

## INTERNATIONAL PAYMENT METHODS

Av. M. Hakan TÜFEKÇİ\* / Arş. Gör. Canan ÜNAL\*\*

### ABBREVIATIONS

<b>D/A</b>	Document against Acceptance
<b>D/P</b>	Document against Payment
<b>ICC</b>	International Chamber of Commerce
<b>ISBP</b>	International Standard Banking Practice for the Examination of Documents under Documentary Credits
<b>No.</b>	Number
<b>p.</b>	Page
<b>Rep.</b>	Reports
<b>SITPRO</b>	The Simpler Trade Procedures Board
<b>UCP</b>	Uniform Customs and Practice for Documentary Credits
<b>URC</b>	Uniform Rules for Collections
<b>USD</b>	American Dollars
<b>v.</b>	versus

### INTRODUCTION

In international trade, mainly four payment methods are used, which are (i) open account (cash against goods), (ii) advance payment (prepayment), (iii) bills for collection (documentary collection), and (iv) letters of credit (documentary credit). These payment methods attempt to reconcile the conflicting economic

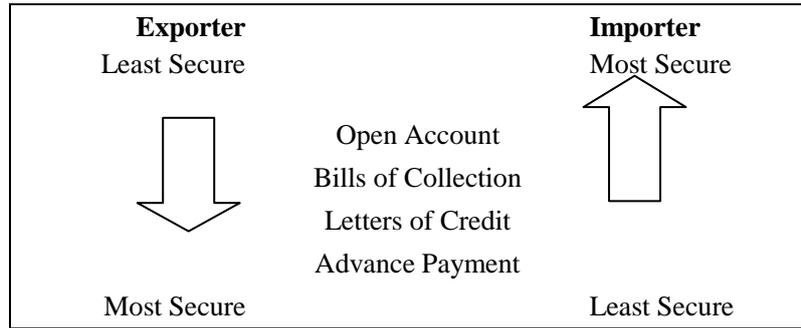
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interests of the parties involved in international transactions. The exporter (seller), on the one hand, would want fairly to obtain the purchase price as soon as possible, however, if the transport documents are documents of title to the goods, the exporter will not wish to part with these before having received payment, or at least confirmation that his draft has been accepted whereas the importer (buyer), on the other hand, would wish to postpone payment of the purchase price until the documents are no longer in the disposition of the exporter<sup>1</sup>. The main factors, determining which payment method will be used are trust relationships between the parties, characteristics of the good, strength of parties in terms of negotiation, risk ratio of states in which parties domiciled or transaction to take place, cost etc.<sup>2</sup>

In the field of international trade, different types of risks may occur. To this regard, various languages, cultures, trade procedures, and statutory law systems shall be taken into consideration<sup>3</sup>. As per the payment methods the risk ladder that exporter and importer are facing is below<sup>4</sup>;



In spite of the payment risk ladder, some payment methods are preferred more in some areas of the world. For instance in the Middle East, South America and Asia the letter of credit is used more while open account is preferred in

<sup>1</sup> **D’Arcy, Leo / Murray, Carole / Cleave, Barbara**, Schmitthoff’s Export Trade: The Law and Practice of International Trade, London 2000, p. 145.

<sup>2</sup> **Polat, Ali**, Uluslararası Ticarete Akreditifli Ödemeler ve UCP 600, İstanbul Ticaret Üniversitesi Sosyal Bilimler Dergisi Yıl:7 Sayı:13 Bahar 2008, p. 209-222, p. 210.

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Europe and North America; open account and bills of collection are in the South Africa and Australia; and advance payment and letter of credit in Africa and Russia<sup>5</sup>.

We will, upon a brief introduction to the first three payment methods hereinabove stated, focus on “letters of credit” mainly in the light of Uniform Customs and Practice for Documentary Credits (UCP) which are the rules generally acknowledged by international trading actors. This paper will, in particular, touch on the UCP’s final publication, namely Uniform Customs and Practice for Documentary Credits “Publication No. 600” (UCP 600) which came into life on 1 July 2007.

### **1. OPEN ACCOUNT (CASH AGAINST GOODS)**

This is the least secure method of trading for the seller/exporter, but the most attractive to buyers. In this case, the seller ships the goods and sends invoice together with the other documents to the buyer, who is invited to pay the agreed amount on the appointed date into the account indicated by the exporter<sup>6</sup>. In other words, the buyers send to the goods to exporter without any instant payment. So that, this payment method provides the exporter no payment protection at all and accordingly limited to transactions involving small amounts or to situations where the exporter has no doubts about the credit worthiness and/or the willingness of his buyer to pay. It assumes that the parties are well known to each other and this mode of payment is then very efficient<sup>7</sup>. However, it is noteworthy to list out the risks which the exporter may face as follows:

- i. He may not to receive the payment on time
- ii. He may not to receive the payment at all
- iii. He may be subjected to bad reputation due to the discrepancy or bad condition of the goods he provided<sup>8</sup>.

Open account can be subjected to a bank guarantee by the buyer and on behalf of the seller in avoiding non-performance of due payment. Also another protection can be provided in the contract between the parties through reserva-

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<sup>5</sup> **SITPRO**, Report on the Use of Export Letters of Credit 2001/2002, 11 April 2003, p. 8, <http://www.sitpro.org.uk/reports/lettcredr/lettcredr.pdf> (last visit 18 December 2009).

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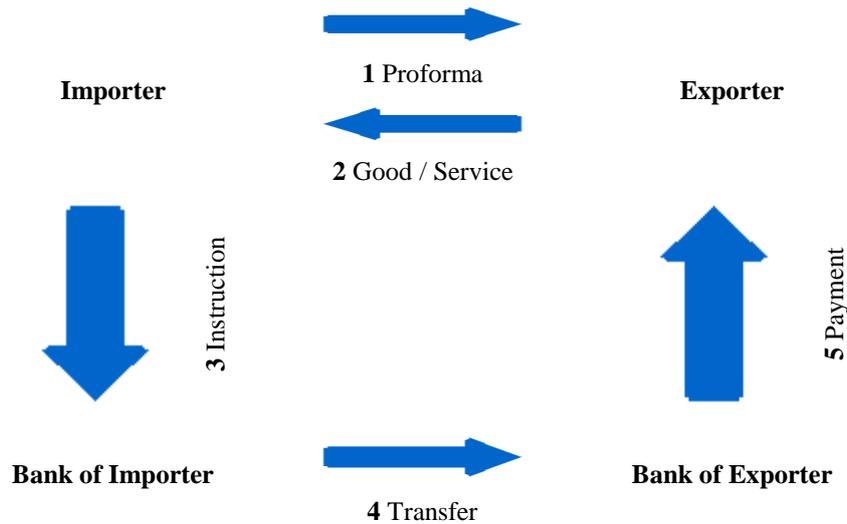
<sup>8</sup> **Sanli, Cemal / Eksi, Nuray**, Uluslararası Ticaret Hukuku, İstanbul 2006, p. 78-79.

tion of title however that does not force the buyer to accept the goods and may not prove to be effective when the goods are shipped to the another country or when the goods have been commingled with or converted into others.

Another alternative for the seller can be to keep the bill of lading until the payment however in this case, the importers may not want to goods any longer and so that there can be only unsecured damages claim<sup>9</sup>.

Briefly speaking, an exporter has little or no control over the process, except for imposing future trading terms and conditions on the importer. Clearly, this payment method is the most advantageous for the importer, in cash flow and cost terms. As a consequence, open account trading should only be considered when an exporter is sufficiently confident that payment will be received<sup>10</sup>.

The following diagram<sup>11</sup> shows the mechanism of open account:



<sup>9</sup> Dalhuisen, p.458.

<sup>10</sup> In certain markets, such as Europe, buyers will expect Open Account terms. The financial risk can often be mitigated by obtaining a credit insurance policy to cover the potential insolvency of customer that provides reimbursement up to an agreed financial limit. **SITPRO**, International Trade Guides, Methods of Payment in International Trade, p. 3, <http://www.sitpro.org.uk/trade/paymentmethods.pdf> (last visit 18 December 2009).

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## **2. ADVANCE PAYMENT (PREPAYMENT)**

Payment is expected by the exporter, in full, prior to goods being shipped. So that, the exporter is in a position to receive the full payment prior to delivery of goods to the importer. It can be therefore said that advance payment is the most secure method of trading for exporters and, consequently the least attractive for importers.

Reasons regarding the utilization of advance payment can be summarized in the following manner:

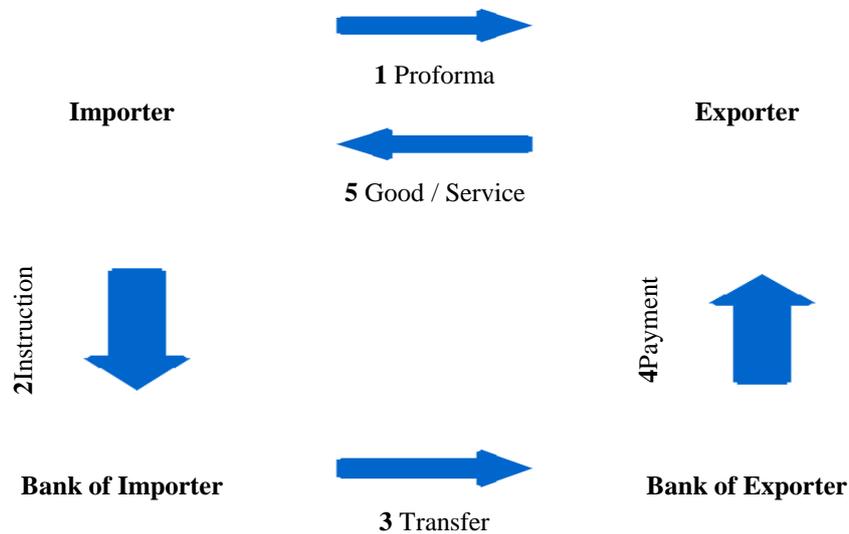
- i. The exporter does not want to bear the risks of state of performance.
- ii. The exporter does not want to bear the risks of the importer.
- iii. The exporter is short of funds.
- iv. The exporter may be in a monopoly position.
- v. The exporter may have given to the importer financial securities such as bank guarantee.
- vi. The importer may be confidence with the exporter and his country.
- vii. The importer may deliberately need the goods that exporter sell.
- viii. The importer may be a new-comer to the relevant market.
- ix. The importer may wish to build up a long business relationship with the exporter.
- x. There is solid and strong confidence between the importer and exporter.
- xi. The contract price may be a small amount<sup>12</sup>.

The following diagram<sup>13</sup> shows the mechanism of advance payment:

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<sup>12</sup> **Özalp**, p.15.

<sup>13</sup> **Özalp**, p.16.



### 3. *BILL OF COLLECTION (DOCUMENTARY COLLECTION)*

Under a collection, the exporter (principal) normally requests his own bank (the remitting bank) to turn over the documents relating to the goods (normally a bill of lading issued by the carrier) to a bank in the country of the importer (the collecting bank). Thus, it is here the seller/creditor who organizes this payment facility. The collecting bank will be acting as the agent of the remitting bank and collect from the importer through the importer's bank (the presenting bank) the money agreed in the contract of sale. It will do against the handing over of the bill of lading to the presenting bank may be combined. Obviously this type of collection will have been discussed between the importer and exporter beforehand and be agreed amongst them<sup>14</sup>.

Due to its importance in unifying the Bill for Collection worldwide, The International Chamber of Commerce (ICC) set and published specific rules, being "Uniform Rules for Collections" document number 522 (URC 522) which are used over 90% of the world's banks. The URC 522 can only apply if parties to

<sup>14</sup> Dalhuisen, p. 458.

the contract agree to do so<sup>15</sup>. However, specific provisions may be excluded by the parties if so required<sup>16</sup>.

In the case of bill of collection, the exporter must instruct the remitting bank and the latter must instruct the collecting bank as to whether the documents shall be delivered to the buyer:

- i. On acceptance of the bill (D/A terms),
- ii. On actual payment (D/P terms) or
- iii. In accordance with special instructions.

D/A, on the one hand, is used where a credit period (e.g. 30/60/90 days - 'sight of document' or from 'date of shipment') has been agreed between the exporter and importer. The importer is able to collect the documents against their undertaking to pay on an agreed date in the future, rather than immediate payment. The exporter's documents are usually accompanied by a "Draft" or "Bill of Exchange" which looks something like a cheque, but is payable by (drawn on) the buyer. When a buyer (drawee) agrees to pay on a certain date, they sign (accept) the draft. It is against this acceptance that documents are released to the buyer. Up until the point of acceptance, the exporter may retain control of the goods, as in the D/P scenario below. However, after acceptance, the exporter is financially exposed until the importer actually initiates payment through their bank<sup>17</sup>.

Whereas D/P, on the other hand, is usually used where payment is expected from the importer immediately, otherwise known as "at sight". This process is often referred to as "Cash against Documents". The importer's bank is instructed to release the exporter's documents only when payment has been made. Where goods have been shipped by sea freight, covered by a full set of bills of lading, title is retained by the exporter until these documents are properly released to the importer<sup>18</sup>.

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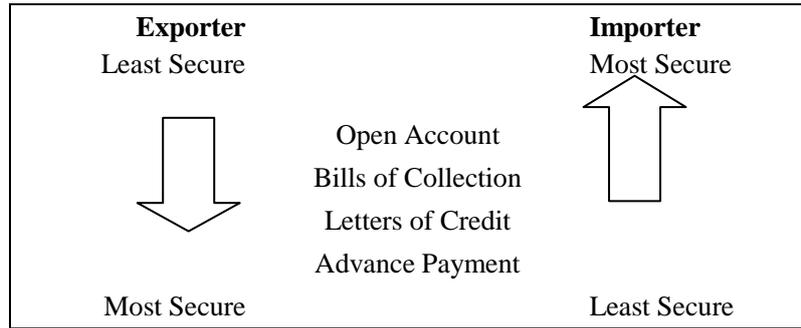
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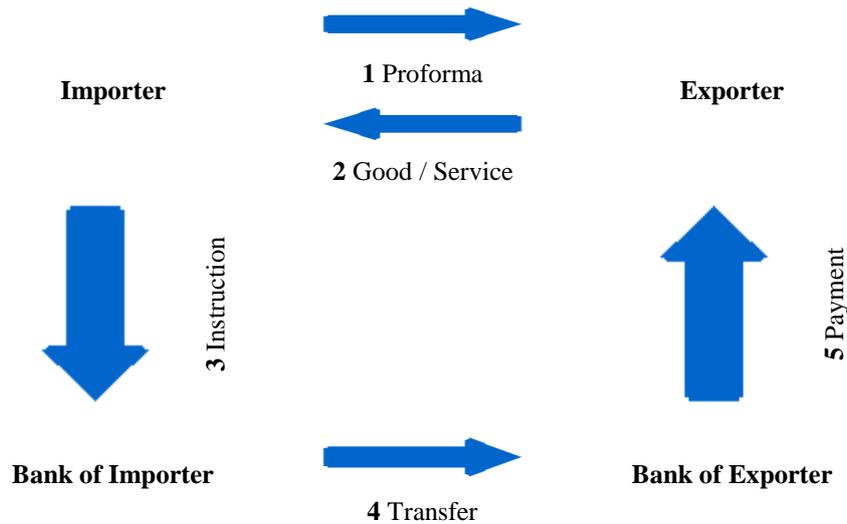
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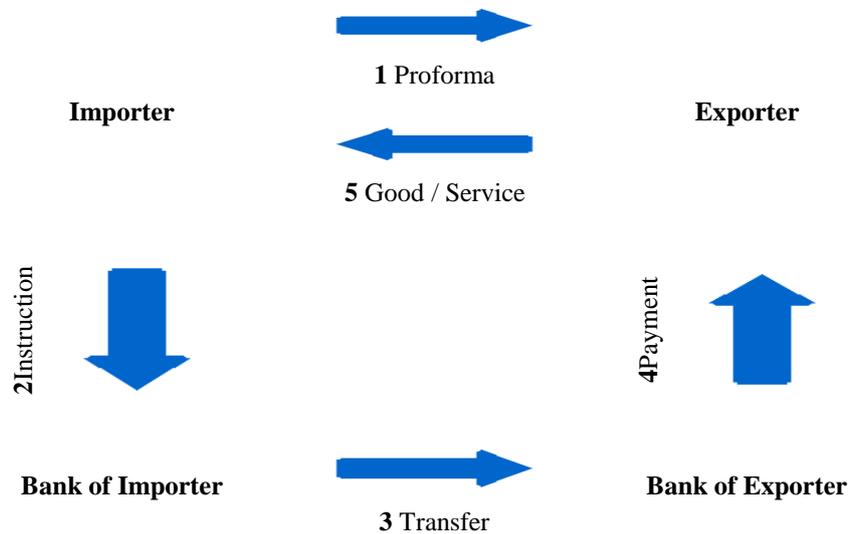
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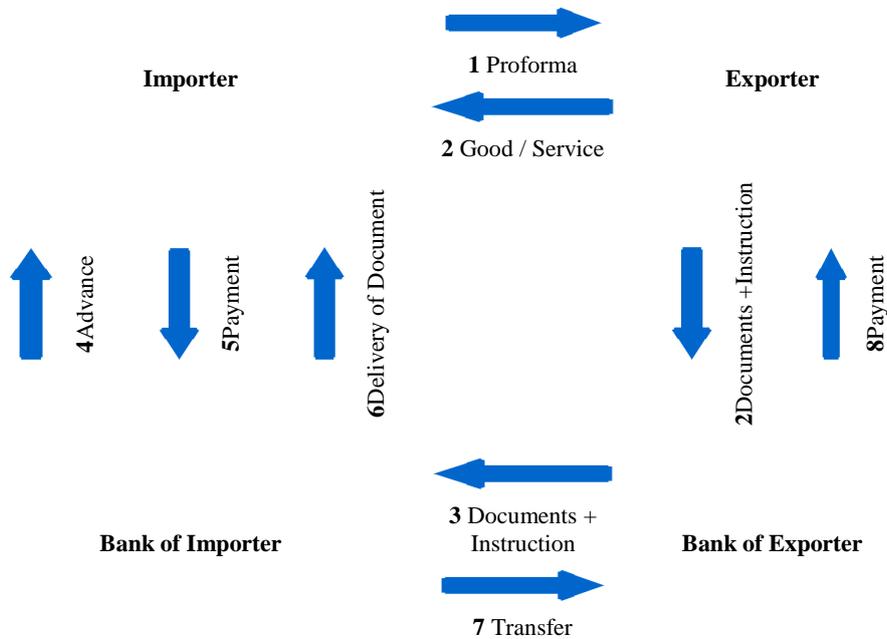
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The following diagram<sup>19</sup> shows the mechanism of bill of collection:



#### 4. LETTER OF CREDIT (DOCUMENTARY CREDIT)

Today, letter of credit is the most frequent payment method in the international trade and has been described by English judges as “the life blood of international commerce”<sup>20</sup>. Since this payment method provides a relative degree of protection for both sellers and buyers. As per the last studies, it has been estimated that the value of letter of credit business is over 1 trillion USD per annum<sup>21</sup>. The letter of credit usage as per the geographic regions is listed below<sup>22</sup>;

European Union	9%
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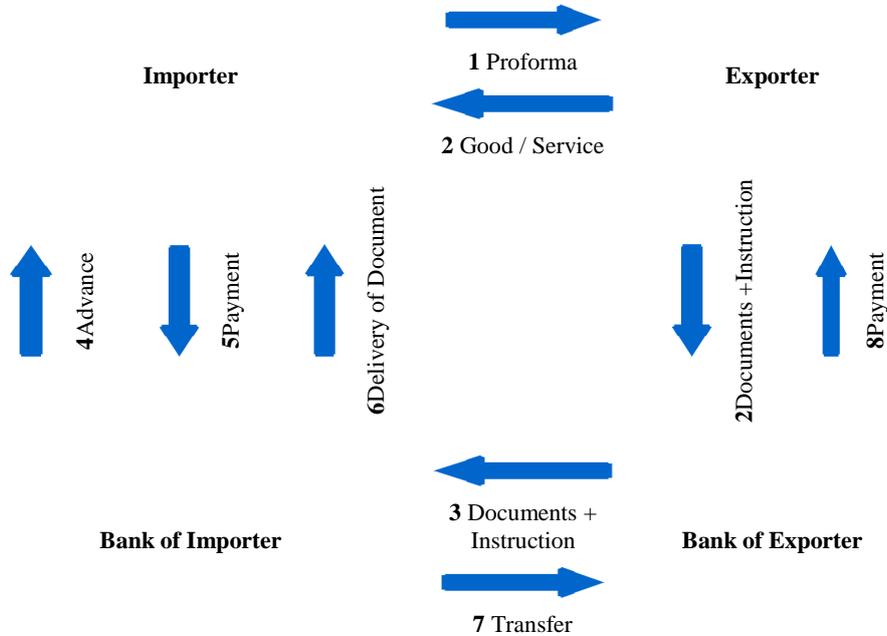
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<sup>22</sup> **SITPRO**, Report on the Use of Export Letters of Credit 2001/2002, 11 April 2003, p. 8, <http://www.sitpro.org.uk/reports/lettcredr/lettcredr.pdf> (last visit 18 December 2009).

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Rest of Europe	20%
North America	11%
Latin America	27%
Middle East	52%
Asia Pacific	43%
Africa	49%
Asia	46%
Aust. & New Zealand	17%

## I. Definition

A letter of credit is best defined as a complex of contractual obligations<sup>23</sup>. The letter of credit is a form of non-monetary account settlement, that is a conditional obligation of the bank to make a payment to an exporter (the beneficiary), depending on certain criteria. In order to start a transaction of this manner, the beneficiary needs to present the appropriate documents to the bank for issuance<sup>24</sup>. The fundamental principles of the letter of credit which are the autonomy principle and doctrine of strict compliance principle<sup>25</sup> will be explained under the title “UCP” below.

Where payment under a letter of credit is arranged, for stages can be distinguished:

1. The exporter and the overseas buyer agree in the contract of sale (underlying contract) that payment shall be made under a letter of credit.
2. The buyer (acting as “applicant”) instructs a bank at his place of business (known as the “issuing bank”) to open a letter of credit for the

<sup>23</sup> For the other views in the doctrine and critics see Göger, Erdoğan, Akreditif vır Hukuki Mahiyeti, Banka ve Ticaret Hukuku Araştırma Merkezi, Ankara 1961; Resioğlu, Akreditif, p. 8-12.

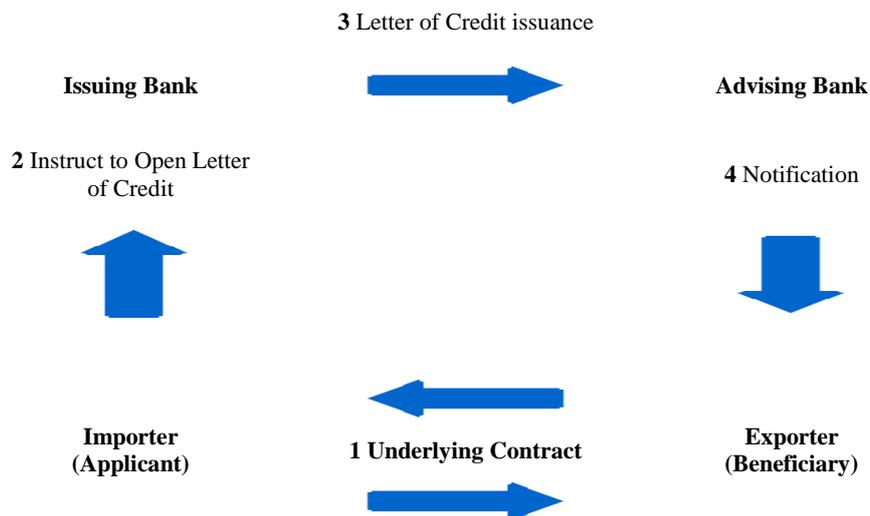
<sup>24</sup> **Koudriachov, Serguei A.**, The Application of the Letter of Credit Form of Payment in International Business Transactions, HeinOnline, Summer 2001, p. 37-43, p. 37. – The Turkish Appeal Court defines letter of credit as an agreement aiming to pay to the seller upon the delivery of the documents as per the agreement made by the buyer with the bank. *Court of Cassation 11<sup>th</sup> Civil Chamber dated 28.2.1980 Docket No. 1980/642 Decision No. 1980/941, Court of Cassation 15<sup>th</sup> Civil Chamber dated 16.2.2004 Docket No. 2003/4030 Desicion No. 2004/722, www.kazanci.com*

<sup>25</sup> **Reisoğlu, Seza**, Türk Hukukunda ve Bankacılık Uygulamasında Akreditif, Ankara 2009, p. 65-73 (Akreditif); **Koudriachov**, p. 37; **Hotchkiss, Carolyn**, International Law for Business, p. 168; UCP 600, Article 4 and 5.

exporter (known as the “beneficiary”) on the terms specified by the buyer in his instructions to the issuing bank.

3. The issuing bank arranges with a bank at the locality of the exporter (known as the “advising bank” to negotiate, accept, or pay the exporter’s draft upon delivery of documents by the seller).
4. The advising bank informs the exporter that it will negotiate, accept or pay his draft upon delivery of the transport documents. The advising bank may do so either without its own engagement or it may confirm the credit opened by the issuing bank<sup>26</sup>.

The following diagram<sup>27</sup> shows the mechanism of letter of credit transaction:



Comparing with other payment methods, letter of credit transactions require a specialization. Since the letter of credits will not furnish any payment guarantee to the exporter neither to furnish any guarantee to the importer regarding

<sup>26</sup> **D’archy / Murray / Cleave**, p. 169. – Sometimes the situation is more complicated. The issuing bank may authorize another bank to confirm, and this bank may instruct to a third bank to advise.

<sup>27</sup> **SITPRO**, Letters of Credit, An Introduction, July 2007, p. 3, <http://www.sitpro.org.uk/trade/lettcredintro.pdf> (last visit 18 December 2009).

the quality and supply of the goods they requested in case it is not handled properly with a special care<sup>28</sup>.

Other than advance payment, a letter of credit is the most secure method of payment in international trade, with the payment undertaking of the bank, as long as the terms of the credit are met. The letter of credit also provides security for the importer who can ensure all contractual documentary requirements are met by making them conditions of the letter of credit.

## II. History

The letter of credit originated in the Middle Ages. The French word “acreditif” means “a power to do something”, which in turn is a derivative of the Latin word, “accreditivus”, meaning trust. In the Middle Ages, a letter of credit is issued because the travelers do not take cash with them on their journeys, and they would give their money in trust to their bank<sup>29</sup>.

The popularity of the letter of credit, as an instrument of international trade, increased during the middle of the nineteenth century. The need for the international unification of the norms and rules regarding the usage of the letter of credit appeared almost simultaneously<sup>30</sup>. Moreover the International Chamber of Commerce (ICC) took an active role in unifying these rules. In order to facilitate the flow of international trade UCP was introduced in 1933 to alleviate the confusion resulted from individual countries’ promoting their own national rules on letter of credit<sup>31</sup>. These rules were revised in 1951. The Uniform Customs and Practice for Documentary Credits issued in 1962 was accepted as the first set of rules having gained global acceptance. These have also been updated in 1971, 1983, and 1993 (hereinafter named as UCP 500)<sup>32</sup>. Today, the 7<sup>th</sup> edition of the 2007 UCP “Publication No: 600” is in operation. This edition has sought (i) to make the UCP more accessible and user-friendly; (ii) to resolve certain specific

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<sup>28</sup> **Polat**, p. 209.

<sup>29</sup> **Koudriachov**, p. 37; **Özalp**, p. 23.

<sup>30</sup> **Koudriachov**, p. 37.

<sup>31</sup> UCP 600, ICC Uniform Customs and Practice for Documentary Credits, International Chamber of Commerce, Publication No: 600.

<sup>32</sup> **Bergami, Roberto**, What can UCP 600 Do for You?, *Vindobona Journal of International Commercial Law & Arbitration*, 2007, p. 1.

issues perceived to exist UCP 500; and (iii) to further harmonize international practice<sup>33</sup>.

### III. Main Characteristics of Uniform Customs and Practice for Documentary Credits Publication No. 600 (UCP 600)

#### A. Application of the UCP 600 (Article 1)

Is the UCP 600 a law, an international agreement, customary law, trade usage, or *lex mercatoria*, or an agreement? The answer would help us understand the application. First of all, the UCP 600 has no force of law. Since ICC does not have a legislative competence<sup>34</sup>. This is purports to codify international banking and practices in relation to letter of credits. Thus it does not apply directly. It must be incorporated into letters of credit in order to gain binding (contractual) status<sup>35</sup>. Besides, the UCP 600 is not an international agreement because it does not require any ratification procedure to apply. These rules cannot be described as customary law or trade usage. Since for these both legal sources, an application is precondition<sup>36</sup>. Moreover, the UCP 600 is not *lex mercatoria*. Although the aim of the application of these rules is harmonization, UCP 600 is not capable to cover all the letters of credits. There are some gaps in the UCP 600 and some areas are regulated by the domestic law<sup>37</sup>.

As per Article 1 of UCP 600, these rules apply to any letter of credit when the text of the credit expressly indicates that it is subject to these rules. Through such an express reference with a clause like “This letter of credit is subject to the UCP 600”, the UCP becomes a part of the agreement of letter of credit<sup>38</sup>.

<sup>33</sup> **Barnett, Michael/Isaacs, Michael**, International Trade Finance – Letter of Credit, UCP 600 and Examination of Documents, Journal of International Banking Law and Regulation, 2007, p. 660.

<sup>34</sup> **Reisoğlu**, Akreditif, p. 55.

<sup>35</sup> **Barnett**, p. 660.

<sup>36</sup> **Reisoğlu**, Akreditif, p. 56.

<sup>37</sup> For instance the claim of abuse of right is evaluated under the domestic law. **Reisoğlu**, Akreditif, p. 57.

<sup>38</sup> **Reisoğlu**, Akreditif ve Uygulama Sorunları, p. 3; The Turkish Appeal Court 11<sup>th</sup> Chamber dated 1.11.2004 Docket No. 2004/1535 Decision No. 2004/10618, www.kazanci.com .- Unless there is express reference to UCP 600, no provision of UCP 600 applies. However *Reisoğlu* argues that these Uniform Customs and Practice applies permanently in the field of international banking, these rules should be regarded while

The UCP 600 can be also applied with exceptions and modifications. For instance, with a clause like “This letter of credit is subject to UCP 600 except Article xx” it is possible to apply the UCP 600 partially<sup>39</sup>. However the excluding or modifying the articles of UCP 600 regulating the fundamental principles of letter of credit is not possible<sup>40</sup>. For instance, it is not allowed to exclude Article 5, which states that banks deal with documents, not with goods, services, performance to which the documents may relate.

The UCP 600 should be applied together with International Standard Banking Practice “Publication No. 681” (ISBP 681), which has repealed ISBP 645<sup>41</sup>.

### **B. Inserting Articles “Definitions” (Article 2) and “Interpretation” (Article 3)**

As a new helpful addition to the rules, two articles regarding the definitions and interpretation have been inserted.

Article 2 is dedicated to the definitions of some terms used in the UCP 600, which considerably simplifies the drafting of the rules as the use of an already-defined terms avoid numerous lengthy repetitions. For instance the terms like “presentation”, “to honour” and “complying presentation” are the terms referred many times in the UCP 600.

In particular, the definitions of “honour” and “negotiation” have resulted in clear of ambiguities<sup>42</sup>. Pursuant to this article, negotiation is “the purchase by the nominated bank of drafts and/or documents under complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank.” The definition of the term “to honour” has regrouped the three methods of payment of a

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interpreting the intents of the parties before a court. For the counter-view see **Somuncuoğlu, Ünal / Bumin, Gaye / Varlık, Ender / Çakalır, Ayberk**, *Türk Hukukunda Akreditif*, İstanbul 2009, p. 6.

<sup>39</sup> **Özalp**, p. 205.

<sup>40</sup> **Reisoğlu**, *Akreditif ve Uygulama Sorunları*, p. 3.

<sup>41</sup> **Erdemol, Haluk**, *A Summary of Updated ISBP*, DCInsight, July-September 2007, Volume 13, Number 3, p. 3-4.

<sup>42</sup> **Doise, Dominique**, *The 2007 Revision of The Uniform Customs and Practice for Documentary Credits*, *International Business Law Journal*, 2007, p. 112.

letter of credit, which are (i) payment at sight, (ii) deferred payment undertaking, and (iii) through acceptance.

Furthermore, the definitions of the actors of transaction of letter of credit have resulted in clarity of the complicated structure. As per Article 2, “applicant” is defined as the party on whose request the letter of credit is issued; and while “beneficiary” means the party in whose favor a letter of credit is issued. “issuing bank” means the bank that issues a letter of credit at the request of an applicant or on its own behalf and “advising bank” is the bank that advises the letter of credit at the request of the issuing bank. “nominated bank” is the bank with which the letter of credit is available or any bank in the case of a letter of credit available with any bank and “confirming bank” means the bank that adds its confirmation to a credit upon the issuing bank’s authorization or request. Although the reimbursement bank has not defined by the UCP 600, it could be described as the bank which in fact makes the process of monetary transfer on the account of the beneficiary<sup>43</sup>. However the actors mentioned above are only some participants in the business transaction. Very often, the same bank can act in multiple functions. For instance, the advising bank can act as an issuing bank and confirming bank. This situation results in actors less, but more complicated structure.

As for interpretations, a new Article 3 has regrouped the principles of interpretation that were previously scattered in different provisions of the UCP 500 which are Article 2 for “branches of banks”, Article 30 for “signatures” and other words such as “first class”, Article 46 for general expressions with respect to dates, and so on and so forth<sup>44</sup>.

By Article 3 of the UCP 600, one of the major modifications is that the letters of credit are irrevocable even if there is no indication to that effect. Previously, they could be revocable if stated as such (UCP 500, Article 6). However in practice revocable letters of credit were hardly ever used. Since the revocation opportunity of the importer provides no security<sup>45</sup>. In parallel, Article 6 and 8 of UCP 500 regarding revocable letter of credits have been removed from UCP 600.

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<sup>43</sup> **Koudriachov**, p. 37.

<sup>44</sup> **Doise**, p. 113.

<sup>45</sup> **Doise**, p. 113.

### C. Principle of Autonomy (Article 4 and 5)

In the UCP 600, principle of autonomy has been defined in the following manner:

- Positively, under Article 4, which provides that letter of credit, by nature, is a separate transaction from the underlying contract; and
- Negatively, under Article 5, which provides that banks deal with documents, not with goods, services, performance to which the documents may relate.

Principle of autonomy is one of the fundamental principles of letter of credit. Hence, the previous UCP editions had been also touched on this principle.

Comparing with the UCP 500, we could observe that the current edition has preferred to expand the positive aspect of the principle. This aspect has been also called as the independence principle. The transaction of letter of credit consists of a complex of contracts and these contracts are independent from each other<sup>46</sup>. Independent / separation from the underlying contract is logical because the banks are not the parties of this contract<sup>47</sup>. To highlight the need for this separation, the UCP 600 has sought to reinforce this principle by addition of sub-article (b), that the issuing bank is obliged to discourage any attempt by the applicant to include, as an integral part of the letter of credit, copies of underlying contract, proforma invoice and the like (Article 4.b of UCP 600).

On the other hand, UCP 600 has used the word “banks” instead of the words “in credit operations all parties concerned” in UCP 500. By this way, the negative aspect of the principle has reached a clearer definition and the role of the banks in the transaction has been reinforced<sup>48</sup>. As a result of the independence principle, the banks do not deal with the goods, services or performance regarding the underlying contract.

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<sup>46</sup> **Reisoğlu**, Akreditif, p. 65; **Polat**, p. 212. As per the Turkish Court of Cassation, issuing a letter of credit does not result in invalidity of the sale contract because of the independence principle (*The Court of Cassation 19<sup>th</sup> Civil Chamber dated 21.11.1995 Docket No. 1995/1770 Decision No. 1995/9992*, www.kazanci.com).

<sup>47</sup> **Bergami**, p. 3.

<sup>48</sup> **Bergami**, p. 3.

In the case of *Power Curber International Ltd. v. National Bank of Kuwait* the distributors in Kuwait bought machinery from Power Curber, an American company carrying on business in North Carolina. The National Bank of Kuwait issued an irrevocable letter of credit, instructing the Bank of America in Miami to advise the credit to the sellers through a bank in Charlotte, North Carolina. The machinery was duly delivered but the Kuwaiti buyers raised a large counterclaim against the sellers in the courts of Kuwait and obtained from them a provisional attachment order which prevented the bank, which was willing to honour the irrevocable credit, from paying under it. The seller sued the bank, which had registered address in London, in the English courts and a judgment against the bank was given. Later, the Court of Appeal upheld this decision. It was held that the order of the court in Kuwait did not affect the obligation of the bank<sup>49</sup>. In such a case the courts have normally refused to issue a freezing injunction (Mareva injunction)<sup>50</sup>.

#### **D. Standard for Examination of Documents – Strict Compliance (Article 14)**

The examination of documents is a very sensitive task on the banks<sup>51</sup>. The documents may be falsified but the more common problem is that they are not, strictly speaking, in compliance with the terms and conditions of the letter of credit<sup>52</sup> in other words, the liability of confirming or issuing banks under a letter

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<sup>49</sup> [1981] 2 W.L.R..

<sup>50</sup> As per the judgment of *Kadıköy 1<sup>st</sup> Commercial Court of First Instance dated 30.11.1998 Docket No. 1998 / 1445*, it was held that the claim of default is not taken into consideration and upon this claim freezing injunction is not issued because of the independence principle under UCP 500.

<sup>51</sup> In international transactions, the duty to examine the documents is normally delegated to a nominated bank appointed by the issuing bank. It does not, however, discharge the issuing bank from its duty in this regard vis-à-vis the buyer of the credit.

<sup>52</sup> Especially if quality certificates are required, they may not be in the precise form. Shipping documents may not be made out to the proper entities (but rather to agents). Especially invoices establishing the sale price are often not in the required form or may slightly deviate in amount. Many deviations are small and do not matter but they may nevertheless require consultation with the issuing bank and subsequently with the buyer to prevent any danger to the reimbursement of the issuing bank by the buyer and of the nominated bank by the issuing bank. **Dalhuisen**, p. 465.

of credit is to pay the beneficiary the sum due, provided that the documents in the letter of credit are presented<sup>53</sup>.

Under the principle of autonomy banks' duty is to check only the documents described in the letter of credit but not to seek whether they are in conformity with the underlying contract between the exporter and the importer. As principle, the banks do not deal with the infringement of the underlying contract. However, if a bank pays upon having accepted discrepant documents, it may be unable for it to obtain reimbursement from its own customer, which in fact makes the checking function key in determining the bank's exposure.

Main principles that govern the banks' liability in paying in connection with the checking of documents may well be drawn from the case law, the UCP and trade practice.

*a. Reasonable Care*

Article 14(a) of the UCP 600 provides that the duty of the bank (with reasonable care) to "determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation". Under Article 2 of the UCP 600, "a complying presentation" is one which is in accordance with "the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice". The UCP 600 has removed the concept of "reasonable care" which was the main feature of the duty of examination lying on the banks under Article 13 of the UCP 500. It does not however mean that the degree or nature of the duty has changed, as it is still reasonable duty of care under which the bank has to observe an obligation of apparent compliance with the terms and conditions of the letter of credit<sup>54</sup>. Though, the commonly held view is that it is unlikely that this will affect what was in any event a restatement of the common law position<sup>55</sup>.

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<sup>53</sup> The documents presented are typically documents that identify (i) the goods (such as commercial invoice [Article 18 of the UCP 600]) (ii) transport and title (most notably bills of lading [Article 19 - 24 of the UCP 600]) (iii) insurance cover (insurance policies/certificates [Article 28 of the UCP 600]) (iv) weight, temperature, origin, quality etc. (certificates). **Barnett**, p. 662.

<sup>54</sup> **Doise**, p. 119.

<sup>55</sup> **Barnett**, p. 662.

Under this article, if, for instance, reasonable care is exercised but discrepant documents are accepted, the paying bank shall be still entitled to debit its customer (the buyer/applicant) due to the fact that it has not breached its duty.

*b. The documents should be “regular on their face”*

The proposition is that documents should be “regular on their face, should not be such as to invite further inquiry, and should not be such as are current trade in question. In other words, they should not be documents that “call for further inquiry or are such as to invite litigation”<sup>56</sup>.

Here, we are only dealing with discrepancies as such, but with form and notation, oddities in documents which might tend to set alarm bells ringing. Given the seeming vagueness of this notion, banks would do well to avoid reliance on such a general principle and rely on positively identified discrepancies that entitle rejection on the basis that they do not strictly comply with the letter of credit. There is authority to support the view that in deciding whether a document is compliant, a bank should not be affected from knowledge of the customs of the many trades that it finances<sup>57</sup>.

As per the survey regarding the types and the frequency of discrepancy the top ten discrepancies leading to the rejection of letters of credit are listed below<sup>58</sup>:

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<sup>56</sup> *M Golodetz & Co. Inc v Czarnikov Ronda Co Inc* [1980] 1 W.L.R 495; **Barnett**, p.663.

<sup>57</sup> *J H Rayner & Co* [1943] 1 K.B. 37 ; **D’arcy / Murray / Cleave**, p. 172 ; **Barnett**, p.663.

<sup>58</sup> **SITPRO**, Report on the Use of Export Letters of Credit 2001/2002, 11 April 2003, p. 13, <http://www.sitpro.org.uk/reports/lettcredr/lettcredr.pdf> (last visit 18 December 2009).

<b>Discrepancy</b>	<b>Reason</b>	<b>Responsibility</b>
Inconsistent data	Different information between the different documents.	Exporter
Absence of documents	Documents required by the letter of credit are missing	Exporter
Other	Other documentation reasons not specifically noted	Exporter; any third party e.g. PSI company, carrier
Late presentation	Documents presented later than 21 days after shipment or after the number of days stipulated in the letter of credit	Exporter
Carrier not named and signing capacity	The name of the carrier on the airway bill is missing or not signed on behalf of the carrier	Exporter
Incorrect data	Information on the set of documents is not in conformity with the letter of credit	Exporter
Letter of credit expired	Documents presented after the letter of credit has expired	Exporter
Incorrect goods description	The goods description on the documents differs from that on the letter of credit	Exporter
Incorrect or absence of Endorsement	The bills of lading, insurance certificate or bill of exchange not endorsed by the exporter or other party	Exporter or insurance company
Late Shipment	Goods shipped after the last date given for shipment	Exporter/carrier

These foregoing explanations are named as strict compliance principle in the letters of credit. In the case of *Viscount Summer in Equitable Trust Co of New York v Dawson Partners Ltd*<sup>59</sup>, this principle was pointed out as:

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

The bank must not consider the commercial purposes of the documents presented before it in accordance with the letter of credit or why they were issued<sup>60</sup>. It shall not concern itself as to these issues. However, the debate here arises regarding the how exactly the strict compliance must be. While it is no part of a bank’s role to consider how relevant discrepancies may be, document examination does require some judgment by the bank and is not simply a mechanical exercise of comparison<sup>61</sup>.

In *Kredietbank Antwerp v Midland Bank plc*<sup>62</sup>, the strict compliance requirement was expressed as follows:

*“The requirement of strict compliance is not equivalent to the test of literal compliance in all circumstances and as regards all documents to some extent; therefore, the banker must exercise its own judgment whether the requirement is satisfied by the documents presented to him”*

This appears to open up a degree of discretion, which is potentially dangerous if the buyer/applicant later complains that the documents should have been

<sup>59</sup> *Viscount Summer in Equitable Trust Co of New York v Dawson Partners Ltd* [1926] 27 Lloyd’s Rep. 49 ; for a more recent case, please see *Seaconsar Far East Ltd v. Bank Markazi Jomhouri Islami Iran* [1993] 3 W.L.R 756, CA; [1993] 3 W.L.R 756, H.L.

<sup>60</sup> As Devlin J. said in *Midland Bank Ltd v. Seymour* [1955] 2 Lloyd’s Rep. 147 “it is not for the bank to reason why”. **D’arcy / Murray / Cleave**, p. 175.

<sup>61</sup> **Barnett**, p. 663.

<sup>62</sup> *Kredietbank Antwerp v Midland Bank plc* [1999] Lloyd’s Rep. 219.

rejected. So, where should the bank draw the line? Of course and again, the guidance comes from case law<sup>63</sup>. For instance, where there is “technical” discrepancies which appear not to affect the value or merchantability of the goods are regarded as non-compliant<sup>64</sup>.

De minimis<sup>65</sup> rule does not apply here, for instance in *Moralice (London) Limited v ED and F Man*<sup>66</sup>, where a shipment of sugar was 3 bags short the bank was entitled to reject the payment.

Trivial discrepancies may still be regarded as compliant, e.g. obvious typos in names are not considered as discrepancies for instance “industries” rather than “industrial”<sup>67</sup>, “Any Western Brand Indonesia” rather than “Any Western Brand”<sup>68</sup> regarded as not discrepant however “Sofan” rather than “Soran”<sup>69</sup>, Pan Associated Pte Ltd” rather than “Pan Associate Ltd”<sup>70</sup> regarded as discrepant.

### c. Fraud

As it has been already stated hereinabove that both Article 4 and Article 5 have regulated that the banks are obliged to control the documents in accordance with the contract of letter of credit disregarding the relationships between the importer and exporter, goods or services in the light of UCP 600 and ISBP 681<sup>71</sup>. Accordingly, a bank which operates a letter of credit is concerned only whether the documents tendered by the exporter correspond to those specified in the instructions. That is why the letter of credit is seen as a paper transaction. It

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<sup>63</sup> **Barnett**, p.663.

<sup>64</sup> In *J.H.Rayner & Co Ltd v Hambro's Bank Ltd* [1943] 1 K.B. 37, the letter of credit required a shipment of a cargo of “Coromandal groundnuts”, whereas the shippers tendered a bill of lading for “machine-shelled groundnut kernels”. These were universally understood in the trade as being the same thing, but the Court held these were rightly rejected for non-compliance. **D'arcy / Murray / Cleave**, p. 174 ; **Barnett**, p.663.

<sup>65</sup> For the definition of De Minimis “Latin for “of minimum importance” or “trifling.” Essentially it refers to something or adifference that is so little, small, minuscule or tiny that the law does not refer to it and will not consider it.” <http://dictionary.law.com/Default.aspx?selected=484> (last visit 12.01.2010)

<sup>66</sup> *Moralice (London) Limited v ED and F Man*, [1954] 2 Lloyd's Rep. 526.

<sup>67</sup> *Hing Hip Hing Fat Co Ltd v. Daiwa Bank* [1991] H.K.L.R 35.

<sup>68</sup> *Glencore v. Bank of China* [1996] 1 Lloyd's Rep. 135.

<sup>69</sup> *Beyene v. Irving Trust Co Ltd*.

<sup>70</sup> *United Bank Ltd v. Banque Nationale de Paris* [1992] S.L.R 64.

<sup>71</sup> **Polat**, p. 213.

is irrelevant to the bank whether the underlying contract concerns the purchase of timber, oil, machinery or whether it concerns another transaction<sup>72</sup> or the subject of the underlying contract is defaulted<sup>73</sup>. The only case in which the bank should refuse to pay under the letter of credit occurs if it is proved to its satisfaction that the documents are fraudulent and that the beneficiary and that the beneficiary was involved in fraud. This is named as “fraud exception”<sup>74</sup>. Except from fraud, banks assume no liability or responsibility for effectiveness of documents as per the Article 34 of UCP 600.

Here, the documents, on their face, seem to be in order however ,in reality, they or their tender are fraudulent. That is to say, the documents may be forged or bear incorrect information in relation to the goods to which they refer, they, nevertheless, on their face appear to be in order and correct.<sup>75</sup>

In determining what amounts to a fraud, three sets of rules can be applied to each alleged case.

Firstly, if there is only a suspicion about a fraud raised by the applicant towards the issuing bank (or the advising bank if a confirmation has been added by it) and even this suspicion is a grave one where there is no further ground then the bank should honour the letter of credit. In *Bolivinter Oil SA v. Chase Manhattan Bank NA*<sup>76</sup>, the Court of Appeal refused an application for an injunction restraining bank to honour the letter of credit.

Secondly, if the fraud is well established to the satisfaction of the bank and evidences provided are unambiguous accordingly, however there is no indication as to whether the seller knew of the fraud since the fraud can be committed

<sup>72</sup> **D’arcy / Murray / Cleave**, p. 170.

<sup>73</sup> **Reisoğlu**, Akreditif ve Uygulama Sorunları, p. 4; Özalp, p. 233;

<sup>74</sup> **D’arcy / Murray / Cleave**, p. 170. – The problem arises on the evidence of fraud. The courts require in principle, that the facts on which the fraud exception is pleaded are established clearly and unambiguously. However, in the case of *United Trading Corporation SA v. Allied Arab Bank Ltd*, it was held that the strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly emanating from the buyer... is required. [1985] 2 *Lloyd’s Rep.* 554 at 56.1

<sup>75</sup> **D’arcy / Murray / Cleave**, p. 210.

<sup>76</sup> *Bolivinter Oil SA v. Chase Manhattan Bank NA* [1984] 1 *W.L.R.* 392 at 393. The English courts have not adopted the practice of the American courts to grant temporary restraining orders on the basis of strong suspicion or/of fraud. **D’arcy / Murray / Cleave**, p. 211. See also *Discount Records Ltd. v. Barclays Bank Ltd* [1975] 1 *W.L.R.* 315 at 320.

by a third party. In this case, the House of Lords decided in *United City Merchants (Investments) Ltd. V. Royal Bank of Canada*<sup>77</sup> that the bank must honour the letter of credit. Here, false date was inserted into the bill of lading by an employee of the loading brokers however the seller did not know anything about it. The House of Lord reasoned its decision that the seller was also deceived by the fraud of third party along with the bank and the applicant.<sup>78</sup> Lord Diplock in this case stated 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 o, if plain English is to be preferred, ‘fraud unravels all’. The courts will not allow their process to be used by a dishonest person to carry out a fraud.”*

He then continued:

*“... what rational ground can there be for drawing any distinction between apparently conforming documents that, unknown to the seller, in fact contain a statement of fact that is inaccurate where inaccuracy was due to inadvertence by the maker of the document, and the like document where the same accuracy had been inserted by the maker of the document with intent to deceive, among others, the seller/beneficiary himself?”*

So, it was held that this case did not fall within the fraud exception to payment.<sup>79</sup> Not surprisingly, this decision was unwelcomed in banking circles. In particular, in the face of Article 34 of the UCP 600, said decision may be reconsidered since the position of the banks in such cases may be doubtful.

Thirdly, if there is well established proof to the satisfaction of bank and the seller knew of this fraud, then it must not honour the letter of credit. So, if the seller himself tenders a fraudulent documents to the buyer or a third party does this with his knowledge or connivance, the bank, in this scenario, shall not honour its obligation under the letter of credit.<sup>80</sup>

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<sup>77</sup> *United City Merchants (Investments) Ltd. V. Royal Bank of Canada* [1983] 1 A.C. 168.

<sup>78</sup> **D’arcy / Murray / Cleave**, p. 211.

<sup>79</sup> **Chuah J.C.T.**, Law of International Trade, London 2005, p.489

<sup>80</sup> *Rafsancan Pistachio Producers Co-operative v. Bank Leumi (U.K.) plc* [1992] Lloyd’s Rep. 513. **D’arcy / Murray / Cleave**, p. 212-213.

Unless there is a valid underlying contract, refusal of the bank is also not against the principle of autonomy because of the same reason, “fraud exception”. The request of the beneficiary is against good faith and named as fraud<sup>81</sup>.

#### **E. “Clean” and “Dirty” Transport Documents (Article 27)**

Under the Article 27 of UCP 600, a “clean” transport documents (such as bills of lading which are the most common transport documents in international trade) can be the one on which there does not appear the word “clean” even though the letter of credits requires the transport document to be “clean on board”. Unlike the past version, the UCP 600 also clarifies the “clean” and “dirty” transport documents. So, where the nominated bank is instructed to pay against a “clean on board” bill of lading under the letter of credit, it shall pay the relevant amount stated therein to the seller even though the bill of lading does not refer the qualification as to the condition of the goods.

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<sup>81</sup> **Reisoğlu**, Akreditif, p. 329.

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