

# The Unique Jurisprudence of Letters of Credit: Its Origin and Sources

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## I. INTRODUCTION

Lawyers, including judges, are prone to misconceive the legal nature of the letter of credit.<sup>1</sup> In the writers' experience this is not uncommon.

There are two reasons for this. Firstly, in legal terms, a letter of credit is a distinctly odd beast. A letter of credit looks like a contract and achieves the purposes of a contract, but does not admit of accurate analysis under contractual principles,<sup>2</sup> for it is a mercantile specialty, not a contract. Secondly, letters of credit tend to be the purview, in practice, of a few specialized banking or international trade lawyers. Accordingly, the first time most judges will encounter a letter of credit in their career is if

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1. Illustrative cases in which a court has misconceived the essential nature of a letter of credit, and failed to give sufficient weight to its autonomy, include: *Bank of Montreal v. Recknagel*, 17 N.E. 217 (1888); *Am. Steel Co. v. Irving Nat'l Bank*, 266 F. 41 (1920); *Bank of Canton Ltd v. Republic Nat'l Bank*, 509 F. Supp. 1310 (1980), *aff'd*, 636 F.2d 30 (1981); *Bank of Taiwan v. Union Nat'l Bank*, 1 F.2d 65 (1924); *Bossier Bank & Trust Co. v. Union Planters Nat'l Bank*, 550 F.2d 1077 (6th Cir. 1977); *Intraworld Indus. Inc. v. Girard Trust Bank*, 336 A.2d 316 (Pa. 1975); *Synergy Ctr. Ltd. v. Lone Star Franchising, Inc.*, 63 S.W.3d 561 (Tex. App. 2001) LEXIS 8070; and *Olex Focas Pty. Ltd. v. Skodaexport Co. Ltd.*, 3 V.R. 380 (1998) (for comment on the last case, see Robert Baxt, *Are Bank Guarantees Safe from the Unconscionable Conduct Provisions of the Trade Practices Act?*, 62 AUSTL. BANKER (1997); Robert Baxt, *A Bombshell on Unconscionable Conduct*, 25 AUSTL. BUS. L. REV. 227 (1997); Robert Baxt, *Unconscionability Taken One Step Too Far?*, 25 AUSTL. BUS. L. REV. 301 (1997); Robert Baxt, *Unconscionable Conduct under Trade Practices Act*, 71 AUSTL. L.J. 432 (1997); Robert Baxt & Joel Mahemoff, *Unconscionable Conduct Under the Trade Practices Act—An Unfair Response By the Government: A Preliminary View*, 26 AUSTL. BUS. L. REV. 5, 13–15 (1998); Ross Buckley, *Unconscionability Amok, or Two Readily Distinguishable Cases?*, 26 AUSTL. BUS. L. REV. 323 (1998); Ross Buckley, *Sections 51AA and 51AC of the Trade Practices Act 1974: The Need for Reform*, 8 TRADE PRACTICES L.J. 5 (2000); Alan Tyree, *Performance Bonds and Section 51AA of the Trade Practices Act*, 8 J. BANKING & FIN. L. & PRAC. 338 (1997); and, Warren Pengilly, *Unconscionability: Are the Litigation Floodgates Opening in Relation to Commercial Transactions?*, 13 TRADE PRAC. L. BULLETIN 11 (1997).

2. For instance, the undertaking of the issuing bank to pay the beneficiary under a letter of credit is typically not supported by consideration, see *infra* text accompanying notes 46, 50.

one comes before them in a case. The case will typically be urgent—for celerity is of the essence with credits. Often it will be an application for interlocutory relief. And thus the scene is set for judicial misadventure: a novel instrument, which is not legally what it appears to be, requiring expeditious analysis.

Likewise, most non-specialist legal practitioners, when called upon to advise upon a letter of credit, will often have to do so quickly as time limits for dealing with letters of credit are often short. In such a situation it is natural to seek to understand the instrument in terms of concepts with which one is familiar, such as contracts and negotiable instruments, the principles of which may well mislead when applied to letters of credit.

This article seeks to illumine the legal nature of the letter of credit instrument, and catalogue the various sources of law and rules that can govern it; and, by doing so, render a service to those who must quickly come to grips with letter of credit law.

The article is in two parts. The first part examines the legal nature of the letter of credit by looking at its definition, operation, and history and by comparing it with negotiable instruments and contracts.<sup>3</sup> The second part considers the rules, customs, and regulations governing letters of credit and introduces the two fundamental principles of the law of letters of credit, the principle of independence and the principle of strict compliance, which in slightly varying form are applied to credits in all legal systems.

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3. There is an abundant literature on practical documentary credit operations. See, e.g., J.F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS* (rev. ed. 1996); E.P. ELLINGER, *DOCUMENTARY LETTERS OF CREDIT—A COMPARATIVE STUDY* (1970); HENRY HARFIELD, *BANK CREDITS AND ACCEPTANCES* (5th ed. 1974); BORIS KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS—A COMPARATIVE STUDY OF CONTEMPORARY COMMERCIAL TRANSACTIONS* (1966); Boris Kozolchik, *Letters of Credit*, in 9 *INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW* ch. 5 (J.S. Ziegel, ed. 1979); BROOKE WUNNICKE ET AL., *STANDBY AND COMMERCIAL LETTERS OF CREDIT* (2d ed. 1996); RAYMOND JACK ET AL., *DOCUMENTARY CREDITS* (3d ed. Butterworths 2001); PAUL TODD, *BILLS OF LADING AND BANKERS' DOCUMENTARY CREDITS* (3d ed. 1998); H.C. GUTTERIDGE & MAURICE MEGRAH, *THE LAW OF BANKERS' COMMERCIAL CREDITS* (7th ed. 1984); LAZAR SARNA, *LETTERS OF CREDIT: THE LAW AND CURRENT PRACTICE* (2d ed. 1986); MICHAEL ROWE, *GUARANTEES: STANDBY LETTERS OF CREDIT AND OTHER SECURITIES* (1987); Ljudevit Rosenberg, *The Law of International Documentary Credits: Principles, Liabilities and Responsibilities*, in *INTERNATIONAL CONTRACTS AND PAYMENTS* 51–67 (P. Šarčević & P. Volken eds., 1991); Clive M. Schmitthoff, *International and Procedural Aspects of Letters of Credit*, in *THE LAW OF INTERNATIONAL TRADE AND FINANCE* 227–42 (Norbert Horn ed., 1989).

## II. THE NATURE OF LETTERS OF CREDIT

### A. Definition

Letters of credit have been defined in a number of ways. The Uniform Customs and Practice for Documentary Credits<sup>4</sup> (U.C.P.) is a set of standard terms that is incorporated by reference into the overwhelming majority of documentary credits issued around the world.<sup>5</sup> Article 2 of the U.C.P. defines a letter of credit as:

[A]ny 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 to the order of a third party (the "Beneficiary"), or is to accept and pay bills of exchange (Draft(s)) drawn by the Beneficiary, or
- ii) authorises 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 document(s), provided that the terms and conditions of the Credit are complied with.<sup>6</sup>

Article 5 of the Uniform Commercial Code (U.C.C.) defines a letter of credit as a "definite undertaking . . . by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial

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4. INT'L CHAMBER OF COMMERCE, ICC UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS PUBLICATION NO. 500 (rev. 1993) [hereinafter U.C.P.].

5. The only jurisdiction in which credits are virtually ever issued not subject to the U.C.P. is the United States and this only because of a comprehensive body of national law on the letters of credit in Article 5 of the Uniform Commercial Code (U.C.C.); *see infra* text accompanying note 108. Even then the only credits issued without incorporating the U.C.P. are domestic ones for transactions entirely within the United States. When the U.C.C. and U.C.P. apply to the one credit, § 5-116(c) of the U.C.C. provides that to the extent of any conflict between the two sets of rules, the U.C.P. will prevail unless the term of the U.C.C. is one that cannot be varied by agreement. U.C.C. § 5-116(c) (2001). The provisions of the U.C.C. that cannot be varied by agreement are § 5-102(a)(9) (inapplicability to consumer transactions), § 5-102(a)(10) (only financial institutions to issue two-party credits), § 5-103(a) (applicability to letter of credit transactions), § 5-103(c) (general disclaimers not effective), § 5-103(d) (independence principle), § 5-106(d) ("perpetual" letters of credit), § 5-114(d) (issuer's consent to an assignment of proceeds), § 5-117(d) (subrogation rights), and § 1-102(3) (obligation of good faith). *See generally* U.C.C. (2001). Interestingly, in a virtually unique provision, the New York U.C.C. provides in art. § 5-102(4) that it will not apply to a letter of credit that is subject in whole or part to the U.C.P.; this exclusion was enacted at the request of a number of New York banks that believed the U.C.C. would interfere with their established credit business under the U.C.P. *See* Joseph J. Ortego & Evan H. Krinick, *Letters of Credit: Benefits and Drawbacks of the Independence Principle*, 115 BANKING L.J. 487, 492 (1988).

6. U.C.P. Art. 2 (1993).

institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value".<sup>7</sup>

Whether the letter of credit is defined as an "engagement" or an "undertaking", it has to be described in general legal terms and different people use different terms. We prefer to define the letter of credit functionally as an instrument, issued to a beneficiary by an issuer for the account of the applicant, by which the issuer promises it will honor a draft or a demand for payment provided the terms specified in the credit are met.<sup>8</sup>

### *B. Operation and Classification*

One way to discover the nature of letters of credit is to examine how they operate. Letters of credit may be categorized in many ways and into many different types. They have been compared with automobiles because both have been used for a long time and their functions have expanded and adapted to meet changes in society.<sup>9</sup> Different types of letters of credit may operate differently. However, modern letters of credit can be divided into two basic forms according to their distinctive function and usage: commercial letters of credit and standby letters of credit. Other types of letters of credit are best regarded as variations or "derivatives" of these two primary forms adapted to meet the special needs of particular transactions.

#### *1. Commercial Letters of Credit*

Commercial letters of credit are the traditional form of letters of credit created as a payment and financing mechanism for

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7. U.C.C. § 5-102(a)(10) (rev. 1995); *cf.* § 5-103(a) of the original Article 5 of the U.C.C., which defined a letter of credit as an "engagement"; *see also* U.C.C. § 5-114 Official Comment 1 (original version) (describing a letter of credit as "essentially a contract between the issuer and the beneficiary.") [hereinafter U.C.C. will refer to the Uniform Commercial Code, original U.C.C. art.5 as Article 5 of the original U.C.C., and U.C.C. art. 5 as the revised Article 5 of the U.C.C.].

8. For some earlier common law definitions *see, e.g.*, *Second Nat'l Bank of Toledo v. M. Samuel & Sons Inc.*, 12 F.2d 963, 966 (2d Cir. 1926); *Border Nat'l Bank of Eagle Pass v. Am. Nat'l Bank of San Francisco*, 282 F. 73, 77 (5th Cir. 1922); *Birkhead v. Brown*, 16 N.Y. 255, 5 Hill 634, 643 (N.Y. Sup. Ct. 1843), *aff'd*, 17 N.Y. 162, 163, 2 Denio 375, 377 (N.Y. 1845), *construed in* *Lafergue v. Harrison*, 9 P. 259, 261 (Cal. 1885); 2 JOHN W. DANIEL, A TREATISE ON THE LAW OF NEGOTIABLE INSTRUMENTS, § 1790, at 2009, § 1797a, at 2014 (6th ed. 1919); *Liggett v. Levy*, 136 S.W. 299, 301 (Mo. 1911).

9. Henry Harfield, *Who Does What to Whom: The Letter-of-Credit Mechanism*, 17 UCC L.J. 291 (1985).

international sales of goods. A prototypal commercial letter of credit operates as follows.

Assume a seller in Sydney wishes to sell some goods to a buyer in Shanghai. The seller and the buyer, however, may not know each other and each is concerned over the other's financial strength and reliability. The seller is worried that, after it has gone to the expense of loading and shipping the goods, the buyer may become insolvent or refuse to pay for the goods upon arrival. If the buyer does not pay, the seller may have to go to great expense to sue the buyer in Shanghai, an unfamiliar foreign jurisdiction, and incur further expense in disposing of the goods in an unfamiliar territory. Similarly, the buyer has no reason to trust the seller's solvency and reliability and is concerned that it may not get the number and quality of goods contracted for if it pays in advance or even worse, that the financial collapse of the seller will leave it without both the money and the goods.

To assuage each other's legitimate fears, the parties may agree to a compromise and arrange their transaction by way of a letter of credit. Under such an arrangement, the buyer agrees to go to a third party, normally a bank of good reputation in Shanghai, and apply for a letter of credit in favor of the seller. When the bank approves the creditworthiness of the buyer, accepts its application and issues the letter of credit, it agrees to assume the primary, direct, and independent obligation to honor the seller's draft presented under the letter of credit provided that complying documents specified in the letter of credit are tendered. The documents specified in a commercial letter of credit usually include a commercial invoice, an insurance policy, and a clean on-board bill of lading, which is a document of title evidencing the ownership of the goods.<sup>10</sup>

This example illustrates that in essence a typical commercial letter of credit transaction involves three parties and three transactions.<sup>11</sup> The three parties are:

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10. The credit mechanism is in this regard very flexible and the parties can draw the credit so as to serve and protect their interests. So, for instance, a credit may call for a certificate from an independent inspection service that the goods meet certain technical specifications, or, as in a recent case concerning a shipment of iron ore, certificates of analysis and of weight. *See Westpac Banking Corp. v. Stone Gemini*, [1999] 110 F.C.R. 434 (Austl.).

11. In practice, more often than not, more parties and transactions are involved. For example, the issuing bank notifies the seller, usually through a correspondent bank in the seller's location. The correspondent bank may be instructed to act as an advising bank, which is a mere intermediary transmitting information, or to add to its own undertaking as a confirming bank, or to participate in the transaction as a negotiating bank by purchasing the drafts drawn by the beneficiary. Sometimes, a letter of credit transaction may only involve two parties. This kind of letter of credit is known as two-

- 1) the buyer, known as the “applicant”, the “account party”, or the “customer”;
- 2) the seller, known as the “beneficiary”; and,
- 3) the bank, known as the “issuer”, the “issuing bank”, or “opening bank”.

The three transactions are:

- 1) the underlying transaction between the buyer and the seller, under which the seller agrees to sell the goods to the buyer and the buyer agrees to pay to the seller the purchase price by way of a letter of credit arrangement;
- 2) the transaction between the buyer and the bank, under which the bank agrees to issue the letter of credit in favor of the seller and the buyer agrees to reimburse the bank for the payment made under the letter of credit plus a commission; and,
- 3) the transaction between the bank and the seller, i.e., the letter of credit itself, under which the bank agrees to take the primary responsibility to honor the seller's draft provided it is accompanied by the required documents specified in the letter of credit.<sup>12</sup>

Such an arrangement has a high degree of commercial utility, and in the normal course of business benefits all parties concerned. Under this arrangement, the seller/beneficiary retains the ownership of the goods until it presents the documents to the issuer, at which time it is paid or its draft is accepted by the issuer. The seller faces almost no risk of non-payment as the credit of the issuing bank is substituted for that of the buyer. The buyer/applicant is, subject to the problem of fraud, assured that its money will not be released until the required documents (which are not only evidence indicating the seller has completed its obligation under the sales contract but also represent the ownership of the contracted goods) are presented to the paying bank. This also usually satisfies the seller's desire for cash and the buyer's desire for credit. Abuse of the system is restrained by the fact that neither the seller nor

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party letter of credit. For illustrations of two-party letters of credit see Gerald T. McLaughlin, *Two Party Letters of Credit: Two More Problems Than Three*, 4 J. BANKING & FIN. L. & PRAC. 226 (1993); Gerald T. McLaughlin & Neil B. Cohen, *Commercial Law*, 9 N.Y.L.J., July 14, 1993, at 3.

12. However, in some types of letters of credit, no draft may be involved. Where a draft is involved in the letter of credit transaction, according to Ellinger the issuer may be committed to perform its promise in one of the following ways: (1) to pay cash against the tender of documents; or (2) to accept the draft drawn on it by the beneficiary in the amount of the purchase price; or (3) to negotiate the draft drawn by the seller on the buyer. The first type prevails in Continental Europe and South America, the second type is the most common type in the United Kingdom, in many Commonwealth countries and the United States, and the third type is common in South East Asia. See E.P. Ellinger, *Letters of Credit*, in *THE TRANSNATIONAL LAW OF INTERNATIONAL COMMERCIAL TRANSACTIONS* 241, 244 (Norbert Horn & Clive M. Schmitthoff eds., 1982).

the buyer is ever in control of the goods and the money at the same time.<sup>13</sup> The bank, whose business is providing services, in turn gets paid a fee. Although it may seem that the bank assumes the risk of extending credit to the buyer until reimbursed, the bank usually takes security, a pledge, over the tendered documents, and often over other assets from the buyer as general security as well.<sup>14</sup>

## 2. Standby Letters of Credit

Standby letters of credit were developed in the 1950s because of “the restrictive scope of the powers conferred on American banks by statutes and by charters.”<sup>15</sup> They became widely used in the United States in the 1960s and have been increasingly popular worldwide since the 1970s.<sup>16</sup>

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13. But one prominent letter of credit expert has asserted that, because of the principle of independence in the law of letters of credit, the buyer is in “an absurdly vulnerable position” under the letter of credit arrangement. Maurice Megrah, *Risk Aspects of the Irrevocable Documentary Credit*, 24 ARIZ. L. REV. 255, 256 (1982). The writer agrees on this point, and intends to explore what may be done through this research.

14. However, some commentators are of the view that the bank’s security interest over the goods or the documents evidencing the ownership of the goods is in practice not an important component of a letter of credit arrangement. “It may be misleading to suggest that bank issuers are always concerned about their security interest in the goods. It is probably fair to say that they do not mind having the security interest but are more concerned about the applicant’s ability to reimburse the issuer when it pays the beneficiary.” DOLAN, *supra* note 3, at 8–23, n.111.

15. E.P. Ellinger, *Standby Letters of Credit*, 6 INT’L BUS. LAW. 604, 611 (1978). See also U.C.C. Article 5, Prefatory Note (1995); James F. Byrne, *Foreword to Boris Kozolchuk, Bank Guarantees and Letters of Credit: Time for a Return to the Fold*, 11 U. PA. J. INT’L BUS. L. 1, 4 (1989); Eric E. Bergsten, *A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, 27 INT’L LAW. 859, 865 (1993).

16. Ross P. Buckley, *Potential Pitfalls with Letters of Credit*, 70 AUSTL. L.J. 217, 227 (1996). They are so popular that the money amount involved in standby letters of credit is far greater than that of commercial letters of credit. It was stated in 1989 that “standby letters of credit in the United States alone have grown to approximately \$175 billion, dwarfing the approximately \$30 billion outstanding in commercial credits.” Byrne, *supra* note 15, at 4, which is consistent with a more recent figure provided by the I.C.C. Banking Commission in 1998: “The amounts of standbys outstanding in value terms exceed those of commercial credits by a ratio of more than 5:1.” I.C.C. The World Business Organization, at <http://www.iccwbo.org/home> (last visited Sept. 30, 2002). However, different views seem to exist with respect to the reasons for their original development. It has been stated that,

[s]tandbys are not, however, by any means a U.S. device since they are used extensively in more than 30 countries in North America, South America, Australia and Asia. Nor is their use, as is sometimes suggested, as a result of peculiarities in the U.S. regulatory scheme under which U.S. banks are generally restricted from issuance of guarantees. The standby represents a deliberate attempt engineered in the early 1950’s in large part under the auspices of Leonard A. Back of Citibank and Henry Harfield of Shearman & Sterling who almost single-handedly led and shaped U.S. letter of credit law



Standby letters of credit legally operate in the same basic framework as commercial letters of credit. A simple standby letter of credit transaction also involves three parties (the applicant, the issuer and the beneficiary) and three transactions (the underlying transaction, the application agreement, and the letter of credit itself).

However, unlike commercial letters of credit, which are generally used to effect or facilitate payment of international sales of goods, standby letters of credit are used in a wide range of transactions. In the words of Professor Dolan: "There are virtually no limits to the variety of transactions that the standby credit can serve. In principle, standby credits can be used in any contract where the performance of one party is executory."<sup>17</sup>

The potential breadth of use of standby letters of credit is perhaps most strikingly demonstrated by the Canadian case of *Rosen v. Pullen*, where a standby letter of credit was used to guarantee performance of a marriage promise.<sup>18</sup>

Nonetheless, there are some industries and transactions where standby letters of credit are used more often than in others. In particular, standby letters of credit are used: 1) in the construction industry, to protect the owner of a construction project against late performance, faulty performance or nonperformance of a contractor; 2) in the financial industry, to bolster corporate issues of commercial paper or take corporate bond issues on the long term market, as a company can take advantage of the credit rating of a reputable bank; and, 3) in international sales of goods, to guarantee service to or performance of the machinery or equipment purchased.<sup>19</sup>

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during the vital decades that standbys were coming to the fore. Their remarkable success was to create a genre of independent or abstracted assurances not by the fashioning of a new instrument but through the extension of the tried and true letter of credit.

Byrne, *supra* note 15, at 4.

17. DOLAN, *supra* note 3, 1-24. See also Boris Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 319, 320 (1982) ("the standby credit can encompass virtually every obligation known to man." *Id.*).

18. *Rossen v. Pullen*, [1981] 126 D.L.R.3d 62.

19. For discussions on the use of standby letters of credit see Cassandra E. Joseph, *Letters Of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816 (1977); Boris Kozolchyk, *The Financial Standby: A Summary Description of Practice and Related Legal Problems*, 28 UCC L.J. 327 (1996); Daniel E. Murray, *Letters of Credit in Nonsale of Goods Transactions*, 30 BUS. LAW. 1103 (1975); ROWE, *supra* note 3; Reade H. Ryan, *Letters of Credit Supporting Debt for Borrowed Money: The Standby as Backup*, 100 BANKING L.J. 404 (1983).

### 3. *Distinction between Commercial and Standby Credits*

Although commercial letters of credit and standby letters of credit have the same “family name”,<sup>20</sup> and although in legal analysis they are of the same nature, nevertheless there are major differences between the two.

First, the commercial purposes of the two kinds of letters of credit are distinctive. Although the commercial letter of credit provides the beneficiary with a secure mechanism for payment due to its regular performance of a commercial obligation, the standby letter of credit is designed as a default instrument to provide security or indemnity to the beneficiary for the hopefully unlikely contingency of the applicant’s defective or non-performance. Because most underlying contracts are expected to be adequately performed, the issuer of the commercial letter of credit normally expects to pay, whereas the issuer of the standby letter of credit does not normally expect to pay. These expectations seem to be borne out in practice.<sup>21</sup>

Secondly, there is a distinction of documentation between a commercial letter of credit and a standby letter of credit. While a commercial letter of credit is payable upon the presentation by the beneficiary of documents, which usually include a bill of lading and a commercial invoice, showing that it has properly performed the underlying contract, payment of a standby letter of credit is triggered by the presentation of a document attesting that the applicant has not, or has not properly, performed its obligation under the underlying contract.

Thirdly, a standby letter of credit is in its most common form more risky than a commercial letter of credit. While the commercial letter of credit provides a high degree of security by requiring documents that confer title or at least evidence of shipment of apparently conforming goods which are often generated by independent third parties, the requirement for a claim under a standby letter of credit is often only a written statement by the beneficiary itself, although some standby letters of credit may require documents issued by independent third parties, such as a certificate of an engineer or a decision by a court or arbitrator. Therefore, “the potential for sharp practice and outright fraud is far

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20. Henry Harfield, *Guaranties Standby Letters of Credit, and Ugly Ducklings*, 26 UCC L.J. 195, 197 (1994).

21. INT’L CHAMBER OF COMMERCE, ICC COMMERCIAL CRIME BUREAU SPECIAL REPORT—PRIME BANK INSTRUMENT FRAUDS 16 (1994) (“The fact is that most of these standby credits . . . are called only in a ‘default’ or ‘non-performance’ situation and the bankers’ estimation suggests that they are called in less than one per cent of all outstanding credits/guarantees.” *Id.*). *But see* DOLAN, *supra* note 3, at 7–42 (“Often beneficiaries draw on standby credit when the applicant is not in default. Standby credits are sometimes ‘direct pay’ credits under which the parties expect the beneficiary to draw.” *Id.*).

greater in most cases in the use of standby credits than it is with trade-related credits.”<sup>22</sup> In other words, payment of a standby letter of credit may be demanded and obtained even though the contingency has not in fact occurred. If this happens, the applicant, in addition to having performed its obligation in the underlying transaction, will have to reimburse the bank that has made the payment in accordance with the terms of the credit. This risk may in some cases have to be borne by the bank if the applicant is found to be insolvent.

#### 4. *Letters of Credit and Guarantees*

As letters of credit and bank guarantees can at times be used interchangeably,<sup>23</sup> guarantees will briefly be considered. However, because “[b]oth terminologically and conceptually the entire area of guarantees is, or at least was marked by confusion, uncertainty and inconsistency,”<sup>24</sup> it is necessary first “to clear up some terminological confusion arising out of the lack of consistency in the use of labels,”<sup>25</sup> According to Professor Roy Goode,

[i]n origin the word “guarantee” denotes a suretyship contract in which the guarantor, or surety, assumes a liability to answer for the debt or default of another. The guarantor’s liability is therefore secondary in character in that the guarantor’s payment obligation does not arise until the principal debtor has defaulted and is in principle limited to the liability of the principal debtor.<sup>26</sup>

This kind of guarantee is usually known as an “accessory”, or “secondary”, “ancillary”, or “conditional” guarantee. The International Chamber of Commerce (I.C.C.) has formulated a set of rules, the Uniform Rules for Contract Bonds,<sup>27</sup> primarily to deal with guarantees or bonds of this kind.

However, the term “guarantee” is now “also used to denote undertakings which are documentary in character”,<sup>28</sup> or stand “on a similar footing to

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22. Buckley, *supra* note 16, at 228.

23. RAYMOND JACK, DOCUMENTARY CREDITS 195 (1991). See also ROELAND BERTRAMS, BANK GUARANTEES IN INTERNATIONAL TRADE 268 n.46 (2d ed. 1996) (“In dealing with the concept of fraud, American courts, like English courts, do not distinguish between documentary credits and standby letters of credit (independent guarantees).” *Id.*).

24. BERTRAMS, *supra* note 23, at 3.

25. ROY M. GOODE, COMMERCIAL LAW 1030 (2d ed. 1995).

26. *Id.*

27. INT’L CHAMBER OF COMMERCE, ICC PUBLICATION NO. 524 (1993).

28. GOODE, *supra* note 25, at 1030.

a letter of credit”.<sup>29</sup> Guarantees of this kind share the legal character of a letter of credit, in that the issuer’s obligation of payment is triggered simply by presentation by the beneficiary of complying documents or a simple demand, and the issuer is not concerned with whether there has been actual default by the principal. The two fundamental principles of letters of credit, the principle of independence and the principle of strict compliance, have been consistently applied to this kind of guarantee by the courts. This kind of guarantee also has many names: bank guarantee, first demand guarantee, independent guarantee, on-demand guarantee, performance guarantee, unconditional bond, or performance bond. To distinguish the first category of guarantees from the second, guarantees of the first kind will be referred as “accessory guarantees” and guarantees of the second kind will be referred as “independent guarantees”.

While standby letters of credit and independent guarantees may serve the same commercial purpose as accessory guarantees, they are legally different in several aspects:

- 1) Payment of standby letters of credit or independent guarantees is triggered by presentation of documents or sometimes a simple demand, not actual default of the applicant, whereas payment of accessory guarantees is triggered by actual default of the underlying contract by the principal, determination of the principal’s default being based on factual investigation.
- 2) The amount of payment under a standby letter of credit or independent guarantee to the beneficiary is the amount specified in the letter of credit or guarantee, the amount of payment under an accessory guarantee is the actual damage caused by the principal’s default.
- 3) While standby letters of credit and independent guarantees are normally issued by banks, accessory guarantees are often issued by specialised surety companies.

Because independent guarantees may properly be seen as legal synonyms of standby letters of credit, the United Nations Commission on International Trade Law (UNCITRAL) has regulated both of them together in the Convention on Independent Guarantees and Standby Letters of Credit (UNCITRAL Convention). As accessory guarantees are legally different from letters of credit, they are outside the scope of this work.

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29. *Edward Owen Engineering, Ltd. v. Barclays Bank Int’l, Ltd.*, [1978] 1 Q.B. 159, 170–71. *See also* *Bolivinter Oil S.A. v. Chase Manhattan Bank*, [1984] 1 Lloyd’s Rep. 251, 257; *Deutsche Rückversicherung AG v. Walbrook Ins. Co., Ltd. and Others*, [1994] 4 All ER 181, 194; *R.D. Harbottle (Mercantile), Ltd. v. Nat’l Westminster Bank, Ltd.*, [1977] 2 All ER 862, 870.

*C. Historical Development**1. Early Forms*

A brief survey of the history of the letter of credit is helpful for understanding the instrument, even if that history is not entirely beyond dispute. Some writers have suggested the precursor of the modern letter of credit was a twelfth century form of bill of exchange used in the Mediterranean region, known as the "letter of payment"<sup>30</sup> or "letter of exchange",<sup>31</sup> under which the creditor requested or ordered its debtor to pay a third party. Others say the forerunner of the letter of credit was the open letter of credit of the medieval age.<sup>32</sup> An open letter of credit, according to Story, is:

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 advances to a third person.<sup>33</sup>

While the relationship between the letter of payment and the open letter of credit has not been completely clarified, it seems that the open letter of credit operated in a similar way to the letter of payment. The open letter of credit was an instrument whereby the issuer asked its correspondent to advance money to its customer. It was, just as the letter of payment, an order, but not a promise of payment. Moreover, the open letter of credit was also used to fulfill the purpose of providing a person abroad with money and thus obviating the necessity of their carrying money with them, as did the bill of exchange.<sup>34</sup>

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30. BORIS KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS—A COMPARATIVE STUDY* 4 (1966). For a detailed discussion of the letter of payment see Abbott Payson Usher, 1 *THE EARLY HISTORY OF DEPOSIT BANKING IN MEDITERRANEAN EUROPE* ch. 3 (1943).

31. DOLAN, *supra* note 3, at 3–5.

32. ELLINGER, *supra* note 3, at 24.

33. JOSEPH STORY, *COMMENTARIES ON THE LAW OF BILLS OF EXCHANGE, FOREIGN AND INLAND, AS ADMINISTERED IN ENGLAND AND AMERICA* § 459 (4th ed. 1860), *cited in* ELLINGER, *supra* note 3, at 5; A.G. DAVIS, *THE LAW RELATING TO COMMERCIAL LETTERS OF CREDIT* 1 (3d ed., Pitman 1963).

34. DAVIS, *supra* note 33, at 2.

## 2. *Buyers' Credits*

Buyers' credits were promises made by merchants or buyers themselves to pay or accept drafts of the sellers. They emerged when the bill of exchange attained its formal status as a negotiable instrument in Europe in the seventeenth century.<sup>35</sup> The buyer's credit was an instrument described as follows:

A merchant doth send his friend or servant . . . to buy commodities or take up money for some purpose, and doth deliver unto him an open letter directed to another merchant requiring him that his friend, the bearer of that letter have occasion to buy commodities or take up moneys . . . that he will procure him the same and will provide him the money or pay him by exchange.<sup>36</sup>

Buyers' credits could only be issued in favor of a designated person and they had to contain a specification of a sum certain or of a maximum amount. They contained promises by the issuers to reimburse the payers. However, these letters of credit could not be protested, even in the case of nonpayment. Because of this, the parties could not comfortably rely on this kind of letter of credit as the source of their respective rights and duties. Their use was confined to cases where there was constant dealing between two or more mercantile houses that normally traded on an open account or credit basis.<sup>37</sup>

## 3. *Modern Letters of Credit*

It is not entirely clear when letters of credit began to take their modern form. However, most writers seem to agree that modern letters of credit emerged around the middle of the nineteenth century.<sup>38</sup>

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35. Boris Kozolchyk, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 AM. J. COMP. L. 395, 396-97 (1965). There are different views over the time of the appearance of the buyer's credit. Professor Ellinger takes the view that the buyer's credit emerged in the 1820s when merchant-bankers began to use them to finance international sales of goods. In the buyer's letter of credit, the merchant-bankers themselves were the consignees of the goods. See ELLINGER, *supra* note 3, at 27. But according to Professor Dolan, the buyer's credit emerged in the thirteenth century. See DOLAN, *supra* note 3, at 3-6.

36. GERARD MALYNES, *THE ANCIENT LAW MERCHANT* 104 (1629), *quoted in* Kozolchyk, *supra* note 35, at 396-97.

37. Kozolchyk, *supra* note 35, at 397-98.

38. Professor Llewellyn, upon examining the early nineteenth century U.S. letter of credit cases, concluded that in the United States the commercial letter of credit emerged from the competition of factorage houses for business, which led to the issuance of promises to accept bills of exchange against shipments. The specialization of banking activities to the point of becoming independent of factoring, the growth of manufacturers, and the use of the telegraph as a means of communicating the terms of contracts of sale at a fixed price were the main factors in the significant volume of issuances in the early 1860s. For Llewellyn's findings see Harfield, *supra* note 3, 158-62. Professor Ellinger suggested that modern documentary credits emerged around 1840 and became "respectable" about 1849. See ELLINGER, *supra* note 3, at 29.

Letters of credit developed fully after the First World War.<sup>39</sup> Several factors helped the increasing use and shaped the letter of credit at that time:

- 1) Great increase in world trade;
- 2) Fluctuations in foreign exchange;
- 3) Unstable economies: merchants might prosper today, but could become insolvent overnight; and,
- 4) Involvement of dishonest people in commercial transactions.

Moreover, once merchants became accustomed to obtaining security for payment by way of letters of credit, they were not likely to discontinue the practice.<sup>40</sup>

This outline of the history of the letter of credit reveals it as a creature of international commerce. But the resemblance, if any, between the modern letter of credit and its predecessors is "only superficial".<sup>41</sup> For example, there are great differences between the open letter of credit and the modern letter of credit:

- 1) The object of today's letter of credit is to guarantee the payment of the purchase price in international sales of goods; the open letter of credit, on the other hand, was used to raise funds for merchants traveling overseas. A merchant who did not wish to carry cash but wished to obtain credit or cash in countries where it would have found it difficult to do so otherwise could ask its banker to issue an open letter of credit for it. On the faith of the open letter of credit, the merchant was able to obtain advances from foreign bankers against its drafts.
- 2) While the issuer of a modern letter of credit promises to pay a seller who has already entered into a contract for the sale of the goods provided the seller submits the required documents, the issuer of an open letter of credit asked others to advance money to his customer.<sup>42</sup>
- 3) In a modern letter of credit the credit is given to some third party with whom the customer has some commercial dealings; in the open letter of credit the letter was given to the banker's customer.

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39. See, e.g., ELLINGER, *supra* note 3, at 37; Boris Kozolchyk, *Symposium, Preface*, 24 ARIZ. L. REV. 235 (1982); Phillip W. Thayer, *Irrevocable Credits in International Commerce: Their Legal Nature*, 36 COLUM. L. REV. 1031 (1936). For a suggestion that letters of credit originated after the First World War see *The Kronprinsessan Margarita* [1921] 1 A.C. 486, 510 (Sumner, L.).

40. ELLINGER, *supra* note 3, at 37.

41. KOZOLCHYK, *supra* note 3, at 4. See also H.N. FINKELSTEIN, *LEGAL ASPECTS OF COMMERCIAL LETTERS OF CREDIT* 4, n.5 (1930).

42. ELLINGER, *supra* note 3, at 6-7.

## D. Letters of Credit, Negotiable Instruments, and Contracts

### 1. Letters of Credit and Negotiable Instruments

The historical development of the letter of credit also reveals it to have a close relationship with the bill of exchange. In the early days, it was sometimes difficult to distinguish between a letter of credit and a bill of exchange. Some courts therefore viewed the letter of credit as being in the nature of a negotiable instrument.<sup>43</sup> And there are indeed similarities between the two instruments. In Dolan's words,

[s]upport for the analogy between credits and negotiable instruments is apparent in the principle of independence, which renders the letter of credit independent of the underlying transaction out of which it grows. This rule is similar to that for negotiable instruments, which are generally independent of the transaction that underlies them. Further support the analogy is evident in the majority view that courts should construe credits strictly and thus enhance the rapid payment of them without extraneous inquiry, all in a fashion similar to the law's attitude on satisfaction of negotiable instruments.<sup>44</sup>

However, a letter of credit is different from a negotiable instrument. First, a negotiable instrument is "one which, by statute or mercantile usage, may be transferred by delivery and endorsement to a bona fide purchaser for value in such circumstances that he takes free from defects in the title of prior parties."<sup>45</sup> A negotiable instrument is an unconditional promise. But the letter of credit usually does not have that kind of negotiability. The letter of credit is normally a conditional promise. Performance of the issuer's obligation is often conditioned upon the beneficiary's delivery of specified documents. Nonpayment by the issuer gives rise to an action by the beneficiary for breach of contract, in which the beneficiary must plead and prove due performance on its part. The issuer may defend such an action by showing that the beneficiary failed to perform its obligations under the letter of credit. Secondly, a negotiable instrument is itself a form of contract which requires consideration, but a letter of credit does not require consideration.<sup>46</sup>

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43. See, e.g., *Second Nat'l Bank of Toledo v. M. Samuel & Sons, Inc.*, *supra* note 8. In more recent times, courts have continued to compare letters of credit with negotiable instruments and to regard them as similar. In *Power Curber Int'l Ltd. v. Nat'l Bank of Kuwait SAK*, [1981] 3 All E.R. 607, 612, Lord Denning stated: "A letter of credit is like a bill of exchange given for the price of goods. It ranks as cash and must be honoured. No set-off or counterclaim is allowed to detract from it . . . . Whereas a bill of exchange is given by buyer to seller, a letter of credit is given by a bank to the seller with the very intention of avoiding anything in the nature of a set-off or counterclaim." *Id.* at 613.

44. DOLAN, *supra* note 3, at 6-77.

45. GOODE, *supra* note 25, at 519.

46. *Id.* For a special comparison between the letter of credit and the negotiable instrument see Comment, *Letters of Credit—Negotiable Instruments*, 36 YALE L.J. 245 (1926). See also *Heritage Housing Corp. v. Ferguson*, 651 S.W.2d 272 (1983);



## 2. *Letters of Credit and Contracts*

Across the whole transaction, the letter of credit normally involves several contracts. In addition, the letter of credit itself is a promise and carries some characteristics of a contract. As a result, many courts and commentators have treated the letter of credit as a kind of contract, often as a contract for the purchase of documents.<sup>47</sup> The contract which for a long time has been regarded as bearing the strongest resemblance to a documentary credit is a sale of goods on C.I.F. terms. As noted above, even Official Comment to the prior version of U.C.C. Article 5 described the letter of credit as “essentially a contract between the issuer and the beneficiary.”<sup>48</sup>

However, the letter of credit does not fit into the traditional rules governing a contract in several respects. First, a letter of credit is issued by the issuer to the beneficiary. It takes effect from the moment when it is issued, and therefore the theory of offer and acceptance of contract law does not apply.<sup>49</sup> Secondly, a letter of credit is an undertaking by the issuer to substitute its financial strength for that of the applicant and it does not need consideration from the beneficiary to the issuer for the credit to be binding.<sup>50</sup> Thirdly, as Professor Ellinger has pointed out:

Although there is a similarity between the handling of documents under c.i.f. contracts and between the handling of documents by a banker under a letter of credit, nevertheless, the difference is that c.i.f. contracts are not contracts for the purchase of documents, but contracts for the purchase of goods evidenced by the delivery of documents. In documentary credits the banker is concerned solely with documents.<sup>51</sup>

It is therefore “most accurate to say that credits are *sui generis* and that the law of contracts supplements the law of credits only to the extent that

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Philadelphia Gear Corp. v. FDIC, 587 F. Supp. 294 (1984); Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172 (1977).

47. ELLINGER, *supra* note 3, at 182. See, e.g., Wells Fargo Nevada Nat'l Bank of San Francisco v. Corn Exchange Nat'l Bank, 23 F.2d 1 (1927); Crocker First Nat'l Bank of San Francisco v. De Sousa, 27 F.2d 462 (1928).

48. U.C.C. § 5-114, Official Comment 1, Original U.C.C. art. 5 (1995).

49. U.C.C. § 5-106(a), Original U.C.C. art. 5 (1995); (“A letter of credit is issued and becomes enforceable according to its terms against the issuer when the issuer sends or otherwise transmits it to the person requested to advise or to the beneficiary.” *Id.*). For a case rejecting the offer and acceptance theory see *Amoco Oil Co. v. First Bank & Trust Co.*, 759 S.W.2d 877 (1988).

50. Revised U.C.C. § 5-105 provides, “[c]onsideration is not required to issue, amend, transfer, or cancel a letter of credit, advice or confirmation.” U.C.C. § 5-105 (rev. 1995).

51. ELLINGER, *supra* note 3, at 199.

contract principles do not interfere with the unique nature of credits".<sup>52</sup> If the letter of credit is a kind of contract, it is, after all, a very special one.<sup>53</sup> Professor Dolan has observed that the use of the term "contract" to describe a letter of credit is "unfortunate".<sup>54</sup>

### E. Summary

From the foregoing discussion, it can be seen why the letter of credit has been defined as either an "arrangement" or an "undertaking". The letter of credit is a creature of the law merchant. It is a "unique device",<sup>55</sup> or "a new type of mercantile specialty[;]"<sup>56</sup> which sits "uneasily between two bodies of established legal doctrine: the law of contract and the law of negotiable instruments";<sup>57</sup> it is neither pure contract nor pure negotiable instrument but a little bit of each mixed in with a good amount of its own unique jurisprudence.

In summary, the letter of credit is a mercantile specialty which is distinctive from any other instrument. No terms other than letter of credit may be used precisely to label it. In other words, a letter of credit is a letter of credit; it is nothing else. When dealing with letters of credit, their distinctiveness must always be kept in mind.

## III. THE LEGAL FRAMEWORK OF LETTERS OF CREDIT

### A. Sources of Law

The law of letters of credit has developed largely through custom. "Many of its operative rules, regardless of geography or legal system, have emerged from the customs of bankers dealing with importers and exporters, and with shipping and insurance companies."<sup>58</sup> Those customs now are embodied largely in the U.C.P., a product of the I.C.C. Besides the U.C.P., the I.C.C. has also introduced the Uniform Rules for

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52. DOLAN, *supra* note 3, at 2-5.

53. See, e.g., *East Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co.*, 593 F.2d 598, 603 (1979). ("[A] letter of credit simply is not an ordinary contract. The letter of credit is a unique device developed to meet specific needs of the marketplace." *Id.*).

54. DOLAN, *supra* note 3, at 2-5.

55. *Id.* at 3-2. For a discussion of various common law theories advanced to explain the nature of the letter of credit see W.E. McCurdy, *Commercial Letters of Credit*, 35 HARV. L. REV. 539 (1922); Carl A. Mead, *Documentary Letters of Credit*, 22 COLUM. L. REV. 297 (1922). It has been described in one case as a "statutory" undertaking. See *San Diego Gas & Electric Co. v. Bank Leumi*, 42 Cal. App. 4th 928, 934-35 (1996).

56. KOZOLCHYK, *supra* note 30, at 421.

57. Guy W. Smith, *Irrevocable Letters of Credit and Third Party Fraud: The American Accord*, 24 VA. J. INT'L L. 55, 71 (1983).

58. KOZOLCHYK, *supra* note 3, at 10.

Contract Guarantees (U.R.C.G.), the Uniform Rules for Demand Guarantees (U.R.D.G.) and the International Standby Practices (I.S.P.98) for independent guarantees and/or standby letters of credit. Apart from the I.C.C. rules, UNCITRAL has, as mentioned above, attempted to set up a universal legal framework for independent guarantees and standby letters of credit with the UNCITRAL Convention.

Due to the highly international character of letters of credit, few individual countries in the world have introduced special legislation governing letters of credit. Where there is any, with the exception of Article 5 of the U.C.C. in the United States, "[i]t tends to consist of only a few provisions often of a general nature."<sup>59</sup> In some jurisdictions, court decisions have constituted an important part of the law of letters of credit. Legal writings or "doctrinal materials" are also considered as supplementary to the law of letters of credit.<sup>60</sup>

The following discussion will introduce generally the I.C.C. rules, the UNCITRAL Convention and Article 5 of the U.C.C.

### *I. U.C.P.*

The U.C.P. is now nearly seventy years old. In view of the international character of letters of credit, it is not surprising to see that the drive for uniformity of the rules governing them commenced at an early stage. Pioneering efforts were made on a national basis. The first important step towards achieving uniformity was the attempt made by the I.C.C. in Vienna in 1933, when it issued the U.C.P. 1933 version.<sup>61</sup> This version was adopted by bankers in some European countries and, on an individual basis, by some banks in the United States. However, banks in the United Kingdom and most Commonwealth countries refused to adopt it.<sup>62</sup>

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59. Stand-by Letters of Credit and Guarantees, *Report of the Secretary-General*, UNCITRAL, 21st Sess., pt. 2, at 11, U.N. Doc. A/CN.9/301 (1988). According to Professor Kozolchyk, in the civil law world only Colombia, El Salvador, Greece, Guatemala, Honduras, Lebanon, Mexico, and Syria have any statutory rules on the letter of credit; and, the only country in the common world is the United States. See KOZOLCHYK, *supra* note 3, at 10. The PRC is in the process of formulating detailed provisions governing letters of credit.

60. KOZOLCHYK, *supra* note 3, at 10.

61. INT'L CHAMBER OF COMMERCE, ICC BROCHURE NO. 82 (1933).

62. E.P. Ellinger, *The Uniform Customs—Their Nature and the 1983 Revision*, LLOYD'S MAR. & COM. L.Q. 578, 578–79 (1984).

There was then no significant development for nearly twenty years. It was not until 1951 that the U.C.P. was subjected to a revision and a new version<sup>63</sup> was adopted by the I.C.C.'s 13th Congress held in Lisbon. This version was accepted by bankers of many countries in Europe, Asia, Africa, and America. However, bankers in the United Kingdom again rejected this version, although "[m]any Commonwealth banking communities toed the line."<sup>64</sup>

The U.C.P. was revised again in 1962. "One of the main objects of the exercise was to evolve a system that would be of world-wide application. To this end, it was necessary to adapt it to the needs of Britain and the Commonwealth. The 1962 revision achieved this breakthrough."<sup>65</sup>

Technological developments, especially the far-reaching container revolution, and the influx of new banks into the market led to further revision of the U.C.P. in 1974.<sup>66</sup> "On this occasion the I.C.C. was assisted by UNCITRAL. Banking organizations in socialist countries, which are not members of the I.C.C., made contributions through an *ad hoc* Working Party. . . . The 1974 Revision attained world-wide acclaim. . . . The 1974 draftsmanship was a considerable improvement on that of the earlier versions."<sup>67</sup>

The U.C.P. was revised again in 1983 to keep up with the changes of the law in the field. The 1983 version of the U.C.P.<sup>68</sup> widened the scope of its application and introduced changes necessitated by technological developments. This version was particularly intended to address the following issues: 1) the negotiation of the documents under a letter of credit, because the 1974 version did not indicate whether a bank that was not specifically nominated in the credit was entitled to negotiate; 2) the

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63. INT'L CHAMBER OF COMMERCE, ICC BROCHURE NO. 151 (1951). For a critical analysis of this version see Soia Mentschikoff, *Letters Of Credit: The Need for Uniform Legislation*, 23 U. CHI. L. REV. 571 (1956).

64. Ellinger, *supra* note 62, at 579. For the differences between the U.C.P. and the practice of the British banks see Rice & Thorne, *The Uniform Customs and Practice for Commercial Documentary Credits*, 56 CAN. BANKER 53 (1949).

65. Ellinger, *supra* note 62, at 580. The 1962 version was published as INT'L CHAMBER OF COMMERCE, ICC BROCHURE NO. 222 (1962), which was effective from July 1, 1963.

66. INT'L CHAMBER OF COMMERCE, ICC BROCHURE NO. 290 (1975) (effective from Oct. 1, 1975 and adopted by bankers in about 170 countries). See Ellinger, *supra* note 62, at 578.

67. Ellinger, *supra* note 62, at 580. For more discussion about the 1974 U.C.P. see Elijah E. Jhirad, *Uniform Customs and Practice for Documentary Credit, 1974 Revision: the Principle Emendations of the 1962 Text*, 9 UCC L.J. 109 (1962); see also Note: *Documentary Letters of Credit and the Uniform Customs and Practice for Documentary Credits (1974 Revision): A Selective Analysis*, 3 J. CORP. L. 147 (1977); B.S. Wheeble, *Uniform Customs and Practice for Documentary Credits (1974 Revision)*, J. BUS. L. 281 (1975).

68. INT'L CHAMBER OF COMMERCE, ICC BROCHURE NO. 400 (1984) (effective from Oct. 1, 1984).

application of the U.C.P. to new types of letters of credit, particularly standby letters of credit and deferred payment letters of credit; and, 3) the transmission of letters of credit and documents issued thereunder by the new technology, because it was possible to transmit letters of credit through special networks such as SWIFT,<sup>69</sup> instead of using the traditional means of telex and telegrams.<sup>70</sup> Starting with this version, the U.C.P. has expressly indicated that it applies to both commercial and standby letters of credit.<sup>71</sup>

The U.C.P. was revised again in 1993 to "address new developments in transport industry and technological applications. It is also intended to improve the functioning of the U.C.P. Some surveys indicate that approximately fifty percent of the documents presented under the Documentary Credits were rejected."<sup>72</sup> Significantly, "[t]his is the first revision in which law professors and lawyers have participated"<sup>73</sup> besides bankers, who have always dominated the formulation of the U.C.P.<sup>74</sup>

69. Society for Worldwide Interbank Financial Telecommunications, an independent network run by the banks.

70. Ellinger, *supra* note 62, at 582. For more discussion about U.C.P. 400 see James E. Byrne, *The 1983 Revision of the Uniform Customs and Practice for Documentary Credits*, 102 BANKING L.J. 151 (1985); David J. Cannon, *The Uniform Customs and Practice for Documentary Credits: The 1983 Revision*, 17 UCC L.J. 42 (1984); Cornelius J. Chapman, Jr., *The 1983 Revisions to the Uniform Customs and Practice for Documentary Credits*, 90 COM. L.J. 13 (1985); Charles del Busto, *Operational Rules for Letters of Credit: Effect of New Uniform Customs and Practice Rules*, 17 UCC L.J. 298 (1985); Henry Harfield, *An Agnostic View*, 45 BROOK. L. REV. 1 (1990); Boris Kozolchyk, *The 1983 UCP Revision Trade Practices and Court Decisions: A Plea for a Closer Relationship*, 9 CAN. BUS. L.J. 214 (1984); Clive M. Schmitthoff, *The New Uniform Customs for Letters of Credit*, 1983 J. BUS. L. 193.

71. U.C.P. art 1 (1993). However, "[e]ven though the UCP did not address standbys until the 1983 revision (U.C.P. 400), standbys had been regularly issued subject to both the 1962 revision (U.C.P. 222) and the 1974 revision (U.C.P. 290)." James E. Byrne, *The International Standby Practices (ISP98): New Rules for Standby Letters of Credit*, 32 UCC L.J. 149, 153, n.8 (1999).

72. Charles del Busto, *Preface to INT'L CHAMBER OF COMMERCE, ICC UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS 4* (1993).

73. Ross P. Buckley, *The 1993 Revision of the Uniform Customs and Practice for Documentary Credits*, 28 GEO. WASH. J. INT'L L. & ECON. 265 (1995). There were ten members in the Working Group of the I.C.C. Commission on Banking Technique and Practice for the 1993 revision. Among them, two were law professors. For the names of the participants and their affiliations see del Busto, *supra* note 72.

74. The U.C.P. is essentially a set of standard terms for banks drafted by bankers. The Working Group which prepared the latest revision was the first to include members other than bankers, in this case some bank lawyers and two law professors. The parties documentary credits serve—exporters and importers—are, regrettably, not directly

The 1993 version was published as I.C.C. Publication No. 500 and came into effect on January 1, 1994.<sup>75</sup> U.C.P. 500 is the latest version, and another version of the U.C.P. will not be available until at least 2003.<sup>76</sup> References to the U.C.P. are therefore be to U.C.P. 500 unless otherwise noted.

The U.C.P. is a compilation of internationally accepted banking customs and practice regarding letters of credit. It is the most successful harmonizing measure in the history of international commerce and has removed a plethora of technical problems that could have undermined the smooth operation of letters of credit. Now virtually every letter of credit incorporates the U.C.P.

Although the U.C.P. is widely accepted and used, due to the legal status of the I.C.C.,<sup>77</sup> it is technically not law. However, practically all evidence indicates that “the UCP rules constitute a defined and reliable supranational code that is often given the force of law.”<sup>78</sup> The U.C.P. contains definitions, treatment of party liability and responsibility, setting norms expected of law. Hence the U.C.P. is “de facto law”<sup>79</sup> and

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represented in the drafting process. See John A. Spanogle, Jr., *The Arrival of International Private Law*, 25 GEO. WASH. J. INT’L L. & ECON. 447, 492 (1992).

75. This version is known as U.C.P. 500. For more discussion about U.C.P. 500 see Buckley, *supra* note 73; John F. Dolan, *Weakening the Letter of Credit Product: The New Uniform Customs and Practice for Documentary Credits*, 1994 REVUE DES DROITS DES AFFAIRES INTERNATIONALES (INT’L BUS. L.J.) 149 [hereinafter RDAI/IBLJ]; John F. Dolan & Philip van Huizen, *International Rules for Letters of Credit—The UCP: A Final Report*, 9 BANKING & FIN. L. REV. 173 (1994); E.P. Ellinger, *The Uniform Customs and Practice for Documentary Credits—The 1993 Revision*, LLOYD’S MAR. & COM. L.Q. 377 (1994); Boris Kozolchyk, *Towards New Customs and Practices for Documentary Credits: The Methodology of the Proposed Revision*, 1993 COM. L. ANN. 371.

76. See *No UCP Revision Before 2003*, at [http://www.iccwbo.org/news\\_archives/2000/no\\_ucp500\\_revision\\_before\\_2003](http://www.iccwbo.org/news_archives/2000/no_ucp500_revision_before_2003) (last modified Aug. 28, 2002). To silence speculation that a new U.C.P. revision was under way, the I.C.C. Banking Commission discussed the matter at its meeting held in Hong Kong on November 3–4, 1999 (I.C.C. Hong Kong meeting) and expressed the view that “undertaking of a revision of the UCP in the near future is premature.” *A future UCP 500 revision: Commission on Banking Technique and Practice*, at [http://www.iccwbo.org/home/statements\\_rules/statements\\_/1999/future\\_ucp\\_500\\_revision.asp](http://www.iccwbo.org/home/statements_rules/statements_/1999/future_ucp_500_revision.asp) (last modified Aug. 28, 2002). Professor Boris Kozolchyk has argued in a newsletter published by the I.C.C. that there is no need for a revision in the near future. See Boris Kozolchyk, *Should UCP 500 be revised in the near future? No, argues Boris Kozolchyk*, 5 DOCUMENTARY CREDIT INSIGHT 3 (Autumn 1999). As Ross Buckley was once reminded by the doyen of letter of credit bankers, Bernard Wheble, the pattern of a revision every decade, apparent in the above series of revisions, reflected the needs of those times rather than a conscious policy of a revision each decade.

77. “ICC is the world business organisation, the only representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world.” See *Introducing the International Chamber of Commerce*, at <http://www.iccwbo.org/home> (last visited Dec. 25, 2002).

78. S. Isabella Chung, *Developing a Documentary Credit Dispute Resolution System: An ICC Perspective*, 19 FORDHAM INT’L L.J. 1349, 1356 (1996).

79. Dolan & van Huizen, *supra* note 75, at 175, n.7.

“the cornerstone of the law pertaining to letters of credit.”<sup>80</sup> Many national courts and legislatures recognize the U.C.P. because the rules of the U.C.P. reflect existing industry practice. In some cases, for example in the case of *Siporex Trade SA v. Banque Indosuez*<sup>81</sup> of the United Kingdom, “[a]lthough there was no reference to the UCP . . . the court relied on UCP Article 3 for its conclusion.”<sup>82</sup> Therefore, the U.C.P. is in every sense the centerpiece of law and practice in the area of letters of credit.<sup>83</sup>

## 2. *eU.C.P.*

The eU.C.P. is the acronym for the Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation. It has been initiated and drafted to meet the needs of electronic trade in the field of letters of credit.

At its meeting on May 24, 2000 in Paris, the I.C.C. task force on the future of its Banking Commission set a greater focus on electronic trade as one of its goals. “Further discussion identified a need to develop a bridge between the current UCP and the processing of electronic equivalent of paper-based credits.”<sup>84</sup> A working group was subsequently established to prepare a supplement to the U.C.P. It concluded that the supplement would “deal with the issues of electronic presentation.”<sup>85</sup> Therefore the supplement, now known as the eU.C.P., does not “address any issues relating to the issuance or advice of Credits electronically since current market practice and the UCP have long allowed for Credits to be issued and advised electronically.”<sup>86</sup> The eU.C.P. was voted and approved by the ICC Banking Commission at its meeting in Frankfurt on

80. Ellinger, *supra* note 62, at 578. For comments to similar effect *see, e.g.*, James G. Barnes, *Internationalization of Revised UCC Article 5 (Letters of Credit)*, 16 NW. J. INT'L. L. & BUS. 215, 216 (1995); (“The UCP . . . is incorporated into substantially all across-border commercial letters of credit, studied and observed by letter of credit bankers and users worldwide, and treated as quasi-law.” Buckley, *supra* note 73, at 268) (“The UCP, while technically only a set of standard terms, has evolved to fulfill the function of law.” *Id.*).

81. *Siporex Trade SA v. Banque Indosuez*, [1986] 2 LLOYD'S REP. 146.

82. Mark A. Wayne, *The Uniform Customs and Practice as a Source of Documentary Credit Law in the United States, Canada and Great Britain: A Comparison of Application and Interpretation*, 7 ARIZ. J. INT'L. & COMP. L. 147, 164 (1989).

83. For a critical assessment of the latest revision of the U.C.P. *see* Buckley, *supra* note 73, at 302–11.

84. *Note to National Committees and Members of the Banking Commission*, ICC BANKING COMM'N DOC. 470/941rev3 (Oct. 12, 2001).

85. *Id.*

86. *Id.*

November 7, 2001, and came into force on April 1, 2002. The eU.C.P. is issued in version numbers that will allow for revisions when necessary.<sup>87</sup> The current eU.C.P. is numbered Version 1.0.

The eU.C.P. covers a range of issues—the relationship of eU.C.P. to U.C.P., format, presentation, originals and copies, and examination of electronic records. The parties wishing to use the eU.C.P. will specifically have to incorporate it into the credit. “All articles of the eUCP are consistent with the UCP except as they relate specifically to electronic presentations.”<sup>88</sup> Under the eU.C.P., a credit subject to the eU.C.P. is also subject to the U.C.P. without express incorporation of the U.C.P. “Where the eUCP applies, its provisions shall prevail to the extent that they would produce a result different from the application of the UCP.”<sup>89</sup> With the eU.C.P. in place, the need for revision of the current U.C.P. becomes less urgent.

### 3. U.R.C.G.

The U.R.C.G. was published by the I.C.C. in 1978.<sup>90</sup> The purpose of the U.R.C.G. is to respond to the need for a set of standard rules to deal with ambiguities or inconsistencies in the field of “[g]uarantees given by banks, insurance companies and other guarantors in the form of tender bonds, performance guarantees and repayment guarantees in relation to projects in another country involving the supply of goods or services or the performance of work.”<sup>91</sup>

However, the U.R.C.G. has rarely been accepted or used. One reason is the conceptual problem that the U.R.C.G. is not clear it is confined to independent guarantees and has no applicability to accessory guarantees. But the major hurdle to the general acceptance of the U.R.C.G. is because of the provision in Article 9, which requires the beneficiary to produce a judgment or arbitral award or the principal’s written approval when making a claim. The condition is meant to deal with the problem of unfair calling, but it “proved too far removed from the market practice”<sup>92</sup> as it has virtually turned independent guarantees into accessory ones.

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87. *Id.*

88. *Id.*

89. eU.C.P. art. e2.

90. INT’L CHAMBER OF COMMERCE, ICC PUBLICATION NO. 325 (1978).

91. *Id.* at 7. Promoters for the creation of the rules were lead “by the United Kingdom international operations community.” James E. Byrne, *Fundamental Issues in the Unification and Harmonization of Letter of Credit Law*, 37 LOY. L. REV. 1, 4 (Spring, 1991).

92. Roy M. Goode, *The New ICC Uniform Rules of Demand Guarantees*, LLOYD’S MAR. COM. L.Q. 190 (1992).



#### 4. *U.R.D.G.*

With the experience of the U.R.C.G., the I.C.C. decided to replace the U.R.C.G. with a new set of rules with a new approach to the question of independent guarantees. Based on the model used by the British Bankers Association, the new rules came out in 1992 as the U.R.D.G.<sup>93</sup> The text of the U.R.D.G. is strongly influenced by the U.C.P., but "[w]orldwide acceptance of the Rules ha[s] been disappointing."<sup>94</sup>

Although the U.R.D.G. is formulated to replace the U.R.C.G., the U.R.C.G. has not been totally abandoned. It was agreed to retain it "for the time being and to review its future at a later date in the light of experience with the new Rules."<sup>95</sup>

#### 5. *I.S.P.98*

I.S.P.98 is a set of rules specifically designed for standby letters of credit. It was created by the U.S. based Institute for International Banking Law and Practice, Inc. with the support of the U.S. Council on International Banking (now the International Financial Services Association) and was revised and adopted in 1998 by the I.C.C.<sup>96</sup> I.S.P.98 came into effect in January 1999, and "its reception has been, on the whole, very positive."<sup>97</sup>

Standby letters of credit have been widely used for decades and their popularity continues to grow, but there were no special rules for standby letters of credit. Most standbys have been issued subject to various versions of the U.C.P., because the U.C.P. was "originally written for use only in commercial letters of credit . . . many of the provisions of the U.C.P. are either inapplicable or inappropriate in a standby credit context."<sup>98</sup> Standby letters of credit could incorporate the U.R.D.G. because standby letters of credit are legally equivalent to independent guarantees, but the reality is that (1) the U.R.D.G. has rarely been used, and (2) "[f]rom the viewpoint of the I.C.C., . . . standby letters of credit continue to be covered by the U.C.P. and are not covered by the U.R.D.G."<sup>99</sup>

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93. INT'L CHAMBER OF COMMERCE, ICC PUBLICATION NO. 458.

94. Randy Katz, Report delivered at the I.C.C. Hong Kong meeting, *supra* note 76, reprinted in INT'L CHAMBER OF COMMERCE, ICC PUBLICATION NO. 470/893, at 19.

95. Goode, *supra* note 92, at 191.

96. INT'L CHAMBER OF COMMERCE, ICC PUBLICATION NO. 590 (1998).

97. Byrne, *supra* note 71, at 180.

98. P.S. Turner, *New Rules For Standby Letters of Credit: The International Standby Practices*, 14 BANKING & FIN. L. REV. 457, 459 (1999).

99. P.S. Turner, *Revised UCC Article 5: The New US Uniform Law on Letters of Credit*, 11 BANKING & FIN. L. REV. 205, 207 (1996).

I.S.P.98 was drafted for standby letters of credit in the same sense as the U.C.P. was for commercial letters of credit and the U.R.D.G. for independent guarantees. However, the application of I.S.P.98 is not limited to standby letters of credit. "Like the UCP and the URDG, ISP98 [applies] to any independent undertaking issued subject to it".<sup>100</sup>

## 6. *UNCITRAL Convention*

The UNCITRAL Convention was drafted from 1989 to 1995, adopted and opened for signature by the U.N. General Assembly by its resolution 50/48 of December 11, 1995,<sup>101</sup> and came into effect on January 1, 2000.<sup>102</sup>

The UNCITRAL Convention applies to an international undertaking such as an independent guarantee or a standby letters of credit, where "the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State," or "the rules of private law lead to the application of the law of a Contracting State," "unless the undertaking excludes the application of the Convention."<sup>104</sup> The UNCITRAL Convention can also apply to commercial letters of credit if the parties expressly state that their credit is subject to it.<sup>105</sup>

The UNCITRAL Convention is modeled upon the U.C.P. and the U.R.D.G., but it is distinctive in that both the U.C.P. and the U.R.D.G. are drafted by the I.C.C., a private organization, as voluntary rules or self regulation, whereas the UNCITRAL Convention is drafted by UNCITRAL,<sup>106</sup> as a uniform law or official regulation for those countries who adopt it. The UNCITRAL Convention, "[i]n addition to being essentially consistent with the solutions found in the rules of

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100. James E. Byrne, *Preface* to JAMES E. BYRNE ET AL., INTERNATIONAL STANDBY PRACTICES ISP98 6. (ICC Publishing, Inc. 1998).

101. *Explanatory Note: UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit*, U.N. Commission on International Trade Law, 30th Sess., note 1, at 1, U.N. Doc. A/CN.9/431 (1996) [hereinafter UNCITRAL Explanatory Note].

102. As of May, 30 2002, the UNCITRAL Convention was rectified by Belarus, Ecuador, El Salvador, Kuwait, Panama, and Tunisia, and signed by the United States. See U.N. Commission on International Trade Law, at <http://www.uncitral.org/english/status/status-e.htm> (last visited Oct. 2, 2002).

103. U.N. CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT art. 1(1)(a) [hereinafter UNCITRAL CONVENTION].

104. UNCITRAL CONVENTION art. 1(1)(b).

105. UNCITRAL CONVENTION art. 1(2).

106. "UNCITRAL is an intergovernmental body of the United Nations General Assembly that prepares international commercial law instruments designed to assist the international community in modernizing and harmonizing laws dealing with international trade." UNCITRAL Explanatory Note, *supra* note 101, at note 2.

practice, . . . supplements their operation by dealing with issues beyond the scope of such rules. It does so in particular regarding the question of fraudulent or abusive demands for payment and judicial remedies in such instances.”<sup>107</sup> In other words, because the legal status of the UNCITRAL Convention is distinctive from the I.C.C. rules, the UNCITRAL Convention contains provisions relating to the fraud rule.

### 7. *Article 5 of the U.C.C.*

The U.C.C. is a collection of model statutes drafted and recommended by the National Conference of Commissioners of Uniform State Laws (NCCUSL) and the American Law Institute (A.L.I.) for enactment by the legislatures of the states of the United States. It consists of eleven different articles, each covering a different aspect of commercial law. Article 5 of the U.C.C. is a uniform statutory scheme governing letters of credit.

When Article 5 of the U.C.C. was first drafted in the 1950s, it was not a complete “code” like some other articles. Instead, it was intended to set up an “independent theoretical framework for the further development of letters of credit.”<sup>108</sup> “The drafters felt that no statute could effectively or wisely codify the law of letters of credit without hampering development of the device.”<sup>109</sup> According to Official Comment 2 to the prior version of U.C.C. Article 5, section 5-102, Article 5 was to be applied in accordance with the canon of liberal interpretation of U.C.C. § 1-102(1), so as to promote the underlying purposes and policies of the Article.

After “almost forty years of hard use”,<sup>110</sup> Article 5 of the U.C.C. was revised in 1995 to cure the “weaknesses, gaps and errors in the original statute which compromise its relevance”<sup>111</sup> and to meet the challenges of the development of letters of credit. Prior to the appointment of the drafting committee for the revision, a special Task Force, composed of eminent letter of credit specialists, was appointed to study “the case law, evolving technologies and changes in customs

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107. *Id.* at note 5.

108. Original U.C.C. art. 5, § 5-101, Official Comment 1 (1995).

109. Note, *Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114*, 63 MINN. L. REV. 487, 493, n.27 (1979).

110. Task Force on the Study of U.C.C. Article 5, Report, *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW 1521, 1532 (1990).

111. *Id.*

and practices.”<sup>112</sup> The Task Force identified a large number of issues, discussed them and made recommendations for the revision of the Article. The revision of the Article was completed in October 1995. The revised Article 5 “represents a substantial improvement over original Article 5.”<sup>113</sup> By May 30, 2002, the revised version of U.C.C. Article 5 had been adopted by almost all the states of the United States.<sup>114</sup>

Despite the existence of Article 5 of the U.C.C., the U.C.P. still has great influence in the United States. “In the entire universe of letter of credit transactions, Article 5 governs only a limited part. Large shares of all letter of credit transactions are international transactions and most of those are governed by the Uniform Customs and Practice (UCP) . . . For many, therefore, the UCP will be a more significant source of law than the UCC.”<sup>115</sup>

In many ways the U.C.P. had a greater influence on the drafting of the latest version of U.C.C. Article 5 than did the prior version of Article 5.<sup>116</sup> This in particular was demonstrated by the following features:

- 1) the revision of the U.C.C. Article 5 was part of the worldwide effort to internationalize the letter of credit law and practice; and,
- 2) a number of participants in the revision of U.C.C. Article 5 were also participating in the revising or drafting of the U.C.P., the U.R.D.G. or the UNCITRAL Convention, and as strong proponents for harmonizing the international law and practice of letters of credit, “sought to exchange information and insights with colleagues throughout the world”<sup>117</sup> during the revision process.

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112. U.C.C. art. 5, Prefatory Note (1995).

113. Senator Lack of Senate Judicial Committee of New York, *Legislation Report* (May 10, 1999), at <http://www.nysba.org/legis/99report> (last visited Sept. 20, 2002).

114. See The National Conference of Commissioners on Uniform State Laws, *Introductions & Adoptions of Uniform Acts (Sept 2, 2002)*, at [http://www.nccusl.org/nccusl/uniformact\\_factsheets/uniformacts-fs-ucca5.asp](http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ucca5.asp) (last visited Sept. 20, 2002). And the first case said to have applied “revised U.C.C. Article 5 other than by analogy” is *Bank of Joliet v. Firstar Bank Milwaukee*, N.A.A. No. 96 C 1145, U.S. Dist. LEXIS 15384 (N.D. Ill. East Div. Sept 26, 1997); see *Litigation Digest 2 DOCUMENTARY CREDIT WORLD* 8, 12 (1998).

115. JAMES J. WHITE & ROBERT S. SUMMERS, 3 *UNIFORM COMMERCIAL CODE* 120 (4th ed., West Publishing Co. 1995). For the application of the U.C.C. and the U.C.P. in the U.S. see, e.g., Katherine A. Barski, *Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits*, 41 *LOY. L. REV.* 735, 739 (1996); Carl W. Funk, *Letters of Credit: U.C.C. Article 5 and the Uniform Customs and Practice*, 11 *HOW. L.J.* 88, 92 (1965); Milton R. Schroeder, *The 1995 Revisions to UCC Article 5, Letters of Credit*, 29 *UCC L.J.* 331, 341–44 (1997). For statutory provisions for how the U.C.P. is applied in the United States, see revised U.C.C. § 5–116(c) (1995); U.C.C. § 5–116(c), Official Comment 3.

116. James J. White, *The Influence of International Practice on the Revision of Article 5 of the UCC*, 16 *NW. J. INT’L L. & BUS.* 189, 211 (1995).

117. James E. Byrne, *Critical Issues in the International and Domestic Harmonization of Letter of Credit Law and Practice*, *COM. L. ANN.* 389, 392 (1995).

Accordingly, Article 5 of the U.C.C. is in many instances consistent with and complementary to the U.C.P. While Article 5 is primarily concerned with issues of liabilities and responsibilities, the U.C.P. provides a vehicle through which international banking lawyers can acquaint themselves with the mechanics of letters of credit practice. However, because Article 5 of the U.C.C. is drafted as a statute or real law, there is one major difference between Article 5 and the U.C.P. or other I.C.C. rules. This is that Article 5, like the UNCITRAL Convention, contains provisions regarding the fraud rule, which the U.C.P. does not. The fraud rule, which in the prior version of U.C.C. Article 5 was to be found in § 5-114(2), is now embodied in § 5-109.<sup>118</sup>

This completes our survey of the formal sources of laws and rules governing letters of credit. It remains to address the two major principles that underpin letter of credit jurisprudence in virtually all national legal systems. These principles are reflected in part in the U.C.P. and Article 5 of the U.C.C., but are primarily the product of judicial decisions.

## *B. Two Fundamental Principles*

### *1. Principle of Independence*

The principle of independence is the cornerstone of the law of letters of credit. Under this principle, the obligation of the issuer to honor the beneficiary's draft or demand for payment under the letter of credit is viewed as entirely separate and distinct from the other related transactions—the underlying transaction between the applicant and the beneficiary, and the application agreement between the applicant and the issuer. The issuer must honor its obligation to the beneficiary under the letter of credit, irrespective of any disputes or claims relating to either the underlying transaction or the application agreement, unless fraud is established in the transaction.<sup>119</sup>

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118. For a detailed consideration of the more significant areas in which the U.C.C. departed from the approach of the U.C.P., to good effect, see Ross P. Buckley, *Documentary Compliance in Documentary Credits: Lessons from the UCC for the UCP*, 1 J. INT'L COM. L. 60, 69 (2002). For an argument that the U.C.P. should address the issue of fraud see Buckley, *supra* note 73, at 302-11.

119. David C. Howard, *The Application of Compulsory Joinder, Intervention, Impleader and Attachment to Letter of Credit Litigation*, 52 FORDHAM L. REV. 957, 966 (1984).

The principle of independence has long been recognized by cases in many countries and is expressed in Articles 3 and 4 of the U.C.P.<sup>120</sup> Article 3, emphasizing the separateness of the letter of credit from the other transactions, provides:

a) Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfill any other obligation under the Credit, is not subject to claims or defenses by the Applicant resulting from his relationships with the Issuing Bank of the Beneficiary.

b) A beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the Applicant and the Issuing Bank.

Article 4, emphasizing the paper-driven or documentary nature of the letter of credit, provides: "In Credit operations all parties concerned deal with documents, and not with goods, services or performances to which the documents may relate."

Therefore, in a letter of credit transaction, the issuer's only concern is whether the documents tendered by the beneficiary on their face conform to the terms and conditions stipulated in the letter of credit. The issuer is entitled to make payment with full recourse against the applicant, even if the documents turn out to be forgeries or include fraudulent statements, as long as it pays in good faith against the documents which are regular on their face.<sup>121</sup> This is embodied in Article 15 of the U.C.P., which provides:

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120. For provisions to the similar effect see U.R.D.G. art. 2(b); UNCITRAL CONVENTION art. 3; I.S.P.98, R.1.06–1.07; Revised U.C.C. art. 5, § 5–103(d). Almost every letter of credit case confirms this doctrine. For some earlier examples see *Frey & Son v. E.R. Sherbourne Co.*, 184 N.Y.S. 661, 664 (N.Y. App. Div. 1920) ("the bank issuing the letter of credit is in no way concerned with any contract between the buyer and seller"); *Imbrie v. D. Nagase & Co.*, 187 N.Y. Supp. 692, 695 (N.Y. App. Div. 1921) ("a bank issuing a letter of credit is in no way concerned with any contract existing between the buyer and seller"); *S.L. Jones & Co. v. Bond*, 191 Cal 551, 555 (1923) ("the letter of credit was . . . an entirely separate and independent contract between the bank and the seller"); *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S. 2d 631, 633 (N.Y. Spec. Term 1941) ("it is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods."). For a case discussing the principle of independence with regard to the application agreement between the applicant and the issuer see *N. Am. Mfrs. Exp. Ass'n, Inc. v. Chase National Bank of City of New York*, 77 F. Supp. 55 (S.D.N.Y. 1948). For comments on the principle of independence in a two-party credit situation see Roy Goode, *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, 39 St. LOUIS U. L.J. 725, 733–34 (1995).

121. *Sztejn v. J. Henry Schroder Banking Corp.*, supra note 120, at 634. ("It is true that even though the documents are forged or fraudulent, if the issuing bank has already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment." *Id.*). See also, e.g., *Woods v. Thiedemann*, 1 H & C 478, 158 Eng. Rep. 973 (1862); *Guar. Trust Co. of New York v. Hannay & Co.*, 2 K.B. 623 (1918); *Springs v. Hanover Nat'l Bank*, 103 N.E. 156 (Ct. App. N.Y. 1913).

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

The issuer's only duty to the applicant is to exercise reasonable care to ensure that the documents are in compliance with the terms and conditions of the letter of credit. Even if the underlying transaction has been cancelled, or the applicant has gone bankrupt, the issuer has to pay as long as the documents tendered are in compliance with the credit.<sup>122</sup>

Like the letter of credit itself, the principle of independence has been fashioned by mercantile usage. The issuers are bankers, not merchants. Bankers are experts in the business of banking, most of which involves paper work. Obviously, banks cannot function properly if they are compelled to investigate and verify facts outside their normal business. Besides, in a letter of credit transaction the issuer is not in control of either the underlying transaction or the applicant's selection of the beneficiary. Hence the issuer can only be required to deal with documents, not goods or services; and, the letter of credit can only be a paper-driven device whose operation must turn upon what appears on the face of papers, not upon circumstances outside them. Document checkers are competent to determine the visible conformity of documents, but they are not in a position to determine the in-fact compliance of the documents, and the law excuses them from having to do so. If the bank is required to go behind the documents, the letter of credit scheme will collapse.<sup>123</sup>

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122. ELLINGER, *supra* note 3, at 186–88.

123. This has been recognized by many cases and commentators. *E.g.*, *Old Colony Trust Co. v. Lawyers' Title and Trust Co.*, 297 F. 152, 155–56 (2d. Cir. 1924).

It would be dangerous if bankers or banking institutions who issue letters of credit were confronted with the problem of deciding anything more than whether or not the documents presented were the documents required under the letter of credit and whether the conditions in the letter of credit set forth were complied with. . . . The banker is always in a position of sharp responsibility, and, if he honours a letter of credit contrary to its terms, he may invite troublesome litigation. Thus, it is to the interest of the merchant as well as the bank that it should not be made difficult to obtain letters of credit because of technical reasons, and hence that the issuance of such letters shall not be embarrassed by placing upon the issuing bank any responsibility to look beyond the documents required under the letter and the conditions, if any, with which under the letter there must be compliance.

From the beneficiary's perspective, the principle of independence reduces the risk of nonpayment due to the applicant's asserting defenses such as breach of warranty. It is even stronger in the case of a standby letter of credit, as payment can be made on demand without documentation. From the applicant's perspective, however, the independence of the letter of credit creates a risk that the issuer may honor a draft even if the beneficiary has failed to perform its obligations but has fraudulently required payment. The best that an applicant can do to protect its interest in this respect is to draft the letter of credit carefully. For example, it may require documents to be issued by reputable agencies to ensure that the beneficiary has fully performed its obligations.

## 2. *Principle of Strict Compliance*

The principle of strict compliance is the other basic doctrine of the law of letters of credit. Under this principle, every party to a letter of credit transaction wishing to receive payment has to tender complying documents. For example, in a transaction where a confirming bank is involved, the beneficiary may tender the documents to the confirming bank, the confirming bank presents them to the issuing bank, and the issuing bank gives them to the applicant. In this chain of document tendering, at every stage the documents tendered must be in strict compliance, on their face, with the terms and conditions of the letter of credit.<sup>124</sup> The presentation of a commercial equivalent, even if of equal or greater value, does not suffice, and the tender must be made strictly in the manner and within the time prescribed in the credit.<sup>125</sup>

If the documents tendered are on their face in strict compliance with the terms and conditions of the credit, the party who is obliged to honor

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United City Merch. v. Royal Bank of Canada, 1 Lloyd's Rep. 269, 278 (1979) ("to hold to the contrary might greatly hold up the smooth running of international trade and might place on banks exceptionally onerous investigations, which they are ill fitted to perform."); Carl Mead, *Documentary Letters of Credit*, 22 COLUM. L. REV. 297, 309-10 (1922) ("while its clerks and employees are presumed to be familiar with the ordinary documents tendered under a documentary letter of credit, they are usually totally unfamiliar with the goods which are the subject of the sale; and an inspection of the goods by them would be of no benefit to any one.").

124. An interesting comparison is with German law, which accepts as complying documents with "small discrepancies . . . if a careful evaluation . . . leads to a sure conclusion that the goal of the credit conditions has been reached" [1960] BGHWm 38. For a significantly less strict approach than strict compliance under U.S. or English law see Paulo A. Grassi, *Letters of Credit Transactions: The Banks' Position in Determining Documentary Compliance. A Comparative Evaluation Under U.S., Swiss and German Law*, 7 PACE INT'L L. REV. 81, 118 (1995).

125. ELLINGER, *supra* note 3, at 277. This is not to say, however, "that a document will be treated as non-conforming if it fails to dot every 'i' or cross every 't' or contains obvious typographical errors." Goode, *supra* note 120, at 740.



the obligation under the letter of credit must take up the presentation and honor its obligation when it receives the documents; it may not add any conditions or look beyond the face of the documents to avoid its obligation. If the documents tendered are not in strict compliance with the terms of the letter of credit, the party tendering the documents may not get paid even though it has fully performed the underlying contract. For instance, if the issuer pays the beneficiary against documents that do not strictly comply with the requirements of the credit, it does so at its peril and may not be reimbursed by the applicant. The doctrine of strict compliance also means that the bank must stick to the instructions of the applicant.<sup>126</sup>

The strict compliance doctrine is not detailed in the U.C.P.,<sup>127</sup> but has long been endorsed by consistent judicial view. In *Equitable Trust Co. of New York v. Dawson Partners*,<sup>128</sup> Lord Sumner put the principle proverbially: "there is no room for documents which are almost the same, or which will do just as well."<sup>129</sup> However, this principle is clearly provided in U.C.C. Article 5. Section 5-108(a), provides that "an issuer shall honor a presentation that . . . appears on its face strictly to comply with the terms and conditions of the letter of credit . . . [U]nless otherwise

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126. However, discrepancies in the documents may be cured or waived. In 1987, a survey in the United States revealed that 90% of documents initially tendered contained discrepancies, but no more than 1% were incurable. See Boris Kozolchyk, *Strict Compliance and the Reasonable Document Checker*, 56 BROOK. L. REV. 45, 48 (1990). Other studies point to a discrepancy rate of between 49% and 51.4% in surveys done in 1983 and 1986 in England and substantially higher rates in earlier surveys in Hong Kong and Australia. CLIVE E. SCHMITTHOFF, *Discrepancy of Documents in Letter of Credit Transactions*, in CLIVE M. SCHMITTHOFF'S SELECT ESSAYS ON INTERNATIONAL TRADE LAW 432, (Chi-Jui Cheng, ed., 1998). See also *Alaska Textile Co., Inc. v. Chase Manhattan Bank* 982 F.2d 813, 824 (2d Cir. 1992).

127. The relevant article in the U.C.P. is Article 13(a), but it merely says: Banks must examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with terms and conditions of the Credit shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.

128. *Equitable Trust Co. of New York v. Dawson Partners*, 27 Lloyd's L. Rep. 49 (1927) [hereinafter *Equitable Trust*]. *Equitable Trust* is a case in which the dispute was between the banker and the applicant.

129. *Equitable Trust*, *supra* note 128, at 52. See also, e.g., *Old Colony Trust Co. v. Lawyers' Title and Trust Co.*, 297 F. 152, 155 (1924) ("the transaction is one to purchase documents and not goods and that, in our view, the documents referred to in a letter of credit must conform in every respect with the requirements of that letter of credit." *Id.*).

agreed with the applicant, an issuer shall dishonor a presentation that does not appear so to apply.”<sup>130</sup>

On the one hand, this principle is evidently designed to protect the applicant. First, the documents required by a letter of credit, especially a commercial letter of credit, usually emanate from numerous sources. Secondly, the review of the tendered documents by the bank further reduces the possibility of the beneficiary’s nonperformance, defective performance or masking of fraud in the underlying transaction. By virtue of the principle, the applicant is guaranteed it will not have to pay or reimburse the issuer (if the bank has paid) except against the documents it has specified as triggering the obligation. On the other hand, this principle also protects the bank involved, as it spares the bank from value judgments about discrepancies in documents presented and stops the bank from opening the door to scrutinize the underlying transaction, which is not within the scope of its normal business. Working hand in hand with the principle of independence, the principle of strict compliance is the other cornerstone of the commercial success and utility of letters of credit.

#### IV. CONCLUSION

The letter of credit is a mercantile specialty—a special creature of international commerce given effect to by the courts in the form developed over time by the merchants. During the course of its historical development, letter of credit jurisprudence has borrowed from that which governs negotiable instruments and contracts, but nonetheless the jurisprudence of letters of credit is unique. As put succinctly by one respected authority:

The legal character of a banker’s commercial letter of credit is a subject susceptible of the most scholastic treatment. It has been a topic of prolonged and erudite discussion. The device has, nevertheless, survived all speculation as to its legitimacy and, responding to the needs of an increasingly sophisticated commercial society, has in a real sense developed its own jurisprudence.<sup>131</sup>

Therefore, whenever dealing with letters of credit, lawyers are best advised to start from the position that a letter of credit is unlike any other commercial instrument.<sup>132</sup> The jurisprudence that governs credits will largely be found in the terms of the U.C.P. and the eU.C.P., and to a lesser extent, the U.R.C.G., U.R.D.G., I.S.P.98 and the UNCITRAL

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130. Cf. U.R.D.G. art. 9; UNCITRAL CONVENTION art. 16(1); I.S.P.98 R.4.01, 8.01(a).

131. HARFIELD, *supra* note 3, at 51.

132. The only possible exception to this is the law relating to bank guarantees and performance bonds, from which many useful analogies can be drawn. But this body of jurisprudence, is not what often leads lawyers, and courts, into error.

Convention. For transactions with a U.S. element, Article 5 of the U.C.C. is obviously an important source of jurisprudence, and even for non-U.S. transactions, Article 5 can be a source of illumination, particularly on matters involving fraud or forgery, and as a source of, often, particularly clear statements of principle. In addition, of course, these formalized sources are supplemented by the domestic law of the relevant jurisdictions, in particular in relation to the doctrines of strict compliance and autonomy, and in relation to the principal exception to the doctrine of autonomy, the fraud exception. It is in these places that legal enquiry into letters of credit must begin—not with what a particular lawyer happens to know about the law of contracts and negotiable instruments.

