By John W. Head

I. Introduction

Most international letters of credit — that is, letters of credit used in commercial transactions involving buyers and sellers in different countries — are not governed by the Uniform Commercial Code (UCC). Instead, they operate under the Uniform Customs and Practice (UCP), a multilateral set of rules that are issued and regularly updated by the International Chamber of Commerce (ICC). If your Kansas client is engaged in a transborder sale-of-goods transaction and wants to maximize the chances of getting paid by the foreign buyer, both you and your client should know the basics about the UCP.

The aim of this article is to provide a nutshell account of international letters of credit, with special emphasis on the UCP. The article focuses on commercial international letters of credit that are used in financing a transborder sale-of-goods transaction of the sort mentioned above. The article does not examine other types of international letters of credit that are commonly confronted in practice, such as standby letters of credit and back-to-back letters of credit.

II. The Setting: International Documentary Sales

Assume that your client, Shera Manufacturing Corp. (Shera), is a Kansas corporation with offices, facilities, and a warehouse in Wichita. Shera produces state-of-the-art geopositioning system (GPS) equipment and has sold that equipment for several years to buyers in the United States — but it recently entered into negotiations with a buyer in the Netherlands named Hugo de Groot Ltd. (Hugo), which wants the GPS equipment shipped to Rotterdam. Shera now seeks your legal advice about how the negotiations, and the transaction itself, should proceed, and particularly about how Shera can be assured of getting paid by Hugo. After all, Hugo is both physically and legally “distant” from Kansas, and Shera does not have total confidence in Hugo.
How might you advise Shera? First, you could point out that, as a general matter, the negotiations and procedure for the transaction can be regarded as falling into four parts: (1) formation of the sales contract, (2) arrangement of financing, (3) shipment of the goods, and (4) payment for the goods. Shera’s biggest concern is over the fourth part — getting paid — but addressing that concern requires proper attention to the other steps as well. You might identify those steps as follows:

Part 1: Formation of the sales contract
Step 1.1: Shera and Hugo negotiate the terms of the transaction, including the requirement of a documentary sale, with payment under a confirmed letter of credit with a U.S. confirming bank.

Step 1.2: Shera and Hugo conclude and sign a contract that fully reflects those negotiated terms.

Part 2: Arrangement of financing
Step 2.1: Hugo approaches its bank in the Netherlands, Amster Bank, and asks it to issue a letter of credit in favor of Shera.

Step 2.2: Amster Bank opens a letter of credit in favor of Shera — this makes it the “issuing bank” — and so advises its correspondent bank in Wichita, Prairie Bank. Amster Bank requests Prairie Bank to confirm the credit. Prairie Bank agrees to do this, thus becoming the “confirming bank.”

Step 2.3: Prairie Bank, in its capacity as the confirming bank, advises Shera that the issuing bank has opened the letter of credit and that Prairie Bank has “confirmed” it.

Part 3: Shipping of the goods and handling of the documents
Step 3.1: Shera is likely to engage a freight forwarder to make detailed arrangements for handling the goods at the port of shipment. Let us assume the parties have designated Houston for the port of shipment.

Step 3.2: Shera has the goods transported to the port of Houston where the freight forwarder facilitates their delivery to the carrier, the operator of the oceangoing vessel that will transport the goods across the Atlantic.

Step 3.3: The goods might be inspected by an inspection agent of Hugo; if so, that inspection agent issues a Certificate of Inspection.

Step 3.4: When the carrier’s vessel arrives in the port of Houston, the goods are loaded onto it, whereupon the carrier issues a negotiable bill of lading.

Step 3.5: Shera arranges for insurance coverage for the goods during their ocean transportation. In this regard, the insurer issues an Insurance Certificate.

Part 4: Payment for the goods and release to buyer
Step 4.1: Shera draws a draft on Amster Bank and presents it and the required documents to Prairie Bank for payment by Prairie Bank to Shera under the confirmed letter of credit. The required documents typically will include:

- Negotiable bill of lading endorsed by Shera;
- The Insurance Certificate;
- A packing list used in putting the GPS equipment into the cartons;
- The Commercial Invoice that Shera prepared for the sale of the goods;
- A Certificate of Origin that Shera would have secured — probably from the Wichita Chamber of Commerce or some similar entity — showing that the GPS equipment comes from the United States; and
- The Certificate of Inspection, if required.

Step 4.2: If Prairie Bank finds that the documents presented by Shera match the documents required in the letter of credit, then Prairie Bank honors the draft and pays Shera.

Step 4.3: Prairie Bank endorses the bill of lading and then forwards it and the other documents listed above to Amster Bank, which pays Prairie Bank, probably by crediting an account that Prairie Bank has with Amster Bank.

Step 4.4: Amster Bank endorses the bill of lading and then transfers it and the other documents to its customer Hugo, typically by charging Hugo’s account with Amster Bank or by giving credit to Hugo.

Step 4.5: When the goods arrive by vessel at the port of destination, Hugo presents the negotiable bill of lading, as endorsed by Amster Bank, to the carrier, whereupon the carrier releases the goods to Hugo.

See Illustration A for a stylized diagram summarizing the movement of goods, documents, and money as described in the pertinent steps enumerated above under a documentary sale with a confirmed letter of credit.

The document that serves as a “lynchpin” in the transnational documentary sale transaction described above is the letter of credit. If properly used, that letter of credit can make the transaction proceed smoothly, to the benefit of all parties involved: the seller gets paid promptly, the buyer receives the goods as ordered, the issuing and confirming banks earn fees for temporarily accepting risks that they were in a good position to assess and bear, the carrier has been paid for transporting the goods, and the freight forwarder has earned a fee for facilitating the movement of goods and documents at the port of shipment.

However, such transactions sometimes do not proceed smoothly. For example, the documents presented by
the seller, in the hypothetical case described above, to the confirming bank might include some discrepancy when compared to the description that the letter of credit gives of the documents that are required thereunder. (As noted below, there are several different types of discrepancies.) In such a case, a question arises for the bank: Should the bank accept those documents and pay the seller, notwithstanding the discrepancy? If it does accept and pay, a similar question would arise when the issuing bank receives the documents (including the discrepancy) from the confirming bank. Another question also might arise: How long does the issuing bank have to make up its mind about accepting or rejecting the documents? And does it have a duty to contact the buyer (its customer) to see if the discrepancy concerns the buyer? Questions of these types, and of many other types, have arisen countless times in transnational documentary sales involving letters of credit, and, not surprisingly, different answers have been given in different legal systems. Because of the role that London has long played as an international commercial and financial center, English law was for years a dominant source of guidance in handling such questions. More recently, an internationally accepted set of rules, the UCP, has largely supplanted the English law — although the latter continues to be influential. The internationally-accepted rules are discussed in the following paragraphs.1

III. The Fundamentals of International Letters of Credit

One source provides this overview of letters of credit:

A letter of credit, in its most basic form, involves three parties: two parties who have entered into a contract between themselves, and a separate, independent party who will guarantee certain funds to one of the contracting parties on behalf of the other party.

In a typical situation, the contracting parties are a buyer and a seller. The third party is most commonly a bank. The bank issues the letter of credit, which is entirely independent of the contract, to the seller on behalf of the buyer. The letter of credit usually reads like a letter and states that the bank will pay the beneficiary (seller) the amount specified in the letter of credit, upon the presentation [by the seller to the bank] of all the documents specified in the letter. The documents (e.g., bills of lading, invoices, affidavits of certain officials, and/or packing lists) serve as proof of the proper completion of the transaction. All the documents must be properly presented in the form specified, otherwise the letter of credit will not be honored at that time.

FOOTNOTES
1. This discussion draws heavily from John W. Head, GLOBAL BUSINESS LAW (2d ed. 2007). For excellent detailed treatments of international letters of credit, see Letters of Credit, appearing in Business Laws Inc., 2 CORPORATE COUNSEL’S GUIDE TO LAWS OF INTERNATIONAL TRADE (loose-leaf) chap. 705 (2005). Another source, focusing especially on nuts-and-bolts issues of letters of credit, is G. Gregory Letterman, LETTERMAN’S GUIDE TO INTERNATIONAL BUSINESS (vol. 6A) (1996) at chapter 6.

... There is a fee for obtaining a letter of credit from the bank, and the customer [the buyer in the transaction] will [typically] have to arrange for security. The customer begins by completing the application, [which] is the legal agreement between the bank and the applicant/customer. ... The information typically asked is:

(1) applicant’s name [and] address;
(2) beneficiary’s name [and] address;
(3) amount of the credit;
(4) tenor of the draft — that is, whether the letter of credit will require presentation of a sight or time draft [that is, payable “at sight” or payable at a specified later time] ... ;
(5) documents required to be presented;
(6) description of the merchandise;
(7) trade definitions or terms ... ;
(8) point of shipment; and
(9) expiration date, or the last date on which the documents may be presented to the bank for payment.

... [Among the] fundamental principles [that] govern the operation of letters of credit [are these]:

(1) The rule of independence, by which the letter of credit is considered independent from the sales contract or any other agreement between the parties; [and]
(2) The rule of strict construction, by which the terms and conditions of the letter of credit are strictly adhered to ...

... [The first of these, the rule of independence, is straightforward.]
Letters of credit are self-contained agreements involving the bank, the bank's customer, and the beneficiary. The bank has the duty to look only at the propriety of the documents presented and does not have a general duty to investigate the underlying performance. As with negotiable instruments, such as checks, parties to a letter of credit are bound to pay according to their obligates as set forth in the credit, regardless of any developments that have occurred in the underlying transactions — with, perhaps, the possible exception of extreme fraud.

... Because the letter of credit is independent from the underlying transaction between the parties, the only real [safeguard] available to the bank customer opening a credit is the ability to specify exactly to whom and on what terms it will be paid. When the... documents presented do not conform to the specifications set forth in the letter of credit, questions of strict construction are raised.

The following two sections of this article examine those two fundamental principles — first the principle of strict construction, more accurately referred to as strict "compliance," and then the principle of independence.

IV. The Principle of Strict Compliance

A case decision often cited to illustrate the principle of strict compliance — the principle that the documents as submitted must strictly comply with (or match) the description of the documents as set forth in the letter of credit — is the Rayner decision from the English Court of Appeal. In that case, decided in 1943, the question was whether a confirming bank acted properly in refusing to pay a seller in England that had submitted documents relating to a shipment of nuts that were to go to a buyer in Denmark. The bank's refusal to pay rested on the fact that whereas the letter of credit (issued by a bank in Denmark) had called for the documents to refer to "Coromandel groundnuts," one of the documents (the bill of lading) had referred instead to "machine-shelled groundnut kernels." The commercial invoice had in fact referred (properly) to "Coromandel groundnuts." The seller had presented evidence at trial that the two terms — "Coromandel groundnuts" and "machine-shelled groundnut kernels" meant exactly the same thing, as anyone involved in the trade, at least in London, would know.

The Court of Appeal ruled in favor of the confirming bank, saying that its refusal to pay the seller had been proper. The court's opinion has been widely cited as a clear expression of the principle of strict compliance:

In [an earlier case, one of our fellow judges has] said: "It is elementary to say that a person who ships in reliance on a letter of credit must do so in exact compliance with its terms. It is also elementary to say that a bank is not bound or indeed entitled to honour drafts presented to it under a letter of credit unless those drafts with the accompanying documents are in strict accord with the credit as opened." And Lord Sumner in Equitable Trust Co. v. Dawson Partners Ltd. said:

"It is both common ground and common sense that in such a transaction... the accompanying documents [must comply] strictly [to the terms of the letter of credit]. 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 defendant bank [in this case] were told by their Danish principals to issue a letter of credit under which they were made to accept documents — an invoice and bills of lading — covering "Coromandel groundnuts in bags." They were offered bills of lading covering "machine-shelled groundnut kernels." ... The words in that bill of lading clearly are not the same as those required by the letter of credit. [Therefore] the bank was entitled to refuse to accept this sight draft on the ground that the documents tendered, the bill of lading in particular, did not comply precisely with the terms of the letter of credit, which they had issued. ... [It is of no consequence that businessmen who deal in such things know that the two terms mean the same thing],... for it is quite impossible to suggest that a banker is to be affected with knowledge of the customs and customary terms of every one of the thousands of trades for whose dealings he may issue letters of credit.

(Continued on next page)
The Raynor case illustrates the principle of strict compliance, as it was applied in English law more than six decades ago. A more recent rendition of that principle appears in the UCP — or, as it is officially cited, the “Uniform Customs and Practice for Documentary Credits (2007 Revision) International Chamber of Commerce Publication No. 600.” The pertinent provisions of the UCP are reprinted below, with particularly important parts underlined.

UCP Article 14, Standard for Examination of Documents

a. A 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.

b. A 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.

d. 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.

g. A document presented but not required by the credit will be disregarded and may be returned to the presenter.

UCP Article 15, Complying Presentation

a. When an issuing bank determines that a presentation is complying, it must honour.

b. When a confirming bank determines that a presentation is complying, it must honour or negotiate and forward the documents to the issuing bank.

UCP Article 16, Discrepant Documents, Waiver and Notice

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

b. When an issuing bank determines that a presentation does not comply, it may in its sole judgement approach the applicant for a waiver of the discrepancies. This does not, however, extend the period mentioned in sub-article 14 (b).

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

The notice must state:

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

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

f. If an issuing bank or a confirming bank fails to act in accordance with the provisions of this article, it shall be precluded from claiming that the documents do not constitute a complying presentation.

The reason why your client Shera (in the hypothetical case introduced above) should care about these rules is that they are almost universally used in international documentary letters of credit. The Uniform Commercial Code (UCC) rules that Shera (or Shera’s lawyers) might be familiar with in the context of domestic documentary sales transactions almost never apply to international documentary sales transactions. Why? Because a decades-long process of creating and updating an international set of rules has been undertaken by the International Chamber of Commerce (ICC), a group of international experts in commercial law and practice, and has resulted in their nearly universal acceptance. As noted above, the most recent iteration in that updating process appeared less than a year ago, in mid-2007.

The specific manner in which the UCP is made applicable to an international documentary sale of goods involving a letter of credit transaction is “incorporation by reference.” That is, in a letter of credit that a bank prepares for a customer in connection with an international sale of goods transaction, the UCP will usually be incorporated by reference. Illustration B shows such a letter of credit. Notice the next-to-last paragraph in the letter.

(Continued on Page 22)
Date of Issue: 9 March 2008

Beneficiary:
Shera Manufacturing Corporation
802 West Book Farm Terrace
Wichita, Kansas

Issuing Bank:
Amster Bank
1648 Westphalia Ave.
Amsterdam, Netherlands

To: Shera Manufacturing Corporation

Dear Sir/Ms:

We are instructed by Amster Bank to inform you that they have opened their irrevocable credit as detailed above, available by negotiation of your drafts at sight drawn on Amster Bank when accompanied by the following documents:

* Commercial Invoice (1 original and 3 copies) covering:
  120 Units GeoStat SuperStar GPS Model R-444 — CIF Rotterdam (Incoterms 2000)
* Packing list and 2 copies
* Full set of clean “On Board” negotiable ocean bills of lading, endorsed in blank marked “Freight Prepaid,” showing “notify Raj Eyck, customs broker, 14 Hoek Pl., Amsterdam”
* Marine insurance policy or certificate, covering All Risks and War Risks
* Certificate of origin and 1 copy
* Certificate of inspection issued by GSG ICPSI showing conformity within technical parameters as advised by Hugo de Groot.

Special Instructions:
* Documents must be presented not later than 10 days after date of shipment but prior to expiration of the credit
* Shipment from Houston, Texas to Rotterdam, Netherlands
* Partial shipments: Not allowed
* Transhipments: Not allowed

This credit is subject to the Uniform Customs and Practice for Documentary Credits (2007 Revision) International Chamber of Commerce Publication No. 600.

We confirm the credit and hereby undertake to purchase all drafts drawn as above specified and accompanied by the required documents.

Confirmation Date: 10 March 2008

By: ____________________________
International Credit Department
LEGAL ARTICLE: HOW LETTERS OF CREDIT OPERATE...

The next-to-last paragraph of this letter of credit makes the UCP applicable to it. Hence, the provisions shown above from Articles 14 to 16 would apply, requiring Sherco to present to Prairie Bank (the confirming bank) the documents exactly as set forth in the letter of credit. Specifically, Article 14a requires that the documents "appear on their face to constitute a complying presentation" — that is, that they are "in accordance with the terms and conditions of the credit" — and Article 2 provides that whether they are in fact in compliance shall be determined by "international standard banking practice." Article 14b allows the bank "a maximum of five banking days following the day of presentation" of the documents, to examine them to see if they are in compliance. If they are, the bank must, according to Article 15, honor them. If they are not, the bank may, according to Article 16, refuse to honor them. That is, it may refuse to pay.

What if there is a very minor point of noncompliance? The UCP is structured in such a way as to protect the bank(s) against having to make judgments of what is and what is not a "minor" point of noncompliance. The reason for this is to minimize the risks to banks and thereby keep the cost of letters of credit low enough to make them attractive as means of facilitating payments in transnational transactions. Just as in the Raynor case referred to above, banks are not expected to know the intricacies of transactions for which they issue and confirm letters of credit. Nor are they expected to ask. As made clear in UCP Article 16b, an issuing bank has no duty to contact the shipper (its customer) to see if the seemingly minor discrepancy concerns the buyer. According to that provision, "[w]hen an issuing bank determines that a presentation does not comply, it may in its sole judgment approach of the applicant for a waiver of the discrepancies." (emphasis added)

It would seem natural, however, that surely some sorts of discrepancies (between documents as submitted and documents as required in the letter of credit, that is) would be so small as to lie outside the scope of the principle of strict compliance. For example, what if there is one single typographical error in a document — say, the bill of lading? Would a bank be justified in refusing to pay against the documents in such a case of a typographical error? One well-known U.S. case illustrated this issue by examining whether a typographical error in the name of the person to whom notice was to be given of the arrival of the goods was sufficient to support the confirming bank's refusal to accept the documents.

In May 1979, Beyene sent Irving all of the documents required under the terms of the letter of credit. Thereafter, Irving telephoned [National Bank of Washington] NBW to inform it of several discrepancies in the submitted documents, including the fact that the bill of lading listed the party to be notified by the shipping company as Mohammed Soran instead of Mohammed Sofan. ... Irving refused to pay.

While some variations in a bill of lading might be so insignificant as not to relieve the issuing or confirming bank of its obligation to pay, we agree with the district court that the misspelling in the bill of lading of Sofan's name as "Soran" was a material discrepancy that entitled Irving to refuse to honor the letter of credit. First, this is not a case where the name intended is unmistakably clear despite what is obviously a typographical error, as might be the case if, for example, "Smith" were misspelled "Smith." Nor have appellants claimed that in the Middle East "Soran" would obviously be recognized as an inadvertent misspelling of the surname "Sofan." Second, "Sofan" was not a name that was inconsistent to the document, for Sofan was the person to whom the shipper was to give notice of the arrival of the goods, and the misspelling of his name could well have resulted in his nonreceipt of the goods and his justifiable refusal to reimburse Irving for the credit. ... In the circumstances, the district court was entirely correct in viewing the failure of Beyene and NBW to provide documents that strictly complied with the terms of the letter of credit as a failure that entitled Irving to refuse payment.

Another point is worth examining regarding the application in practice of the principle of strict compliance: How comprehensive and specific do the documents as presented to a bank need to be in order to "match" adequately the documents as described in the letter of credit? The key UCP provisions touching on this issue also appear in Articles 14-16 reprinted above. Among other things, those provisions state that the details in a document "need not be identical to, but must not conflict with" the details in "any other stipulated document or the credit." This tells us that there must not be inconsistencies between two of the documents. Presumably, if any one document (among the set of documents being presented to a confirming or issuing bank) has a nonconforming element, then that nonconformity is not "cured" by the fact that another document was compliant. Recall that in the Raynor case the commercial invoice properly noted "Coromandel groundnuts"; this fact could not overcome the fact that the bill of lading carried the term "machine-shelled groundnut kernels."

IV. The Independence Principle and Its Exceptions

Another of the fundamental principles applicable to letters of credit asserts that the letter of credit is to be considered independent from the sales contract or any other agreement
I seller's fraud has been called to the bank's attention before the contract of sale will typically not provide grounds for interrupting the payment under a documentary letter of credit, as long as the documents themselves, as presented by the seller, comply with the terms of the letter of credit.

A famous old U.S. case— not resting on UCP rules but generally regarded as reflective of their intent— illustrates this principle. At issue was whether a bank should pay the seller under a letter of credit relating to a sale of paper that, according to the underlying contract, was to be of a specified tensile strength. The letter of credit did not require the submission of any document certifying that factual matter. The court ruled that the bank was to pay under the letter of credit despite a deficiency in the quality of the paper:

If the paper when delivered did not correspond to what had been purchased, either in weight, kind, or quality, then the purchaser had his remedy against the seller for damages. Whether the paper was what the purchaser contracted to purchase did not concern the bank and in no way affected its liability. It was under no obligation to ascertain, either by a personal examination or otherwise, whether the paper conformed to the contract between the buyer and seller. The bank was concerned only in the drafts and the documents accompanying them. This was the extent of its interest. If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for. ...”

It is noteworthy that the principle of independence is almost surely subject to an exception in the case of fraud. This exception has been developed in case law. It is generally thought that where the documents submitted by a seller are fraudulent— in that they do not represent actual merchandise but instead cover boxes fraudulently filled with worthless material— then a bank is not required to pay against those where the seller’s fraud has been called to the bank’s attention before the documents have been presented to the bank for payment. In other words, in such a case the principle of the independence of the bank’s obligation under the letter of credit should not be extended to protect the unscrupulous seller. Obviously, this fraud exception can be important in some cases. The UCP offers little guidance in this regard, however, so uncertainty can arise about the exact scope of the fraud exception in actual practice in cross-border letter-of-credit transactions. The reason why the drafters of the UCP have not defined clearly the contours of the fraud exception is (according to some sources) that the UCP provisions are designed to serve as rules of best banking practice, not rules of law, and issues of fraud are traditionally regarded as legal issues. Not surprisingly, some authorities, and many lawyers, find this situation unsatisfactory.

V. Conclusion

To sum up: Letter of credit transactions— including in particular those international letter of credit transactions governed by the UCP— proceed on the basis of certain principles designed to protect the banks involved against undue responsibility and liability. Hence the principle of strict compliance and the principle of independence. There are, to be sure, some exceptions to these principles— as in the case of a single, patently unimportant typographical error, or as in the case of fraud known by the bank before paying against documents. These exceptions are, however, very narrow. Why? In part because any significant expansion of the exceptions would expose the banks to substantially greater risks, which in turn would naturally increase the costs the banks would charge for undertaking letter of credit obligations.

Lawyers assisting their clients with cross-border commercial transactions need to be aware of the facilitative role that letters of credit can play in those transactions. Such letters of credit, when properly used, can reduce risk both to the seller (of not getting paid) and to the buyer (of getting nonconforming goods). Specifically, lawyers need to have at least a basic understanding of the rules that govern the use of letters of credit in documentary sales. The most commonly used rules appear in the ICC’s Uniform Customs and Practice, which are incorporated by reference into most letters of credit for such transnational transactions.

About the Author

John W. Head is a professor of law at the University of Kansas School of Law. His teaching and scholarship focus on international business law, public international law, and comparative law. He is the author of “Global Business Law” (2nd ed. 2007) and several other books and articles. Able assistance in the preparation of this article was provided by Katie Lula and Justin Waggoner. The article is dedicated to Shera Bhala and her parents.