

BANKERS' LETTERS OF CREDIT: A MICROSCOPIC  
ANALYSIS OF THE CONTRACTUAL RELATIONSHIPS  
OF THE PARTIES INVOLVED.

BY

REGISI CHAWATAMA  
CHWREG001

Masters in Commercial Law (LLM)  
University of Cape Town  
School of Advanced Legal Studies  
Supervisor: Professor RH Christie  
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Research dissertation presented for the approval of Senate in fulfillment of the requirements for the Masters in Commercial Law (LLM) in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Masters in Commercial Law (LLM) dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

Signature: Signed by candidate  
Signature Removed

Date: 04/02/08

## Dedications

*This, my second piece of written work, and hopefully not the last, is dedicated to Florence my mum, Paddy my dad and my wife to come.*

## Acknowledgements

Thanks be unto God for his unspeakable gift!

I wish to place on record my heartfelt gratitude to my ingenious supervisor Professor RH Christie for his invaluable support and unparalleled guidance throughout my research and writing of this thesis. Never in my life have I seen an academic so meticulous and efficient. You were fantastic to work with and I owe it to you Dick! However, I unreservedly admit that uncertainties and ambiguities, if any, associated with this work, are mine.

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## CHAPTER ONE

### Introduction

Trade has always occupied a pivotal role of any society's economy since time immemorial. However, it has increased in sophistication and volume and has tended to become more international with each passing day due to increased geographical connectivity. This is a part of the ongoing boom in globalization which has literally reduced the world to a global village which knows no boundary restrictions. This phenomenon has seen an unprecedented growth in large volumes of goods being traded across oceans and across continents and it therefore means huge sums of money have to change hands as purchase price.

Out of this flourishing business however, one need not lose sight of the fact that international trade abounds with multifarious risks<sup>1</sup>. One major risk in this regard which is of interest to the present writer is the risk of non payment. It does not require any fertile imagination for one to realize how important it is to consider this risk especially when one reflects on the scenario where the seller is dealing with a foreign buyer whose creditworthiness he is unsure of. It is almost always the case that the buyer does not want to pay before he is in possession of the goods and the seller does not want to ship the goods without payment or any assurance that he will be paid. In order to ensure that the interests of both parties to international trade transactions are secured various methods and mechanisms of financing have been developed over the years.<sup>2</sup>

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<sup>1</sup> See John Schiller's lecture notes on *Risk exposure in international sales* for an enumeration of the various risks present in international trade. These risks have been categorized into risks from poor draftsmanship, from default of the other party to the contract; from outside sources and from one's own failings.

<sup>2</sup> For a summary of the various methods of payment used international trade see Chapter 10 of Jason Chua, *Law of international trade* (2005) 3<sup>rd</sup> ed, see also Sami T Juutinen *Methods of payment and exporter's risk* (1999) Unpublished LLM Dissertation, University of Cape Town.

Bankers' letters of credit<sup>3</sup> are one of the ways which have been developed to strike the balance between these seemingly irreconcilable interests of the buyer and the seller.

### **What is a Letter of Credit?**

To answer this question one should look no further than the Uniform Customs and Practice for Documentary Credits, 2007 Revision<sup>4</sup>, ICC Publication No. 600 hereinafter referred to as UCP 600<sup>5</sup>. Article 2 thereof defines a credit as 'any arrangement, however named or described that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.' UCP 500<sup>6</sup>, the predecessor to the current version was more detailed and it defined a credit in the following way:

'any arrangement, however named or described, whereby a bank (the 'Issuing Bank') acting at the request and on the instructions of a customer ( the 'Applicant') or on its own behalf,

i) is to make a payment to or 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) authorizes another bank to effect such payment or to accept and pay such bills of exchange (Draft(s)),

or

iii) authorizes another bank to negotiate,

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<sup>3</sup> They are also called by other names such as bankers' documentary credits, commercial letters of credit, documentary credits or just credits among others. For the sake of convenience throughout this dissertation the term letters of credit shall be used consistently with the appropriate variations where necessary.

<sup>4</sup> It is the sixth revision of the rules since they were first promulgated in 1993, a product of a 3 years work by the International Chamber of Commerce's (ICC) Commission on Banking Technique and Practice, see <http://www.letterofcreditforum.com/node/3>, accessed on 23 July 2007.

<sup>5</sup> These are the rules that apply to any documentary credit and they are binding when parties have chosen them copy of which has been downloaded from the site in Note 4 above. The rules became effective on the 1<sup>st</sup> of July 2007. As to their nature, applicability and status see pg 4 below.

<sup>6</sup> <http://www.dmg-intertrade.com/documents.ucp500.pdf> accessed on 23 July 2007.

against stipulated document(s), provided that the terms and conditions of the Credit are complied with.’<sup>7</sup>

In essence the two definitions of a credit above are the same. Put differently and to use the words of Eitelberg and in the context of a sale, a documentary credit is a documented promise of a bank, undertaken on behalf of a buyer, to pay a seller the amount specified in the letter of credit, provided the seller complies with the terms and conditions set forth in that letter of credit.<sup>8</sup>

### Outline of a Letter of Credit Transaction<sup>9</sup>

The documentary credit operates in the following manner:

The Applicant (the buyer) concludes a sales contract with the Beneficiary (the seller), providing for payment by letters of credit. The buyer requests that his bank (known as the Issuing Bank)<sup>10</sup> issue the credit in favour of the seller, setting out in detail the terms and conditions on which the bank is to issue the credit and stipulated documents. The Issuing Bank draws up the credit in accordance with the buyer’s instructions and requests a Nominated Bank<sup>11</sup> to notify the seller of the credit opened in his favour and the terms and conditions thereunder. The Nominated Bank advises the seller of the credit (thereby becoming the Advising Bank)<sup>12</sup> and if confirmation is required, confirms it (thereby becoming the Confirming Bank).<sup>13</sup> The seller ships the goods and presents the stipulated documents to the Nominated Bank in order to obtain payment or acceptance of its draft. The Nominated Bank checks the documents against the credit and if the documents conform to the credit, pays or accepts the seller’s draft. The nominated bank sends the documents to the Issuing Bank for reimbursement. The Issuing

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<sup>7</sup> Art 2 thereof.

<sup>8</sup> Eduard Eitelberg, ‘Autonomy of documentary credit in South African law?’ (2002) 199 SALJ 120. Almost all the authorities are agreed on this standard definition of letters of credit.

<sup>9</sup> The whole of the outline of the letter of credit transaction given has been adapted *in toto* from an article by Emmanuel T. Laryea entitled ‘Payment for paperless trade: Are there valuable alternatives to the documentary credit?’ (2001-2002) 33 *Law & Policy in International Business* 3 at 11.

<sup>10</sup> See UCP 600 Art 7.

<sup>11</sup> *Idem* Art 12 as regards nomination.

<sup>12</sup> *Idem* Art 9.

<sup>13</sup> *Idem* Art 8.

bank checks the documents and if they conform to the credit requirements, reimburses the Nominated Bank. The buyer collects the documents from the Issuing Bank, presents them to the carrier and takes delivery of the goods. The buyer may reimburse the Issuing Bank before or after receiving the documents, depending on the arrangement between the parties.

It is submitted that the above summary by Laryea<sup>14</sup> captures graphically the essential features which are at the core of a letter of credit transaction. Perhaps it is important at this stage to underscore that the focus of this dissertation is on the standard four-party confirmed letter of credit.

### **The Uniform Customs and Practice for Documentary Credits, UCP 600**

It has become ‘a rule of convention’ so to speak that almost all letters of credits are made subject to the UCP. These rules are published by the International Chamber of Commerce (ICC) and Goode says that they are ‘an outstanding successful codification of banking practice in relation to documentary credits’<sup>15</sup> In apparent concurrence with Goode, Eitelberg submits that ‘the UCP in its various revisions has become a universally recognized standard, stating and establishing custom and practice for letters of credit.’<sup>16</sup>

The UCP first published in 1933 have been revised six times.<sup>17</sup> The current version is UCP 600 which came into force on the 1<sup>st</sup> of July 2007.<sup>18</sup> The general view in international trade circles is that the UCP reflects existing practice. Van Houtte aptly summarises the UCP in the following way:

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<sup>14</sup> Op cit note 9.

<sup>15</sup> Roy Goode *Commercial law* (2004) 3<sup>rd</sup> ed at p 951.

<sup>16</sup> Op cit note 8 at 121.

<sup>17</sup> See EP Ellinger in a recent articles entitled “The Uniform Customs and Practice for Documentary Credits (UCP): their development and the current revisions” [2007] LMCLQ Part 2 at 152 where he traces these revisions and also touches on the debate surrounding the legal status of the UCP.

<sup>18</sup> Loc cit note 4. The website in its foreword and introduction to UCP 600 also provides a good background to the process leading to this last revision of the UCP. See also ICC’s official site [www.iccwbo.org](http://www.iccwbo.org) accessed on 27 July 2007.

The UCP lays down rules for *inter alia* the form of the documentary credits, the requirements for the issuing bank and for further stages (advising, confirming) of the credit, the obligations and liabilities of the banks, the documents necessary for the documentary credit, the transfer of the documentary credit, etc<sup>19</sup>

However, he is quick to point out, rightly so, that the UCP is not a comprehensive regulation i.e. it is not the ‘alpha and the omega’ so to speak if I may use that oft quoted biblical phrase. A clear illustrative example he gives is that it does not regulate, for instance, the attachment of rights under the documentary credit.<sup>20</sup>

The question that has raised more than eyebrows and has generated enormous debate about UCP, characterised by arguments and counter-arguments among academics and lawyers alike is its legal nature. Accordingly it is worth considering some of the views that have been exchanged in this regard. The starting point in ventilating the issues around this debate is Article 1<sup>21</sup> which reads:

The...UCP are rules that apply to any documentary credit (“credit”) (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit.

What is no doubt clear from this Article is that parties may expressly exclude or modify some of the UCP provisions. This provision, says Hugo, which is materially the same in all the previous revisions of the UCP, creates the impression that drafters regarded the UCP

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<sup>19</sup> Hans Van Houtte *The law of international trade* (1995) at 266.

<sup>20</sup> See Van Houtte *supra* at 266.

<sup>21</sup> of UCP 600.

as a universal supranational set of rules which is automatically applicable unless expressly excluded by the parties.<sup>22</sup>

So what is the legal status of the UCP? Throughout his article Hugo traces the variations from country to country of opinions on the legal nature of the UCP focusing on some of the so-called big countries. He submits that in Germany the UCP are considered to be either commercial usage in the sense of '*Handelsbrauch*' or standard conditions of contract (*allgemeine Geschäftsbedingungen*). The views of the Dutch, Swiss, French<sup>23</sup> and Spanish commentators according to him range from regarding the application of the UCP as dependent upon contractual incorporation to its application as trade usage or customary law independent of the will of the parties.<sup>24</sup>

In England the traditional view seems to be that the UCP despite having achieved near-universal application it does not have the force of law.<sup>25</sup> According to Goode as far as the English are concerned the UCP 'are contractual in nature, are subordinate to mandatory legislation, may be excluded or restricted by contract and if incorporated into the contract, are, a set of contractual terms, subject to the court's normal powers...'<sup>26</sup>

It is submitted that the debate on the legal status of the UCP is as extensive as it is heated and is a topic which can be the subject of another dissertation and I have no intention of taking the discussion any further than this. Suffice to say that different commentators have different views on the question as shown above. However; the reality on the ground is much less controversial than the debate of the application and legal status of the UCP

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<sup>22</sup> Charl Hugo 'The legal nature of the Uniform Customs and Practice for Documentary Credits: Lex mercatoria, custom or contracts?' (1994) 6 *SA Merc LJ* 143 at 149.

<sup>23</sup> Ellinger op cit note 17 says that a French author Friedel has suggested the recognition that the documentary credit is a 'legal instrument consecrated by a mercantile custom.'

<sup>24</sup> As regards the American views see John F Dolan *The law of letters of credit, commercial and standby credits* (1991) 2<sup>nd</sup> ed from 4-22 to 2-25, see also Hugo supra note 21 at 159-160.

<sup>25</sup> See Paul Todd *Cases and materials on international trade law* (2003) 1<sup>st</sup> ed at 401.

<sup>26</sup> Op cit note 15 at 970.

because inevitably parties to a letter of credit transaction expressly subject their credit to the current version of the UCP. Further the current trends in international trade can prove that it is almost safe to now conclude that the UCP has achieved near-universal application status.

### The eUCP

In line with the ongoing technological advances which have revolutionised the world to levels unimaginable the International Chamber of Commerce introduced what has become to be known as the eUCP<sup>27</sup> to supplement the UCP in the area of electronic presentation. It came into force in April 2002.<sup>28</sup> The eUCP is not concerned with the electronic issue of letters of credit as is sometimes believed to be by many but rather it deals with presentation of electronic records, either alone or with paper-based records. The ideal electronic presentation system has been seen to have so many advantages. These range from convenience by allowing the beneficiary to present documents directly to the issuing bank instead of to an advising bank or confirming bank depending on the circumstances to providing an automated system for checking of documents.<sup>29</sup> The process of checking documents was being done manually and authorities therefore submit that the conversion to automated checking of documents will alleviate the problem of discrepancies in documents and at the same time saving labour.<sup>30</sup> This in business terms is an effective cost-cutting measure which has the potential to translate into huge profits for banks and traders alike. However, we would be naïve to think that eUCP is without its fair share of practical implementation problems.<sup>31</sup> But whatever the problems the eUCP remains very invaluable and credit must go to ICC for this initiative which of course will be improved with the

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<sup>27</sup> The current version which came as a supplement to UCP 500 is Version 1.0 copy of which has been accessed in Todd op cit note 23 at 1026 as Appendix M.

<sup>28</sup> See <http://www.iccbooks.com/products/ProductsInfo.aspx?.d=223> accessed on 31 July 2007.

<sup>29</sup> Goode op cit note 15 at 952.

<sup>30</sup> Goode loc cit note 27 says 'But it is likely to be many years before electronic presentation comes into general use.' However, I am of the view that considering the rate at which people are embracing technology nowadays we might not have to wait for many years as Goode predicted before the bulk of presentation is done electronically.

<sup>31</sup> See [http://www.globaltradecorp.com/archives/media\\_eucp1](http://www.globaltradecorp.com/archives/media_eucp1) accessed on 31 July 2007 for some of the early practical challenges encountered in trying to implement eUCP.

passage of time. In fact flexibility in the sense of coming up with new models and rules to suit the ever-changing environment of international trade has been one of ICC's strengths. Their response has been very encouraging and they have been very much alive to the need to put 'new wines in new wineskins' as it were.

### Functions of Letters of Credit

The role of letters of credit in international trade is beyond measure and indeed Hans Van Houtte<sup>32</sup> quoting with approval from Kerr J in *R.D. Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* refers to them as 'the lifeblood of international commerce.'<sup>33</sup> He further argues that this is so because the letter of credit is the most frequently used method used to pay for goods in international trade.<sup>34</sup> However it should be noted that while this is the main use of letters of credit they are also used to cover obligations which do not necessarily arise from the purchase and sale of goods. Such other types of international transactions range from long term international construction and investment projects to insurance contracts.<sup>35</sup> A very good example of the latter is the case of *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and others, Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and others*<sup>36</sup> which graphically shows the use of letters of credit in insurance contracts. Despite the numerous uses of letters of credit the focus of this dissertation is their use in the international sale of goods.

Letters of credit have different functions but perhaps the security function is arguably the most important of all. This is because letters of credit operate in such a way that they secure a transaction for both the buyer and seller. Through the use of letters of credit both parties are comforted by some degree of certainty that their contractually agreed obligations

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<sup>32</sup> Op cit note 18.

<sup>33</sup> [1978] QB 146 at 155.

<sup>34</sup> Hans van Houtte op cit note 18 at 258. Also according to Charl Hugo, 'Documentary credits: The basis of the bank's obligation', (2000) 117 SALJ 224 at 224, its popularity stems from the fact that it is perceived to be a very secure method of payment.

<sup>35</sup> Hans van Houtte ibid note 30.

<sup>36</sup> [1991] 4 All ER 181(QB).

will be fulfilled by either party to the contract. This sense of security is absolute in theory only especially with reference to the buyer because the seller is paid upon presentation of documents only and circumstances may arise as they often do in practice that what the buyer receives is not in conformity with what was agreed upon. Of course the buyer in those circumstances has the usual remedies for breach of contract. It just goes to illustrate that the security function of letters of credit is not absolute. According to Hugo<sup>37</sup> security being the most important of the functions of letters of credit they have other roles in multinational transactions namely the payment function and sometimes the credit function.

The payment function is realized where the buyer and the seller agree that payment shall be in the form of a letter of credit. This creates an obligation on the buyer to arrange for the opening of a credit in favour of the seller. In other words the buyer is required to pay by means of a letter of credit and failure to do so will be understood to be a breach of contract. The general opinion however is that the opening of a credit does not amount to absolute payment. It therefore means that if for some reason payment is not made by the responsible bank the buyer is still obliged to do so under the contract.

Though not credit instruments by nature letters of credit sometimes do have a credit function in circumstances where the parties make arrangements to that effect. Such a function arises in circumstances where the bank is willing to issue the credit prior to receiving the money from its client. The bank therefore enables the buyer to finance the credit out of the proceeds of the sale of the goods bought from the seller who is the beneficiary of the credit.<sup>38</sup> Unless so arranged therefore there is no credit purpose served by letters of credit since the bank normally requires a deposit from the buyer or at the very least some form of security before it can issue out the letter of credit. It could be safely

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<sup>37</sup> Hugo CF *Documentary Credits: The law relating to documentary credits from a South African perspective with special reference to the legal position of the issuing and confirming banks* (1996) Unpublished LLD Thesis, University of Stellenbosch at page 19.

<sup>38</sup> Hugo supra note 37 at 20.

argued however that the whole issue turns on the existent banker-customer relationship between the buyer and the bank to an extent that the bank might be willing to issue out the letter of credit without any security deposit from the buyer on account of his good track record with the bank.

### **The Documentary Nature of Letters of Credit**

Letters of credit are documentary in nature hence the name documentary credits is often used sometimes to refer to them. They are essentially document centered and this is amplified by UCP 600 where it says that ‘banks deal with documents and not with the goods, services or performance to which the documents may relate’<sup>39</sup> These documents, as Rafiqul Islam puts it, ‘play a decisive role for the operation and coming-into-effect of a documentary credit.’<sup>40</sup> This is because the confirming bank or such other bank as the case may be is only bound to pay the beneficiary upon presentation of documents which on their face conform in all material respects with the terms of the letter of credit.<sup>41</sup> This in essence is the cornerstone of the operation of letters of credit. Some of the fundamental accompanying documents which cannot be dispensed with include the following:

### **Bill of Lading<sup>42</sup>**

The bill of lading is a signed and dated receipt issued by the carrier upon taking the custody of the goods to be delivered to the specified destination.<sup>43</sup> It is a multipurpose document for it serves functions such as being proof of delivery of the goods to the carrier or his representative, proof of the contract of carriage and of the obligation to deliver the goods to the specific destination to the legitimate holder of this document, title for the holder of the bill of lading to take possession of the goods at the place of destination and a

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<sup>39</sup> Article 5 thereof.

<sup>40</sup> M Rafiqul Islam, *International trade law* (1999)1<sup>st</sup> ed at 342.

<sup>41</sup> Art 2 of UCP 600 defines complying presentation as presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international banking practice.

<sup>42</sup> See Art 20 of UCP 600.

<sup>43</sup> Islam op cit note 39 at 343.

negotiable instrument which represents the mentioned goods.<sup>44</sup> It is normally this last function as a document of title which makes the bill of lading a document of utmost importance in letters of credit enabling the holder thereof to take possession of the goods. In the same vein it allows a buyer to sell the goods in transit and transfer title to second buyer through an endorsement on the bill.

### **Commercial Invoice<sup>45</sup>**

The commercial invoice is a document prepared by the seller that describes the goods, the quantity, quality and such other things hence it is a crucial document. It is trite at law that the commercial invoice must follow the credit to the letter. Indeed Dolan is emphatic in this regard where he says that ‘It is a well established principle of letter of credit law that the description of the goods in the commercial invoice must **mirror** the description in the credit itself. The careful seller **tracks** the credit language in his invoice<sup>46</sup> (emphasis is mine). He further stresses the fact that the description of goods in this invoice serves as a benchmark for the more general descriptions of the goods in other documents.

### **Insurance Document<sup>47</sup>**

The insurance document which can either be an insurance policy, insurance certificate or a declaration provides proof that the seller has procured insurance for the cargo. On the whole it contains such details as the risks covered, the insured value, and the currency which details must conform to the credit. Normally the question as to who should take out insurance and the details thereof is laid bare by the sale contract itself and sometimes depends on the INCOTERM used by the buyer and seller upon contracting.<sup>48</sup> In the same

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<sup>44</sup> See Van Houtte op cit 18 at 269.

<sup>45</sup> Art 18 of UCP 600.

<sup>46</sup> Op cit note 24 at 1-34, See also Art 18 (c) of UCP 600 which says that the description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit.

<sup>47</sup> See Art 28 of UCP 600.

<sup>48</sup> INCOTERMS are international commercial trade terms published by the International Chamber of Commerce (ICC) and the most widely adopted terms in international trade. The current version is

vein the issue of the risks covered is taken care of sometimes but not always by the use of Institute Cargo Clauses.<sup>49</sup>

Although the above three documents stick out as a sore thumb the list is not exhaustive on the documents used in letters of credit for it is a matter of contract as to what documents to incorporate therein and there is no limit to such. The list of these documents includes multimodal transport documents,<sup>50</sup> consular documents,<sup>51</sup> certificates of origin,<sup>52</sup> certificate of inspection<sup>53</sup> among others. The letter of credit must expressly mention the details of these documents, such as who should issue them and what would be their contents.<sup>54</sup>

### Types of Letters of Credit

In the same fashion as many things that always come in different sizes and shapes letters of credit have different types or rather more appropriately referred to as forms or classifications of credit. The manner of classification was succinctly posited by Goode in the following way:

The classification is done normally with reference to such things as revocability or otherwise of the bank's undertaking, the presence or absence of a separate undertaking from a second bank, the time and mode of settlement, the range of parties entitled to enforce the undertaking, whether the credit is fixed or floating, the transferability

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INCOTERMS 2000 (ICC Publication No 560). For a detailed review of INCOTERMS visit [http://www.tradepage.co.za/customs/incoterms\\_index.htm](http://www.tradepage.co.za/customs/incoterms_index.htm) accessed on 1 August 2007.

<sup>49</sup> Institute Cargo Clauses are standard policy wordings issued by the Institute of London Underwriters. The widest cover is given under Cargo Clauses A and the scope of cover descends as you move towards Cargo Clauses C, see <http://www.dtgruelle.com/articles/nuinsabc.html> accessed on 1 August 2007.

<sup>50</sup> Art 19 of UCP 600.

<sup>51</sup> A consular document is a certificate by a consular official residing in the seller's country which basically certifies that the shipment satisfies certain statutory or other regulations of the importing country, See Dolan *op cit* note 22 at 1-3.

<sup>52</sup> A certificate of origin recites that the goods originated in a specified country, see Dolan *ibid*.

<sup>53</sup> A certificate of inspection evidences that the goods have been inspected and are in compliance with the contractual requirements. However the weight attached to such representation depends on whether the certificate has been issued by an independent third party or not, Dolan *ibid*.

<sup>54</sup> Islam *op cit* 39 at 343.

of the undertaking given to the seller by the bank and so on.<sup>55</sup>

Some of the more recognized types or classifications of letters of credit are given below. The description of each of them does not purport to be exhaustive but just a brief and general outline.

### **Revocable or Irrevocable credits**

Letters of credit are either revocable or irrevocable. A revocable credit is one which may be cancelled or revoked by the issuing bank without notice.<sup>56</sup> By contrast an irrevocable credit as its name suggests cannot be cancelled or revoked at any time for as long as the terms of the credit are met. In light of this distinction it is not that hard to imagine even to the uninitiated why the irrevocable letter of credit is the one which is always used in practice. It is simply because it provides security to the seller and no seller worth his salt would accept a revocable letter of credit. Almost all the authorities<sup>57</sup> on letters of credit have emphasized that the credit must clearly indicate its nature because in the absence of such indication it shall be deemed irrevocable.<sup>58</sup>

### **Confirmed and Unconfirmed Credits**

Confirmation means 'a definite undertaking of the confirming bank, in addition to that of the issuing bank, to honour or negotiate a complying presentation'<sup>59</sup> A confirmed letter of credit therefore is basically one where the confirming bank adds its own undertaking to that of the issuing bank and thereby confirms the issuing bank's obligation to pay the

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<sup>55</sup> Op cit 15 at 958.

<sup>56</sup> Goode supra.

<sup>57</sup> For example see Hans van Houtte op cite note 18 para 8.05 at 261, Goode op cit note 15 at 959, Islam op cit 39 at 345.

<sup>58</sup> Art 3 of UCP 600 states that 'a credit is irrevocable even if there is no indication to that effect.'

<sup>59</sup> As defined by Article 2 of UCP 600.

beneficiary upon complying presentation.<sup>60</sup> An unconfirmed credit on the other hand is one where there is no such independent undertaking by the confirming bank to pay the beneficiary upon presentation hence the latter has recourse against the issuing bank only.<sup>61</sup>

### **Sight, Acceptance and Deferred Payment Credits<sup>62</sup>**

The basis of this classification is evidently the time at which the beneficiary receives payment. A sight credit is one which provides that the confirming bank will pay against documents.<sup>63</sup> An acceptance credit requires the beneficiary to present a draft to the issuing bank, advising bank or another bank as the case may be for acceptance against documents and payment by the accepting bank at maturity.<sup>64</sup> A deferred payment credit does not provide for payment on presentation of documents or acceptance of a draft but after expiry of stated period e.g. 60 days after sight.<sup>65</sup>

### **Straight and Negotiation Credits**

A straight credit is one in which the issuing bank's or such other bank's undertaking is given in favour of the beneficiary alone as opposed to the negotiation credit where such undertaking is not merely to the beneficiary but also to those negotiating the beneficiary's drafts or documents.<sup>66</sup> Negotiation is defined by UCP 600 as 'the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to

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<sup>60</sup> Confirmation is normally requested by the seller where he wants to receive payment from a bank in his home country as opposed to the issuing bank in the buyer's country. As regards confirming bank undertaking see Art 8 UCP 600. Also note this is the subject of Chapter 4 of this dissertation.

<sup>61</sup> A credit may be irrevocable without being confirmed, but a confirmed credit is always irrevocable says Goode op cit 15 at 959.

<sup>62</sup> See Art 2 of UCP 600 under the definition of honour.

<sup>63</sup> Goode *ibid*.

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

<sup>65</sup> *Ibid*.

<sup>66</sup> Goode op cit note 15 at 961.

the beneficiary on or before the banking day on which reimbursement is due to the nominated bank<sup>67</sup>

### **Red Clause and Green Clause Credits**

A red clause credit authorises the confirming bank to pay in part as an advance to the beneficiary with or without pre-shipment documents hence it is sometimes called an anticipatory credit.<sup>68</sup> The green clause credit operates in similar fashion save that the goods are required to be warehoused in the bank's name.<sup>69</sup>

### **Back-to-Back Credits**

This comes into being where a credit is issued by the buyer in favour of the seller and against this first credit the seller applies to his bank and seeks to create another credit in favour of a third party usually a supplier who has sold goods to him.<sup>70</sup> In the words of Van Houtte the original credit and the second credit are thus 'placed back-to-back'<sup>71</sup> Important to remember is the fact that the second credit is independent from the first.

### **Revolving Credits**

This is the type that is normally used in long term commercial relationships between two parties. Instead of being for a fixed amount or for fixed time the revolving credit enables the beneficiary to present documents as often as he wishes during the credit period so long as the overall limit specified in the credit is not exceeded.<sup>72</sup> The obvious advantage of this

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<sup>67</sup> Art 2 thereof.

<sup>68</sup> Islam op cit note 39 at 347.

<sup>69</sup> Goode op cit note 15 at 968. I think this serves as some form of security to the bank if the goods are warehoused in its name. The reference as to the colours 'red' or 'green' it is said is due to the fact that such credits normally bear a notation or ink in red or green. Such credits are conspicuous by their rarity in modern day international trade financing.

<sup>70</sup> Islam op cit note 39 at 346.

<sup>71</sup> Op cit note 18 at 277.

<sup>72</sup> Goode op cit note 15 at 968.

credit is that it is cheaper because there is no need to incur the costs of opening or renewing the credit now and then.

### **Transferable Credits**

A transferable letter of credit is one which allows the beneficiary to transfer it to a third party and request the paying bank to effect payment directly to such third party. The third party is normally the beneficiary's supplier. Transferable credits are provided for in the UCP 600.<sup>73</sup> Under this article it is clear that a letter of credit is transferable only to the extent and manner agreed to by the transferring bank and it shall expressly say so on the face of it.<sup>74</sup> There is therefore no presumption of transferability in letters of credit.

### **Standby Letters of Credit**

The discussion on forms of credit cannot be complete without the mention of the standby letter of credit. A lot could be said about it but it is beyond the scope of the present study. Suffice to say that a standby credit is simply a bank guarantee in the form of documentary credit.<sup>75</sup> Put differently it is 'a form of documentary credit that serves as a bank-sponsored performance guarantee against any default of non-performance of obligation under the underlying contract of a sale.'<sup>76</sup> This has led commentators to conclude, justifiably so, that standby credits are not true documentary credits. Authorities are further agreed on the fact that standby credits originated mainly from the United States of America where their law did not allow banks to pose as sureties and to issue bank guarantees.

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<sup>73</sup> See Art 38 thereof.

<sup>74</sup> Art 38 (a) and (b) of UCP 600.

<sup>75</sup> See Van Houtte op cit note 18 at 274.

<sup>76</sup> Islam op cit note 39 at 346. Further he goes on to give useful distinction of a standby credit and a letter of credit at 347, See also Dolan op cit note 45 at 1-15ff and Goode op cit note 15 at 1015ff who both clear the confusion that sometimes surrounds the true nature of standby credits vis-à-vis demand guarantees and performance bonds.

The above represents a summary of the various classifications of letters of credit. As pointed out from the outset the list does not claim to be exhaustive but largely represents the major forms and any omissions are not intentional.

### **Autonomy of Letters of Credit**

Autonomy of a letter of credit is a time honoured principle which is at the core of the fluid operation of letters of credit and it basically says that a credit is a separate transaction independent from the underlying contract between the buyer and seller i.e. it is an autonomous obligation, to be more legalistic. The UCP 600 is very instructive in this regard and it says:

A credit by its nature is separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank<sup>77</sup>

Invariably the courts have religiously followed the above prescription from the UCP. One such illustrative case is **Hamzeh & Sons v British Imex Industries Ltd** where Jenkins L.J. said:

it seems plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not....<sup>78</sup>

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<sup>77</sup> Art 4(a) thereof.

<sup>78</sup> [1958] 2 QB 127 at 129. This dictum has been extensively quoted by most leading authorities on the subject as it is really spot on in so far as pronouncing the principle of autonomy of credits is concerned. See for example Jason Chua op cit note 2 at 488, Todd op cit note 23 at 399 among others.

The rationale underpinning the autonomy principle in letters of credit has been postulated as the need to give ‘certainty in relation to payment obligations in commercial instruments.’<sup>79</sup> Chua quoting with approval from Dandy and Davidson also says that ‘the reason is that “an elaborate commercial system had been built up on the footing that bankers’ confirmed credits are of that character.” It would be wrong to interfere with the legitimate mercantile desire for certainty’<sup>80</sup>

## **Conclusion**

This general overview establishes the foundation upon which this dissertation is built. Having given this general bird’s eye view on letters of credit the focus now shifts to an analysis of the contractual relationships of the parties therein which is the crux of this dissertation. The intention is to put each of the contracts under the microscope with a view to establishing the kind of legal relationship obtaining between the two parties involved at every stage in the letter of credit transaction. It is very important at this juncture to reiterate the fact that this research focuses on the standard four-party confirmed irrevocable letter of credit whose parties are the applicant, the issuing bank, the confirming bank and the beneficiary.<sup>81</sup>

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<sup>79</sup> Goode op cit note 15 at 972. See also Ellinger, ‘The Autonomy of letters credit after the American Accord’ (1983) *Australian Business Law Review* 188.

<sup>80</sup> Op cit note 2 at 488.

<sup>81</sup> The terms applicant and beneficiary and buyer and seller respectively are used interchangeably throughout the dissertation.

## CHAPTER TWO

### The Contractual Relationships Involved

In the famous case of *United City Merchants v Royal Bank of Canada, The American Accord*<sup>82</sup>, Lord Diplock said that it is trite law that there are four autonomous contracts in an irrevocable confirmed credit. I have succumbed to the temptation to quote extensively from the learned judge, understandably so because the passage captures graphically the heart and soul of this dissertation. He said thus:

It is trite law that there are four autonomous though interconnected contractual relationships involved: (1) the underlying contract for the sale of goods, to which the only parties are the buyer and the seller, (2) the contract between the buyer and issuing bank under which the latter agrees to issue the credit and either itself or through a confirming bank to notify the credit to the seller and to make payments to or to the order of the seller (or to pay, accept or negotiate bills of exchange drawn by the seller) against presentation of stipulated documents, and the buyer agrees to reimburse the issuing bank for payments made under the credit. For such reimbursement the stipulated documents, if they include a document of title such as a bill of lading, constitute a security available to the issuing bank, (3) if payment is to be made through a confirming bank, the contract between the issuing bank and the confirming bank authorizing and requiring the latter to make such payments and to remit the stipulated documents to the issuing bank when they are received, the issuing bank in turn agreeing to reimburse the confirming bank for payments made under the credit, (4) the contract between the confirming bank and the seller under which the confirming bank undertakes to pay to the seller (or to accept or negotiate without recourse to drawer bills of exchange drawn by him) up to the amount of the credit against presentation of the stipulated documents<sup>83</sup>

### The Relationship between the Applicant and the Beneficiary

For one to fully understand the relations of the parties involved in a letter of credit transaction it is imperative to analyse the legal relationships between them. Although the applicant, beneficiary and the issuing bank are said to be the minimum parties required there can be more parties depending on the circumstances of the particular letter of credit

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<sup>82</sup> [1982] 2 Lloyd's Rep 1 or [1983] 1 AC 168.

<sup>83</sup> [1982] 2 Lloyd's Rep 1 at 6.

under review.<sup>84</sup> The scope of this dissertation is on the four-party confirmed irrevocable letter of credit as posited by Lord Diplock in the *United City Merchants* case quoted above.

### The Underlying Contract

The contract between the applicant and the beneficiary occupies an important position for it is the *conditio sine qua non* for the use of the credit as a payment method.<sup>85</sup> This contract, which in the present discussion takes the form of a contract of sale of goods, is more often than not, in the letters of credit world, referred to as the underlying contract or agreement.<sup>86</sup> There is no formula as to the formation of the underlying contract between the applicant and the beneficiary but it is simply a matter of contract on which the parties have an unfettered discretion as to what terms to include in the contract. However, McCullough reckons that the parties must consider various matters, including economic, political and legal issues in the contract negotiations.<sup>87</sup>

### The Law Governing the Contract

A pertinent issue that usually crops up at this stage is: What law will govern the contract? In terms of both the common law and the Rome Convention<sup>88</sup> the parties can expressly or impliedly choose the law governing their contract failing which it will be governed by the law of the country with which it is most closely connected as decided by the court or the arbitration tribunal depending on the dispute settlement method chosen. In the

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<sup>84</sup> See *ICC Guide to documentary credit operations for the UCP500*, 1994 by Charles del Busto at 23 where it says that there exists a distinct triangular contractual arrangement. It goes on to list the main parties as the applicant, the beneficiary and the issuing bank but leaves scope for the inclusion of the confirming bank or such other bank into the equation.

<sup>85</sup> Goode op cit note 15 at 978 describes it as 'the root contract from which all others stem' Note that the applicant is the buyer and the beneficiary the seller. These terms are normally used interchangeably.

<sup>86</sup> It does not necessarily have to be a contract of sale of goods. There could be other reasons or transactions giving rise to the obligation on the applicant to pay the beneficiary where a letter of credit is used.

<sup>87</sup> Burton V McCullough, *Letters of credit: Commercial and standby letters of credit, bankers' and trade acceptances*, Publication 387 Release 37, 2007 at 2-4ff where he gives a detailed analysis of some these factors to be taken into account by the parties to an international trade transaction.

<sup>88</sup> Rome Convention on the Law Applicable to Contractual Obligation. See the Report by Giuliano & Lagarde OJ 1980 No. C282/1. See also [www.rome-convention.org/instruments/i\\_conv\\_orig\\_en.htm](http://www.rome-convention.org/instruments/i_conv_orig_en.htm) Accessed on 20 September 2007.

international trade arena the applicant and the beneficiary coming from different countries are more often than not, very suspicious of each other's legal system. This explains their reluctance to subject their contract to the contract law of either country as the law governing their contract. Inevitably the trend nowadays is for the parties to choose transnational law i.e. a system of law unconnected with any country otherwise popularly known the modern *lex mercatoria*.

Various codes and conventions have been developed to provide a useful source of this transnational law. The United Nations Convention on the International Sale of Goods better known as the CISG is the leading light in this regard because it has gained enormous popularity by parties in international sale of goods since it was crafted with the internationality of the contract in mind.<sup>89</sup> In essence it governs the formation of the contract of sale and the rights and obligations of the seller and the buyer.<sup>90</sup> The other general principles normally referred to are the UNIDROIT Principles<sup>91</sup> and the Principles of European Contract Law (PECL)<sup>92</sup> which in practice are usually used together with the CISG.<sup>93</sup> These codes and principles which form part of the transnational law can be the subject of another extensive discussion outside the present scope. Suffice to say that the applicant and the beneficiary have these at their disposal at the contracting stage as an invaluable tool to reaching an acceptable solution to their difficulties as to the law governing their contract.

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<sup>89</sup> So many authors have written extensively on the CISG see for example *Review of the Convention on contracts for the international sale of goods (CISG) 2000-2001* edited by Pace International Law Review, *The United Nations Convention on contracts for the international sale of goods: New Zealand's proposed acceptance*, Report No.23 New Zealand Law Commission 1992, *Twenty years of international sales law under the CISG(The UN Convention on contracts for the international sale of goods)* edited by Michael R. Will 200, the Pace University School of Law and Institute of International Commercial Law website at <http://www.cisg.law.pace.edu> among others.

<sup>90</sup> See Art 4 thereof.

<sup>91</sup> See [www.unidroit.org/english/principles/contracts/main.htm](http://www.unidroit.org/english/principles/contracts/main.htm) accessed on 27 November 2007.

<sup>92</sup> See [www.jus.uio.no/lm/eu.contract.principles.1998/doc.html](http://www.jus.uio.no/lm/eu.contract.principles.1998/doc.html) accessed on 27 November 2007.

<sup>93</sup> See Pace International Law Review supra at 373 where it discusses gap-filling.

What is of interest to the present scope is what is known as the credit clause. The credit clause is a clause in the underlying contract providing for the issuing of a letter of credit in favour of the seller.<sup>94</sup> It is strongly recommended that parties agree on almost all the details of the letter of credit to be issued as leaving it uncertain will give rise to problems the cost of which will be too huge to count for both parties. In that eventuality it will be up to the court whether or not to imply the ‘reasonable’ or ‘usual’ terms into the credit a scenario which both parties must as far as they can, avoid at all costs.<sup>95</sup>

### **Issuance of Letter of Credit as a Condition Precedent to Formation of the Underlying Contract**

The issuance of a letter of credit may be made a condition precedent to the formation of the underlying contract i.e. where it stipulates that the contract is ‘subject to the issuance of a letter of credit by bank X.’ What it simply means is that for as long as the applicant has not secured the issuance of a letter of credit in favour of the beneficiary then it is as good as there is no contract in existence at all between the parties. McCullough<sup>96</sup> discusses this by referring to *Dix v Grainer*<sup>97</sup> which he describes as ‘one of the shortest cases ever tried.’ In that case, the defendant agreed to ship blankets to the plaintiff, but failed to do so. The plaintiff sued for breach of contract. At the commencement of the of the proceedings, Bailhache J inquired as to whether the plaintiff had provided the letter of credit called for in the underlying contract. When counsel for the plaintiff replied that the credit had never been issued his Lordship stated ‘Then that is the end of the case.’<sup>98</sup> This case illustrates the importance that should be attached to the obligation to issue a letter of credit by the applicant where the contract spells out that it is condition precedent to the formation of the contract. If the applicant does not take this seriously he does so at his own peril as shown in the case above and must be prepared to bear the brunt of his wilful conduct.

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<sup>94</sup> An Oelofse, *The law of documentary letters of credit in comparative perspective* (1997) 1<sup>st</sup> ed at 67, see also McCullough op cit note 87 at 2-61.

<sup>95</sup> See *Ficom SA v Sociedad Cadex Limitada* [1980] 2 Lloyd’s Rep 188 at 131.

<sup>96</sup> Op cit note 87 at 2-62.

<sup>97</sup> [1922] 10 Lloyds Law Report 496.

<sup>98</sup> At 497.

### Issuance of Letter of Credit as a Condition Precedent to the Performance by the Beneficiary

If issuance of the letter of credit cannot be said to be a condition precedent to the formation of the underlying contract then it certainly will be a condition precedent to the performance of the contract by the beneficiary.<sup>99</sup> Lord Denning, one of the greatest and illustrious law lords to ever sit on the bench had the occasion, as he always does, to graphically explain the distinction between the issuance of a letter of credit as a condition precedent to the formation of the underlying contract and issuance of the letter of credit as a condition precedent to the performance of the contract by the seller in *Trans Trust S.P.R.L v Danubian Trading Company Ltd*<sup>100</sup> in the following way:

...The ability of the seller to carry out the transaction is therefore, dependent on the buyer providing the letter of credit: and for this reason the seller stipulates that the credit should be provided at a specified time, well in advance of the time for the delivery of the goods.

What is the legal position of such a stipulation? Sometimes it is a condition precedent to the formation of a contract, that is, it is a condition which must be fulfilled before any contract is concluded at all. In those cases the stipulation “subject to the opening of a letter of credit” is rather like a stipulation “subject to contract.” If no credit is provided, there is no contract between the parties. In other cases a contract is concluded and the stipulation for a credit is a condition which is an essential term of the contract. In these cases the provision of the credit is a condition precedent not to the formation of the contract but to the obligation of the seller to deliver the goods. If the buyer fails to provide the credit, the seller can treat himself as discharged from any further performance of the contract and can sue the buyer for damages for not providing the credit<sup>101</sup>

It is very rare for the issuance of the letter of credit to be a condition precedent to the formation of the underlying contract.<sup>102</sup> It is submitted that this is understandable because

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<sup>99</sup> McCullough op cit note 87 at 2-62.

<sup>100</sup> [1952] 2 QB 297.

<sup>101</sup> At 304.

<sup>102</sup> McCullough op cit note 87 at 2-63. According to Professor Ellinger, the position that the buyer’s duty to procure a documentary credit is an essential term of the contract of sale, and is a condition precedent to the seller’s duty to ship the goods, is the rule in France. See footnote 13 in McCullough at 2-64.

when parties in international trade enter into contract negotiations they do so with the intention to implement the contract to its logical conclusion. They would not want the contract to fail because of the failure by the buyer to issue out a letter of credit as payment. An alternative method of payment could be equally acceptable to the seller so that it makes business sense to make the letter of credit a condition precedent to the performance of the contract because the seller can waive that requirement in the event of difficulties. On the other hand making it a condition precedent to the formation of the underlying contract does more harm than good because failure by the buyer to procure the credit simply means there is no contract in existence between the parties. In light of this if one considers the amount of effort and costs involved in the negotiation of such international sale contracts it becomes apparent why it is rare in practice to provide that the issuance of the letter of credit is a condition precedent to the formation of the underlying contract.

### **Time Required for Opening of a Credit**

The applicant and the beneficiary must make sure that the credit clause stipulates the time within which the former must obtain the letter of credit from the issuing bank. It is trite at law that where the time is specified then the credit must be issued within that time. Failing such pronouncement in the underlying contract the courts have held that the beneficiary is entitled to have the letter of credit in his hands within a reasonable time. The word 'reasonable' does not always carry the same meaning all the time but it rather takes the shade of its surroundings. It is advisable therefore for parties to put the matter beyond any shadow of doubt by merely stipulating in no uncertain terms in the contract the time by which the credit is to be opened. However, where there is no such specification the term "reasonable time" has been interpreted by the courts, as Goode<sup>103</sup> puts it, to mean no later than the earliest shipping date open to the beneficiary under the contract<sup>104</sup> and probably

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<sup>103</sup> Op cit note 15 at 980.

<sup>104</sup> See *Pavia & Co S.P.A v Thurmann Nielsen* [1952] 2 QB 84.

a sufficient time before that date to enable him to make the necessary shipping arrangements.<sup>105</sup>

The law as regards the time of issuance of a credit can be aptly summarized by the following dictum in the Pavia case:<sup>106</sup>

In the absence of express stipulation, the credit must be made available to the seller at the beginning of the shipment period. The reason is because the seller is entitled, before he ships the goods, to be assured that, on shipment, he will get paid. The seller is not bound to tell the buyer the precise date when he is going to ship, and whenever he does ship the goods must he must be able to draw on the credit. If the buyer is to fulfill his obligations, he must, therefore, make the credit available to the seller at the very first date when the goods may be lawfully shipped in compliance with the contract.<sup>107</sup>

According to Oelofse even the fact that the buyer could not find a bank willing to issue the letter of credit on his instructions or failure by the bank to open the credit in time is no defence against the seller.<sup>108</sup> In short the applicant has an absolute obligation to ensure that the letter of credit is issued in favour of the beneficiary within the time stipulated in the underlying contract. Failure to do so amounts to breach of contract which attracts the usual remedies against the applicant. In fact as a general rule the credit must conform to the requirements of the underlying contract.

### **A Letter of Credit - Absolute or Conditional Payment?**

An important question worth considering at this stage is whether or not a letter of credit constitutes absolute or conditional payment. In other words what is the effect of opening of a confirmed irrevocable letter of credit on the obligation of the buyer to pay the

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<sup>105</sup> See *Ian Stach Ltd v Baker Bosley Ltd* [1958] 2 QB 130.

<sup>106</sup> Supra note 104.

<sup>107</sup> Per Denning L.J at 88.

<sup>108</sup> Op cit note 94 at 75.

purchase price in terms of the underlying contract? According to Oelofse and many other authorities it is generally accepted that the buyer's obligation to pay the purchase price in terms of the underlying contract of sale is not simply terminated when the letter of credit required by the credit clause is issued.<sup>109</sup> Put differently the opening of a letter of credit in favour of the seller is generally considered to be conditional payment in the absence of any express agreement to the contrary. The authorities seem to suggest that during the currency of the letter of credit the seller's right to sue the buyer for the purchase price is suspended but is revived automatically by failure of the issuing bank to honour the credit. In his article exploring the effect of opening an irrevocable credit and of acceptance of bills drawn thereunder on the position of a buyer Ellinger says that English, Commonwealth and American authorities have all established that both operate as mere conditional discharges, so that if the issuing banker fails to perform the undertaking given in the irrevocable credit, or fails to meet the acceptance, the buyer's duty to pay the price is revived.<sup>110</sup>

In *WJ Alan & Co Ltd v El Nasr Export and Import Co*<sup>111</sup> Lord Denning had the occasion to consider all the possible effects of issuing a letter of credit on the underlying claim of the seller against the buyer for the purchase price. Firstly it may be argued that the letter of credit constitutes absolute payment and as regards the effect of this the learned judge had this to say:-

If the letter of credit is absolute payment of the price, the consequences are these: The seller can only look to the banker for payment. He can in no circumstances look to the buyer. The seller must present the documents to the banker and get payment from him in cash or get him to accept sight or time drafts. If the banker does not take up the documents, the seller will retain them, resell and sue the banker for damages. If the banker takes up the documents in exchange for time drafts, and the banker afterwards becomes insolvent, the seller must prove in liquidation. He cannot sue the buyer.<sup>112</sup>

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<sup>109</sup> *Supra* at 83.

<sup>110</sup> See Ellinger EP 'Does an irrevocable credit constitute payment?' (1977) 40 *MLR* 91.

<sup>111</sup> [1972] 1 *Lloyd's Rep* 313.

<sup>112</sup> At 321.

Secondly and which seems to be the general rule the letter of credit may constitute conditional payment and for this Lord Denning explained thus:-

If the letter of credit is conditional payment of the purchase price, the consequences are: The seller looks in the first instance to the banker for payment: but if the banker does not meet his obligations when the time comes for him to do so, the seller can have recourse to the buyer. The seller must present the documents to the buyer. One of two things may happen :(i) The banker may fail or refuse to pay or accept drafts in exchange for the documents. The seller then, of course, does not hand over the documents. He retains dominion over the goods. He can resell them and claim damages from the buyer. He can also sue the banker for not honouring the credit... But he cannot, of course, get damages twice over. (ii) The bank may accept time drafts in exchange for the documents, but may fail to honour the drafts when the time comes. In that case the banker will have the documents and will usually have passed them on to the buyer, who will have paid the bank for them. The seller can then sue the banker on the drafts, or if the banker fails or is insolvent, the seller can sue the buyer. The banker's drafts are like any ordinary payment for goods by a bill of exchange. They are conditional payment, but not absolute payment. It may mean that the buyer (if he has already paid the bank) will have to pay twice over. So be it. He ought to have made sure that he employed a 'reliable and solvent paymaster'<sup>113</sup>

Finally it may be that the letter of credit constitutes no payment at all. About this he had this to say:-

If the letter of credit is no payment at all, but only a means by which payment maybe obtained, i.e. if it is only collateral security, the consequences are these: The seller ought to present the documents to the banker. If the seller does not do so, he will be guilty of laches in enforcing his security and the buyer will be discharged...But if on presentation the banker fails or refuses to take up the documents, then (if the letter of credit is only collateral security) the seller will be entitled to take the documents round to the buyer (or send them to him) and demand that he take them up and pay the price. This situation finds no place in any of the authorities.<sup>114</sup>

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<sup>113</sup> At 322.

<sup>114</sup> Idem.

Lord Denning's conclusion from his analysis was that a letter of credit normally operates as conditional payment and not as absolute payment. He drew an analogy to the case where under a contract of sale, the buyer gives a bill of exchange or a cheque for the price which is presumed to be given not as absolute payment nor as collateral security but as conditional payment. Only in circumstances where to hold otherwise would do violence to clear instructions or indications will a letter of credit operate as absolute payment. It seems therefore as Hugo puts it that whether payment is absolute or conditional is therefore a question of construction of the contract hence there is warning against generalisation.<sup>115</sup>

According to Todd<sup>116</sup> the principles in *W.J. Alan & Co. Ltd v El Nasr Export and Import Co.*<sup>117</sup> create only a presumption, which is rebuttable, and therefore the courts must treat payment under a letter of credit as absolute rather than conditional payment where the circumstances so indicate. One such situation as per Lord Denning in that case is where the seller 'stipulates for the credit to be issued by a particular bank in such circumstances that it is to be inferred that the seller looks to that particular banker to the exclusion of the buyer'<sup>118</sup> Even then it has been held that the mere fact of the seller choosing a particular banker does not on its own automatically make the letter of credit absolute payment since that choice only is one of the factors to be taken into account before coming to that conclusion. It is clear from the above and rightly observed by Todd<sup>119</sup> that there appears to be a strong presumption in favour of construing letters of credit as conditional payment only, unless there is an express stipulation to the contrary.

### **The Effect of Payment under Reserve on the Buyer's Payment Obligation**

Payment under reserve, according to Oelofse means that the bank to which the documents are presented pays the beneficiary but subject to an agreement that the beneficiary will

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<sup>115</sup> Hugo op cit note 37 at 25.

<sup>116</sup> Paul Todd, *Bills of lading and bankers' documentary credits* (1993) 2<sup>nd</sup> ed at 71.

<sup>117</sup> Supra note 111.

<sup>118</sup> At 321-2.

<sup>119</sup> Op cit note 116 at 72.

repay the bank if the paying bank's mandator eventually rejects the documents.<sup>120</sup> This procedure is normally used by the bank in circumstances where it has a reasonable doubt about the conformity of the documents presented and so it "pays under reserve" to cover its back so to speak. This is understandable if regard is had to the fact that reality on the ground indicates that presentation of discrepant documents is a regular occurrence. The question in the present context then is: What is the effect of payment under reserve on the buyer's obligation to pay? Whilst "normal payment" under the letter of credit is absolute and final, in the case of payment under reserve the payment becomes absolute and final and therefore payment under the letter of credit only when the "reserve" falls away thereby discharging the buyer from the obligation to pay.<sup>121</sup>

## Possible Claims and Defences

### Claims

It is trite law that regarding breaches of the underlying contract the normal principles of contract law apply. Take for instance, in the event of the credit received by the seller not conforming to the requirements stipulated in the underlying agreement the buyer will be in breach of this contract either through repudiation or positive malperformance as Hugo puts it.<sup>122</sup> One of the most common if not daily happenings is that the beneficiary delivers nonconforming goods but somehow manages to draw under the letter of credit. In that eventuality and according to McCullough, depending upon the circumstances the applicant may have a claim against the beneficiary for a wrongful draw under the letter of credit based upon breach of contract, fraud, money had and received or some other ground for relief.<sup>123</sup> He further submits that one of the claims that the applicant may have against the beneficiary but which is rarely used in practice is a claim for breach of warranty. The warranty is that the drawing of money by the beneficiary under the letter of credit does

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<sup>120</sup> Op cit note 94 at 102.

<sup>121</sup> Supra at 104.

<sup>122</sup> Op cit note 37 at 22.

<sup>123</sup> Op cit note 87 at 2-77. Some other ground for relief could possibly include a claim for unjustified enrichment.

not violate the agreement between the applicant and the beneficiary or any other agreement intended by them to be augmented by the letter of credit.<sup>124</sup> Thus, according to him, if the drawing does violate the underlying contract between the applicant and the beneficiary, the applicant will most likely have a direct cause of action for breach of contract against the beneficiary.<sup>125</sup> This summary of claims does not purport to be exhaustive but only illustrative for it may be possible to sustain other claims depending on the circumstances giving rise to the cause of action.

### Defences

It is common knowledge that the rationale underpinning the issuance of a letter of credit in international trade transactions is to provide the beneficiary with a mechanism of payment that is certain and is free of any disputes that come with the underlying contract. Such disputes normally border around the non-compliance of goods with the description in the underlying contract which non-compliance can either be qualitative or quantitative or both depending on the circumstances. Defences arising from the underlying relationship between the applicant and the beneficiary cannot be used by the former to stop payment by the bank to the latter. As Oelofse puts it, the validity of any complaints that the buyer might have concerning the underlying contract will have to be decided later after the seller has received payment under the credit, a principle normally expressed by the maxim “pay first and litigate later”.<sup>126</sup> This is in line with the principle of autonomy or independence of letters of credit which is the heart and soul of the smooth operation of letters of credit in international trade.<sup>127</sup>

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<sup>124</sup> *Supra* at 2-78.

<sup>125</sup> For examples of claims involving letter of credit see the following American cases cited and discussed by McCullough in detail, *Sherkate Sahami Khass Rapol v Henry R. Jahn & Son, Inc* 701 F 2d 1049, *Fertico Belgium S.A v Phosphate Chemicals Export Assn Inc* 100 AD 2d 165, *Hyosung America, Inc v Sumagh Textile Co. Ltd* 25 F Supp 2d 376.

<sup>126</sup> *Op cit* note 94 at 376.

<sup>127</sup> For a detailed discussion of the principle of autonomy of letters of credit as outlined in the UCP and applied in case law see Chapter 1 above at 17-18.

It would be folly for the beneficiary to think that in all the circumstances he will be entitled to payment despite the applicant raising a defence because the law does recognize some exceptions to the independence principle. The leading, if not the only exception in this regard is the fraud exception. Thus the court will, at the instance of the applicant interfere and almost certainly interdict the bank from paying the beneficiary where the transaction is tainted by clear fraud on the part of the beneficiary.<sup>128</sup> This is because “fraud unravels all” if I may borrow that expression from Lord Denning, used with reference to demand guarantees but equally applicable to letters of credit since the principles that guide the operation of both instruments are basically the same.<sup>129</sup> The possibility of illegality of the underlying agreement as another exception giving rise to a possible defence to a claim under a letter of credit was explored in the case of *United City Merchants (Investments) Ltd and Ors v Royal Bank of Canada and Ors*.<sup>130</sup> Although due to the peculiar circumstances of that case the court recognized the illegality exception a warning has been given not to take that case as authority for the general proposition that any illegality inherent in the underlying relationship will provide a valid defence to claim under the letter of credit relationship.<sup>131</sup> It is submitted however that the courts should not hesitate to treat illegality of the underlying agreement in the same manner as fraud thereby recognizing a further exception to the independence principle. This is because it does violence to logic and to the tenets of good faith to allow a party to an illegal agreement to profit from a claim under the letter of credit issued pursuant to that illicit contract on the basis of upholding the principle of autonomy of credits. Surely this is where the law should move away from rigidity and possibly expand the exceptions to the general rule. The law must indeed carve

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<sup>128</sup> See the dictum of Kerr J in *RD Harbottle (Mercantile) Ltd and Anor v National Westminster bank Limited and Others* [1977] 2 All ER 862 at 870. There are a plethora of cases on the fraud exception and the leading cases include *Discount Records Ltd v Barclays Bank Ltd and Anor* [1975] 1 All ER 1071, *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Umma Bank* [1978] 1 All ER 976 among others. The subject of fraud is canvassed in greater detail in the final chapter of this dissertation.

<sup>129</sup> See the judgment of Lord Denning in the *Edward Owen Engineering Case* supra.

<sup>130</sup> [1981] 3 All ER 142, [1982] 2 All ER 270.

<sup>131</sup> See Oelofse op cit note 94 at 391 and 394. The peculiar circumstances of the case which led the court to recognize a further exception to the autonomy principle under the head of illegality was that the agreement seemed to contravene Article VIII (2) of the International Monetary Fund Agreement to which Britain was a part. This played a major role in the court’s conclusion hence the warning not to take the case as establishing a further exception.

a further exception to the fraud exception and provide a valid defence to a claim under a letter of credit in such circumstances. As it stands the law recognizes the fraud exception only.

## CHAPTER THREE

### The Relationship between the Applicant and the Issuing Bank

The second of the four contracts under the microscope in a letter of credit transaction is the contract between the applicant (buyer) and the issuing bank. The issuing bank is invariably referred to as the issuer whilst the applicant is branded the account party.<sup>132</sup>

Pursuant to the underlying agreement the applicant approaches and concludes a contract with a bank in terms of which the latter undertakes to issue a letter of credit in favour of the beneficiary. It therefore means that whatever instructions the applicant gives to the issuing bank and the resultant letter of credit have to follow the credit clause in the underlying agreement to the letter otherwise it will be open to challenge by the beneficiary for want of conformity with the underlying agreement.

### The Legal Nature of the Relationship

The relationship between the applicant and issuing bank is that of banker and customer, generally understood to be governed by a contract of mandate.<sup>133</sup> In its very basic form the contract of mandate has been defined as ‘a contract in terms of which the mandatary (in this case the [issuing] bank) undertakes to perform a commission or task for the mandator (in this case the applicant), either gratuitously or for reward.’<sup>134</sup> A divergent view has sought to classify the contract between the applicant and the issuing bank as one of agency.

According to this school of thought deciphered from the cases of *Midland Bank Ltd v Seymour*<sup>135</sup> and *Bank Melli Iran v Barclays Bank (Dominion, Colonial and Overseas)*<sup>136</sup> the issuing bank acts as the applicant’s agent. However, this characterization has been dismissed by

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<sup>132</sup> See Dolan op cit note 24 in Chapter 7 of his book, who consistently uses these terms. This is because essentially the letter of credit is issued for the account of buyer i.e. the applicant and the bank issuing out the credit understandably becomes the issuer. However, the terms applicant and issuing bank shall be consistently used in this thesis to refer to the parties to this contract with the minimal variations where necessary. Note that this is in line with terminology of UCP 600. Further as McCullough op cit note 87 at 3-7 rightly points out there can be non-bank issuers of credit but the focus here is on that of a bank issuer.

<sup>133</sup> See Oelofse op cit note 94 at 112, Hugo op cit note 37 at 28.

<sup>134</sup> Supra note 133 at 113.

<sup>135</sup> [1955] 2 Lloyd’s Rep 147.

<sup>136</sup> [1951] 2 Lloyd’s List Rep 367.

almost all the authorities as based on a clear misunderstanding of the relationship obtaining between the applicant and the issuing bank in a letter of credit transaction.

To clear the air Oelofse has explained the difference between agency and a general mandate relationship as follows:

An agent performs a juristic act in the name of his principal, thereby creating legal relationships for the principal. A mandatary simply performs some or other act (not necessarily a juristic act in the name of the mandator) on the instruction of the mandator. The two relationships may overlap but need not. An issuing bank is the applicant's mandatary but not his agent, because the issuing bank is not authorised to perform a juristic act in the name of the applicant.<sup>137</sup>

Another possibility that has been explored is to classify the relationship between the applicant and the issuing bank as fitting into the phenomenon of a contract for the benefit of a third party, more popularly known in contract law circles as *stipulatio alteri* or *ius quaesitum tertio*.<sup>138</sup> However, this possibility has also been dismissed off hand on the basis that the contract of mandate between the applicant and the issuing bank creates no rights for the beneficiary and further that the issuing bank becomes bound to the beneficiary only on the issuing of the letter of credit to him.<sup>139</sup> Oelofse submits, rightly so, that the relationship between the applicant and the issuing bank is not a contract for the benefit of a third party is supported by the UCP.<sup>140</sup> Article 4 (a) of UCP 600 says that a beneficiary can in no case avail itself of the contractual relationship existing between banks or between the applicant and the issuing bank. The conclusion therefore, to which the present writer subscribes, is that the relationship between the applicant and the issuing bank in a letter of credit transaction is a contract of mandate.

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<sup>137</sup> See Oelofse op cit note 94 at 112 in footnote 2. See also Ellinger as quoted by Hugo op cit note 37 at 28 where he points out that the relationship is not one of agency because 'the issuing bank does not contract on the buyer's behalf but at the buyer's request'. See also Goode op cit note 15 at 982.

<sup>138</sup> For a clear explanation of this concept see RH Christie, *The law of contract in South Africa*, 5<sup>th</sup> ed 2006, at 261 ff.

<sup>139</sup> Oelofse op cit note 94 at 113.

<sup>140</sup> Ibid.

### **Agreement for Issuance of a Letter of Credit**

Invariably the agreement between the applicant and the issuing bank comes into being following a formal application by the former to the latter through the use of a standard application form. In relation to the basic principles of contract law the applicant's filling in and submission of the application form constitutes an offer which the issuing bank accepts by conduct in issuing the letter of credit or rejects by refusing to issue out the credit.<sup>141</sup> Indeed the issuing bank is not obliged to accept the offer by automatically issuing out a letter of credit once an application form is submitted. Just like in any contract situation and in line with doctrine of freedom of contract it is well within its power to either accept or reject the offer. McCullough puts it thus 'the [issuing] bank is empowered to act upon the application and open a letter of credit, but it is not bound to do so.'<sup>142</sup>

Procedurally therefore the applicant having identified the appropriate issuing bank proceeds to fill in the issuing bank's standard application form setting out the details as he would want them to appear in the letter of credit. Again in the same way that the contract law of most countries does not require contracts to be written, the contract between the applicant and the issuing bank need not be in writing. However, it has become a rule of convention that the contract is written and normally takes the form of a standard application form. This is not hard to imagine if regard is had to the fact that writing minimizes, if not eliminates potential disputes about the exact terms and conditions of the contract and moreover there is no better proof of the existence of such a contract than a written document to which signatures of the parties are affixed.

Generally the standard application form consists of two parts namely, an application form containing the instructions of the applicant to the issuing bank and a contract for reimbursement and security agreement combined with some additional provisions.<sup>143</sup> It is

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<sup>141</sup> Goode op cit note 15 at 981.

<sup>142</sup> Op cit note 87 at 3-16.

<sup>143</sup> Ibid.

imperative that the applicant's instructions to the issuing bank must be clear and unequivocal. The UCP 500 was very instructive in this regard. Article 5 thereof emphasized that the instructions be complete and precise and discouraged the inclusion of excessive detail to avoid confusion and misunderstandings. It is observed that for reasons best known to the ICC this provision was omitted in the UCP 600.<sup>144</sup> It is the opinion of the writer that such an omission does not necessarily alter the position because it is indispensable that instructions by the applicant to the issuing bank be clear and precise. It is clearly in the interests of both parties to the contract that it be so. The problem with vague instructions is that logically the letter of credit will be ambiguous as well and it will be construed against the issuer. In *Credit Agricole Indosuez v Muslim Commercial Bank Ltd*<sup>145</sup> the terms of the credit left it unclear whether the presentation of certain specified documents was a condition of the credit and the confirming bank was held entitled to conclude that they were not and to receive payment from the issuing bank.<sup>146</sup>

Besides ensuring that his instructions to the issuing bank are clear the applicant also has to see to it that his instructions are consistent with the terms of the underlying agreement with the beneficiary. Regardless of what is contained in the underlying agreement, the issuing bank is concerned only with its customer's instructions as contained in the application for the letter of credit.<sup>147</sup> However, failure by the applicant to model his instructions along the lines of the underlying agreement might spell disaster for him. This is so because if the letter of credit issued is at variance with the underlying agreement the beneficiary will rightfully be entitled to reject the letter of credit. This might mean that the applicant will be held liable for breach of underlying agreement for failing to provide a

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<sup>144</sup> Perhaps as regards the discouragement of including excessive detail by the applicant Article 4 (b) of UCP 600 can be said to cover that by saying that 'an issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like.'

<sup>145</sup> [2000] 1 Lloyd's Rep 275.

<sup>146</sup> See also the following cases all of which show the dangers of imprecise and unclear instructions, *Ireland v Livingstone* [1872] LR 5 395, *Midland Bank Ltd v Seymour* [1955] 2 Lloyd's Rep 142, *Commercial Banking Co of Sydney v Jalsard Pty Ltd* [1973] AC 279.

<sup>147</sup> McCullough op cit note 87 at 3-14. See also Article 5 of UCP 600.

valid letter of credit as per the contract stipulation.<sup>148</sup> Such breach will no doubt attract the usual claims for damages; therefore the applicant must be careful when sending his instructions to the issuing bank for mere laxity in that regard will result in him facing consequences too ghastly to bear.

### **The Basic Terms**

The basic terms of the agreement between the applicant and the issuing bank are contained predominantly in the application form requesting the issuance of the letter of credit. Invariably the application form incorporates the UCP (UCP 600 in this case) and therefore most of the provisions of the UCP automatically constitute the basic terms of the agreement between the applicant and the issuing bank.<sup>149</sup> In summary the application is basically a request by the applicant to the issuing bank to issue an irrevocable letter of credit in favour of an identified party (the beneficiary) available by draft drawn on a specific branch.<sup>150</sup> It specifies the amount covering the cost, in the event of an underlying agreement of sale, of certain objects basically described, indicating place of shipment and destination, as well as details of the documents to accompany the drafts.<sup>151</sup> The issuing bank is also further requested to notify the beneficiary of the credit by cable, mail or other means of transmission.<sup>152</sup>

One of the most important basic terms is the stipulation by the issuing bank that the obligations of the applicant include payment of the amounts honoured by the bank as drawn under the credit.<sup>153</sup> One need not lose sight of the fact that the bank is not a charitable organisation but is in it for the business. In light of this the issue of security of payment by the applicant is of utmost importance to any bank worth its name. For this

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<sup>148</sup> See Chapter 2 of this thesis at page 28.

<sup>149</sup> See for example provisions like Art 14 of UCP 600 on the standard for examination of documents and Art 34 of UCP 600 on the various disclaimers by the bank.

<sup>150</sup> Lazar Sarna, *Letters of credit: The law and current practice* (1989) 3<sup>rd</sup> ed at 3.4.

<sup>151</sup> *Ibid.*

<sup>152</sup> *Ibid.*

<sup>153</sup> *Ibid.*

reason the applicant is usually required to give the issuing bank security in the form of warehouse receipts, bills of lading, certificates of insurance, as well as standard forms of security upon movables upon the goods shipped by virtue of the letter of credit.<sup>154</sup> It is evident from this therefore that the issuing bank can never be truly disinterested in the goods in reality.<sup>155</sup> Finally it is always one of the basic terms of the agreement that besides the obligation to repay the bank the applicant is also liable for all the costs and fees levied by the bank for issuing and honouring the credit. In most cases these charges are lumped up under the heading of fees and commission from which the bank makes its own profit.

### **The Rights and Obligations of the Applicant and the Issuing Bank<sup>156</sup>**

#### **The Issuing Bank**

The application form submitted by the applicant having been accepted and approved by the issuing bank becomes the contract document between the two parties. A widely held misconception is that the resultant credit governs the relationship between the applicant and the issuing bank. Far from it the relationship between the applicant and the issuing bank is governed by the written agreement i.e. the application agreement supplemented by the law where gaps exist. This agreement not only determines the applicant's liability to the issuing bank but also the bank's obligations to the applicant. Numerous rights and obligations for both parties flow from that agreement breach of which attracts the usual contractual remedies. Some of these rights deriving from the said agreement are explored hereunder.

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<sup>154</sup> Lazar op cit note 151 at 3-5.

<sup>155</sup> Supra note 154 where he says that although the bank is entitled to disregard the goods themselves in favour of the commercial documents relating to the shipment at the time of honouring draws, it is not correct to say that the bank, for all practical purposes, has no interest in the shipment itself.

<sup>156</sup> Note that in most cases the one party's obligations are the other's corresponding rights. Therefore in dealing with the duties of one, the rights of the other are canvassed therein.

### **The Issuing Bank's Duty to Open the Credit.**

Once the issuing bank has made a decision to accept the applicant's instructions, in other words once the offer has been accepted there is an obligation on the issuing bank to open the credit in accordance with the applicant's instructions. This can arguably be said to be the issuing bank's primary duty in this relationship as it is the main reason behind the application for the credit in the first place. Succinctly put the bank's duty is to open the credit in accordance with instructions and in good time.<sup>157</sup> It follows therefore that failure by the issuing bank to open the credit as per the applicant's instructions amounts to breach of contract to which the bank will be liable for any losses occasioned on the applicant. Thus it is conceivable that the failure by the issuing bank to open the credit may cause the beneficiary to cancel the underlying agreement with the applicant and claim damages. In principle, in that eventuality, the issuing bank would be liable to the applicant on the basis of breach of contract for the loss suffered by the latter.<sup>158</sup> Further, failure on the part of issuing bank to open the credit in accordance with the applicant's instructions will result in it forfeiting its right to reimbursement of the money paid pursuant to such letter of credit.

### **The Issuing Bank's Duty to Honour the Applicant's Mandate**

Since the contract between the applicant and the issuing bank is a contract of mandate it follows that one of the main obligations of the issuing bank as the mandatary is to follow the applicant's mandate. It is basically one of the usual duties inherent in the ordinary banker-customer relationship where the bank is obliged to strictly observe the terms of its customer's mandate. Put into the current context, it is on this obligation that the doctrine of strict compliance in letters of credit is founded.<sup>159</sup> In particular the issuing bank is responsible for ensuring that the letter of credit issued to the beneficiary complies strictly with the instructions contained in the application for the credit and payment, acceptance

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<sup>157</sup> Oelofse op cit note 94 at 123. As regards time Oelofse submits that the time within which the credit should be opened must be stated in the instructions but it can also be implied from such things as the shipping date or shipping period.

<sup>158</sup> Ibid.

<sup>159</sup> Hugo op cit note 37 at 30.

or negotiation is effected only on presentation of documents which fully accord with the terms of the credit.<sup>160</sup> This obligation comes with the attendant duty on the party of the applicant to ensure that his instructions to the issuing bank are very clear and unambiguous to enable the bank to comply with the mandate.<sup>161</sup>

Strict compliance prohibits the issuing bank from paying against discrepant documents save with the concurrence of the applicant; otherwise it loses its right to reimbursement if it exceeds its mandate. One does not therefore have to overemphasise the need for the issuing bank to obey the applicant's instructions and carry them out carefully. Thus in the event that the issuing bank accepts documents which do not conform to the applicant's mandate, or if it refuses to take up documents which do conform to the mandate it is liable to the applicant in damages for any loss that he suffers.<sup>162</sup> The issuing bank's need to strictly comply with the applicant's mandate has been observed to impose a further obligation on the bank, the duty to act with reasonable care and skill.<sup>163</sup> Regarding this further obligation Sarna had this to say:

The issuer may generally be said to owe an obligation to the customer to use reasonable care, good faith and a degree of skill expected of bankers in their trade to review documents required by the credit and ultimately tendered for the purpose of determining whether all documents have been presented, whether those documents contain no discrepancy which would either betray their invalidity, insufficiency or non-conformity with the credit requirement.<sup>164</sup>

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<sup>160</sup> Goode op cit note 15 at 981.

<sup>161</sup> Sarna op cit note 150 at 3-10 says that if the instructions given by the customer [applicant] to the issuer as to the documents to be tendered are ambiguous or capable of covering more than one kind of document, the issuer is not in breach of his duty if he acts upon a reasonable meaning of the ambiguous expression or accepts any kind of document which fairly falls within the wide description used.

<sup>162</sup> G.A Penn et al, *The law & practice of international banking* (1987) Volume 2 at 337.

<sup>163</sup> See Penn *et al idem*, Goode op cit note 15 at 981, and Hugo op cit note 37 at 30 where he says that the bank as provider of professional services is required to act with the care and skill expected of a *bonus argentarius*, that is, without negligence.

<sup>164</sup> Op cit note 150 at 3-8.

One of the rights that the applicant derives from the issuing bank's duty to honour the mandate is the applicant's right to countermand instructions. Oelofse writes that since the relationship between the applicant and the issuing bank is one of mandate, the applicant is, in principle entitled to revoke his instructions to the issuing bank.<sup>165</sup> However, he further submits, correctly so, that it stands to reason that he may validly do so only if the issuing bank has not yet become irrevocably bound toward the beneficiary or another bank, nor paid the beneficiary. Note should be taken however, of the caveat placed by Goode.<sup>166</sup> He says that since the letter of credit issued by the issuing bank to the beneficiary constitutes an autonomous engagement in which the issuing bank acts as principal, not as agent for the applicant, it follows that the applicant is not entitled to give instructions to the issuing bank to withhold payment or deviate from the terms of the credit. The issuing bank is both entitled and obliged to ignore any such instructions so long as the documents are presented within the period of the credit and conform to it. Thus whilst there is an obligation on the issuing bank to follow the applicant's instructions, the bank must not blindly follow any instruction that proceeds from the applicant.

### **Issuing Bank's Obligation to Pay**

By agreeing to issue out the credit in favour of the beneficiary the issuing bank assumes a duty to pay under the credit and to refrain from paying where it is apparent that the beneficiary has not complied with the terms of the letter of credit.<sup>167</sup> As Clark puts it, 'a fundamental principle of the law of irrevocable letters of credit is that the issuing bank's duty to honour the seller's drafts depends only upon the written promise embodied in a letter of credit and is independent of the underlying sales agreement.'<sup>168</sup> A corollary of the independence principle is that absent some defect in the documents or fraud the applicant has no right to stop the issuing bank from making payment under the credit.<sup>169</sup> He further

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<sup>165</sup> Op cit note 94 at 138.

<sup>166</sup> Op cit note 15 at 982.

<sup>167</sup> See Art 7 of UCP 600 which clearly spells out this obligation.

<sup>168</sup> Clark L Derrick, "An issuing bank's duty of payment under an irrevocable letter of credit: *Asociacion de Azucareros de Guatemala v United States National Bank of Oregon*" (1970) 12 *Ariz L Rev* 835.

<sup>169</sup> Dolan op cit note 24 at 7-6.

writes that this principle is founded on the consideration that a free, uninhibited flow of international commercial transactions requires that credit instruments furnish a high degree of certainty of the bank's promise to pay.<sup>170</sup> This is in line with the payment function of letters of credit.<sup>171</sup>

The sticky point as regards this issuing bank's duty to pay has been the question whether this obligation is owed to the applicant or the beneficiary. It is common knowledge that a beneficiary may complain when the issuing bank fails to honour a draft or demand for payment if the beneficiary has satisfied the credit conditions.<sup>172</sup> As Dolan has observed, there is less authority, however, for the proposition that the applicant also may complain about such improper dishonour.<sup>173</sup> This is because the applicant is not a party to the credit but is party to the credit application agreement that governs the issuing bank-applicant relationship.<sup>174</sup> But the application agreement usually contains express provisions requiring the issuing bank to honour conforming drafts. And even if the application agreement does not contain the issuing bank's express promise to the applicant, in many commercial credit situations the applicant clearly suffers from the bank's failure to pay.<sup>175</sup> It is on this basis therefore that it can be argued that the issuing bank's duty to pay under the credit is owed to both the applicant and the beneficiary.

### **The Issuing Bank's Duty to Counsel the Applicant**

Some leading authorities on the subject have raised the possibility of a further obligation on the part of the issuing bank to advise the applicant in structuring the letter of credit

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<sup>170</sup> Clark op cit not 166 at 835.

<sup>171</sup> See Chapter 1 of this thesis at page 9 for an explanation of the payment function of letters of credit.

<sup>172</sup> Dolan op cit note 24 at 7-4.

<sup>173</sup> Ibid.

<sup>174</sup> Ibid.

<sup>175</sup> Ibid.

transaction.<sup>176</sup> These authorities suggest that there may be a legal duty on the part of the issuing bank to counsel the applicant concerning, for example, the kind of documents he needs to protect himself as a buyer in an international sale.<sup>177</sup> This is indeed what Sarna has branded the issuing bank's duty to inform.<sup>178</sup> The International Chamber of Commerce's Commission on Banking Technique and Practice's position on this issue has been underlined by a reluctance to impose liability on issuing banks that fail to advise their customers but it rather urges banks, in their own interests and as a guard against misunderstanding, to encourage simplicity in the credit.<sup>179</sup>

Most bankers deny the existence of such an obligation as a duty to counsel or inform their customers in letter of credit transactions. Despite their denial however, reality on the ground has shown that issuing banks have religiously embraced this duty whether consciously or unconsciously. In many circumstances the issuing bank does suggest to the applicant the standard stipulations, conditions and requirements which ultimately find their way into the letter of credit issued to the beneficiary.<sup>180</sup> Assuming that there is no legal obligation on the issuing bank to advise the applicant, it is indeed in the best interests of the bank to voluntarily assume this duty. This is because failure to do so may have grievous ramifications for the issuing bank. Take for example; failure of the issuing bank to advise the applicant, just before the opening of the credit, that the documents sought are from start inconsistent will inevitably lead to non-payment or the issuance of a revised credit yet it is in the interests of the bank to have the credit operation carried to completion.<sup>181</sup>

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<sup>176</sup> Dolan op cit note 24 at 7-94. Other authorities holding the same view include Kozolchyk, 'The letter of credit in court: An expert testifies' (1982) 99 *Banking LJ* 340 and Ellinger, 'Fraud in Documentary Credit Transactions' 1981 *J Bus Law* 258 at 267.

<sup>177</sup> Ibid.

<sup>178</sup> Op cit note 150 at 3-19.

<sup>179</sup> See Dolan op cit note 24 at 7-95 who gleaned this position from the Chairman of the Commission back then in 1983. It is likely that the ICC's position on this matter is still the same.

<sup>180</sup> Sarna op cit note 150 at 3-19.

<sup>181</sup> Ibid.

Further and more disastrously, the bank may lose business and any bank worth its name should not be found in such a situation but rather be fighting to increase its business.

Sarna has explained well how a bank can lose business and has put it thus:

...if the applicant is a long-standing customer of the bank, the failure of the bank to advise the customer adequately on the best means of drafting the credit will certainly alienate him and his valuable business in the event that the credit transaction proves to be to his detriment. Often the only recourse of the disgruntled customer who has seen his bank pay upon an incomplete or fraudulent transaction is to take his business elsewhere.<sup>182</sup>

It is therefore not hard to imagine why it is in the interests of not only the applicant but the issuing bank also for the latter to assume the duty to counsel the former in the absence of an explicit legal obligation on the part of the bank to do so. Finally, an extension of the duty to inform which has raised its fair share of controversies is the imposition on the issuing bank of a duty to pass on to the applicant, any information which it may acquire concerning the standing of the beneficiary and which may affect the relationship between the applicant and the beneficiary.<sup>183</sup> The controversy seems to have stemmed from the case of *Midland Bank v Seymour*<sup>184</sup> where the issuing bank agreed at the request of the applicant to open a letter of credit in favour of a firm in Hong Kong with which the applicant was dealing. The issuing bank made routine inquiries as to the financial standing of the Hong Kong firm and the replies being satisfactory it passed the information to the applicant. The issuing bank later received information which cast doubt on the integrity and financial standing of the Hong Kong firm, the beneficiary under the credit. The bank failed to pass this information to the applicant and it was held liable for its failure to do so. Following the finding of the court in this case some commentators have taken the view that a duty arises on the part of the issuing bank to pass information about the beneficiary in all cases but others have submitted that there is no general duty on the issuing bank to provide the

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<sup>182</sup> Op cit note 150 at 3-20.

<sup>183</sup> Penn *et al* op cit note 162 at 338.

<sup>184</sup> [1955] 2 Lloyds Rep 147.

applicant with any information it may have about the financial standing of the beneficiary and the case is an exception to the general rule.<sup>185</sup>

Sarna has explained that in the course of negotiating the opening of a credit the applicant may request the issuing bank to supply him any information it may obtain with respect to the credit worthiness of the beneficiary.<sup>186</sup> In that case the bank will, as part of its overall service to the customer, make summary inquiries at the institution where the beneficiary banks and advise the applicant accordingly. He further writes that a bank which has undertaken to obtain credit reports and fails to pass on such information to the applicant will be liable for breach of duty in damages caused as a result of the withholding of material information.<sup>187</sup> The bank, however, is not under an obligation, unless specifically requested, to conduct at its initiative and at the expense of the customer a full and further inquiry into the financial standing of the proposed beneficiary.<sup>188</sup> I am utterly unable to reconcile my views with those of such commentators who are of the opinion that there exists a general blanket obligation on the issuing bank to pass information about the beneficiary in all cases. In the premises it is submitted that the correct position seems to be that there is no such general duty on the issuing bank but the duty can arise in certain circumstances either at the behest of the applicant or where the bank itself expressly or by conduct, voluntarily assumes such obligation. It is therefore an exception to the general rule.

### **The Applicant**

Having discussed fully above the obligations placed on the issuing bank once the letter of credit is opened I now proceed to deal with the corresponding duties placed on the applicant if the issuing bank conforms to the letter of credit and fulfils its duties under it.

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<sup>185</sup> See Penn *et al* op cit note 162 at 339.

<sup>186</sup> Op cit note 150 at 3-22.

<sup>187</sup> Ibid.

<sup>188</sup> Ibid

### The Applicant's Duty to put the Issuing Bank in Funds

The applicant is under a duty to put the issuing bank in funds to meet the seller's drafts before they become due.<sup>189</sup> According to the court in the case of *Reynolds v Doyle*,<sup>190</sup> a customer of bank who requests it to open a credit is under a duty to pay it the amount for which it has accepted bills of exchange drawn by the beneficiary and must do this a reasonable time before the bills fall due for payment. This is to ensure that the bank has funds to meet the bills before it is called on to pay them. Apparently the customer is not required to put the bank in funds when the credit is actually issued, but the issuing bank can expressly stipulate that its customer must furnish it with the amount payable by it to the beneficiary of the credit before or at the time the credit is issued, so that the bank does not at any time risk its own funds.<sup>191</sup> If the applicant operates an account with the issuing bank it has been held that the bank can be granted power to debit the applicant's account provided there is a sufficient credit balance to meet the payment.<sup>192</sup> However, in the absence of sufficient funds in applicant's account the issuing bank can advance the money and later rely on its entitlement to be reimbursed the amount it pays under the credit.<sup>193</sup> Thus one of the fundamental rights of the issuing bank arising out of its relationship with the applicant is the right to be reimbursed.

It has also been held that where the applicant for the credit fails to provide the bank with adequate funds, so that it pays or purchases the beneficiary's drafts out of its own pocket, the bank is entitled to charge the applicant the current rate of interest from the date the bill is paid or purchased by it.<sup>194</sup> The obligation of the applicant to put the bank in funds

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<sup>189</sup> Penn *et al* op cit note 162 at 340.

<sup>190</sup> (1840) 1 M & G 753.

<sup>191</sup> Penn *et al* op cit note 162 at 340.

<sup>192</sup> Ibid.

<sup>193</sup> Ibid.

<sup>194</sup> Authority for this is the case of *Re Ludwig Tillman* (1918) 34 T.L.R 322 where the court held that if an applicant for a credit does not fulfill his express or implied obligation to put the bank in funds by the date the bill of exchange accepted by the bank falls due, the bank may borrow from another source and charge the applicant with the interest it has to pay the lender, or alternatively, the bank may use its own resources and charge the applicant the current commercial rate of interest from the date the bill fell due, cited in R.R Pennington *et al*, *Legal topics series: Commercial banking law* (1978) 1<sup>st</sup> ed at 362.

is the counterpart of the bank's obligation to honour the credit.<sup>195</sup> The full import of this is that if the issuing bank repudiates its obligation either expressly or by implication, for example, as a result of ceasing its business or by going into liquidation, the applicant's corresponding obligation to provide it with funds falls away.<sup>196</sup> The position was fortified in the case of *Greenhough v Munroe*.<sup>197</sup> In that case an American court held that the buyer's obligation to put the bank in funds could not be enforced after the bank had ceased carrying on business and had stopped payment of its debts as they fell due.

### **The Applicant's Duty to Reimburse the Issuing Bank**

It follows from the general principles of the law of mandate that mandator has to reimburse any amount that the mandatary has expended in properly carrying the mandate.<sup>198</sup> The applicant therefore has a duty to reimburse the issuing bank, an obligation which most of the authorities choose to name in the converse as the issuing bank's right to reimbursement. Nothing much really turns on that distinction. The bottom line is that the applicant has an obligation to reimburse the issuing bank and conversely the latter has a right to be reimbursed by the former. The issuing bank "is not a volunteer", to borrow the words of one writer and it therefore deserves to be reimbursed.<sup>199</sup> It is as simple as that. The obligation to reimburse the issuing bank is not absolute however. It is predicated upon the issuing bank having conformed strictly to the instructions given to it in the application for the opening of the letter of credit. If the issuing bank exceeds its mandate it will have no one else to blame but itself as it automatically loses its right to reimbursement.<sup>200</sup> In circumstances where the issuing bank exceeds its mandate when the

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<sup>195</sup> Pennington *et al* supra at 362. See also Penn *et al* op cit note 162 at 340.

<sup>196</sup> Ibid.

<sup>197</sup> (1931) 53 F 2d 362.

<sup>198</sup> Oelofse op cit note 94 at 140.

<sup>199</sup> See Dolan op cit note 24 at 7-83.

<sup>200</sup> See Penn *et al* op cit note 162 341. See also Pennington *et al* op cit note 194 at 363. The only exception to the loss of the right to reimbursement where the bank exceeds its mandate is when the applicant ratifies expressly or impliedly what the bank has done. For instance, in *Midland Bank Ltd v Seymour* [1995] 2 Lloyd's Rep 147 it was held that the applicant had ratified the acceptance of the beneficiary's drafts by the bank at a branch other than the one specified in the credit, when the customer knew that the drafts had been at that

applicant has already put the bank in funds, the applicant is entitled to a refund of its money, some form of reimbursement, which is properly called restitution. Pennington *et al* submits that the substantive issues in both reimbursement claims by the bank and restitution claims by the applicant are therefore precisely the same.<sup>201</sup>

As regards the time when the applicant must reimburse the issuing bank, more often than not, the parties enter into arrangements where the applicant is given some sort of a grace period after which he should pay the amount paid under the credit. In international sale of goods contracts, this arrangement usually allows the applicant to obtain possession of the goods together with the documents before reimbursing the bank.<sup>202</sup> The applicant will therefore be able to reimburse the issuing bank from the proceeds of the sale of such goods. Since the bank is not there for charity such deferred reimbursement usually comes with a charge of interest on the amount due. The rate of such of interest is determined by the applicable law.<sup>203</sup>

A pertinent question on this issue has been what effect does the insolvency of either party have on the applicant's duty to reimburse or the issuing bank's right to reimbursement? An applicant, who has reimbursed the issuing bank in advance, that is, before the bank has paid the beneficiary, carries a risk of the issuing bank's intervening insolvency.<sup>204</sup> This is because such an applicant would still have to pay the beneficiary and then seek to recover from the issuing bank the money he had advanced.<sup>205</sup> Circumstances may also arise where the issuing bank goes insolvent before reimbursement by the applicant. In that scenario if the issuing bank has already paid the beneficiary, it will be entitled to reimbursement, its

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other branch and that the bank proposed to accept them there, and the applicant did nothing to prevent the bank going ahead.

<sup>201</sup> Ibid.

<sup>202</sup> Oelofse op cit note 94 at 141.

<sup>203</sup> As to the applicable see below at 48.

<sup>204</sup> Oelofse op cit note 94 at 145.

<sup>205</sup> Oelofse op cit note 94 at 145. For a further detailed analysis of other complicated situations that can arise from the insolvency of the issuing bank, see the case of *Sale Continuation Ltd v Austin Taylor & Co Ltd* [1968] 2 QB 849.

insolvency being a non-event in so far as the applicant's duty to reimburse is concerned.<sup>206</sup> If, however, the issuing bank has not yet paid, and if the general rule applies that reimbursement is due only after payment, the applicant will be entitled to withhold reimbursement.<sup>207</sup>

Whilst the insolvency of the applicant will be of no consequence to the beneficiary's entitlement to payment it certainly affects the relationship between the applicant and issuing bank. According to Oelofse, usually a contract of mandate in terms of which the mandatary undertakes to perform a juristic act for or on behalf of the mandator, is automatically terminated by the mandator's insolvency.<sup>208</sup> As to whether this general rule applies when the issuing bank has already bound itself to the beneficiary in terms of the credit it has been held that it does not apply and can therefore not affect the issuing bank's right to reimbursement.<sup>209</sup> The rationale underpinning this position is not that difficult to decipher if one considers that holding otherwise would mean that the issuing bank will have no claim for reimbursement after it has made payment to the beneficiary, a situation that is untenable by any stretch of imagination. Where the applicant has provided advance cover to the issuing bank the latter will not suffer any loss as a result of the former's insolvency.<sup>210</sup> Similarly where the issuing bank has been diligent enough to have taken out sufficient security to its eventual claim for reimbursement, the applicant's insolvency will cause little or no harm to the bank.<sup>211</sup> In the absence of security and depending on the transport document, i.e., whether it is a document of title, the goods forming part of the underlying contract can be a source of security for the bank<sup>212</sup>, further confirming the

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<sup>206</sup> Ibid.

<sup>207</sup> Ibid.

<sup>208</sup> Op cit note 94 151.

<sup>209</sup> Ibid.

<sup>210</sup> Ibid.

<sup>211</sup> Ibid.

<sup>212</sup> Oelofse op cit note 94 at 153. See also Dolan op cit note at 7-86 who talks of subrogating issuer to account party's rights against the beneficiary writing that where an account party becomes insolvent before the issuer pays the beneficiary, the issuer will look to the goods to recoup its payment. Subrogation is provided for in terms of the American UCC s5-117.

earlier submission that the bank can never be completely disinterested in the goods even though it deals with documents only.

### **The Applicant's Duty to Pay the Issuing Bank's Fees and Commission.**

As has already been highlighted, charity has no place at the issuing bank's doorstep and therefore the issuing bank has a right to charge fees and commission for its role in financing international trade. The applicant is under an obligation to pay the issuing bank's fees, commission and/or other customary charges for the issuing of and payment under the letter of credit. The issuing bank's fee can be a specific amount or a small percentage of the amount available under the credit over the period of the availability of the credit.<sup>213</sup> According to McCullough, the commissions or fees charged by banks for the issuance and use of letters of credit are in the low fractions of 1 per cent of the amount of the credit or the amount of the drafts drawn under the credit.<sup>214</sup>

Apart from the issuing bank's own fee, the applicant is also liable to reimburse the issuing bank for the payment of the fee of the advising, nominated or confirming bank, if any.<sup>215</sup>

The issuing bank can also charge the applicant customary charges but they are few and relatively insignificant and they cover such items as cable fees, postage among others.<sup>216</sup>

Depending on the agreement between the parties sometimes the applicant may be liable to pay interest on any monies outstanding to the issuing bank at a rate agreed between the two. This is obviously meant to cushion the issuing bank from non-payment and to encourage the applicant to pay up in time to avoid accruals of interest.

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<sup>213</sup> Oelofse op cit note 94 at 139.

<sup>214</sup> Op cit note at 3-185. He says that a common commission is 0.25% split into an issuance fee and a negotiation fee while most banks charge an issuance fee of 0.125%. It is submitted that although the percentage figures for fees and commissions appear so small, in reality the banks make reasonable profits out of them because the figures involved in such international transactions are huge.

<sup>215</sup> Oelofse op cit note 94 at 139.

<sup>216</sup> McCullough op cit note at 3-186.

### **The Law Applicable to the Relationship between the Applicant and the Issuing Bank.**

The question does often arise, what is the applicable law to the agreement between the applicant and the issuing bank? Perhaps the starting point should be to point out that although letters of credit are often made subject to the UCP (in this case UCP 600), not all questions that arise in the context of letters of credit are answered by the UCP.<sup>217</sup> It is imperative therefore to determine the law that is applicable to the relationship between the applicant and the issuing bank in a quest to find answers to some of these questions.

Parties to a contract are free to choose the law applicable to their contract also known as the proper law of the contract. This is in terms of both the common law more particularly the doctrine of party autonomy and also in terms of the Rome Convention on the Law Applicable to Contractual Obligations, 1980.<sup>218</sup> Put into context therefore, the applicant and the issuing bank can agree on the law applicable to their relationship. Thus typically such a choice would be expressed by way of a choice of law clause in the application form for the issuance of a letter of credit. However, more often than not, parties forget, ignore or simply do not see the need to choose a law that will govern their contract. In the absence of choice the law applicable is that with which the contract has its “closest and most real connection.” This is in accordance with both the common law<sup>219</sup> and in terms of Art 4 of the Rome Convention.<sup>220</sup>

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<sup>217</sup> See Oelofse op cit note 94 at 507.

<sup>218</sup> According to Oelofse Ibid it is at present undoubtedly the most significant system of private international law rules with respect to contractual obligations.

<sup>219</sup> The *locus classicus* on this formulation is *Bonython v Commonwealth of Australia* [1951] AC 210.

<sup>220</sup> Art 4 provides that:

(1) To the extent that the law applicable to the contract has not been chosen in accordance with Article 3, the contract shall be governed by the law of the country with which it is most closely connected. Nevertheless a severable part of the contract which has a closer connection with another country may by way of exception be governed by the law of that other country.

(2) Subject to the provisions of paragraph 5 of this Article, it shall be presumed that the contract is most closely connected with the country where the party who is to effect the performance which is characteristic of the contract has, at the time of conclusion of the contract, his habitual residence, or, in the case of a body corporate or unincorporated, its central administration. However, if the contract is entered into in the course of that party's trade or profession, that country shall be the country in which the principal place of business situated or, where under the terms of the contract the performance is to be effected through a place of

In light of this the relationship between the applicant and issuing bank has been boldly held to be governed by the law of the seat of the issuing bank.<sup>221</sup> According to Morse there can be little doubt in this situation that the characteristic performance is that of the issuing bank and the law of the country in which the bank's principal place of business or place of business, as the case may be, is situated will be the governing law.<sup>222</sup> In concurrence with this, Fredericks and Neels, in a fairly recent article dealing with the issue, had this to say:-

In the context of the contractual relationship between the applicant and the issuing bank, the following factors indicate that the contract is most closely connected to the law of the country of the issuing bank: (a) the residence or domicile, or both, of the issuing bank, (b) at least one performance of the issuing bank (providing the banking facility to the applicant) is effected in its own country. If no nominated or confirming bank is involved, payment of the beneficiary against presentation of conforming documents also takes place in the country of the issuing bank, (c) the applicant effects its performance at the location of the issuing bank, as the former pays the issuing bank its commission at this location, (d) the applicant usually holds an account at the issuing bank, (e) a contract of mandate exists between the applicant and issuing bank, which contract should, generally, be governed by the law of the country where the mandatary (issuing bank) is situated and (f) reimbursement of the issuing bank by the applicant takes place at the location of the issuing bank.<sup>223</sup>

The majority of factors above indicate the law of the country of the issuing bank as the proper law of the contract. According to the two authors the most important factor to determine the proper law is the *locus solutionis* (the place of performance).<sup>224</sup> So where no nominated or confirming bank is involved, the characteristic performance (providing the banking facility and payment of the beneficiary against presentation of conforming documents) and the payment of commission by the applicant take place at the location of

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business other than the principal place of business, the country in which that other place of business is situated.

<sup>221</sup> Oelofse op cit note 94 at 519.

<sup>222</sup> C G J Morse, "Letters of Credit and the Rome Convention" 1994 *LMCLQ* 560 at 570.

<sup>223</sup> Eesa A Fredericks and Jan L Neels, "The proper law of a documentary letter of credit (Part 2) (2003) 15 *SA Merc LJ* 207. See also the Part 1 of the article in the same journal at page 63.

<sup>224</sup> *Ibid* at 208.

the issuing bank.<sup>225</sup> But where a nominated or confirming bank is involved the *locus solutionis* of the characteristic performance partly differs from the *locus solutionis* of payment.<sup>226</sup> In this case the characteristic performance is effected at the location of the issuing bank (it provides banking facility to the applicant) and in the country of the correspondent bank (the issuing bank appoints and instructs the correspondent bank and pays the beneficiary via this bank on presentation of conforming documents).<sup>227</sup> Further, payment is effected at the issuing bank: the applicant pays the bank its commission at this location. As already highlighted above since the majority of factors indicate that the contract between the applicant and issuing bank is most closely connected to the law of the country of the issuing bank, this legal system is also the *lex loci solutionis* in respect of payment and partly the *lex loci solutionis* in respect of characteristic performance.<sup>228</sup> So the law of the country of the issuing bank should govern the contract.

The conclusion therefore is that the relationship between the applicant and the issuing bank is governed by the law of the country of the issuing bank.<sup>229</sup> This is often less complicated by the fact that, in most but not all cases, both the applicant and the issuing bank are located in the same country.

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<sup>225</sup> Ibid.

<sup>226</sup> Ibid.

<sup>227</sup> Ibid.

<sup>228</sup> Ibid at 209.

<sup>229</sup> This conclusion, which can be said to be beyond any shadow of doubt is supported by the Rome Convention as amplified in case law particularly the case of *The Bank of Baroda v The Vysa Bank* [1994] 2 Lloyd's Rep 87 at 92 and the view in the Guiliano- Largade Report on the Convention that the law of the banking establishment with which the transaction is made will normally govern and that characteristic performance is the provision of a banking facility by banks. See also the dictum in *Laconian Maritime Enterprises v Agromar Lineas* 1986 (3) SA 509 at 529E-F.

## CHAPTER FOUR

### **The Relationship between the Issuing Bank and the Confirming Bank.**

As a point *in limine*, it is noted that not much has been written about the contract between the issuing bank and the confirming bank in letters of credit. The writers, for reasons that I have failed to ascertain, have not been as enthusiastic about analysing this contract as they have been with the other three contracts in a confirmed irrevocable letter of credit which I have branded the standard four-party credit. That notwithstanding, a fair attempt is made hereunder to bring this agreement between the issuing bank and the confirming under the microscope with a view to unraveling the obscurities thereto.

It is often the case in international sale of goods that the applicant (buyer) and the issuing bank are situated in one country whereas the beneficiary (seller) is resident in another country. It is human nature to be suspicious of anything foreign and the beneficiary is sometimes reluctant to accept an undertaking to be paid by a foreign bank upon presentation of the conforming documents once he has dispatched the goods. In the result the issuing bank will employ the services of another bank, normally referred to as an intermediary or correspondent, in the beneficiary's country to confirm the letter of credit. Such intermediary or correspondent banks can be employed to act in various capacities. As Gutteridge and Megrah put it, an intermediary bank may perform one of three functions.<sup>230</sup> It may be called to advise the credit to the beneficiary, in which capacity it will be referred to as the "advising bank" in the UCP<sup>231</sup>, to pay, to incur a deferred payment undertaking, to accept or negotiate drafts on behalf of the issuing bank with or without obligation on its part, in which capacity it is referred in the UCP as the "nominated bank"<sup>232</sup> or to confirm the credit by adding its undertaking to that of the issuing bank, in

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<sup>230</sup> Gutteridge & Megrah's Law of bankers' commercial credit by Richard King at 87 on <http://www.books.google.com/books?id> accessed on 30 December 2007.

<sup>231</sup> See Art 9 of UCP 600.

<sup>232</sup> See Art 12 of UCP 600.

which capacity it is referred to in the UCP as the “confirming bank.”<sup>233</sup> It is the relationship of the intermediary in its capacity as a confirming bank with the issuing bank that is the focus of this chapter.

Confirmation by a bank in the beneficiary’s home country means that the beneficiary obtains an undertaking to pay, accept or negotiate, as the case may be, by a bank in his own jurisdiction in addition to the undertaking of the issuing bank.<sup>234</sup> This has the advantage for the beneficiary not only that he has two banks to rely on for payment, but also that he can litigate in his own courts against the confirming bank.<sup>235</sup> Further, confirmation by a bank in the beneficiary’s home country also relieves the beneficiary of the complications caused by the political and monetary measures and disturbances in the applicant’s country.<sup>236</sup>

### **The Nature of the Contract between the Issuing Bank and the Confirming Bank.**

Considerable debate has been generated by writers, lawyers and judges alike, around the question of classification of the nature of the contract between the issuing bank and the confirming bank in a confirmed irrevocable letter of credit. The contract has sometimes been loosely referred to as the contract between banks. On the nature of this relationship Hugo begins by pointing out that the continental sources have no hesitation in classifying the contract as a contract of mandate.<sup>237</sup> He cites German and Dutch authorities in which the correspondent bank is taken to act as the mandatary of the issuing bank.<sup>238</sup> However, the contract between the issuing bank and the confirming bank has been categorized by the

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<sup>233</sup> See Art 8 of UCP 600.

<sup>234</sup> Oelofse op cit note 94 at 52.

<sup>235</sup> Ibid.

<sup>236</sup> Ibid.

<sup>237</sup> Op cit note 37 at 32.

<sup>238</sup> Ibid.

majority of the authorities as one of agency in that the confirming bank acts as the issuing bank's agent in the letter of credit transaction.<sup>239</sup>

Most of these authorities seem to converge in the case of *Bank Melli Iran v Barclays Bank (Dominion, Colonial & Oversea)*<sup>240</sup> in which the question of the relationship between the issuing bank and the confirming bank arose. The judge in that case, Justice McNair quoting with approval from Professor Gutteridge and with reference to the particular facts before him said:-

In my judgment, both on the construction of the documents under which the credit was established and in principle, the relationship between Bank Melli, the instructing bank, and Barclays Bank, the confirming bank, was that of principal and agent. This relationship was held to exist in substantially similar circumstances in *Equitable Trust Company of New York v Dawson Partners, Ltd...*

I accept the statement of Professor Gutteridge, KC, in his book on *Bankers' Commercial Credits*, at p51, that "as between the issuing banker" (in this case Bank Melli) "and the correspondent" (in this case Barclays Bank) "the relationship is , unless otherwise agreed, that of principal and agent..."<sup>241</sup>

That the relationship between the issuing bank and the confirming bank is one of agency has received confirmation in many cases after the *Bank Melli Iran* case. One such case is the leading case of *Bank of Baroda v Vysya Bank*<sup>242</sup> where Mance J held that as between the issuing bank and the confirming bank the relationship is one of agency, although as against the beneficiary the confirming bank commits itself as principal.<sup>243</sup> In terms of the law of

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<sup>239</sup> See Hugo Ibid, Chua op cit note 2 at 506, Goode op cit note 15 at 984, Sarna op cit note 150 at 3-29, Penn *et al* op cit note 162 at 345, Gutteridge & Megrah op cit note 230 at 87 among others.

<sup>240</sup> [1951] 2 Lloyd's Rep 367.

<sup>241</sup> At 376.

<sup>242</sup> [1994] 2 Lloyd's Rep 87.

<sup>243</sup> Ibid at 90. But see *Credit Agricole Indosuez v Muslim Commercial Bank Ltd* [2000] 1 Lloyd's Rep 275 at 280 where the judge Sir Christopher Staughton said "it is of course right that there is not in law an agency relationship between an issuing bank and a confirming bank. I find it hard to believe that either Mr. Justice Devlin or Lord Diplock thought that there was. But in terms of commerce the confirming bank is the

agency what the confirming does as the agent will therefore bind the issuing bank as the principal for all intents and purposes.<sup>244</sup> Consequentially if an invalid acceptance of the documents was made to the beneficiary by the confirming bank, the issuing bank is similarly bound as far as the beneficiary is concerned but not as far as the confirming bank is concerned.<sup>245</sup>

Some of the confusion surrounding the nature of the contract between the issuing bank and the confirming bank has arisen from the peculiar position of the latter. The confirming bank's position is peculiar in that it is an agent to the issuing bank at the same time being a principal with respect to its undertaking to the beneficiary. This has led some other authors to confuse the relationship between the issuing bank and the confirming bank with that of the confirming and the beneficiary. There is a world of difference between the functions and the position of the confirming bank in those two relationships and there is a great need to keep the distinction clear. Jack as quoted by Hugo has explained this distinction succinctly when he said:-

The obligation of a confirming bank to pay... is an obligation which it gives as a principal. This does not prevent it from acting in other respects as the agent of the issuing bank. ... The position is that in carrying out its functions, where appropriate, it will act in a dual capacity. In so far as its interests as a confirming bank are concerned, it acts as a principal: at the same time as regards the issuing bank it acts as agent. Thus in accepting documents it acts as a principal in relation to its obligation as confirming bank, and it acts as agent for the issuing bank with regard to the obligations of the issuing bank<sup>246</sup>

That the relationship between the issuing bank and a correspondent bank which is merely an advising bank, is one of principal and agent has been held to be indisputable by most

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correspondent of the issuing bank, and acts for the issuing bank in order to do what the issuing bank is not present to do for itself..."

<sup>244</sup> Chua op cit note 2 at 506.

<sup>245</sup> Ibid.

<sup>246</sup> Jack R *Documentary Credits* 2<sup>nd</sup> ed (1993) at 121 as quoted by Hugo op cit note 37 at 33.

authorities.<sup>247</sup> However, the categorisation of the relationship between the issuing bank and the confirming bank as one of agency has been held by some authorities to be misleading in many respects.<sup>248</sup> Sarna contends that if one were to assert that the confirming bank is nothing more than an agent, there would be no juridical basis for finding that the confirming bank has a personal and direct obligation towards the beneficiary to make payment or accept drafts.<sup>249</sup> In apparent agreement to this Goode submits that the confirming bank's relationship to the issuing bank, like that of the issuing bank's relationship to the applicant, is not an ordinary agency relationship but is analogous to that of a commission agent.<sup>250</sup> If one follows this line of thought to its logical conclusion, the relationship between the issuing bank and the confirming bank correlates exactly with that between an applicant and the issuing bank.

Despite all the confusion regarding the relationship between the issuing bank and the confirming bank, in summation it is submitted that Professor Gutteridge's position is the correct one.<sup>251</sup> Thus it is respectfully submitted that this relationship is, unless otherwise agreed, in simple terms, one of agency. As to whether it is a special type of agency is another thing. But in its very basic form it is one of principal and agent such that with respect to its obligations to the issuing bank, the confirming bank acts for and on behalf of the issuing bank as agent and the confirming bank's right to remuneration or reimbursement is dependent upon it having complied strictly with its principal's mandate.

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<sup>247</sup> See Hugo *op cit* note 37 at 32.

<sup>248</sup> See for example Sarna *op cit* note 150 at 3-29.

<sup>249</sup> *Ibid.*

<sup>250</sup> *Op cit* note 15 at 974. See also Hugo *op cit* note 37 at 35 who says that as such the correspondent's legal position as against the issuing bank is similar to that of the issuing bank as against its client.

<sup>251</sup> See page 53 above.

## The Rights and Obligations of the Issuing Bank and the Confirming Bank under the Contract

### Issuing Bank's Duty to Give Clear Instructions to the Confirming Bank

The rights and liabilities of the confirming bank are governed by the terms of the instructions it receives from the issuing bank on the one hand and of its advice or notification to the beneficiary in pursuance of such instructions on the other.<sup>252</sup>

The confirming bank will invariably receive authorization or a request from the issuing bank to add its confirmation to the credit. It goes without saying that there is therefore an obligation on the part of the issuing bank to be clear and precise in its instructions to the confirming bank especially in detailing the terms of the credit. Having regard to the fact that the corresponding duty of the confirming bank is to follow the principal's mandate strictly, clarity and precision by the issuing bank in its instructions to open a confirmed irrevocable credit will enable the former to carry out its duties properly. Ambiguous instructions are always bound to cause problems in the operation of letters of credit for both the issuing bank and the confirming bank.<sup>253</sup> The problem arises from the fact that if the confirming bank misstates the tenor of the credit which it is requested to confirm, albeit as a result of ambiguous instructions or out of its own accord, it will be liable on the terms it has confirmed regardless of the tenor of the original letter of credit.<sup>254</sup>

Understandably, a standard practice as old as the letters of credit themselves, is that upon receiving instructions requesting confirmation from the issuing bank, the confirming bank will cable back to seek verification of the instructions before it proceeds to add its confirmation. So the issuing bank must always dutifully give clear and complete instructions to the confirming bank when requesting confirmation and the same holds for the confirming bank's right to be apprised of any amendments to the letter of credit.

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<sup>252</sup> Gutteridge op cit note 230 at 87.

<sup>253</sup> See the two Indian cases of *United Bank of India Ltd v Nederlandsche Standard Bank* A I R 1962 Cal 325 and *Eastern Bank Ltd v Sha Misrimal Bherajee* (1961) 2 M L J 88 which demonstrate the problems arising from the lack of clear instructions in confirmed irrevocable letters of credits.

<sup>254</sup> Sarna op cit note 150 at 3-30.

### **Bank's Obligation to Inform in terms of Article 8 of UCP 600**

It sometimes happens that the would-be confirming bank for a variety of reasons is not prepared to confirm the credit as per the issuing bank's request. In that case the "confirming bank" has a duty to inform the issuing bank without delay. This is provided for in Art 8 (d) of UCP 600 where it says that 'if a bank is authorized or requested by the issuing bank to confirm a credit but is not prepared to do so, it must inform the issuing bank without delay and may advise the credit without confirmation' in which case it becomes a mere advising bank and not a confirming bank. Sarna has raised the possibility of some banks issuing verbal or silent confirmations especially in politically sensitive situations.<sup>255</sup> This practice is not popular in the world of international trade finance and has been dismissed, rightly so, by Byrne as riddled with legal and operational difficulties.<sup>256</sup> He submits that while the obligation of the bank issuing the confirmation is clear, its protections are scant indeed in the case of silent confirmation.<sup>257</sup>

### **The Confirming Bank's Right to Reimbursement.**

The confirming bank's right to be reimbursed places no doubt the most important obligation on the issuing bank, i.e. the duty to reimburse, without which there can be no talk of confirmation of the credit. This obligation of the issuing bank is clearly spelt out in the UCP.<sup>258</sup> One of the basic tenets of the relationship between a principal and an agent is that the latter is entitled to be remunerated and to be refunded any moneys expended in fulfilling the former's mandate. Similarly when the confirming bank has fully complied with its mandate it is entitled to reimbursement of any moneys it has properly paid.<sup>259</sup> Logically it follows that in the event of any form of non-compliance with the mandate, for

<sup>255</sup> Ibid at 3-29.

<sup>256</sup> James E Byrne, 'U.C.C Survey: Letters of Credit', (1988) Vol 43 *The Business Lawyer* 1353 at 1365.

<sup>257</sup> Ibid.

<sup>258</sup> Art 7 of UCP 600 says that "an issuing bank undertakes to reimburse a nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the issuing bank. Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not the nominated bank prepaid or purchased before maturity. An issuing bank's undertaking to reimburse a nominated bank is independent of the issuing bank's undertaking to the beneficiary."

<sup>259</sup> Op cit note 250 at 87.

example paying against non-conforming documents, the confirming bank will not be entitled to reimbursement. Whilst the confirming bank will not be entitled to be reimbursed by the issuing bank where it is clearly at fault in accepting non-conforming documents the law does provide some respite for the confirming bank in that it can proceed against the beneficiary and other parties who might have occasioned its loss.<sup>260</sup>

The confirming bank is also entitled to be reimbursed for any loss suffered or to be suffered by reason of it complying with the mandate.<sup>261</sup> According to Gutteridge<sup>262</sup>, in so acting the confirming bank has the benefit of the principle that it is not in default if it acts upon a reasonable meaning of an ambiguous expression, further emphasising the need for clear instructions as explained above. If the confirming bank has accepted bills payable a fixed period after sight or on a specified date it is entitled to be reimbursed on paying the bills, whether or not there is any dispute between the applicant and the beneficiary, provided that the documents it has taken up are in conformity with the terms of its instructions.<sup>263</sup>

The obligation placed on the issuing bank to reimburse the confirming bank in terms of Art 7 of UCP 600 requires that payment be in full as of the date on which the confirming bank paid the beneficiary. The issuing bank must within in a reasonable time indicate whether it accepts or rejects the documents submitted by the confirming bank.<sup>264</sup> If it simply retains the documents without indication of its intention and thereby causes the confirming bank to be in breach of its matching obligation to the beneficiary, the issuing bank is liable to the confirming bank for reimbursement on the latter's liability in the face of discrepant documents.<sup>265</sup> In *Bank Melli Iran v Barclays Bank (D.C.O Ltd)*<sup>266</sup> the court held

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<sup>260</sup> See the recent case of *Standard Chartered Bank v Pakistan National Shipping Corp* [2003] 1 AC 959.

<sup>261</sup> *Ibid.*

<sup>262</sup> *Ibid.*

<sup>263</sup> Penn *et al* op cit note 162 at 345.

<sup>264</sup> Sarna op cit note 150 at 3-29.

<sup>265</sup> *Ibid.*

<sup>266</sup> Op cit note 240.

that an issuing bank waives its right to reject documents taken up by the intermediary bank if it delays in exercising that right for an unreasonable length of time from the time the documents are tendered to it, or from the time it has knowledge that the documents taken up by the intermediary bank do not conform to the conditions in the credit. In fact the judge in that case held that the inaction or silence by the issuing bank amounted to ratification of the agent's (confirming bank's) action by the principal.<sup>267</sup> In *Westminster Bank Ltd v Nazionale di Credit Roche* J said:

...If the parties keep the documents which are sent them, purporting to be sent them, or possibly sent them, in consequence of some mandate, which they themselves have issued, and keep them for an unreasonable time, that may amount to a ratification of what has been done as being done within the mandate...<sup>268</sup>

It is very common that sometimes the issuing bank instructs another bank to reimburse the confirming bank on its behalf. Such instructions are usually contained in the letter of credit that is issued by the issuing bank and sent to the confirming bank for confirmation and it forms part of the contractual agreement between the parties and the agreed way in which reimbursement must be made.<sup>269</sup> This gives rise to what has become popularly known as bank-to-bank reimbursement. Bank-to-bank reimbursement is canvassed by Art 13 of UCP 600 which details the obligations of the parties involved in such arrangement. Important to note is that if the reimbursing bank fails to honour the claim made on it by the confirming bank which is known as the claiming bank under this arrangement, the issuing bank is itself liable to the confirming bank as the claiming bank.<sup>270</sup>

International practice in relation to reimbursement has developed beyond what is contained in Article 13 of the UCP 600 and this development culminated in the publication of the Uniform Rules for Bank-to-Bank Reimbursement under Documentary

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<sup>267</sup> See also *National Bank of Egypt v Hannevig's Bank Ltd* [1919] 1 Lloyds L R 69 where it was held that if the issuing bank acknowledges the receipt of the documents without making any objection to them it waives its right to reject the document and the confirming bank is then entitled to reimbursement.

<sup>268</sup> [1928] Lloyds L R 306.

<sup>269</sup> Gutteridge op cit note 230 at 92.

<sup>270</sup> See Art 13 (c) of UCP 600.

Credits (known as the “URR”).<sup>271</sup> Article 13 of UCP 600 provides that the credit must state if the reimbursement is subject to these ICC rules for bank-to bank reimbursements in effect on the date of issuance of the credit.<sup>272</sup> The URR provide for the rights of the parties upon the issuing bank instructing a third bank (the reimbursing bank) to reimburse the claiming bank (in this case the confirming bank). Caution must be taken however, for the rules are not intended to override or change the provisions of the UCP.<sup>273</sup>

As far as damages are concerned, it has been held that if an issuing bank fails to reimburse the confirming bank and to take up documents, it could be liable to the confirming bank in damages for the difference between the amount paid out to the beneficiary and the amount recovered on the sale of goods in question following the issuing bank’s refusal to accept the documents.<sup>274</sup> A further consequence of the confirming bank being in the position of an agent for the issuing bank is that a confirming bank is not entitled, on its own behalf and for its own benefit, to discount drafts drawn by the beneficiary on the issuing bank.<sup>275</sup> This is because leaving the confirming bank to do so will result in it making a profit contrary to the guiding principles governing a principal-agent relationship as the one prevailing in this scenario. It would therefore be guilty of breach of duty in making a profit out of the transaction which it has entered into as an agent, and would be accountable for the amount of the discount to the issuing bank.<sup>276</sup>

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<sup>271</sup> ICC Publication No. 525 copy of which has been accessed at <http://www.bexi.co.id/images/res/URR.pdf> on 5th January 2008.

<sup>272</sup> See Art 13 (a) thereof.

<sup>273</sup> See Art 1 of the URR. See also Gutteridge op cit note 250 at 93-97 for a detailed analysis of the application and operation of the URR in letters of credit reimbursements.

<sup>274</sup> See *Bayerische Aktiengesellschaft v National Bank of Pakistan* [1997] 1 Lloyd’s Rep 59.

<sup>275</sup> Penn *et al* op cit note 162 at 346.

<sup>276</sup> Ibid.

## The Law Applicable to the Relationship between the Issuing Bank and the Confirming Bank

Finally the all important question ought to be answered, what is the law applicable to the contract between the banks? To answer this it is reiterated that according to both the Rome Convention and the common law parties are given a wide discretion to choose the law applicable to their contract and there is no doubt that this discretion is available between banks as in the present context.<sup>277</sup> In the absence of such a choice the contract is governed by the law of the country with which it is most closely connected and it shall be presumed to be most closely connected with the country of the party who effects the characteristic performance of the contract.<sup>278</sup> According to Morse, applying this formula, the first step is to identify the performance which characterises the contract between the two banks and having done this, the applicable law will be that of the country of the principal place of business or as the case may be, place of business, of the “characteristic performer.”<sup>279</sup>

Perhaps in attempting this we have the benefit of the case of *The Bank of Baroda v The Vysya Bank Ltd*<sup>280</sup> which falls squarely on the issue at hand. The case concerned a dispute between an issuing and confirming bank and the litigation between the parties concerned the confirming (Bank of Baroda) bank’s claim for reimbursement after having paid under the credit. One of the issues that fell for determination by the court was the question of the law applicable to the relationship between the two banks. As anyone would have guessed by now, in order to apply the Rome Convention to the relationship between the Bank of Baroda (the confirming bank) and Vysya Bank (the issuing bank), the primary question concerned the characteristic performance of their contract. In answering the question the learned judge Mance J, after having identified the relationship between the issuing bank and the confirming bank as one of agency, had this to say:

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<sup>277</sup> As regards the Rome Convention see the explanation given on page 48 above.

<sup>278</sup> See Art 4 (1) and (2) of the Rome Convention.

<sup>279</sup> Op cit note 222 at 563-4.

<sup>280</sup> [1994] 2 Lloyd’s Rep 87.

...under a contract between an issuing bank and a confirming bank the performance which is characteristic of the contract is the adding of its confirmation by the latter and its honouring of the obligations accepted thereby in relation to the beneficiary [i.e., the seller]. The liability on the part of the issuing bank to reimburse or indemnify the confirming bank **is consequential on the character of the contract; it does not itself characterise the contract.**<sup>281</sup> (emphasis is mine)

The conclusion reached therefore was that the Bank of Baroda had provided the characteristic performance as the confirming bank and since it had done so through its London office, English law was the law applicable to the relationship between these two banks. This conclusion has been held to be in line with Article 4(2) of the Rome Convention.<sup>282</sup> Fredericks and Neels have also come to the same conclusion and have observed that the characteristic performance is effected at the location of the confirming bank as it provides the relevant banking facility to the issuing bank and pays the beneficiary against presentation of conforming documents.<sup>283</sup> Payment is also effected at the location of the confirming bank, and then the issuing bank pays the former bank at this location whilst the majority of the other factors support the law of the country of the confirming bank as the proper law of the contract.<sup>284</sup> In conclusion, I therefore have no hesitation in submitting authoritatively that in the absence of choice, the law applicable to the contract between the issuing bank and the confirming bank is the law of the country of the confirming bank.

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<sup>281</sup> Ibid at 91.

<sup>282</sup> See also the Giuliano-Lagarde Report at 21 where it is stated that “in a banking contract the law of the country of the banking establishment with which the transaction is made will normally govern the contract... [I]n an agency contract in France between a Belgian commercial agent and a French company, the characteristic performance being that of the agent, the contract will be governed by Belgian law if the agent has his place of business in Belgium”

<sup>283</sup> Op cit note 223 at 214.

<sup>284</sup> Ibid.

## CHAPTER FIVE

### The Relationship between the Confirming Bank and the Beneficiary

The last, but by no means least, contract under scrutiny under the confirmed irrevocable letter of credit is the relationship between the confirming bank and the beneficiary otherwise known as the bank-beneficiary relationship.<sup>285</sup> Before proceeding it is important to point out that the legal nature of the letter of credit itself has been misunderstood and confused with the relationship between the confirming bank and the beneficiary. It is therefore worth putting the record straight from the outset.

### The Letter of Credit Distinguished

At this stage it is prudent enough to revisit the fundamental definition of a letter of credit in order to get the basics right. Perhaps the summary by McCullough best captures what a letter of credit really is for the purposes of making this distinction. He says:-

A letter of credit is a written undertaking to pay money. It is a promise by one party (the issuer) to accept or pay or pay the draft or demand for payment of another party (the beneficiary). The promise to accept or pay is conditioned upon compliance by the beneficiary with the terms and conditions of the written undertaking. The undertaking is extended by the issuer at the request of a third party (the applicant), and generally for the purposes of substituting the credit worthiness of the issuer in place of the credit worthiness of the applicant. By the issuance of a letter of credit, the applicant seeks to induce the beneficiary to extend goods or services to the applicant in reliance upon the financial strength of the issuer.<sup>286</sup>

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<sup>285</sup> Some of the authorities have only an analysis of the relationship between the issuing bank and the beneficiary but it is submitted that the same principles apply *mutatis mutandis* to the relationship between the confirming bank and the beneficiary. This is because the obligations of the confirming bank are essentially the same as those of the issuer of an irrevocable credit. See for example Gutteridge and Megrah, *The Law of Bankers' Commercial Credits* (1984) t 70 who when referring to the analysis of the relationship between the confirming bank and the beneficiary by Lord Diplock in *United City Merchants Case* (see pg 18 of above), say that the point is no different if the bank concerned were the issuing bank. See also Hugo op cit note 37 at 181ff who repeatedly talks of the relationship between the issuing or confirming bank and the beneficiary.

<sup>286</sup> Op cit note 87 at 4-18.

The major confusion as to the legal nature of a letter of credit stems from the incorrect but genuinely held view that a letter of credit is essentially a contract between the issuing or confirming bank and the beneficiary. McCullough emphatically submits that it is not a contract.<sup>287</sup> There are three reasons why a letter of credit fails to qualify as a contract. First, it does not require consideration, secondly, the issuing or confirming bank and the beneficiary seldom, if ever, negotiate the terms and conditions of the credit.<sup>288</sup> Finally the parties are generally unknown to each other until the applicant applies for the credit and so there is no meeting of the minds.<sup>289</sup> So the letter of credit has rightfully been held not to be a contract between the confirming bank and the beneficiary. A letter of credit has also been distinguished from a suretyship obligation. This is so because the liability of a surety is secondary and arises upon nonperformance of the principal obligor whereas the liability of the issuing or confirming bank is primary and generally arises upon the presentation of documents, regardless of the performance or nonperformance of the parties to the underlying transaction.<sup>290</sup>

Although similar in some respect to a negotiable instrument a letter of credit is not a negotiable instrument and it is not an agency agreement. Neither does a letter of credit create a debtor-creditor relationship with the confirming bank as a debtor of the beneficiary.<sup>291</sup> So one might ask, If not all of the above, what then is a letter of credit? McCullough has the answer. A letter of credit is a separate and independent obligation, to be interpreted in accordance with its own terms and conditions without reference to any other contract. In particular, a letter of credit is separate and independent from the underlying transaction.<sup>292</sup> So a letter of credit is simply what it is, a letter of credit. It is not anything else but a creation of the law merchant which is unique and should be treated as

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<sup>287</sup> Op cit note 87 at 4-20.

<sup>288</sup> Ibid.

<sup>289</sup> Ibid.

<sup>290</sup> Ibid.

<sup>291</sup> Ibid.

<sup>292</sup> Ibid. See Art 4 of UCP 600 which supports this submission by McCullough.

such.<sup>293</sup> Having said this, the focus of this chapter is on the relationship obtaining between the confirming bank and the beneficiary as result of the former's addition of its confirmation on the credit. There is no doubt however; that much of the relationship between the confirming bank and the beneficiary is shaped by what is contained in the letter of credit as confirmed by the bank.

### **The Legal Nature of the Relationship between the Confirming Bank and the Beneficiary**

As explained in the previous chapter<sup>294</sup> the beneficiary might want an undertaking from a local bank over and above that of the issuing bank. This brings the confirming bank into the picture whereby it undertakes the same obligations assumed by the issuing bank and it holds itself out to the beneficiary as responsible for the performance under the letter of credit. Such confirmation is independent and separate from the issuing bank's obligation. Though given in response to the issuing bank's request the undertaking by the confirming bank is given by it as principal and not agent for the issuing bank. As Goode puts it, it is not a case of joint and several liability on the part of the issuing bank and the confirming bank.<sup>295</sup> If the terms of the confirmation are more restricted than those of the credit as issued, the confirming bank's liability to the beneficiary is limited accordingly because the promises of the two banks are separate and self-contained.<sup>296</sup>

As regards the legal foundation of the relationship between the confirming bank and the beneficiary, to the uninitiated it is a simple one. But alas, there is more than meets the eye in this relationship. There have been as many theories as there are authors suggested to explain the nature of the relationship between the confirming bank and the beneficiary and consensus has been hard to come by on this issue. Some of the more prominent theories are explored hereunder. Contrary to what one would have expected the UCP does not come anyway close to defining the legal nature of the relationship between the

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<sup>293</sup> Ibid, at 4-33.

<sup>294</sup> See pages 51-52 thereof.

<sup>295</sup> Op cit note 15 at 986.

<sup>296</sup> Ibid.

confirming bank and the beneficiary save to mention that the liability of the confirming bank is a definite undertaking.<sup>297</sup> One author has suggested that in the quest to find a proper theoretical basis for the bank-beneficiary relationship it is fundamental to heed the provisions of the UCP in two specific areas namely, the independence principle and the moment from which the parties are bound in terms of the credit.<sup>298</sup> Regarding the second area, although the UCP says that the issuing bank is irrevocably bound as of the time “it issues the credit” and the confirming bank as of the time “it adds its confirmation” such words have been observed to be susceptible to multiple interpretations.<sup>299</sup> It is submitted that where time is of the essence it should always be stated in definite terms but the elasticity of the terms used in the UCP has left the provisions unclear and will accordingly have to be interpreted by the courts. The conclusion by Hugo that the UCP does not appear to provide clear guidance as to the precise moment from which the parties are bound is right.<sup>300</sup>

One of the leading theories to explain the legal nature of the relationship between the confirming bank and the beneficiary is what has been termed the offer and acceptance theory.<sup>301</sup> In simple terms this theory suggests that the letter of credit is an offer by the bank which can be accepted by the beneficiary by tendering documents.<sup>302</sup> This theory has found expression in so many cases for example, in the American case of *Moss v Old Colony Trust Co* the court said:-

A Letter of credit is an offer by a bank or other financial agency to be bound to the person to whom it is directed when accepted and acted upon by the latter according to its stipulations. The letter of credit, when so accepted and acted upon by the person in whose favour it is issued, becomes a contract between them wholly independent of the writer of the letter of credit and its customer.<sup>303</sup>

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<sup>297</sup> See Art 2 of UCP 600 under the definition of confirmation.

<sup>298</sup> Hugo op cit note 37 at 182ff. As regards independence of the credit see Art 4 of UCP 600.

<sup>299</sup> See Articles 7(b) and 8(b) of UCP 600.

<sup>300</sup> Hugo supra, at 187.

<sup>301</sup> Op cit note 285 at 30.

<sup>302</sup> Ibid.

<sup>303</sup> (1923) 140 NE 803 at 808.

According to Gutteridge and Megrah, the suggestion by this theory does not meet the situation which arises in the case of an irrevocable credit.<sup>304</sup> They submit that if the credit in such a case is merely an offer there must be an intervening space of time, i.e., until the tender of documents, during which the banker can withdraw the offer and cancel the credit, thus defeating the very object for which it was issued.<sup>305</sup> The other query surrounding this theory is the question whether the offer is for a unilateral contract.<sup>306</sup> This question arises because the beneficiary does not normally make any undertaking towards the bank and therefore if the credit is to be viewed as an offer by the bank to the beneficiary it can only be regarded as an offer for a unilateral contract.<sup>307</sup> So the question that has brought more questions than answers, has always been, when does acceptance of the offer, if any, take place and what form does it take? Finally the offer and acceptance theory has been challenged by almost every author on the basis of the English law contract doctrine of consideration. The application of this doctrine to the relationship between the confirming bank and the beneficiary requires the confirming bank to receive consideration specifically from the beneficiary for the bank's undertaking otherwise there cannot be a valid contract. The discussions by authors on the issue of consideration are very extensive but suffice to say that offer and acceptance has found a seemingly insurmountable obstacle in this English law doctrine.<sup>308</sup>

The so-called guarantee theory has been suggested to explain the bank-beneficiary relationship but has been found to be wanting in many respects. According to this theory the letter of credit amounts to a guarantee by the bank to the beneficiary, that the applicant will perform his obligations under the contract of sale.<sup>309</sup> The theory is regarded a non-starter for a couple of reasons. These include that it violates the independence principle because the confirming bank would not be liable to pay if the buyer is discharged

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<sup>304</sup> At 31.

<sup>305</sup> Ibid.

<sup>306</sup> Hugo op cit note 37 at 189.

<sup>307</sup> Ibid.

<sup>308</sup> For a detailed discussion of the doctrine in this relationship see Hugo op cit note 37 at 192-196, Gutteridge and Megrah op cit note 285 at 26-30 and Todd op cit note 23 at 228-230.

<sup>309</sup> Hugo op cit note 37 at 196.

from his contractual obligations, that the confirming bank assumes primary liability whereas the liability under a guarantee is secondary and it encounters the same problems as the offer and acceptance theory in dealing with the consideration requirement.<sup>310</sup>

Attempts have also been made to classify the bank-beneficiary relationship as a contract for the benefit of a third part but to no avail. In this light is argued that the relationship is regarded as a contract entered into by the issuing bank and the confirming bank for the benefit of the beneficiary. Its has been rejected on the grounds that it violates the doctrine of privity of contract whereby a contract cannot, as a general rule confer rights or impose obligations on any person except the parties to it.<sup>311</sup> Further attempts to bring the contract within the exceptions to this general rule have also been rubbished.

Agency is always one of the theories that are not left out in any attempt to explain a specific relationship in a letter of credit transaction and this is no exception to the relationship between the confirming bank and the beneficiary. The following passage from Gutteridge and Megrah shows their full support for theory and they argue that:-

The parties contemplate that the seller is not content to rely on the buyer's ability or readiness to pay the price, but insists on payment being made in such form as will obviate the possibility of the buyer's failing to pay... . The seller therefore requires the buyer to procure an independent promise of payment made by a bank.... If a contract of sale is entered into in these circumstances there does not seem to be any reason why it should not be held that the buyer has the implied authority of the seller to arrange for the payment of the price to be made in the manner stipulated for.<sup>312</sup>

Just as with the other theories advanced to explain the relationship between the confirming bank and the beneficiary the agency theory has been dismissed because it does not conform with the intention of the parties in a letter of credit transaction. Similarly such theories as

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<sup>310</sup> Ibid.

<sup>311</sup> Hugo op cit note 37 at 197.

<sup>312</sup> Op cit note 285 at 33.

the assignment and novation theories<sup>313</sup> and the estoppel or trustee theories<sup>314</sup> have all cropped up but fell short of satisfactory explanation of the bank-beneficiary relationship. The list of theories is endless and the above discussion does not purport to be exhaustive. Having regard to the fierce debate and disagreement of the highest order on the legal nature of the relationship between the confirming bank and the beneficiary, the conclusion which seems to be appealing to me for now and to which I assent is the position put forward by Lord Diplock in *The American Accord*<sup>315</sup> that the relationship is contractual. I once again succumb to the temptation to quote at length from Davis in his article dealing with the legal nature of this relationship to fortify my conclusion. He concludes thus:-

Thus far, it has been sought to show that the relationship between the banker and the seller is a contractual one, that it arises from an offer by the banker to the seller, contained in the letter of credit, to honour the seller's drafts if they are forwarded, accompanied by specified documents to the banker, that this offer is accepted by the seller when, having had notice of it, i.e. having received the letter of credit, he either expressly notifies his acceptance- although this is not in accordance with the usual course of business and there seems to be no reported case in which it has been done- or does some act referable to the sales contract showing acceptance. If, to support this contract, some consideration moving from the seller can be found, then, it is submitted, the legal validity of the contract between the bank and the seller is established. The difficulty is to discover the existence of any consideration.... Bankers' confirmed credits are another illustration of the fact that the English doctrine of consideration has outgrown its usefulness.<sup>316</sup>

There is therefore no way to avoid the conclusion that the relationship between the confirming bank and the beneficiary in a confirmed irrevocable letter of credit is a contract

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<sup>313</sup> See Gutteridge and Megrah op cit note 285 at 32-3 and Hugo op cit note 37 at 201-3.

<sup>314</sup> See Gutteridge and Megrah supra note 313 at 32 and Hugo supra note 313 at 206-7.

<sup>315</sup> Op cit note 82.

<sup>316</sup> Davis AG, 'The relationship between the banker and the seller under a confirmed credit' (1936) 52 *Law Quarterly Review* 225 at 239.

between two principals.<sup>317</sup> If the conventional theories of the law of contract and the realities of the bank-beneficiary relationship cannot perfectly fit like the pieces of a jigsaw puzzle, then perhaps this is where the argument that the credit should not be compromised by legal niceties but the law must fit around commercial practice, could be raised.

## **The Rights and Obligations of the Confirming bank and the Beneficiary**

### **The Confirming Bank's Rights and Obligations**

There is no better source of a clear expression of the confirming bank's duty to honour the credit than the UCP itself where it has been defined beyond all doubt. Article 8 (a) of the UCP 600 says that "provided that the stipulated documents are presented to the confirming bank or to any other nominated bank and that they constitute a complying presentation, the confirming bank must honour..." and 8(b) provides that "the confirming bank is irrevocably bound to honour or negotiate as of the time it adds its confirmation to the credit." It is clear from these provisions that the confirming bank is under a duty to the beneficiary to honour the credit, namely to pay, accept or accept bills presented to it by the beneficiary, either on demand if the credit is an open one, or if, as is more usually the case, the credit is a documentary letter of credit on fulfillment of the conditions set out in that letter of credit.<sup>318</sup> There is also a duty within a duty as regards the confirming bank's obligation to honour the credit. This is because whenever the beneficiary submits documents to the bank and before the bank decides to honour the credit it has to satisfy itself that the documents constitute complying presentation.<sup>319</sup> There is therefore a duty on

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<sup>317</sup> Besides Davis other writers also seem to favour this conclusion. See for example Todd op cit note 23 at 80-81, Gutteridge and Megrah op cit note 230 at 77 and Hugo op cit note 37 at 262.

<sup>318</sup> Penn *et al* op cit note 162 at 319.

<sup>319</sup> See Art 15 of UCP 600.

the confirming bank to examine the documents and determine whether they are in accordance with the terms and conditions of the credit.<sup>320</sup>

The undertaking by the confirming bank to honour the credit though given at the request of the issuing bank, is given by the former as principal and not agent of the latter. Thus the obligation of the confirming bank is in addition to the obligation of the issuing bank but is also separate from the obligation of the issuing bank.<sup>321</sup> This is apparent from the definition of “confirmation” as provided for in the UCP where it says that “confirmation means a definite undertaking of the confirming bank, **in addition to that of the issuing bank**, to honour or negotiate a complying presentation.”<sup>322</sup> (My emphasis).

The confirming bank’s duty to honour the credit has also found judicial expression in a plethora of cases. To illustrate this it is worth reproducing the apposite encapsulation by the court in the leading *United City Merchants*<sup>323</sup> case. Referring to contract (4), being the contract between the confirming bank and the beneficiary, Lord Diplock said:-

Again, it is trite law that in contract (4), with which alone the instant appeal is directly concerned, the parties to it, the seller and the confirming bank, “deal in documents and not in goods,” as article 8 of the Uniform Customs puts it. If, on their face, the documents presented to the confirming bank by the seller conform with the requirements of the credit as notified to him by the confirming bank, that bank is under a contractual obligation to the seller to honour the credit, notwithstanding that the bank has knowledge that the seller at the time of presentation of the conforming documents is alleged by the buyer to have, and in fact has already, committed a breach of his contract with the buyer for the sale of goods to which the documents appear on their face to relate, that would have entitled the buyer to treat the contract of sale as rescinded and to reject the goods and refuse to pay the seller the purchase price. The whole commercial purpose for

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<sup>320</sup> As regards the bank’s duty in examining documents presented see The International Standard Banking Practice for the Examination of Documents under Documentary Credit (the ISBP) (2007 Revision for UCP 600), ICC Publication No. 681.

<sup>321</sup> McCullough op cit note 87 at 4-99.

<sup>322</sup> Art 2 thereof.

<sup>323</sup> See note 82.

which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment.<sup>324</sup>

So in general the confirming bank is obliged to honour the credit if the documents appear on their face to comply with the requirements of the credit. Breach of the underlying agreement does not concern the confirming bank. This is a bold affirmation of the independence or autonomy of the credit principle, a principle which oils the letter of credit engine. If the confirming bank exceeds its mandate by accepting non-conforming documents the issuing bank may reject them and the confirming bank thereby loses its right to reimbursement. A pertinent question at this juncture would be, in what circumstances will the confirming bank be entitled to refuse to honour the credit? In answering this question I find the enumeration of the circumstances by Goode appealing.<sup>325</sup> He submits that the confirming bank is entitled and obliged to refuse to honour the credit if:

- (a) the documents tendered do not on their face conform to the credit,
- (b) the person presenting the documents is not the party entitled to payment,
- (c) the issue of the letter of credit was induced by fraud or misrepresentation,
- (d) there is other established fraud, whether in relation to the credit or the underlying sales transaction,
- (e) by the governing law or the law of the place where the credit is due to be honoured, it would be illegal to do so, or

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<sup>324</sup> [1982] 2 Lloyd's Rep 1 at 6.

<sup>325</sup> Op cit note 15 at 990-1.

- (f) the credit was issued to support an underlying transaction which to the knowledge of the bank was either unlawful in itself or lawful in the making but entered into for an unlawful purpose.

Of all the listed circumstances above, it is intended to deal only with the confirming bank's entitlement to refuse honouring the credit where there is fraud, because the other circumstances seem to be straightforward and have not generated much problems and controversy as fraud has done.

### **Fraud**<sup>326</sup>

Once again the starting point on the discussion of the right to refuse honouring the credit in circumstances where presentation is tainted by fraud is *The American Accord*.<sup>327</sup>

Continuing with his discussion of contract (4) Lord Diplock said:-

To this general statement of principle as to the contractual obligations of the confirming bank to the seller, there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue.<sup>328</sup>

That the confirming bank has a right to reject documents that are tainted with fraud and therefore entitled to refuse to honour the credit is a fundamental principle which was established by the highly celebrated American case of *Sztejn v J. Henry Schroder Banking Corporation*<sup>329</sup> This American case was referred to with approval in *Edward Owen*

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<sup>326</sup> There is much to be said about fraud in a detailed discussion which is beyond the scope of this thesis. This is just a superficial highlight of the main points on fraud. For detailed exposition of the issue see for instance Edith Kiragu, *Letters of credit: The fraud exception* (2008) Unpublished LLM Thesis, University of Cape Town.

<sup>327</sup> See note 82.

<sup>328</sup> [1982] 2 Lloyd's Rep 1 at 6.

<sup>329</sup> (1941) 31 NYS 2d 631.

*Engineering Ltd v Barclays Bank International Ltd.*<sup>330</sup> It is generally agreed that the exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio*, literally meaning “fraud unravels all.” Most but not all the times, fraud takes the form of forgery or falsified shipping documents and the English courts have held that the confirming bank can only reject documents which are formally in order where the fraud is the beneficiary’s i.e. where the beneficiary knowingly presents forged or falsified documents or where he ships rubbish knowingly or such fraud by a third party is attributable to him.<sup>331</sup> Consequentially, if the shipping documents are forged or falsified by a third party for whom the beneficiary cannot be held responsible the confirming bank cannot reject the shipping documents and refuse to honour the credit.<sup>332</sup>

The Americans on the other hand have held that the fraud does not necessarily have to be in relation to the letter of credit but can also be in relation to the underlying transaction.<sup>333</sup> This does not mean however that the bank is entitled to reject the documents merely because the beneficiary has not fulfilled the terms of the underlying contract or the applicant has repudiated the contract.<sup>334</sup> This would be violent to the independence principle. The bank is entitled to reject the documents only if the beneficiary attempts to take advantage of the irrevocable nature of the letter of credit.<sup>335</sup> By comparison it can be said therefore that the American concept of fraud entitling the confirming bank to refuse to honour the credit is wider in scope than the English because it is not only in relation to the letter of credit but ‘it pierces the veil’ so to speak, by extending to the underlying

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<sup>330</sup> [1978] 1 Lloyd’s Rep 166 or [1978] QB 159. Though this was a case about a performance bond the bank assumes obligations to a buyer analogous to those assumed by a confirming bank to the seller under a documentary credit.

<sup>331</sup> Penn *et al* op cit note 162 at 330.

<sup>332</sup> Ibid.

<sup>333</sup> See the Sztejn case where it was held that although the bank cannot reject documents because of a dispute between the parties relating to the quality of the goods supplied, the courts will grant an injunction to restrain the bank from making payment where the seller’s fraud is called to the bank’s attention before the documents are presented for payment.

<sup>334</sup> Penn *et al* op cite note 162 at 331.

<sup>335</sup> Ibid.

transaction. However, I agree with Goode that there is no reason why in appropriate circumstances the fraud exception should be confined to fraud in relation to the issue of the letter of credit.<sup>336</sup> It is submitted that once fraud is established and it is attributable to the beneficiary the confirming bank must be entitled to refuse to honour the credit irrespective of whether it is in relation to the credit or the underlying transaction. Not only is this sound but it promotes good faith dealing which is very crucial in international trade. It smacks of impropriety to me to turn a blind eye on fraud on the basis of adhering to the independence principle. It is also important to note that if the confirming bank has paid the amount of the credit as a result of fraudulent misrepresentation by the beneficiary it is entitled to recover the payment as money paid under mistake of fact.<sup>337</sup>

### **The Beneficiary's Rights and Obligations**

It has often been said that there is no obligation on the beneficiary to fulfill the terms of the credit but it is in his interest to do so because if he wishes to benefit under it he must conform to the terms of the credit as a condition precedent to insisting on performance of the confirming bank's obligations.<sup>338</sup> The doctrine of strict compliance applies in so far as the presentation of documents by the beneficiary is concerned.

### **Strict Compliance**

It is well established in case law that the beneficiary must strictly comply with the terms of the credit for there to be an indisputable obligation on the confirming bank to honour the credit. To borrow the oft-quoted words of Viscount Sumner in *Equitable Trust Company of New York v Dawson Properties Ltd*<sup>339</sup> "there is no room for documents which are almost the

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<sup>336</sup> Op cit note 15 at 992.

<sup>337</sup> Penn *et al* op cit note 162 at 331. See also Goode op cit note 15 at 997.

<sup>338</sup> Penn *et al* op cit note 162 at 320. See also McCullough op cit note at 4-256.3 where he says that the beneficiary does not have a duty to comply with the terms and conditions of the letter of credit.

<sup>339</sup> [1927] 27 Lloyd's Rep 49 at 52.

same or which will do just as well.” Indeed the courts have held that there is no room for the *de minimis* rule (the rule is that the law does not concern itself with trivialities) in letters of credit.<sup>340</sup> The argument is that banks are not expected to test the materiality of the information or particulars required under the credit and the contract between the applicant and the beneficiary.

The famous case of *JH Rayner & Co. Ltd v Hambro's Bank Ltd*<sup>341</sup> is often used to illustrate this point. The credit in that case described the goods as “Coromandel groundnuts”. The beneficiary had tendered a bill of lading referring to the goods as “machine-shelled groundnut kernels” and an invoice for “Coromandel groundnuts”. Although it was well known in the trade that the two terms were one and the same, the court held that the bank was entitled to reject the documents and refuse payment. This was because “it was quite impossible to suggest that a banker is to be affected with knowledge of the customs and customary terms of every one of the thousands of trades for whose dealings he may issue a letter of credit.”

There is another school of thought however, that in appropriate circumstances something less than strict compliance will suffice.<sup>342</sup> They argue that substantial or reasonable compliance is the standard to be applied, at least where there is no possibility that the bank could be misled.<sup>343</sup> This view is still in its embryonic stage and as it stands the beneficiary is well advised to adhere to the strict compliance doctrine if he entertains any hopes of being paid by the confirming bank. And according to Goode there is an additional requirement that the documents as a whole should be commercially acceptable and should not be in such a condition or contain features such as are calculated to put a reasonable banker on an inquiry.<sup>344</sup> Further, although the description of the goods in all other documents other than the commercial invoice can be general the documents should not appear on their face

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<sup>340</sup> An example is the case of *Far East Ltd v Bank Markazi Jomhouri Islami Iran* [1993] 3 756. However, Art 30 of UCP 600 allows the bank to disregard certain minor variations subject to the express provisions of the credit.

<sup>341</sup> [1943] KB 37.

<sup>342</sup> McCullough op cit note 87 at 4-256.4 ff.

<sup>343</sup> Ibid.

<sup>344</sup> Op cit note 15 at 984.

to be inconsistent with another.<sup>345</sup> Finally if the beneficiary presents non-conforming documents it does not always follow that the confirming bank will refuse to honour the credit because the bank has various options open to it. Indeed the confirming bank can refuse payment or it can seek the issuing bank's waiver of the discrepancy and the issuing bank will in turn seek the applicant's waiver.<sup>346</sup> The confirming bank may also decide to pay the beneficiary "under reserve"<sup>347</sup> To conclude, it is very clear in light of the foregoing, that although there is no obligation on the beneficiary to comply strictly with the terms of the credit it is imperative that he voluntarily assumes such obligation if he wishes to benefit under the credit and therefore insist on the confirming bank's performance. Strict compliance is therefore indispensable for the smooth operation of letters of credit.

### **The Law Applicable to the Relationship between the Confirming Bank and the Beneficiary**

As already shown in the previous chapters, where the parties have not chosen the law applicable to their contract it will be governed by the law of the country with which it is most closely connected. Applying this principle to the relationship between the confirming bank and the beneficiary it is now established and indisputable that the proper law of this contract is the law of the country of the confirming bank. This is because the confirming bank effects the characteristic performance i.e. payment of the beneficiary against presentation of conforming documents in the country of the confirming bank, the

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<sup>345</sup> See Art 14 (d) and (e) of UCP 600 as read with 18 (c) thereof. This was implied in the *Bank Melli* case op cit note 240 where the credit called for "new Chevrolet trucks" but the invoice referred to the goods as "in new condition", the delivery order described them as "new-good" and certificate stated "new, good Chevrolet trucks". The court held that the tender was bad because the documents were clearly inconsistent with each other. Compare with *Midland Bank Ltd v Seymour* [1955] 2 Lloyd's Rep 147.

<sup>346</sup> Art 16 of UCP 600.

<sup>347</sup> According to Kerr LJ in *Banque de l'Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd* [1983] QB 711 payment under reserve suggests "that payment [is] to be made ... in the sense that the beneficiary would be bound to repay the money [to the confirming bank] on demand if the issuing bank should reject the documents, whether on its own initiative or on the buyer's instructions."

beneficiary often holds an account at the confirming bank and to obtain payment, the beneficiary has to present conforming documents at the location of the confirming bank.<sup>348</sup>

This conclusion is in tune with the Rome Convention as amplified by the *obiter dictum* of the courts in the *Bank of Baroda*<sup>349</sup> case where the court held that Article 4(5) of the Rome Convention should be invoked because it leads to a desirable result that the relationship between the beneficiary and the confirming bank, the relationship between the issuing bank and the beneficiary, and the relationship between the confirming bank and the issuing bank are all governed by the same legal system - the law of the country of the confirming bank.<sup>350</sup> Finally it should be noted that the applicability of the law of the country of the confirming bank to this relationship is not problematic due to the fact that more often than not, the confirming bank and the beneficiary come from the same country.

### **Concluding Remarks – Some Thoughts**

The analysis above of the relationship between the confirming bank and the beneficiary has shown that most of the elements constituting this relationship are settled in law. Any questions that have arisen in respect of this relationship have been answered by reference to the UCP and a perusal of a number of court judgments. However, it has also been observed that there are some pockets of grey areas regarding the foundational basis of the relationship between the confirming bank and the beneficiary in legal theory. Although it has been concluded and is now generally agreed that the relationship between the confirming bank and the beneficiary is contractual on the basis of the offer and acceptance

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<sup>348</sup> Fredericks and Neels op cit note 223 at 219 and Morse op cit note 222 at 567. See also a brilliant article, whose author I was unable to ascertain, which gives a detailed analysis of the various authors' views on the proper law of this contract available at <http://www.etd.rau.ac.za/theses/available/etd-02142005> accessed on 14 January 2008.

<sup>349</sup> Op cit note 280.

<sup>350</sup> Fredericks and Neels op cit note 223 at 222. This is contract to the application of Art 4(2) of the Convention which would lead to a situation where the relationship between the issuing bank and the beneficiary on the one hand and the relationship between the beneficiary and the confirming bank, on the other, are governed by different legal systems i.e. the law of the county of the issuing bank and the law of the country of the confirming bank, respectively.

theory the realities of the relations between the parties does not seem to fully support the existence of the conventional contract. The two main problematic areas as already shown center around the question of determining the moment of irrevocability and the problem of the consideration doctrine. It is submitted that these problems currently exist due to lack of a definite and clear position in the provisions of the UCP and therefore these are problems which the UCP can arrest. Since the UCP is a living document that is subject to future revision I am tempted to hazard a few suggestions. It is often suggested we can make meaningful progress by learning from others and in that spirit I submit that the American Uniform Commercial Code 2003<sup>351</sup> can be a source of the solutions to some of these problems. As regards the question of consideration Art 5-105 thereof provides that “consideration is not required to issue, amend, transfer or cancel a letter of credit, advice or confirmation.” It is suggested that perhaps if the ICC incorporates this provision into the UCP this would put to rest the controversy that there is no consideration in the contract between the confirming bank and the beneficiary hence there is no valid agreement. This supports my earlier submission that the functioning of the letter of credit should not be hampered by strictures of such legal niceties as some old English doctrine of consideration which some authors submit has since outgrown its usefulness. It is therefore strongly recommended that the letter of credit be ring-fenced from the doctrine of consideration using the architecture of such provisions as Art 1-105 of UCC.

Further concerning the question of determining the moment of irrevocability the UCP has to come out clean by being clear in its provisions. In particular Articles 7(b) and 8(b) should remove any doubt as to the time of the establishment of the irrevocable credit because it determines the point at which the bank is no longer free to take unilateral action in so far as the amendment or cancellation of the credit is concerned. It can either adopt the dispatch or the receipt of the credit as the time of such irrevocability. Although the current UCC opted for the dispatch it is submitted that the UCP must adopt the receipt

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<sup>351</sup> Copy of which was accessed on the Cornell University Law School website <http://www.law.cornell.edu/ucc/5/> on 15 January 2008.

theory which some authors have suggested augurs well with contractual approach to the relationship between the confirming bank and the beneficiary.

It is further humbly submitted that the above suggestions may not be the best possible ways to deal with the problems apparent in the bank-beneficiary relationship. Neither is it suggested that those are the only ways in which the problems can be solved. Be that as it may, there is no doubt that the issues raised above need immediate attention if the controversy surrounding the bank-beneficiary relationship is to be purged. Having regard to the fact the UCP 600 is fairly new after having come into effect only in July 2007 it looks like it is going to take a while for us to starting talking of another revision wherein such concerns as these can be addressed. One can only hope that the longer it takes to revise the UCP the more time it gives to people to come up with meaningful and long-lasting solutions to these legal problems.

~~THE END~~

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