendly methodology to transact with this instrument. This paves way for competition among banks since this brings huge profit with minimum investment. The present practice of banks is most favourable to customers. The personal discussion with the bankers revealed that sellers ordinarily do not present documents that strictly conform to the requirements of the letters of credit[120]. Normally they will talk to the buyer customer and get his oral assurance to waive the discrepancy. Though the discrepancy commission is charged for each discrepancy, the bank will bargain to relax the rate of commission. Apart from this there is no uniformity among banks

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[117] *Ibid.*

[118] The top ten discrepancies are inconsistent data, absence of documents, other documentation reasons not specifically noted, late presentation, carrier not name and signing capacity, incorrect data, letter of credit expired, incorrect goods description, incorrect or absence of endorsed late shipment.

[119] The Banking Regulation Act, 1949, s. 36 (1) gives power to the Reserve Bank of India to give advice or to caution banking companies. The Reserve Bank of India prohibits a banking company from entering into any particular transaction.

[120] Sometimes documents might be missing, late or fail to precisely match the details about the shipment provided in the letter of credit.

to charge the discrepancy commission. Therefore when the bank receives request for release order from the buyer, the banker will pay the beneficiary. As a result the buyer is bound to accept the document even if there is discrepancy in the document. Published references relating to the discrepancy problems in India are not available though they leavy huge discrepancy commission[121]. The buyer will suffer heavy loss if the products are not of required quality and fraud is identified only after payment is made. However the reported litigations in India are limited to the issue of suspected fraud[122]. Those reported cases with regard to the suits for injunction to restrain bankers from paying[123]. The practice followed by three nationalized banks, two private scheduled banks and one foreign bank were studied to ascertain their practices relating to issue of documentary credit. It revealed that discrepancies in documents are considered irrelevant because the buyer waived the discrepancies in most of the cases[124]. The practice followed by Indian bankers is summarized below.

Letters of Credit Application: Procedures followed by Banks in India

In India the letters of credit are categorized as export letters of credit and import letters of credit. Documentary credit operations of most of the banks are done by their international division department situated in Mumbai. Manual of instruction on foreign exchange business including letters of credit are issued by

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[121] For published references to the discrepancy problems in America, see Vincent M. Maulella, "Payment Pitfalls for the Unwary: How to Make Your Letter of Credit Work", *WORLD TRADE*, 1999, at 76., as mentioned in Ronald J.Mann, "The Role of Letters of Credit in Payment Transactions", *Supra* n.42 at p.2495.The U.S. banks report that 50% to 60% of all letter of credit document presentations are found discrepant on first examination.

[122] For instance see *United Commercial Bank* v. *Bank of India*, (1981) 2 S.C.C. 766, *Saw Pipes Ltd* v. *Gas Authority of India*, A.I.R.1999 Del. 30

[123] For example see *U.P.Co-op Federation Ltd* v. *Singh Consultants and Engineers (P) Ltd*, (1988) 1 S.C.C .174, *Hindustan Steelworks Construction Ltd* v. *Tarapore &Co*, (1996) 5 S.C.C. 34.

[124] See the appendix-I

them to their concerned branches. All the branches transacting letters of credit business are required to follow these guidelines.

Generally banks open letters of credit for customers known to be participating in the trade and maintains a current account with them. Payment under the credit can be availed only against the presentation of shipping documents. In case of import of goods banks will ensure that the goods concerned can be physically brought into India as per the current Foreign Trade Policy[125]. Letters of credit should not be opened for import of goods which are under restricted category unless the importer submits a valid license marked 'For Exchange Control Purposes'[126]. Import license is essential for opening letters of credit in India for import of goods. The Reserve Bank of India will inform banks about the particulars of licenses cancelled and also in case of subsequent cancellation of import licenses. The international division of the bank in turn will advise the branches by issuing circulars[127]. If import is from Nepal or Bhutan, the payment must be made in Indian rupees treating the same for all practical purposes as a domestic letters of credit[128].

All banks have their own internal procedures for carrying out foreign exchange operations. The Reserve Bank of India will monitor the internal circulars issued by banks. However these guidelines are discretionary.

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[125] Trade Control lays down the policy and regulation relating to physical movement of goods in India. See, trade control requirements under the Foreign Trade Policy (2004-2009).
[126] See the Manual of Instructions on Foreign Exchange Business, issued by various banks.
[127] *Ibid.*
[128] *Ibid.*

In addition to the main application for opening letters of credit, banks will normally obtain security documents as per the terms agreed with the applicant[129]. Third party guarantee cannot be accepted as security for opening letters of credit. The application form has an agreement part also[130]. It has to be affixed with necessary stamp. Since banks supply printed and stamped formats to the applicants, they only need is to fill in all details properly and sign them[131].

On receiving the application, name of the bank abroad through whom the letters of credit is to be advised is ascertained from the customer[132]. If the importer has no particular preference of any particular bank, the letters of credit will be advised by the foreign department of the issuing bank through a correspondent bank of its choice. Whether the letters of credit is to be advised by airmail or cable should be clearly mentioned in the application. In the absence of any such stipulation it will be advised to be send by airmail only[133]. Amount and currency in which the letters of credit is to be established should be specifically mentioned along with name and full address of the beneficiary. The application should contain name and full address of the opener, merchandise description, port of shipment and destination, documents required[134], whether

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[129] Securities will be in the form of guarantee from borrower or sureties, execution of pledge or hypothecation agreements, obtaining collateral securities etc.

[130] Letter of credit agreement is separate which contain certain terms which hold the bank harmless in the event of any damage to merchandise shipped or deficiency or defect in the documents.

[131] FEDAI has evolved a standard credit format for adoption by banks based on ICC standard credit application.

[132] While indicating the name of the country, ICC allows banks to adopt two letter country codes as given in I.S.O. This would avoid confusion arising out of different place with the same names in the same country or in different countries and help identification of countries by ISO Standard Code. See, Manual of Instructions on Foreign Exchange Business, issued by various banks.

[133] In case of advise by cable, foreign department will advise the letter of credit by cable conveying essential details only.

[134] Documents required are classified as financial documents, commercial documents, transport documents and risk covering documents.

part shipment allowed or not, transshipment, shipment date, negotiation date, and periods for presentation of document and bank charges.

On the reverse of the application, branches should certify about the margin, commission, postage and stamp duty collected by them. Letters of credit application is allotted with a serial number. Full particulars of the letters of credit are recorded in letters of credit cum liability register. Margin required are collected from the customer and credited to sundry liabilities. At the time of retirement of documents or after expiry of the letters of credit, amount held in sundry liabilities is to be reversed. No interest is allowed on amounts held in sundry liabilities as margin.

Banks having export letters of credit have infrastructural facilities and expertise. All other branches without these facilities should route letters of credit transaction through their concerned foreign divisions. A non-designated branch receiving letters of credit amendment from abroad for advising to beneficiaries should forward it immediately to nearest designated branch even if the beneficiary is the customer of that branch. In case of delay to advise beneficiary due to location of designated branch in far off place they may arrange to send a mere intimation of receipt of letters of credit[135]. However letters of credit advised by other banks in India can be promptly passed on to the beneficiary along with the advising bank's letter. The advising bank's charges are collected from the beneficiary and passed on to the advising bank.

[135] Some banks branch forward a photocopy of the letters of credit so received to the beneficiary duly marking it as 'unauthenticated' and with a letter giving the facts and informing that the original letters of credit will be advised by FD/FEX Cell in due course.

Another aspect relates to the adding of confirmation to export letters of credit. On receiving requests from customers for adding confirmation to export letters of credit or effecting transfers it will be referred to servicing foreign department[136]. Adding confirmation amounts to extending a line of credit and hence requires sanction of limits to the letters of credit of opening bank[137]. The following conditions are required for adding confirmation:

1. There should be authorization or request for adding confirmation from the issuing bank

2. Method of payment and terms of settlement should strictly be in consonance with Exchange Control (FEMA) regulations.

3. None of the clauses should be contrary to the Exchange or Trade Control Regulations.

4. Letters of Credit should not contain any derogatory or ambiguous or onerous clauses.

5. Letters of credit must be available for negation or acceptance at the counters of the bank.

6. In case the Letters of credit was advised originally through another bank in India, before adding confirmation suitable undertaking is to be obtained to the effect that they would communicate all future amendments through the bank branch.

7. Where letters of credit provide for payment or settlement by the opening bank upon receipt of documents at their counters, the same should not be treated as simultaneous reimbursement.

8. Adding confirmation to letters of credit emanating from listing countries should be subject to the terms and conditions specified in their sanction order.

9. Confirmation is not available if documents are discrepant.

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[136] Adding confirmation to "revocable letter of credit" is not permitted. Words "confirmation added" is to be written in red ink against the entry appearing in ELC register as well as on the office copy of advising letter.

[137] *Supra* n.13.

10. In the event of adverse political or economical developments after adding confirmation, subsequent amendments to such letters of credits and amendments with unacceptable provisions are to be advised to beneficiary duly mentioning that confirmation it will not be available for the amendment, but only for original terms of letters of credit.

11. Request for adding confirmation should not be entertained in the cases of letters of credit which do not explicitly state that they are governed by provisions of the UCP 500[138].

12. Where confirmation charges are for the account of beneficiary. Confirmations are added only after collection of appropriate commission. Were the confirmation charges are for account of openers, confirmation can be added and charges are to be claimed from the issuing bank.

The export letters of credit are taken up for advise only after verification of signatures or tallying of test to ensure the genuiness of the letter of credit.

It was found that there were instances where there won't be any specific request or authorization from the opening bank to add such confirmation but the beneficiary approach the bank to get confirmation. They would be willing to pay confirmation charges. In these cases the bank provides the confirmation and approach the issuing bank with a request to add confirmation to such letters of credit. Adding confirmation to export letters of credit is a non fund based activity and considered as a source of income generation. Therefore if attempts are not made to add confirmation, it will lead to loss of an opportunity to the bank to earn confirmation commission[139].

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[138] Now U.C.P.600

[139] Liability register is to be maintained for posting correspondent wise confirmation liability. In respect of letters of credit confirmed by the authorized branches, day book slips are to be passed at the time of preparing balance sheet. See *Supra* n.13

Apart from this branches are allowed to negotiate export bills issued by prime banks[140] provided negotiations are restricted to any bank and outstanding negotiations are to all times within specific sanctioned limits[141]. If customers submit bills under credits restricted for negotiation to another bank, branches must forward the documents to the other bank for negotiation. International division of banks provides branches with a list of banks with risk category-wise countries for this purpose. However branches are not allowed to negotiate documents under letters of credit in certain circumstances[142].

Difficulties faced by the Bankers

The main problems areas faced by bankers in India relates to documentary compliance and fraud situations. Though banks are following the U.C.P. provisions, they have their own internal practice to scrutinize the discrepant documents. The discrepancies found on the examination of documents will be advised in the prescribed form[143].In such cases while forwarding the intimation to the customer, branch should attach this form advising the discrepancies. The customer has an option to accept or reject the documents within a reasonable time from the date of presentation of the documents. If the documents are not acceptable to the customer on account of

[140] The following category of banks are treated as 'Prime Banks': (a) banks ranking from 1 to 1000 as per "bankers magazine excluding banks in off credit and ECGC restricted category" countries(b) other correspondent banker (c) other Indian Public Sector Banks (d) Subsidiary or joint venture banks of banks ranking upto 500 as per "Banker" Magazine and of the "State Bank of India".(e) "Non-correspondent banks located in low-risk category countries can be taken "only in respect of existing good clients". The exposure is subject to credit limits, FEMA guidelines. Country classification, Foreign Trade Policy and Restricted cover category. See, Circular No.ID/56/CBD/15/2006 dated 10.04.2006 issued by banking departments.

[141] Manual of Instructions on Foreign Exchange Business, *Supra* n.69

[142] For instance, in case of revocable credit receiving of notice of revocation, negotiation under the letter of credit restricted by another bank, letters of credit providing for negotiation to the counters of issuing bank or any other nominated bank.*Ibid.*

[143] In some banks it is termed as Form IF (IMP) 1618.

the discrepancies, he is required to intimate the same to the branch immediately[144]. He should return a copy of the form sent to him duly dated and signed. When such notice of rejection is received, the branch will convey the same to the foreign department[145]. In case of discrepancies advised by cable, the branch should get the customers approval in writing to waive the discrepancy before forwarding the documents to the correspondent bank to ensure that the same would be acceptable to them despite discrepancies. Sometimes discrepant documents are accepted by bank branches "on approval basis" as per the instruction from foreign department when the overseas correspondent bank decide to forward the same[146]. In practice branches are required to lodge such documents in their register allotting number and an intimation of the same should be sent to the customer advising such discrepancies. Usually considering the element of cost of business transaction the customer will give permission to accept the document and make payment accordingly. Thus the discrepant documents does not create problem for the beneficiary to receive payment and banks get high discrepancy commission. Only the buyer will be affected.

Another difficulty faced by the banks in India relates to fraud circumstances. Fraud relating to documentary credit is reported in India and abroad since 1980[147]. Many banks in India have become involved in it. There is a possibility of Indian Banks suffering considerable losses. Reserve Bank of India has directed all the banks to tackle these issues[148]. The frauds which the banks

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[144] Time allowed is 5 days from the date of presentation, see the U.C.P.600, Article 16(d).
[145] Any delay to convey the same result in forfeiting the right to reject.
[146] In case of "approval basis" the foreign department has to communicate to the overseas bank within a reasonable period as to whether the documents are acceptable or not to enable them to negotiate the same.
[147] R.Viswanthan, "Letter of Credit: A Scam in the Making?", *supra* n.27
[148] See Circular Letter No.10/80 dated 25th February,1980 issued by the Reserve Bank of India

got involved have made the concerned banks aware of the short-comings in their customer's information as well as in their operational procedures regarding the issuance of letters of credit.

Common types of fraud are issue of forged bills of lading and insurance policies. Sometimes they cover shipments which are not made by using the names of non-existent ships or ship nowhere near the port of lading at the time of issuing. This is done by collusion between shipping companies, shippers and insurers. However in this type of fraud banks are not affected as banks deal with documents only and not concerned with the goods. In practice they try to convince themselves that such shipments are actually made[149].

Another type of fraud is the issue of shipping documents without actual shipment. A typical case narrated by one Indian bank was relating to import of PVC resins and cloves from Singapore. Two ships believed to be carrying the cargo were sunk. But it is widely believed that neither the cargo was on the board of the ships nor the ships were seaworthy. However bank was bound to pay against documents even though the goods never reached India. This show the danger involved in import financing without proper assessment of the proposals for opening letters of credit. This also shows the shortcomings in the internal procedures and assessment of the banks.

[149] This is an instance of maritime fraud. Alertness on the part of banking and trading communities alone can present. This commercial information on all sides can effectively prevent reoccurrence of such frauds.

The Reserve Bank of India has made some suggestions in this connection to control this type of fraud[150]. In spite of this, the instances of fraud committed by foreign exporter are in increase[151]. The applicants for the letters of credit are the most affected persons. The exchange variations in control rates are causing loss to the Indian economy. Another instance was also brought to the notice of all banks by FEDAI. It was a case of an importer who received bricks against an import order for lead ingot. The ICD inspector had also forwarded a report which confirmed this fraud. But on the basis of documents received under letters of credit, bank made the payment[152].

Most of the frauds are going unnoticed by authorities. Only when one of the parties raises dispute, the matter comes to light. The empirical survey revealed that there is a branch of a foreign bank which exclusively deals with letters of credit business and the frauds goes unnoticed.

Documentary Credit Laws in India: A Critical Evaluation

The current documentary credit system is exclusively governed by the U.C.P. which is now considered as "the most influential source of commercial letter of credit law the world"[153]. The effort of the I.C.C. in codifying the law and practice of documentary credits in the U.C.P is so dominant that in the

[150] R.B.I. has made the following suggestions: 1.Letters of credit should stipulate that shipments should be made only by conference vessels which are on the Lloyd's approved list and which is seaworthy 2.Letters of credit should call for certificate of inspection by well known international inspection agencies. 3. In case of large value import contract, banks should obtain credit reports on the suppliers before issuing letters of credit.4.Letters of credit should call for certificate of origin from an independent third party like chamber of commerce. 5. To see whether the import contract on the basis of which letters of credit are issued was reasonable. *Supra* n.69.

[151] The booklet on *Documentary Credit & Standby Credit*, *Supra* n.13.

[152] This detail is intimated by FEDAI circular dated 18th July, 2006.

[153] B. Kozolchyk, "Letters of Credit", 9 *International Encyclopedia Comparative Law* 5 (1979).

international arena, any applicant intending a letter of credit not subject to the U.C.P. would face a very difficult task to find a bank to transact in documentary credit business. However the U.C.P. was neither designed nor intended to be law[154]. Any statutory scheme for documentary credit must come to grip with them if it is to be effective. Therefore the U.C.P principles are often adopted by judicial decision in all countries including India.

The practice found in India is that every major bank participant has its own training manuals and guidelines. These internal practices resulted in creating massive fraud which goes undetected. There is staggering potential for committing massive fraud on the banking system in the form of discounting of letters of credit bill[155]. This shows the absence of clear supervision over banking related financial scam. Many private and foreign banks are deploying their surplus funds in bills drawn under the letters of credit. Many banks have incurred big losses in discounting letters of credit bills. It is reported that despite the heavy loss incurred by banks in these scam transactions, the business of letters of credit finds an increase even for local trade[156].

Another problem is the issue of standby letters of credit. It can be seen that foreign banks can issue it without prior permission of R.B.I[157]. It is the most dangerous aspect compared to ordinary letters of credit as it is equivalent to a form of guarantee performance undertaken by bank when third party fails to

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[154] R.P. Buckley, "The 1993 Revision of the Uniform Customs and Practice for Documentary Credits", 28 *The George Washington Journal of International Law and Economics* 265 (1995), p.269.
[155] See the report of the scams reported in R.Vishwanathan, "Letter of Credit: A Scam in the Making?", *supra.* n.27.
[156] *Ibid.*
[157] *Supra* n.13.

meet their obligations. In the absence of strict control, there will be increase in risks pertaining to bank solvency and liquidity.

It can be seen that most if the U.C.P. provisions which are incorporated in India are followed through guidelines issued by FEDAI. However most of the banks are following their own internal procedures as FEDAI guidelines are only directory in nature. There are no penal consequences for any violations. Apart from this a voluntary code was issued by the Reserve Bank of India to set minimum standards of banking practices for banks to follow when they are dealing with individual customer[158]. According to this the bank will inform the individual customer if the information provided by him for making a payment abroad is adequate or not. In case of any discrepancies and incomplete documentation the bank will advise the individual customer immediately provide assistance to him to rectify and complete the same.

A developing country like India has considerable limitations on its foreign exchange reserves. In view of this, whenever a letter of credit is issued on behalf of a buyer by a bank in India, the seller inevitably insists that such letter should be confirmed by another bank in his own country. Alternatively the seller insists that a negotiating bank in his country should be authorized to collect the amount from the correspondent of the issuing bank, merely on a demand[159]. In the latter case, the negotiating bank being assured of payment tends to be more inclined to accept documents though they are not strictly in conformity with the

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[158] See Code of Banks Commitment of Individual Customers, Published by Banking Codes and Standards Board of India, reported in The New Indian Express, Monday July 10, 2006.

[159] In India, there is no uniformity in the matter of documentation. However, almost all letters of credit contain a clause to the following effect: - "In reimbursement (1) Debit out Central Office Account with you- or (2) claim from..... (named foreign bank) see the booklet *Documentary Credits & Standby Credits*, *Supra* n.13.

terms of the letters of credit. When the documents are ultimately presented to the issuing bank in India, it is of little consequence whether the documents are really with the letter of credit or not, because payment has already been realized by the seller and settling the dispute is practically not possible.

Therefore the administrative control over letters of credit remains only a paper work. In actual practice the banks in India enjoys the discretionary power to indulge in documentary credit transactions with minimum regulatory framework. Though such a freedom for banks to transact is appreciable from the commercial point of view it should not be a shelter for fraudulent activities.

CHAPTER-9

CONCLUSION AND SUGGESTIONS

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The discussions in the previous chapters have revealed that documentary credit secures the interests of all parties involved in the international trade transaction. It provides liquidity to importer and exporter and affords the parties a local entity to sue in the event of a dispute. Apart from this, as banking institutions play a pivotal role in promoting the use of these instruments they serve as a means to increase the foreign exchange reserves of a nation. Merchants the world over used this instrument as a means for payment from time immemorial. Their increased uses in trade brought a new meaning to documentary credit as a security devise apart from payment device. They are now used as guaranteeing instrument which assures satisfactory performance of the contract in connection with transactions not involving sale of goods. The law in this area is nebulous. The study of this aspect revealed the intricacies involved in this transaction.

Benefit from Trading Documentary Credit as an Independent Contract

The reason for the widespread acceptance of documentary credit as a mercantile instrument lies in the fact that it ensures prompt payment on presentation of stipulated documents by the seller. The heart of every documentary credit transactions is the issuing bank's promise to the beneficiary that it will honour the beneficiary's demand for payment regardless of any underlying disputes between the applicant and the beneficiary. Therefore in a

sale of goods context the seller beneficiary can use the documentary credit as collateral to finance production. Once the goods are shipped the seller is assured prompt payment upon presentation of complying documents. On the other hand it enables the buyer to ensure that he receives the goods as ordered. Banks by acting as intermediaries between the parties earn commissions which are relatively high.

The burden of conformity of goods to the terms of sales contract shifts to the buyer once the bank has honoured the letter of credit upon proper presentation of documents. The bank has no duty to determine the performance of obligations under the contract by the beneficiary. They are therefore 'documents driven' and not 'fact driven'. If there is a clause in the letter of credit obligating the bank to verify whether the beneficiary had factually performed the underlying contract, it cannot be treated as a letter of credit. This is to avoid the tainting of the commercial use of letters of credit with uncertainty. Thus the peculiar feature of this instrument is autonomy. If this principle is eroded, the commercial use of letters of credit will be adversely affected. For the free flow of trade and commerce it is necessary to safeguard the principle of autonomy. But it should not be a ground for abuse. If it is not properly administered, it may even lead to insolvency of banks and economic crisis of nations.

Problems Created by Autonomy Principle

Under the basic rule of the independence principle, issuing banks are not bound by underlying contracts between the buyer and the seller. They deal exclusively in documents and not in goods to which the documents may relate.

The fact of payment by the issuing bank therefore does not ensure that the buyer gets the goods he has contracted. The beneficiary gets security for the goods he supplies from the bank but there is absence of security to the buyer 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, only remedy available to the buyer applicant is the recourse against the seller. Issuing bank is not at all liable to the buyer. Therefore, scholars and courts have been struggling for the solution to the question as to how strictly this rule of autonomy should be applied.

Many problems arise due to autonomy principle. They often become a hideout for unscrupulous parties to indulge in commercial frauds based on documents. To overcome this abuse, courts have recognized the doctrine of strict compliance and fraud exception to the principle of autonomy.

The doctrine of strict compliance seeks to protect the interests of the buyer and the paying banker. It was held by courts that no reliance need to be placed on trade customs as they may differ from place to place and it would be unreasonable to expect banks in one jurisdiction to be aware of what are customary practices of banks in another jurisdiction. In documentary credit transactions banks make payment based on documents alone. Therefore it is necessary to ensure strict compliance of documents with the terms of letters of credit. This doctrine creates difficulties for all parties. The seller faces difficulty in receiving payment if he fails to present correct documents. The buyer will suffer loss if the transport documents are forged. At the same time bank also will be in peril if they handle erroneous and ambiguous letters of credit. Sometimes they

may be contrary to exchange control regulations and bank will incur loss. The country also may be deprived of its legitimate foreign exchange. Therefore ascertaining the authencity of documentary credits as well as satisfying its correctness assumes utmost importance.

Problems Due to Discrepant Documents

Another common problem found relates to discrepancies in documents. The rates of discrepancies in documents are high because there are documents of different nature. Courts bind on the banker to scrutinize the documents with meticulous care before making payment. They have held that the documents should be in exact compliance. This will result in delay in transaction. Hence the cost of transaction will increase. In order to avoid these difficulties banks in India use their own internal precautions while handling documents. They have instructed their branches to forward the documents to the foreign exchange department of the bank concerned to confirm its authentic nature. But this practice is only an internal arrangement.

Apart from this it can be seen that bankers spend a lot of time in checking documents for compliance with the terms of credit. The bulk of the U.C.P. provisions relates to standards for checking documents. The process of checking is done by both negotiating and issuing banks. It is a tedious process to transport these documents from one bank to another before making payment. The charges levied by banks are high. Both the parties need to pay for document examination. To waive the discrepancy of documents discrepancy commission is

charged which is often very high. There is no uniformity of charges among banks.

In this area, laws are not concerned about refining the rules for checking documents. There is no uniformity in accepting the documents, waiving discrepancies or charging commission. This results in competition among banks in accepting discrepant documents by bargaining with applicant for waiver of discrepancy. This will result in the increase of documentary credit frauds. Courts and the U.C.P allow some tolerance for discrepancy of document. This is to make prompt payment to the beneficiary. The revised U.C.P. 600 made an attempt to reduce the ambiguities of documents used in letters of credit transactions. The revised article relaxed to an extent the problem created by the term 'original document' in the earlier article. The following documents will count as originals unless the document itself indicates that it is not an original:

a) any document bearing an apparently original signature, mark, stamp or label of the issuer of the document;

b) any document which appears to be written, typed, perforated or stamped by the issuer's hand;

c) any document which appears to be on the issuer's original stationery;

d) any document which states that it is original[1].

However how far this revision is effective to clear the ambiguities of documents and promote the speedy examination of documents by banks remains unanswered.

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[1] U.C.P. 600, Article 17

Practice Relating to Fraud Exception

The fraud exception should be considered as a deterrent which assists the healthy movement of letters of credit. It represents a departure from the independence principle. Fraud rule allows banks and courts to interfere with the payment under a letter of credit when fraud is involved. It is the most confusing and controversial area on the law governing letters of credit. It is mainly because the standard of fraud cannot be fixed. The divergent views expressed by courts and commentators with respect to the essence of the standard of fraud reflect the tension between two different policy considerations. One is the principle of the autonomy of documentary credit. The other is the importance of discouraging fraud in the documentary credit transaction. The rules and standards regarding the fraud are neither direct nor clear in addressing the issue of the identity of fraudulent parties. They are more concerned with the nature of the documents presented.

The analysis of the decisions shows that the courts have accepted the argument put forward by beneficiaries in every case and have held that the fraud rule should not apply when the fraudulent party is the applicant or a third party. The development of the fraud rule was to prevent beneficiary fraud and the cases in which the fraud is perpetrated by parties other than the beneficiary are very rare. While the fraud exception has been a milestone in the development of letter of credit law it is silent with regard to the third party priority rules. The later development has tilted the balance sharply in favour of the seller. If fraud

exception law is feeble it will enable an unscrupulous seller to manipulate the incautious buyers and third parties. The interest of equity and efficiency can only be served if the third party priority rule with respect to letter of credit is made subject to the fraud exception.

Apart from this, the U.C.P. does not contain provision for defeating fraud. The lack of provision to defeat fraud in the U.C.P. indicates that the intention of the drafters was to leave it to the municipal law. This is a wise decision because the municipal laws of various countries regarding fraud in documentary credit are not uniform. Moreover it creates an incentive for various jurisdictions to fashion fraud rule to suit the marketability of credits issued by banks in their countries. In America, Article 5 of the Uniform Commercial Code contains provision for the fraud and forgery. The provision makes it clear that fraud must be found either in the documents or must have been committed by the beneficiary. It must be "material" and the standard for injunctive relief is high. The burden remains on the applicant to show by evidence that fraud was committed and mere allegation of fraud is not sufficient. The courts in India shaped the fraud rule by taking into account the United States decisions relating to fraud exception. An analysis of cases in India shows that the practical applicability of the fraud rule is very limited. Only when fraud is established the courts will grant an injunction to prevent the bank from making paying on the credit. It is found that fraud rule is necessary to limit the activities of fraudsters but its scope must be carefully delimited so as not to deny commercial utility of the instrument. The courts also face difficulty since municipal fraud rules are diverse and unclear. This creates a situation where the decisions of courts relating to fraud are criticized.

Transfer of Obligations

Another aspect relates to transfer of rights and obligations under documentary credit. The rights created under letter of credit are contractual rights. These rights can be transferred subject to the rules governing transfer of contractual rights. A study of this area revealed that there are only few decisions on this topic. It is recognized in India also that credits are transferable if they are expressly made so. Though the advantages of transfers are many the awareness among parties seems to be limited.

Problems Faced by Issuing and Corresponding Banks

The rights of issuing bank and its problems are also matters of concern. Issuing banks are entitled to get reimbursement once they complied with the terms of the credit. This is based on the general principle of law of agency that an agent is only entitled to reimbursement from his principal if he acts in accordance with his instructions. Therefore if the buyer commits breach of the term, the issuing bank has a right to sue him. The judicial decisions show that the rights of the issuing bank depend on the fulfillment of the agreed terms. These terms may vary from case to case. So it is difficult to determine the scope of the rights of issuing banks.

Similarly the duties of correspondent banks and their problems are also far from satisfactory. The payment to the beneficiary is made by the correspondent bank situated in the beneficiary's country on the basis of instructions received from the issuing bank. This creates certain obligation on

the correspondent bank also. The obligations vary according to the nature of the function they agree to perform. If they agree merely to advise the beneficiary, their liability is limited. If they add confirmation to the credit, the obligation to pay will arise. In the United Kingdom courts use broad discretion and apply the test of reasonableness in deciding the duties of correspondent bankers. The judicial trend seems to be liberal. This affects the interest of the applicant as he has no contractual relationship with the correspondent bank. So he cannot sue or claim damages for any breach of obligation by the bank.

Once the corresponding bank agrees to make payment to the beneficiary its basic duty is to examine the documents on their face. The bank puts a lot of time in checking these documents. Since the documents involved are of different nature expertise of banker in examining them is expected. This results in delay in making payment. The revised U.C.P 600 increased the problem by deleting the word 'reasonable' and restricting the days of giving discrepancy notice to the party concerned[2]. It is not clear when the seller can insist payment. It is not specified whether he has to wait until the fifth day for payment. This may create problems for the buyer. Thus the process of examination of paper documents is problematic in the revised U.C.P. also.

Nature of Administrative Controls over Documentary Credits in India

Administrative control over documentary credit and the practice followed by banks in India are not beneficial for the applicant for credit. Administrative controls are mainly based on the guidelines and master circulars issued by the

[2] U.C.P.600,Article 16(d)

Reserve Bank of India from time to time. An examination of these circulars showed that they are aimed at protecting the solvency and liquidity of banks. Apart from this, the Foreign Exchange Dealers Association, an association of persons dealing in foreign exchange has issued certain guidelines and preventive measures which member banks must follow when they transact documentary credit. Many banks in India have their own internal measures to regulate activities connected with letters of credit. Even though they try to bring the international standards in their circulars they often fail to implement it in practice. Lack of uniformity and liberal rules governing letters of credit creates a platform for fraudsters to indulge in documentary credit frauds.

Practice of Indian Courts

The study shows that customary practice followed by merchants and codified by the association of International merchants are the basic rules for determining the rights and obligations under documentary credit transactions. They are often applied as legal principles. In India there is no statute which specifically governs letter of credit. The courts try to apply the provision regarding guarantees embodied in the Indian Contract Act, 1872 to decide cases relating to letters of credit. Apart from this, they also apply the legal principles laid down by English courts. This creates confusion. The study of various decisions shows that there is no clarity regarding the principles applicable to documentary credits in India.

The courts in India equate the letters of credit with bank guarantees. They often create confusion regarding these instruments. They have failed to

carve out a clear law. However, the courts in earlier period were aware of the distinction between letters of credit and bank guarantees. They made it clear that there is a distinction not merely on the function but also in their legal nature. The irrevocable letter of credit payment does not depend on the performance of obligations by the seller. It depends only on those duties expressly imposed under the letter of credit. In the case of bank guarantee unless there is some act or omission or commission on the part of the third party, payment would not become due. There is always the question of contingency on the occurrence of which the guarantee becomes enforceable. If this is accepted the principle of indemnity cannot be applied to decide bank guarantee cases. Later this trend changed. Now in every case, courts treat both the instruments as analogous. They often say that there is no practical difference between a bank guarantee and letter of credit. All depends on the facts of each and every case apart from the language of the document. This situation has arisen due to the absence of clear legislative provisions. To overcome the above difficulties the following suggestions are made.

Need to Limit Application of Autonomy Principle

The principle of independence of the letter of credit dictates that the banker is obliged to make payment upon presentation of conforming documents without regard to any defenses which the applicant may have against the beneficiary. Further, whether the document is genuine or not is not a matter which the bank is obliged to investigate. The bank's duty is limited to examine documents for compliance only on their face. As a result the banks tend not to be proactive in regard to identifying "red flags" that could indicate problems in

legal effect of sufficiency, accuracy, genuineness, falsification of any documents. Therefore the bank bears little 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 goes unchecked because if the document itself is false, it may have no collateral value. The application of the independence principle must not be allowed to facilitate fraud in such transactions. Therefore the autonomy principle need to be limited and banks should be required to check and to question the authenticity and correctness of the 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.

Need for Clarity in Application of Fraud Rule

The fraud exception to the rule of autonomy, as developed by courts remains elusive. Courts have not identified the degree of fraud required to hold that there is fraud justifying the violation of the principle of autonomy. Only when the case is adjudicated it will become clear whether the conduct at issue comes within the fraud exception.

Apart from this, to define the fraud is a very difficult task. If it is defined too narrowly the effectiveness of fraud rule will be lost. A very rigid standard of fraud may encourage growth of fraudulent conduct by beneficiaries and discourage the use of documentary credits by applicants. On the other hand, if fraud is defined too widely the fraud rule may be abused by an applicant who does not want the issuer to pay the credit simply because it will not make profit

from the underlying transaction. If obstruction of payment of a letter of credit is permitted too often, business confidence in letters of credit will be destroyed.

Therefore a proper standard of fraud should be one reflecting a sensible compromise between the competing interests. It should serve the purpose of the fraud rule and be workable for the courts. Courts should provide some guidelines to determine the fraud situations. It is suggested that while framing guidelines in India, a combination of the provisions of the revised U.C.C. article and the UNCITRAL Convention can be made.

Need to Impose Minimum Obligation on the Beneficiary

When the documents presented by the seller conform on their face to the credit, the bank is under a contractual obligation to honour the credit. This is irrespective of allegation of fraud by the buyer and the bank's knowledge that the seller has fraudulently breached the underlying sales contract at the time of presenting the conforming documents. The buyers will discover the fraud only when they go to collect their cargo weeks or months after the fraud has been perpetrated. By that time the fraudster might have spirited away his ill-gotten gains and melted into the shadows. One of the reasons for this trend is the cost of investigation of international fraud and the low priority given to this by law enforcement agencies. To overcome this problem a minimum contractual obligation need to be imposed on the seller beneficiary. A contractual term to the effect that the beneficiary will not commit a fraudulent act on the bank in a documentary credit transaction should be imposed in the credit. In case if the

beneficiary try to escape from this contractual obligation the bank should be able to freeze the beneficiary's account or seize his property.

Need to Recognise New Exceptions to the Rule of Autonomy

A narrow interpretation of the fraud exception provides the unscrupulous seller-beneficiary with an opportunity to take advantage of the system because if there is fraud the only right available to the buyer applicant is to seek an injunction to restrain the bank from making the payment against the presented documents. Therefore apart from fraud, grounds such as unconscionable conduct, illegality and violation of public policy and nullity of underlying contract need to be recognised to refuse prompt payment to the seller beneficiary. These grounds should be included in the statute as exceptions to the rule of autonomy to prevent unfair calls.

Need to Initiate Measures to Reduce Discrepant Documents

The high discrepancy rates of the documents tendered indicate that sellers pay little attention to the question of documentary compliance. 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. If this trend continues it will result in unfair abusive trade practices relating to documentary credits. One of the reasons for this increase of discrepancies is the bulk nature of documents required by the documentary credit for making payment and the lack of expertise in handling these documents. To overcome this problem a combination of documents from

sources that would not involve lengthy process of documentation can be insisted. For instance a certificate from an independent third party i.e. a major accounting firm or a government department indicating the authencity of the documents can be accepted by the bank as an essential document for making payment. Apart from this a training programme for the exporters regarding the preparation of various documents needs to be given. Along with this the precautionary measures that the bank staff needs to initiate while examining the documents can also be highlighted through various workshops and special training programmes. If proper awareness of the frequently occurring discrepancies is made to the parties handling documents it will reduce the undue rejection or acceptance of unfair documents.

Need for Unification of Law Relating to Documentary Credit

The rights and obligations of various parties to a letter of credit transaction are now based on common law. So far, no attempt has been made to standardize the laws relating to letters of credit through international conventions. Cross-border trade has increased dramatically and there is a greater need for harmonization of commercial law including documentary credit law at international level. Obvious methods of creating transnational commercial law include international conventions and forms of soft law such as model laws, international restatements and contractually incorporated uniform rules. Though the adaptation of the Uniform Customs and Practice by almost all the countries in the world made the basic principles applicable to letters of credit "uniform" throughout the world, it became effective only when the parties incorporate it in their contract. The UNCITRAL convention becomes applicable only in those

countries, which have ratified it. To overcome all these problems international cooperation is needed.

Need to Develop Regulatory System for Documentary Credit Dispute Resolution

The number of disputes involving documentary credit is on the increase both at national and international levels. The judicial mechanism is lethargic and often confusing. This calls for an extra-judicial mechanism for resolving documentary credit disputes. International Commercial Arbitration is one such regulatory mechanism. Apart from this the Documentary Instruments Disputes Resolution Expertise also works as a dispute regulatory body at international level. However in order to exercise their benefit as an effective regulatory mechanism the parties should contemplate them in the contract. Thus the parties need to incorporate an arbitration provision in the underlying sales contract in order to subject them to international commercial arbitration. The provision could state that an arbitrator may award compensatory and consequential damages in case a letter of credit has no conceivable basis, or involves material, egregious, willful or intentional fraud. There are no legal or contractual barriers to limit the use of international commercial arbitration in letter of credit disputes in India. Therefore separate regulatory mechanisms to tackle the documentary credit dispute need to be developed. The proposed system should involve the direct participation of banks and thereby enhance the general acceptability of a documentary credit dispute resolution system.

Need to Distinguish Documentary Credits from Bank Guarantee

Non-recognition of the distinction between documentary credit and ordinary bank guarantee creates confusion. A letter of credit that functions as a guarantee should be treated as such under the law. In many cases banks are exceeding their authority while issuing guaranty letter of credit. The traditional letter of credit is not a guaranty. Under the guaranty letter of credit, the bank's sole function is to act as surety and to pay when customers fails to pay. The banks liability is secondary. If proper regulation is not made to control the issue of such guarantee it may be instrumental to increase risk in banking industry. The strict application of the rule of autonomy is commercially justifiable in the case of letters of credit. Autonomy principle is effective because banks pay upon receipt of documents. These documents provide some security for banks as they transact with title to the goods. There is no such security in the case of bank guarantees. While there is commercial *quid pro quo* for the principle of autonomy in letters of credit, there is no such justification in bank guarantees. So the analogy between letters of credit and bank guarantees needs a reappraisal.

Therefore separation of these instruments based on its nature is essential. This calls for making special rules based on UNCITRAL and U.C.P. provisions relating to documentary credits. They must be codified and should be applied only in documentary credit transactions.

In order to overcome the uncertainty created by conflicting decisions, a special legislation codifying the principles of documentary credit could be made.

The principle of autonomy of the credit must be applied only to documentary credit. This should be applied after analyzing the nature of document.

Need to Appoint a Banking Commission on Documentary Credit in India

Reserve Bank of India should appoint a committee to study the problems faced by buyers and beneficiaries in dealing with documentary credits. They should suggest the measure to reconcile the problems and also effective measures to prevent frauds. They should consider methods to strengthen the existing measure of lending operations concerning letters of credit.

Need to Strengthen the Banking Ombudsman System

Banking Ombudsman system is at present functional in India. They are playing a pivotal role to settle disputes between banks and their customers. Their functions include the authority to decide the documentary credit issues. But cases decided are few. Therefore there is a need to strengthen the banking ombudsman system and encourage them to decide the documentary credit disputes also.

Need to Widen the Insurance Coverage under the Export Credit Guarantee

In documentary credit, parties usually take trade credit insurance to protect against the other party default or fraud. Export credit insurance can compensate the seller for the losses suffered as a result of the importer's default. Import credit cover can indemnify the importer fully or partly for losses suffered as a result of exporter default or fraud. Sometimes the buyer in order to protect

himself against fraud can demand a performance guarantee issued by a reputable bank from the seller so that in the event of breach of contract by the seller the bank would pay an agreed sum to the buyer. But this practice will result in the change of nature of documentary credit. Apart from this transfer guarantee scheme under Export Credit Guarantee Corporation does not cover the risk of non-payment under a letter of credit due to any discrepancy pointed out by issuing bank. Since most of the loss occurs due to discrepant document presentation, it is necessary to cover this risk also so that the commercial utility of this instrument will not be eroded.

Need to Promote Use of Electronic Letters of Credit

E-commerce has made fundamental changes in the present day banking scenario. It holds great potential to revolutionise payment systems. New electronic payment system may lead to the possibilities of large scale entities entering into the financial sector of electronic money. The documentary credit mechanism can operate electronically without major problems. They remain the best option in the current age of advanced technology. Much trade credit related information can be currently transmitted electronically. There is a need to develop electronic trade credit system in India also which is generally accepted. An electronic contract in this regard needs to have all the legal qualities of its paper counterpart. It should constitute a binding contract between the parties. It should be made a business records for the parties as legal evidence in the event of dispute. For instance, SWIFT is functioning without many problems and the banks in India adopt it. Therefore banks that have the appropriate electronic system should advise credits electronically. It saves them time and costs. The

reason for remaining paper based system is the lack of acceptable electronic interfaces between customer and their banks. If electronic system is widely accepted, more credits can be electronically advised. Both banks and customers will benefit immensely from this electronic documentary credit as it reduces cost, save time and promote accuracy.

Need to Promote Documentary Credits as Non-fund Facilities

Documentary credit is a non-fund based business and banks could reap good profits out of it if viewed from the credit angle. But it has its own risk. The bank pledges its own credit involving its reputation so it has no defense except in case of fraud. Therefore if properly tendered documentary credits are not honoured, the reputation of the bank would be at stake. Further the business community both at domestic and international would black-list banks which do not honour documentary credits properly. They will not be ready to accept documentary credits issued by those banks. This will result in loss of business besides irreparable damage to their standing and reputation.

Apart from this a developing country like India has considerable limitations on its foreign exchange reserves. In view of this, whenever a letter of credit is issued on behalf of a buyer by a bank in India, the seller inevitably insists that such letters should be confirmed by another bank in his own country. Alternatively, the seller insists that a negotiating bank in his country should be authorized to collect the amount from the correspondent of the issuing bank merely on a demand. The negotiating bank being assured of payment tends to be more inclined to accept documents though they are not strictly in conformity with the terms of the credit. When the documents are ultimately presented it is

of little consequence whether the documents really agree with the terms of the credit or not, because payment has already been realized by the seller. The settling of the dispute is practically not possible. To overcome this difficulty the Uniform Rules for Bank to Bank Reimbursements under Documentary Credits 1996 issued by the International Chamber of Commerce has been adopted in India. The Foreign Exchange Dealers Association of India has advised its member banks that all letters of credit established by them should stipulate that the letters of credit issued by them are subject to these rules. But these rules are not strictly followed by all banks. Therefore these rules with necessary amendments need to be adopted by the Reserve Bank of India.

The administrative guidelines issued by the Reserve Bank of India must be modified to promote the healthy form of banking practice from time to time. Interest of the parties should be given a paramount importance by way of avoiding fraud situations. Guidelines need to be invoked in each and every case with due care. The self regulatory guidelines issued by trade associations like Foreign Exchange Dealers Association of India in concurrence with the Reserve Bank of India need to be followed uniformly by all banks. Statutory powers can be conferred on these agencies to strengthen their role in documentary credit. Self discipline followed by bankers should be in conformity with laws. The Reserve Bank of India should oversee the working of self regulatory agencies. It should also monitor the documentary credit transactions.

It is expected that by implementing these measures the law governing documentary credits in India could be made in tune with the international standards which will enable Indian banks to meet the global challenges.

Appendix – I

QUESTIONS ASKED IN THE INTERVIEW SCHEDULE

Practice of Indian Bankers Relating to Documentary Credits

1. Name of the Bank.
2. Name of the Branch.
3. The nature and type of documentary credit handled by you.
   a) Have you acted as a confirming banker.
4. Have you acted as an issuing bank and correspondent bank.
5. What are the methods you are following while issuing documentary credits.
6. Is there any limitation towards the countries to which documentary credits are issued by you. If so, what are the conditions to which documentary credits are not issued.
7. What are the types of goods covered by the letter of credit.
8. Is there any guidelines by your bank in relation to confirming banker.
   a. If answer is yes, what are those guidelines.
9. Whether the directions issued by the Head Office are R.B.I. based or the U.C.P. based.
10. How far the guidelines issued by the RBI are implemented in your bank.
11. Whether you are aware of the new U.C.P. provisions.
12. Whether you refer U.C.P. provisions in each case.
13. Whether you have come across with discrepancy in the following documents, if so what is it's nature,
    a. Defective documents
    b. Missing documents
    c. Late shipment
    d. Late presentation

e. Partial shipment

f. Incorrect shipment

14. Whether the discrepancies appeared to be curable.
15. How the waiver of discrepancies was sought and how many days were elapsed before the applicant waived the discrepancies.
16. Had there been any instances where the issuing banker refused the payment based on discrepancy of document. If answer is yes, give details.
17. What is the practice followed in your bank for charging discrepancy commission.
18. Have you come across with any fraud situation; if the answer is yes, what was the nature of fraud involved.
19. Is there any pending litigation relating to documentary credits in your bank.
20. As a negotiating bank have you come across cases of foreign banks refusing to honour their commitments under letters of credit which according to you were unjustified or unreasonable.
21. What are the major problems you encounter while handling documentary credits, Please give details.
22. Do you feel that some change is required to strengthen the documentary credit transactions in India.
23. According to you, what aspect of the letters of credit poses problems to the banks in India.
24. Based on your experience do you recommend any specific amendments to the UCP.

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