



**LETTER OF CREDIT AS A SECURITY DEVICE IN
INTERNATIONAL TRADE.
What will change under the Uniform Customs and Practice 600?**

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ABSTRACT.

Letters of credit are truly peculiar devices. Owing to their flexible structure coupled with contractual nature they satisfy numerous needs in commerce. One of their function is security. But this security has many facets. On one hand, created as “child of distrust” between seller and buyer, letter of credit serves as a secure payment mechanism. But it also serves as a way of financing trade and operates as a security device. Indeed, by far the largest dollar amount is utilized in the form of standby letter of credit, for transactions between supplier in one country and buyer in another. Letters of credit are utilized at a great scale. Over \$ 1 000 000 000 000 is paid by means of letters of credit each year, amounting to 15 % of international transactions.

As peculiar devises, letters of credits are govern by rules of *sui generis* nature - The Uniform Customs and Practice for Documentary Credits, known as UCP. These are the most successful attempt at unifying law ever achieved by means of private business self-regulation. The UCP were first published in 1933. Since then they developed as international trade expanded, adjusting to changing times and growing needs of commerce. The ICC publication known as the UCP 600 is the sixth version since the law was first promulgated. Now it is used by merchants and bankers in more than 175 countries worldwide, including all the major trading nations in the world.

The focus of this paper is on security function of letters of credit. By way of comparison of various faces of this function across the globe the paper introduces to issues that may arise in connection with the use of letters of credit. One of the threats to commercial

parties is discrepancy in the presented documents which frustrates the security payment function of documentary credits. Another, more complex issue is connected to the use of bills of exchange in connection with letters of credit. It is shown in this paper how these and some other issues are addressed in the new UCP 600.

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INTRODUCTION.

Letters of credit are utilized at a great scale. Over \$ 1 000 000 000 000 is paid by means of letters of credit each year, amounting to 15 % of international transactions.¹ There are various purposes for which letters of credits are used. On one hand letter of credit is a secure method of payment. On the other operates as a security device supporting performance of obligations. In addition, international trading community developed numerous way of financing trade under the umbrella of letters of credit transaction.

The Uniform Customs and Practice for Documentary Credits, known as the UCP, governs letters of credit if incorporated to the contract by the parties. It is considered to be the most successful attempt at unifying law ever achieved by means of private business self-regulation² and enjoy near-universal recognition and acceptance. The previous version of the UCP, namely the UPC 500 has been in force for 13 years. During this period some other documents of international range have been promulgated in order to supplement and develop the law governing letters of credit. The eUPC were issued in response to development in field of modern means of communications. In 1998 International Standby Practices (ISP98) came into life, supplementing the UCP 500 in the area of standby letters of credit. In October 2002 the International Chamber of Commerce promulgated the International Standard Banking Practices (ISBP). These were coupled with developing body of court decisions and ICC's Banking Commission policy statements and opinions. As a result, the commerce have witnessed significant improvement in this peculiar area of law.

¹ Carter H. Klein, *Letter of Credit Law Developments* - an article prepared for CBA Commercial & Financial Transactions Committee in connection with the works on the UCP 600, Chicago, January 2006. Available at http://www.jenner.com/files/tbl_s18News%5CRelatedDocuments147%5C2050%5CKlein_Letter_of_Credit_Law_Developments_2006.pdf (last accessed in April 2007).

² Foreword to the UCP.

The development of new methods of financing trade in last two decades could not remain without impact of the use of letters of credits. Various problems have arisen on the junction of letter of credit law and law of bills of exchange.

Another issue is connected to the growing number of discrepancies in presented documents that threatened the secure payment mechanism to be turned into method of refusing payments.³

In connection with the above-mentioned issues the International Chamber of Commerce contemplated the revision of the UCP. It has been now achieved and the new rules, labeled the UCP 600, come into effect starting July, 1 2007.

The aforementioned issues will be dealt with in this paper.

The paper will first discuss the basics of letter of credit mechanism in the first chapter. The areas affected by the revision will get special attention.

The second chapter will discuss the security function of letters of credit. As it is a tremendous task, reaching far beyond the purpose of this thesis, only a brief outline will be set forth in order to draw a background for the next chapter. It will help to illustrate the place of the UCP in the letter of credit law.

³ Introduction to the UCC 600.

Changes introduced by the current revision of the Uniform Customs and Practice with the focus on utilizing letter of credit as a mean of secure payment and way of financing international trade is the domain of the third chapter.

There is an opinion expressed by some writers that too technical provisions of UCP 500 turned letters of credit form payment vehicle into method of avoiding payment. This problem was addressed by the drafters of UCP 600 and the paper will apprise the recent changes in that respect. By way of presentation of the revisions introduced to UCP 600 as compared to USC 500, and by way of comparison to American UCC, this paper will show how the new procedures and policies intent to stop the decline of using letters of credit.

In addition, an answer will be given to the question, whether letter of credit may be utilized as a security device within the meaning of Article 9 of American Uniform Commercial Code.

UCP 600 is a new law, enacted on 25th November 2006. It follows that beside conference materials, drafts, comments submitted to the drafting group, and international discussion in form of articles, materials on the subject as such, do not exist. There are however works dealing with previous version of UCP (UCP 500) and regulation concerning letters of credit enacted by state legislators (most significantly Article 5 of Uniform Commercial Code in the United States).

Bearing in mind the few sources on the latest revision of UCP, as it has not entered into force yet, the thesis will be based to a considerable extent on author's own conclusions. Another approach would be adopted in case of dealing with solutions that are settled in law for considerable period of time. The conclusions will be supported by the well-settled and existing concepts/laws and available materials, as well as comparison of UCP 500 and UCP 600. Conclusions will be also based on developed body of court decision under the rule of UCP 500. Comparison to leading jurisdictions such as US and Germany will take a considerable part of the paper.

The first chapter of the thesis will address the basic mechanism of operation of letters of credit as well as will explain their functions. This chapter will be limited to basic ideas because it is not the purpose of the thesis to analyze in detail various types and uses of L/C.

Since the paper deals with the recent revision of UCP, the history of UCP will be mentioned in the second chapter. Also, the place of this particular source of law and its legal nature should be mentioned there.

The purpose of the third chapter is to answer the questions why was a new UCP necessary and what were the key issues the drafters had to deal with.

In the fourth chapter the process of redrafting the UPC (subsequent stages) will be dealt with.

The substantial provisions of the new UCP will be explained in chapter five. An comparative approach will be adopted where applicable (UCP 500 v. UCP 600).

The summary chapter will answer the questions outlined in the abstract. Some issues specifically related to secured transactions will be highlighted and summed up.

Given the fact that the revision of UCP took place recently, the author of the thesis hopes to contribute to the field by presenting and evaluating the new procedures and policies adopted by the drafters.

CHAPTER I. LETTERS OF CREDIT IN GENERAL.

Four sections of the first chapter discuss the basics of letters of credit. The first section explains the mechanism of working of letter of credit transactions: the parties involved and the ability of letter of credit to suit their commercial needs. The availability of letters of credit is discussed in the second section. Various uses of letters of credit are presented in the third section. The issue of sources of law governing letter of credit transactions is addressed in the fourth section. This chapter serves as an introduction to the realm of letters of credits and as such intends to provide a basis for discussion following in the next chapters. For this purpose, this chapter presents the basics of letters of credit in a jurisdiction-neutral way, and references are made not only to the UCP but also to laws and court decisions of various jurisdictions. From all of the jurisdictions, the American Uniform Commercial Code is referred to most often, for it distinguishes itself from other laws by its comprehensiveness and level of development. It is equally important, that there is a rich body of court decisions related to the UCC, rendered in environment of sophisticated trade and banking practice. All these factors contribute to the UCC being a suitable comparator for the purpose of this paper. Since the subject of this paper is a revision of law, the need for a comparative approach is self-evident.

Section 1. The Basics of Letter of Credit Mechanism.

A Simple Setting.

Letter of credit transactions, in its simplest form, involve three parties: applicant, issuing bank (or other issuer) and beneficiary. Accordingly, there are three independent relationships between the parties: 1) the underlying transaction between the applicant and the

beneficiary, e.g. contract of sale, which calls for payment by the applicant. The parties agree that the payment is made or supported by means of letter of credit; 2) the relationship between the issuing bank and the applicant which creates the obligation of the bank to issue the letter of credit in favor of the beneficiary and provides for its reimbursement by the applicant; 3) the relationship between the beneficiary and the bank based on the letter of credit itself, obligating the bank to pay the beneficiary upon the presentation of conforming documents.

It is best to illustrate the mechanism of letter of credit in the context of international sale contract. The contract of sale is the underlying transaction here. Given the limited trust between parties which may not know each other or encounter difficulties in assessment of their creditworthiness, as well as reasonable commercial care routinely exercised in the world of commerce, each party seeks to secure its interests in the transaction: the purchaser wants to be sure that he will pay the price on the condition that the goods are in fact shipped and thereby avoid risky payment before the dispatch of goods subject to the sale contract; the seller has his own interest in receiving the price for his merchandise which is shipped to a foreign country. Naturally, the underlying transaction creates legally binding obligations, but practical aspects of their enforcement involve issues of foreign jurisdiction, foreign language, and the need for a professional legal assistance, to name just a few. Costs and time resources need to be sacrificed and the result may still be uncertain. Obviously, this is not what the commerce needs. Commercial transactions should be by their very nature fast, massive in terms of quantities and efficient in terms of costs. To mitigate the risks each party wants to avoid, the parties to the underlying transaction provide for a method of payment⁴ involving a third party, namely the bank. The purchaser (applicant) instructs his bank to issue a letter of credit in favor of the seller (beneficiary). The letter of credit will provide assurance that the

⁴ Or for a method of backing up the original payment obligation if standby letter of credit is utilized.

payment will be made by independent third party with no interest in the underlying transaction. This independence of the third party has a legal nature⁵: the obligation of the bank to pay upon presentation of stipulated documents is independent of the two remaining relationships: that between the applicant and the bank and that of the underlying agreement. The seller may, thus, deem himself secure to ship goods, for the payment cannot be stopped by the purchaser (as in case of payment by check) or refused by the bank on grounds relating to the underlying transaction (e.g. that goods are defective). The purchaser on his side gets assurance that goods are in fact shipped and the payment is not processed unless the stipulated documents are presented and are free of defects.

Letters of credit are by no means a wonderful and complete solution that allows to avoid every possible risk connected to a given commercial transaction. Since the process of letter of credit payment is based exclusively on documents, the purchaser bears the risk that documents are forged or goods do not conform to the underlying contract. Banks are concerned with the documents alone and do not deal with goods or services subject to the underlying agreement. The seller's risks are inferior: it assumes the contingency that the bank will become insolvent⁶ or that it will dishonor his draft⁷.

⁵ UCP sub-Article 4(a): "A credit by its nature is a separate transaction from the sale or other contract on which they may be based." UCC Section 5-103(d): "Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary."

⁶ The insolvency of the issuing bank, although rarely happening, will not deprive the beneficiary of his claim against the applicant which he has on the underlying transaction. But it will deprive him of all the benefits and convenience connected to payment by letter of credit. Furthermore, the insolvency of the issuing and confirming banks (if any) will expose the beneficiary to the risk that in case of applicant's bankruptcy his claims will not be satisfied in full or at all. Interestingly, commercial reality proved to provide setting where the insolvency of the issuing bank threatened interests of the applicant as well (*see* E. D. & F. Man Ltd v Nigerian Sweets and Confectionery Co. Ltd [1977] – an English case discussed further in this chapter).

⁷ This risk can be off course avoided by careful drafting and examination of the letter of credit upon its receipt by the beneficiary. If it contains defects such as documentary conditions impossible to satisfy or not properly corresponding to the underlying agreement, prudent beneficiary should request the applicant to amend the letter of credit, otherwise the document will be worthless. Furthermore, beneficiary should attempt to clarify with the issuing bank all ambiguous terms (i.e. terms which are not clear and equivocal) and not conform himself by the *contra proferentem* rule. Letters of credit are sophisticated devices used by sophisticated parties and should be

A More Complex Setting: Corresponding Banks

Letter of credit transactions happen to be more complex than illustrated above. They will often involve corresponding banks⁸: nominated bank⁹, advising bank¹⁰ and confirming bank¹¹. Accordingly, it is possible that a single letter of credit transaction involves up to seven different relationships¹².

It may happen that the issuing bank is not present in the country where the beneficiary conducts his business and it would be burdensome for beneficiary to visit the place of issuing bank to process the payment by letter of credit. Sending valuable documents by postal or courier services is both time consuming and marked by risk of loss¹³. In such a case the issuing bank usually authorizes other bank (nominated bank) with presence in beneficiary's country to pay under the letter of credit. The nominated bank simply makes credit available to the beneficiary, takes up and forwards the documents to the issuing bank, without engaging in any direct relationship with the applicant¹⁴. It does not itself assume any letter of credit undertaking and is not obligated to honor or negotiate upon complying negotiation. The same merely technical and procedural role is played by advising bank, which, acting at the request

dealt with accordingly, that is with the highest standard of care. Statistics repeatedly show that this is often not the case, since large portion of drafts on letters of credit are defective and as a result banks refuse to pay on them.

⁸ The term *corresponding bank* is not used in the text of UCP. UCC is also silent on this term, but it is often used by legal scholars to refer to nominated bank, advising bank or confirming bank.

⁹ According to the terminology of UCC: *nominated person* (UCC Section 5-102(a)(11)).

¹⁰ According to the terminology of UCC: *adviser* (UCC Section 5-102(a)(1)).

¹¹ According to the terminology of UCC: *confirmer* (UCC Section 5-102(a)(4)).

¹² Not all of these relationships are of contractual nature. Relationships between advising and/or negotiating bank and beneficiary are regarded as quasi-contractual (see, e.g., Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001)). It is also not clear whether there are any contractual relationship between the applicant and the advising or confirming bank. See Kurkela, *How Banks Treat Letters of Credit*, 3 Int'l Fin. L. R. (Nov., 1984).

¹³ It should be noted, however, that letter of credit transaction may be processed electronically. In this respect letters of credit are superior to payment by checks. Compare UCP Article 11(a) and UCC Section 5-104 in connection with 5-102(a)(14). See also eUCP (the 12-articles-supplement to UCP 500 for electronic presentations, ICC Publication No. 500/2). While eUCP deals with electronic presentations, UCP Article 11(a) and UCC deal with electronic issuance and amendment of letters of credit. In addition, UCC deals with electronic advice, confirmation, transfer and cancellation of credits.

¹⁴ Compare UCP Article 2, Article 6(a), Article 7(a) and (c), UCC Section 5-102(a)(11), Section 5-107(b)

of the issuing bank (as its agent), notifies the beneficiary of the terms of the letter of credit but does not itself undertake any obligation in the nature of letter of credit¹⁵. There is no direct contractual relationship with applicant and the beneficiary in either of these cases. It is not uncommon that the issuing bank authorizes the same bank to notify the beneficiary of the issuance of the letter of credit (thus to advise the credit) and to process the payment (thus to act as a nominated bank).

The situation is different if nominated bank¹⁶ itself undertakes to honor the presentation under letter of credit issued by another bank (issuing bank), at its request or authorization¹⁷. Confirmation of letter of credit creates an independent obligation to honor complying presentation in addition to the obligation of the issuing bank. This means that confirming bank's undertaking is identical to that of the issuing bank; it steps into shoes of the issuing bank and is treated as if it had issued the letter of credit itself¹⁸. Thus, confirming bank has definite, direct contractual obligation to the beneficiary to honor a confirming draft¹⁹.

Confirmation is usually requested in international trade, in particular by sellers exporting goods to countries which they deem unstable. If a letter of credit is issued by a bank domiciled in such an unstable country, simple advice and nomination may prove to be

¹⁵ Compare UCP Article 2, Article 9, UCC Section 5-102(a)(1), Section 5-107(c).

¹⁶ On rare occasions a confirming bank will be not a nominated bank.

¹⁷ Compare UCP Article 2, UCC Section 5-102(a)(4).

¹⁸ UCP Article 8, UCC Section 5-107(a), UCC OC Comment 1 to 5-107.

¹⁹ On a disputed issue whether confirming bank is obligated to pay upon non-complying presentation in its capacity of confirming bank (i.e. not acting only as an advising bank) if the allegedly non-complying documents were later accepted by the issuing bank, see *Pasir Gudang Edible Oils Sdn Bhd v The Bank of New York [1999]*, Index No 603531/99 (NY Sup. Ct. 1999). The court ruled that in such circumstances the waiver of discrepancies by the issuing bank does not reach the confirming bank. Accordingly, the confirming bank is under no obligation to effect payment to the beneficiary solely because the discrepancies were waived by the issuing bank. A separate waiver by the confirming bank would be required. The position of the ICC's Commission on Banking Technique and Practice on the matter at issue is unclear. The Opinion TA 530 (2003), which reflects the current Commission's position, is in line with the ruling in *Pasir*. However in its prior opinions TA 404 and TA 457 the Commission took view to the contrary.

insufficient, since nomination is not instrument separated from issuance of the letter of credit. In such cases confirmation by bank domiciled in seller's country accommodates the concerns of the exporters, for the confirming bank assumes its own direct undertaking to honor conforming presentation by the beneficiary. This mechanism is often utilized in exports from the United States as American exporters demand confirmation by American banks, while imports into the United States usually involve only advising and nominated bank²⁰.

Section 2. Availability of letters of credit.

Availability of credits is one of the central issues connected to letter of credit transactions. Different manners of making credits available shape the rights and defenses granted or not to the parties involved. The flexibility provided to the parties by the different manners of drawing facilitates letters of credit payment security function, making it possible to provide financing by banks at the same time. Availability is also a very litigated and controversial area of letter of credit law worldwide. Given the complexity of letter of credit transactions, in particular in connection with medium-term capital goods financing (forfaiting), courts in different jurisdictions rendered inconsistent opinions, causing confusion in global trading community. This section outlines only basic concepts and points out the main issues. The availability of credits in context of changes introduced with the UCP 600 is discussed in details in the subsequent chapter, where the development of this area of law is highlighted.

²⁰ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006) at 533.

The UCP Article 6, following its predecessor²¹, classifies letters of credit according to their availability, i.e. how they can be drawn. A credit may be available by honor (that is by sight payment, by deferred payment or by acceptance) or by negotiation²². According to the UCP a credit must state how it is available.

Credit is available with the issuing or with the nominated bank²³ (which may add its own undertaking by confirming the credit). Freely available credits are available with any bank²⁴. Credit cannot be available with issuing bank by negotiation.

Sight payment means that a credit is payable on presentation. Credits available by sight payment are honored (i.e. performed) by payment at sight²⁵.

In contrast to sight credits, deferred payment letters of credits are payable at a certain time after the presentation, stipulated in the credit. Such credits are honored upon incurring a deferred payment undertaking and payment at its maturity²⁶. Deferred payment letter of credit is a relatively new instrument in the world of commerce and seems to be developed from acceptance credits²⁷. These devices facilitate applicant's refinancing the credit amount extended by the issuing bank.

Acceptance credit resembles deferred payment credit in that both involve payment at a future date. Acceptance letter of credit involves the confirming bank accepting a draft in favor

²¹ UCP 500 Article 10(a).

²² UCP sub-Article 6(b). Compare also UCC Section 5-102(a)(8).

²³ Besides the availability "by" and availability "in" there is a third qualification of bank's undertaking, namely availability "to". This is the case where a letter of credit is transferable and may be available to the secondary beneficiary. See UCP Article 38 and the concept of transferability of credits later in this paper.

²⁴ UCP 500 terminology used the term "freely negotiable" (UCP 500 sub-Article 10(b)(i)).

²⁵ UCP Article 2, UCC Section 5-102(a)(i).

²⁶ UCP Article 2, UCC Section 5-102(a)(iii).

²⁷ *Banco Santander SA v Banque Paribas [2000]*, Lloyd's Rep. Bank 165

of a beneficiary²⁸. Thus, it requires an acceptance, which is not necessary with deferred credits. A credit available by acceptance is honored upon acceptance of a draft (bill of exchange) and payment at maturity²⁹. As the deferred payment credit, it may facilitate financing. Here, similarly, an issue arises how the financing should be secured. It may be that proceeds of the letter of credit are accepted as a security. Acceptance credits may be used by banks in connection with forfaiting transactions. Such circumstances involve, for example, a confirming bank offering to discount the bills of exchange from a beneficiary (assuming that the underlying transaction is sale of goods). The confirming bank acting in the capacity of a forfaiter credits the account of the beneficiary with the discounted amount and subsequently attempts to collect the payment on the maturity of the letter of credit in its own capacity. It is important to distinguish here in what exactly capacity the confirming bank acts when it effects the premature payment and attempts to collect the payment from the issuing bank. A confirming bank acting solely as such would normally effect the payment upon the maturity date because its undertaking virtually mirrors the undertaking of the issuing bank. But if it engages in discount of the export documents, the circumstances seem to be blurred, as negotiable instrument creates yet another separate abstract obligation. First, by making the premature payment the confirming bank acts outside of authority granted by the issuing bank. The key issue here is whether the credit permits to negotiate draft and/or documents. Second, such a payment outside of the authority extended by the issuing bank may be regarded as a loan secured by letter of credit proceeds and the confirming and issuing banks remain bound to pay under the letter of credit at its maturity.

²⁸ *Id.*

²⁹ UCP Article 2, UCC Section 5-102(a)(ii).

Negotiation credits are truly complex transactions that happen to be difficult to comprehend even in the sophisticated world of finance.³⁰ It is so because undertakings under letters of credits are coupled with those arising under negotiable instruments (i.e. drafts, bills of lading), causing confusion. The term “negotiating bank” is not defined in the UCP. UCC Article 5 does not provide any definition of “negotiating bank” or “negotiation” either³¹. The new UCP 600, following its predecessor, defines the term “negotiation” 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 the beneficiary on or before the banking day on which reimbursement is due to the nominated bank^{32 33}” Accordingly, the negotiating bank is a nominated bank that negotiates the draft and/or documents under a complying presentation. Functionally, negotiating bank extends credit to the beneficiary, secured by the letter of credit lodged with that bank. For the

³⁰ The ICC Commission on Banking Technique and Practice observed in one of its policy statements (Position Paper No.2 on UCP 500, September 1, 1994): “The Banking Commission notes with regret that, notwithstanding the clear definition contained in the above sub-Article, a number of banks fail to understand the meaning of the term 'negotiation' in connection with the availability of a documentary credit.”

³¹ The concept of negotiation is, however, covered in UCC Article 3 (Negotiable Instruments) and in Article 4 (Bank Deposits and Collections). Letters of credits, bills of lading and securities are not negotiable instruments within the meaning of UCC and separate articles are devoted to these devices. They rely however heavily on concepts developed in the negotiability system (see Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (Aspen Publishers, New York 2006) at 626). The negotiation is defined under Section 3-201(a) and means “a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes its holder.”

³² UCP Article 2.

³³ Notwithstanding the definition under UCP 500 sub-Article 10 (b)(ii), misinterpretations and misapplications of negotiation concept caused the ICC Commission on Banking Technique and Practice to issue a Position Paper No.2 on UCP 500, September 1, 1994 and the Opinion TA.569, to explain the meaning and application of negotiation within the framework of the letter of credit transaction. The latter states: “A letter of credit that is stated to be available with a nominated bank, by negotiation, must not include any reference to claiming reimbursement from a reimbursing bank or, indeed, any reference to the debiting of the issuing bank's account held with the nominated bank. This form of structure is a payment letter of credit. A negotiation letter of credit should specify that the nominated bank is to send the documents to the issuing bank and upon the issuing bank ascertaining that they comply with the terms and conditions of the credit, the issuing bank will reimburse in accordance with the instructions of the negotiating bank.” The Position Paper No. 2 further clarifies that “[F]ailure by the beneficiary to seek and /or secure 'negotiation' from the Nominated Bank under a documentary credit which allows negotiation, does not affect the undertakings of the Issuing Bank and/or the Confirming Bank (if any), nor does it constitute non-compliance with the documentary credit terms, provided that conforming documents are presented by the beneficiary within the validity of the documentary credit and the sub-Article 43(a) period of time where appropriate, to a Nominated Bank or direct to the Confirming Bank (if any) or to the Issuing Bank.”

negotiation to occur it is not enough that the nominated bank examines the documents. It must advance or agree to advance funds in order to acquire status of a negotiating bank.

By negotiation nominated bank acquires its own right to make presentation and demand payment from issuing bank at maturity. This right is better than that of the beneficiary, since the nominated bank normally obtains status of a holder in due course. A conclusion follows that it may be more attractive for a nominated bank to negotiate a credit instead of honor it and take proceeds of a letter of credit as a security, since the assignee cannot obtain a better right than that of the assignor has. As will be shown further in this paper, the situation complicates as different jurisdictions have different bills of exchange laws and/or different rules (if any) on conflicts between rules derived from letter of credit law and bills of exchange law.

Another uncertain issue under the UCP 500 was whether and when a draft was required or was optional. The position of English law on this subject will be presented in the second chapter.

Section 3. The principle of independence and standard of compliance.

The principle of independence of letters of credit (also known as the principle/doctrine of separability or autonomy) and standard of strict compliance define the nature of letters of credit. This section provides only basic considerations concerning both principles. It should be noted that these principles facilitate operation of each other.

The principle of independence.

The primary function of letters of credit is to provide for a secure payment mechanism. The principle of independence facilitates this function by conditioning payment upon documentary conditions, not upon performance of the underlying contract itself. Thus, the payment under a letter of credit, though discharges the purchaser (applicant) under the underlying transaction, technically, is not purchaser's performance, but performance under a separate transaction by the bank that issuing or confirming the credit undertook to honor or to negotiate it. This involvement of a third party strips the payment claim from defenses available under the underlying contract³⁴. Once these defenses are put aside and limited only to the parties to the underlying contract, the seller can be assured that he will be paid subject to fulfillment of documentary conditions only. Any defense available under the underlying contract will not reach beyond this contract and parties thereto.

The principle of independence is expressed in the UCP in the following way:

“A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honor, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defenses by the applicant resulting from its relationships with the issuing bank or the beneficiary.”³⁵

Another provision of the UCP further provides:

³⁴ This defense-stripping mechanism is essential for any payment obligation to developed into a secure payment system. Legal systems recognize various concepts that facilitate this function. For example, holder in due course of a negotiable instrument holds the instrument free from personal defenses available to prior parties and may enforce the payment claim incorporated in the instrument as such (*see, e.g.*, Section 38 of the Bills of Exchange Act of 1882 (United Kingdom), UCC Article 3-305(b)). In the context of letter of credit transactions it should be noted that the position of a draft's holder in due course is better than the assignee of proceeds of letter of credit.

³⁵ UCP sub-Article 4(a)

“Banks deal with documents and not with goods, services or performance to which the documents may relate.”³⁶

The UCC puts it into following wording:

“Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.”³⁷

It needs to be emphasized that the principle of independence does not leaves the applicant defenseless. If goods delivered are not of merchantable quality, the applicant still has claims and defenses in his capacity of a purchaser arising under the sale contract. The effect of letter of credit arrangement is that the dispute over quality of goods cannot stop payment under letter of credit and the applicant may claim his rights after the payment is made. One function of such an arrangement is that it shifts the burden of litigation over price to the purchaser. Also, in a reverse circumstances where the beneficiary was refused to avail himself of payment under letter of credit as a result of submission of discrepant documents, he is still entitled to the purchase price under the sale or other contract³⁸, unless the parties did not contemplate the letter of credit to be the only source of payment or look to a particular bank to the exclusion of the buyer³⁹.

In the context of security function of standby letters of credit it is necessary to point out, that the principle of independency is one of the differentiating features between guaranties and standbys. Accordingly, undertaking under a letter of credit is a primary and

³⁶ UCP Article 5.

³⁷ UCC Section 5-103(d).

³⁸ See an American case *Samsung America Inc v Yugoslav-Korean Consulting & Trading Co., Inc.* [1998], 670 N.Y.S. 2dn 466.

³⁹ See an English case *E D & F Man Ltd v Nigerian Sweets & Confectionary Co Ltd* [1977], 2 Lloyd's Rep. 50.

unconditional one, while the obligation of the guarantor bank is of a secondary nature. This position has been attacked by debtors in a string of American cases involving bankruptcy setting⁴⁰. The argument was that payment under the letter of credit would violate automatic stay in bankruptcy proceeding⁴¹. The principle of independence defended itself in opinion delivered *in re Ocana*⁴², where the court held that since the money used to pay the beneficiary is the bank's money and the claim under the letter of credit is against the bank, payment under the letter of credit does not violate the automatic stay in bankruptcy, which concerns actions against debtors and debtors' property. The tough issue in *Twist* and *in re Ocana* was however the effect of conversion by means of standby letter of credit of unsecured claim (which the beneficiary had under the underlying transaction) into secured one (which the bank had as it secured its reimbursement claim against the applicant). This issue will be discussed in details in the subsequent chapter dealing with security function of letters of credit.

The principle of independence is not absolute. Bank may dishonor (and in certain circumstances must dishonor) a presentation despite the fact that the presented documents comply with the terms of credit, if honor of the presentation would facilitate fraud by the beneficiary⁴³. The relationship between the principle of independence and doctrine of strict compliance on one hand and fraudulent abuse of letter of credit by the beneficiary was

⁴⁰ See, e.g., *Twist Cap. Southeast Bank of Tampa*[1979], 1 B.R. 284 (Bankr. M.D.Fla. 1979), where a draw on a standby letter of credit was enjoined by the court.

⁴¹ 11 U.S.C. § 362(a) prevents "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate" and "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title".

⁴² *In re Ocana* [1993], 151 B.R. 670 (S.D.N.Y. 1993)

⁴³ This will be the usual case. But it is recognized as well, that a fraud may be committed by a third party. The leading English case dealing with liability of banks in case of fraud that impacted the international trade law is *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, [1983], 1 A.C. 168. In this case the beneficiary was unaware of fraud committed by the loading brokers (agents for the carrier) who misrepresented on the bill of lading the date of receipt of goods for shipment. The House of Lords, reversing the unanimous decision of Court of Appeal, ruled that the bank was obliged to honor a complying presentation, provided that the beneficiary did not know of the fraudulent misrepresentation by the third party. But the English standard was not followed in the United States. For further reading see Stephen J. Leacock, *Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions*, 17 VAND. J. TRANSNAT'L L. 885, 899 (1984).

analyzed in the United States in the pre-code *Sztejn* case⁴⁴. The judge in *Sztejn* observed: “In such a situation, where a seller’s fraud has been called to the banks attention before the drafts and documents have been presented for payment, the principle of the independence of the bank’s obligation under the letter of credit should not be extended to protect unscrupulous seller.”

The UCP does not cover the issue of fraud⁴⁵, thus it is left to the applicable local law to provide for supplemental rules. As a result, various standards may apply⁴⁶ and there is no uniformity in this area. A typical remedy available is an injunction, which will be utilized by the applicant confronted with bank’s refusal to dishonor an allegedly fraudulent presentation. But conditions for application of the injunction vary from one jurisdiction to another. It has been observed that in jurisdictions where courts take rather liberal view on restraining orders the standing of banks as issuing and confirming banks in letter of credit transactions has declined⁴⁷. This should not be surprising and only reinforces common view⁴⁸ that the principle of independence is crucial for success of letters of credit as payment system and security device.

⁴⁴ *Sztejn v J. Henry Schroder Banking Corporation* [1941], 31 N.Y.S. 2d 631.

⁴⁵ UCP Article 34 contains only a disclaimer of liability of banks which may apply in case of fraud: „ A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance represented by any document, or for the good faith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person.” This provision, however, reinforces the principle of independence.

⁴⁶ See, e.g., UCC Section 5-109.

⁴⁷ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 34.

⁴⁸ See, e.g., *Nobel Insurance Co. v First National Bank of Brundidge* [2001], 821 So. 2nd 210 (Ala. 2001), where the court observed: “We recognize that, as a general rule, letters of credit cannot exist without independence from the underlying transaction. Thus, when courts begin delving into the underlying contract, they are impeding the swift completion of the credit transaction.”

Another exception to the principle of independence is illegality. The illegality may affect the underlying transaction, or the performance under letter of credit (honoring) may be illegal⁴⁹. Here, again, the lack of uniform international rules calls for application of municipal law.

Standard of Compliance.

Banks deal with documents and not with goods, services or performance to which the documents may relate⁵⁰. Thus, the key issue connected to bank's performance under a letter of credit relates to whether the draft and/or documents comply with the term of credit. If they do, the issuing bank or the confirming bank must honor⁵¹. Various standards may apply in determination whether the presentation is complying. Furthermore, given the principle of freedom of contracts, parties to the letter of credit transaction (applicant and issuing bank in this case) may specify their own "custom" compliance standard. This latter observation points out that standard of compliance impacts relation between the applicant and the issuer as well, providing for a guidance for not only when a bank must honor, but also when a bank must dishonor presentation⁵².

⁴⁹ See Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 988-989.

⁵⁰ See UCP Article 5. Furthermore, a new rule sub-Article 4(b) requires that the issuing bank discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, pro forma invoice and the like. This rule reinforces the separability of credits and underlying transactions and, more importantly, facilitates correct complying presentation by discouraging excessive descriptions of goods.

⁵¹ See UCP sub-Article 7(a), 8(a) and 15, UCC Section 5-108(a) and 5-107(a).

⁵² See, e.g., UCC Section 5-108(a) second sentence: „[...] unless otherwise agreed with the applicant, an issuer shall dishonor a presentation that does not appear so [i.e. strictly] to comply.”

The rule that banks deal with documents not with the underlying transaction certainly limits the scope of examination of documents. But how far is this rule reaching? This issue is well illustrated in *JH Rayner and Company, Ltd. v Hambros Bank Ltd.*⁵³, where the court was confronted with the following discrepancy: the terms of credit called for presentation of bill of lading covering “a shipment of about 1400 tons Coromandel groundnuts in bags at 12l” but the bill of lading accompanying the presented draft covered “machine-shelled groundnut kernels.” Both terms were considered as interchangeable in the relevant trade concerned. In the action by the beneficiary against the bank for wrongful dishonor the court ruled for the plaintiffs, but the Court of Appeal set aside, opining that:

“It is quite impossible to suggest that a banker is to be affected with knowledge of customs and customary terms of every one of the thousands of trades for whose dealings he may issue letters of credit. [...] it seems to me, whether it is reasonable or unreasonable for the principals to say that they want a bill of lading for “Coromandel groundnuts” or whether the bank had or had not knowledge of some of the trade practices which are referred to, is not the question. The question is “What was the promise which the bank made to the beneficiary under the credit, and did the beneficiary avail himself of that promise?”

It appears that the true issue in *Rayner* was not whether the descriptions of goods in the bill of lading were corresponding, but rather whether banks are obliged to investigate non-documentary circumstances such as trade usage in this case.

The UCC provides for a rule corresponding to *Rayner*. Section 5-108(f)(3) reads that “[a]n issuer is not responsible for observance or knowledge of the usage of a particular trade other than the standard practice [of financial institutions that regularly issue letters of credit].

The *Rayner* case clarifies the nature of bank’s undertaking to honor, conditioning it on presentation complying in a purely documentary sense. This is a subtly distinct feature of

⁵³ *JH Rayner and Company, Ltd. v Hambros Bank Ltd.* [1943], 1 K.B. 37.

letters of credit law than standard of (strict) compliance, for it does not answer the question what degree of conformity in documents is required. Surveys constantly show that most documents presented for honor are somehow discrepant. The relevant issue is thus to work out such a standard that can consistently discern the difference between a meaningless error and a significant discrepancy⁵⁴. Letter of credit law and practice have worked out at least four standards in this respect.

One possibility is that banks would require a literal compliance. In such a case the presentation would have to literally mirror the terms of the credit. The application of this “mirror image” test is, however, to harsh to apply, for every mistake resulting in change or omission of a single letter, or even a coma, would not be acceptable. This is the reason why the literal compliance standard has been rejected by the trading community⁵⁵. One must however note that some discrepancies, even if grammar or typographical only, are of a serious relevance.⁵⁶

The other possibility is that bank adopts somehow liberal approach and refuse to honor only if there is a substantial discrepancy in presented documents. This substantial standard compliance standard was once used in some jurisdiction in the United States⁵⁷, but was

⁵⁴Conley, Comment: Hanil Bank v Pt. Bank Negara Indonesia: the Problem with Form over Substance in Documentary Compliance Rules, 50 Cath. U. L. Rev. 977, 1002-07 (2001)

⁵⁵ See, e.g., ISBP Rule 62, which reads: “The description of the goods in the invoice must correspond with the description in the credit. There is no requirement for a mirror image.”

⁵⁶ There is a considerable body of court decisions dealing with misprints in every jurisdiction of a significant trading nation. They can be abstracted to a rule stated in the ISBP which reads: “Misspellings or typing errors that do not affect the meaning of a word or the sentence in which it occurs, do not make a document discrepant. For example, a description of the merchandise as “mashine” instead of “machine”, “fountan pen: instead of “fountain pen” or “modle” instead of “model” would not make the document discrepant. However, a description as “model 123” instead of “model 321” would not be regarded as a typing error and would constitute a discrepancy” (ISBP Rule 28). The underlying idea seems to be that if a mistake may be misleading, there is a discrepancy, but where there is no room for interpretation, documents may be compliant.

⁵⁷ See, e.g., *Banco Espanol de Credito v. State Street Bank and Trust Company*, 385 F.2d 230, 234 (1st Cir.1967).

subsequently rejected by the 1995 revision to the UCC,⁵⁸ which now provides for strict compliance standard⁵⁹.

Strict compliance standard has gained more acceptance and is almost common in contemporary transactions. It was first formulated in *Equitable Trust Co. of New York v. Dawson Partners Ltd.*,⁶⁰ decided by the English court in 1927. In this case Lord Sumner formulated famous statement:

“There is no room for documents which are almost the same, or which will 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; it departs from the conditions laid down, it acts at its own risk”.

The strict compliance rule is not as harsh as it may appear, for it accepts minor grammar and typographical errors⁶¹. However, the strict compliance standard may still have many faces. It clearly rejects the uncertain and somehow blurred guidelines of substantial compliance test, but the degree of conformity may still vary. The Official Comments to the UCC clarifies that it does not require “oppressive perfectionism” and “slavish conformity to the terms of the letter of credit⁶²”. The ISBP similarly requires that the documents be consistent, not that they be identical⁶³. The UCP does not expressly prescribe any standard, setting out that banks must determine on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation⁶⁴. The ISP98 seems to follow the UCP, stating that “[w]hether a presentation appears to comply is determined by

⁵⁸ The Official Comments to the UCC, Comment 1 to Section 5-108.

⁵⁹ UCC Section 5-108(a).

⁶⁰ *Equitable Trust Co. of New York v. Dawson Partners Ltd.*, 27 Lloyd’s List L.R. 49 (1927).

⁶¹ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 30-31.

⁶² The Official Comments to the UCC, Comment 1 to Section 5-108.

⁶³ ISBP Rule 24.

⁶⁴ UCP sub-Article 14(a).

examining the presentation on its face against the terms and conditions stated in the standby as interpreted and supplemented by the Rules”.⁶⁵ ISP98 Official Commentary explains that the avoidance of reference to the strict compliance standard was dictated by the crude and abstract nature of this standard. Nevertheless, the Commentary admits that strict compliance test is more accurate than the substantial compliance test.⁶⁶

What is common to these abovementioned provisions is that they all refer to other rules of different nature in order to determine whether the presentation is complying. The UCC refers to “terms and conditions of the letter of credit”⁶⁷ and “standard practice of financial institutions that regularly issue letters of credit”.⁶⁸ The UCP refers to “terms and conditions of the credit” and “international standard banking practice”.⁶⁹ The ISB98 also calls for “the terms and conditions stated in the standby”.⁷⁰ The guidelines of examination of documents are thus scattered across various regimes and no source provides for exhaustive set of rules. The terms of the credit should be considered in the first place, some of them may be, however, disregarded by banks⁷¹. But they rarely depart from standard rules providing for comprehensive rules. Both, the UCP and the UCC refer to international standards of practice of the industry, although they do it using different names. These are customary technical rules of conduct of banks and financial institutions⁷². Finally, the applicable law fills the remaining gaps, if any, as well as sets general framework of dealing with these different rules.

⁶⁵ ISP98 Rule 4.01(b).

⁶⁶ ISP 98 Official Commentary, Rule 4.01, Paragraph 1, quoted in: Robert J. Spjut, *Documentary and Standby Letters of Credit*, published at: <http://library.findlaw.com/1999/Sep/1/131155.html>.

⁶⁷ UCC Section 5-108(a).

⁶⁸ UCC Section 5-108(d): “An issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination of the issuer’s observance of the standard practice is a matter of interpretation for the court. The court shall offer the parties a reasonable opportunity to present evidence of the standard practice.”

⁶⁹ UCP Article 2: „Complying presentation means a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice.”

⁷⁰ ISP98 Rule 4.01(b).

⁷¹ UCP sub-Article 14(h), UCC Section 5-108(g), ISP 98 Rules 2.03 and 4.11.

⁷² For further details as to the nature of these standards see the following section on rules governing letter of credit transactions.

Yet another approach to the examination of documents existed in the United States before its rejection by the UCC, the so-called bifurcated standard. As the name suggests, this rule provided for a separate standard for the undertaking of the bank to honor the beneficiary's presentation and another for the applicant's obligation to reimburse the bank⁷³. Under this rule strict compliance test was applied to the bank's liability for wrongful dishonor, whereas substantial compliance test applied to the bank's liability for wrongful honor⁷⁴.

Regardless what standard will be applied, it needs to be emphasized that letters of credits are documentary transactions. Any inclusion of non-documentary conditions into the terms of credits will be disregarded by the document checker and left without any impact on bank's undertaking to honor⁷⁵. Furthermore, any excessive conditions such as descriptions of goods by reference to the underlying contract or pro forma invoices should be discouraged⁷⁶.

Section 4. Letter of credit law.

Legal regimes governing and applying to letter of credit transactions are scattered across various acts. There are only a few comprehensive regulations such as the American Uniform Commercial Code (Article 5) and the Uniform Customs and Practice for Documentary Credits (UCP 600), but even these rules do not cover every issue⁷⁷.

⁷³ Robert J. Spjut, *Documentary and Standby Letters of Credit*, published at: <http://library.findlaw.com/1999/Sep/1/131155.html>.

⁷⁴ See William D. Warren, Steven D. Walt, *Payments and credits*, 6th Ed., New York: Foundation Press, 2004.

⁷⁵ UCP sub-Article 14(h), UCC Section 5-108(g), ISP 98 Rules 2.03 and 4.11.

⁷⁶ UCP sub-Article 4(b).

⁷⁷ For instance, the UCP does not cover, *inter alia*, the issues fraud and statute of limitations. The UCC Article 5 version that was in force prior to the 1995 revision contained even an explicit acknowledgment of incompleteness in Section 5-112(3).

It is striking that most of the municipal laws do not have any rules designed specifically for documentary credits⁷⁸. Thus, in an unfortunate case where the parties do not opt for the UCP or for law of a jurisdiction with a fairly developed letter of credit rules, provisions applicable to bank credits and general law of obligations will apply. This is the case of most European countries, where only Greek Commercial Code explicitly governs documentary credits in a fairly comprehensive manner (Articles 25-34 of the Code).⁷⁹ A truly original technique was adopted in Hungary, for the Decree No. 6/97 of the President of the Hungarian Federal Reserve Bank incorporates the UCP into all documentary credits.⁸⁰

Another peculiarity of letter of credit law is that parties to a letter of credit transaction are often confronted with conflict of laws. This is due to extensive use of these devices in international trade as a primary method of payment or as a security. To make things more complicated, different relationships which exist between involved parties may be subject to laws of different jurisdictions. In fact it is rather a rare exception that all transactions are governed by law of only one jurisdiction. In this respect the need for uniformity is clearly visible. Since the nature of letter of credit relationships is that of a contract, the UCP are feasible to provide the desired uniformity to the extent the matters covered in their rules,

⁷⁸ For a rather comprehensive compilation of municipal laws of documentary credits see Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001). This unique compilation includes statutes from over 35 countries published for the first time in English.

⁷⁹ The excerpt published in English in: Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001) at 68-70. The documentary credit is defined as “an agreement between a banking corporation (creditor) and another party (debtor) to issue a credit for the benefit of a third party (beneficiary). By this agreement the bank undertakes to pay to such third party the credit amount upon presentation of the bill of lading. Such amount shall be reimbursed by the debtor upon forwarding the bill of lading.” (Article 25.1).

⁸⁰ § 14.5 of the Decree No. 6/97 of the President of the Hungarian Federal Reserve Bank on money traffic reads: “The provisions of the Uniform Customs and Practice for Documentary Credits issued by the International Chamber of Commerce, Paris shall be binding for documentary credits.” The English translation published in: Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001) at 76.

provided that parties incorporate them into the terms and conditions of their credits on a regular basis. So far it has been achieved.

Below is a short outline of the most significant regimes governing the letter of credit transactions.

National laws.

As mentioned above, these are featured by lack of comprehensive regulations save some jurisdictions. The American UCC is often referred to in this paper for several reasons. First, it is the most comprehensive law on letters on credit worldwide. Second, there is a significant body of court decisions interpreting and developing the UCC. There are also court decisions rendered in the pre-code time which are still a good law. Third, court decisions dealing with standby letters of credit are numerous in the United States because US banks were prohibited from acting as a guarantor or a surety⁸¹. Consequently, to remain competitive on the global market of backing up obligations by means of bank/demand guarantees, the US domestic banks were forced to develop a similar device⁸². Thus, development of standby letters of credit law is in a great part thanks to the American courts and financial institutions of that country. As a result, decisions of American courts provide one of the richest resource dealing with standbys worldwide which is valuable for the purpose of this paper. Finally, the United States is one of the major trading nation in the world, thus, utilization of sophisticated devices of providing payment and financing is not strange to the parties. English law on letters of credit shares many of the above characteristics, save the lack of codified rules.

⁸¹ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (Aspen Publishers, New York 2006) at 606

⁸² See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (Aspen Publishers, New York 2006) at 606.

Accordingly, letter of credit law scattered across numerous court decisions. English courts recognize the principle of independence⁸³ and doctrine of strict compliance⁸⁴. Injunctions are available in case of fraud, both restraining the beneficiary from dealing with proceeds of letter of credit and prohibiting the bank from effecting payment⁸⁵. Like in the US, developed methods of financing are allowed under letters of credit.

As regards other national laws, although they may not contain many rules dealing with documentary credits as such, they certainly recognize letters of credits as legal instruments.⁸⁶

International law.

Attempts to provide uniformity of letters of credit law by means of international conventions have not been very successful. The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit⁸⁷ drafted by The United Nations Commission on International Trade Law has not enjoyed wide recognition so far. To this date only eight countries have ratified the CIGSLC.⁸⁸ The United States signed the Convention in 1997 but have not yet ratified it. The Convention is not a mandatory law and may be departed from by the parties.⁸⁹ Article 1(1) provides that the Convention applies to an international undertaking

⁸³ See, e.g. *E. D. & F. Man Ltd v Nigerian Sweets and Confectionery Co. Ltd* [1977], abstracted in: King Tak Fung *Leading Court Cases on Letters of Credit*, 2004 Edition, ICC Publication No. 658, at 22-24 (excerpts published).

⁸⁴ *Equitable Trust Co. of New York v. Dawson Partners Ltd.*, 27 Lloyd's List L.R. 49 (1927).

⁸⁵ *Boliviner Oil SA v Chale Manhattan Bank (C.A.)* [1984], 1 WLR 392, excerpts quoted in: King Tak Fung *Leading Court Cases on Letters of Credit*, 2004 Edition, ICC Publication No. 658, at 170-171. In respect to the different standards applied to injunctions restraining the beneficiary from dealing with proceeds of letter of credit and prohibiting the bank from effecting payment see the Hong Kong case *Prime Deal (HK) Enterprises v. the Hong Kong and Shanghai Banking Corporation and Another* [2002], 831 HKCU 1.

⁸⁶ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001) at 9 and Roy M. Goode, *Commercial Law, Second Edition*, London: Penguin Books, 1995, at 984-986.

⁸⁷ United Nations documents A/CN.9/XXVIII/CRP.I/Add.9.

⁸⁸ Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, Tunisia. The current status is reflected at http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html.

⁸⁹ The Explanatory note by the UNCITRAL secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit explains in paragraph 5: "The Convention gives legislative support to

defined in Article 2 as an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person ("guarantor/issuer") to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person. The Convention applies also to an international letter of credit not falling within Article 2 definition if the credit expressly states that it is subject to this Convention.

The ICC Commission on Banking Technique and Practice has endorsed the Convention, stating that "the ICC rules cannot be fully effective in all countries without their being recognized under local law. In this respect, the recent work of UNCITRAL on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit provides an important impetus to attain this objective."⁹⁰

Private business self-regulation.

the autonomy of the parties to apply agreed rules of practice such as the Uniform Customs and Practice for Documentary Credits (UCP), formulated by the International Chamber of Commerce (ICC), or other rules that may evolve to deal specifically with stand-by letters of credit, and the Uniform Rules for Demand Guarantees (URDG, also formulated by ICC)."

⁹⁰ International Chamber of Commerce, Policy Statement, Commission on Banking Technique and Practice, 21 June 1999, available at: <http://www.iccwbo.org/id420/index.html> (last accessed in April 2007). In respect to the development of letter of credit law the Banking Commission further stated: "ICC appreciates that the Convention was drafted in full recognition of the role of the various ICC rules in this field, that the UNCITRAL Working Group was directly and indirectly influenced by, and in turn influenced, the revision of the UCP, ICC's Uniform Rules for Demand Guarantees (URDG) and its recently adopted rules on International Standby Practices (ISP 98). ICC also notes that the UN Convention expressly defers to international banking practice as represented by ICC rules."

This legal regime embraces several documents published by the International Chamber of Commerce.

The most significant document is the Uniform Customs and Practice for Documentary Credits (current 2007 revision known as the UCP 600 enters into effect as of July, 1 2007). This is by far the most successful attempt to unify a given area of law by means of industry self-regulation ever achieved, comparable maybe only with another ICC's publication Incoterms 2000.⁹¹

The legal nature of the UCP is disputed⁹² and it is not the purpose of this paper to discuss this issue. It suffices to mention that the UCP applies 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.⁹³ The UCP cannot apply unless incorporated into contract, explicitly or by conduct⁹⁴. The UCP is thus a part of the contract between the parties and its nature is contractual. Most legal systems recognize the concept of standard contract terms (standard terms and conditions) incorporated into contract by reference. Standard terms and conditions are also recognized internationally.⁹⁵ Thus, it is for the applicable national or international law to determine whether the UCP apply in a particular case. Some authors opine, that the UCP are a restatement of custom in the industry

⁹¹ ICC Publication No. 560 But Incoterms have never gained near-universal acceptance as the UCP have.

⁹² The possible qualifications include at list the following: *lex mercatoria*, *sui generis* law/rules, common law between traders, uniform commercial custom and customary law. For further reading see Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001) at 12-13 and Roy M. Goode, *Commercial Law, Second Edition*, London: Penguin Books, 1995, at 984-986.

⁹³ UCP Article 1.

⁹⁴ For credits communicated through the SWIFT financial messaging network, the SWIFT rules provide for incorporation of the UCP, unless otherwise stipulated by the transmitting party. See, Roy M. Goode, *Commercial Law, Second Edition*, London: Penguin Books, 1995, at 984.

⁹⁵ For example, the prerequisites for the effective incorporation of standard contract terms into the international contract of sale falling under the UN Convention on the International Sale of Goods are to be taken from Article 8 of the CISG, to the exclusion of domestic law. See, Peter Schlechtriem and Ingeborg Schwanzer, *Commentary on the UN Convention on the International Sale of Goods, Second (English) Edition*, Oxford: Oxford University Press, 2005, at 136.

which do not purport to be law⁹⁶. The UCP, as a record of banking practice, may supplement the terms of a credit even without special reference to them⁹⁷. One may only add that there is a considerable body of court decision developed under The UCP worldwide. As these decisions develop letter of credit law, they will inevitably indirectly impact those cases where the parties did not incorporate the UCP into the credit as well.

The UCP covers both commercial (documentary⁹⁸) and standby letters of credit. In addition, there is a specific document dealing specifically with standbys – the International Standby Practices (commonly known as the ISP98)⁹⁹, in effect since January, 1 1999. These relatively new rules were published with the intent to replace the UCP as to standby letters of credits.¹⁰⁰ Their nature is that of the UCP, that is, they apply if the parties choose to incorporate them into the terms of the credit.¹⁰¹ As they have not gained any recognition comparable to that of the UCP, Uniform Customs and Practice still remain important set of rules that apply to both commercial and standby letters of credit. This position has been confirmed by retaining the explicit reference to standbys in Article 1 of the UCP 600.¹⁰² This position may change in the future as more credits will refer to the ISP98.

Yet another set of rules by the ICC applicable to the letters of credit is the International Standard Banking Practice for Examination of Documents under Documentary

⁹⁶ Ralph H. Folsom, Michael Wallach Gordon, John. A. Spanogle, Jr., *International Business Transactions, A Problem-Oriented Coursebook*, 6th Ed., West Group 2003.

⁹⁷ J. Dolan, *The Law of Letters of Credit*, 4-19-33, 6-70-72 (Rev. ed., 1996).

⁹⁸ Some authors, usually outside of the United States, use the term „documentary credit” instead of “commercial credit” as opposed to standby credit. This position is not justified; both commercial and standby credits are documentary credits by their nature. The UCP Article 1 appears to confirm this view, for it states: “The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 (“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.”

⁹⁹ ICC Publication No. 590.

¹⁰⁰ Robert J. Spjut, *Documentary and Standby Letters of Credit*, published at: <http://library.findlaw.com/1999/Sep/1/131155.html> (last accessed April 2007).

¹⁰¹ ISP98 Rule 1.01.

¹⁰² See *id.*

Credits (ISBP).¹⁰³ It is not purported to be a separate source of rules on documentary credits; its role is rather supplementary. The Foreword to the ISBP explains that the ISBP is “a practical complement” to the UCP. It does not amend the UCP, it rather “explains, in explicit detail, how the rules are to be applied on a day-to-day basis.”¹⁰⁴ Thus, the ISBP contains rules of technical nature for document checkers, bringing uniformity to this area as well. Although the publication contains 200 rules, it is by no means exhaustive.¹⁰⁵ Furthermore, it reflects only current practice and as such is subject to changes.

A note needs to be made here on references contained in the UCP to “international standard banking practice”¹⁰⁶ and in the UCC to “standard practice of financial institutions that regularly issue letters of credit”.¹⁰⁷ Both references are made in the context of standard of compliance which is to be observed by financial institutions in connection to the checking of the documents. Those are not references made exclusively to the ISBP as the publication by the ICC. The ISBP may fall under these references and in fact will do in most cases, but given their non exhaustive nature, there may be some other practices applied by bankers and acceptable under the UCP and the UCC. The Introduction to the ISBP explicitly discourages any attempt to incorporate it by reference into the terms of a credit, because the requirement to follow practices is implicit in the UCP.

¹⁰³ ICC Publication No. 645 (2003). The revised version consistent with the UCP 600 will be published under No. 681.

¹⁰⁴ ISBP, at 3.

¹⁰⁵ ISBP, Introduction, at 6

¹⁰⁶ UCP Article 2.

¹⁰⁷ UCC Section 5-108(e).

Another supplementary publication to the UCP is the electronic supplement to UCP, known as eUCP.¹⁰⁸ It is purported to facilitate electronic or part-electronic presentations of documents. So far it has not gained much recognition.

The current revision of the UCP resulted in necessary updates (but not revisions) of the ISBP and eUCP. Both updates were merely technical undertakings, bringing consistency with the UCP 600.¹⁰⁹

¹⁰⁸ The first version, eUCP 500, in force since April 2002.

¹⁰⁹ See UCP 600, Introduction.

CHAPTER II. SECURITY FUNCTION OF LETTERS OF CREDIT IN INTERNATIONAL TRADE.

The second chapter's focus is on security function of letters of credit. First, various uses of letter of credit will be outlined. Then the security function will be broken down. This chapter will not focus on any specific regulation. Rather, references will be made to all relevant laws to provide the reader with the widest spectrum of possible solutions. Again, given the developed laws on letters of credit and secured transactions under the UCC, American law will get most of the attention.

The purpose of this chapter is to show how letters of credit operate as a security device. This cannot be done by way of presentation of abstract concepts existing under specific legal orders, separated from their real commercial context. Rather, it is necessary to illustrate existing solutions by real transactions involving secured financing, taken from court rulings rendered across the globe.

Given the immense complexity of this area of law, only the basics are presented. The purpose is to provide the reader with a fairly wide background necessary to see where is the place of the UCP in this respect. This is indispensable introduction to comments on changes introduced in the current revision of the UCP which will follow in the next chapter.

Section 1. Various Uses of Letters of Credit. Payment Mechanism.

The primary secure payment function of letters of credit, facilitated by defense-stripping operation of the principle of independence, has advanced letters of credit to one of the primary means of payment in international transactions. The credibility of banks, coupled

by their reputation as reliable financial institutions, has also contributed to the success of these devices. It is estimated that over \$1 000 000 000 000 is paid by means of letters of credit in international trade.¹¹⁰ Only U.S. banks and U.S. branches of foreign banks had issued and outstanding over \$500,000,000,000 in letters of credit at the end of second quarter of 2005.¹¹¹

The focus of this section is on the function of letters of credit in circumstances involving transactions performed as intended by the parties, i.e. in a normal course of events. But even in such circumstances, where letters of credit are anticipated to serve as a primary payment mechanism, they are much more than a simple secure payment system. Due to the peculiar nature of the issuers, and thanks to their flexibility, letters of credit developed into a complete facility for financing international trade. In fulfilling this role, they virtually merged with bills of exchange, which is particularly true with respect to acceptance and negotiable credits. In this contexts it is not always appropriate to contradict secure payments v. secured transactions, as these devices do not have to be alternatives but may coexist within a framework of a wider multiparty commercial transaction. “Obviously, every phase of commerce involved is but a part of one transaction, namely, the sale and payment for goods.”¹¹²

¹¹⁰ Carter H. Klein, *Letter of Credit Law Developments* - an article prepared for CBA Commercial & Financial Transactions Committee in connection with the works on the UCP 600, Chicago, January 2006. Available at http://www.jenner.com/files/tbl_s18News%5CRelatedDocuments147%5C2050%5CKlein_Letter_of_Credit_Law_Developments_2006.pdf (last accessed April 2007).

¹¹¹ Id

¹¹² The Official Comment to the Uniform Commercial Code, 1996-97, at 35

Other payment systems. Cash, wire transfers and checks.

Letters of credits are not the only existing payment system used for settlement of significant transactions. Checking system and wire-transfer system share some common features with letters of credit in that they involve third parties (usually banks) providing facilities for settlement of obligations. But they also share features that make them inferior to letters of credit. Cash payments and wire transfers, for instance, require immediate payment before the shipment can be arranged, thus placing much risk on the purchaser. If made after dispatch or receipt of goods, they shift to much risk to the seller. In addition, cash payments cannot be used for large amounts or distance transactions and are generally inconvenient, what makes them extremely unusual in commercial transactions.¹¹³ They may facilitate payments in advance by the purchasers or sales on credit opened by the seller. Checking systems share some of these features too. In addition, checks provide the purchaser with the power to stop payment,¹¹⁴ something that owing to the principle of independence is not possible under letter of credit transaction. A separate, definite undertaking of the bank also eliminates problem related to overdrafts, a common seller's risk attached to checks.¹¹⁵ Finally, none of these payment systems facilitate transactions involving both payment and credit.

¹¹³ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (Aspen Publishers, New York 2006) at 291.

¹¹⁴ See, e.g., UCC Section 4-404: "A customer or any person authorized to draw on the account if there is more than one person may stop payment of any item drawn on the customer's account or close the account by an order to the bank describing the item or account with reasonable certainty received at a time and in a manner that affords the bank a reasonable opportunity to act on it before any action by the bank with respect to the item described in Section 4303."

¹¹⁵ See, e.g. UCC Section 404(a): "A bank may charge against the account of a customer an item that is properly payable from that account even though the charge creates an overdraft." Thus, in case of overdraft, bank has right to honor the check, but may dishonor it at its sole discretion. See also: Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 298.

Bills of exchange (drafts).

Letters of credit are not the only device able to facilitate both payment and credit transactions. Any system based on concepts of negotiability and securitization is capable of fulfilling this role.¹¹⁶ How letters of credit distinguish themselves from other developed payment systems?

One of the payment mechanisms used in international commerce is based on bills of exchange (drafts). Briefly discussed above checks are one specific type of them¹¹⁷ that due to extensive use over decades developed its specific rules, but the use of which systematically decline even in the United States, as they become obsolete owing to the emergence of new payment mechanisms based on electronic technology.¹¹⁸

A typical sale transaction involving secure payment by draft would involve a draft drawn by the seller instructing the buyer to pay the face amount. The draft is sent together with bill of lading (or other shipment document such as non-negotiable sea/air waybill) and presented to the buyer for payment. If sight draft is used, it will be paid against the documents upon presentation.¹¹⁹ Time drafts are accepted against transport documents and paid at maturity date.¹²⁰ Similarly to letters of credits, banks usually offer facilities for documentary

¹¹⁶ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 291.

¹¹⁷ See, e.g., UCC 3-104(f).

¹¹⁸ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 293.

¹¹⁹ URC 522 Article 6; documents against payment or D/P.

¹²⁰ URC 522 Article 6; documents against acceptance or D/A.

transactions acting as intermediaries who handle the documents. Such transactions are known as documentary collections.¹²¹

Use of drafts solves several problems connected to payment for goods or services. First, draft is an unconditional order to pay to the bearer, specified person or to the transferee.¹²² Thus, it is stripped from some (but not all) defenses the buyer could normally assert against the seller. If transferred by negotiation before becoming overdue or dishonored to a transferee who takes it for value and in good faith, without notice of any defect in the title of the person who negotiated it, the transferee becomes a holder in due course and as such may acquire better title than the transferor himself had.¹²³

Documentary transactions in the United States facilitate reservation of security interest¹²⁴ in the goods covered by documents of title by the seller.¹²⁵ Alternatively, in slightly changed circumstances, reservation of possession of the goods as security comes into play.¹²⁶ In the latter case, the seller would reserve possession of the goods covered by document of title as security by instructing the carrier to issue a nonnegotiable bill of lading to

¹²¹ Documentary collections are addressed by ICC's publication No. 522 (1995), Uniform Rules for Collections (URC 522) in effect as of January, 1 1996 (URC 522 replaced the previous version, URC 322, in force since January 1979). In the United States they are covered by Article 4 of the UCC.

¹²² Section 3 of the Bills of Exchange Act 1882 (England) provides: "A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer." See also UCC Section 3-104.

¹²³ See, e.g., Bills of Exchange Act Section 38 in conjunction with 29 or UCC Section 3-305(b) in conjunction with 3-302(a). See also Article 30 and 29 of the UNCITRAL Convention on International Bills of Exchange and International Promissory Notes, 1988. The UNCITRAL Convention, similarly to common law jurisdictions, distinguishes between two types of holders, referred to in the text of the Convention as "holder" and "protected holder", but does not require "giving of value" and provides for presumption that every holder is protected unless proven to the contrary. For further information see *Annex to the Convention - Explanatory Note by the UNCITRAL Secretariat on the United Nations Convention on International Bills of Exchange and International Promissory Notes* (available at

<http://www.jus.uio.no/lm/un.bills.of.exchange.and.promissory.notes.convention.1988/doc.html#567>).

¹²⁴ In other jurisdiction documentary sale may facilitate retention of title by means of documents of title.

¹²⁵ UCC Article 2-505(1)(a): "Where the seller has identified goods to the contract by or before shipment, his procurement of a negotiable bill of lading to his own order or otherwise reserves in him a security interest in the goods."

¹²⁶ UCC 2-505(1)(b).

himself.¹²⁷ The carrier would then wait for instructions of the seller as to the fate of goods and the seller would not instruct to deliver to the buyer until the buyer procures secure payment facility.¹²⁸

Draft-based payment mechanism becomes problematic for the seller, even if the transaction is secured in the abovementioned manner, if the draft is dishonored by the buyer.¹²⁹ In such case the seller will be left with goods at some distant place, bearing costs of warehousing, possibly insurance, risk of loss or deterioration (depending on the nature of goods they may even expire rapidly) and consequently forced to sell them, usually at a lower price in order to avoid further costs. Naturally, the seller may bring a court action against the buyer, but this is exactly what he wants to avoid, in particular if the contemplated action would have to be commenced in a foreign jurisdiction.

Letters of credit are capable of accommodating such seller's concerns. They are superior to drafts in that the payment is provided by a third party whose undertaking is primary, abstract, definite and conditioned only upon presentation of complying documents. Even if the buyer has some defenses capable of succeeding in court, they will not stop the payment under letter of credit as it is a separate undertaking of the bank. In the words of Judge Olszewski, reflecting the principle "pay first, argue later", they are "a valid risk shifting device."¹³⁰

¹²⁷ See Donald B. King, Calvin A. Kuenzel, Bradford Stone, W. H. Knight, Jr., *Commercial Transactions under the Uniform Commercial Code and Other Laws, Fifth Edition*, New York: Mathew Bender & Co Ltd, 1997, at 340.

¹²⁸ Id.

¹²⁹ See Roy Goode, *Commercial Law*, London: Penguin Books, 1995, at 962; Donald B. King, Calvin A. Kuenzel, Bradford Stone, W. H. Knight, Jr., *Commercial Transactions under the Uniform Commercial Code and Other Laws, Fifth Edition*, New York: Mathew Bender & Co Ltd, 1997, at 345.

¹³⁰ *Samuel Rappaport Family Partnership v. Meridian Bank*, 657 A.2d. 17, 21 (Pa. Super. 1995).

Secure payment mechanism ensured by letters of credit is in some cases more valuable than security interest.¹³¹ Naturally, if circumstances involve security interest granted by the buyer (not reserved by the seller) in some highly liquid asset, the contrast will not be as sharp as illustrated above.

Drafts and Credits.

The universal use of letters of credit has not eliminated drafts from commercial transactions. To the contrary, trading community developed transactions involving utilization of letters of credit and drafts in order to facilitate secured financing of goods and services. This has led to the emergence of acceptance and negotiation credits, but drafts are also used in connection with sight payment. This latter practice has been lately criticized as being pointless and unnecessary.¹³² The current position under and Hong Kong law is that use of drafts (bills of exchange) is optional under credits available by sight payment and by negotiation, required under letter of credit available by acceptance and not required if a credit is available by deferred payment.¹³³ Accordingly, financing by purchase of drafts is allowed under acceptance and negotiation credits.

¹³¹ Not only for the reasons stated above. The lack of international uniformity in the area of secured transactions law is another risk a secured party must face. In *Hong Kong and Shanghai Banking Corp., Ltd. v. HFH USA Corp.*, (USA) 805 F. Supp. 133, 140 (W.D.N.Y. 1992), the American court recognized German retention of title clause as a reservation of a security interest which due to the lack of public notice (by filing) could not constitute effective security for the plaintiff (an agent for the seller) and consequently extinguished upon loss of possession before the filing could take place. What is interesting about the facts of the case is that the security interest held by the defendant (a bank), which survived plaintiff's attack, secured issuance of at least two letters of credit in favor of some sellers other than the plaintiff. Those sellers were fully paid and were insulated from the bankruptcy of the buyer. Had the plaintiff insisted on the payment by letters of credit, he would have been paid in full as well, for the bankruptcy of a buyer is no cause to enjoin a seller from drawing on the letter of credit. But see *in re Ocana* and *in re Compton Corp.* discussed in the following sections for further information on the issue of bankruptcy of the applicant and its impact on fate of standby letters of credit.

¹³² King Tak Fung *Leading Court Cases on Letters of Credit*, 2004 Edition, ICC Publication No. 658, at 73.

¹³³ King Tak Fung *Leading Court Cases on Letters of Credit*, 2004 Edition, ICC Publication No. 658, at 72-73.

A hypothetical transaction involving financing under a letter of credit may involve an issuing bank that issues a letter of credit available by acceptance with the advising bank. The advising bank adds its conformation becoming thereby separately and definitely obliged to pay at maturity date if the complying documents will be presented. The beneficiary is advised of the credit issued in his favor and notified of the conformation.

The advise includes confirming bank's offer to purchase the export documents at discount and the offer is accepted by the beneficiary-seller.¹³⁴ At some later time the beneficiary makes a complying presentation as required by terms of the credit. At the time the presentation is found to be complying on its face, the obligations of both banks to pay at maturity crystallize.¹³⁵ The conforming bank acting on the discount contract credits the beneficiary's account with the discounted sum and receives letter of credit proceeds as a security. The beneficiary obtains immediate financing and needs not wait for the credit to mature.

The confirming bank presents the purchased documents to the issuing bank under its own name in his capacity of a holder in due course of a negotiable instrument and gets paid at maturity. Alternatively, the confirming bank may be reimbursed as a paying bank under the letter of credit or, if the discount of drafts was secured by the proceeds of the letter of credit, as an assignee.

¹³⁴ Forfaiting transaction is contemplated in this illustration, but many various scenarios are possible. See, e.g., Roy Goode, *Commercial Law*, London: Penguin Books, 1995, at 1025, where two other examples are provided: the seller's bank may negotiate seller's drafts drawn on the buyer or the issuing bank on a recourse basis; alternatively, the seller's bank may advance the draft (or part of it) at interest, collecting it for the seller at maturity and recouping itself from the sum so collected.

¹³⁵ See definition of honor in connection with credit available by deferred payment (UCP Article 2, UCC Section 5-102(a)(8)(iii)).

The junction of letter of credit law and law of bills of exchange has been always problematic.¹³⁶ As shown in the third chapter, the revised version of the UCP addressed some of the issues connected to it.

Section 2. Various Uses of Letters of Credit. Standby Credits.

Commercial v. Standby Letters of Credit.

Letters of credit are flexible devices that may be used for various purposes. When letter of credit is issued on assumption that the beneficiary will avail himself of the credit, the device serves as payment mechanism. If parties involved in letter of credit transaction assume that the device will not be used until and unless applicant's default on the underlying transaction, letter of credit supports the original claim and secures the performance of the original obligation.

The difference between commercial and standby letters of credit is not stated in the UCP. The UCC is silent on that matter as well. Even the ISP98 simply states that it applies to standby letters of credit but does not attempt to define them¹³⁷. This silence of lawmakers is justified by lack of necessity to provide definitions of commercial and standby credits. It is left to the parties to choose which type of credit will best suit their commercial needs. The difference will be ascertained from documentary conditions for presentation: if credit will require documents showing that the beneficiary performed his part of the bargain, the credit will be commercial; if a proof of applicant's default will be required, it will be a standby letter of credit.¹³⁸ Thus, letters of credit are truly flexible devices.

¹³⁶ See *Banco Santander* case reported in the third chapter.

¹³⁷ ISP98 Rule 1.01.

¹³⁸ See the following subsection on the nature of the proof of default.

The UCP makes it clear that it applies to any documentary credit, including any standby letter of credit¹³⁹. Drafters of the UCC did not even feel that it was necessary to acknowledge that¹⁴⁰. As mentioned briefly in the section devoted to the sources of letter of credit law, standbys developed in the United States due to historical concerns. Because domestic banks were prohibited to act as a guarantor or a surety, they developed device serving the same purposes but in the form of letters of credit.¹⁴¹ The drafters of the UCP accommodated the needs of the American banks by inclusion of explicit reference to standbys in Article 1 of the UCP, starting from the 1983 revision.¹⁴² ¹⁴³ For this reasons the case law developed by the American courts is of a particular value as regards standbys.

The ICC Publication No. 590, the ISB98, is devoted exclusively to standby letters of credit. It has gained some recognition but not yet wide enough to abandon the reference to the standbys in the UCP, which by this reason, has been upheld in the current revision. The ISP98 is similar to the rules applied by the American courts under Article 5 of the UCC.¹⁴⁴

Security function of Standby Letters of Credit.

The primary function of standby letters of credit is to back up the original obligation of the applicant which he has under the underlying transaction. It may be a contract for sale of goods or some other transaction, virtually any (standby credits may support non-financial

¹³⁹ UCP Article 1.

¹⁴⁰ Compare UCC Section 5-103(a) and 5-102(a)(10).

¹⁴¹ Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006) at 606.

¹⁴² ICC Publication No. 400.

¹⁴³ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 962 and 964.

¹⁴⁴ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 607.

undertaking as well financial ones).¹⁴⁵ Standbys are frequently used in connection with workmen's compensation insurance fronting arrangements¹⁴⁶ and land development contracts. They also support public issues of securities to enhance their credit rating¹⁴⁷ and value (while securitization itself increases the value of assets by enhancing their liquidity, additional guarantee by financial institution adds security, increasing the value even more).

Standby letters of credit are not security agreements in a sense that they create or provide for security interest in assets.¹⁴⁸ They are classified among personal security devices, creating *in personam* security rights. Such rights are not interests in property, but "contractual undertakings by a person other than the debtor, in case of which the recourse of the secured party on default is against such a third person."¹⁴⁹ Both, standbys and security interest are realized upon default and as such do not represent the usual course of events in a commercial transaction.

The mechanism of operation of standbys differs from that of commercial letters of credit in that beneficiary does not approach bank as a primary source of payment.¹⁵⁰ If the applicant defaults under the underlying transaction, the beneficiary may avail himself of the letter of credit by providing documents stipulated in the terms of the credit and evidencing the applicant's default. It is important to note, that the "proof" of default required by terms of standby credit is purely documentary in its nature. Banks do not look into the underlying transaction investigating whether the default has in fact taken place, because this would violate the principle that banks deal with documents and not with goods, services or

¹⁴⁵ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1031.

¹⁴⁶ Carter H. Klein, *Letter of Credit Law Developments*. The author enumerates 31 various uses standby of letters of credit.

¹⁴⁷ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1031.

¹⁴⁸ But the agreements between issuing bank and applicant usually provide for some security in favor of the bank, securing bank's reimbursement claims.

¹⁴⁹ Tibor Tajti, *Comparative Secured Transactions Law*, Budapest: Akademiai Kiado, 2002, at 84.

¹⁵⁰ This does not mean that bank's liability is not primary.

performance to which the documents may relate.¹⁵¹ This is an important feature that differentiates standby credits from demand guarantees and suretyship bonds.¹⁵² Furthermore, the terms of the credit may stipulate that a simple demand satisfies the requirements of complying presentation.¹⁵³ Naturally, fraud exception may apply if the documents constitute fraudulent misrepresentation and the bank has actual notice of the fraud or the documents on their face appear to be fraudulent.¹⁵⁴ But banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon.¹⁵⁵

By facilitating the separation of payment undertaking from the underlying transaction standby letters of credit denote the principle “pay first, litigate later”. This principle was explained by the court in *Nobel Insurance Co. v First National Bank of Brundidge*¹⁵⁶ in the following way: “Shifting litigation costs is one of the function of a standby credit. [...] This cost shifting function gives one party the benefit of the money in hand pending the pending the outcome of any litigation”. Indeed, this is owing to the principle of independence, the significance of which cannot be overrated.

¹⁵¹ UCP Article 5.

¹⁵² Guarantees, being like letters of credit subject to principle of contractual freedom, are by no means homogenous devices. First demand guarantees operate very much like letters of credit. Accordingly, they do not require proof of actual default for the payment could be effected.

¹⁵³ This is the case of so-called clean standby letters of credit. See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 613.

¹⁵⁴ The issue of fraud is one of the few areas where uniformity of letters of credit law has not been achieved. But in every jurisdiction standards required to establish the fraud exception in a court are high. Courts are well aware of the importance of the principle of independence and will safeguard it. See, e.g., *Nobel Insurance Co. v First National Bank of Brundidge* [2001], 821 So. 2nd 210 (Ala. 2001), where the court stated: “The certainty of payment is the most important aspect of a letter of credit transaction, and this certainty encourages hesitant parties to enter into transactions, by providing them with a secure source of credit. [...] The extensive use of the fraud exception may operate to transform the credit transaction into a surety contract. A standby credit is essentially equivalent to a loan made by the issuing bank to the applicant. Like a surety contract, the standby credit ensures against the applicant’s nonperformance of an obligation. Unlike a surety contract, however, the beneficiary of the standby credit may receive its money first, regardless of pending litigation with the applicant.”

¹⁵⁵ UCP Article 34.

¹⁵⁶ *Nobel Insurance Co. v First National Bank of Brundidge* [2001], 821 So. 2nd 210 (Ala. 2001).

Section 3. Letters of credit in the bankruptcy context, security interests and subrogation.

As mentioned above, when a buyer procures security in favor of a seller in the form of a standby letter of credit, unlike under security agreement, no security interests in buyer's assets is created or provided for. But if certain conditions are met, a virtually functional substitute situation may arise under American law.

When a standby letter of credit is issued in favor of the seller, and the issuance is secured by the security interest granted in assets of the applicant, a specific chain of relationships is created. First, the seller has two separate claims: one unsecured on the underlying contract of sale and another against the bank. The bank has secured claim for reimbursement that may crystallize in the future if the beneficiary (seller) avails himself of the credit. The security interest in the collateral does not need to be arranged specifically for issuance of a particular letter of credit. Not unusually, the applicant being in a long-term relationship with his bank will grant security interest in a collateral (after-acquired collateral¹⁵⁷ including) for any future advances in exchange for the bank opening a continuing line of credit.¹⁵⁸ If in such circumstances the bank pays the beneficiary, it steps into shoes of him under the underlying transaction (subrogation). Since the bank already has the perfected security interest in the applicant's assets, the overall effect of this arrangement is that unsecured claim of the beneficiary against the applicant is converted into secured claim of the bank.¹⁵⁹

¹⁵⁷ See UCC Section 9-204(a).

¹⁵⁸ See UCC Section 9-204(c). This arrangement ensures the bank that each advance, whether in the form of letter of credit or not, will be perfected as of the date of the original perfection. The

¹⁵⁹ It is interesting to note that if the bank had to be eliminated from the overall picture, in order to achieve the same effect, the seller would have to arrange for security interest on his own, incurring additional costs related to assessment of financial standing of the buyer and to monitoring his performance under the sale on credit contract. Banks can do it more efficiently and at lower costs since they reap scale economies. Furthermore, banks diversify the risk of "something going wrong" by engaging in numerous transactions. It seems that the theory of financial intermediaries and delegated monitoring (D. W. Diamond, *Financial Intermediation and Delegated Monitoring*, *Review of Economic Studies* 51 (July 1984), 393-414) is transferable to the illustrated

From the legal point of view the above arrangement is not objectionable unless it arises in the bankruptcy setting. Two types of objections may arise.

Action against property of the debtor's estate in bankruptcy.

The first objection is that the draw on a letter of credit in bankruptcy violates automatic stay in bankruptcy because it allegedly involves action against property of debtor's estate.¹⁶⁰ This argument is based on 11 U.S.C. § 362(a), according to which a bankruptcy petition operates as a stay of "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate" and "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title". The rationale underlying this argument is that payment under the letter of credit is an indirect distribution of debtor's estate to unsecured creditor to the detriment of the remaining unsecured creditors (the beneficiary on the separate underlying transaction is on equal footing with other unsecured creditors) and that bank's anticipation of being paid in full, justified by reason of its security interest, increases its willingness to pay.¹⁶¹ American courts were confronted with this issue in a string of cases before the 1995

arrangement, showing from different angle that the peculiar nature of banks as commercial actors greatly contributes to the success of letters of credit, and, ultimately, to the enhancement of credit.

¹⁶⁰ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 616.

¹⁶¹ See Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 617.

revision¹⁶² of the UCC Article 5. For the purpose of this paper it suffices to refer to *in re Ocana*¹⁶³ that illustrates the issue well.

In re Ocana was a case involving Latino Americano Reaseguros S.A. (the applicant for standby letter of credit) filing for bankruptcy and succeeding at enjoining the beneficiary from collecting on the standby credit. The stay of the beneficiary's action on the letter of credit, granted by the bankruptcy court, was subsequently subject to appeal. The district court seized with the appeal made the following comments:

“Hannover’s [i.e. beneficiary’s] action against Banco Cafetero [that is the bank obliged to honor] is not brought against debtor (LARSA) nor against the debtor’s property. [...] The beneficiary’s action is against the bank, not the account party, and the money to be used in making the payment is the bank’s money. The fact that the issuing bank holds collateral of the debtor to secure the bank’s extension of credit to LARSA has no bearing on the beneficiary’s right to receive payment from the bank on the bank’s contract.”

As a result, the court *in re Ocana* upheld the principle of independence of letter of credit undertaking. Two further important observations deserve some explanation here. First, the court considered the purpose of standby letters of credit, stating that

“allowing the debtor’s bankruptcy to interfere with payment on clean, irrevocable letters of credit would vitiate the purpose if such letters.[...] One of the principal purposes of letters of credit is to relieve the seller-shipper from worry as to the purchaser’s solvency, for the seller looks not to the purchaser, but to the bank, for payment.”

¹⁶² See *In re Twist Cap., Inc.*, 1 B. R. 284 (Bankr.Fla.1979), where the court enjoined the beneficiaries from getting paid on letter of credit. The decision was widely criticized for showing no deference to the principle of independence.

¹⁶³ *In re Ocana* [1993], 151 B.R. 670 (S.D.N.Y. 1993), also abstracted in Lynn M. LoPucki, Elizabeth Warren, Daniel Keating, Ronald J. Mann, *Commercial Transactions: A Systems Approach* (New York: Aspen Publishers, 2006), at 616-617.

This observation is crucial because for any security device to be of some value to the creditor, it must provide for the protection in bankruptcy. *In re Ocana* shows that standby letters of credit are such reliable security devices, capable of passing the bankruptcy test.

The second observation made by the court seems *prima facie* to be of somewhat abstract nature, for it entertains considerations of international commerce.¹⁶⁴ But it is not to be overlooked that letters of credit are a product of international trade community which by its own efforts achieved the great deal of legal uniformity that has never been reached in a given area of law by intergovernmental actions of the states. Hence, the court showed respect for those efforts and exercised great deal of care in order not to jeopardize the operation of letters of credit as security devices in international commerce.

Subrogation and voidable preferences.

Another issue with bankruptcy in the background for the operation of standby letters of credit is illustrated by the American case *in re Compton Corp.*¹⁶⁵ In that case the court too, was fully aware of the importance of the principle of independence and function of standbys and showed respect to these principles. However, the result of the case was different. The case is important because it illustrates the limits of the independence principle and confronts the security function of letters of credit with overriding considerations of voidable preferences in bankruptcy.

¹⁶⁴ In this respect the court stated: "If the payment of letters of credit could be stayed, as here, merely because the account party has obtained the protection of a bankruptcy court, this would do incalculable harm to international commerce. Letters of credit would no longer reliably perform the function they were designed for."

¹⁶⁵ *In Re Compton Corp.*, United States Court of Appeals, Fifth Circuit, 1987, 831 F.2d 586. The case was reproduced in: Donald B. King, Calvin A. Kuenzel, Bradford Stone, W. H. Knight, Jr., *Commercial Transactions under the Uniform Commercial Code and Other Laws, Fifth Edition*, New York: Mathew Bender & Co Ltd, 1997, at 1384-1393.

In the case Compton Corporation, the applicant and later the debtor in bankruptcy, induced Abilene National Bank (later MBank) to issue an irrevocable standby letter of credit. The credit was secured by collateral pursuant to prior security agreement containing future advances clause. The filing gave proper public notice and bank's security interest remained perfected.

The letter of credit was intended to secure payment for oil shipment which had been already made by the time the letter of credit was requested and procured. Furthermore, the letter of credit was arranged after applicant's default on the underlying transaction.

On May 7, one day after the issuance of the letter of credit, an involuntary bankruptcy petition was filed. Some two weeks later, following debtor's default on the underlying transaction, the beneficiary (Blue Quail Energy, Inc.) to the letter of credit transaction, which was not otherwise secured, got paid under the standby. The bank fully recovered his secured reimbursement claim in the bankruptcy proceeding.

The trustee for Compton subsequently attacked the payment to the beneficiary. But unlike in *re Ocana*, where the stay was grounded on the violation of the mandatory stay, trustee's complaint asserted that the beneficiary had received a preferential transfer under § 547 through the letter of credit transaction. The beneficiary filed the answer asserting that he had been paid from bank's funds, not from property of the debtor's estate. The bankruptcy court agreed and granted beneficiary's motion. After the affirmation by the district court the case reached the Fifth Circuit.

The court of appeal, referring to the principle of independence, made the following observations: “It is well established that a letter of credit and the proceeds therefrom are not property of the debtor’ estate under § 541. [...] It should be noted, however, that it is the risk of the debtor’s insolvency and not the risk of a preference attack that a bank assumes under a letter of credit transaction.” Citing in re North Shore (30 B. R. at 378) the court emphasized that the independence principle is necessary to insure “the certainty of payments for services or goods rendered regardless of any intervening misfortune which may befall the other contracting party.” Thus, by restating the function of letters of credit, the court put certain limits on the separability of bank’s undertaking under the letter of credit. But it was not said that every payment under letter of credit, if made within the preference period prescribed in the bankruptcy code, was voidable. The court pointed out the irregularities of the transaction at bar:

“the irrevocable standby letter of credit was not arranged with Blue Quail’s initial decision to sell oil to Compton on credit. Compton arranged for the letter of credit after Blue Quail had shipped the oil and after Compton had defaulted in payment. *The letter of credit in this case did not serve its usual function* of backing up a contemporaneous credit decision, but instead served as a back up payment guarantee on an extension of credit already in jeopardy. *The letter of credit was issued to pay off an antecedent unsecured debt.* [...] Blue Quail [...] did not give new value for the issuance of the credit.”¹⁶⁶

As a result, the court found indirect preferential transfer to the beneficiary. The abuse of letter of credit in *re Compton* occurred because it was issued to pay off an antecedent unsecured debt. Since no new value was given, this constituted preference prohibited under bankruptcy law. Accordingly, initial issuance of standby letter of credit to secure the payment before the shipment is not a preferential transfer voidable under bankruptcy.¹⁶⁷

¹⁶⁶ Italics added.

¹⁶⁷ The court found the MBank protected from a preference attack, because it gave new value for the increased security interest (the bank issued the letter of credit) See § 547(c)(1) of the Bankruptcy Code. Furthermore, the transfer of the debtor’s property in the form of the security interest related to the date of attachment of the prior

It is apparent from *in re Compton* that the courts will not allow for abuse of letters of credits in the bankruptcy context, facilitated by the peculiar nature of these devices. At least American courts will look into the function of a particular transaction and scrutinize it in the context of the purpose of letters of credit as security devices.¹⁶⁸

Conclusions.

The two cases abstracted above show a peculiar feature of letters of credit transaction. They virtually substitute unsecured creditors for secured creditors. This is always to the detriment of the remaining unsecured creditors, for they are worse off in the competition for debtor's assets in the bankruptcy setting. So far only American courts have learned to deal with such cases.¹⁶⁹ They will frustrate the principle of independence if they find an abuse, understood as departing from the legitimate payment/security function of letters of credit.

Those above cases also shown how indistinct and vulnerable may be the theoretical distinction between personal and real securities when standby letters of credits are used. Traditionally classified as *in personam* security rights, they seem to be something more, for banks usually take some security in exchange for their issuance and the substitution phenomenon occurs. If banks are regarded as intermediaries "transferring security" from the applicant in one jurisdiction to the beneficiary in the other, this function of letters of credit is

security agreement covering future advances, therefore not fitting within the 90 day preference window (see § 547(b)(4)(A) of the Bankruptcy Code)

¹⁶⁸ The court in *re Compton* further commented: "The purpose of the letter of credit transaction in this case was to secure payment of an unsecured antecedent debt. This is the only proper way to look at such letters of credit in the bankruptcy context. The promised transfer of pledged collateral induced the bank to issue letter of credit in favor of the creditor."

¹⁶⁹ The author of his paper is unaware of cases in other jurisdictions dealing with similar issues.

clearly visible.¹⁷⁰ Sellers are no longer forced to care about dealing with security interests, because this work is done by banks. Dealing with security interests can indeed require special knowledge and experience.¹⁷¹ Banks, as sophisticated parties, are well-suited for this job and can be vested with the task of monitoring debtors. Being able to diversify risk by employing scale economies of numerous transactions, they may assume risks related to the abstract and definite undertakings inherent to letters of credit. The overall effect is cost efficiency reflected in fees charged by banks for transactions involving letters of credit.¹⁷²

Section 4. Transfer v. assignment.

Dealing with security function of letters of credit, a question inevitably arises whether letter of credit can be utilized as a collateral. This question is particularly relevant with regard to those jurisdictions which have developed secured transaction laws, for under such laws virtually any type of asset may be utilized as a collateral.

As will be shown further in this paper, there is no one universal answer to this question. It is so because the trading community developed many different types of letters of credits.

¹⁷⁰ Further risk is related to the lack of international uniformity of secured transactions laws. By using the uniform umbrella of letters of credit law, this issue may be overcome by the parties itself, for the nature of secured transaction law makes it quite immune to attempts of unification by means of some private self-regulation similar to the UCP and would require governmental action, eventually supported by uniform rules in the form of model law.

¹⁷¹ A good illustration for this argument is the so-called "Benedict ritual". Today of historical meaning only, it was a method of dealing with account receivables financing, one of the independent security devices in the United States. For further reading see Grant Gilmore, *Security Interests in Personal Property*, New Jersey: The Lawbook Exchange (reprint), 1999, at 250-271.

¹⁷² Thus, the peculiar nature of issuers, that has contributed so much to the international success of letters of credit, is not only due to their creditworthiness and reputation, but also due to their ability to reap scale economies.

Right to draw v. right to the proceeds of a letter of credit.

It has been said that the letter of credit mechanism rests on assumption that a third party, almost always a bank, incurs a separate undertaking to pay upon complying presentation. Such contractual obligation is, however, not in such a nature that it itself could be subject to security interest. This is due to purely documentary qualification of the bank's undertaking to honor. A hypothetical secured party could not avail itself of the benefit of the letter of credit in case of the default of the original beneficiary because it could not comply with the requirements for presentation, as letter of credit is granted *prima facie* in favor of the original beneficiary alone.

This is also the exact reason why letters of credit are not in themselves negotiable instruments. Even if the beneficiary transfers the draft and/or other documents required for the presentation, the transferee will not be able to draw on the credit because the bank will be entitled to dishonor the presentation on the grounds of discrepancy in the documents¹⁷³ (the name of the beneficiary will be different, resulting in discrepant invoices, drafts and/or other documents depending on the circumstances).

Thus, it is necessary to distinguish the right to draw on a letter of credit from the right to the proceeds of a letter of credit. The right to draw on a letter of credit is subject to documentary conditions of presentation. It cannot be transferred unless the credit is transferable.¹⁷⁴ ¹⁷⁵ The letter of credit proceeds, on the other hand, may be assigned even if

¹⁷³ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 981-982. But the terms and conditions of the credit may provide for a negotiation credit.

¹⁷⁴ See UCP Article 38(b): "Transferable credit means a credit that specifically states it is "transferable". A transferable credit may be made available in whole or in part to another beneficiary ("second beneficiary") at the request of the beneficiary ("first beneficiary")." This is not to be confused with "transferred credit" which means "a credit that has been made available by the transferring bank to a second beneficiary" (UCO Article 38(b).

¹⁷⁵ Such transferable credits are quite different devices in themselves and will be discussed later.

the credit itself is non-transferable.^{176 177} Since the assignment of the letter of credit proceeds is distinct from the right to draw, it transfers merely the right to payment under the credit, the assignee must present the documents as an agent for the beneficiary-transferor¹⁷⁸ or claim the payment after the complying presentation has been made by the beneficiary himself.

The UCC provides for definition of the proceeds of a letter of credit. They are defined as “the cash, check, accepted draft, or other item of value paid or delivered upon honor or giving of value by the issuer or any nominated person under the letter of credit. The term does not include a beneficiary's drawing rights or documents presented by the beneficiary.”¹⁷⁹ It is, thus, clearly stated that beneficiary’s drawing rights or documents presented by the beneficiary are not the proceeds of a letter of credit. These may be subject to transfer by negotiation.¹⁸⁰

To make the picture complete, the UCP contains yet another definition, that of a letter-of-credit right. It is defined as “a right to payment or performance under a letter of credit, whether or not the beneficiary has demanded or is at the time entitled to demand payment or performance. The term does not include the right of a beneficiary to demand payment or

¹⁷⁶ A separate note needs to be made on the terminology. While “transfer” and “assignment” are usually synonyms, customary distinguished by referring to transfer of intangibles as to “assignment” and reserving the term “transfer” to transfers of interests in other types of property, in the context of letters of credit law they have separate meanings and cannot be used interchangeably. See Tibor Tajti, *Comparative Secured Transactions Law*, Budapest: Akademiai Kiado, 2002, at 36-37.

¹⁷⁷ See UCP Article 49: „The fact that a credit is not stated to be transferable shall not affect the right of the beneficiary to assign any proceeds to which it may be or may become entitled under the credit, in accordance with the provisions of applicable law.”

¹⁷⁸ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1023.

¹⁷⁹ See UCC Section 5-114(a).

¹⁸⁰ Drafts and/or documents may be transferred by negotiation if the credit is negotiable. In such cases the transferee acquires right to make presentation under his own name (which is a central feature of negotiability). The negotiation applies to the corresponding banks. The negotiating bank (which may be a confirming bank) that advances or agrees to advance the funds to the beneficiary upon the purchase of drafts and/or documents, acquires right to make its own presentation to the issuing bank. Hence, the capacity in which a bank acts making the recourse to the issuing bank, may differ depending on the manner by which credit is available.

performance under a letter of credit.”¹⁸¹ This definition was created for the sole purpose of Article 9 and secured transaction law. Thus, it reflects the concept of the letter of credit proceeds as opposed to the right to draw on a letter of credit within the framework of Article 9 of the UCC.

Unlike the assignment of proceeds, the transfer of a letter of credit results in change of the parties’ configuration under the letter of credit transaction. The effect of the transfer is not always that the transferee steps into shoes of the original beneficiary-transferor, removing him out of the picture completely. This effect could be achieved under general contract law by means of transfer by assignment (with the consent of the issuing bank), but such transactions are not practiced in commerce.¹⁸² The transfer simply makes the same credit available, in part or in the whole, to another party, who acquires thereby his own right to draw on the credit. The effect of the transfer is normally limited to the bank-beneficiary relationship and does not affect the underlying contract.¹⁸³

The term transferable credit is misleading for one more reason. Namely, it is a rule of the letter of credit law, that if a transferable credit is issued, no bank is under any obligation to transfer the credit unless it expressly consented to it.¹⁸⁴ Consequently, the beneficiary is not free to transfer the letter of credit and needs to seek the transferring bank’s consent to the transfer.¹⁸⁵ Letters of credit are not negotiable instruments transferred by indorsement and delivery.^{186 187}

¹⁸¹ See UCC Section 9-102(a)(51).

¹⁸² Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1016.

¹⁸³ Naturally, a „total” transfer is also possible. It may occur as a result of a universal succession or willingness of the parties facilitated by the principle of contractual freedom. But such a transfer is outside of our interest because it bears no or very little relation to the security function of letters of credit.

¹⁸⁴ UCP Article 38(a).

¹⁸⁵ An issuing bank may be a transferring bank. See UCO Article 38(b).

¹⁸⁶ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1016.

Security interest in the proceeds of a letter of credit.

The proceeds of a letter of credit are liquid assets than can be subject to security interests. The UCC makes it clear that not only the proceeds outstanding after the presentation may be assigned; the prospective rights to the proceeds of the letter of credit may also be subject to the assignment.¹⁸⁸ It is the latter case that will usually take place.

The assignment of the letter of credit proceeds facilitates secure financing of the seller.¹⁸⁹ A typical transaction would involve a seller acquiring goods from its supplier. The financing may be provided by an external financier, but, the supplier may agree to sell goods on credit secured by the letter of credit proceeds as well.¹⁹⁰

Under the UCC, an issuer or nominated person need not recognize an assignment of proceeds of a letter of credit until it consents to the assignment.¹⁹¹ Nor has an issuer or nominated person any obligation to give or withhold its consent to an assignment of proceeds of a letter of credit, but consent may not be unreasonably withheld if the assignee possesses and exhibits the letter of credit and presentation of the letter of credit is a condition to honor.¹⁹² The first rule of Section UCC Section 5-114(c) appears to reverse the default rule of the law of contracts that the debtor's consent to assignment is not required. The UCP Article

¹⁸⁷ The commerce developed devices termed "negotiable credits", but they are not negotiable instruments. The reference to negotiability denote that draft drawn under the letter of credit and/or documents may be negotiated with the authorized bank(s).

¹⁸⁸ UCC Section 5-114(b): „A beneficiary may assign its right to part or all of the proceeds of a letter of credit. The beneficiary may do so before presentation as a present assignment of its right to receive proceeds contingent upon its compliance with the terms and conditions of the letter of credit.”

¹⁸⁹ See Donald B. King, Calvin A. Kuenzel, Bradford Stone, W. H. Knight, Jr., *Commercial Transactions under the Uniform Commercial Code and Other Laws, Fifth Edition*, New York: Mathew Bender & Co Ltd, 1997, at 1383.

¹⁹⁰ If a transferable credit is issued, available to the seller as the first beneficiary and the supplier as the second beneficiary, this will better facilitate parties' commercial needs, for the supplier will have his own right to present documents under the credit.

¹⁹¹ UCC Section 5-114(c).

¹⁹² UCC Section 5-114(d).

39 provides to the contrary and reaffirms the general rule of assignability of claims. Thus, under the UCP the issuing or confirming bank must expressly exclude the assignability of the right of the beneficiary to assign any proceeds if it does not wish it to happen, otherwise it may not ignore it. The UCC Section 5-114(d) softens the default exclusion of assignability by providing that the bank may not be unreasonably withhold its consent. Until and unless the consent is not given, the assignment is effective only as between the beneficiary-assignor and the assignee. But this may be enough for the security interest to attach. But for perfection of security interest in letter-of-credit right is not enough.

According to Section 9-203(b) of the UCC a security interest is enforceable¹⁹³ against the debtor (i.e. the beneficiary), and third parties with respect to the collateral only if each of the following conditions is satisfied: 1) value has been given; 2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party and 3A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned or 3D) the collateral in deposit accounts, electronic chattel paper, investment property, or letter-of-credit rights, and the secured party has control under Section 9104, 9105, 9106, or 9107 pursuant to the debtor's security agreement.

As to the first condition, i.e. giving of value, it is usually satisfied by extending credit to the beneficiary. The second condition is also easily satisfied, for the debtor's rights may represent either a current or a future legal interest in the collateral.¹⁹⁴ Under the third condition the security interest attaches if the security agreement reasonably identifies the

¹⁹³ That is, it attaches.

¹⁹⁴ Kenneth W. Clarkson, Roger LeRoy Miller, Gaylord A. Jentz, *West's Business Law, 9th Edition*, Thompson, 2003.

letter-of-credit right.¹⁹⁵ Alternatively, it becomes enforceable if the assignee obtains control of the letter-of-credit right. A secured party has control of a letter-of-credit right to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under subdivision (c) of Section 5114 or otherwise applicable law or practice.¹⁹⁶ The concept of control is borrowed from Article 8 of the UCC where it governed the right of purchasers and secured parties in investment property.¹⁹⁷ The control of the letter-of-credit right resembles the control of investment securities held through securities intermediary, the control of which is obtained if the intermediary agrees to act on instructions from the secured party. But unlike security interests in investment securities, which may be perfected in several ways, the security interests in letter-of-credit rights are perfected only by control,¹⁹⁸ save the circumstances when the letter of credit is a supporting obligation within the meaning of Section 9-102(a)(77).¹⁹⁹ Supporting obligation is defined as a letter-of-credit right or

¹⁹⁵ This method of attachment does not require bank's consent to the assignment, but the consent will be required for the perfection anyways.

¹⁹⁶ UCC Section 9-107. It appears that the consent may be given either under Section 5-114 subdivision (c) or under any other law or practice that is otherwise applicable. Certainly, the UCP is such a "law or practice". A question inevitably arises whether explicit consent is required if the UCP governs the letter of credit transaction, as the default rule under Article 39 of the UCP is that a consent is not required for the proceeds to be assignable. Hence, it may be argued that by the incorporation by reference to the UCP the issuer has already given its consent to any future assignment. But the Article 39 of the UCP reads: "the fact that a credit is not stated to be transferable shall not affect the right of the beneficiary to assign any proceeds to which it may be or may become entitled under the credit, *in accordance with the provisions of applicable law*". The wording *in fine* of the first sentence leads back to the UCC, which requires the consent by virtue of Section 5-114(c). It seems to be an impasse. If the underlying idea of the UCP is to be taken into account, that is, the need for uniformity of the letter of credit law, giving priority to the UCC would strip the Article 39 of any sense, for it would provide for no uniformity anymore, referring back to the municipal law. In other words, the Article 39 could equally well not exist at all and nothing would change in respect of assignability of the proceeds. Thus, it seems that incorporation of the UCP avoids the effect of Section 5-114(c) of the UCC and consequently no explicit consent is required for the security interest to attach if the parties stipulated for the incorporation of the UCP, because such consent is given by the incorporation of the UCP itself. The wording "in accordance with the provisions of applicable law" would be limited to the issues of giving notice of assignment and the like ancillary or procedural issues, but could not affect the principle of default assignability. The argument to the contrary may be rested on the mandatory nature of rules concerning perfection of security interests. These rules cannot be departed from or modified by parties. For this argument to succeed it must rely on the assumption that the consent to the assignment cannot be given in advance.

¹⁹⁷ William D. Warren, Steven D. Walt, *Payments and credits*, 6th Ed., New York: Foundation Press, 2004, at 407.

¹⁹⁸ UCC Section 9-312(b)(2).

¹⁹⁹ Perfection of a security interest in collateral also perfects a security interest in a supporting obligation for the collateral

secondary obligation that supports the payment or performance of an account, chattel paper, document, general intangible, instrument, or investment property. This definition corresponds with the use of standby letters of credit.²⁰⁰ An example of a letter-of-credit right as supporting obligation may involve bonds backed up by standby letters of credit. If such bonds are granted as a security, the security interest in the standby letter-of-credit right supporting the bonds is attached and perfected automatically.

Back-to-back letters of credit.

The back-to-back- letters of credits are used if non-transferable credits have been issued in the favor of the first beneficiary.²⁰¹ In this respect the initial circumstances resemble those where the beneficiary grants security interest in the proceeds of the letter of credit. But instead of providing his creditor with a real security, the beneficiary secures his creditor with a security device in the form of another letter of credit.²⁰² This second credit is the back-to-back letter of credit. Its issuance is procured by the first non-transferable letter of credit.²⁰³ The back-to-back letters of credit are issued by issuing or conforming banks in the first letter of credit transaction. There is no need to mention that both credits are separate from each other.²⁰⁴ But they need to be carefully adjusted so that the documents to be presented under the (second) back-to-back credit will constitute complying presentation under the first

²⁰⁰ William D. Warren, Steven D. Walt, *Payments and credits*, 6th Ed., New York: Foundation Press, 2004, at 409. The authors provide following illustrations: sports franchise assures a basketball player that if its promissory note for the athlete's salary is not paid, the athlete can rely on a standby letter of credit; a dealer assigns its accounts to a financier and backs the accounts by a letter of credit.

²⁰¹ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 19.

²⁰² The credit not need to be standby; it may be commercial as well, providing for a secure payment mechanism. The use of the term "security" in the context of letters of credit may be somehow confusing and denote different meanings depending on circumstances of a particular transaction. In fact, the beneficiary of commercial letter of credit may deem himself at least as equally secure as the beneficiary of a standby letter of credit.

²⁰³ There are no legal objections that the first letter of credit has to be non-transferable. But where a transferable credit is issued, there is no need for the issuance of another credit, for the first one will simply be transferred by way of security to the beneficiary's creditor.

²⁰⁴ They are, naturally, separate from the underlying transactions as well.

credit.²⁰⁵ They may be used to accommodate secure financing of the seller when issued in favor of the supplier.²⁰⁶ Back-to-back letters of credit are rarely issued because they expose banks to significant risk connected to the bankruptcy of the seller. Therefore, they are issued either only at requests of customers of first-class standing or their issuance is additionally secured by security interests.²⁰⁷

Transferable letters of credits.

Transferable credits are quite distinct devices in themselves. The UCP devotes to them Article 39 which consists of eleven sub-articles. Like the assignment of the proceeds of letters of credit and back-to-back letters of credit, they are used to accommodate secured financing of the seller.²⁰⁸ But unlike these former devices, transferable credits are complete facilities for financing the beneficiary within the framework of one letter of credit.

As briefly mentioned before, the term transferable, like many terms used in connection with letters of credit, may cause some confusion. First, transferable credits cannot be freely transferred by the beneficiary without explicit consent of the transferring bank.²⁰⁹ Second, they do not necessarily lead to the complete replacement of the beneficiary-transferor by the transferee. They rather make a credit available to another beneficiary, in whole or in part. The UCP puts it into the following words: “a transferable credit means that the credit may be

²⁰⁵ Rolf A. Schütze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 19

²⁰⁶ For the illustration of use of back-to-back letters of credit in the context of secure financing of the supplier see Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1023-24.

²⁰⁷ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1024.

²⁰⁸ Donald B. King, Calvin A. Kuenzel, Bradford Stone, W. H. Knight, Jr., *Commercial Transactions under the Uniform Commercial Code and Other Laws, Fifth Edition*, New York: Mathew Bender & Co Ltd, 1997, at 1383.

²⁰⁹ UCP Article 38(a).

made available in whole or in part to another beneficiary ("second beneficiary") at the request of the beneficiary ("first beneficiary").²¹⁰

Article 39(b) of the UCP defines the transferable credit as a credit that specifically states it is "transferable". Thus, for the credit to be transferable, the issuing bank must specifically label it as such. For the credit to be transferred, the transferring bank must, acting at the request of the first beneficiary, express its consent to the transfer and make it available to the second beneficiary.

The legal nature of the transfer is disputed,²¹¹ but most authors agree that transfer, at least that within the framework of the UCP, closely resembles opening of another new credit for the benefit of the second beneficiary at the request of the first beneficiary, or virtually constitutes an issuance of such a new credit.²¹² Compared to the back-to-back letter of credit it differs in that it accommodates the same needs of the parties but within the conceptual framework of a single credit.

The life of transferable credit may follow this pattern: at the request of the first beneficiary the nominated bank authorized to transfer the credit (the transferring bank)²¹³ makes it available in part to the second beneficiary. This is achieved by issuance of a new letter of credit to the second beneficiary. The part of credit transferred to the second beneficiary covers the price (and other connected costs) the first beneficiary owes to the second beneficiary under the underlying transaction, which is lower than that owed by the

²¹⁰ UCP Article 38(b).

²¹¹ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 38.

²¹² Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1016; Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 39.

²¹³ UCP sub-Article 38(b) defines a transferring bank as "a nominated bank that transfers the credit or, in a credit available with any bank, a bank that is specifically authorized by the issuing bank to transfer and that transfers the credit" and clarifies that "an issuing bank may be a transferring bank."

applicant to the first beneficiary. Both letters of credit covers the same goods. When the second beneficiary is done with his presentation, he gets paid by the transferring bank.²¹⁴ At this moment the transfer is complete²¹⁵ and the second beneficiary is removed from the picture. Since the credit has been consumed in part, the first beneficiary may be paid only the remaining part which, roughly, is his profit under the underlying transaction. For this purpose the first beneficiary makes his presentation under the credit before the documents are remitted by the transferring bank to the issuing bank. This presentation is of a peculiar nature, because the UCP equips the first beneficiary with “the right to substitute its own invoice and draft, if any, for those of a second beneficiary for an amount not in excess of that stipulated in the credit. [U]pon such substitution the first beneficiary can draw under the credit for the difference, if any, between its invoice and the invoice of a second beneficiary.”²¹⁶

As well illustrated by the preceding hypothetical transaction, transferable credit is one credit that is made available to more than one beneficiary. The UCP permits transfer to more than one beneficiary, provided that partial drawings or shipments are allowed.²¹⁷ What has always been problematic with transferable credits is the careful drafting of documentary requirements for presentation, so that the documents under multiple presentations match,²¹⁸ i.e. as to description of goods in the invoices. The right to substitute the invoice and/or draft facilitates the non-disclosure of the details the supplier to the ultimate buyer, for reasons of competition and trade secrets.²¹⁹

²¹⁴ Presentation of documents by or on behalf of a second beneficiary must be made to the transferring bank (UCP sub-Article 38(k)).

²¹⁵ UCP sub-Article 38(b).

²¹⁶ UCP sub-Article 38(h).

²¹⁷ UCP sub-Article 38(d). But once transferred, the credit cannot be transferred further at the request of a second beneficiary to any subsequent beneficiary.

²¹⁸ Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1019.

²¹⁹ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 38; Roy Goode, *Commercial Law*, London: Penguin Books 1995, at 1019.

Section 5. Conclusion. Limited coverage of the UCP.

As shown in this chapter, letters of credit are truly peculiar devices. They operate as a security in international trade, but they do it in many different ways. First, letters of credit may constitute a secure payment mechanism, which is their original and primary function. Second, they may back up the obligations under the underlying transaction. Finally, the proceeds of letters of credit may constitute a real security. But these conceptual dividing lines are often made shady and indistinct, as various devices are used simultaneously within the framework of one commercial transaction. Standby letters of credit used in tandem with security interests in applicant's assets securing banks recourse substitute secured for unsecured creditors, what may lead to problems in the bankruptcy context. In a totally different configuration standby credits may support the performance of some obligation, let's say embodied in an instrument that itself secures another obligation as a collateral. Moreover, various uses of letters of credit are interchangeable and may be substituted one for another. Back-to-back letters of credit, transferable credits and assignment of proceeds are good examples. Finally, when letters of credits require drafts for presentation, further possibilities open to secure financing of the seller. The number of possible configurations, resulting from great flexibility of these devices, makes it possible to accommodate virtually any need of the contraction parties.

The UCP, being a document containing 39 articles, cannot cover all these matters. The number of facets of the commercial relationships is simply too big. What it does, is unifies usages universally accepted by the international banking community. Matters left outside its scope are to be governed by applicable national and international law.

CHAPTER III. CHANGES INTRODUCED TO THE UCP 600.

Section 1. The revision.

The current revision of the UCP is the fifth in its history and produced the sixth version of uniform customs and practice since it was first published in 1993.

The history of the UCP.

The UCP is a product of the international commercial community; more precisely – the financial community. Before its emergence, there was no international uniformity in this field of law and letters of credit was governed by rules set up by national banking associations.²²⁰ In France, the *clauses et modalites applicable aux ouvertures de credit documentaire par l'Union Syndicale des Banques de Paris et de la Province* of January, 14 1924 were devoted to documentary credits.²²¹ In Germany documentary credits were covered in the *Regulativ fur das Akkreditivgeschaeft der Berliner Stempelvereinigung* of January, 1 1923.²²² In the United States corresponding regulations were adopted by the New York Bankers' Commercial Credit Conference in 1920.²²³

Those rules lacked international uniformity. The first version²²⁴ adopted in 1933 was designed to bring such uniformity, but it was acknowledged only in Belgium, France,

²²⁰ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 11.

²²¹ Id.

²²² Id.

²²³ Id.

²²⁴ ICC Publication No. 69.

Germany, Italy, Romania, the Netherlands and Switzerland.²²⁵ The first revision²²⁶ of the UCP was in 1951 and the document gained more international recognition. But common law countries did not recognize the rules until the second revision²²⁷ in the 1962. By then, the UCP were truly uniform rules, near-universally accepted by banks in 178 countries and territories.²²⁸

While the 1974 revision²²⁹ was caused by emergence of new sophisticated transportation and shipment systems,²³⁰ the revision published in 1983²³¹ addressed new telecommunication systems and for the first time deferred payment credits.²³²

The UCP 500, like its successor, aimed at elimination of ambiguities and user-friendliness.²³³

The current revision.

The work on the current revision of the UCP took three years.²³⁴ According to the private nature of the UCP, it involved private bodies from all over the world. The leading role and main work was done by the UCP Drafting Group chaired by Gary Collyer.²³⁵ The

²²⁵ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 11.

²²⁶ ICC Publication No. 151.

²²⁷ ICC Publication No. 222.

²²⁸ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 11.

²²⁹ ICC Publication No. 290.

²³⁰ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 12.

²³¹ ICC Publication No. 400.

²³² Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 12.

²³³ Rolf A. Schutze, Gabriele Fontane, *Documentary Credit Law Throughout the World*, ICC Publication No. 633 (2001), at 12.

²³⁴ The Foreword to the UCP 600.

²³⁵ Id

Consulting Group, consisting of members from more than 25 countries, served as an advisory board.²³⁶ The work was coordinated within the framework of the ICC's Commission on Banking Technique and Practice.

Worldwide consultations were made available mainly through ICC national committees and the Drafting Group sifted through more than 5000 comments.²³⁷

The focus of the revision was to “address developments in the banking, transport and insurance industries. Additionally, there was a need to look at the language and style used in the UCP to remove wording that could lead to inconsistent application and interpretation.”²³⁸ As pointed out in the Introduction to the UCP 600, a real problem under the UCP 500 was the number of discrepancies in documents resulting in rejections on the first presentation that reached 70%. The Banking Commission regarded it as a serious threat to the future of the letters of credit. Thus, the changes to the standard of examination of documents under the current revision are aimed to address this issue. The publication of the ISBP was considered not sufficient to remedy the situation but was acknowledged by the drafting group. “It is the expectation of the Drafting Group and the Banking Commission that the application of the principles contained in the ISBP, including subsequent revisions thereof, will continue during the time UCP 600 is in force. At the time UCP 600 is implemented, there will be an updated version of the ISBP to bring its contents in line with the substance and style of the new rules.”²³⁹

²³⁶ Id.

²³⁷ Id.

²³⁸ Introduction to the UCP 600.

²³⁹ Id.

The Drafting Group contemplates to issue the Commentary to the rules, ICC Publication 601. It will represent “the Drafting Group's views” as to the reasons underlying the articles of the UCP.

Section 2. What has changed?

This section deals with the changes introduced to the UCP. The focus is on issues connected to the security function of letter of credits. Given the comprehensive scope of the revision of the UCP it is not possible to review every revised provision of the new version. Therefore, topics more remotely related to the security function are left with no comments in this paper. These include, *inter alia*, some general matters such as interpretations (Article 3 – a novelty in the UCP), Articles of the UCP 500 not covered in the current revision and particularities related to specific documents (e.g. insurance documents – Article 28, bills of lading – Article 20, air transport documents – Article 23, etc.).

This section discusses changes according to matters revised in the new UCP. This organization is chosen because it better suits the need of showing relevant changes in the context of the security function of letters of credit than discussion following subsequent articles of the UCC, commonly adopted in commentaries. It roughly mirrors the pattern adopted in the first chapter of this thesis.

Accordingly, the first issue discussed is the availability of the credits. The second issue is the principle of independence and standard of compliance, followed by the transferable credits. The last issue discussed concerns standby letters of credit.

Issue 1 – Availability of Credits.

General.

As outlined in the first chapter, the credit may be available by sight payment, deferred payment, acceptance or negotiation. The availability is the primary mean of shaping the rights and obligations of parties existing under a letter of credit transaction. As showed in the second chapter, it has a great bearing on the way the seller is financed under a letter of credit transaction and decides whether drafts are used and how they may be used. Needless to say, it is the different manners of drawing on the credits that permit the great flexibility of these devices.

Negotiation, acceptance and deferred payment – problematic notions under the UCP 500.

Negotiation is a concept that caused probably most confusion under the UCP. This happened regardless a definition existing under sub-Article 10(b)(i)²⁴⁰ and frustrated the ICC Banking Commission,²⁴¹ leading to the issuance of policy statements and opinions.²⁴² Negotiation was also litigated issue, because if a bank acts as a negotiation bank, it may present the documents under its own name and acquire clean title as a holder in due course. Hence, it will be immune from fraud exception, which would apply if the recourse to the issuing bank was made in the capacity of a nominated or confirming bank.

²⁴⁰ Negotiation means the giving of value for Draft(s) and/or document(s) by the bank authorized to negotiate. Mere examination of the documents without giving of value does not constitute a negotiation.

²⁴¹ See supra note 30.

²⁴² See supra note 33.

These issues were dealt with in several cases under the UCP 500. For the purpose of illustration *Banco Santander SA v Banque Paribas*²⁴³ will be now briefly reported.

The English case *Banco Santander SA v Banque Paribas* was probably the most commented one. Banco Santander was a confirming bank nominated by Banque Paribas for the letter of credit available by deferred payment and issued in favor of Bayfern Ltd. The confirmation of the credit was coupled with offer to discount the export documents, which was subsequently accepted by the beneficiary, whose account was credited with the discounted amount of some \$19.6 million. The presentation made was compliant on its face and as such caused crystallization of the payment undertaking in the amount of some \$20.3 million under the letter of credit, which was to be effected at maturity (180 days after the presentation, that is on 27th November 1998). Proceeds of the letter of credit were assigned to Banco Santander.

The documents were remitted to the Banque Paribas, the issuing bank. Banque Paribas discovered fraud and informed the confirming bank about the problem arisen. When the maturity date came, the payment to the confirming bank was refused on the grounds of fraud.

The fraud was not disputed in this case. Nor was it disputed that both banks had notice of established fraud before November 27th, 1998, i.e. the date when the payment was due.

The refusal to reimburse the confirming bank was on the grounds that the confirming bank cannot have better right than the beneficiary, who in turn may be refused to get paid on the basis of fraud exception regardless of the facially compliant presentation. But had Banco

²⁴³ *Banco Santander SA v Banque Paribas* [2000], Lloyd's Rep. Bank 165.

Santander acted as a negotiating bank, it would have had, as a holder in due course, good title free from any defect caused by the fraud otherwise.²⁴⁴

In the absence of fraud the confirming bank, as the assignee and in its own capacity as a confirming bank, would have had no claim to be paid by Paribas until November, 27 1998 (maturity date). At maturity, it would have been paid \$20.3 million, thereby making profit on the discount.

Accordingly, the key issue in the case was whether Banco Santander was authorized to negotiate the documents under the letter of credit. In this respect the court observed:

“Ultimately the question to be asked is what precisely the Issuing Bank has requested the Confirming Bank to do, and what the Issuing Bank has promised to do if the Confirming Bank does what is requested of it. The answer, as it seems to me, is that the Issuing Bank has requested the Confirming Bank to give its own undertaking to pay on 27th November 1998, in addition to that of the Issuing Bank, and has promised to reimburse the Confirming Bank when it pays on that deferred payment undertaking ie. pays \$ 20,315,796.30 on 27 November 1998. There is no request from Paribas that Santander should discount or give any value for the documents prior to 27 November 1998, and albeit it may not be a breach of mandate for Santander to do so, it is up to Santander whether it does so or not.”

It follows, that the confirming bank did not act within the authority expressly given by the issuing bank. The question left whether the deferred payment credit in itself gives the nominated bank the right to negotiate. The court, comparing deferred payment and acceptance credits,²⁴⁵ held that it does not:

²⁴⁴ See Section 38 of the Bills of Exchange Act of 1882.

²⁴⁵ “There are two types of letter of credit which contemplate presentation of documents and an acceptance of an obligation to pay in the future. There is the "acceptance credit" used for many years which involves the Confirming Bank accepting a draft in favour of the beneficiary; and there is the newer instrument the "deferred payment" letter of credit which involves the bank promising payment at a future date, as in this case. It seems that this latter kind of letter of credit may have come into use because if drafts were produced the result was that in many countries stamp duty had to be paid. But drafts did have this advantage. A negotiable instrument was produced which could be discounted or sold in the forfait market. To such drafts s 38 of the Bills of Exchange Act 1882 applies.”

“I have ultimately concluded that if parties agree for whatever reason that they will not provide a negotiable instrument, and do not provide by terms of the trade or even by the express terms of the instrument itself the protection for assignees that a negotiable instrument would provide, they must live with the consequences.”

Consequently, deferred credits were distinguished from acceptance credits in that they do not permit negotiation under the credit. The only type of financing under deferred payment credits is the payment on the maturity date.²⁴⁶ That said, Banco Santander failed to establish that it was acting as a negotiating bank. The claim left to him under the capacity of an assignee of the letter of credits proceeds was not sufficient to prevail because “assignments normally take effect subject to equities” and consequently assignees are liable to defenses available against assignors.²⁴⁷

The lack of a clear definition of acceptance under the UCP 500 resulted in decisions conflicting with *Banco Santander*. In *Bank of China v. Agricultural Bank of China*²⁴⁸ the Chinese court held that a letter of credit “available with the issuing bank by acceptance [...] precludes any bank [...] from effecting payment, incurring a deferred payment undertaking, accepting or negotiation the letter of credit.”

²⁴⁶ King Tak Fung *Leading Court Cases on Letters of Credit*, 2004 Edition, ICC Publication No. 658, at 40.

²⁴⁷ As the case was widely commented worldwide, it has been noticed that under the UCC the outcome of the case would be different, because it contains express rule that equals the position of the assignee and holder in due course. Section 5-109(a)(1) provides that in case of fraud “the issuer *shall honor* the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.” In any other case the issuer may either honor or dishonor the presentation. For further reading see Roger Fayers, James G. Barnes, *Contrasting UK and US views of the controversial Banco Santander Case*, *Documentary Credits Insight*, Volume 6 No 3 (Summer 2000), also available at: <http://tradefinanceindia.com/case%20laws/santander/santander%20-%20uk%20vs%20usa.htm> (last visited April 2007).

²⁴⁸ *Bank of China v. Agricultural Bank of China*, Shao Zhong Fa Jing Chu Zi No. 20 - Zhejiang Shaoxing Intermediate People's Court, 30 June 2000 (PRC). The excerpts of the case are reproduced in English and commented in King Tak Fung *Leading Court Cases on Letters of Credit*, 2004 Edition, ICC Publication No. 658, at 61-64.

Solutions found in the UCP 600.

The new UCP has clarified the issue of secure financing under the letters of credit. The current version contains a new definition article which is a novelty in itself to the UCP and makes the whole document more transparent and the other provisions more streamlined. The new UCP contains only 39 Articles compared to 49 Articles of the UCP 500.

Although Article 6(b) repeats former Article 10(a)²⁴⁹ and states that a credit must state whether it is available by sight payment, deferred payment, acceptance or negotiation, Article 2 makes it clear that negotiation is a quite different method of settlement of credits than honor. Thus, the current position is that the credit is available either by honor or negotiation, the honor embracing sight payment, deferred payment and acceptance.²⁵⁰ Article 2 of the UCP provides for the following definition of „honor“:

“Honor means:

- a. to pay at sight if the credit is available by sight payment.
- b. to incur a deferred payment undertaking and pay at maturity if the credit is available by deferred payment.
- c. to accept a bill of exchange ("draft") drawn by the beneficiary and pay at maturity if the credit is available by acceptance.”

A credit may be available with either issuing bank or nominated bank.²⁵¹ A credit may state that it is available with any bank.²⁵² With the issuing bank it may be available by honor

²⁴⁹ UCP 500 Article 10(a): „All Credits must clearly indicate whether they are available by sight payment, by deferred payment, by acceptance or by negotiation.”

²⁵⁰ This rule resembles that found in Section 5-102(8) of the UCC.

²⁵¹ UCP 6(a).

²⁵² Sub-Article 10(b)(i) contained a rule to the following effect: „In a freely negotiable Credit, any bank is a Nominated Bank.” This narrowed the availability of the credit with any bank to negotiation credits and appeared to be inconsistent with the flexible nature of the devices. While the availability by negotiation with any bank is the most common case, there are no legal objections why a credit could not be framed as available with any bank by sight payment, deferred payment or acceptance. Following this change the terminology will have to be adjusted, for it is not appropriate to use the UCP 500 terminology and refer to all freely available credits as “freely negotiable credits”.

only (i.e. by sight payment, deferred payment or acceptance).²⁵³ ²⁵⁴ With the nominated bank credit may be available by honor or by negotiation.

Negotiation has new definition in the UCP. It is defined 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 the beneficiary on or before the banking day on which reimbursement is due to the nominated bank.”²⁵⁵ Thus, there are two constituent elements of the negotiation: the purchase of drafts and/or documents and advancing or agreeing to advance funds to the beneficiary. The latter replaced the vague term “giving of value” that in connection with letters of credit caused confusion.²⁵⁶ The new concept incorporates to the UCP clarifications made in the Position Paper No. 2, where the Banking Commission suggested that “the phrase 'giving of value' [...] may be interpreted as either 'making immediate payment' (e.g. by cash, by cheque, by remittance through a Clearing System or by credit to an account) or 'undertaking an obligation to make payment' (other than giving a deferred payment undertaking or accepting a draft).”

²⁵³ This rule is now highlighted in sub-Article 7(a), which reads: “Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, *the issuing bank must honour* if the credit is available by: (i) sight payment, deferred payment or acceptance with the issuing bank; (ii) sight payment with a nominated bank and that nominated bank does not pay; (iii) deferred payment with a nominated bank and that nominated bank does not incur its deferred payment undertaking or, having incurred its deferred payment undertaking, does not pay at maturity; (iv) acceptance with a nominated bank and that nominated bank does not accept a draft drawn on it or, having accepted a draft drawn on it, does not pay at maturity; (v) negotiation with a nominated bank and that nominated bank does not negotiate.” (emphasis added). The corresponding rule governing the conforming bank’s obligation contrasts the above rule by stating that the confirming bank must honor (sub-Article 8(a)(i)) *or* negotiate (sub-Article 8(a)(ii)).

²⁵⁴ Naturally, the credits are not required to state, starting from July, 1 that they are available by honor. This not only would sound odd, but would also violate the rule of Article 6 that credits must clearly state their availability.

²⁵⁵ Sub-Article 10(b)(ii) reads: „Negotiation means the giving of value for Draft(s) and/or document(s) by the bank authorized to negotiate. Mere examination of the documents without giving of value does not constitute a negotiation.”

²⁵⁶ See The ICC Commission on Banking Technique and Practice, Policy Statement, Position Paper No.2 on UCP 500, September 1, 1994, available at: <http://www.iccwbo.org/id357/index.html> (last accessed in April 2007).

The changes discussed so far restate the rules worked out under various documents issued by the ICC under the UCP 500 and make the provisions of the UCP more clear and transparent, reorganizing various concepts developed by the global financial community. But they do not provide rules for issues the trading community was confronted with in *Banco Santander*, *Bank of China v. Agricultural Bank of China* and similar cases: the authority of nominated banks to provide financing under letters of credit. Sub-Article 12(b) of the UCP introduces a completely new rule to the UCP that accommodate the need for international uniformity in respect to purchase of drafts or prepay occurring under documentary credits.²⁵⁷ Sub-Article 12(a) of the UCP 600 restates the universally accepted rule that a nominated bank, unlike the bank that adds its confirmation, is under no obligation to honor or negotiate. It reads:

“Unless a nominated bank is the confirming bank, an authorization to honour or negotiate does not impose any obligation on that nominated bank to honour or negotiate, except when expressly agreed to by that nominated bank and so communicated to the beneficiary.”²⁵⁸

Sub-Article 12(c) further clarifies that “receipt or examination and forwarding of documents by a nominated bank that is not a confirming bank does not make that nominated bank liable to honour or negotiate, nor does it constitute honour or negotiation.”

²⁵⁷ It is interesting to note, that in *Banco Santander* Justice Waller seemed not to acknowledge the need for explicit provisions in the UCP dealing with new methods of financing developed in the international trade. Commenting on discounting drafts by forfaiting (non-recourse purchase of bills of exchange) he was confronted with in the case at bar, he stated: “In bringing this new type of instrument into operation, it seems it has not been thought necessary to make express provision in the UCP to cover the situation, or to make express provision in the letters of credit themselves.” But the reality has brought different court decisions across the globe, often proving the financing under letters of credit to be a risky business. The current revision could not ignore the lack of uniform rules any further.

²⁵⁸ The UCP 500 equivalent was sub-Article 10(c): “Unless the Nominated Bank is the Confirming Bank, nomination by the Issuing Bank does not constitute any undertaking by the Nominated Bank to pay, to incur a deferred payment undertaking, to accept Draft(s), or to negotiate. Except where expressly agreed to by the Nominated Bank and so communicated to the Beneficiary, the Nominated Bank's receipt of and/or examination and/or forwarding of the documents does not make that bank liable to pay, to incur a deferred payment undertaking, to accept Draft(s) or to negotiate.” The first difference that will be noticed by letter of credit practitioners is the length of these two corresponding articles. The reduction of unnecessary repetitions was achieved by means of the new definition article.

In addition, the rule of sub-Article 12(a) sets up the scope of authority of a nominated bank. It is authorized to honor *or* negotiate. Thus, it reflects the current position adopted in Article 2 mentioned above. The scope of authority of a nominated bank is further dealt with in sub-Article 12(b), which covers the case of prepay or purchase of drafts under letters of credits. This provision reads:

“By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorizes that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank.”

The above applies also to any confirming bank which is a nominated bank.²⁵⁹

The rule of sub-Article 12(b) deals with the issue of deferred credits and acceptance credits. By virtue of this provision: 1) if a credit is available by deferred payment with a nominated bank, the authority to honor (as defined in sub-Article 12(a) in conjunction with Article 2) covers also the authority to prepay or purchase the amount of a deferred credit before the maturity date; 2) if a credit is available by acceptance with a nominated bank, the authority to honor covers also the authority to purchase a draft accepted. Thus, the concept of nomination includes implicit authority to prepay a deferred credit or to purchase an accepted draft. It should be noted that this authority may be expressly excluded by the issuing bank. Under the revised UCP banks and applicants must be aware of this default position and its consequences.

Under Sub-Article 7(c) an issuing bank undertakes to reimburse a nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the

²⁵⁹ This is not always the case and on rare occasions a confirming bank will not be a nominated bank.

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.²⁶⁰ Thus, the consequences of implicit authorization in sub-Article 12(b) are that the issuing bank and confirming bank, if any, are obliged to reimburse a nominated bank that prepaid or purchased a draft before maturity. But the reimbursement does not become due until the maturity date.

A new rule protecting the nominating bank is now found in second paragraph of Article 35, covering the unfortunate case where the documents are lost in transit.²⁶¹ According to this provision “if a nominated bank determines that a presentation is complying and forwards the documents to the issuing bank or confirming bank, whether or not the nominated bank has honoured or negotiated, an issuing bank or confirming bank must honour or negotiate, or reimburse that nominated bank, even when the documents have been lost in transit between the nominated bank and the issuing bank or confirming bank, or between the confirming bank and the issuing bank.” It is worth pointing out that this rule protects also the beneficiary.

²⁶⁰ Corresponding rule of Sub-Article 8(c) reads: “A confirming bank undertakes to reimburse another nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the confirming bank. Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not another nominated bank prepaid or purchased before maturity. A confirming bank's undertaking to reimburse another nominated bank is independent of the confirming bank's undertaking to the beneficiary.”

²⁶¹ The corresponding Article 16 of the UCP 500 contained only a disclaimer on liability for loss and delay in transit of documents and errors in translations. This rule has been upheld, although slightly modified, in the first paragraph of Article 35 of the UCP 600.

Issue 2 – The Principle of Independence and Standard of Compliance.

General.

As explained in the first chapter, the principle of independence and standard of documentary compliance are central features of letters of credit. As shown further in the second chapter, they facilitate both secure payment (support) mechanism and secure financing under letter of credit. This chapter will discuss changes introduced to the UCP 600 in respect of these features of letters of credit.

The principle of independence.

The principle of independence is reinforced in the UCP 600 by new sub-Article 4(b) that reads:

“An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, pro forma invoice and the like.”

There was no corresponding rule in the UCP 500. Article 4(b), if followed by the parties to a letter of credit transaction, will facilitate efficient examination of documents. Inclusion of documents like pro forma invoices or contracts into the terms of credit will usually constitute excessive description of goods.

The new provision follows the rule worked out in the ISBP. Rule 59 provides that “invoices identified as ‘provisional’, ‘pro-forma’, or the like are not acceptable unless specifically authorized in the credit.”

The principle of independence is closely related to the documentary nature of letters of credits. This philosophy is well expressed in Article 5 of the UCP 600:

“Banks deal with documents and not with goods, services or performance to which the documents may relate.”

The wording of this rule is changed.²⁶² The current position highlights that banks deal with documents, not with the underlying transaction, which is a necessary condition for the principle of independence to operate. Thus, the new provision qualifies the performance of banks as independent of the performance of the parties under the underlying transaction.

Standard of documentary compliance.

The revised Article 14 of the UCP 600 contains rules for standard for examination of documents. Its rules are now coupled with the definition of “complying presentation in Article 2. This definition is a novelty to the UCP. “Complying presentation” is defined as:

“a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice.”

Conceptually, the new definition is rather a drafting technique than a substantial change. The reference to the international standard banking practice is not confined to the ISBP, otherwise the reference would be explicit , use capital letters and indicate the details of

²⁶² Corresponding Article 4 of the UCP 500 provided: „ In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate.”

publication. As explained in the first chapter, it is the UCP counterpart of the UCC's term "standard practice of financial institutions that regularly issue letters of credit."²⁶³

Sub-Article 14(a) provides the basic rule for examination of documents that:

"A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation."²⁶⁴

The new provision is more streamlined owing to the definition. The current version enumerates nominated bank, confirming bank and issuing bank as banks involved in the process of examination of documents, which is also a change connected to redefining these terms in Article 2.

The requirement of examination on the basis of documents alone bears close relation to Article 5 of the UCP 600 mentioned above. Both rules need to be read in conjunction and produce rule that banks are under no obligation to investigate the facts of the underlying transaction not reflected in the documents.

The former version required the document checker to consider all documents stipulated in the credit. This requirement was removed as superfluous; the definition of "complying presentation already speaks of "accordance with the terms and conditions". Sub-Article 14(g) provides that a document presented but not required by the credit will be

²⁶³ UCC Section 5-108(e).

²⁶⁴ The corresponding rule of the UCP 500 was found in sub-Article 13(a): "Banks must examine all document stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit."

disregarded and may be returned to the presenter. If a credit contains a condition without stipulating the document to indicate compliance with the condition, banks will deem such condition as not stated and will disregard it (Sub-Article 14(h)).

References to “reasonable care” and “reasonable time” were removed in the new rule. Furthermore, the time for banks to examine the documents has been shortened from seven to five banking days.²⁶⁵ The position under the former rule was that banks should not avail themselves of the whole period of 7 days but act within reasonable time. The removal of “reasonable time” should not lead to full utilization of five banking days. Sub-Article 15(a) states that when an issuing bank determines that a presentation is complying, it must honour. Thus, waiting until the last permissible day would violate that rule.²⁶⁶

Article 22 of the UCP 500 stated that “unless otherwise stipulated in the Credit, banks will accept a document bearing a date of issuance prior to that of the Credit, subject to such document being presented within the time limits set out in the Credit and in these Articles.” This rule is now modified in the following way: “a document may be dated prior to the issuance date of the credit, but must not be dated later than its date of presentation.” Consequently, bank will not accept documents which bear the date later than their presentation. The new rule should alert the parties contemplating issuance of documents in black.

²⁶⁵ nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation

²⁶⁶ The same obligation is now put on confirming and nominated banks with respect to their respective undertakings. Sub-Article 15(b) states that “when a confirming bank determines that a presentation is complying, it must honour or negotiate and forward the documents to the issuing bank.” Sub-Article 15(b) states that “when a nominated bank determines that a presentation is complying and honours or negotiates, it must forward the documents to the confirming bank or issuing bank.”

Addresses and contact details are issues that are liable to cause many discrepancies in the past. It is so not only because there may be some mistakes related to them; a party may simply change its address after the issuance of a credit. Contact details are normally subject to changes even more frequently than addresses. Thus, strict compliance is particularly harsh in this respect. The new rule of sub-Article 14(j) reads:

“When the addresses of the beneficiary and the applicant appear in any stipulated document, they need not be the same as those stated in the credit or in any other stipulated document, but must be within the same country as the respective addresses mentioned in the credit. Contact details (telefax, telephone, email and the like) stated as part of the beneficiary's and the applicant's address will be disregarded. However, when the address and contact details of the applicant appear as part of the consignee or notify party details on a transport document subject to articles 19, 20, 21, 22, 23, 24 or 25, they must be as stated in the credit.”

It is apparent from this provision that strict compliance is not prescribed as to the addresses. The documents are now compliant if the addresses are within the same country. Furthermore, contact details are no consideration to the document checker, save when the address and contact details of the applicant appear as part of the consignee or notify party details on a transport document.

The UCP 600, following its predecessor, states that “data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit.”²⁶⁷ Thus, there is no requirement of “mirror image” in relation to the examined documents.

²⁶⁷ Similar rule was contained in Article 21 of the UCP 500: “When documents other than transport documents, insurance documents and commercial invoices are called for, the Credit should stipulate by whom such documents are to be issued and their wording or data content. If the Credit does not so stipulate, banks will accept such documents as presented, provided that their data content is not inconsistent with any other stipulated document presented.”

For some exceptional cases the UCP 600 seems to adopt standard of substantial compliance, referring to the compliance of the function of the documents. Sub-Article 14 (f) provides that:

“If a credit requires presentation of a document other than a transport document, insurance document or commercial invoice, without stipulating by whom the document is to be issued or its data content, banks will accept the document as presented if its content appears to fulfill the function of the required document and otherwise complies with sub-article 14 (d).”

Examples of such documents may be certificates of origin.²⁶⁸ It should be emphasized that in determining the compliance in function of documents it is not permitted to investigate the non-documentary circumstances of the underlying transaction. Banks deal with documents only. Likewise, banks are not equipped and are not required to be equipped with knowledge of customs and customary terms of the trade concerned.²⁶⁹

Issue 3 – Transferable Credits.

The UCP 600 continues to govern transfer and assignment of letter of credit proceeds, relevant provisions are found, respectively. In articles 38 and 39.²⁷⁰

Article 39 is devoted to transfer. As many other provisions of the new documents, the sub-articles were reordered and streamlined by use of definitions. With respect to Article 38 the definitions, however, are not moved to Article 2, which suggests that the terminology of the article is transfer-specific and cannot be used across the entire act. This is expressly reinforced in the definition sub-Article 38(b), which reads:

²⁶⁸ Compare the Rules 196-200 of the ISBP.

²⁶⁹ Hence, the *Rayner* rule remains good law.

²⁷⁰ Articles 48 and 49 of the UCP 500.

“For the purpose of this article:

Transferable credit means a credit that specifically states it is "transferable". A transferable credit may be made available in whole or in part to another beneficiary ("second beneficiary") at the request of the beneficiary ("first beneficiary").

Transferring bank means a nominated bank that transfers the credit or, in a credit available with any bank, a bank that is specifically authorized by the issuing bank to transfer and that transfers the credit. An issuing bank may be a transferring bank.

Transferred credit means a credit that has been made available by the transferring bank to a second beneficiary.”

According to the definition article, transferable credits are to be distinguished from transferred credits. Transferable credit is a credit that, labeled as such, may be made available in whole or in part to the second beneficiary. The use of the wording “making credit available” does not correspond with the expression “advancing funds” used in relation to negotiation credits.²⁷¹ While “advancing funds” denotes the activity of the bank (usually crediting an account), a credit “made available” denotes the right of the second beneficiary to use the credit. Accordingly, transferred credit is not a credit that has been used by the second beneficiary, but this expression refers to the state after the transferring bank has consented to the request of the first beneficiary.

Another new definition is that of “transferring bank”. Usually transferring bank will be a nominated bank²⁷² but Article 38 expressly contemplates the possibility of a transfer by an issuing bank. Mere authorization to transfer does not give the nominated bank the status of a transferring bank. The transfer must actually occur. It appears that a nomination coupled with issuance of transferable credit includes authorization for the nominated bank to transfer, while with credits freely available specific authorization from the issuing bank is needed.

²⁷¹ UCP Article 2.

²⁷² See illustration in the second chapter.

A new rule is now found in sub-Article 38(g). This provision repeats the former rule of sub-Article 48(h)²⁷³ that the transferred credit must accurately reflect the terms and conditions of the credit but clarifies that confirmation is to be reflected too. The list of exceptions is left without any change.

Sub-Article 38(k) is a completely new rule without any corresponding provision of the UCP 500. It provides that presentation of documents by or on behalf of a second beneficiary must be made to the transferring bank. This rule corresponds with traditional rule of transferable credits that the first beneficiary must be given the opportunity to substitute the second beneficiary's documents for his own.²⁷⁴

The remaining provisions of Article 38 remain substantially unchanged.

There are no changes in relation to assignment of the proceeds of a letter of credit. The relevant articles roughly mirror each other.

Issue 4 – Standby Letters of Credits.

Nothing has changed in respect of standby letters of credit. The new UCP continues to apply to standbys regardless the fact that there is a specific publication better designed for them, namely the ISP98. But so far, it has not gained so recognition and acceptance as to abandon the reference to standby credits in the UCP. This may change in the future as letter of

²⁷³ The rule was: “The Credit can be transferred only on the terms and conditions specified in the original Credit”.

²⁷⁴ UCP sub-Articles 38(h) and (i).

credit law will further develop. It should be however noted, that the ICC published uniform rules for demand guarantees,²⁷⁵ which are devices that compete with standby letters of credit.

²⁷⁵ Uniform Rules for Demand Guarantees (URDG 458), ICC Publication No. 458 (1992).

CONCLUSION.

Letters of credit owe its success to the principle of independence and standard of documentary compliance which is rather strict and forbids the document checker from looking into the underlying transaction.

These features have advanced letters of credit to one of central devices utilized in the international trade. Coupled with the flexibility of these instruments, backed up by their contractual nature, they have brought up numerous uses of letters of credits. Security function has many facets and, as shown in the second chapter, cannot be abstracted from the framework of a commercial transaction. But as letters of credit has become quite complete facility for trade financing, they borrowed many concepts from other areas of commercial law, notably the negotiability discussed earlier. This has in turn created confusion even for experienced practitioners. Such terms as negotiability, deferred payment, assignment and transfer have their specific meaning in the area of letter of credit law and cannot be understood the way they are understood in the areas of law they were taken from.

The standard of compliance have always been discussed in the letters of credit context. As shown in the second chapter, various standards were developed in this respect. As the doctrine of strict compliance has gained the most acceptance and is now even expressly stated in the American UCC, the ICC has always been reluctant to label the standard of compliance in international documents it published. Consequently, neither the UCP, nor the ISP98 has opted for any express choice. Instead, the way chosen to follow was the publication of detailed rules, in the UCP itself, but most notably in the ISBP, developing the doctrine of

international standard banking practice. This doctrine is now present in the ICC's publications and in the UCC. In the latter, it coexist with strict compliance, but this is not a problem as parties may opt for any standard they wish, save, perhaps the instance where it would amount to violation of the nature of letters of credits.

The new UCP follows this path, providing for some general rules on standard of examination of documents and referring to international standard banking practice and, naturally, to the terms and conditions of the credit. The new rules in the UCP appear to soften the often adopted strict approach which may produce undesirable results. Thus, it follows the guidelines set for the revision. The practice will show whether this approach was correct one. One result is definitely the increased number of detailed rules to follow by a document checker and this seems to be the main danger. New training for bankers will definitely have to follow the current revision of the UCP.

As regards the second main issue, which is related to the emergence of new methods of financing under letters of credit, the UCP 600 addresses this issue by providing rules concerning authority of nominated banks to finance under credits available by deferred payment and acceptance on one hand, and connecting this to the issue of reimbursement on the other. The *Banco Santander*-like cases have now uniform rules.

It needs to be pointed out that the new uniform rules do not entertain unnecessary details and may be departed from. The contracting parties need now be aware of the changes, and it is expected that they will be, for letters of credit transactions normally involve sophisticated parties.

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