

**STRIKING THE BALANCE BETWEEN THE CONSIDERATIONS OF
CERTAINTY AND FAIRNESS IN THE LAW GOVERNING LETTERS
OF CREDIT**

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Abstract

Given that Commercial Law tries to balance considerations of certainty and fairness, it follows that the law relating to letters of credit, as part of the general body of Commercial Law, involves a similar balancing exercise. This thesis argues that this balance should employ five basic principles, namely: (1) party autonomy (freedom and sanctity of contract); (2) certainty; (3) flexibility; (4) fairness; and (5) good faith.

The thesis begins with a brief introduction to the objectives of the study. Chapter one introduces readers to the basis of letters of credit and the historical background. The five basic principles and the tensions between them are examined in chapter two. Chapter three discusses briefly how these five basic principles are applied to the law regulating letters of credit. Chapter four focuses on disputes arising between the issuing bank and the beneficiary, evaluating in particular the principle of independency and the fraud exception. The most important doctrine in the law of letters of credit, the doctrine of strict compliance is explored in chapter five. Disputes between the issuing bank and the applicant are examined in chapter six and the standard of compliance governing the reimbursement agreement (whether strict compliance or bifurcated compliance) is evaluated in the light of the basic principles. Chapter seven, deals with disputes between the applicant (buyer) and the beneficiary (seller), evaluating the law on the nature of payment (whether absolute-conditional) in the light of the basic principles.

The concluding chapter draws on the key points of the thesis to put forward an overview as to the adequacy of the law. Essentially, the law founds itself on two cornerstone principles, the independency principle and the doctrine of strict compliance. Whereas the former protects the interests of sellers, the latter protects the interests of buyers. In each case, however, the principle designed for protection

(and certainty) can be turned into a principle licensing unfairness—in one case, shielding fraudulent sellers, and in the other case shielding bad faith buyers.

In the modern law, the central problem is to find the right way of addressing and balancing these competing considerations. The main proposals offered in the thesis recommend that the qualified strict compliance test be adopted and where actual fraud has taken place or is suspected on reasonable grounds by the bank, the fraud exception should operate. In addition, and with a view to striking the right balance between certainty and fairness, it is suggested that punitive damages be awarded exceptionally in cases where good faith and gross negligence have taken place, that the bifurcated compliance standard should be adopted where the issuer has been considered to have acted in good faith and without harming the customer, and that conditional payment be adopted in relation to payment under documentary credit.

It should be emphasised that the position argued for in this thesis is that there should be some marginal adjustment to the ruling doctrines. No modification should be considered, however, where the essential certainty of the law would be jeopardised.

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Dedication

To My Father's Soul

and

To My Mother

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Appendix B: U.C.C. - Article 5 - Letters of Credit (Original Version)	

Appendix C: U.C.C. - Article 5 - Letters of Credit (Revised 1995)

**Appendix D: Uniform Commercial Code Revised Article 5 (1995)
Compared With the Original Version—Letters of Credit**

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Introduction

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Introduction

Numerous academic works have been dedicated to the subject of the law governing letters of credit¹. Indeed, letters of credit are seen as indispensable to the smooth transaction of commerce in almost every century; their history can be traced back to 3000 BC, during the era of ancient Babylon. They are often described as a special contract, with the applicant, the beneficiary and the issuing bank as the main parties, so the general principles governing the law of contract should be equally applicable to them. It is widely recognised that Commercial Law tries to balance considerations of certainty and fairness, from which it follows that the law relating to letters of credit, as part of the general body of Commercial Law, can be expected to involve a similar balance. The central aim of this thesis is to look more carefully at this balance, doing so by employing five basic principles which arguably should govern the law relating to letters of credit. These five principles concern autonomy (freedom and sanctity of contract), flexibility, certainty, fairness and good faith.

Despite the huge volumes of academic writing on the law of letters of credit, so far, nothing substantial has been written on the application of the five basic principles to the law governing letters of credit. Accordingly, this thesis aims to:

- describe the law governing the framework and the mechanism of letters of credit;
- critically examine (in the light of the five basic principles) the main issues in the law of letters of credit: namely (i) the availability of punitive damages; (ii) the independency principle and fraud in the underlying transaction; (iii) fraud by a third party; (iv) the impact of fraud (bad faith actions) committed

¹ As regards the technical terms used in this thesis, the terms 'commercial letter of credit', 'documentary letter of credit', 'letter of credit' and 'credit' have been used to mean the same. Also, the bank which opens the credit has been referred to as the 'opening', 'issuing' bank or the banker and the person in whose favour the credit is issued has been referred to as 'beneficiary' or 'seller'. Finally, the person who applies for the credit has been referred to as the 'applicant' for the credit, the 'account party' or the 'buyer'.

by the seller (beneficiary) on both innocent bank and buyer in relation to the reimbursement contract; (v) the prevailing standard of compliance in the “reimbursement” contract (whether “strict compliance” or “bifurcated compliance”); (vi) absolute and conditional payment and the position of buyer and seller on banker’s insolvency; and finally (vii) the three rival tests of compliance, i.e. the “strict compliance” test, the “substantial compliance” test and the “qualified strict compliance” test;

- illustrate the conflict between the five basic principles in relation to those issues;
- assess the adequacy of the law governing letters of credit in relation to the five basic principles; and
- formulate a number of proposals which are designed to make the law more sensitive to question of fairness but without sacrificing the certainty that is essential for commercial dealings.

In so doing, the thesis largely focuses upon the law regulating letters of credit in the United Kingdom, the UCP² and the UCC³ Article 5.⁴

The introductory chapter, chapter one, aims to introduce readers to the basis of letters of credit and the historical background. It also gives a general idea about how documentary letters of credit operate in the area of international finance

² The UCP is the “Uniform Customs and Practice For Documentary Credits”. ICC Publication No. 500 Effective January 1, 1994.

³ The American Uniform Commercial Code. Article 5 of it is concerned with letters of credit.

⁴ It is to be noted here, in relation to Article 5 of the UCC, that the research has consulted the original Article rather than the revised (1995) version. This is because at the time of writing this thesis the revised Article 5 has not been adopted by all of the American States. The author has been in touch with the American Law Institute (ALI) inquiring about the possible effective date when it will be in force. The answer was that the (ALI) works with the National Conference of Commissioners on Uniform State Law (NCCUSL) on revising and augmenting the Uniform Commercial Code (UCC). Following NCCUSL’s approval of revisions to Article 5, the Institute approved the revised article at its 1995 ALI Annual meeting. Once an act is officially approved by ALI and NCCUSL, it is up to the individual states, on a state-by-state basis, to create legislation enacting the official revisions and additions to the Code. However, in order to bring this study up to date, the author has added a special Appendix, Appendix D, examining the revised Article 5 and comparing it with the original one expressing the new modifications that the revised Article has come with, in relation to the issues under examination.

and trade. The five governing basic principles are examined in section one of chapter two. Tensions between these principles are the centre of concern in section two of the chapter. Chapter three discusses briefly how these five basic principles are applied to the law regulating letters of credit. Chapter four focuses on the relationship between the issuing bank and the beneficiary. Section two of this chapter evaluates first of all, the principle of independency and its fraud exception, and secondly the availability of damages to the beneficiary in the light of the aforementioned principles. The most important doctrine in the law of letters of credit, the doctrine of strict compliance, will be explored and evaluated in chapter five. Disputes between the issuing bank and the applicant are examined in chapter six and those between the applicant (buyer) and the beneficiary (seller) are dealt with in chapter seven. The final chapter draws on the key points of the thesis to put forward a concluding overview as to the adequacy of the law.

The core ideas of this thesis can be put in the following way. Traditionally, the law of letters of credit gives a very high priority to the value of certainty. This is reflected in such fundamental principles as that of strict compliance (requiring the documents tendered to conform precisely to the terms of the credit arrangement) and independency (according to which the credit arrangement operates at a distance from the underlying sales contract). However, it is generally accepted that the modern law of contract has been moving away from doctrine designed for certainty to doctrine designed for fairness in transactions. In English law, the Unfair Contract Terms Act 1977 is frequently cited as a clear example of this movement. There is a sense, therefore, in which the modern law of contract is pulling against the law of international trade in which certainty has been regarded as of the essence. In this context, this thesis is more than an essay in description. It considers not only existing doctrine and the values implicit in such doctrine, but also whether the modern law of letters of credit should follow the modern law of contract in re-striking the balance between certainty and fairness.

The position argued for in this thesis is that there should be some adjustment of the law of letters of credit, that certainty should not be the absolute priority, that some allowance should be made for fairness between the parties, and that the law should take some steps to protect parties against bad faith manipulation of their rights. In saying this, and to avoid any misunderstanding, two important points should be emphasised.

First, although the argument is that there should be some adjustment of the law, it would be quite wrong to think that this amounts to an abandonment of certainty for the sake of fairness. On the contrary, the position advanced in this thesis treats the maintenance of certainty as the first consideration and, to this extent, it is in line with traditional commercial thinking. However, it is suggested that, in some cases, doctrine can be *marginally* adjusted in order to respond to the worst cases of unfairness but without sacrificing certainty. So, for instance, it is argued that a doctrine of qualified strict compliance might be more appropriate than the classical doctrine of strict compliance. At the same time, however, it is argued that a doctrine of substantial compliance would not be appropriate because this would give more than a margin of appreciation for considerations of fairness and would seriously undermine the certainty of the law. Another way of putting this is to say that the law of letters of credit cannot serve its purpose unless it passes a threshold of certainty. The argument in the thesis fully accepts that this is so and, in proposing that the traditional threshold should be adjusted in some cases, the argument is that such adjustments are to be only very slight ones.

Secondly, in England at least, there has been a debate for some time about whether the modern law of contract should incorporate a general doctrine of good faith. The debate is not about whether there should be a requirement of subjective good faith (which is essentially a requirement of honesty) but about whether there should be a general principle of objective good faith, in the sense of a general principle of fair dealing. Although the principal argument of the thesis is that there should be some adjustment to doctrine, it is no part of this

argument that a general doctrine of good faith (in an objective sense) should be adopted. The problem with a general doctrine of good faith (in this objective sense) is that it needs an agreed reference point on which it draws for its standard of fair dealing. In the case of letters of credit, the UCP represents a quite remarkable attempt to draw together practice. Even so, if the law adopted a general doctrine of good faith (in an objective sense), and if questions of fair dealing were then judged by reference to international banking practice, this would satisfy the requirement of *certainty* only if one could be confident that practice was more or less uniform. So long as banking practice varies from one community to another, the position taken in this thesis is that it would be inappropriate for the law of letters of credit to take such a bold step in the direction of fairness.⁵

In sum, the premise on which this thesis is written is very close to traditional thinking. It is that, without certainty, the law of letters of credit cannot function. So, first, there must be certainty and then (so long as certainty is not sacrificed) there can be some adjustment for fairness. Hence, the adjustments to doctrine that are proposed (such as the argument in favour of qualified strict compliance) are only marginal; and suggestions for more sweeping changes to doctrine (such as the idea of a general doctrine of objective good faith) are firmly rejected.

⁵ The same applies to a general doctrine of reasonable expectations. See, Chapter Two, Section One, (5.6.).

Chapter One: General Background

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Chapter One: General Background

1. The Basic Commercial Functions of a Letter of Credit

Documentary credits, or letters of credit as they are most commonly called, are without doubt one of the most effective methods of financing an export transaction. They have been described as the 'lifeblood' of international trade.¹ They symbolise the most secure mode by which a seller may obtain the price of goods he has contracted to sell. They originate from international sale transactions involving distant buyers and sellers.² This method of payment is used where an exporter, who contracts to sell goods or provide services to a foreign buyer, is reluctant to dispatch the subject matter of the contract in reliance on the buyer's own credit, either because the buyer is unknown to him or equally because the seller is uncertain about the buyer's creditworthiness. On the one hand, the seller is unwilling to face the risk of the buyer's insolvency or dishonesty in situations where the buyer wrongfully refuses or delays payment on the grounds of breach of contract;³ on the other hand, the buyer is reluctant to part with his money until the goods are dispatched to him. Therefore, one method of solving this is to reach a compromise, which is achievable if the buyer in the underlying contract of sale, agrees to bring about the opening of a commercial credit by a reliable bank in his own locality in favour of the seller. The credit is then advised to the seller, usually, but not always, through a bank in the seller's own country (called the 'advising bank'), which may or may not be the exporter's own bank. The seller, therefore, becomes assured of being paid the purchase price following his dispatch of the

¹ Per Kerr, J., in *R.D. Harbottle (Mercantile) Ltd. v National Westminster Bank Ltd* [1978] Q.B. 146, 155. See generally Davis A.G., 'Commercial Letters of Credit' 5 *Sydney Law Review* (1965) 14 at 14.

² Adam, M. I., 'The Perceived Problems in the Utilisation of Letters of Credit: A Comparative Study'. A Ph.D Thesis, (1991). p. 1. See also Forte, A.D.M., 'United Kingdom: Payment "Under Reserve"' *Journal of World Trade Law* (1983) 355, at 355; Day, D.M., *The Law of International Trade* (2nd ed.) (Butterworths, London, 1993) p. 154.

³ Adam, M. I., *supra* note 2 at 1.

goods and tendering the shipping documents to the bank.⁴

The nature of the letter of credit mechanism is best illustrated by a hypothetical example: suppose a Jordanian dealer in computers (buyer) wishes to purchase a consignment of computers from a British manufacturer (seller). No information about the buyer or his creditworthiness is known by the seller. He may question the possibility of being paid upon shipment of the consignment, as the buyer might become insolvent or refuse payment for any dilatory act as an excuse for non-payment. Confronted with this situation, the seller would have to raise an action against the buyer in Jordan, as well as incurring the expenses of disposing of the goods. In order to prevent the occurrence of such a risk and be sure of being paid upon shipment, the seller would ask the buyer to either pay cash in advance or procure the opening of a letter of credit in his favour, usually, an irrevocable confirmed credit. In the usual circumstances the *buyer* will prefer to pay via the credit arrangement, even though he has to pay for the bank services because he thereby becomes assured that the payment will not be effected until the documents are checked. Consequently, the buyer approaches his banker in Amman, and fills in a standard application form provided by the issuing bank on acceptance of which the issuing bank undertaking takes place. On the application form, the buyer specifies the documents he requires to be tendered along with the seller's drafts. The buyer then undertakes to pay a commission and to reimburse the issuing bank or provide it in advance with the amount payable under the credit. The issuing bank may demand a collateral security from the buyer to secure subsequent reimbursement. Having agreed to all the credit conditions, a binding contract is formed between the issuing bank and the buyer. Once an irrevocable confirmed credit is agreed to, the Amman banker communicates with a London banker to advise and undertake to honour the seller's drafts upon tender of complying documents.

⁴ Penn, Shea, Arora., *The Law and Practice of International Banking Law* vol. 2 (London, Sweet & Maxwell, 1987) p. 290.

The credit arrangement comes into play once the beneficiary is notified of it. The confirming bank's undertaking to the seller is absolute, direct, primary and also independent from any other contractual relationship, i.e. the underlying contract and the reimbursement contract, provided that the terms and conditions of the credit are complied with.

The seller's duty is to deliver the consignment to a carrier at the designated place of shipment and obtain a negotiable bill of lading, a document of title showing that he is the owner of the goods. Other documents, such as an insurance policy and certificates of origin or quality, may also be required. Upon shipment of the consignment, the seller or a collecting bank presents a draft drawn under the credit along with an invoice and other required documents. On tender of regular and conforming documents, the confirming banker must pay⁵, even though the consignment is still in transit.

This arrangement results in substituting the buyer's credit with the paying bank's credit against which the seller (beneficiary) is assured of being paid. The advantages that the confirmed credit grant are (i) in case of default in payment, the beneficiary need not sue the buyer or the issuing bank in a foreign jurisdiction, instead, he can directly bring an action against the confirming banker in his own domestic courts;⁶ (ii) the seller (beneficiary) can avoid some potential risks related to letters of credit such as currency blocking, inconvertibility and exchange rate fluctuations, by receiving payment in his own currency; (iii) the beneficiary, by receiving prompt payment on tender of the requisite documents, resolves the problem of tying up capital whilst the goods are in transit. In addition, the buyer benefits by postponing payment until the shipping documents have been checked by the bank.⁷

⁵ See about the nature of payment clause whether absolute-conditional, Chapter Seven, Section One, (6.2).

⁶ Adam, M. I., *supra* note 2 at 2.

⁷ Ellinger, E P., 'The Relationships Between Banker and Buyer Under Documentary Letters of Credit' 7 *U. Western Australia L. Review* (1965) 40 at 40; see also Comment, 'Commercial Letters of Credit: Development and Expanded Use in Modern Commercial Transactions' 4 *Cumberland-Samford Law Review* (1973) 134 at 145.

It is interesting to reveal further details of this commercial arrangement by examining briefly the historical development of the letter of credit and some issues therein. However, it is important to define the documentary credit itself beforehand.

2 What is a “Letter of Credit”?

A documentary credit can be defined as a bank undertaking to pay a sum of money to the person in whose favour the credit is issued, or to accept or purchase a bill of exchange drawn or held by that person. However, this “undertaking is usually conditional on the presentation of certain specified documents to the bank showing that the goods described in the credit have been dispatched to the buyer”.⁸ Barclays Bank’s version states that a documentary credit is a written undertaking given by a bank on behalf of the importer to pay the exporter an amount of money within a specified time provided the exporter presents documents which conform with the terms laid down in the letter of credit.⁹

A comprehensive definition of documentary credit is to be found in the Uniform Customs and Practice for Documentary Credits¹⁰ where it provides:

“For the purpose of these Articles, the expressions ‘Documentary Credit(s)’ and ‘Standby Letter(s) of Credit’ (hereinafter referred to as ‘Credit(s)’) mean any arrangement, however named or described, whereby a bank (the ‘issuing bank’) acting at the request and on the instructions of a customer (the ‘Applicant’) or on its own behalf,

- i. is to make a payment to or to the order of a third party (the ‘Beneficiary’) or is to accept and pay bills of exchange (Draft(s)) drawn by the beneficiary, or
- ii. authorises another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s)), or
- iii. authorises another bank to negotiate,

against stipulated document(s), provided that the terms and conditions of the credit are complied with.”

⁸ Penn, Shea, Arora., *The Law and Practice of International Banking Law* p. 290.

⁹ Barclays Bank Services for Business: Documentary Letters of Credit p. 6.

¹⁰ Article 2 U.C.P 1993 Revision.

Under the UCC, article 5-103(a),¹¹ 'letter of credit' is defined as:

“(a) "Credit" or "letter of credit" means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honour drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honour or a statement that the bank or other person is authorised to honour.”

It is essential to understand that the essence of the letter of credit transaction is its documentary character, i.e. where the goods are represented by a bill of lading, a letter of credit is a document which functions as a means of financing the transaction. Lord Wright¹² described the letter of credit as a bridge between the period of the shipment and the time of obtaining payment against documents.¹³

3 Brief History of Commercial Documentary Credits

In ancient times,¹⁴ the temples of Babylon and Egypt performed banking functions and utilised documents which conform to the current negotiable instruments. Indeed, there is a promissory note inscribed on clay from Babylon, of about 3000 BC, which specifies a repayment date for principal and interest. This is located in the University Museum in Philadelphia. Moreover, in the middle of the 12th century, banks were formed in some European cities such as Genoa and Venice. Also, elsewhere in Europe, the receipts used in business transactions which called for payments by a church treasury were clearly negotiable and absolutely transferable. In the 13th century, letters of credit were found in the Mogul Empire in China. Subsequently, they were brought into general use by the Jews and the

¹¹ For update see, Section 5-102(10) in Appendix C.

¹² In *T.D Bailey, Son & Co. v. Ross T. Smyth & Co. Ltd.* (1940) 56 T.L.R. 825, 828.

¹³ In relation to this, Schmitthoff, contended that “the documentary character of this type of banker’s credit, as used in international trade, cannot be over-emphasised: the paying bank is prepared to pay the exporter because it holds the documents as collateral security and, if necessary can take recourse to the issuing bank, which, in turn can take recourse to the buyer as instructing customer”. Schmitthoff, C M., *Schmitthoff's Export Trade: The Law & Practice of International Trade* 9th ed. (London, Stevens & Sons, 1990) p. 401.

¹⁴ Trimble, R.J., ‘The Law Merchant and the Letter of Credit’ 61 *Harvard Law Review* (1984) 981 at 982; see for details about the ancient history of letters of credit, Read, F., ‘The Origin, Early History, and Later Development of Bills of Exchange and Certain other Negotiable Instruments’ No. VII Sept. *Canadian Bar Review* (1926) 440, at 440-456.

Lombards when they were used as a device to facilitate the transfer of funds among distant merchants.¹⁵ In the 14th century, the merchants-bankers of Venice, Genoa, Florence, and other commercial cities in Europe started using letters of credit.¹⁶

Long before the 17th century, banking systems and dealing in negotiable instruments were established. In this early, ancient era, it seems to be difficult to distinguish between letters of credit and bills of exchange because of their similarities.¹⁷ However, it can be concluded that “a business letter requesting a person to pay money, or make his credit available, to a third person, on the credit of the writer or against payment by him, is a letter of credit”.¹⁸

Although letters of credit have been in use for a very long time, their characteristic has altered substantially over that period.¹⁹ Such an operation was described by a seventeenth century writer²⁰ as follows:

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

It is evident when referring back to the early 19th century, that a letter of credit used to be issued in the buyer's [sic] favour. This particular credit allowed the

¹⁵ Ominsky, H., 'Letters of Credit Withstand FDIC Rejection' 112 *Banking Law Journal* (1995) 479 at 482. Moreover, Read contended that it is evident that the Chinese were the first to invent letters of credit. See Read, F., 'The Origin, Early History, and Later Development of Bills of Exchange and Certain Other Negotiable Instruments' 4 *Canadian Bar Review* (1926) 440 at 443.

¹⁶ Trimble, R.J., *supra* note 14 at 985.

¹⁷ *Ibid* at 983.

¹⁸ *Ibid* at 983-4.

¹⁹ Todd, P., *Bills of Lading & Bankers' Documentary Credits* 3rd ed. (Lloyd's of London Press Ltd, 1998) p. v. Also Professor Davis, A.G., in his article, 'Recent Development in the Law of Commercial Letters of Credit' *Journal of Business Law* (1959) 323, observed that “The commercial letter of credit is, in terms of legal history, a somewhat novel document. Indeed, it may be said that the problems surrounding the modern letter of credit did not come before courts before this century, and it was only after the First World War that the legal profession, and then only those of its members who had a commercial practice, realised that there were legal problems connected with this type of instrument”, at 323.

²⁰ Malynes, *Consuetudo vel lex mercatoria* (2 ed. London, 1629) at p. 76.

buyer to both draw on the issuer for the purchase price in addition to the transportation costs. When a person in whose favour the bill was drawn, presented this type of credit, the insurer was obligated to accept a bill of exchange covering the total amount. The buyer would then have one of two options, of which the first would be to either send both the bill drawn on the issuer as well as the letter of credit directly to the seller. This would enable him to gain the acceptance of the issuer in relation to the bills or alternatively, the other option would be for the buyer to send the bill directly to the seller himself, upon obtaining the issuer's acceptance.²¹ A substantial change in the structure of the letter of credit came into being, as evident in the 1870s and 1880s. In a situation where a creditor was found to have been paid via the credit method, he was perceived as the *beneficiary*, as is used nowadays, rather than as the *issuer's customer*. The modern letter of credit has thus introduced a new third party to the transaction (the beneficiary). Indeed, the present form of a letter of credit is considerably different. However, the main purpose of a letter of credit remains, i.e., "it provides a mechanism under which the credit of one party is made available to another, thereby assuring payment and facilitating the underlying transaction"²².

The main character of the modern form of credit is that it brought the seller (beneficiary) into an immediate relationship with the issuing bank, rather than being merely a third party as used to be the case under the old form where he was brought to the scenario as a result of the contract between the buyer and the issuing bank.²³

²¹ Penn, Shea, Arora., *The Law and Practice of International Banking Law* p. 292; Leon, C., contends that "originally, they were two-party arrangements whereby a powerful or wealthy individual issued a letter promising payment in order to induce a merchant to deliver goods or advance money to that individual's servant or agent. They were similarly used between merchants themselves, with the reliability factor supplied by the closeness of the merchant network". Leon, C., 'Letters of Credit: A Primer' 45 *Maryland Law Review* (1986) 432 at 433.

²² Leon, C., *supra* note 21 at 433. For more detail on the early and modern letter of credit see Todd, P., *Bills of Lading & Bankers' Documentary Credits* p. 263, et. seq.

²³ Penn, Shea, Arora., *The Law and Practice of International Banking Law* p. 292.

3.1 Outline History of Letters of Credit in the UK

Although letters of credit have been utilised by merchants from ancient times, cases such as Orr & Barber v. Union Bank of Scotland²⁴, The British Linen Company Bank v. The Caledonian Insurance Company²⁵ and Re Agra & Masterman Bank v. Ex Parte Asiatic Banking Corporation²⁶, show that it is only by the second half of the 19th century when transactions similar to the modern commercial credit began to appear that banks become properly involved in the utilisation of the credit arrangement.²⁷ One commentator has put it clearly that, today's letter of credit, in its modern form might be regarded as a "creation of the merchandise [sic but query 'mercantile'] genius of the British people".²⁸ Along with this basic form of a modernised letter of credit, which had developed dramatically since the First World War, further duties have been attached to it, as required by the increasing complexity of commercial practice.²⁹

3.2 Outline History of Letters of Credit in the USA

The first statutory reference to letters of credit which can be traced in the United States was the draft of a civil code for New York in 1862 which included a chapter dedicated to 'Letters of Credit'. Under this draft a letter of credit is defined as "a written request addressed by one person to another, requesting the latter to give credit to the person in whose favour it is drawn".³⁰

The present form of the letter of credit has been in use for over a hundred years³¹.

²⁴ *Orr & Barber v. Union Bank of Scotland*, (1854) H.L. p 513.

²⁵ *The British Linen Company Bank v. The Caledonian Insurance Company*, (1861) 4 Macq. H.L. Cas. 107; 4 L.T. 162.

²⁶ *Re Agra & Masterman Bank v. Ex Parte Asiatic Banking Corporation*, (1867) L.R. 2 Ch. App. p 391.

²⁷ Adam, M. I, *supra* note 2 at 23.

²⁸ Wren, P. J., Automation's Challenge to Letters of Credit 98 *Canadian Banker*, Sep-Oct (1991) 14 at 15.

²⁹ Penn, Shea, Arora., *The Law and Practice of International Banking Law* p. 293.

³⁰ Mentioned in *British Linen Company v. The Caledonian Insurance Company*, (1861) 4 Macq. H.L.Cas. 107; 4 L.T. 162.

³¹ Symons, E L., 'Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief' 54 *Tulane Law*

According to Harfield, “the letter of credit has been used within the United States since the earliest days of the republic,”³² and, in fact, letters of credit litigation started early in the 19th century.³³ However letter of credit cases were relatively uncommon until the 1920s³⁴, when the United States was recognised as the centre for judicial development of letter of credit law, in a period of flourishing international trade.³⁵ Subsequently, the intensity of litigation involving letters of credit depended on the economic situation, declining in times of abundance and increasing in times of hardship, whereby those in commerce very often try to avoid their contractual obligations.³⁶ Nowadays, because of the large use of both letters of credit and standby letters of credit³⁷, either in the domestic or the international sphere, litigation has become more extensive than previously.³⁸

Review (1980) 338 at 344.

³² Harfield, H., ‘The Increasing Domestic Use of the Letter of Credit’ 4 *U.C.C.L.J* (1972) 251 at 251.

³³ See for example, *Russel v. Timothy Wiggin & Co.* 21 Fed. Cas. 68 NO. 12, 165 (c.c.d.) Mass (1842) discussed by Trimble supra note 14 p.992. It should be noted that letters of credit litigation started in the United States as far back as 1809 e.g., *Robins v. Bringham* 4 John, 476 (N.Y. 1809); *Walsh v. Bailie* 10 Johns 180 (N.Y. 1813); *Coolidge v. Rayson* 2 Wheat (US) 66 (1817); *Lanusse v. Baker & Wheat* (US) 101 (1818), See also McCurdy, W.E., ‘Commercial Letters of Credit’ 35 *Harv. L. Rev.* (1971) 539 at 546; Hershey, O.F., ‘Letters of Credit’ 22 *Harv. L. Rev.* (1918) 1; Kozolchyk, B., ‘The Legal Nature of the Irrevocable Commercial Letter of Credit’ 14 *Am. J. of Comp. L* (1965) 395 at 398.

³⁴ Harfield, H., ‘Code, Customs and Conscience in Letter-of-Credit Law’ 4 *U.C.C. L.J* (1971) 7 at 8.

³⁵ Thayer, P.W., ‘Irrevocable Credits in International Commerce: Their Legal Nature’ 36 *Colum. L. Rev.* (1936) 1031 at 1058.

³⁶ Harfield, H., supra note 34 at 16.

³⁷ Schmitthoff, C.M., defines standby letters of credit as: “an undertaking by a bank to make payment to a third party (the beneficiary) or to accept bills of exchange drawn by him, provided that he timely complies with the stipulations of the credit which, in international trade transactions, invariably include the tender of one or several documents. The bank may also be instructed to authorise another bank to pay, accept or negotiate bills of exchange against the stipulated documents.” He continues saying the difference between letters of credit and standby letters of credit is this: “the ordinary letter of credit is a payment instrument which normally obliges the beneficiary to tender, together with other specified documents, the transport documents. The standby credit is intended to protect the beneficiary in case of default of the other party to the (underlying) contract. Consequently in a standby credit the required documents need not include the transport documents but this type of credit may be activated by a document of any description, e.g. a demand by the beneficiary or a statement by him that the other party is in default”. Schmitthoff, C.M., *Schmitthoff's Export Trade: The Law & Practice of International Trade* pp. 429-30. For more detail on standby letters of credit see Kozolchyk, B., ‘The Emerging Law of Standby Letters of Credit and Bank Guarantees’ 24 *Arizona Law Review* (1982) 319.

³⁸ Symons, E.L., supra note 31 at 344.

After this brief introduction to the nature and history of letters of credit, we can now turn to the topic of the next chapter which involves the basic values around which the modern law should be organised. Such values concern party autonomy, certainty, flexibility, fairness and good faith.

Chapter Two: Five Basic Principles for Commercial Law

Chapter Two: Five Basic Principles For Commercial Law

Introduction

It is widely recognised that Commercial Law tries to balance considerations of certainty with those of fairness. This general balance can be broken down into five basic principles which arguably should govern Commercial Law doctrine. These five principles concern party autonomy (freedom and sanctity of contract), predictability, flexibility, fairness and good faith. The first four principles are broadly accepted in English law. However, there is lack of express adoption of a general principle of good faith into English law. By contrast, its adoption and application in the civil law systems and even in the American Uniform Commercial Code is rather clear, as will be seen later in the chapter when the issue of good faith in both civil law systems and the UCC is dealt with.

This chapter will, first of all, examine the aforementioned five basic principles. In the second part of the chapter, possible tensions between these principles will be discussed.¹

Section One: Five Basic Principles

1 Party Autonomy

1.1 Introduction

English Commercial Law generally recognises and applies the principle of party autonomy. The spirit behind this principle is embodied in Sir George Jessel's well-known remarks:

“If there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the *utmost liberty of contracting*, and that their contracts when entered into freely and voluntarily shall be *held sacred* and

¹ By “tension” it means that whilst there are some principles which pull in the same direction (e.g. party autonomy and predictability, good faith and fairness etc.), others pull against one another (e.g. fairness and certainty, predictability and good faith, party autonomy and good faith etc.).

shall be enforced by courts of justice. Therefore, you have this paramount public policy to consider that you are not lightly to interfere with this freedom of contract".²

Two major ideas in this speech form the two limbs of the principle of party autonomy: freedom of contract, and sanctity of contract.³ In drawing a distinction between the two limbs, Brownsword⁴ has said that freedom of contract, on the one hand, concerns utmost contractual freedom within the rules, while sanctity of contract, on the other hand, concerns the enforcement of what has been freely agreed upon. A detailed explanation of the two limbs, from both a classical and a modern point of view, will be given below for a thorough understanding of the principle.

1.2 Freedom of Contract

The concept of freedom of contract is deemed to be the cornerstone of many legal systems. Indeed, the fundamental policy of the common law asserts that those partaking in business activities, should be left to determine their own legal framework⁵ as well as allowing them to select which deals they take part in⁶. Yet there are some restrictions to such freedom. According to Schmitthoff,⁷ "the basis of Commercial Law is the contractual principle of autonomy of the parties' will. Subject to the ultimate reservation of public policy, the parties are free to arrange their affairs as they like". Correspondingly, such a freedom is not acceptable when

² *Printing and Numerical Registering Co v. Sampson*, L.R 19 EX. 462, at 465. Emphasis added.

³ Brownsword, R., "Remedy-Stipulation' in the English Law of Contract-Freedom or Paternalism?' 9 *Ottawa Law Review* (1977) 95 at 98. See for further detail about the nature of autonomy and freedom of contract, Smith, S.A., 'Future Freedom and Freedom of Contract' 59 *Modern Law Review* (1996) 167, 177-180.

⁴ Brownsword, supra note 3 at 98.

⁵ Goode, R., 'The Codification of Commercial Law' 14 *Monash University Law Review* (1988) 135 at 148. See for more about freedom of contract, Mensch, B., 'Freedom of Contract as Ideology' 33 *Stanford Law Review* (1981) 753.

⁶ See generally, Atiyah, *Freedom of Contract and the New Right* (1988) 20 Skriftserien, Juridiska Fakulteten i Stockholm, p 11. And Kronman, A., 'Contract Law and Distributive Justice' 89 *The Yale Law Journal* (1980) 472, 475-476.

⁷ Schmitthoff, 'The Concept of Economic Law in England' *Journal of Business Law* (1966) 309, 315.

it applies to a contract that is entirely excessive for one of the parties⁸. Freedom of contract cannot be absolute and therefore, parties to a contract are not allowed to do whatever they want. In cases where contract terms are oppressive, restrictive or against society's goals so that they offend against public interest, the court has a duty to act to limit freedom of contract.⁹

Generally speaking, English courts take a non-interventionist approach in relation to commercial contracts. There is a presumption that judges work on the belief that the bargaining power, as utilised amongst businessmen, is based on equality, and therefore if this non-interventionist approach is applied, it is clear that courts are even inclined to refuse to determine the adequacy of consideration. It is also evident that they will not involve themselves in contracts where the situation appears to be unfair, in order to defend such equality, based on the belief that this will enable the conduct of trade by promoting certainty¹⁰. Pollock, in his discussion around freedom of contract and who is in support of the non-interventionist approach, affirms that:

“The business of the law ... is to give effect, so far as possible, to the intention of the parties, and all the rules for interpreting contracts go back to this fundamental principle and are controlled by it ... The guiding principle still is, or ought to be, the consideration of what either party has given the other reasonable cause to expect of him”.¹¹

The classical approach to freedom of contract is in fact different from what it means nowadays. The freedom of contract approach in classical law was more extensively used than in the modern law.¹² It is useful to state both approaches at

⁸ Ibid.

⁹ Schmitthoff, *supra* note 7 at 315; Goode, *supra* note 5 at 149. Goode adds, regarding freedom of contracts in the UCC, that although freedom of contract appears as a fundamental principle of the Code in 1-102(2) (b), freedom of contract is not absolute too, as provided by § 1-102 (3) of the UCC.

¹⁰ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials*, 2nd ed (London, Butterworths, 1999) p 10.

¹¹ Pollock, *Contract in Encyclopedia Britannica* Vol. 6 (14 th ed., 1929), p. 342. Cited by Trakman, L E., ‘Frustrated Contracts and Legal Fictions’ 46 *Modern Law Review* (1983) 39 at 41.

¹² See Brownsword, ‘The Philosophy of Welfarism and its Emergence in the Modern English Law of Contract’ in Brownsword, Howells, Wilhelmsson. (eds) *Welfarism In Contract Law* (London, Dartmouth, 1994) 21 at 21; See also Atiyah, *Introduction to the Law of Contract* (5th ed, 1995), pp

this stage.

1.2.1 The Classical Approach to Freedom of Contract

The classical approach to freedom of contract was one of the foundations “of nineteenth-century laissez-faire economics”.¹³ According to this approach, it is evident that parties were given the utmost freedom to choose their contract terms, as freely as possible.¹⁴ In other words, it is the freedom of a party to enter into a contract if he chooses to do so, and on whatever terms he may consider advantageous to his interests. The clarity of such a feature can be seen as one of the most important terms of the petition which was submitted by the London Merchants to Parliament that “freedom from restraint is calculated to give the utmost extension to foreign trade and the best direction to the capitalised industry of the country”.¹⁵

1.2.2 The Modern Approach to Freedom of Contract

The modern law on the idea of freedom of contract has moved away from the classical approach.¹⁶ In general, freedom of contract is considered reasonable only if the contracting parties appear to have equality of bargaining power and the contract does not harm the overall economic community interest.¹⁷ Now that society operates under more complex social and industrial conditions, the concept of freedom of contract, despite its original status, has proved to be far from practical.¹⁸ It became apparent that the law started to intervene in contracts in

27-34, about the influence of notions of *laissez faire* on the nineteenth century law and the gradual increase in controls over contracts in the modern approach, as will be discussed later. See defences of the regime of freedom of contract submitted by Epstein, ‘Unconscionability: A Critical Reappraisal’ 18 *Journal of Law and Economics* (1975) 293, 293-4.

¹³ Beatson, J., *Anson’s Law of Contract* (27th ed) (Oxford University Press, 1998). p.4.

¹⁴ Ibid.

¹⁵ Guest A.G., *Anson’s Law of Contract* (26th ed) (Clarendon Press, Oxford, 1984) p. 4 (This statement does not appear in the 1998 edition)

¹⁶ Fridman, ‘Freedom of Contract’ 2 *Ottawa. L. Rev* (1967) 1, 22.

¹⁷ Beatson, J., *Anson’s Law of Contract* p. 4.

¹⁸ Ibid.

order to protect the vulnerable party, at the time when monopolised establishments emerged and which insisted on utilising their own specified terms in relation to conducting business. Thus, the notion of “freedom of contract” was perceived by many as an illusion for those parties wanting to acquire goods or services from those particular firms¹⁹. The Restrictive Trade Practices Act 1976 and the Fair Trading Act 1973 (which have been recently replaced by the Competition Act 1998) are examples of statutes which were enacted to promote competition in industry and to safeguard the interests of consumers.²⁰

Another typical example to illustrate the statutory intervention in the principle of freedom of contract is the codification of employment law. Modern legislation has made it clear that an employee is to be protected against unfair dismissal and redundancy. Indeed, under such a statute an employee has come to know his terms of service.²¹

There are other legislative provisions which confine the terms of contract which people can make in order to protect the public against economic pressure. The Rent Act 1977 (as amended by the Housing Act 1988 and the Landlord and Tenant Acts 1985, 1987 and 1988), the Unfair Contract Terms Act 1977 and the Consumer Credit Act 1974 are some good examples. The encouragement to move courts more towards intervening in some types of contract, derived from the Unfair Contract Terms Act 1977, particularly with regards to standard form contracts²².

¹⁹ Bradgate, R., *Commercial Law* 2nd ed (Butterworths, London, 1995) p 15.

²⁰ Beatson, J., *Anson's Law of Contract* p 5.

²¹ *Ibid* at 4-5.

²² However, Bradgate maintains that “what may be described as ‘pure’ commercial contracts are often excluded from the ambit of such interventionist legislation. An example to illustrate that is the Consumer Credit Act. It has no application to contracts with companies, or where the amount of credit involved exceeds £15,000. [Note that the Consumer Credit (Increase of Monetary Limits) Order 1983, SI 1983/1878, art 4, Schedule, Pt ii, is amended by SI 1998/996, substituting the sum “£25,000” for the sum “£15,000”]; similarly the Unfair Contract Terms Act has no application to a wide range of contracts including those for the international supply of goods, contracts of insurance, charter parties, and so on”. *Ibid*. Nonetheless, the Unfair Terms in Consumer Contracts Regulations, as amended in 1999, SI 1999 No. 2083, apply to insurance contracts. See generally, Adams & Brownsword, *Key Issues in Contract* (Butterworths, London, 1995) p. 283.

Contract law lawyers in England agree that the modern law of contract is relatively “interventionist”.²³ Indeed, “classical law” was organised around the principle of freedom of contract. But clearly, there is a significant change in the policy and structure of society, especially in the commercial field. Naturally, the appropriateness of the classical law principle should be reconsidered when comparing it with contemporary contract law, particularly as the modern law of contract is said to be more concerned about fairness and reasonableness.²⁴ In 1980, in the House of Lords, Lord Diplock observed: “A basic principle of the common law of contract ... is that the parties are free to determine for themselves what primary obligations they will accept”.²⁵ Despite the fact that the modern approach to freedom of contract is relatively interventionist, it is still a strong presumption under English law that it is for the parties to choose whether or not they will enter into a contract and on what terms.²⁶

1.3 Sanctity of Contract

1.3.1 Introduction

Contract law is sometimes described as a law for enforcing promises.²⁷ If parties enter into a contract freely, the contractual terms are to prevail unless they are illegal. And thus, the promises or terms, in themselves are sacred. This is exactly the notion of ‘sanctity of contract’.

The idea of sanctity of contract is very often confused with the idea of freedom of contract although they are in some way linked together.²⁸ Atiyah²⁹ commented that:

²³ See Brownsword, ‘The Philosophy of Welfarism and its Emergence in the Modern Law of Contract’ in Brownsword, R., Howells, G., Wilhelmsson, T., (eds) *Welfarism In Contract Law* 21, 21.

²⁴ *Ibid* at 23.

²⁵ *Photo Production, Ltd. v. Securicor Transport, Ltd.*, [1980] A.C. 827, at p. 848.

²⁶ Beatson, J., *Anson’s Law of Contract* p 7.

²⁷ Cohen, ‘The Basis of Contract’ 46 *Harvard Law Review* (1933) 553, 571.

²⁸ Brownsword, *supra* note 3 at 98.

²⁹ Atiyah, P., *An Introduction to the Law of Contract* 4 (2nd ed, 1971) pp 9-10 (This statement does not

“[it is] merely another facet of freedom of contract, but the two concepts cover, to some extent, different ground. The sanctity of contractual obligations means that once a contract is freely and voluntarily entered into, it should be held sacred and be enforced by the courts if it is broken”.

This means that parties to a contract, having acted freely, are required by the principle of sanctity of contract to respect the bargains that they have struck, i.e. they should abide by their agreed terms.³⁰

A party is thus, entitled to benefit from two things. The first is his right to claim benefit from his proposed bargain and the other is related to his right to request strict compliance, as agreed by both parties, either in relation to the time of performance or quality of the subject matter of the contract.³¹ Courts, therefore, should enforce such an agreement to the extent of the freedom given to the parties.³² The effect of such a principle is twofold: first, given that parties to a contract must stick to their deal, they should be masters of their own bargains. It follows, therefore, that courts should not intervene to adjust any term which may be regarded as excessive or ‘unreasonable’.³³ Second, as long as parties must be held to their own terms, they should not be easily relieved from performing their agreements.³⁴

In Professor Goode’s view, the English courts are not willing to interfere with contracts. He further states that;

“in a contest between contract and equity in a commercial dispute, contract wins almost every time.....It takes a great deal to persuade an English court that change of circumstances modifies or discharges even a long-term contract”.³⁵

appear in the 1995 edition). See also Brownsword, R., ‘Static and Dynamic Market Individualism’ in Halson, R., (ed) *Exploring The Boundaries of Contract* 48, 52.

³⁰ Adams, J., & Brownsword, R., *Understanding Contract Law* 2nd ed (London, Fontana Press, 1994) 187.

³¹ Goode, R., *supra* note 5 at 148-149. There will be more discussion in chapter five about parties’ right to insist on strict performance, the perfect tender rule when dealing with parties’ to letters of credit right to insist on the doctrine of strict compliance, as a consequence to freedom of contract.

³² Brownsword, *supra* note 3 at 98.

³³ Adams & Brownsword, *Understanding Contract Law* p 188.

³⁴ *Ibid.*

³⁵ Goode, *supra* note 5 at 149.

Two examples from the general law of contract will be examined here to illustrate the principle of sanctity of contract.

The first example, concerning withdrawal for breach of condition, is the case of L. Schuler A G v Wickman Machine Tool Sales Ltd.³⁶ An agreement was entered into between Schuler and Wickman. Clause 7 (b) of the agreement, which was designated as a “condition” of the contract, placed Wickman under a specific obligation to visit named manufacturers. The majority view in the House of Lords was that Clause 7(b) was not a condition in the strict sense – that Schuler had no right to withdraw when Wickman breached the term. However, the principle of sanctity of contract is manifested in Lord Wilberforce’s dissenting judgment:

“to call the clause arbitrary, capricious or fantastic, or to introduce as a test of its validity the ubiquitous reasonable man is to assume, contrary to the evidence, that both parties to this contract adopted a standard of easygoing tolerance rather than one of aggressive, insistent punctuality and efficiency. This is not an assumption I am prepared to make, nor do I think myself entitled to impose the former standard upon the parties if their words indicate, as they plainly do, the latter”.³⁷

It can be inferred from Lord Wilberforce’s judgment that the intention of the contract parties should be respected and therefore, sanctity of their contract should be upheld.

The second example is the case of Davis Contractors Ltd v. Fareham Urban District Council.³⁸ This case illustrates how courts deal with cases of alleged frustration.³⁹ In this case, a contract was entered into between contractors and a local authority to build 78 houses for a fixed sum within a period of eight months. In a letter dated before the time of concluding the contract it was stated that it was subject to adequate supplies of labour being available as and when required. Due to unexpected circumstances, and without fault of either party, adequate supplies

³⁶ *L.Schuler AG v. Wickman Machine Tool Sales Ltd* [1974] AC 235.

³⁷ *L.Schuler AG v. Wickman Machine Tool Sales Ltd* [1974] AC 235, at 263.

³⁸ *Davis Contractors Ltd v Fareham UDC* [1956] AC, 696.

³⁹ See generally, about the doctrine of frustration, Posner and Rosenfield, ‘Impossibility and Related Doctrines in Contract Law: An Economic Analysis’ 6 *Journal of Legal Studies* (1977) 83.

of labour were not available and the work took 22 months, far longer than expected, to complete. The defendants pleaded that their letter was attached to their form of tender. Consequently, the contractors contended that (i) the contract price was subject to the availability of adequate supplies of labour; and (ii) the contract was frustrated. It was held that “the letter...was not incorporated in the contract and that the contract had not been frustrated. The fact that, without the fault of either party, there had been an unexpected turn of events, which rendered the contract more onerous than had been contemplated, was not a ground for relieving the contractors of the obligation which they had undertaken and allowing them to recover on the basis of a *quantum meruit*”.⁴⁰ Indeed, in an earlier case⁴¹ Lord Loreburn, while talking about frustration of contracts, stated that:

“In most of the cases it is said that there was an implied condition in the contract which operated to release the parties from performing it...It is in my opinion, the true principle, for no court has an absolving power, but it can infer from the nature of the contract and the surrounding circumstances that a condition which is not expressed was a foundation on which the parties contracted.”⁴²

Despite the fact that in certain situations, parties to a contract may be set free from performing their obligations due to change of circumstances occurring after the contract was entered into, the doctrine of frustration has a very limited scope, and will not apply simply because a subsequent event adversely changes the financial situation of the parties. In short, the principle of sanctity of contract prevails unless there is a very serious event which will result in enforcing a different contract from what had been agreed upon.⁴³

1.3.2 The Classical Approach to Sanctity of Contract

The concept of sanctity of contract is upheld in classical law in order to set a secure transactional framework. Very often, contractors who try to escape some

⁴⁰ *Davis Contractors Ltd v Fareham UDC* [1956] AC, 696, 697.

⁴¹ *Tamplin (F.A) Steamship Co Ltd v. Anglo-Mexican Petroleum Products Co Ltd.* [1916] 2 A.C 397.

⁴² *Ibid* at 403.

⁴³ Beatson, J., *Anson's Law of Contract* pp 7-8; See also regarding exceptions to the rule of sanctity of contract, Cohen, *supra* note 27, 553 at 571.

or all their obligations by raising excuses would be successfully challenged by contract law. The objective theory of agreement, as adopted by the classical law, obstructs appeals on the part of contractors to their subjective state of mind. Nevertheless, through the interpretation of the doctrines of mistake and frustration, although limited, some contractors may be released from their extravagant contracts.⁴⁴

1.3.3 The Modern Approach to Sanctity of Contract

The modern approach is much more interventionist with regard to the idea of sanctity of contract than it was in the classical model.⁴⁵ In the modern approach, the question of whether it is reasonable to hold a contractor to his apparent bargain is taken seriously.

The above mentioned case of Schuler illustrates the contrast between the classical and the modern approach. Lord Wilberforce's dissenting speech illustrates a classical approach: he says that the contracting parties have made their bargain, which gives Schuler the right to terminate if Wickman are in breach of the visiting obligation, and the courts should thus enforce the bargain as agreed. The majority judgments in the House of Lords illustrate the modern approach: it would be unreasonable that Schuler could terminate for breach of the visiting obligation, and so the parties should be held to a bargain read through the lens of reasonableness.

The Unfair Contract Terms Act reasonableness test is another example of the codification of the modern approach towards sanctity of particular classes of commercial contracts. This Act provides that a contracting party not be held to certain terms that have apparently been agreed if they are adjudicated to be unreasonable. What the UCTA reasonableness test, set out in Schedule 2 of the UCTA⁴⁶, amounts to is that the courts will take a hard look at whether the party

⁴⁴ Adams & Brownsword, *Key Issues in Contract* p 52.

⁴⁵ Ibid. See also Brownsword & Howells, 'The Implementation of the E.C. Directive on Unfair Terms in Consumer Contracts-Some Unresolved Questions' *Journal of Business Law* (1995) 243 at 255.

⁴⁶ (a) the strength of the bargaining positions of the parties relative to each other, taking into account

truly agreed to the term by considering questions of knowledge and bargaining power etc. One could argue that the classical and modern approaches towards sanctity of contract are similar. The answer to that is that the modern law takes a harder look at whether the party has agreed to the term or not.⁴⁷

With regard to the doctrine of frustration, as we have said, the position in the classical law is that parties are rarely excused from performance, otherwise sanctity of contract would be undermined. In the modern law, though, excuses are more readily recognised under the doctrine of frustration. However, even in the modern law, there are limits to the excuse, and the caveat towards interference by the courts can best be illustrated by the words of Bailhache J. “Nothing...is more dangerous in commercial contracts than to allow an easy escape from obligations undertaken”.⁴⁸ As Davis v Fareham shows, mere economic hardship is not enough to bring the principle of frustration into play — there must be a radical change in the circumstances before the courts think it would be unreasonable to hold a party to the bargain.

As emphasised by Trakman⁴⁹, frustration can be grounded on the occurrence of the following, namely (1) if there is lack of risk perception on the part of the promisor, (2) this lack of risk perception was reasonable in the circumstances (3) such event cannot be avoided by the promisor and (4) the economic loss resulting from performance goes beyond the economic profit that flowed from permitting non-performance. Otherwise, it seems impossible to infer frustration of an agreement just because the contract has turned out to be less profitable than the contracting

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- (among other things) alternative means by which the customer’s requirements could have been met;
 - (b) whether the customer received an inducement to agree to the term, or in accepting it had an opportunity of entering into a similar contract with other persons, but without having to accept a similar term;
 - (c) whether the customer knew or ought reasonably to have known of the existence and extent of the term (having regard, among other things to any custom of the trade and any previous course of dealing between the parties); etc.

⁴⁷ Brownsword & Howells, *supra* note 45 at 255.

⁴⁸ Per Bailhache J. in *Comptoir Commercial v. Power* [1920] 1 K.B. 868, 878.

⁴⁹ Trakman, L E., *supra* note 11 at 50.

parties had expected.

To summarise, no civilised system of law can accept the implications of absolute sanctity of contractual obligations.⁵⁰ The modern law approach to sanctity operates by reference to the reasonable expectations of the parties. This is because of the complexity of the commercial environment. As Pollock explained: “ The guiding principle still is, or ought to be, the consideration of what either party has given the other reasonable cause to expect of him”.⁵¹

1.4 Conclusion

It can be concluded that from the legal point of view, the notion of sanctity of contract (i.e. that parties should be held to their bargain) cannot be convincing without genuine freedom of contract. The modern approach to both the notion of freedom of contract and the notion of sanctity of contract has changed. In both cases, courts are taking a more interventionist approach due to the increased importance of the element of fairness and reasonableness. Nevertheless, the spirit behind the principle of party autonomy stays alive and important in contemporary commercial law.

2 Predictability (Certainty)

2.1 Introduction

“In all mercantile transactions the great object should be certainty: and therefore, it is of more consequence that a rule be certain, than whether the rule is established one way or other. Because speculators in trade then know what ground to go upon”.⁵²

So stated Lord Mansfield in the case of Vallejo v. Wheeler⁵³. It is obvious that businessmen have special needs, one of which is that they require the decision of

⁵⁰ Waddams, S.M., ‘Unconscionability in Contracts’ 39 *Modern Law Review*. (1976) 369, 370.

⁵¹ Pollock, *Contract in Encyclopedia Britannica* p. 342.

⁵² *Vallejo .v. Wheeler*. [1774] 1 COWP 143, 153.

⁵³ *Vallejo .v. Wheeler*. [1774] 1 COWP 143.

courts on commercial issues to be predictable in order that they “know where they stand”⁵⁴. This explains what the principle of predictability, or certainty, is in the simplest form. Regarding the principle, it was said to be one of the first criteria considered by contractors, particularly commercial contractors, as they should know where they stand. Indeed, Waddams agrees that the primary goal of contracts in our society is to render the future more certain, and that:

“the purpose of contract law is to enable persons to exercise some control over the uncertainties of the future ... One of the chief uses of contract law ... is to make the future more predictable”.⁵⁵

When analysing the main element of this principle, it appears to be an expectation, that the same rules from previous cases will continue to be observed by the courts, when planning and undertaking transactions.⁵⁶

There are instances where the principle may, however, be eroded. For instance, in a commercial dispute, courts may grant equitable relief. As will be further explained below, equitable relief of this kind is really not consistent with the principle of predictability in commercial transactions.

2.2 Certainty in English Law

Having defined certainty, we can consider two categories of illustrative cases, of which the first deals respectively with reliance on exclusion clauses. The second category will consider the following four linked examples; (i) the right to withdraw, (ii) classification of a term—whether condition or warranty, (iii) certainty in relation to a term in which time is agreed to be of the essence and (iv) the seller’s right to repudiate a sale contract on the ground of buyer’s non-compliance.

First, in relation to reliance on exclusion clauses: the English courts’ respect for

⁵⁴ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials*, p. 10.

⁵⁵ Waddams, ‘The Modern Role of Contract Law’ 8 *CBLJ* (1983-84) 2 at pp. 8-9.

⁵⁶ Goode, *supra* note 5 at 150.

the principle of certainty can be found in the case of Photo Production Ltd v. Securicor Transport Ltd,⁵⁷ where the House of Lords emphasised the non-interventionist approach in the commercial context. In this case, the plaintiff, a company which owned a factory, entered into a security service contract with the defendants. By this contract the defendants were to provide security service at the factory, including night patrols. There was an exception clause in the contract that “under no circumstances’ were the defendants ‘to be responsible for any injurious act or default by any employee ... unless such act or default could have been *foreseen* and avoided by the exercise of due diligence on the part of the [defendants] as his employer”.⁵⁸

One night the patrol guard lit a fire in the factory and consequently it was destroyed. In the Court of Appeal it was held that this exemption could not avail the defendants because they had been guilty of a fundamental breach but the House of Lords unanimously reversed this decision. Lord Willberforce said:

“After [the Unfair Contract Terms] Act, in commercial matters generally, when the parties are not of unequal bargaining power, and when risks are normally borne by insurance, not only is the case for judicial intervention undemonstrated, but there is everything to be said, and this seems to have been Parliament’s intention, for *leaving the parties free to apportion the risks as they think fit* and for respecting their decisions. ... At the judicial stage there is still more to be said for leaving cases to be decided straightforwardly on what the parties have bargained for rather than upon analysis, which becomes progressively more refined, of decisions in other cases leading to inevitable appeals”.⁵⁹

Furthermore, his Lordship thought that the clause was completely clear and adequate to cover the defendant’s position. The plaintiff’s action therefore failed.⁶⁰ In commenting on the above case, it is apparent that the rationale behind the decision stemmed from the insurance position, despite the fact that the plaintiff

⁵⁷ *Photo Production Ltd v. Securicor Transport Ltd* (1980) AC 827. See for more discussion, Adams & Brownsword, ‘The Unfair Contract Terms Act: A Decade of Discretion.’ 104 *Law Quarterly Review* (1988) 94, 96.

⁵⁸ It was not alleged that the defendants had been negligent in engaging this employee. This clause is mentioned in *Photo Production v. Securicor Ltd* [1980] A.C, 827, at 827.

⁵⁹ *Photo Production v. Securicor Ltd* [1980] A.C, 827 at 843, emphasis added.

⁶⁰ *Ibid* at 828.

suffered substantial loss. When addressing this type of commercial contract, it is evident that the main purpose of the stipulated provisions are to allocate risks and to ultimately determine which party is to insure against such risks. Thus, in applying the doctrine of certainty, and making the parties stick to their original agreed terms, the courts do take into account the reasonableness of the whole circumstance. In this case, the defendants would know where they stood.

The principle of predictability simply means this: parties must, so far as possible, be able to know where they stand, or at least to obtain helpful advice from their lawyers on the basis of which they can act with a reasonable degree of confidence.⁶¹ Clearly, certainty cannot be achieved if the rules on paper are not reflected in practice.⁶²

Under the second category, the first situation to deal with is the right to withdraw for breach of contract. As established by the English case law, the right to withdraw from a commercial contract will be available where the particular term breached is judged to be a “condition”.⁶³

Yet, in some instances, an innocent party may be permitted to cite a breach of condition as the legal reason for withdrawal when the real explanation lies in some collateral economic reasons. For example, “when a supplier wishes to withdraw on a rising market, or a buyer wishes to withdraw on a falling market”.⁶⁴ Here, there should be a degree of certainty or predictability in order to enable the contractors to know where they stand. The Laconia, Mardorf Peach & Co. Ltd. v. Attica Sea Carriers Corporation Of Liberia⁶⁵ illustrates how judges adopt such a principle. In that case, a condition was stated in clause 5 of the parties’ contract that:

“payment of said hire to be made in New York in cash in United States Currency, semi-

⁶¹ Goff, ‘Commercial Contracts and the Commercial Courts’ *Lloyd’s Maritime And Commercial Law* (1984) 382, 392.

⁶² Adams & Brownsword, *Key Issues in Contract* p 205.

⁶³ *Ibid* at 163.

⁶⁴ *Ibid* at 165.

⁶⁵ *The Laconia, Mardorf Peach & Co. Ltd. v. Attica Sea Carriers Corporation of Liberia*. [1977] HL 850.

monthly in advance, and for the last half month or part of same the approximate amount of hire ... otherwise failing the punctual and regular payment of the hire ... the shipowners shall be at liberty to withdraw the vessel from the service of the charterers, without prejudice to any claim they (owners) may otherwise have on the charterers ...”

On appeal by the shipowners, it was held:

“that on the proper construction of clause 5 of the charterparty, once a punctual payment of any instalment had not been made, a right of withdrawal accrued to the owners, who must give notice of its exercise within a reasonable time, and, unless the default was waived, the charterers could not avoid the consequences by tendering an unpunctual payment”.⁶⁶

This decision can be seen to be defensible because even if clause 5 is relied on for economic advantage, it is arguable that the decision is necessary to ensure that predictability is not be jeopardised.

Secondly, the classification of a term—whether condition or warranty. A typical example can be seen in the case of Bunge Corpn. v Tradax S.A.⁶⁷. Here, a contract (incorporating GAFTA form 119) was drawn, of which one of the clauses stated that the buyers had to give a specified time of notice (of readiness of a vessel) to the sellers. Nonetheless, the buyers in actual fact were late in giving notice by 5 days. The failure to comply with the time factor was therefore put forth as the main component leading to default of the original terms of the contract by the sellers.

For the present purpose, the material point in this case, with specific reference to mercantile contracts, is that where initial compliance with a specific condition in the contract would influence the other party’s ability to accomplish the task, the former obligation would be treated as a condition. In other words, the completion of the sale by the second party was dependant on the compliance by the first party’s actions, as was the case in Bunge where the seller could not calculate which loading port would be utilised to load the goods for delivery, until the buyers had given prior notice.

⁶⁶ Ibid at 851.

⁶⁷ *Bunge Corpn. v Tradax S.A* [1981] 1 W.L.R, 711

Following the appeal by both appellants and respondents one of the questions that was raised, asked whether there was in place any criterion that the court could utilise to determine the level of priority placed on complying with the condition. For example, where a requirement in a mercantile contract stated that one party should perform some obligation within a specified time, was it to be considered as a (i) strict condition or, (ii) an innominate or intermediate term?

Strictly speaking, there are three types of terms: conditions, warranties and intermediate terms.⁶⁸ Conditions are the major terms in a contract, breach of which entitles the innocent party to terminate the contract and sue for damages. Warranties are minor terms in a contract, breach of which entitles the innocent party to sue for damages but not to rescind.⁶⁹ The concept of an intermediate term was introduced in Hong Kong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd⁷⁰, where the Court of Appeal held that there are many terms which in the first place are neither conditions nor warranties, but which are in an intermediate category. If the result of a breach is serious, the term will be considered as a condition; if the result of a breach is minor, the term will amount only to warranty. Before this case, the court had to decide whether a term was a condition or a warranty according to the intention of the parties.⁷¹ The flexible approach in the Hong Kong Fir case allows the court some room in handling cases whereby the so-called “innocent party” is obviously taking advantage of a trivial breach, in order to escape the consequences of a contract that turns out to be less profitable than it had initially thought it would be.⁷²

According to Lord Wilberforce in Bunge, it was a dangerous misunderstanding of the Hong Kong Fir analysis, to apply it to breaches of time clauses in mercantile

⁶⁸ For more on the ‘Intermediate Terms’, see the relevant judgment in the case of *Bunge Corpn. v Tradax S.A* [1981] 1 W.L.R, 711, where the *Bunge* case was compared to the *Hong Kong Fir* case., at 714.

⁶⁹ *Hong Kong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd.* [1962] 2 Q.B. 26, 69.

⁷⁰ *Hong Kong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd.* [1962] 2 Q.B. 26.

⁷¹ See the judgment of Lord Diplock, *Ibid*, at 72.

⁷² See in this regard, *Cehave NV v Bremer Handelgesellschaft HbM* [1976] QB 76. For commentary on this case, see generally, Adams & Brownsword, *Key Issues in Contract* p. 45.

contracts. Hong Kong Fir was more concerned with breaches occurring during the actual course of journey. It evolved from the case that it could be predicted that there were diverse forms of breaches ranging from the extremely trivial such as the absence of a nail to more serious such as defects in machinery. The main conclusion drawn from the case highlighted the difficulty in pre-ascribing to the obligation, the character of a condition. The appellants in Bunge tried to utilise the analysis in Hong Kong Fir and apply it to the time clause as was present in the mercantile contracts which were completely different in character. Nonetheless, there was no room for applying different terminology as the parties involved were either in breach or were not and this had been the main problem that came about from attempting to apply the rulings derived from the Hong Kong Fir case to the Bunge Corp. v. Tradax S.A. case. Lord Wilberforce, in relation to the time clause, further commented that, there was only one kind of breach possible, namely, to be late.” His Lordship based his argument on two questions: “first, what importance have the parties expressly ascribed to this consequence and second, in the absence of expressed agreement, what consequence ought to be attached to it having regard to the contract as a whole”.⁷⁴

The analysis suggested by the appellants did not comply with the above proposition. They contended that the breach actually committed must be, first, considered and then, secondly, it is to be decided whether the default would deprive the party not in default of substantially the whole benefit of the contract.

Therefore, in attempting to demonstrate the Hong Kong Fir case as an incompatible test case when applied to Bunge, it would appear that the outcome would be commercially undesirable. An argument would arise in attempting to establish the extent or effect that the delay in notice may have on the supplier. In essence it would remove the certainty of impact of the conditions within mercantile contracts, which is one of the main qualities, and consequently lead to

⁷³ *Bunge Corpn. v Tradax S.A* [1981] 1 W.L.R, 711, 715.

⁷⁴ *Ibid.*

more arbitration.

In addition to this, the seller would experience difficulty in quantifying damages owed, via the courts. Despite the outcome of the Bunge cases, while adjudicating the Hong Kong Fir case, the Court of Appeal relied on the “gravity of the breach” approach and therefore it was reluctant to interpret contractual clauses as conditions. The Hong Kong Fir case leads the way in demonstrating greater flexibility in the law of contracts. Nonetheless, Lord Wilberforce⁷⁵, in Bunge, contended that if the intention of the parties is expressed in the contract to regard an obligation as having the force of a condition, then the courts should be ready to interpret such a contractual clause as a condition. This should also apply to any time clause within mercantile contracts.

In Bunge, Lord Scarman agreed with Lord Wilberforce, but he also put forward a few additional observations with regards to innominate terms in contractual law. Utilising the Hong Kong Fir case as a reference, he affirmed his agreement with that of Lord Wilberforce, that English law was aware of the fact that contractual terms were neither conditions nor warranties, but ‘intermediate’.⁷⁶

In the Hong Kong Fir case, ‘seaworthiness’ was the term in question, and as already mentioned earlier in the text, various levels of breach could be applied, ranging from the trivial to the more serious faults. As Lord Scarman said:

“If the stipulation is one, which upon the true construction of the contract the parties have not made a condition, and breach of which may be attended by trivial, minor or very grave consequences, it is innominate, and the court (or arbitrator) will, in the event of dispute, have the task of deciding whether the breach that has arisen is such as the parties would have said, had they been asked at the time they made their contract: ‘it goes without saying that, if that happens, the contract is at an end’”.⁷⁷

On application of this analysis, if the parties had not made a term a condition on drawing up of the contract, which if broken might subsequently lead to either a trivial, minor or serious incident, it would be termed as ‘intermediate’, because the

⁷⁵ Ibid.

⁷⁶ *Bunge Corpn. v Tradax S.A* [1981] 1 W.L.R., 711, 717.

⁷⁷ Ibid.

effect of non-performance could be dependent on the nature and the consequence of the breach. The court, in this situation, would be asked to determine whether the parties could have anticipated such a breach to have occurred, had they been asked at the time of making their initial contract.

Lord Scarman, concluded by holding that the particular term at issue, in the Bunge case should be treated as a condition and *not* as an innominate term. He believed that it made more commercial sense, as the seller was dependent on sufficient notice by the buyer to enable him to select the loading port, and overall was also generally necessary, so that both parties involved, 'knew where they stood' whilst undertaking the transaction.

Lord Lowry was in agreement. An additional comment offered by Lord Lowry, pointed out that the whole concept of drawing up contracts was to abide by them and not to 'avoid' that which was formally agreed upon.⁷⁸

Lord Lowry concluded by offering his views on *certainty*. He agreed that its value with regards to string contracts would benefit both the buyers and the sellers as their roles were potentially interchangeable. He further stated that by having more legal support, this would enable the parties to participate in their business undertakings more confidently. His belief was that innominate terms would prove difficult and that litigation would consequently arise, resulting in potential delays before the case was finalised.

In assessing damages, conditional terms were seen as more favourable and recent cases also highlighted that the term was seen as a condition. This in turn would aid those parties involved in similar cases, with a test case which they could rely on.

His final thought was that the innocent party would have the opportunity to treat the condition as an innominate term or as a warranty in situations where the consequences of the breach of condition were considered slight.

⁷⁸ Ibid at 719.

Lord Roskill commented further on the aspect of *certainty* by emphasising the importance of the parties' awareness in relation to their rights:

“Parties to commercial transactions should be entitled to know their rights at once and should not, when possible, be required to wait upon events before those rights can be determined”.⁷⁹

An exception to this dicta, would be in cases of ‘alleged frustration or of alleged repudiatory delay’ where it would be necessary to await for the rights to form.

Lord Roskill clearly acknowledges the need for *certainty*, in mercantile contracts by affirming its importance as a determining factor in deciding the true construction of terms in any such contract.

In summing up, following a thorough reading of the judgment of the Bunge case, it can be noticed that the House of Lords identified that uncertainty arose from the Hong Kong Fir approach and hence, took a firm stand in favour of *certainty*.

Thirdly, certainty, in relation to a term where time is agreed to be of essence, is explained in the Union Eagle Ltd. v. Golden Achievement Ltd. (P.C.).⁸⁰ In this case, which involved a contract of sale relating to property, an agreement was made under which time of completion was of the essence. The purchaser failed to comply with these pre-agreed terms by arriving 10 minutes late in completing. Following this, the vendor as had been agreed, forfeited the deposit and rescinded the contract. The purchaser argued that this was “unconscionable”. Ultimately, the case highlighted that the level of penalty would not be minimised simply because the breach was of a minor nature.

It was held that “failure to complete on time was a repudiatory breach of contract rendering performance by the purchaser impossible and entitling the vendor to reject the late tender of the purchase price and to rescind the contract...”⁸¹

Commenting further on this case, Brownsword states, “the Privy Council

⁷⁹ Ibid at 725.

⁸⁰ Union Eagle Ltd. v. Golden Achievement Ltd. (P.C.). [1997] A.C., 514.

⁸¹ Union Eagle Ltd. v. Golden Achievement Ltd. (P.C.). [1997] A.C., 514 at 514.

determined that, in cases of this kind, far from indulging the purchaser's trivial breach, it was appropriate to restate quite firmly that equity would not intervene".⁸²

In other words, certainty is the main concern expressed by the court other than fairness.

Fourth, certainty, in relation to seller's right to repudiate a sale contract upon buyer's non-compliance with the contract's conditions, is illustrated in Cargill v. Continental U.K.⁸³ This particular case highlighted the importance of the buyer complying with a vessel nomination clause (which was to give 8 days notice of readiness) as incorporated within the contract. Upon failing to do so, the buyer was subsequently deemed as being in default and the seller was ultimately allowed to cancel the contract, which they chose to take advantage of, based on the apparent raise of the price in the market.

The main issue which arose from the judgment of this case, was whether a buyer of goods on f.o.b. terms, was permitted to substitute another vessel to take delivery of the goods from the seller to replace the current one which was originally nominated by the buyer. In summing up the case, it was therefore held that the buyers were unable to depend upon any general rule which would permit them to do so, as in this case where once a substitution had been made, it was too late for the buyers to make a further valid nomination within the stipulated time as agreed within the contract.⁸⁴

2.3 Comparison Between the Strict Compliance Test and Breach of Condition in the Law of Contract

Turning from the need for certainty in the general law of contract to certainty in

⁸² Brownsword, R., 'Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law' in *Good Faith in Contract: Concept and Context*, Edited by Brownsword, Hird and Howells (Dartmouth, 1999), 67, at 72.

⁸³ *Cargill v. Continental U.K.* [1989] 1 Lloyd's Rep. 193; Q.B. (Com. Ct.).

⁸⁴ *Ibid* at 197.

letters of credit, we can note that relaxation of the strict compliance rule (in documentary credits) would be analogous to relaxation of the strict condition rule in Hong Kong Fir. However, insistence on strict compliance would resemble the cases of Union Eagle and Bunge Corpn which concern *certainty*. Although the named cases do not concern letters of credit, they will provide some assistance when examining the issues of strict compliance and qualified strict compliance in Chapter Five.

This analogy can be taken a little further in the following way. In the general law of contract, the Hong Kong Fir approach is seen as representing an indirect way of dealing with bad faith. An alternative (not adopted in English law) would be to have a direct test of good/bad faith through a general doctrine of (objective) good faith. Similarly, in letters of credit law, both tests of qualified strict compliance and substantial compliance could be likened to an indirect Hong Kong Fir approach. Having said this, in the general law of contract, the Hong Kong Fir approach is perceived to be too threatening to certainty and so, in Bunge v Tradax, we find the traditional condition/warranty distinction being revitalised (and this is the parallel to strict compliance). In other words, the analogy is at two points as follows:

(i) strict compliance: Bunge v Tradax

(2) qualified strict compliance or substantial compliance: Hong Kong Fir (an indirect test of good faith)

2.4 Conclusion

Regarding certainty, it has been contended that the law should be clear in order to give certain results, and contracting parties ‘must know where they stand’.⁸⁵ It would be appropriate, however to end with Goode’s words, that certainty cannot be absolute for all times. He maintains that:

“every business man and his lawyer should know that there are tides in judicial philosophy, that every action ultimately produces a reaction, that a form of liability

⁸⁵ Adams & Brownsword, *Key Issues in Contract* p 244.

denied by one generation of judges will be vigorously developed by the next".⁸⁶

3 Flexibility

3.1 Introduction

Apart from certainty, flexibility has been regarded as another important need for businessmen. It is fundamental that the law remains open to change, to enable it to take into consideration current business practices.⁸⁷ "The commercial law has had to be flexible in order to be able to adapt to and accommodate constantly changing commercial practices".⁸⁸ Such commercial practices exist by merchants' day-to-day informal conduct of business. The fact is that commercial law should be responsive to those constantly changing ideas of conduct.⁸⁹ A detailed explanation of this principle will be given below under the following sub-headings namely, (1) the tradition of flexibility in the UK and the USA, (2) flexibility achieved by the incorporation of custom and usage, (3) flexibility and the modern approach to consideration and finally (4) flexibility and the modern approach to offer and acceptance.

3.2 The Tradition of Flexibility in the United Kingdom and the United States

Where the needs of the business community are concerned, it appears that the UK courts are willing to respond to such needs and at the same time, are hesitant to dismiss the 'legal efficacy' of commercial instruments and those practices which

⁸⁶ Goode, *supra* note 5 at 150 To the same effect, Waddams also agrees that, "certainty, though an important value in contract law, is not an absolute one..." in Waddams, *supra* note 50, at 391. He gives an example of uncertainty which could happen by the linkages between undue influence on the one hand and economic duress and unconscionability on the other. Same Article pp 391-392.

⁸⁷ Bradgate, *Commercial Law* p 5. See also Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* pp. 10-11.

⁸⁸ Bradgate, *Commercial Law* p. 5.

⁸⁹ Devlin, P., 'The Relation Between Commercial Law and Commercial Practice' 14 *Modern Law Review* (1951) 249, 250.

are widely used⁹⁰. This is apparent where it is evident that the courts are willing to serve commercial practices, such as the growth of hire purchase contracts and retention of title clauses⁹¹.

The following commercial activities, which have also been exposed to certain changes, have recently been considered by the courts in relation to their status and the effects. Such practices comprise of letters of intent, letters of comfort, credit and cheque guarantee cards and financial instruments⁹². This willingness of the English courts to adapt as well as apply a principle of flexibility is evidenced in the words of Lord Devlin in Kum v. Wah Tat Bank Ltd⁹³:

“the function of commercial law is to allow, so far as it can, commercial men to do business in the way they want to do it and not to require them to stick to forms that they think to be outmoded. The common law is not bureaucratic.”⁹⁴

Lord Goff also expressed the attitude of judges towards the principle, by stating that:

“Our only desire is to give sensible commercial effect to the transaction. We are there to help businessmen, not to hinder them: we are there to give effect to their transactions, not to frustrate them: we are there to oil the wheels of commerce and not to put a spanner in the works, or even grit in the oil.”⁹⁵

The tradition of flexibility in the United States is reflected in the UCC.⁹⁶ Karl Llewellyn, due to his awareness of the importance of such a need, invited a wide range of flexible terms and concepts into the Code in order to encourage its development. Observance of the general policies and philosophy of the code as a whole was left to courts. Therefore, the UCC contains not only references to the continued expansion of commercial practices through custom ‘usage and

⁹⁰ Goode, *supra* note 5 at 49.

⁹¹ Bradgate, *Commercial Law* p 5.

⁹² *Ibid* at 6.

⁹³ *Kum. v. Wah Tat Bank Ltd* [1971]1 Lloyd’s Rep 439.

⁹⁴ *Ibid* at 444, per Lord Devlin.

⁹⁵ *Ibid* at 391, per Lord Goff.

⁹⁶ Goode, *supra* note 5 at 150.

agreement of the parties'⁹⁷, but also obligations of good faith, diligence, reasonableness and care.⁹⁸ Moreover, the preservation of general principles of law and equity are also found in the UCC.⁹⁹

3.3 Flexibility Achieved by the Incorporation of Custom and Usage

The need for flexibility has been met by judicial recognition of mercantile custom and usage thereby incorporating it within the common law. It is indeed a well-established rule that a contract may be subject to terms that are sanctioned by custom, although they have not been expressly mentioned by the parties. In the case of Hutton v Warren¹⁰⁰ in 1836, for instance, it was proven that, by a local custom, a tenant was bound to farm according to a certain course of husbandry and that, on quitting his tenancy, he was entitled to a fair allowance for seed and labour on the arable land. The Court of Exchequer held that the lease made by the parties must be construed in light of this custom.

Custom and usage is often adopted by the legislature as the standard rule for the conduct of the business in question. The law in such cases is not so much imposed *ab extra* by judges or Parliament as developed by the pressure of commercial convenience or local idiosyncrasy. Many commercial law principles have been derived from mercantile custom and usage; the legal status of the bill of lading and bill of exchange derived from their commercial use is a typical example. It is suggested therefore, that the law must be changed in conjunction with any alterations made to the customs¹⁰¹. Nonetheless, customs which have been directly incorporated and utilised by judicial recognition are apparently uncommon¹⁰². At the same point, it is evident that such a custom will be rejected by the court unless

⁹⁷ UCC § 1-102(2) (b).

⁹⁸ UCC § 1-102(3).

⁹⁹ UCC § 1-103.

¹⁰⁰ *Hutton v Warren* (1836) 1 M&W 466.

¹⁰¹ Bradgate, *Commercial Law* p 5.

¹⁰² Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* pp 10-11.

the custom can be demonstrated as being both reasonable and consistent with the terms, as expressed by the contract. In addition to this, it should be perceived as being recognisable in the universal sense, and held as binding within a business environment¹⁰³.

In Cunliff-Owen v. Teather and Greenwood¹⁰⁴ Ungood-Thomas J. said,

“‘usage’ is apt to be used confusingly in the authorities, in two senses, (1) a practice, and, (2) a practice which the court will recognise. ... For the practice to amount to such a recognised usage it must be certain, in the sense that the practice is clearly established, it must be notorious, in the sense that it is so well-known, in the market in which it is alleged to exist, that those who conduct business in the market contract with the usage as an implied term; and it must be reasonable.”¹⁰⁵

Having said that a custom cannot be used unless it passes the test of reasonableness, the question which then transpires is how the term reasonable can be defined. One suggestion is that “it is not reasonable unless it is fair and proper and such that reasonable, honest and right-minded men would adopt”¹⁰⁶. An example can be seen in North & South Trust Co v. Berkeley.¹⁰⁷ In that case, Donaldson J. held that the practice which was followed by Lloyd’s underwriters to use Lloyd’s insurance brokers, who were acting as their agents, instructing them to obtain an assessors’ report for them, was utterly unreasonable and incapable of being a legal usage or custom. It was regarded as unreasonable as it conflicted with the very basic principle of the law of agency which states that “an agent cannot lawfully place himself in a position in which he owes a duty to another which is inconsistent with his duty to his principal”¹⁰⁸.

The main aim of custom is to fulfil the law rather than destroying it and in doing so it would apply to the variety of disputes evident within different contracts. This

¹⁰³Ibid at pp 10-11.

¹⁰⁴ *Cunliff-Owen v Teather and Greenwood* [1967] 1 WLR 1421 at 1438-1439.

¹⁰⁵ Ibid at 1438-1439.

¹⁰⁶ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* pp. 22-23.

¹⁰⁷ *North & South Trust Co v. Berkeley* [1971] 1 WLR 470.

¹⁰⁸ Ibid at 471.

would in turn, promote commercial efficacy. In other words, the consideration of custom and usage makes the law more flexible. It must not contradict the express terms of a contract but must serve rather to reinforce them and assist their general purpose and policy. Lord Jenkins has emphasised both the negative and the positive test to be applied before it is to be admitted:

“An alleged custom can be incorporated into a contract only if there is nothing in the express or necessarily implied terms of the contract to prevent such inclusion and, further that a custom will only be imported into a contract where it can be so imported consistently with the tenor of the document as a whole”.¹⁰⁹

3.4 Flexibility and the Modern Approach to Consideration

Flexibility in commercial law can also be seen from the modern approach to the doctrine of consideration.¹¹⁰ The general rule in English law is that a promise is not binding as a contract unless it is either made in a deed or supported by some consideration. The purpose of such a requirement is to put some legal limits on the enforceability of agreements even where they are intended to be legally binding and are not vitiated by some factors such as mistake, misrepresentation, duress or illegality¹¹¹. The reason behind such a doctrine is the idea of reciprocity: “some thing of value in the eye of the law” must be given for a promise in order to make it enforceable as a contract.¹¹²

The question of consideration arose in an interesting way in Williams v. Roffey¹¹³. To avoid any misunderstanding, it should be emphasised that this is not a case

¹⁰⁹ *London Export Corpn Ltd. v Jubilee Coffee Roasting Co.* [1958] 2 All ER 411 at 420, [1958] 1 WLR 661 at 675. See also *Kum v Wah Tat Bank Ltd.* [1971] 1 Lloyd's Rep 439.

¹¹⁰ The case of *Currie v. Misa*, (1875) L.R. 10 Exch 153, 162, explains what constitutes a valuable consideration. See for more details, Atiyah, ‘Consideration: A Restatement’. in *Essays on Contract*, (1990) p 179 seq; Beale, H.G., Bishop, W.D., and Furmston, M.P., *Contract: Cases and Materials*, 3rd ed (Butterworths, London, 1995) ch 6 p 93; Adams, J.N., ‘Consideration for Requirements Contracts’ 94 *LQR* (1978) 73.

¹¹¹ Treitel, G.H., *The Law of Contract* 10th ed (London, Sweet & Maxwell, 1999) 63.

¹¹² *Ibid.*

¹¹³ *Williams v. Roffey Bros & Nicholls (Contractors) Ltd.* [1991] 1 Q.B. 1. For comments on this case see, Treitel, G.H., *The Law of Contract* p 89; Adams & Brownsword, ‘Contract, Consideration and the Critical Path’ 53 *MLR* (1990) 536, 541. See generally, Adams, ‘Consideration for Requirements Contracts’ 94 *LQR* (1978) 73.

dealing specifically with letters of credit but it is an illustration from the general law of contract that the law should be flexible to fit in with commercial practice. The defendants entered into a contract to refurbish a block of 27 flats. They sub-contracted the carpentry works in the refurbishment to the plaintiff for a price of £20,000. Although there was no formal arrangement to this effect, the plaintiff was paid money on account. After the contract had been running for some months and the plaintiff had finished the carpentry at nine of the flats and done some preliminary work in all the rest, for which he had received some £16,200 on account, he found that he was in financial difficulties. These difficulties arose partly because the plaintiff had underestimated the cost of doing the work in the first place and partly because of faulty supervision of his workmen. The plaintiff and the defendants had a meeting at which the defendants agreed to pay the plaintiff a further £10,300 at a rate of £575 per flat to be paid as each flat was completed. The plaintiff carried on work and finished some eight further flats but only one further payment of £1,500 was made.

The plaintiff stopped work and brought an action for damages. The defendants argued that they were not liable as they had simply promised to pay the plaintiff extra for doing what he was in any case obliged to do, that is to finish the contract. The Court of Appeal might perhaps have found consideration in what Russell L.J. described as the replacement of 'a haphazard method of payment by a more formalised scheme involving the payment of the specified sum on the completion of each flat' since it was clear that under the original contract there was no express agreement for stage payments. However, all three members of the Court of Appeal appear to have concurred in the leading judgment which was delivered by Glidewell L.J. who said:

- "The present state of the law on this subject can be expressed in the following proposition:
- (i) if A has entered into a contract with B to do work for, or to supply goods or services to, B in return for payment by B, and
 - (ii) at some stage before A has completely performed his obligations under the contract B has reason to doubt whether A will, or will be able to, complete his side of the bargain, and
 - (iii) B thereupon promises A an additional payment in return for A's promise to perform his contractual obligations on time, and
 - (iv) as a result of giving his promise B obtains in practice a benefit, or obviates a

- disbenefit, and
- (v) B's promise is not given as a result of economic duress or fraud on the part of A, then
 - (vi) the benefit to B is capable of being consideration for B's promise, so that the promise will be legally binding."¹¹⁴

It is clear that where one party to a contract refuses to go on unless he is paid more, this will often be improper and in modern cases has been characterised as economic duress. In the present case, however, there was no suggestion that the plaintiff had ever made any improper threat; Glidewell LJ thought that in the circumstances the critical question was whether the defendants had received a benefit. It is clear that in cases of this kind there are often good commercial reasons why a promisor would choose to promise more to ensure the performance. If the promisee were to go out of business or become insolvent it would almost inevitably cost a good deal more to engage somebody to complete the work. Good and reliable trading partners are hard to find and it may be sensible to help them keep afloat rather than look for a new partner.¹¹⁵

Turning to the question of consideration in commercial letters of credit, Atiyah has stated that an irrevocable confirmed credit becomes binding on the bank as soon as it has notified the seller that the credit has been opened.¹¹⁶ There seems to be no consideration given by the beneficiary for the issuing bank's promise in the letter of credit¹¹⁷. Nevertheless, it appears to have been assumed in all the cases that there was good consideration for the banker's promise.

¹¹⁴ *Williams v. Roffey Bros & Nicholls (Contractors) Ltd.* [1991] 1 Q.B. 1, 15-16.

¹¹⁵ Note that the decision has been criticised by Coote as 'remote from received learning'. See, Coote, B., 'Consideration and Benefit in Fact and in Law' 3 *Journal of Contract Law* (1990) 23 at 24. See for more recent discussion on *Williams v. Roffey*, Carter, Andrew and Poole, 'Reactions to Williams v Roffey' 8 *Journal of Contract Law* (1995) 248.

¹¹⁶ According to Atiyah, *The Sale of Goods*, 9th ed (London: Pitman, 1995) pp 389-391. See especially *Hamzeh Malas & Sons v. British Imex Industries Ltd* [1958] 2 Q.B. 127, 129 per Jenkins, LJ, [1958] 1 All E.R. 262, 263, per Jenkins; *Urquhart Lindsay & Co v. Eastern Bank Ltd* [1922] 1 K.B. 318; *United City Merchants (Investments) Ltd v. Royal Bank of Canada* [1983] 1 A.C. 168, 183, per Lord Diplock.

¹¹⁷ Penn, Shea and Arora, *The Law and Practice of International Banking Law* (London, Sweet & Maxwell, 1987) 293.

In the case of Urquhart Lindsay Co v. Eastern Bank,¹¹⁸ Rowlatt, J. had no doubt that consideration moved from the seller acting upon the undertaking contained in the letter of credit. His honour observed that:

“There can be no doubt that upon the plaintiffs acting upon the undertaking contained in this letter of credit consideration moved from the plaintiffs, which bound the defendants to the irrevocable character of the arrangement between the defendants and the plaintiffs”.¹¹⁹

However, the dissenting arguments against the existence of a valid consideration are based on the common law rule that consideration must move from the promisee. The promise to reimburse the banker as well as paying him charges, moves solely from the buyer of the goods and is consequently insufficient to support any promise made by the banker to the seller.¹²⁰

Therefore, it is important to consider what constitutes consideration for the promise on the part of the banker to the beneficiary. Clearly, the seller's (beneficiary) undertaking to deliver the goods to the buyer does not constitute consideration for the banker, simply because the underlying contract (contract of sale) is created before the credit is issued by the bank and thus, such consideration would be past.¹²¹

While consideration is still a real factor in the English law of contract, the attempt to find a legal basis for the contract between a banker issuing a credit and the beneficiary is yet academic because of the view of the Courts that a binding contract arises. Harfield¹²² concludes that:

“the banker's letter of credit is a legally enforceable instrument, rooted in the law merchant and contractual in nature. There is neither need nor utility to employ procrustean techniques to establish its validity.”

¹¹⁸ *Urquhart Lindsay & Co v. Eastern Bank*. [1922] 1 K.B. 318.

¹¹⁹ *Ibid* at 321-22.

¹²⁰ Gutteridge, and Megrah, *The Law of Banker's Commercial Credit* (London, Europa Publications Limited, 1976) 27.

¹²¹ *Ibid*.

¹²² Harfield, H., *Bank Credits and Acceptance* 5th ed. (The Roland Press Company, New York, 1974) p 55.

In handling the issue of consideration in commercial letters of credit, Article 5-105 of the UCC states that, “no consideration is necessary to establish a credit or to enlarge or otherwise modify its terms”.¹²³

Concluding from the above views, it can be said that commercial law has certain special characteristics, one of which is that of flexibility. Although there is some opposition to the non-consideration requirement in letters of credit, the judicial trend leans towards the opinion that consideration is not necessary in letters of credit transactions. Any other view would be seriously at odds with the parties’ understanding of the rights and obligations arising under a credit arrangement.

3.5 Flexibility and the Modern Approach to Offer and Acceptance¹²⁴

The flexibility of modern commercial law is also illustrated in the case of Trentham Ltd v. Archital Luxfer.¹²⁵ Although, again, this case is not concerned with letters of credit, it illustrates how modern flexibility allows a contract to be formed in certain circumstances, contrary to the classical rule of offer and acceptance of contract law. In this case, an agreement between the plaintiff and the defendant was entered into for the purpose of designing and building industrial units in two phases. Phase 1 was to be governed by the main contract agreement, whereas phase 2 was to be governed by the supplemental agreement. It was common ground that Archital undertook, for Trentham, the window works in both phases and that Trentham paid Archital for carrying out the window works. There, the plaintiff contended that two separate sub-contracts came into existence, and alleged that there were defects in the work in both phases 1 and 2 and therefore, claimed damages for breach of contract. The defendant, however, argued that there had never been a binding contract. The Court of Appeal ruled in favour of the plaintiff. The two

¹²³ See Chapter Three for more on consideration.

¹²⁴ See for general information, Winfield, ‘Some Aspect of Offer and Acceptance’ 55 *LQR* (1939) 499; Beale H.G, Bishop. W.D, and Furmston. M.P., *Contract: Cases and Materials*, Ch. 8; Vorster, ‘A Comment on the Meaning of Objectivity in Contracts’ 103 *LQR* (1987) 274.

¹²⁵ *Trentham Ltd.v. Archital Luxfer*. [1993] 1 Lloyd’s Law Rep 25.

contracts were held¹²⁶ to be concluded, as it was plainly the parties' intention to enter into binding contractual relations. There was evidence of simultaneous exchanges and the carrying out of what was agreed in those exchanges which supported the view that there was a course of dealing. As a result of which, a right to performance of the work by the defendant was created on the plaintiff's side and a right to be paid on an agreed basis was created on the defendant's side. A contract came into existence during performance. It impliedly governed pre-contractual performance and a binding contract was concluded in respect of phase 1. Moreover, since a contract was concluded in respect of phase 1, the submission by the defendant that during negotiations for phase 2 the parties were mistakenly of the view that a contract had been made in respect of phase 1 would be rejected.

Brownsword, commenting on this case, stated that the Court of Appeal did not follow the common law direction of compliance to the formation of contracts, which is based on the offer and acceptance theory. Rather, "it recognised that a contract could come into existence in stages, without there being a particular moment at which a comprehensive offer was definitively accepted and a contract (as classically conceived) materialised".¹²⁷ Commercial law should, therefore, accommodate such commercial expectations. It has to be flexible enough to adapt to the constantly changing commercial practices. It has been said that the danger in any branch of the law is that it becomes rigid and ossified¹²⁸. To prevent this from happening, courts should be induced to recognise the altered use of custom and usage.

3.6 Conclusion

The principle of flexibility in commercial law means that the law should be elastic in its application, to adapt to and accommodate regularly changing commercial

¹²⁶ Ibid at 25.

¹²⁷ Brownsword, 'Static and Dynamic Market Individualism' in Halson, R., (ed) *Exploring The Boundaries of Contracts* 48, 52.

¹²⁸ Devlin, P., *supra* note 89 at 251.

activities. In its attempt to facilitate commercial transactions, commercial law, in relation to both its substance and its procedure, aims to satisfy the needs of the any community involved in trading activities¹²⁹. Generally speaking, courts are willing to apply the rigid common law rules flexibly to commercial law in order to promote business efficacy. Examples are by incorporating the custom and usage of trade, adopting a less rigid approach to the doctrine of consideration, and applying a more generous approach in the compliance to common law 'offer and acceptance' theory in commercial cases.

4 Fairness

4.1 Introduction

Many people think that the law should be fair. Yet this is a vague concept. What does it mean? When we talk about certainty, for instance, it is clear; in its definition it claims that the law should be certain so that people know where they stand. Nonetheless, so far as fairness is concerned, regardless of its ambiguous meaning, it is a value that the law should reflect.

According to the Collins Cobuild English Dictionary, 'fairness' is the 'quality of being reasonable, right, and just'. Its meaning, in the legal sense, is very much the same, except that in law, there is a need to distinguish between procedural and substantive fairness. The reason is that, in making a contract there are two issues: the means which are used to achieve a result; and the end result itself.¹³⁰ That is to say, some questions of fairness deal with the process of contracting and others deal with the resulting contract.

In this section, the meaning of 'procedural fairness' and 'substantive fairness' will be explained and the importance of fairness in both respects will be discussed.

¹²⁹ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* pp 10-11; Bradgate, *Commercial Law* p. 5.

¹³⁰ Leff, A.A., 'Unconscionability and The Code-The Emperor's New Clause' 115 *University of Pennsylvania Law Review* (1967) 485, 487.

Procedural fairness is the main concern of the classical law, while the modern approach tends to be concerned more about substantive fairness, but still one can argue that both procedural and substantive fairness are common features of modern law as well.

It will be found later in this section that in fact, it is very difficult to separate the two concepts of fairness¹³¹ as they tend to both overlap and feed upon each other. There are writers who do not always find the distinction too helpful.¹³² They treat both forms of fairness without suggesting that the distinction is of general importance.

4.2 What is 'Procedural Fairness'?

Bargaining defects may be referred to as 'procedural unconscionability'.¹³³ This is concerned with the whole process of how agreements are negotiated until they are concluded.¹³⁴ It requires that nobody shall gain the benefit of a bargain entered into by fraud, force, duress, misrepresentation,¹³⁵ undue influence and mistake. For example, 'a contract signed at the point of a gun' can hardly be regarded as a valid contract at all.¹³⁶ In other words, the focus here is on what happened between the parties while making the contract; therefore if both parties were well aware of what they were doing and engaged freely in the process, the result should not concern the law. This supposition means that having controlled the process of making the contract, as suggested by Atiyah, the result should then be treated as

¹³¹ Phang, A., 'The Uses of Unconscionability' 111 *LQR* (1995) 559, 561.

¹³² Atiyah, 'Contract and Fair Exchange' in *Essays on Contract* (Oxford, Clarendon Press, 1990) 329, fn 1 at 333; See also by the same writer, *The Rise and Fall of Freedom of Contract*, (Oxford: Clarendon Press, 1979) pp 402-405.

¹³³ Leff, *supra* note 130 at 487. See further, Bamforth, N., 'Unconscionability as a Vitiating Factor' *LMCLQ* (1995) 538.

¹³⁴ Leff, *supra* note 130 at 487. See also in this regard Winder, 'Undue Influence and Coercion' 2 *Modern Law Review* (1939) 97, 100 ; Millett, P.J., 'Equity's Place in the Law of Commerce' 114 *Law Quarterly Review* April (1998) 214, 220.

¹³⁵ See the Misrepresentation Act 1967, § 2(2) which rescind the contract, even though someone's statement was made not only honestly but with reasonable grounds for believing it to be true.

¹³⁶ Fuller, L.L., 'The Forms and Limits of Adjudication' 92 *Harvard Law Review* (1978) 353, 364.

fair.¹³⁷

A pure procedural school of thought cannot assess whether a contract is substantively fair or not, but one is entitled to ground one's judgement solely on the means (procedure) by which the contract was made. This resembles the classic *laissez-faire* free market philosophy which advocates that only the parties to the contract are entitled to assess their needs as against their ability to perform¹³⁸. If this is accepted to be true, then there must be an assumption that the market price¹³⁹ is fair, and to do otherwise is not considered as fair.

4.3 What is 'Substantive Fairness'?¹⁴⁰

It cannot be denied that there are procedural rules of fairness which must be met, but it is argued that there are substantive norms as to the end result, which must be met by any contract. 'Substantive fairness' refers to the good or evils in the resulting contract.¹⁴¹ The material question then would be concerned with the contract once 'made', and this is concerned with what agreements provide.

What, however, is the criterion of substantive fairness? The following five theories of substantive fairness (namely, efficiency, distributive, incentive, co-operation and

¹³⁷ Atiyah, P. S., 'Contract and Fair Exchange.' in *Essays on Contract* p 330.

¹³⁸ Beatson, J., *Anson's Law of Contract* p. 4.

¹³⁹ See the argument about (i) distributive justice and (ii) unjust enrichment in Gordley, 'Equality in Exchange' 69 *California L.R.* (1981) 1587, 1588-90.

¹⁴⁰ Leff, *supra* note 130 at 487. Regarding the difference between procedural and substantive unfairness see P.J. Millett, *supra* note 134 at 220. For the discussion about the linkage between undue influence and economic duress and unconscionability; See also Waddams, *supra* note 50, 369 et seq.; Getzler, 'Unconscionable Conduct and Unjust Enrichment as Grounds for Judicial Intervention' 16 *Monash Univ. L. Rev* (1990) 283. For comparative analysis; Enman, S., 'Doctrines of Unconscionability in Canadian, English and Commonwealth Contract Law' 16 *Anglo-AM. L. Rev* (1987) 191; Angelo & Ellinger, 'Unconscionable Contract-A Comparative Study' 4 *Otago L. Rev.* (1979) 300; and by the same authors, 'Unconscionable Contracts: A Comparative Study of the Approaches in England, France, Germany, and the United States' 14 *Loy. L.A. Int'l Comp. L. J.* (1992) 455; See also, Smith, S.A., 'In Defence of Substantive Fairness' 112 *Law Quarterly Review* January (1996) 138, 138-158. See further about substantive and procedural fairness, Smith, S.A., *supra* note 3 at 172-75.

¹⁴¹ Leff, *supra* note 130 at 487.

screening theory) as advanced by Buckley¹⁴², represent an interesting attempt to assess the fairness of the end result of a contract. According to Buckley, the efficiency approach will gradually lead to the best solution.¹⁴³ On this logic, in the long run, the aim of the law should be to follow a path which leads to the most efficient results for *all* parties.

4.3.1 Efficiency Theory

According to this theory, the overall objective of contract law is to strive for the market arrangement that leads to the most efficient result¹⁴⁴. This is essentially utilitarianism, which suggests that the substantively fair result is the one that ends in an arrangement that leads to the maximum utility. This theory is best illustrated by a hypothetical situation and with the help of mathematical equations. Assuming Andrew and Benjamin are the contracting parties. In algebraical representation, assuming the following:

happiness of Andrew before the contract = a;
 happiness of Benjamin before the contract = b;
 happiness of Andrew after the contract = A; and
 happiness of Benjamin after the contract = B.

If $(a + b) < (A + B)$ then the contract is substantively fair. Alternatively, if $(a + b) > (A + B)$ then the contract is substantively unfair. However, there are serious problems with this approach. If different solutions that a contract may lead to are being examined, the theory will potentially leads to very diverse and unfair results. For instance, using the same assumption as above, if in a contract X, between Andrew and Benjamin:

Overall happiness before contract = $(a + b) = 0$; and
 overall happiness after contract $(A + B) = 10$.

While in another contract Y, between the same parties:

Overall happiness before contract = $(a + b) = 0$; and
 overall happiness after contract = $(A + B) = 6$

¹⁴² Buckley, F.H., 'Three Theories of Substantive Fairness' 19 *Hofstra Law Review* (1990) 33. et seq.

¹⁴³ *Ibid* at 37.

¹⁴⁴ *Ibid* at 34.

Mathematically speaking, since $10 > 6$, the final overall happiness level of contract X is greater than that of Y, and hence, on the face of it, contract X seems to be 'fairer'. Yet, problems become apparent if a few more figures are built into the equation; assuming in contract X:

A = 9; and B = 1

While in contract Y:

A = 3; and B = 3

Although contract X leads to a better *overall* result, the benefits of the contract are severely distorted in favour of Andrew. By contrast, although the overall efficiency gains in contract Y are small by comparison, at least the gains are distributed fairly between Andrew and Benjamin.

The criticism of this test of substantive fairness is therefore that, it is potentially unfair in the way that it deals with contracts; for the sake of global efficiencies it is prepared to sacrifice the individual.

4.3.2 Distributive Theory¹⁴⁵

As with the efficiency theory we are looking at the end result of the contract, but this theory seeks to understand whether it is fair as to the effect that it has *on the parties involved*. Taking the previous example of the two contracts, X and Y, whereas the efficiency theory passes no comment on the distribution of benefits, this school of thought finds a way to say that the distribution under contract X is unfair and as a result wrong.

The fundamental difficulty of this theory is to explain *why* it is unfair for one person to earn substantially more than another does, as this is basically a moral question. On one side, it may be said that everybody has a different moral viewpoint and it is better to let everybody be free to earn his just rewards in the

¹⁴⁵ For more details about distributive and commutative justice see Gordley, 'supra note 139 at 1588-90; Kronman, A., supra note 6, at 472 et seq.

market place (i.e. rely solely on procedural fairness). On the other side, it may be argued that moral rules can be constructed on the basis of what individuals would agree to under a veil of ignorance. However, this supposition is also unclear.¹⁴⁶

Buckley¹⁴⁷ comments that the doctrine of procedural fairness is inadequate and is not doing enough to regulate contracts. Likewise distribution theory is dismissed as lacking adequate justification. Moreover, the theory is also criticised, as the law is often self-defeating in its attempts to aid the weaker party to the contract. The economy is often weakened by excessive regulatory intervention and since the overall strength of the economy is our major objective, the law should strive for an arrangement which is substantively fair in terms of *efficiency*. This theory thus fails in explaining why and how laws should be constructed so as to intervene in contractual disputes.

4.3.3 Incentive Theory

The incentive argument is that without legal regulation, parties to a contract will be encouraged to take excessive pre-bargain care. That is to say, in order to avoid the risks of one-sided contracts forced on them by their situation, parties will have to invest heavily in advance on precautions which would not be necessary if they could be confident that a contract would be regulated fairly by the courts.

This argument works for the stronger party to the contract as much as it does for the weaker. In the long run, without this fairness provision, the weaker party will either be discouraged from taking risks in contracts; or will invest heavily beforehand in pre-bargain care so as to ensure that he will never need the help of the stronger party. As a result, there will be a damaging effect on the society as a whole, as there will be fewer contracts made and a significant decrease in economic activities.

Where the bargaining parties cannot obtain a reasonable contract because of their

¹⁴⁶ Buckley, *supra* note 142 at 36.

¹⁴⁷ *Ibid* at pp 34-36.

respective power levels, then the law must regulate. At what level the weaker party deserves protection is a discretionary decision, there are no definitive answers. Nevertheless, on this moral basis, the power to regulate is still justified. Two illustrative and insightful hypothetical examples cited by Buckley are worth mentioning:

First there is the starving millionaire story.¹⁴⁸ Stuck in the desert, a starving millionaire has no choice but to give up his fortune in return for some food from an innkeeper.

According to the logic of the efficiency argument, in the future, the result of this contract being valid without amendment is that, the millionaire will be either discouraged from travelling, or he will be forced to spend excessive amounts on pre-bargaining care. As a result, either innkeepers would no longer be needed which could result in fewer inns in the future, or people would no longer risk travelling. Consequently, the world would be a poorer place.

By contrast, if interventions and regulations exist, not only would the millionaire be happier, but future travellers would be encouraged to travel and waste less money on safety knowing that they would not be taken advantage of in the case of misfortune. Moreover, innkeepers could rely on a steady stream of customers in the future. Thus, everyone is a winner.

The second story is about an unfortunate traveller.¹⁴⁹ This story is used to show that there are limits to the incentive theory. In this story, a specialist rescuer has invested a lot of money in becoming a rescuer. It is presumed that becoming a rescuer is a good business and should be encouraged. If the trade is regulated, then they might be less inclined to continue in it in the future. As this is an anti-social result we should not risk intervention here and the contract should stand. That is to say, pre-bargaining care is useful and should be encouraged under this situation.

¹⁴⁸ Ibid at 41.

¹⁴⁹ Ibid at 45.

The essence of this scenario is that rescuers should be encouraged, however, people should not be allowed to take advantage of the situation, as lots of money may be wasted on precautions which would be better dealt with by adequate rescue facilities. This again has to be a discretionary decision on the part of the judges, which no amount of economic formula will help to resolve.

4.3.4 Co-operation Theory¹⁵⁰

This theory takes the doctrine of substantive fairness a stage further. Again, the aim is to strive for the best result for *all* parties, which is to say the best result is the most socially efficient solution.

Essentially, in the long run, more contracts will be made where all parties operate under, or recognise, 'fair' rules of bargaining. By contrast, where some parties adopt hard bargaining techniques, the weaker party will suffer and eventually go out of business if they continue to receive insufficient reward for their work. The economy will suffer as a result because there will be less players on the market, reducing competition, and thus less business and less economic efficiency.¹⁵¹ In order to have this problem solved, law should regulate certain business practices so as to encourage and facilitate business affairs generally. There is much to be said for this approach, but there is still much uncertainty as to how any overall social result could be calculated.

4.3.5 Screening Theory

Screening theory is concerned with contracts that have been inadequately considered by one of the parties.¹⁵² This is inevitable in a market economy where individuals and large companies are trading with one another. Provided that there is a means by which there is assurance that consumers will not be taken advantage

¹⁵⁰ Ibid 48.

¹⁵¹ See for the argument between fairness and economic efficiency, Burrows, J.F., 'Contractual Co-operation and the Implied Term' 31 *MLR* (1968) 390.

¹⁵² Buckley, *supra* note 142 at 59.

of by big companies, things will not get problematic. However, it is indeed impractical and thus impossible to expect every consumer to analyse the finer points of the contract — some form of interference is needed to re-establish a fair contract. The issue is by *what criteria*.

Due to the weak bargaining position of an individual, courts' assistance is necessary. Buckley¹⁵³ argues that whilst some consumers will not adequately screen contracts, others will. Thus the non-screener will in practice be protected by the screeners. It could be argued that the *pressure* of the screeners will protect all consumers to the contract, because the company can hardly distinguish the legally minded consumers from the rest. If this process does work, it will indeed be preferable as consumers are in the better position to know their needs than the court does. More often than not, though this *pressure* may be insufficient and thus the original problem remains.

Buckley¹⁵⁴ further argues that the court should only intervene and screen contracts if the contractual terms have nothing to do with economic efficiency, all other terms should be left to the parties to decide upon. In addition, regarding the price of screening, substantive fairness norms are most appropriate where screening costs are high.

4.3.6 Buckley's Conclusion

Buckley concludes¹⁵⁵ by rejecting the distribution theory, and promoting the efficiency theory. Society and law is built upon the premise that it is there to promote the welfare of the *individual*. In this respect markets are necessary because they promote freedom and choice, furthermore, contracts and business facilitate the operation of markets. However, all markets are secondary to the law, and where the law perceives that individuals are being adversely affected by the

¹⁵³ Ibid at 63.

¹⁵⁴ Ibid at 64.

¹⁵⁵ Ibid at pp 65-66.

operation of the market, or where the market is manifestly inefficient, then intervention is necessary. We do need to co-ordinate it so as to work fairly for individuals, to provide incentives for fair business, and to screen unfair contracts.

4.3.7. Efficiency Theory or Distributive Theory of Fairness?

It is to be noted here that, contrary to Buckley, the author favours the distributive theory over the efficiency theory. The preference was derived from the outcome of the mathematical equation outlined above. The outcome clearly illustrates that the efficiency theory does not take into account whether the contract outcome is severely distorted in favour of one party than the other. By contrast, according to the distributive theory, the question of how the contract outcome is distributed between the parties is the main concern. It is true that no justification for this preference is offered but neither is there any justification for maximising in accordance with the efficiency theory. Having expressed a preference for a distributive test of substantive fairness, it will be applied to the remainder of the thesis, in particular when considering the question of unfairness in some problematic issues, such as, punitive damages, strict compliance, the fraud exception and the nature of payment clause. The following analysis explains how this distributive theory relates to the law of credits. For instance, if punitive damages are always awarded, this would entail that one party to a contract would be over-compensated whilst the other party would be subjected to a severe loss, which would be highly unfair. Furthermore, as far as the strict compliance test is concerned, according to the distributive theory, the test can be perceived as unfair, because the beneficiary would lose his right to payment for trivial discrepancies whilst the buyer could still benefit from possession of the goods. Further, with regards to the nature of the payment clause, adopting the absolute payment rule could result in an unequal balance of advantage in favour of the buyer at the expense of the seller—for example, if the bank becomes insolvent or if the bank rejects the documents for trivial discrepancies in the documents. In both situations the buyer obtains the goods but the seller relinquishes his right of payment. Finally,

in relation to the fraud exception, the current state of English law, insists on two conditions before the fraud exception rule is to be allowed: firstly, the seller's knowledge of fraud and secondly the bank having a positive proof of it. In light of the distributive theory, the current state of English law is unfair in cases where there has been fraud but the bank for some reason cannot prove it, in which case the seller gets the money whilst the buyer receives defective goods but still has to pay the bank. Thus, if we apply the distributive theory of fairness, it is arguable that the confines of the fraud exception should be broadened under English law, as will be further elaborated in the Conclusion Chapter.

4.4 The Classical Approach to Substantive Fairness

According to the classical approach to substantive fairness, the court's intervention cannot be justified simply because there is an apparent inequality related to the transaction, certain terms appearing unfair, or discriminatory, or the bargaining power between the parties appears to be unequal. Yet, intervention would no doubt be justified if fraud or duress occur¹⁵⁶. Below are some representative examples – namely, the doctrine of consideration, strict liability, interpretation and mistake– illustrating the classical approach towards substantive fairness.

4.4.1 The Doctrine of Consideration and Strict Liability

It is submitted that the classical law refuses to adjust contracts in order to achieve a fairer distributive outcome, which is more in line with the original expectations of the parties¹⁵⁷. Its position in common law courts, towards the issue of fairness is, firstly, that the adequacy of consideration in contracts is irrelevant to the validity of contract. This is because once a contract is freely entered into, the assumption is that each party is satisfied with the bargain, then, there is simply no room for any investigation into the fairness of the exchange because the parties knew what they

¹⁵⁶ Adams & Brownsword, *Key Issues in Contract* p. 255.

¹⁵⁷ Collins, H., *The Law of Contract* 3rd ed (Butterworths, London, 1997) p. 253. Also Atiyah, *Essays on Contract* p. 329.

were at. Secondly, as we have seen already, even if ensuing events make the duty of one party much more burdensome than anticipated, a contract will still be strictly enforced.¹⁵⁸

4.4.2 Interpretation

While interpreting contracts, the courts have the opportunity to construct parties' obligations to bring them in line with the reasonable expectations of the parties. Nonetheless, it is not for the courts to rewrite the terms of the agreement in order to make them comply with the required standard of fairness. What they can do, however, is to "interpret vague terms and insert implied terms in order to bring the contractual obligations more into balance and to protect reasonable expectations".¹⁵⁹

4.4.3 Doctrine of Mistake

The classical law is reluctant to intervene with contracts on grounds of mistake. In other words, the classical law is not willing to intervene on grounds of substantive unfairness. The slogan of the classical law is that a free contract is a fair contract. The focus is procedural not substantive fairness. There is some logic in regarding a mistake as vitiating the intention to enter into a particular contract. This logic however, cannot be allowed to govern contracts, for, it would provide an open-ended excuse to avoid any transaction that turns out to be unfair in some way.¹⁶⁰

A better way of looking at the doctrine of mistake may be to view it in the context of the interpretation of contracts. Using this observation, "certain facts could be regarded as a condition precedent to the obligations arising under the contract".¹⁶¹ If these conditions did not exist due to a mistake, then the contractual obligations should be unenforceable. However, doubt may be cast on such a doctrine, as it

¹⁵⁸ Collins, H., *The Law of Contract* p. 253.

¹⁵⁹ *Ibid* at pp 258.

¹⁶⁰ *Ibid* at 259.

¹⁶¹ *Ibid*.

may be open to abuse by the party seeking to avoid the consequences of a bad bargain i.e. if it turns out to be a loss.

The position under English law is illustrated by the case of Bell v Lever Bros Ltd.¹⁶² Here, B and S entered into a contractual relationship with L company to act respectively as chairman and vice-chairman of N company. B and S broke their service contracts by entering on their own account into secret speculations in a commodity in which the N company dealt. Following amalgamation of N company with another company there was no need for both B and S and so the L company therefore agreed to compensate them for the termination of their service contracts. This was done without being aware of previous breach of service contracts. The question was, whether the compensation agreement made by company was based on the mistaken belief that the service contracts were valid and not terminable without compensation. This was later confirmed in the Court of Appeal where it was held that such compensation agreements were in actual fact void, based on the company's initial mistake. However, the House of Lords reversed that ruling. According to Lord Atkin's judgment "mistake as to quality...will not affect assent unless it is the mistake of both parties, and is as to the existence of some quality which makes the thing without the quality essentially different from the thing as it was believed to be".¹⁶³

He further went on to distinguish between cases concerning fraud and innocent misrepresentation, as grounds for a contract being rescinded. If there has been a fraudulent statement as to the quality of the subject matter of the contract, then the contract may be rescinded. Yet, if there has been an innocent misrepresentation, a contract cannot be rescinded unless there is a complete difference in substance between what has been agreed upon and what has been delivered. For instance, suppose that "A. buys a picture from B. ; both A. and B. believe it to be the work of an old master, and a high price is paid. It turns out to be a modern copy. A. has

¹⁶² *Bell v Lever Bros Ltd.* [1932] A.C., 161.

¹⁶³ *Ibid* at 218.

no remedy in the absence of representation or warranty”.¹⁶⁴

However, the position under the American law in relation to interpretation of the doctrine of mistake is distinct. This is explained in the case of Sherwood v Walker¹⁶⁵. Here, the plaintiff (buyer) entered into a contractual relationship with the defendants (sellers) to buy a cow. The contract price was \$80. When the buyer demanded possession of the cow, the seller declined to deliver it, contending that the price they had agreed to was taken on the mistaken assumption that the cow was barren, whereas she was with calf and worth between \$750 and \$1000. The Michigan Court of Appeals held that a barren cow is a completely different thing from a breeding one and therefore the defendants were entitled to rescission of the contract on the mistake of the subject matter, which went to the root of the contract.¹⁶⁶

4.5 The Modern Approach to Substantive Fairness

The modern approach in treating the issue of substantive unfairness is simple. A bargain can be interfered with simply if some particular terms appear to be unfair or because the bargaining power is perceived as being disproportionate¹⁶⁷. A particularly strong example to illustrate this is found in Section 36 of the Nordic Contracts Act which provides:

“if a contract or a term thereof is unfair, or its application would be unfair, it may be adjusted or left unapplied. When considering the unfairness the whole content of the contract, the position of the parties, the circumstances when the contract was made and thereafter and other circumstances shall be taken into account...price is to be considered one possible term for adjustment”.

In England as some commentators contend, the modern approach can be

¹⁶⁴ Ibid at 224.

¹⁶⁵ *Sherwood v Walker* 66 Mich 568, 33 NW 919 (1887).

¹⁶⁶ However, it is not clear whether this judgement was influenced largely by the commercial value of the two kinds of animal or, rather, their external appearance? Collins, *The Law of Contract* p 260. For a theoretical discussion of the scope of the seller’s duty to disclose, see Kronman, ‘Mistake, Disclosing Information, and the Law of Contracts’ 7 *Journal of Legal Studies* (1978) 1.

¹⁶⁷ Adams & Brownsword, *Key Issues in Contract* p 255.

supported by referring to the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contracts Regulations, as amended in 1999 (implementing the European Community Directive on Unfair Terms in Consumer Contracts).¹⁶⁸ The Unfair Contract Terms Act contains a “black-list” of terms upon which a contracting party will not be allowed to rely. Thus, any term excluding or restricting liability for death or personal injury resulting from negligence, is in effect, void under section 2 (1) of the Act. A further example is also given by section 6(2) of the Act which provides that, as against any party dealing as a consumer, there can be no reliance on any term which excludes or restricts the seller’s liability under the terms implied by sections 13-15 of the Sale of Goods Act 1979.¹⁶⁹ The Unfair Contract Terms Act also provides a “grey list” of terms which will not be enforced if they do not satisfy the reasonableness test. For instance, under section 2(2), losses other than those indicated in subsection (1), may be excluded or restricted only if the reasonableness test is satisfied. Moreover, under section 6(3), in a business-to-business contract, the terms covered by section 6(2) are subject to the reasonableness test. Regarding the Unfair Terms in Consumer Contracts Regulations (as amended in 1999) they “contains an indicative and non-exhaustive list of terms regarded as unfair”.¹⁷⁰ A term is regarded as unfair if “contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer”.¹⁷¹ The idea of significant imbalance, it should be noted, reflects closely the idea of fairness as *distributive* fairness.

¹⁶⁸ Under the Directive on Unfair Terms in Consumer Contracts Regulations, as amended in (1999) SI 1999 No. 2083; See the E.C. Directive on Unfair Terms in Consumer Contracts 93/ 13/ EC which took effect on July 1, 1995; Reynolds, ‘Unfair Contract Terms’ 110 *L.Q.R.* (1994) 1; Hondius, ‘E.C. Directive on Unfair Terms in Consumer Contracts: Towards a European Law of Contract’ 7 *Journal of Contract Law* (1994) 34; Brownsword & Howells, *supra* note 45 at 243 et seq; Harrison, *Good Faith in Sales* (Sweet & Maxwell, London, 1997) ch 19 p 699.

¹⁶⁹ Further, section 9, 10 or 11 of the Hire-Purchase Act [1973] cannot be excluded or restricted. See Section 6(2) of the UCTA.

¹⁷⁰ Adams & Brownsword, *Key Issues in Contract* p. 256.

¹⁷¹ Under the Directive on Unfair Terms in Consumer Contracts Regulations, as amended in (1999) an unfair term is defined under Section 5(1).

In summing up, the UCTA applies to both commercial and consumer contracts whereas the Regulations apply only to consumer contracts. This modern statutory control over unfair contract terms enhances fairness and, generally, courts are able to interfere with contract terms in a way that they can avoid unconscionable outcomes.¹⁷²

4.6 Conclusion

In English case law, the distinction between procedural and substantive unfairness has been adopted.¹⁷³ Lord Brightman, in the case of Hart v. O'Connor¹⁷⁴, commenting on the case of Archer v. Cutler¹⁷⁵, said:

“If a contract is stigmatised as ‘unfair’, it may be unfair in one of two ways. It may be unfair by reason of the unfair manner in which it was brought into existence;...‘procedural unfairness’. It may also, in some contexts, be described...as ‘unfair’ by reason of the fact that the terms of the contract are more favourable to one party than to the other. In order to distinguish this ‘unfairness’ from procedural unfairness, it will be convenient to call it ‘contractual imbalance’. The two concepts may very often overlap. Contractual imbalance may be so extreme as to raise a presumption of procedural unfairness, such as undue influence or some other form of victimisation. Equity will relieve a party from a contract which he has been induced to make as a result of victimisation. Equity will not relieve a party from a contract on the ground only that there is contractual imbalance not amounting to unconscionable dealing.”

Atiyah¹⁷⁶ observes that substantive fairness of exchange within the modern law of contract, is of significant importance. Nevertheless, as in the classical law, procedural fairness should be a matter of concern, too, because procedures after all affect results and that is why fair procedures are focused on. In other words, it can be assumed that something has gone wrong, whilst formulating a contract, if the outcome is found to be markedly in favour of one of the parties.

¹⁷² Adams & Brownsword, *Key Issues in Contract* p. 6.

¹⁷³ Note that the concept of ‘contractual imbalance’ is used to mean ‘substantive unfairness’.

¹⁷⁴ *Hart v. O'Connor* [1985] 2 All E.R. 880, 887.

¹⁷⁵ *Archer v. Cutler* [1980] 1 NZLR 386. See for more cases about fairness the Australian case of *Tremills v. Benyon* and quoted Hodges J. (18 VLR 607, at 622-623).

¹⁷⁶ Atiyah, ‘Contract and Fair Exchange’ in *Essays on Contract* p. 331-32.

5 Good Faith¹⁷⁷

5.1 Introduction

According to Robert Summers:

“[W]ithout a principle of good faith, a judge might, in a particular case, be unable to do justice at all, or he might be able to do it only at the cost of fictionalising existing legal concepts and rules, thereby snarling up the law for future cases. In begetting snarl, fiction may introduce inequity, unclarity or unpredictability. In addition, fiction can divert analytical focus or even cast aspersions on an innocent party”¹⁷⁸.

The doctrine of good faith is acknowledged in many legal systems, some of which require good faith in performance, enforcement, and some even in negotiation as well; but different jurisdictions apply and acknowledge the doctrine to a different extent. In English law, some judges have drawn parallels between the cases on reasonable notice, such as *Interfoto*, and the good faith test now found in the Unfair Terms in Consumer Contract Regulations¹⁷⁹, but there is no express adoption of it, as opposed to most of the civil law systems.

In this section, first of all, the meaning of ‘good faith’ will be discussed. A comparison of the treatment of the doctrine of ‘good faith’ in English law, the United States, and some other civil law countries, will follow. This section will be concluded by some observations on how the doctrine might develop in English law in the near future.

¹⁷⁷ See generally on good faith in English contract law, Brownsword, R., ‘Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law’ in *Good Faith in Contract: Concept and Context*, Edited by Brownsword, Hird and Howells (Dartmouth, 1999), 67. See also in the same reference, Brownsword, Hird and Howells, ‘Good Faith in Contract: Concept and Context’, 1. See about the development of the concept of good faith in legal theory, O’Connor, J.F., *Good Faith in International Law* (Dartmouth, 1991) ch 3 p 17; Powell, ‘Good Faith in Contracts’ 9 *Current Legal Problems* (1956) 16.

¹⁷⁸ Summers, R.S., ‘Good Faith’ in General Contract Law and the Sales Provisions of the Uniform Commercial Code’ 54 *Virginia Law Review* (1986) 195, 198-199.

¹⁷⁹ SI 1999 No. 2083, the Unfair Terms in Consumer Contracts Regulations, as amended in 1999; see the judgment of Brooke LJ., in *Laceys Footwear v. Bowler International* [1997] 2 Lloyd’s Rep. 367 at p 385.

5.2 Subjective and Objective sense of the Doctrine of 'Good Faith'

In plain English, 'good faith' simply means compliance with standards of decency and honesty. When it comes to the legal definition, strictly speaking, there is no single authoritative definition in English law. Despite this, the distinction between the subjective and objective sense of good faith becomes apparent as there is often an issue of "whether the test of good faith performance is purely subjective or whether it has an objective component as well".¹⁸⁰ Before examining this issue, it is useful to know first of all, what the subjective and objective sense of good faith mean?

The subjective sense of good faith means "honesty in fact in the conduct or transaction concerned."¹⁸¹ It is used to describe a state of mind. A party to a contract acts in good faith only if he acts innocently or with lack of notice.

The objective test of 'good faith' moves away from a state of mind of innocence, suspicion, or notice requirements to *decency, fairness or reasonableness* in performance or enforcement instead.¹⁸²

Whilst there appears to be difficulty, on the part of English lawyers, to define good faith, two definitions are advanced in the Uniform Commercial Code. Both the subjective and objective senses will be further discussed below in operation of some of the sections in the UCC.

¹⁸⁰ See Farnsworth, 'Good Faith in Contract Performance' in Beatson, J., & Friedmann, D., (Ed) *Good Faith and Fault in Contract Law* (Clarendon Press, Oxford, 1995) 153, 163; Brownsword, 'Good Faith in Contracts' Revisited 49 *Current Legal Problems* (1995) 111.

¹⁸¹ UCC § 1-201 (19).

¹⁸² Farnsworth, 'Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code' 30 *U. Chi. L. R.* (1963), 666, 668.

5.3 Good Faith Principle under the Uniform Commercial Code¹⁸³

Farnsworth,¹⁸⁴ commenting on the relevant sections of the good faith requirement in the UCC, argues that the standard of good faith should be constituted by reasonable commercial standards of fair dealing in the trade. Likewise, being inspired by the Code, Section 205 of the Restatement provides that:

“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement”.

From this, it can be perceived that parties, during the process of performance and enforcement of a contract, are generally expected to both deal fairly and act in good faith¹⁸⁵.

In fact, the Code uses the term ‘good faith’ in two fundamentally different senses:¹⁸⁶ purchase and performance sense. Section 1-203 of the UCC provides: “every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement”.¹⁸⁷ The general definition of good faith is also given in Article 1-201(19), where good faith means “*honesty in fact in the conduct or transaction concerned*”. These sections involve ‘good faith purchase’.¹⁸⁸ It is called

¹⁸³ Farnsworth, ‘The Concept of “Good Faith” in American Law’ Centro di studi e ricerche di diritto comparato e straniero diretto da M.J. Bonell. SAGGI, CONFERENZE SEMINARI p 2, at <http://www.cnr.it/CRDCS/farnsworthhtm>. However, the same writer states that the fact that the Americans have statutory definitions of “good faith” does not, however, mean that the Americans are in complete agreement as to what “good faith” means in the context of good faith performance. p 3. For more details about the debate over good faith see Farnsworth, *supra* note 182 at 679; Summers, *supra* note 178 at 200, 232-33; Summers, ‘The General Duty of Good Faith-Its Recognition and Conceptualisations’ 67 *Cornell. L.Rev.* (1984) 497; Burton, S., ‘Breach of Contract and the Common Law Duty to Perform in Good Faith’ 94 *Harv. L. Rev.* (1980) 369, 369, 372-73; Also, Burton, S., ‘Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code’ 67 *Iowa. L. Rev.* (1981) 1; Burton, ‘More on Good Faith Performance of a Contract: A Reply to Professor Summers’ 69 *Iowa. L.Rev.* (1984) 497; Stewart, I.B., ‘Good Faith in Contractual Performance and in Negotiation’ 72 *Australian Law Journal* May (1998) 370. See further about the standard of good faith under the UCC, Herbert III, A.J., ‘Comments: Lender Liability: Good Faith and Demand Notes’ 64 *Tulane Law Review* (1989) 187, 193.

¹⁸⁴ See R. Brownsword, ‘Static and Dynamic Market Individualism’ in R.Halson (ed) *Exploring the Boundaries of Contract* 48, 53.

¹⁸⁵ *Ibid.*

¹⁸⁶ Farnsworth, *supra* note 182 at 668.

¹⁸⁷ UCC § 1-203; Restatement (2d) of Contracts, s 205.

¹⁸⁸ Farnsworth, *supra* note 182 at 668.

good faith purchase in which parties are required to make an honest judgement.¹⁸⁹ For example, the criterion upon which it is to be decided whether a holder of a negotiable instrument is to be so, depends on whether he purchased in good faith. That is not to say that parties should not pursue their own interests but they should do so honestly.¹⁹⁰

Section 2-103(1)(b), the sales article, however, contains a special merchant's definition of 'good faith' under which 'good faith' means honesty in fact and "the observance of *reasonable commercial standards* of fair dealing in the trade". With regard to the previous example, the holder is required to exercise the prudence and caution of a *reasonable person*.¹⁹¹ The enquiry here concerns decency, fairness or reasonableness in performance or enforcement.¹⁹² Clearly, this kind of good faith performance can be measured by an *objective* standard based on the decency, fairness or reasonableness of the community, commercial or otherwise, of which one is a member.¹⁹³ The issue that emerges is whether a subjective standard of good faith is an appropriate alternative to that of an objective standard.

Indeed, the UCC has explicitly incorporated an *objective* standard.¹⁹⁴ Farnsworth emphasises this point by stating that it is not only the objective standard that is to be adopted, we should also bear in mind that the test is *not* whether one party actually believed that he was acting decently, fairly or reasonably, but he must also do so.

¹⁸⁹ Farnsworth, 'Good Faith in Contract Performance' in Beatson, J., & Friedmann, D., (Ed) *Good Faith and Fault in Contract Law* (Clarendon Press, Oxford, 1995) 153, 163. See further about the concept of good faith purchase, Weinberg, H.R., 'Markets Overt, Voidable Titles, and Feckless Agents: Judges and Efficiency in the Antebellum Doctrine of Good Faith Purchase' 56 *Tulane Law Review* (1981) 1.

¹⁹⁰ Farnsworth, 'Good Faith in Contract Performance' in Beatson, J., & Friedmann, D., (Ed) *Good Faith and Fault in Contract Law* p. 164.

¹⁹¹ Farnsworth, *supra* note 182 at 667. For justification for an objective element of good faith, see Chobot, J.C., 'Objective Aspects of Good Faith in Insecurity Clause Debt Accelerations' 94 *Commercial Law Journal* (1989) 13, 19.

¹⁹² Farnsworth, *supra* note 182 at 668.

¹⁹³ *Ibid* at 671-672.

¹⁹⁴ *Ibid*.

Summing up, the Code uses 'good faith' in two senses, that of 'good faith performance' as well as that of 'good faith purchase'; and, according to Farnsworth, both common sense and tradition favour an *objective* standard of good faith performance (i.e. over and above the usual rules concerning fraud and dishonesty).

5.4 Good Faith in Civil Law Countries and in International Uniform Laws

In contrast to common law systems, the requirement of good faith is explicitly stated in civil law systems. For example, Article 1134(3) of the French Civil Code provides that the performance of any agreement should be achieved in good faith¹⁹⁵. Moreover, Under Sections 157, 242 of the German Burgerliches Gesetzbuch a good faith requirement is also applied to the performance of contracts¹⁹⁶.

However, that is not to say that the adoption of good faith clauses is exceptional to civil law systems. For example, a requirement of good faith in the performance and enforcement of contracts is also provided by Article 1-203 of the American UCC, mentioned above, which forms part of the common law system¹⁹⁷. Israeli law, as a mixed system, contains both sets of norms governing the bargaining process: the duty of good faith and the variety of devices which have been employed by English law to mitigate the absence of the duty of good faith. Thus, Section 12(a) of Contracts (General Part) Law states that "in negotiating a contract, a person shall act in customary manner and in good faith". Subsection b, which deals with sanctions for the breach of this duty, states:

"a party who does not act in customary manner and in good faith shall be liable to pay compensation to the other party for the damage caused to him in consequence of the

¹⁹⁵ Adams & Brownsword, *Understanding Contract Law* p. 113. See also, Harrison, *Good Faith in Sales*. pp. 694-697.

¹⁹⁶ Adams & Brownsword, *Understanding Contract Law* p. 113. See for more details about good faith in German law, Schlechtriem. P., Centro di studi e ricerche di diritto comparato e straniero diretto da M.J. Bonell. SAGGI, CONFERENZE SEMINARI, Web site <http://www.cnr.it/CRDCS/slechtriem.htm>, at 1

¹⁹⁷ Adams & Brownsword, *Understanding Contract Law* pp 113-114.

negotiations or the making of the contract...”¹⁹⁸.

Furthermore, the principle of good faith also has a place in international uniform rules.¹⁹⁹ Article 1.7 of the UNIDROIT Principles of International Commercial Contracts provides:

- “(1) Each party must act in accordance with good faith and fair dealing in international trade.
- (2) The parties may not exclude or limit this duty”.

Likewise, Article 1.106 of the Principles of European Contract Law²⁰⁰ states:

- “(1) In exercising his rights and performing his duties each party must act in accordance with good faith and fair dealing.
- (2) The parties may not exclude or limit this duty”.

Finally, Article 7(1) CISG reads:

“In the interpretation of this convention, regard is to be had to its international character and to the need to promote uniformity in its application in the observance of good faith in international trade”.

5.5 The View of Good Faith in England

Goode comments that the English have difficulty in defining the phrase ‘good faith’²⁰¹ as a result of which English lawyers²⁰² cannot avoid struggling with such a concept. The core of the trouble for them is: what does ‘good faith’ mean? How wide or narrow should the concept be?

In accordance with an English authority, it was initially significant to establish whether good faith could merely imply that a party was expected to perform with a clear conscience or alternatively whether there were certain external standards of

¹⁹⁸ See generally about Israeli law Cohen, N., ‘Pre-Contractual Duties: Two Freedoms and the Contract to Negotiate’ in Beatson and Friedmann (ed) *Good Faith and Fault in Contract Law* 25, 32.

¹⁹⁹ See for more details about how the concept of good faith is dealt with in different international uniform laws. Schlechtriem, P., *supra* note 196, at 1-6.

²⁰⁰ See in this regard, Collins, H., ‘Good Faith in European Contract Law’ 14 *Oxford Journal of Legal Studies*, (1994) 229.

²⁰¹ Goode, R., ‘The Concept of “Good Faith” in English Law’ Centro di studi e ricerche di diritto comparato e straniero. diretto da M.J. Bonell. SAGGI, CONFERENZE E SEMINARI, Web site at <http://www.cnr.it/CRDCS/goode.htm>. p. 1.

²⁰² Steyn, J., ‘Contract Law: Fulfilling the Reasonable Expectations of Honest Men’. 113 *LQR* (1997) 433, 439.

good faith dealing. If the last one was to be taken, then one would need to ascertain whether it was a particular commercial community who determined such external standards or if there was in place a 'critical moral benchmark'. In addition to this, the following two issues arose, (i) how would one determine the perimeters of a good faith requirement and (ii) whether good faith only related to performance and enforcement or whether negotiation also was to be protected.²⁰³

According to English law, good faith is not a general requirement for enforcement of legal rights or exercise of legal remedies. This can be seen as having certain disadvantages, in particular a party to a contract may wish to terminate a contract for breach even though he has not suffered any loss but to escape the consequences of an unprofitable bargain. The scenario can be developed further, under English law, where a party's obligation to co-operate in relation to carrying out of a contract is not a condition precedent to the other party's performance. Where the other party attempts to terminate the deal, having realised that it is unprofitable, he is still entitled to claim the contracted sum subsequent to proceeding with the performance²⁰⁴.

5.5.1. Reception of Good Faith in English Law

Given the above disadvantages which non-adoption of a general doctrine of good faith in contract law may bring, consider the following two cases in which good faith is recognised.

First, there is the Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd²⁰⁵

²⁰³ Adams & Brownsword, *Understanding Contract Law* p 114. See generally also, Brownsword, 'Two Concepts of Good Faith' 7 *Journal of Contract Law* (1994) 197; Kessler and Fine, 'Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study' 77 *Harvard Law Review* (1964) 401.

²⁰⁴ Goode, *supra* note 5 at 151. See generally, *White & Carter (Councils) Ltd. v. McGregor* [1962] A.C. 413. Goode adds, at p 151 fn 40, that "in extreme cases the court may be willing to find that the innocent party ought to have accepted a repudiation and mitigated his loss, as in *Attica Sea Carriers Corporation v. Ferrostaal Poseidon Bulk Reederei GmbH (The Puerto Buitrago)* [1976] 1 Lloyd's Rep. 250.

²⁰⁵ *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd.* [1989] QB 433.

case which shows how English law receives cases of good faith and fairness. The defendants in this case contracted to use some photographs from the plaintiffs. The photographs were sent with a delivery note which contained a date for the return of the photographs to the plaintiffs and a condition which was concerned with the holding charges for late return of the photographs. The defendant defaulted in returning them on time. He was asked to pay a sum of £3,783.50, as holding charges but he refused to pay. It was held that:

“where clauses incorporated into a contract contained a particularly onerous or unusual condition, the party seeking to enforce that condition had to show that it had been brought fairly and reasonably to the attention of the other party;...since the plaintiffs had done nothing to draw the defendant’s attention to condition 2, the condition never became a part of the contract or the defendants were relieved from liability under the clause;...therefore, the plaintiffs could only recover a holding fee assessed on the basis of quantum meruit”.²⁰⁶

Following the judgment of the Interfoto case, the court believed that, it was the responsibility of the enforcer to ensure that the other party was reasonably and fairly informed about specific conditions. There were however, differing opinions on the precise effect of ‘inadequate’ notification. Unlike Lord Justice Dillon, who held that inadequate notification resulted in non-incorporation, Lord Justice Bingham granted that the clause discharged the defendants from liability.

In summary of the English authorities’ position, Lord Bingham postulated that it tended to look at the nature of the transaction in question and the character of the parties to it. He further went on to state that the English approach was,

“[t]o consider what notice the party alleged to be bound was given of the particular condition said to bind him; and to resolve whether in all the circumstances it is fair to hold him bound by the condition in question. This may yield a result not very different from the civil law principle of good faith, at any rate so far as the formation of the contract is concerned”.²⁰⁷

According to Lord Justice Bingham, from his review of the Interfoto case, the English law of obligations differed from the equivalent law apparent in the majority of cases outside the common law world. The main difference was that it neglected

²⁰⁶ Ibid

²⁰⁷ Ibid, per Bingham LJ, at 445.

to recognise the overriding principle which impelled parties to act in ‘good faith’ whilst composing and carrying out contracts. Indeed, he outlined that English law almost confined itself to the contrary, by neglecting to acknowledge the determining principle, instead developing fragmentary solutions in response to indisputable problems of ‘unfairness’. Lord Bingham went on further to outline how the English legal system received the principle of ‘good faith’ by pronouncing that as a result of it:

“[e]quity has intervened to strike down unconscionable bargains. Parliament has stepped in to regulate the imposition of exemption clauses and the form of certain hire-purchase agreements. The common law has also made its contribution, by holding that certain classes of contract require the utmost good faith, by treating as irrecoverable what purport to be agreed estimates of damages but are in truth a disguised penalty for breach, and in many other ways”.²⁰⁸

This statement highlighted two main issues, one of which was questioning whether one party had sufficiently informed the other with regard to a term incorporated within a contract. The other issue was whether it would be fair ‘in all circumstances’ to hold a party bound by an unusual or restrictive condition.

Lord Bingham, in the course of delivering his judgment, observed that:

“[The defendants] are to be relieved because the plaintiffs did not do what was necessary to draw this unreasonable and extortionate clause fairly to their attention. I would accordingly allow the defendants’ appeal and substitute for the judge’s award the sum which he assessed upon the alternative basis of quantum meruit”.²⁰⁹

Despite the fact there is no explicit adoption of a general requirement of good faith, it is asserted by Sir Thomas Bingham, that the issue of unfair dealing has more or less been tackled. According to Sir Thomas, English law has “developed piecemeal solutions in response to demonstrated problems of unfairness”²¹⁰.

Secondly, there is the case of Laceys Footwear v Bowler International²¹¹. Laceys (the plaintiffs), who were wholesalers of shoes accepted a quotation by Bowler

²⁰⁸ Ibid at 439.

²⁰⁹ Ibid at 445.

²¹⁰ *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd.* [1989] QB 433, 439.

²¹¹ *Laceys Footwear v. Bowler International* [1997] 2 Lloyd’s Rep. 367.

(the defendants), to transport their merchandise from Spain. Accompanying the quotation was a detailed letter in which Bowler described their trading conditions, one of which provided that:

“17 ... (3) In no case whatsoever shall any liability of the company howsoever arising and notwithstanding that the cause of loss or damage be unexplained exceed (a) the value of the relevant goods ... ”

In Lacey’s letter of acceptance, it was emphasised that Bowler was to ensure that its driver delivered the goods to a specific address as advised, particularly as they had experienced problems in the past with the goods being lost en-route. Despite this, the driver delivered the consignment of goods to the wrong address and Lacey’s subsequently claimed damages for breach of contract and negligence and for breach of this particular expressed term.

One of the questions raised by this case was whether Bowler could rely on clause 17(3) as their defence.

This question was considered in a relevant way by Brooke L.J. The key points made by his Lordship were as follows.

First, both Lacey’s and Bowler were in themselves, not perceived as highly sophisticated traders. When questioning whether reasonable notice had been given to Lacey’s of the contract limitations, it became apparent that the relevant condition had been cited, amongst other information, in small print, proffered by Bowler’s, a company which Lacey’s had never been in business with before.

It followed that Bowler had made no real effort to forewarn Lacey’s of the inclusion of this particular ‘onerous’ requirement. From this, the question of fairness arose. Was it fair to hold Lacey’s bound by the condition in question, which they were unaware of because the other party had made no effort to fully disclose relevant information in a clear and fair manner.

Secondly, comparatively, an extra judicial lecture by Sir Johan Steyn (as he then was) on the role of good faith in contract law further illustrated the rule by stating

that a party could not 'snap up' an offer which he knew to have been made on the basis of error.²¹² Brooke LJ. (in Laceys)²¹³ went on to clarify the vital component of maintaining a relationship of confidence between parties and the implied obligation of good faith in contracts of employment by referring to Sir Nicholas Browne-Wilkinson's judgment which introduced that every contract of employment contained an implied term:

"That the employers will not without, reasonable and proper cause, conduct themselves in a manner calculated or likely to destroy or seriously damage the relationship of confidence and trust between employer and employees."²¹⁴

Following a period of involvement within the European Union, both English common law judges and European civil law judges have gained an awareness and understanding of the strengths and weaknesses connected with their legal system. Under the Directive on Unfair Terms in Consumer Contracts Regulations, as amended, (1999) an unfair term is defined under Section 5(1) as:

"A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer".

As a consequence of Lord Justice Bingham's observations in the Interfoto case, English law has now developed a similar concept over the years. The law now consists of cases where it would be considered an insult to good faith, to allow a party to rely on a 'small print' term of a contract which would result in the other party becoming disadvantaged as a result, with no abatement of the consideration which flowed from that party when it thought it was acquiring the benefit in question.

Lord Justice Brooke took the view that the overall value of incorporating a good faith principle within the English legal system, along with better communication

²¹² In his 1991 Royal Bank of Scotland Lecture, 'The Role of Good Faith in Contract Law: A Hairshirt Philosophy?' *The Denning Law Journal* (1991) 131, at pp. 136-37. See Editorial Note on the case of *Hartog v. Colin & Shields* [1939] 3 All. E.R. 566 at 566.

²¹³ *Laceys Footwear v. Bowler International* [1997] 2 Lloyd's Rep. 367 at p 385.

²¹⁴ *Imperial Group Pension Trust Ltd and Others v. Imperial Tobacco Ltd and Others* [1991] 2 All. E.R. 597, 606.

would ensure greater consistency between lawyers and judges and thus promote a more 'common approach' to legal dealings and disputes with regards to fair dealing.

In judgment of the case in question, Lord Justice Brooke recommended that Lacey's should be entitled to recover damages at a level that was in accordance with their reasonable contractual expectations.

5.5.2. Restrictions to Good Faith

A view on the question of why English law has declined to adopt such a principle was put forward by Walford v Miles,²¹⁵ where the Court of Appeal's suggestion that English law might recognise the validity of an agreement to negotiate in good faith, was rejected by the House of Lords.²¹⁶ Lord Ackner put it clearly that:

"the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations ... A duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with the position of a negotiating party".²¹⁷

A similar view was adopted in the Canadian case of Re Empress Towers Ltd and Bank of Nova Scotia²¹⁸, where Wallace J.A. said in his dissenting judgment:

"I have always had difficulty in determining what constitutes 'good faith' in contract negotiations. If one of the parties substantially or 'unreasonably' refuses to accept an offer or make a counter-offer, the other party usually categorises the first person's conduct as 'refusing to bargain in good faith'. It usually reflects one party's view of the conduct of the other party where that person remains adamant and refuses to move from a bargaining position he or she has adopted...In my view, where there is neither fraud nor deceit and one is simply exercising his or her contractual right to maintain a certain bargaining position, the question of 'good faith' does not enter into the issue"²¹⁹.

²¹⁵ *Walford v. Miles*. [1992] 1 All E.R. 453. See for more discussion about this case, Wheeler, S., & Shaw, J., *Contract Law Cases, Materials and Commentary* (Clarendon Press, Oxford, 1994) pp 168-172.

²¹⁶ For commentary on this case, see generally, Brownsword, 'Static and Dynamic Market Individualism' in R.Halson.(ed) *Exploring the Boundaries of Contracts* 48, 57.

²¹⁷ *Walford v. Miles*. [1992] 1 All E.R. 453 at 460-61. For more English authorities on good faith in negotiation, see, Harrison, *Good Faith in Sales* p 28.

²¹⁸ *Re Empress Towers Ltd and Bank of Nova Scotia*. 73 DLR (4 th) (1991) 400.

²¹⁹ *Ibid* at 409-410.

Indeed, in mercantile contracts, it is still the case that there are limits to good faith in performance and enforcement as explained in CTN. Cash and Carry Ltd v Gallaher Ltd²²⁰. The case involved a plaintiff company which ran a cash and carry in six towns. Their trade was in selling cigarettes, purchased in consignments from the defendant distributors. Each transaction involved contracts based on standard terms as set by the defendants, part of which incorporated an arranged credit facility for the plaintiff, which could be withdrawn by them at any time at their own discretion. The defendants were not contractually compelled to sell any goods to the plaintiffs, and the terms of the business set separate contracts, made sporadically.

Following one such sale, where an order was placed, an error occurred, which led to the goods being delivered to a different warehouse. Initially, it was agreed by both parties, that the defendants would take on responsibility of rearranging transfer of goods to the correct destination, but prior to this, the goods were stolen from the premises. The plaintiff were subsequently invoiced in the belief that the goods had been at their risk at the time of the theft.

The plaintiffs initially rejected the invoice, but later changed their mind after the defendants threatened to withdraw their credit facilities. Later, the plaintiffs issued a writ, claiming repayment of the amount invoiced, stating that they had paid initially under duress, mainly due to the defendants' threat of credit withdrawal for future transactions. The deputy judge, refused to make a case for economic duress, due to there being no cause of action. An appeal was put forth.

Following the appeal, it was sustained that economic duress was more likely to be associated with situations where there was a request for payment in conjunction with a threat to perform an unlawful act. It was also confirmed that this may prove difficult in the context of the case in question, where two companies were not partaking in commerce face to face and where one party believed that their demand

²²⁰ *CTN. Cash and Carry Ltd v Gallaher Ltd*. [1994] 4 All ER 714.

was being made in good faith and was thus legitimate.

If any attempt was made to attenuate the degree of duress to include coercion which was determined as lawful, with regards to mercantile transactions, in order to seek the claim of 'bona fide' standing, then it may be perceived as an extremist movement with far-reaching ramifications. It could for instance, potentially initiate a substantial and undesirable element of '*uncertainty*' within the commercial bargaining process, by for example, enabling parties involved in commercial dealings to reopen bona fide resolved accounts when they fell out.

The defendants, could in essence, by right, manipulate the terms of the agreement by cancelling the credit facilities, and alleging that the demand for payment was separately requested in 'good faith' and thus being done out of sincerity. Proceeding this, the court settled that the defendant's actions did not signify duress and hence the plaintiffs appeal was discharged.

A counterclaim was then launched by the plaintiffs. The question re-emerged, as to who should actually suffer loss as a result of the robbery. Lord Steyn²²¹ addressed this query by pronouncing that although the property in the goods had not formally been assigned to the plaintiffs, the deputy judge had substantiated that the defendants had acted in good faith in their belief that the stock had been at the plaintiffs' risk at the time of the theft. This part of the judgment was not actually challenged.

From further examining the facts of the case, it was established that a discussion had taken place, between both parties in relation to who would pay for the stolen goods. The defendant had clearly instructed the plaintiff that unless the stolen goods were paid for they would not, in future grant them credit, and as a consequence the plaintiff had felt that settling the bill was the better option of the two. The plaintiffs later deducted the sum following a writ, which entitled them to recover the original payment.

²²¹ Ibid at p 716.

Following the trial, the judge upheld that the only dispute was whether the plaintiffs were entitled to do this as well as

“[s]et off that sum against their admitted liability for underpayment in respect of the goods ordered and received in the final weeks of trading”.²²²

Although this plea was not formally made, the defendants were happy for the deputy judge to settle the issue. The plaintiffs were conscious of the fact that success in reclaiming the payment was dependant on confirmation that duress had taken place during the transaction.

Acting for the plaintiffs, Miss Heilbron QC, submitted that by repudiating the plea of duress, the deputy judge had been mistaken. She suggested that the payment had been made under unlawful coercion. In further emphasising her point she added that there was;

“[n]o legal basis for demanding the price of the goods and the threat of withdrawing the credit facilities was made solely in order to obtain the payment. The threat was powerful because the removal of the credit would have seriously jeopardised the plaintiffs’ business”.²²³

Thus, it is evident from her assertion that the act of duress had taken place in order to extract money from the plaintiff, of which the defendants were not entitled to. Utilising a number of authorities which demonstrate developments in this branch of law, Miss Heilbron maintained that the defendants could be perceived to be in a more superior position. As a consequence of this, she postulated that common law, did not in fact recognise the principle concerning ‘inequality of bargaining power’ within business dealings. She ascertained that the fact that the defendants were in a monopoly position cannot therefore by itself convert ‘what is not otherwise duress into duress’.²²⁴

Another feature of the case in question, was the fact that legally, the defendants could withdraw from any future business dealings with the plaintiffs, at any point

²²² Ibid at 717.

²²³ Ibid.

²²⁴ Ibid.

without the need for justifying their decision. From this, one could argue, that it could have been just as detrimental to the plaintiff's financial position. If this was so, then it should be equally lawful for the defendants to insist upon withdrawal of their credit facilities without the need for reason. Thus, when questioning the outcome of the case, it can be stated that there was neither a breach of contract or tort, when the defendants threatened to withdraw the credit facilities in conjunction with the demand for payment.

The third point, with relation to the case, was the fact that the defendants believed that the plaintiffs owed them the sum in question, based on a 'bona fide' assumption that the goods had been at the plaintiffs' risk, once they had been delivered, and that this was the reason why pressure had been exerted. The pressure and threat exerted by the defendants, was based solely on commercial self-interest in obtaining the amount, which they considered as due to them.

In evaluating these three notions, there was little to demonstrate support for the plaintiff's case. Lord Steyn, in response, accepted that although the defendants had used lawful means in pursuing their payment, this did not necessarily mean that the case would instinctively be excluded from application of the economic duress principle.

In summary of the case, Lord Steyn, proposed that the overall aim of commercial law must be to advocate fair trading between parties, and that it was a misconception for the law to set its vision too highly when the question was not whether the behaviour was legitimate but whether it was morally or socially unacceptable. In his view, his Lordship confirmed that there were also policy factors which militated against ruling that the defendants seized payment of the disputed invoice by force.

From evaluating the findings of the case, it is essential to recognise that difficulties may arise in attempting to establish a claim for duress, especially where the defendants believed he had acted in good faith and that his demand was therefore justified.

In conclusion of the case, Lord Steyn was satisfied that the defendants had behaved in a way which did not signify duress, and although they could be perceived to have retained a sum which was not apparently deserved by them, the court was obliged to grant this outcome, which was to dismiss the appeal.

Furthermore, Bridge, who is a well-known opponent of the idea that there should be a general doctrine of good faith, puts forth his rejection in relation to good faith for commercial commodity contracts, by demonstrating that it becomes weak in its failure to identify that contracting contexts are not similar. He advocates that, 'a doctrine of good faith' needs to be used in conjunction with context if it is to be perceived as sensitive:

"It is a fair reproach to English contract law that it unthinkingly treats the rules and principles of commodity sales, time and voyage charterparties and so on as though they could be applied without modification in very different contractual settings. Good faith theorists should avoid making the same sort of mistake. In my view, what is needed is an informed treatment of different areas of commercial contract and market activity".²²⁵

Bridge continues to say that it would be inappropriate to introduce a doctrine of good faith into the commodities markets, where dealing is fairly competitive and where opportunistic behaviour is anticipated. This is because those dealing in the business field, work on an equal footing basis. However, this does not indicate that, in practice, it is totally rejected within the commodities markets.

In sum, according to Bridge, not introducing a general doctrine of good faith, is the most appropriate for the markets to determine as they are in the best position to do so rather than adopting the fair dealing principle.

5.6 Good Faith and Reasonable Expectation

One of the most important features of modern English contract law is to protect the reasonable expectations of contracting parties. Effect, therefore, "must be given to the reasonable expectations of honest persons".²²⁶

²²⁵ Bridge, 'Good Faith in Commercial Contracts' in Brownsword, Hird and Howells (eds) *Good Faith in Contract: Concept and Context* (1999), 139, 147.

²²⁶ Steyn, J., *supra* note 202 at 433

According to English law, effect is given to reasonable expectations based upon an *objective* theory of contract which involves an external standard by using the concept of the reasonable person. By 'reasonable expectation', it means those expectations in the *objective* sense, i.e. expectations that are common to both parties who are ordinary right thinking persons. Moreover, what is considered as 'reasonable' is graded by the usage and practice of the community of the involved parties. Lord Steyn²²⁷ states that an introduction of a general duty of good faith in English law is not necessary as long as English courts continue to respect the reasonable expectations of parties. In other words, 'objective good faith' resembles 'reasonable expectations'.

It is to be noted, however, that in relation to the concept of good faith in the law of credits, this thesis (i.e. the present doctoral thesis) argues strongly against adopting an objective good faith principle in favour of a more subjective stance, in which the parties must act honestly.

It follows that the author also argues against adoption of a general doctrine of reasonable expectations in the law of letters of credit. The rejection of such a doctrine is based on the same reason given against adoption of a general doctrine of good faith (in an objective sense). As stated in the introduction to the thesis, the problem with a general doctrine of good faith or reasonable expectations is that it needs an agreed reference point on which it draws its standards of fair dealing. In the case of letters of credit, the UCP represents a quite remarkable attempt to draw together practice. Even so, if the law adopted a doctrine of reasonable expectations, and if questions of reasonable expectations were then judged by reference to international banking practice, this would only satisfy the requirement of *certainty* if one could be confident that practice was more or less uniform. So long as banking practice varies from one community to another, the position taken in this thesis is that it would be inappropriate for the law of letters of credit to take

²²⁷ Ibid at 439.

such a bold step in the direction of *fairness*.

5.7 Conclusion

There is no doubt that English Law holds a good faith principle in a subjective sense. What it does not have is a general principle of good faith in an objective sense.

It should be further noted that despite the silence of English law in the express recognition of the notion of good faith, in some case law the duty of good faith is apparently adopted, especially in insurance cases.²²⁸ The principle of good faith, in accordance with Lord Mansfield²²⁹, is applicable to *all* contracts. Therefore, good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.

Moreover, under English law, the duty of good faith is imposed upon some particular kinds of relationships: First, the agent owes a duty of good faith to his principal by subordinating his own interests to those of his principal. Secondly, a company director owes a duty of good faith to the company that employs him. Thirdly, a trustee owes a duty of good faith to his beneficiary. The last example is that duties of good faith are also required if the court is asked to grant the so-called 'equitable remedies', provided that the plaintiff has acted in good faith. Such remedies dilute the stubbornness of the common law.²³⁰

Finally, although the English law of contract has not yet committed itself to an express general requirement of good faith, there are signs that it is moving towards recognising a good faith requirement. For instance, with the advent of model

²²⁸ See about the early development and rationale of utmost good faith in insurance law, Feldman, D., & Meisel, F., (eds), *Corporate and Commercial Law* (Lloyd's of London Press Ltd, 1996) ch 14 p 247. See also, Harrison, R., *Good Faith in Sales* Ch 2 p 19.

²²⁹ *Carter v Boehm* [1766] 3 Burr, 1905 at 1918.

²³⁰ Goode, *supra* note 201 at 4.

contracts for international trade, general clauses requiring the notion of good faith are certainly incorporated.²³¹ Furthermore, the common law jurisdictions are becoming more receptive to the notion of good faith. This is evident, not only in the United States, but also more so around the Commonwealth²³². This can be seen from Article 3 of the EC Directive on Unfair Terms in Consumer Contracts, which has been adopted in English consumer law. As we have seen, this Article provides that a term is unfair if “contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer”. After the implementation of that Directive into English consumer law, there is a good indication that the principle of good faith should be expressly adopted and widely applied at least within the area of consumer contracts. Further, there are commentators who say that the trend of recognition of the doctrine of good faith is likely to influence domestic English commercial law.²³³ The general position taken in this thesis, however, is that in commercial law generally, and letters of credit law in particular, a good faith doctrine represents too great a threat to the certainty of doctrine.

²³¹ Adams & Brownsword, *Understanding Contract Law* p 116.

²³² *Ibid.* This point can be further supported by reference to the judgment of Priestley JA in *Renard Constructions (ME) Property Ltd v Minister for Public Works* (1992) 26 NSWLR 234 where he said “[P]eople generally, including judges and other lawyers, from all strands of the community, have grown used to the courts applying standards of fairness to contract which are wholly consistent with the existence in all contracts of a duty upon the parties of good faith and fair dealing in its performance. In my view this is in these days the expected standard, and anything less is contrary to prevailing community expectations”. at 268.

²³³ Steyn, J., *supra* note 202 at 439.

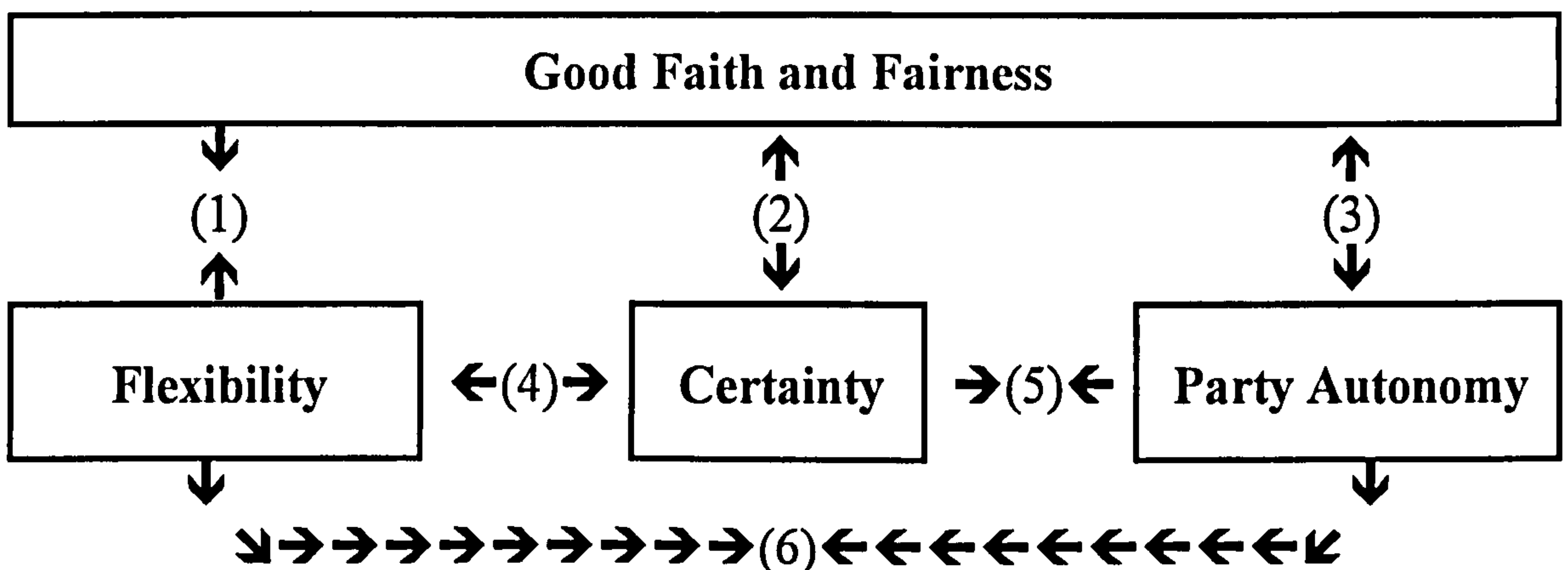
Section Two: The Relationships Between the Basic Principles

1 Introduction

Having defined and explained the five basic principles in the first part of the chapter, it is important to examine the relationships between them in operation. This Section is a brief overview of how the doctrines in general stay in harmony or conflict with each other. The aim is not to spell out all possible circumstances under which the doctrines might relate with each other, as the detail and specific issues will be demonstrated in later chapters.

Indeed, not all of the five principles move in the same direction: some pull in the same direction, and the rest pull against one another. This part of the chapter intends to explore these tensions which occur between the principles. These tensions can be conveniently summarised in the following flow chart:

Flow Chart: Relationship Between the Five Basic Principles*



Facing this chart, the first question which one might ask is why good faith and fairness are put together in the same box. The reason is that, on examination of the relationship between the five basic principles, one could almost immediately discover the similarities of the notion of good faith and fairness. Therefore, in order to produce a lucid chart for readers to understand their relationship more

* Arrows pointing away from each other (i.e. $\leftarrow \rightarrow$) indicate that principles are pulling against one another. Arrows pointing to each other (i.e. $\rightarrow \leftarrow$) indicate that principles are pulling in the same direction.

easily, good faith and fairness are put in the same box.

Generally, the two principles pull towards each other. It is almost certain that a contract can hardly be considered as 'fair' if the element of 'good faith' is ignored. Very often, the question of fairness is used to answer the question of whether the doctrine of good faith is being observed or vice versa. For example, under the Directive on Unfair Terms in Consumer Contracts transactions are treated as *unfair* when they are contrary to *good faith*.²³⁴ Nonetheless, whether good faith (subjectively) or (objectively) pulls in the same direction as fairness needs some explanation. It is possible that even though one side deals in good faith subjectively, the other party may find the contract unfair. In other words, acting in subjective good faith might turn out to be unfair whereas acting in objective good faith covers fair dealing and it is unlikely that it would turn out to be unfair.

Having understood the resemblance of the notion of good faith and fairness, the rest of the relationships, i.e. (1) to (6), will be further explained below.

2 Relationship (1): Good Faith and Fairness vs. Flexibility

Having already defined flexibility in this chapter, it follows therefore that the law must be sufficiently flexible in order for it to be adaptable to new commercial practices, which can be seen from the adoption of commercial law to some doctrines which provide fairness. This is illustrated by the adoption of commercial law to the following doctrines, such as misrepresentation, "the equitable doctrine of mistake" and undue influence. In adopting such flexibility parties will be relieved from performance.²³⁵ All these doctrines are introduced to promote fairness and good faith which is very often impliedly recognised in the modern commercial law.

In other words, legislation that recognises a doctrine of good faith in the performance and enforcement of contracts is a signal of the incorporation of

²³⁴ Teubner, G., 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences' 61 *Modern Law Review*, (1998) 11 at 11.

²³⁵ Beatson, J., *Anson's Law of Contract* p 7.

flexibility. Courts can employ flexibility and use the notion of good faith as a tool, for instance, to extend parties' obligations in the execution of contract.

The proposition that these three doctrines pull towards each other is not without criticisms. As put forward in Section 5.6 above, effect is given to the reasonable expectation of a reasonable person acting in good faith (in the *objective* sense). Snyderman²³⁶ rehearses the familiar objection that the commercial reasonableness standard is too vague and its meaning may differ from one context to another thus being of no practical use. Yet, it might also be argued that, if such a standard is to be adopted, flexibility may be jeopardised. It has been said that:

“The phrase ‘observance of reasonable commercial standards’ carries with it the implication of usage, customs or practices. If this is true there immediately arises the very difficult problem of what usage, customs or practices are those intended to be included in the standard. Any lawyer who has ever attempted to prove what a usage or custom is will immediately recognise how litigious such a standard could grow to be. More serious still is the possibility that ‘reasonable commercial standards’ could mean usage, customs or practices existing at any particular time. This could have the very bad effect of freezing customs and practices into particular moulds and thereby destroy the flexibility absolutely essential to the gradual evolution of commercial practices”.²³⁷

It can be inferred from this quote that linking reasonable commercial standards to usage, customs, or practice runs a risk of rendering the law inflexible. However, the problem of inflexibility occurs only if the reasonable commercial standards are viewed to be static. This risk, however, can be avoided if such reasonable commercial standards are viewed as moving with the time, as usage, customs, and practice do. In other words, there should be no problem as to inflexibility of law as long as the reasonable commercial standards are taken up in this flexible way.

3 Relationship (2): Good Faith and Fairness vs. Certainty

Some commentators fear that recognition of an obligation of good faith and the requirement of fairness generates problems of vagueness in definition and uncertainty in application. Their opinion is that, the aim of commercial law ought

²³⁶ Snyderman, M., ‘What’s So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending’ *The University of Chicago Law Review* 1335, pp 1340-1.

²³⁷ Malcom, D., ‘The Proposed Commercial Code’ 6 *Bus Law* (1951) 113, 128.

to be to encourage predictable dealings between parties.²³⁸ Although rules can be seen as certain, justice can be jeopardised as a result. With regards to legal principles, which are formulated to ensure that justice is upheld and that good faith is put forward positively, this may in fact prove uncertain by virtue of the way in which they interact²³⁹. It is also claimed, that there is an underlying conflict between the judicial instinct for justice and the traditional perception of a judge's function in adjudicating contract or commercial cases. As discussed in Section One, certainty is very important in the commercial world, businessmen would like to know where exactly they stand. Does it mean that the rules of justice, that is, the spirit of the law, can be undermined? It is suggested by some commentators, that the predictability of the legal rule outweighs fairness (absolute justice)²⁴⁰. Nevertheless, knowing the importance of the rules of justice, a balance should be struck carefully between them to keep the notion of fairness and good faith in contracts on the one hand, and to keep it predictable and certain on the other.

An example of the tension, which these apparent oppositions create is reflected in the incorporation and construction of terms in order to achieve a just result. A new philosophy is adopted in Article 2-302 of the Uniform Commercial Code, which claims that it should be open to the courts to interfere for the sake of justice. This confers upon American courts an overriding discretion to cancel or amend contracts, or parts of contracts, for the sale of goods that are regarded as unconscionable.²⁴¹ The following are examples to illustrate the conflict between the application of fairness and good faith against certainty. To avoid any misunderstanding these illustrative examples are drawn from the general law of contract and not from the law related specifically to letters of credit.

²³⁸ Schlechtriem, P., *supra* note 196 at 1.

²³⁹ Adams & Brownsword, *Key Issues in Contract* 5. See also, Bradgate, *Commercial Law* 5; Schlechtriem, *supra* note 196 at 1.

²⁴⁰ Goode, 'The Concept of "Good Faith" in English Law' Centro di studi e ricerche di diritto comparato e straniero diretto da M.J. Bonell. SAGGI, CONFERENZE SEMINARI p 5.

²⁴¹ Tiplady, D., 'The Judicial Control of Contractual Unfairness' 46 *Modern Law Review* (1983) 601, 602. at 602.

3.1 Privity of Contract

The first example concerns the doctrine of privity of contract, which is more relevant to certainty and fairness than the notion of good faith. In accordance with this doctrine, where a contract is made between two parties, and they clearly agree to another named party benefiting from it, it is evident that this third party cannot then, enforce such a contract²⁴². One may argue, on the one hand, that such a doctrine is certain because A, B and C know where they stand. On the other hand, it can be argued that the doctrine is unfair because if B fails to perform and, for some reason, A is unable to enforce the contract, as a result, C does not get the intended benefit. This outcome is arguably unfair in two respects: first, B gets away with breaching the contract with A, and secondly, C may already have relied on B's promise of performance. Or if not, C may have formed the expectation of performance²⁴³.

The Law Commission reconsidered this position in 1996.²⁴⁴ It recommended that the privity rule should be amended so that a third party, such as C, would have the right to enforce the contract between A and B. This recommendation should work on the assumption that A and B intended that their contract should benefit C, and that their contract should create an enforceable obligation in favour of C.²⁴⁵ It is submitted that this proposal may promote *fairness* between the three parties, but at the expense of certainty.²⁴⁶ To explain how certainty is affected consider Section 1 (1) of the Contracts (Rights of Third Parties) Act 1999 (which implements the Law Commission's main recommendations). It provides that:

“Subject to the provisions of this Act, a person who is not a party to a contract (a "third party") may in his own right enforce a term of the contract if-

²⁴² Adams & Brownsword, *Key Issues in Contract* p 5.

²⁴³ Ibid.

²⁴⁴ Law Commission No. 242, p.35, et. seq. see especially para 3-29. A bill implementing the proposal has recently completed its passage through Parliament. See the Contracts (Rights of Third Parties) Act 1999.

²⁴⁵ Adams & Brownsword, *Key Issues in Contract* p 5.

²⁴⁶ Ibid at 5.

- (a) the contract expressly provides that he may, or
 - (b) subject to subsection (2), the term purports to confer a benefit on him.
- (2) Subsection (1)(b) does not apply if on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party”.

Section 1 (1)(a) of the Act is straightforward on the point and causes no problem as to certainty. However, what might cause uncertainty is Section 1 (1)(b) which causes two problems. The first one is that the phrase used in the subsection suggests that a term can be enforced if it is intended to confer a benefit on a third party. This phrase is open to interpretation in which certainty may be jeopardised. The second problem is its linkage to the parties’ implicit intention, as demonstrated in Section (2).

3.2 The Right of an Innocent Party to Withdraw from a Contract

Section 13 of the Sale of Goods Act 1979 provides that it is an implied condition in contracts of sale that the goods shall correspond with their description. The section aims at giving the buyer the right to reject the goods if they do not conform to their description. Thus, if the nonconformity is so serious as to render the goods unacceptable, the buyer is absolutely entitled to reject them. However, this section is, sometimes, interpreted in a literal way in which the right to reject is granted even if the nonconformity is *trivial*, i.e. even if the goods could have been used for the intended purpose. The fear of such literal interpretation is to encourage unfaithful buyers (acting in bad faith) to reject the goods “on the ground of trivial breach as a pretext to escape from the contract in order to take advantage of more attractive prices elsewhere”.²⁴⁷ Such behaviour is arguably in bad faith and unfair.²⁴⁸

An example to illustrate this is found in Arcos v. Ronaasen,²⁴⁹ where the buyers were able to reject the timber for breach of condition even though they could have used it. Lord Atkin observed that: “If the written contract specifies conditions of

²⁴⁷ Ibid at 6.

²⁴⁸ Ibid.

²⁴⁹ *Arcos Ltd v E A Ronaasen & Son* (1933) HL 470.

weight, measurement and the like, those conditions must be complied with".²⁵⁰ The main objection to *Arcos* is that the buyers were unreasonably permitted to reject the timber when it could have been used for its intended purpose. A more significant objection is that, the real reason for rejecting the goods was that timber prices were falling, therefore, in fact the buyers were keen to find a way to get out of the contract. Initially, the buyers tried to reject the shipping documents on the ground that the timber was not shipped 'during the summer' as stipulated in the contract. This argument did not succeed at arbitration, therefore, the buyers then purported to reject the timber when it arrived, this time on the ground that it did not correspond with its contractual description. Since the timber seemed perfectly suitable for its intended purpose, the buyers' intention was clear — they were looking for a breach in order to escape from the contract and benefit from the economic opportunity resulting from the falling market²⁵¹. Lord Atkin observed:

"A man may require goods for a particular purpose and make it known to the seller so as to secure the implied condition of fitness for that purpose: but there is no reason why he should not abandon that purpose if he pleases, and apply the goods to any purpose for which the description makes them suitable. If they do not correspond with the description there seems no business or legal reason why he should not reject them if he finds it convenient so to do".²⁵²

Thus, although Lord Atkin was aware of such opportunistic behaviour, on the part of the buyers, he was of the opinion that they were permitted to withdraw based on breach of condition.

3.3 Use of Standard Form Contracts

The third example to illustrate the contradiction between fairness and certainty is the use of standard form contracts where one party purports to exclude or restrict its liability for any breach. Courts taking a classical approach in such cases are

²⁵⁰ Ibid at 479.

²⁵¹ Adams & Brownsword, *Key Issues in Contract* 171. See also in this regard, Brownsword, 'Bad Faith, Good Reasons and Termination of Contracts.' in Birds, Bradgate, Villiers (eds) *Termination of Contracts* (Chichester: Chancery Law Publishing, 1995) ch 10 p 227.

²⁵² *Arcos Ltd v E A Ronaasen & Son* (1933) HL 470, at 480.

inclined to enforce the standard form contract which contains a small print condition which excludes or restricts the liability of the seller. Thus, the intention of the courts is to emphasise certainty over fairness and good faith.²⁵³ Unlike the classical law view, according to the modern law approach, courts are not inclined to enforce the standard form contract where it would be unfair and unreasonable to do so especially where unusual terms have not been properly drawn to the attention of the other party, as shown in the cases of Interfoto and Laceys, discussed under Section 5.5.1. See also for limitation on good faith, cases examined under Section 5.5.2.

3.4 Striking a Balance

How to strike a balance between these two principles depends on what context one is faced with. Sometimes, there are reasons for the triumph of certainty over fairness and good faith, sometimes the other way round. In the following examples, one of them shows when the consideration of certainty of contract prevails over the notion of fairness and good faith, and the other example shows the opposite.

3.4.1 Certainty Prevailing Over Fairness and Good Faith

It is argued that businessmen prefer certainty to justice and good faith, and hence they know where they stand.²⁵⁴ In English commercial law, cases in which certainty has overruled fairness are not rare, for the application of the equitable standard of constructive notice to commercial transactions has been disapproved by the courts due to the overriding consideration for certainty.²⁵⁵ Further, traditionally, the courts have resisted attempts to introduce the concept of equitable ownership into the sale of goods (as an instrument to achieve fairness) unless expressly agreed by the

²⁵³ Ibid at 7.

²⁵⁴ The Right Hon Lord Justice Staughton, 'Good Faith and Fairness in Commercial Contract Law' 7 *Journal of Contract Law* (1994) 193, 194.

²⁵⁵ Scott, S.R., 'The Remedial Constructive Trust in Commercial Transactions' *Lloyd's Maritime and Commercial Law Quarterly* (1993) 330, 352.

parties. Sir Robin Cooke has commented:

“It is very easy to say that, if judges decide according to their view of what is *fair*, the law *ceases to be certain*. The chancellor’s foot is readily rejected as a criterion, but without consideration of how far differences in the length of human feet are significant in relation to the object to be measured. In truth, however, the cases as regards which that kind of argument is raised are usually cases where the law is uncertain: the person appealing to certainty is really appealing for the more conservative solution”.²⁵⁶

Although the Sale of Goods Act 1995 has recently modified²⁵⁷ the position relating to passing of property of bulk goods, the common law cases illustrate concern for certainty over fairness.

Traditionally, an agreement for the sale of goods does not of itself vest equitable ownership in the buyer: he either acquires a legal title or acquires nothing beyond a mere contractual right. In Re Wait²⁵⁸, the buyer (P) bought 500 tons of wheat, out of 1000 tons on board the ship Challenger, from the seller (S). The seller, after being paid, went bankrupt before the 500 tons paid for by P had been identified from the bulk. In the course of trusteeship, S’s trustee claimed ownership in the whole 1000 tons as assets in the bankruptcy basing their claim on the fact that no property in the 500 tons had passed to P, according to Section 16 of the Sale of Goods Act 1893²⁵⁹ which prevents the passing of property in unascertained goods. P, therefore, claimed that there had been an equitable assignment which gave him a pro rata equitable interest in the bulk. A majority of the Court of Appeal rejected P’s argument. Atkin LJ stated that:

“the total sum of legal relations arising out of the contract for the sale of goods may well be regarded as defined by the Code. It would have been futile in a code intended for commercial men to have created an elaborate structure of rules dealing with rights at law, if at the same time it was intended to leave, subsisting with the legal rights, equitable rights inconsistent with, more extensive, and coming into existence earlier than the rights so carefully set out in the various sections of the Code.

The rules for transfer of property as between seller and buyer, performance of the contract, rights of the unpaid seller against the goods, unpaid sellers’ lien, remedies of the seller, remedies of the buyer, appear to be complete and exclusive statements of the

²⁵⁶ Cooke, ‘Fairness’ 19 *V.U.W.L.R.* (1989) 421, 422.

²⁵⁷ See Article 20A of the Sale of Goods Act 1995.

²⁵⁸ *Re Wait* [1927] 1 Ch 606.

²⁵⁹ Sale of Goods Act 1893, as it was at the time of *Re Wait* [1927] 1 Ch 606.

legal relations both in law and equity.”²⁶⁰

Nevertheless, that is not to say that the doctrines of equity are completely rejected in all circumstances. On the contrary, some of these equitable doctrines are still in application, e.g., the imposition of constructive trusts to combat commercial fraud is applied from time to time. Further, remedies such as the Mareva injunction and Anton Piller Order are still available.²⁶¹ Further, so far as penalty clauses and forfeitures are concerned, they have always been challenged by common law (originally, equity). Sometimes, parties to a contract stipulate that if one party declines to carry out some stipulated obligations, he should bear additional contractual penalties or forfeiture. Such provisions are often void due to them being considered as unfair i.e. because they are designed to punish a contract-breaker in order to prevent him from breaking the contract.²⁶² In other words, although in many commercial transactions, the notion of certainty seems to prevail over those of good faith and fairness, fairness still has a role to play in the commercial sphere.²⁶³ Having said that equitable doctrines may be applied, the legal writers claim that “over-reliance on equitable concepts should be avoided”.²⁶⁴ The main reason for favouring certainty is that, as long as contracts have been freely agreed, the courts should refrain from intervening. In addition, the law should not easily confer extra rights upon contractors via the medium of equitable intervention.

3.4.2 Good Faith and Fairness Prevailing Over Certainty

The American case of K.M.C. Co., Inc. v. Irving Trust Co.²⁶⁵ is an example

²⁶⁰ *Re Wait* [1927] 1 Ch 606 at 635-636.

²⁶¹ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* p 11.

²⁶² Atiyah, P.S., *An Introduction to the Law of Contract*, 5th ed (Clarendon Press: Oxford, 1995) pp 298-99. See further the E.C Directive on Unfair Contract Terms on penalties and forfeitures.

²⁶³ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* p 11.

²⁶⁴ *Ibid* at p 21.

²⁶⁵ *K.M.C. Co., Inc. v Irving Trust Co.*, 757 F 2d 752 (6th Cir 1985). See for details, West and Haggerty, ‘The “Demandable” Note and the Obligation of Good Faith’ 21 *Uniform Commercial Code Law Journal* (1988) 99.

whereby the court focused on good faith, undermining certainty as a result. In this case, KMC entered into a line of credit fund agreement with Irving Co. Irving, without giving notice, declined to keep up its agreement which resulted in KMC's collapse. In the course of delivering judgment, the jury found that Irving had breached its engagement, and it was affirmed by a Sixth Circuit panel.²⁶⁶ The bank's action was deemed to be egregious and was apparently motivated by a personality conflict between the bank officer and K.M.C's president. The court, basing its judgment on these facts, upheld the magistrate's jury instructions regarding the obligation of good faith.

This court decision came in line with Section 2-309 of the UCC's sales provisions, which requires reasonable notification before termination of an ongoing agreement. Here, the court held that Irving had a good faith obligation to notify K.M.C before termination, notwithstanding the express conditions of the line of credit agreement, as to repayment on demand. Irving's contention that a good faith notice requirement was inconsistent with its right to repayment on demand, under the loan agreement, was, therefore, rejected. The court based its decision on Section 1-208 of the UCC²⁶⁷, that a demand provision, like a general insecurity or specific default clause, is subject to a good faith standard of reasonableness and fairness.²⁶⁸ UCC Section 1-208 provides:

A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral 'at will' or 'when he deems himself insecure' or in words of similar import shall be construed to mean that he shall have power to do so only if he *in good faith believes* that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.²⁶⁹

Snyderman²⁷⁰ argues that the section 1-208 rule is consistent with the reasonable

²⁶⁶ *K.M.C. Co., Inc. v Irving Trust Co.*, 757 at 759.

²⁶⁷ *K.M.C. Co., Inc. v Irving Trust Co.*, 757 at 760.

²⁶⁸ Snyderman, M., *supra* note 236 at 1352-3.

²⁶⁹ Emphasis added.

²⁷⁰ Snyderman, M., *supra* note 236 at 1353.

expectations of parties to an agreement containing an insecurity clause. 'When he deems himself insecure' must mean at least when the party has an honest belief in insecurity, and not merely 'whenever he feels like it'. Section 1-208 thereby gives effect to the words of the contract.

There is actually a disagreement over the meaning of 'good faith' in Section 1-208: some courts have held that good faith in this section depends only on the accelerating party's mental state; other courts seem to favour some form of reasonableness standard. Gilmore²⁷¹ believes that Section 1-208 means the "creditor has the right to accelerate if, under all the circumstances, a reasonable man, motivated by good faith, would have done so".

The good faith principle, as broadly interpreted, has caused critical issues. Courts, therefore, have given an expansive interpretation to good faith performance in borrower lawsuits. This large interpretation caused uncertainty to the lenders as to the standard of behaviour that the law requires.²⁷²

In summing up, the previous submission which was to favour certainty over fairness, is not absolute because relief from contractual obligations is in fact, widely and frequently given on the grounds of unfairness.²⁷³

3.5 Conclusion

The question now goes back to how and where to strike the balance. In English law, certainty counts for more in commercial contracts than in consumer contracts. This contention is maintained by Nolan²⁷⁴ who asserts that where a contract is concluded by two parties of similar bargaining strength, the need for a principle of good faith and fairness is much reduced. The best way to proceed, he suggests,

²⁷¹ Gilmore, G., *Security Interests in Personal Property* (Little, Brown, 1965). § 43.4 at 1197.

²⁷² Snyderman, *supra* note 236 p.1347.

²⁷³ Waddams, *supra* note 50 p. 369.

²⁷⁴ Nolan, 'The Classical Legacy and Modern English Contract Law' 59 (1996) *Modern Law Review* 603, 614.

seems to be recognition of a good faith duty in consumer contracts, but not in cases involving two commercial parties.

As was noted in the introduction, the argument in this thesis is that the adoption of a general doctrine of good faith would seriously undermine the certainty which is required in commercial contracting. To this extent, therefore, the author agrees with Nolan.

4 Relationship (3): Good Faith and Fairness vs. Party Autonomy

Party autonomy is considered as opposing in values with the notion of good faith and fairness. Reiter, has referred to individualism (freedom) and altruism (fairness) as two conflicting notions in contract law²⁷⁵. Kennedy, states that:

“The substantive and formal conflict in private law cannot be reduced to disagreement about how to apply some neutral calculus that will ‘maximize the total satisfaction of human wants’. The opposed rhetorical modes lawyers use reflect a deeper level of contradiction. At this deeper level we are divided among ourselves and also within ourselves between irreconcilable visions of humanity, and society, and between radically different aspirations for our common future”.²⁷⁶

Indeed, the notion of freedom of contracting has not taken into account the equality of bargaining power (fairness) nor the honesty (good faith in a subjective sense) of the contracting parties. The principle of party autonomy would indeed result in inequality if parties were of unbalanced bargaining power. The doctrine of sanctity of contract does not consider whether parties are dealing in good faith, the law only interferes if illegality is involved. However, whether or not parties are acting in good faith very often does not involve the issue of legality.

In other words, party autonomy is concerned with letting parties set their own contract terms, as freely as possible, within the legal framework and, as a result, to stick to their agreed terms. That was the case under classical law. On the other

²⁷⁵ Reiter, B., ‘The Control of Contract Power’ *Oxford Journal of Legal Studies*. (1981) 347 at 347.

²⁷⁶ Kennedy, ‘Form and Substance in Private Law Adjudication’ 89 *Harv Law Review* (1975-76) 1685, 1687-91, 1698-1700, 1713-18, 1738-40. See also for a detailed discussion about the tension occurs between party autonomy (Market-Individualism).

side of the coin, however, according to the modern approach such terms could contradict the requirements of fairness and good faith which may then be used to override the express terms of a contract. The enforcement of the duty to perform in good faith and fair dealing is enforcement of the background understanding that is properly an aid to interpretation of contract terms, not a term in and of itself. The hazard in materialising community standards is that it conflicts with the notion of a freely entered agreement. Hence, a presumption to look beyond the express terms of the contract will be created. As shown (under Section 3.4.2.) in the case of K.M.C. Co., Inc. v. Irving Trust Co²⁷⁷, the notion of fairness and good faith has created uncertainties in the law, so that courts will more likely override contract terms based on their own conceptions of decency and fairness.²⁷⁸

An example to show potential unfairness in complying with the principle of party autonomy is by looking at how the courts decide the amount of damages. For stipulated remedies for breach and its relation to both freedom and fairness, it is generally accepted that there is no reason, *prima facie*, for a court to disallow, awarding a particular remedy for breach, which has been stipulated by the parties. However, what would a court do if the stipulated remedy was found to be unjust as such, being either too generous or too mean? Would it award such a remedy and mutter about freedom of contract, or would it be refused in the name of justice?²⁷⁹

In conclusion, the notion of party autonomy can conflict seriously with fairness and good faith. On the one hand, the modern law tightens up on the processes by which contracts are made. For example, the idea of duress is extended; negligent misrepresentation becomes actionable in damages; the requirement of reasonable notice in relation to the incorporation of terms is interpreted more stringently; and

²⁷⁷ *K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F2d 752 (6th Cir 1985). See for details, West and Haggerty, *supra* note 265 at 99.

²⁷⁸ Snyderman, *supra* note 236 at 1346/7.

²⁷⁹ Brownsword, *supra* note 3 at 100.

standard form contracting (because of its potential for unfair surprise) is regulated. On the other hand, the modern law regulates contractual outcomes – whether by implying standard non-excludable terms or by permitting challenge to the substantive fairness of the bargain.²⁸⁰ A contract is procedurally unfair if the dominant contractor abuses its bargaining position; and, a contract is substantively unfair if its outcome is incompatible with the free agreement of the parties.

5 Relationship (4): Flexibility vs. Certainty

Flexibility and certainty conflict with one another in the sense that a rule cannot be flexible as long as it follows the requirements of certainty and vice versa. Legislation may well be certain but certainty may be procured at the expense of inflexibility.²⁸¹

It is common sense that in order to adapt to and accommodate constantly changing commercial practice, commercial law has to be very flexible. However, this presumption might contradict certainty which proposes that commercial rules and practices should be predictable and therefore, as explained in Section One, businessmen would know where they stand. Whereas flexibility aims to make commercial rules eager to adapt to and accommodate the constantly changing commercial practices, certainty intends to make commercial rules predictable and unchangeable over the term of a contract. Yet, the fact is that the relative certainty of English law has been preferred over the more flexible approach.²⁸²

Nolan²⁸³ claims that flexibility can be obtained if contract law develops *special rules* for relational contracts. For instance, contract law should soften the rules relating to offer and acceptance so that relational contracts will not be rejected on grounds of uncertainty, where the contractual obligations were not fixed in all

²⁸⁰ Ibid.

²⁸¹ Reiter, B., *supra* note 275 at 365.

²⁸² Enman, S., *supra* note 140, at 192.

²⁸³ Nolan, *supra* note 274 at 618.

respects at the time the deal was concluded. Moreover, contract law should broaden the categories regarding change of circumstances which permit non-performance of a relational contract.

By contrast, some commentators say that “the changes proposed for relational contracts should either be applied to all contracts, through reform of the general norms of contract law, or not adopted at all”.²⁸⁴ This contention is supported by various reasons. The first reason is that there is a difficulty in inventing a legally enforceable test to differentiate relational and non-relational contracts. Secondly, while the supporters of special rules are inclined to view the relational contract as the exception and discrete contracts as the norm, Eisenberg is of the view that “the great bulk of contracts either creates or reflects relationships”.²⁸⁵ Finally, the difficulties caused by the existing rules are not confined to relational contracts but extend to contracts of any duration. Although such difficulties may concern relational contracts more than any other type of contract, courts are still needed to fill gaps in the terms agreed by the parties in contracts of any duration.²⁸⁶ McKendrick²⁸⁷ points out that, in fact, there may be a great demand for adjustment in long-term contracts but the parties often insert *force majeure*, hardship and other clauses intended to deal with changes of circumstances.²⁸⁸

A mixture of flexibility and certainty is like a mixture of water and oil. They can never mix together. The notion of certainty used to dominate in governing the principles of commercial contract, yet, nowadays, there is a gradual move towards favouring flexibility over certainty. But since both principles are one of the five basic principles, so the tension between flexibility and certainty will be there

²⁸⁴ This is the argument of both Eisenberg and McKendrick, cited by Nolan, *ibid* at 618.

²⁸⁵ Eisenberg, M.A., ‘Relational Contracts’ in *Good faith and Fault in Contract Law* (ed) 291, 297.

²⁸⁶ Cited by Nolan, *supra* note 274 p. 618.

²⁸⁷ McKendrick, The Regulation of Long-Term Contracts in English Law in Beatson, J., and Friedmann, D., (ed) *Good Faith and Fault in Contract Law* 305, 325.

²⁸⁸ For more on relational contract, see generally, McKendrick, The Regulation of Long-Term Contracts in English Law in Beatson, J., and Friedmann, D., (ed) *Good Faith and Fault in Contract Law* 305, 307 et seq.

forever. The main question in any particular case is which principle is to be preferred over the other.

6 Relationship (5): Certainty vs. Party Autonomy

One of the main reasons for upholding contracts is said to be that the enforcement of contractual undertakings helps to promote security and predictability, which is a matter of importance to the business world.²⁸⁹ Certainty is promoted by contract law in two ways. First, it can be seen to promote freedom and sanctity of contract. The second way is to disregard adequacy of consideration as well as not intervening in contracts on the grounds of fairness²⁹⁰. In other words, party autonomy and predictability move in the same direction.

Party autonomy focuses on allowing parties to a contract to be free to choose their own terms, as long as they abide within the ambit of law. Predictability, on the other hand, concerns stability and certainty for those contractors who want to know where they stand to ensure that no new rules are generated which change the parties' reasonable expectations.

7 Relationship (6): Flexibility vs. Party Autonomy

Flexibility allows businessmen to incorporate the latest business practice and custom within their trade. This is so that when courts apply the common law rules on commercial cases, those considerations will be taken into account to promote business efficacy. Flexibility, therefore, cannot contradict party autonomy. What party autonomy is concerned with is that parties should be able to contract freely and be able to determine for themselves what primary obligations they will accept. This freedom of contract is where parties are given the flexibility to do whatever they like, except where illegality is involved. The contracts made would, thereby, adapt to and accommodate the constantly changing commercial practices. Suppose

²⁸⁹ Goode, *supra* note 5 p. 149, 150.

²⁹⁰ Bradgate, *Commercial Law* p 5.

one business community adopts a new practice by virtue of setting new free contract terms, the duty of commercial law here is to accept such practices, so long as it does not contradict with justice and the law.

Conclusion

The five basic principles – party autonomy, certainty, flexibility, fairness and good faith – which, arguably should, regulate and control commercial activities are fully discussed in Section One of this Chapter. Section Two of the Chapter has been devoted to examining how the five principles relate to each other.

The notions of freedom of contract and sanctity of contract have a long history. In the 19th century, English courts took the view that persons of full capacity should in general be allowed to make what contracts they liked. The spirit of these notions is incorporated in the principle of party autonomy, and has become one of the most important foundations for commercial law.

In applying the principle of party autonomy, the notion of certainty is no doubt observed. And indeed, certainty is arguably what businessmen care most about. It has been said that businessmen prefer certainty over fairness and good faith, because in the business world, people care most about where exactly they stand. Flexibility is important as well. There are some commercial customs and usage which are constantly changing; if the law is too rigid, i.e. inflexible, the legislature needs to change the law very often which makes the legal system uncertain, thereby undermining the Rule of Law, which is indeed undesirable.

As a result, courts might have to take the risk of having to disregard the notions of good faith and fairness. It is arguable that good faith is not recognised in English commercial law, and indeed, there is no express adoption. Fortunately, the common law has lubricated the unfairness by letting the courts interfere in some cases, e.g. misrepresentation, undue influence or illegality.²⁹¹

²⁹¹ Atiyah, *The Rise and Fall of Freedom of Contract* (Clarendon Press, Oxford, 1979, reprinted 1995) Chaps 9, 10, 11.

Flexibility also comes into play when judges consider the question of fairness. Bearing in mind that good faith, fairness and flexibility are no doubt important in regulating commercial transactions, certainty, which is equally important, will nevertheless be undermined. The question is: since the notion of fairness is pulling against the notion of certainty, where and how can the judge strike a balance? To answer these questions is not an easy task. Different contracts, different situations require different considerations in balancing. The future of trading and commerce will only flourish if these five principles are observed and well balanced. In the following Chapters, the same questions will be raised and attempted answers will be put forward with regard to different doctrinal issues in the law concerning letters of credit transactions.

**Chapter Three: Application of These Five Principles to the
Law Governing Letters of Credit**

Chapter Three: Application of the Five Basic Principles to the Law Regulating Letters of Credit

Introduction

The previous chapter described the five basic principles which arguably should govern Commercial Law doctrine. These five principles concern party autonomy (freedom and sanctity of contract), predictability, flexibility, fairness and good faith. It is widely recognised that Commercial Law tries to balance considerations of certainty and fairness, from which it follows that the law relating to letters of credit, as part of the general body of Commercial Law, can be expected to involve a similar balance. In this chapter, an attempt is made to examine the relevance of each principle to the law regulating letters of credit and how they apply in practice. In the following chapters, specific aspects of the law relating to letters of credit will be considered with a view to deciding which doctrinal position strikes the right balance relative to the key principles.

Five Basic Principles

1. Party Autonomy in the Law of Letters of Credit

1.1. Introduction

This principle, as described in the previous chapter, has two limbs, freedom of contract and sanctity of contract. Both features are applied in the law regulating letters of credit.

1.2. Freedom of Contract

Parties to a letter of credit are free to conclude their letters of credit according to the UCP rules, UCC rules or their domestic law. Such freedom can be seen from the terms of both the UCP and the UCC. Article 1 of the UCP, which deals with how these rules are applied to letters of credit, provides:

“The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500, shall apply to all Documentary Credits (including to the extent to which they may be applicable, Standby Letter(s) of Credit) where they are incorporated into the text of the Credit. They are binding on all parties thereto, unless otherwise expressly stipulated in the Credit.”¹

Under English law the UCP rules are not binding unless otherwise expressly agreed to.² To put it in another way, the UCP rules do not have the force of law.³

Freedom of contract is also recognised under the modified section 5-102⁴ of the UCC. Unless otherwise agreed, if by its terms or by agreement, course of dealing or usage of trade, such letters of credit are subject in whole or in part to the UCP, this Article i.e. Article 5 UCC, does not apply to a letter of credit. Similarly, if the UCC is involved for a certain letter of credit arrangement, the UCP will cease to have any effect.⁵ Moreover, parties to a letter of credit are also given the freedom (at least, in law) to subject their contract to the United Nations Convention on Independent Guarantees and Standby Letters of Credit.⁶

Therefore, the law regulating letters of credit tends to grant freedom of contract. It is also the case, however, that the law regulating letters of credit restricts complete

¹ Article 1 UCP, 1993 Revision.

² Sealy, L.S., and Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* 2nd ed (London, Butterworths, 1999) p 765.

³ Ellinger, ‘Letters of Credit’ in Horn, N., & Schmitthoff, C., *The Transnational Law of International Commercial Transactions*. (Eds.) Vol. 2 (Antwerp; Boston: Kluwer-Devanter, 1982) p 241 at 252. It is also submitted by the same author that “in most legal systems, the Uniform Customs may constitute an independent source of law only in so far as this Code has been entrenched by a binding mercantile usage. In the absence of such a usage, the Code has to be regarded as a set of standard terms and conditions, the adoption of which depends on the will of the parties”. at 251.

⁴ This section 5-102 of the UCC is modified version of the Original Article 5 UCC adopted by New York, Missouri, Alabama and Arizona. This further subsection to section 5-102(4) reads: “Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practices for Commercial Documentary Credits fixed by the Thirteenth or by any subsequent Congress of the International Chamber of Commerce”. In addition, see section 5-116(c) under revised Article 5 UCC, Appendix C. See also Appendix D, Section 13 which describes the revised Article 5’s sections as default rules.

⁵ See Appendix D, Section (13).

⁶ The Convention was approved in December 1995 by the General Assembly of the United Nations. Article 1(2) of the Convention reads “*This Convention applies [also] to a [commercial letter of credit] [letter of credit other than a stand-by letter of credit] if it expressly states that it is subject to this Convention*”. <http://www.his.com/~pildb/wg2-wp83.html>.

freedom of contract⁷. Indeed, freedom of contract certainly implies freedom not to contract.⁸ For instance, when asked to lend a bank's money or credit, the banker concerned may refuse to do so. Furthermore, the beneficiary of a credit commitment may also decline the credit if its terms and conditions are unacceptable. Moreover, it is not obligatory by law for an applicant for financial accommodation to enter into a credit agreement if the terms are unacceptable to him.⁹ In other words, as far as letters of credit are concerned, parties should be free to stipulate their individual rights and duties in any arrangement they enter into, as long as their agreed terms do not offend against declared public policy.¹⁰

The morals of the marketplace and the legitimate needs and convenience of businessmen should be the guidelines for determining the policies of commercial law. The policies should focus on freedom of contract, either letter of credit contract, bank guarantee or any similar financial device, thus leaving businessmen free to choose the particular device that best suits their purposes.¹¹

In sum, the law recognises agreements that are freely entered into. Whether the parties have such freedom in practice is another matter. For example, although the theoretical suggestion is that the law offers freedom of contract, in the law of letters of credit such freedom may not appear as clear as we suggest, if the bank uses standard forms and insists on the use of the UCP which is drafted by banking interests.

⁷ Harfield, H 'UCC. Article 5 Symposium: An Agnostic View' 56 *Brooklyn Law Review* (1990) 1 at 2.

⁸ *Ibid.*

⁹ *Ibid* at 8.

¹⁰ *Ibid.*

¹¹ *Ibid.*

1.3. Sanctity of Contract

Sanctity of letters of credit becomes apparent from the fact that all parties concerned should stick to their agreed terms.¹² Indeed, the law relating to letters of credit, whether UCC, UCP¹³ or case law, as will be advanced in the following chapters, provides enforceability of contracts. The terms of an irrevocable confirmed credit, for instance, once issued freely should be held sacred¹⁴. The adoption of the independency rule further gives sanctity to the credit since the enforcement of the contracts (the underlying contract and the letters of credit contract) are independent of each other. That is to say, even if the underlying contract is for some reason not enforceable, the letter of credit contract remains undisturbed. However, the sanctity of letters of credit, as of any contract, is not absolute. There are some exceptions to this, such as committing fraud, contracting against public policy or where the parties agree not to enforce some terms. There will be ample examples presented to support this later in Chapter Four.

2. Certainty in the Law of Letters of Credit

2.1. Introduction

Since businessmen like to know where they stand and to have the law, which they use in their day-to-day business, as predictable as possible, the law regulating letters of credit as part of commercial law, responds to such needs. Therefore, once a letter of credit is opened the beneficiary relies on an assured and prompt payment from a solvent paymaster. Further, because of the adoption of the independency rule in the law of credits, minimum litigation and less judicial interference is assured, and this is another advantage of the letter of credit device.

¹² Thorup, A.R., 'Injunctions Against Payment of Standby Letters of Credit: How Can Banks Best Protect Themselves?' *Banking Law Journal* (1984) 6 at 6.

¹³ See section 5-114(1) of the original UCC (Appendix B) and section 5-103(d) of the revised UCC (Appendix C). See also Article 4 of the UCP about the independency rule.

¹⁴ See Article 9 (a) of the UCP 1993 Revision.

In conventional sale of goods transactions, letters of credit are useful in making clear the buyers' intentions, reliability and good faith, and it is also important in reducing the problems of foreign litigation.¹⁵

2.2. Features of Certainty

Features of certainty in the law of letters of credit, as the main point of this section, should be taken into account as follows:

- (i) Certainty becomes clear when applying the independence rule. The agreement between the customer (buyer) and beneficiary (seller), that calls for the letter of credit, is the underlying contract for goods or services. This contract is governed by the substantive law of the jurisdiction and is independent of the rights and obligations generated by the letter of credit. Thus, "certainty of payment, independent of other claims, set-offs or other causes, is a core element of the commercial utility of letters of credit".¹⁶

Owing to such certainty of payment, parties who are unknown to each other and thus hesitant to enter into business transactions, are encouraged to do so because they can rely upon a secure source of credit and therefore are able to assess the possible risks in the undertaking more accurately.¹⁷ It has been stated that interpretation of Article 5 of the UCC and Articles of the UCP should favour certainty of payment in order to support the integrity of letter of credit transactions.¹⁸

- (ii) As mentioned above, the commercial viability of letters of credit depends on their ability to provide assurance of payment. Consequently, to enjoin the issuing banks from paying the letters of credit, would directly contradict the

¹⁵ Symons, E.L., 'Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief' 54 *Tulane Law Review* (1980) 338 at 344.

¹⁶ Dolan, J.F., '*The Law of Letters of Credit. Commercial and Standby Credits.*' Revised Edition. (Warren, Gorham and Lamont 1996) APP p. A-7.

¹⁷ Leon, C., 'Letters of Credit: A Primer' 45 (1986) *Maryland Law Review* 432 at 432.

¹⁸ *Ibid* at 439.

intent of the legislature and erode the certainty that should accompany letter of credit transactions.¹⁹ Thus, it is not easy for a court to enjoin the issuing bank from paying a letter of credit.²⁰ (See Chapter Six for detail).

- (iii) A breach of warranty by the beneficiary should not cause the withholding of letters of credit payment. The only cause which satisfies withholding payment is egregious fraud.²¹ (See Chapter Seven, the section concerned with warranty).
- (iv) The importance of certainty becomes apparent when the credit is irrevocable and confirmed because such a credit cannot be cancelled or amended unless the consent of all parties concerned is obtained.²² Consequently, the issuing bank, once having issued an irrevocable credit, cannot revoke the credit, even though the applicant has become insolvent or purported to revoke his instructions to the banker. Such a bank undertaking, cannot be revoked also by reason of disputes concerning the underlying sale of goods contract between buyer and seller. The issuing bank's undertaking here is absolute as to honour the credit, provided that the terms and conditions of the credit, are complied with.²³
- (v) In a case where the credit is silent as to whether it is revocable or irrevocable, it should be construed against the issuer as the latter. This presumption of irrevocability enhances certainty in letter of credit transactions and encourages their use.²⁴

¹⁹ Stern, M., 'The Independence Rule in Standby Letters of Credit' 52 *U. Chi. L. Rev.*, Winter (1985) 218 at 229.

²⁰ See § 5-114(b) UCC, Appendix B and § 5-109(b) UCC in Appendix C.

²¹ Leon, C., *supra* note 17 at 457. See Chapter Seven, Section One (4.1.) See § 5-110 UCC Appendix C, cmt, Appendix D, Section 5.

²² See article 9 (d) (i). UCP 1993 Revision. See about consent of amendment, § 5-106 (revised). UCC Appendix C.

²³ Davis, A.G., 'The relationship between banker and seller under a confirmed credit' 52 *L.Q.R.* (1936) 225 at 227. See Chapter Seven *ante* about nature of payment clause.

²⁴ Leon, C., *supra* note 17 fn 71 p. 445. See UCC, § 5-106(a) (revised) and UCP Article 6.

- (vi) Even where the credit is revocable, it still has some extent of certainty since the issuer cannot revoke the letter of credit after the beneficiary's delivery of the draft or demand for payment from either the issuing or confirming bank.²⁵
- (vii) Another feature of certainty is the assignability of a letter of credit, provided that a letter of credit expressly provides that the beneficiary may assign it, and the credit may not be assigned by the assignee. This characteristic provides businessmen with certainty.²⁶
- (viii) A narrow exception to the independence rule is fraud in the underlying contract. If fraud is proved to have occurred in the transaction, the court can grant an injunction to the buyer to stop the issuing bank from payment. Hence, if a broad interpretation of fraud in the transaction is given, the certainty of the credit will be undermined as this means that the court can easily stop payment. This narrow fraud exception, under American case law, will be further examined in Chapter Four when dealing with the case of Sztejn v Henry Schroder Banking Corp²⁷. This narrow interpretation of fraud in the transaction exception has been codified in section 5-114 of the UCC and has been accepted and reconfirmed by English courts²⁸. Courts, therefore, while adjudicating cases involving traditional letters of credit, have given the fraud in the transaction exception a narrow interpretation, restraining its application to cases of egregious fraud carried out by the beneficiary. It has been suggested that "egregious fraud" means "outrageous conduct which shocks

²⁵ Leon, C., supra note 17 at 446.

²⁶ See Article 48 of the UCP and § 5-116 of the UCC, in Appendix B ; see generally Berman, H.J., and Kaufman, C., 'The Law of International Commercial Transactions' 19 *Harvard International Law Journal* (1978) 221 at 249.

²⁷ *Sztejn v. Henry Schroeder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). (Facts are set out in Chapter Four, Section One (5.1.).

²⁸ See for more details *United City Merchants Ltd v. Royal Bank of Canada, (The American Accord)*, [1979] 1 L.L.R. 267, 275-77; also, *Establisement Esefka International Anstalt v. Central Bank of Nigeria*, [1979] 1 L.L.R. 445, 449. See Chapter Four and Six for facts and decisions regarding these cases.

the conscience of the court”.²⁹ This narrow interpretation is obviously justified on the grounds that a broader interpretation of fraud would destroy the certainty of letter of credit transactions and erode one of the fundamental purposes of the letter of credit assuring prompt payment to the beneficiary.³⁰

No doubt, the granting of the injunction in fraud cases would serve public interest, nonetheless, the sanctity of letters of credit should not be impaired because their purpose is to remove the risk of nonpayment or nonperformance and thus provide certainty.³¹ While the UCP is silent on this issue, the UCC acknowledges this problem and contemplates a strict standard of fraud akin to the common law tort action of deceit.³² (See Chapter Six for detail).

- (ix) Section 5-111(1) of the UCC provides that there is a warranty that the documents tendered by the seller should comply with the requirements under the credit. This provides the buyer with an adequate remedy at law against the beneficiary in case the beneficiary is engaged in fraud. This point will be further discussed in Chapter Seven.
- (x) Where a beneficiary obtains payment against forged or fraudulent documents an issuing or confirming bank may recover the amount paid as paid under ‘mistake of fact’ under English law.³³ As stated by Gutteridge and Megrah, “except where the beneficiary has in good faith altered his position as the result of payment...the bank would have a right of recovery against him for payment under mistake”.³⁴ However, Professor Goode argues that the bank

²⁹ Stern, M., *supra* note 19 at 228.

³⁰ *Ibid.*

³¹ Avidon, M.E., ‘The Prime Motor Inns Case and its Impact on Indentures, Trustees, Bondholders, and Letters of Credit’ 108 *The Banking Law Journal* (1991) 491 at 493.

³² Note, ‘Letters of Credit: Injunction As A Remedy for Fraud in UCC Section 5-114’ 63 *Minn. L. Rev* (1979) 487 at 500.

³³ Goode, R., ‘Reflections on Letters of Credit-III’ *J.B.L* (1980) 443, 444. Note that bank may recover money paid as paid against breach of warranty. See Chapter Four, Section One (6.4.).

³⁴ Gutteridge & Megrah, *The Law of Bankers' Commercial Credits*. 7th ed.(London, Europa Publications Limited, 1984) p 86.

has no right to reject the documents once it has accepted them, this being the case even though the beneficiary did not 'irretrievably change his position'.³⁵ He goes on to explain that the recovery of money paid under mistake is a restitutionary remedy which cannot be pursued unless there is total failure of consideration.³⁶ Since payment against defective documents does not constitute total failure of consideration, allowing the bank to recover its payment would be contrary to the principle and hence destroy certainty.

- (xi) Specification of an appropriate standard of strict compliance would make the rights and obligations of the parties more certain and predictable and consequently would reduce the volume of litigation over what constitutes complying documents. The main advantage of the strict compliance rule is that it injects reliability into letters of credit and promotes their virtues as a certain payment and financing device. Subscribers to that doctrine contend that the doctrine ensures certainty and predictability.³⁷ (See Chapter Five for full discussion about the different standards of compliance).

A letter of credit is reliable because it solves two problems which are usually dominant in the sale of goods between distant parties. Firstly, it excludes the risk by the seller that the buyer may not have credit upon which the seller could rely. Secondly, it removes the need of the buyer to pay for the goods in advance.³⁸

From the above, it can be said that both of the UCP and the UCC rules are in favour of certainty.

When we talk about certainty we generally talk about certainty of legal doctrine so that parties know where they stand. In practice the certainty that matters here is to

³⁵ Goode, *supra* note 33 at 445.

³⁶ *Ibid.*

³⁷ Adam, M.I., 'The Perceived Problems in the Utilisation of Letters of Credit: A Comparative Study'. A Ph.D Thesis (Aberdeen University, 1991) p 7.

³⁸ Gabriel, H.D., 'Standby Letters of Credit; Does the Risk Outweigh the Benefits?' *Colum. Bus. L. Rev* (1988) 705 at 707.

do with certainty of payment, from the sellers' perspective, and it follows that certainty associated with the doctrine of strict compliance and the independency principle assesses the certainty of the seller being paid.

3. Flexibility in the Law of Letters of Credit

3.1. Introduction

A commercial world without flexibility is like soil without water. The law regulating letters of credit has to be less rigid, in the sense that it becomes responsive to continuously changing commercial activities. In other words, the law needs to be adjustable and modifiable rather than merely taking one rigid position.

Article 5³⁹ of the UCC provides rules that can be waived or modified by agreement between the parties. Since almost the entirety of Article 5 is variable by agreement, the specific provisions of the UCP may also become part of the agreement between the parties, or its provisions may be waived by agreement. Thus in between the expanded reliance upon existing standards of business practices as a default rule and the ordinary ability of the parties to vary the default rules, Article 5 grants commercial people the maximum flexibility to tailor their relationships under letters of credit. As a result, there is considerable freedom to vary by agreement the framework of rights and duties established in Article 5. In addition the courts are encouraged to be sensitive to the commercial expectations created by custom and usage that "are not inconsistent with the essential definitions and substantive mandates of the statute".⁴⁰ In addition, in an attempt to achieve the maximum degree of flexibility, letters of credit, may also be governed by "the United Nations Convention on Independent Guarantees and Standby Letters of Credit".⁴¹ Moreover, the UCP is a set of

³⁹ Note that this is the modified § 5-102 of the UCC which was adopted by New York, Missouri, Alabama and Arizona. See Revised § 5-116(c) UCC in Appendix C. See the introductory section in Appendix D on flexibility.

⁴⁰ (1995) UCC section 5-101, cmt. See for details sections (1) and (9) in appendix D.

⁴¹ The Convention was approved by the General Assembly of the United Nations in December 1995. It would not be applied to letters of credit unless expressly agreed to. Similar to UCC Article 5, the law imposed

international trade practice that is commonly adopted by international and domestic letters of credit and as such is the “law of the transaction” by agreement of the parties.⁴² These international practices are commonly employed by the major issuers and users of letters of credit.⁴³ These rules should be flexible enough to accommodate changes in technology and practices that international law recognise.⁴⁴ (See Appendix D for flexibility offered by revising Article 5 of the UCC).

3.2. Features of Flexibility

The followings are the main features of flexibility in the law of letters of credit, details of which will be discussed in the later chapters:

- (i) Relaxation of the ordinary requirement of consideration is indicative of a flexible approach. The general rule of English contract law demands that a contract is not legally binding unless there is consideration or it is concluded in a deed.⁴⁵ However, in letters of credit, even if consideration exists for the bank’s promise to pay, it does not move from the beneficiary as promisee but from a third person, usually the buyer.⁴⁶ Nevertheless, it appears to have been assumed in all the cases that there was good consideration for the banker’s

by the Convention may also be variable by agreement. However, according to Article 14(2) “...an issuer may not be exempted from liability for its failure to act in good faith or for any gross negligent conduct”. See Turner, P.S., ‘The United Nations Convention on International Standby Letters of Credit: How Would it Change Existing Letter of Credit Law in the United States?’ 114 *Banking Law Journal* (1997) 790 at 795.

⁴² Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits*, at App. A-14.

⁴³ Ibid at App-A 8. Indeed, in order to achieve maximum harmony in international rules governing letters of credit, the 1995 revision of the UCC Article 5 has been made. This would bring harmony between the UCC rules, on the one hand, and the current international practices and the UCP, on the other hand. See Appendix D.

⁴⁴ Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits*, at App A-5.

⁴⁵ Treitel, G.H., *The Law of Contract* 10th ed (London, Sweet & Maxwell, 1999) 63.

⁴⁶ Eberth, R., ‘Documentary Credits in Germany and England’ *J.B.L* (1977) 29 at 32. See generally Gutteridge & Megrah, *The Law of Bankers’ Commercial Credits* pp. 24-28.

promise.⁴⁷ So far as the US law is concerned, section 5-105 of the UCC provides that “[n]o consideration is necessary to establish a credit or to enlarge or otherwise modify its terms”. Further, in the case of Boise Cascade Corp. v First Security Bank⁴⁸, it was held that lack of consideration was no defence for an issuer. Thus, the banker issuing the credit cannot rely on a defence of lack of consideration as between himself and the customer in an endeavour to escape payment to the beneficiary.⁴⁹ The UCP is, however, silent regarding consideration.

- (ii) Flexibility can be further achieved in the UCP exceptions of the *de minimis* rule which allows a difference in the margin of 5 % more or less than the amount or the quantity indicated, whenever the words “about”, circa or similar expressions are used.⁵⁰
- (iii) Flexibility is also enshrined in the rules governing the bank’s determination of the compliance of the tendered documents. The commercial invoice must contain the description of the goods with some particularity and allow the linkage with the other tendered documents, such as those relating to transport, insurance, pre-shipment inspection, and so on. The U.C.P. provides in Article 37(c), “the description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit”. Sometimes the literal descriptions of the goods in the credit are different from that in the invoice although there is no doubt that both documents are describing the same goods. Hence, it can be stated that

⁴⁷ See Chapter Two, Section One, (3.4.) for more on consideration. See also in this regard the judgment of Lord Mansfield in *Pillans v. Van Mierop* 97 Eng. Rep. 1035 (K B 1765).

⁴⁸ *Boise Cascade Corp. v First Security Bank*, 183 Mont. 378, 600 p. 2d 173 (1979).

⁴⁹ *Ibid* at 388.

⁵⁰ Article 39 (a) (b) of the UCP 1993 Revision. See Chapter Five, Section One, (3.1.1.) for more detail.

Article 37 (c) of the UCP mitigates, to some extent, the effect of the doctrine of strict compliance.⁵¹

- (iv) The common law tends to be quite rigid as to the discrepancies in the tendered documents under the credit, but an adoption of different standards of compliance can increase flexibility. Thus, the “substantial compliance” standard, and the “qualified strict compliance standard” though their applicability is not without debate,⁵² were introduced in some cases. (See Chapter Five for details).

4. Fairness in the Law of Letters of Credit

4.1. Introduction

According to one commentator:

“the most common standard of fairness in commercial transactions law requires that one party treat the other or others as a regular participant in that transaction would wish to be treated when viewing its own advantage”.⁵³

This is similar to the distributive view of fairness argued for in Chapter Two. Such an approach will be explored further in the remaining chapters of the thesis.

4.2. Features of Fairness

The law regulating letters of credit has some clear features of fairness which are illustrated below.

- (i) The courts’ application of the waiver⁵⁴ and estoppel doctrines illustrates how fairness can come into play in the area of letters of credit.⁵⁵ For example,

⁵¹ Schmitthoff, C.M., *Schmitthoff’s Export Trade: The Law and Practice of International Trade*. 9 th ed (London, Stevens & Sons, 1990) p. 414; Jack, R., *Documentary Credits* (London, Butterworths, 1993) p. 154; see chapter Five, ante.

⁵² See Chapter Five, Sections (6.2.2.) and (6.2.3.) consecutively, ante.

⁵³ Kozolchik, B., ‘Strict Compliance and the Reasonable Document Checker’ 56 *Brooklyn Law Review* (1990) 45 at 72; See also by the same author, ‘Fairness in Anglo and Latin American Commercial Adjudication’ 2 *B.C. Int’l & Comp. L. Rev.* (1979) 219 at 233. Further, by the same author, ‘The Commercialization of Civil Law and the Civilization of Commercial Law’ 40 *La. L. Rev.* (1979) 1, 27-35.

⁵⁴ See later Chapters for more on waiver in the letter of credit context.

⁵⁵ The UCP deals with preclusion, Article 14(c). The UCC deals with waiver and estoppel § 5-108(a).

despite the harshness of the rule of strict compliance, the adoption of these doctrines by the courts has softened the rule and made it more acceptable in terms of fairness. Courts have acknowledged that the issuer may waive or be estopped from demanding strict compliance in appropriate cases⁵⁶ where fairness and justice demand it. The notion of fairness here is based on the distributive theory in the sense that the court try to achieve fairness between the individuals.

The doctrine of equitable estoppel can be raised by the beneficiary, whenever appropriate, as a protection against the abuse of the strict compliance standard.⁵⁷ For instance, in the event that the banker delays in examining the document within a reasonable time to the detriment of the beneficiary, the banker is estopped from raising objections at a later time.⁵⁸ In addition, an estoppel theory may preclude an issuer from dishonouring, when the issuer has acquiesced in the past to defects in documents. However, estoppel is not available to a beneficiary if the issuer has obtained the customer's consent when acquiescing to such defects in past transactions.⁵⁹ (See the rest of the Chapters about waiver).

- (ii) Furthermore, there are some other principles which may dilute the rigors of the doctrine of strict compliance and thus enhance fairness. Namely (1) the rule of contra proferentem; (2) the "render performance possible" rule; (3) the "plain meaning" rule; (4) some provisions of the UCP for documentary credits

⁵⁶ Leon, C., supra note 17 at 454. See also Chapter Seven, Section One (1.4.). Chapter Five, Section One, (7.7.) where the contract law principles dilute strict compliance, and as a result provide fairness.

⁵⁷ Adam, M.I., supra note 37 p 199.

⁵⁸ See Article 14 of the UCP 1993 Revision. Under UCC § 5-114(4)(b) The issuing bank shall have the reasonable time of (three banking days). Also under Section 5-108(b) 2 of the UCC (1995) revision, the issuing bank shall have the reasonable time of (seven banking days, see Appendix C.).

⁵⁹ See for more detail, *Crocker Commercial Serv. Inc. v. Countryside Bank*, 538 F. Supp. 1360, 1363-64 (N.D. III 1981). It has to be mentioned here that issuer's past actions do not stop future rejection since issuer obtained customer's consent. See in this regard *Courtlands N. Am. Inc. v. North Carolina Nat'l Bank*, 528 F. 2d 802, 807 (4 th Cir. 1975); see Chapter Five about estoppel, ante.

such as Articles 37(c) and 39(b); (5) reformation of the written terms of a letter of credit; (6) the parol evidence rule; (7) course of dealing and course of performance; (8) banking customs; (9) good faith; (10) duty to notify the beneficiary of oppressive terms; and (11) the UCC presentment warranty.⁶⁰ The notion of fairness here is based on the distributive theory in the sense that the court tries to achieve fairness between the individuals. (See Chapter Seven for further discussion).

5. Good Faith in the Law of Letters of Credit

5.1. Introduction

As mentioned in the previous chapter, there are two tests of good faith: the subjective and the objective test. In the law specifically relating to letters of credit, good faith tends to be applied in its subjective sense. English law, as was described in the previous chapter, does recognise the principle of good faith in its subjective sense. The UCC also recognises subjective good faith in letters of credit. The UCP is, however, silent upon the question of good faith.

5.2. Features of Applying Good Faith

(i) Under Article 5 of the UCC, good faith is defined as “honesty in fact in the conduct or transaction concerned”.⁶¹ Implicit in this definition is a deliberate rejection of the wider meaning attributed to good faith in other parts of the UCC which includes the “observance of reasonable standards of fair dealing”.⁶² This narrower meaning was chosen in order to follow the ‘independence principle’, the idea being that an issuer should not be able to use the beneficiary’s failure to meet standards of ‘fair dealing’ to avoid the obligation to pay the beneficiary. There is also a feeling that any application of the ‘fair dealing’ standard, would

⁶⁰ Thorup, A., *supra* note 12 at 39. See Chapter Seven, *ante*.

⁶¹ (UCC § – 1-201) (pre-1995 Revision). UCC § – 5-102(a)(7).

⁶² UCC § – 5-102, cmt.3.

adversely affect the strict compliance test that is used to monitor the issuer's duty to honour a letter of presentation under a letter of credit.⁶³ Thus, letters of credit are more certain and obligations easier to understand when a narrow interpretation of good faith is adopted. Moreover, the status of the letter of credit as a cheap form of contract which enables payment to be made swiftly can be preserved this way. This is because according to the 'strict compliance' test the duty of the issuer is simple, that is to establish compliance of the documents with the specific terms of the letters of credit unburdened by considerations of what is and what is not 'fair dealing'.

The narrow definition of good faith has also another advantage in relation to the doctrine of preclusion against the issuer (Section 5-108(d)) which was modified under the "fair dealing" standard to enable the issuer later to raise additional deficiencies in the presentation. The rights and obligations arising from presentation, honour, dishonour and reimbursement, are independent and strict, and thus "honesty in fact" is seen traditionally as an appropriate standard.⁶⁴

- (ii) Definition of good faith differs according to the contractual relationship. For example, the reimbursement contract (the contract between the applicant and the issuer) is governed partially by Article 5 UCC e.g. 5-114(3)⁶⁵ and partly by other laws (e.g., the general law of contracts). Therefore, the definition of good faith, used in the provisions within Section 5-201⁶⁶, applies only to the extent that the reimbursement contract is regulated by such provisions. Regarding the part which is governed by other laws, the definition of good faith in such other law would apply.⁶⁷ Hence, as long as Section 5-201⁶⁸ is applicable, an issuer in

⁶³ UCC § – 5-102, cmt.3.

⁶⁴ Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits*, at App. A-16.

⁶⁵ Similarly, UCC § 5-108(i), § 5-111(b), and § 5-103(c) of the revised Article 5. See Appendix C.

⁶⁶ Similarly, UCC § 5-102 (a) (7), Appendix C.

⁶⁷ Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits*, at App. A-17.

the reimbursement contract is not liable for examining the documents, unless it has acted in “bad faith” or committed “gross negligence”.⁶⁹ The UCP is silent upon the issue of good faith.

- (iii) The underlying contract between the buyer and seller is not governed by Article 5 of the UCC and, therefore, the narrow definition of good faith would not apply. This contract is governed by applicable contract law, such as Article 2 or the general law of contracts. According to such applicable law i.e. Section 2-103(1)(b) or Restatement of Contracts 2d, s 205, the definition of good faith includes the principle of “fair dealing”.⁷⁰ If the underlying contract is subjected to English Law, then the standard of subjective good faith would prevail.

Conclusion

The law regulating letters of credit, whether it is the UCP, UCC or Common Law, is guided by the principles of party autonomy, certainty, flexibility, fairness and good faith. However, these doctrinal principles do not operate altogether without possible tensions by virtue of their characters. The rest of the chapters, i.e. Chapter Four to Chapter Seven, will deal in more detail with the application of these principles in the law regulating letters of credit as well as considering possible tensions resulting from their application and assessing the best doctrinal balance.

⁶⁸ Similarly, UCC § 5-103 (c), Appendix C.

⁶⁹ Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits*, at App. A-21.

⁷⁰ *Ibid.*

Chapter Four: Disputes Between the Issuing Bank and the Beneficiary

Chapter Four: Disputes Between the Beneficiary and The (Non Paying) Issuing Bank

Introduction

This chapter deals with disputes between the beneficiary (seller) and the (non-paying) issuing bank on the letter of credit contract. As there are many types of letter of credit, it is important to point out that revocable and irrevocable credits are the main types of credit that are commonly issued. Furthermore, an irrevocable credit could either be classed as confirmed or unconfirmed. Having said that revocable and irrevocable credits are the main type of credits, other types of credit will be listed. Although the legal contractual relationship between the beneficiary and the issuing bank is well settled and the courts have always perceived the letter of credit as a contract, there are some theories, advanced only by academics, which will also be listed.

Having described these different types of credits as well as the legal contractual relationship, the focus of attention then moves to some key doctrinal issues which form the cornerstone of the contractual relationship between the issuing bank and the beneficiary. These doctrinal issues are as follows: (i) beneficiary's remedies against the issuing bank; (ii) bank's defences against payment of a letter of credit; (iii) banker's right of recourse against seller (beneficiary); and (iv) the position of holders of seller's drafts.

The second section of the chapter deals with the evaluation of punitive damages, the independency principle and its fraud exception (both seller's fraud and fraud by a third party), and the strict compliance rule in the light of the basic principles.

Section One: Contract Between Issuing Bank and Beneficiary

1. Main Types of Documentary Credits: Revocable and Irrevocable Credits

Article 6 of the UCP introduces both revocable and irrevocable credits:

- “(a) Credits may be either (i) revocable, or (ii) irrevocable.
- (b) The credit, therefore, should clearly indicate whether it is revocable or irrevocable.
- (c) In the absence of such indication the Credit shall be deemed to be irrevocable.”

Having said that revocable and irrevocable credits are the main types of credit commonly issued in letters of credit, irrevocable credit could either be confirmed or unconfirmed. Beside the aforementioned types of credit, there are several types of documentary letters of credit. Since a detailed description of such a variety of letters of credit is not essential to the main argument of the thesis, they are simply listed as follows¹:

1. Back-to- back Credit
2. Revolving Credits
3. ‘Red Clause’ Credits
4. Straight and Negotiation Credits
5. Transferable and Non-Transferable Credits
6. Standby Credits.

2. The Legal Nature of the Contract Between the Issuing Bank and Seller

According to the law of contract, a contract is not formed unless an acceptance matches an offer. Although this does not seem to be the case between the bank and the beneficiary, it has always been assumed that a letter of credit is a contract,

¹ See generally for a variety types of letters of credit, Todd, P., *Bills of Lading and Bankers’ Documentary Credits* 3rd ed (Lloyd’s of London Press, 1998) p. 34 et.seq; Gutteridge, H.C., and Megrah, M., *The Law of Banker’s Commercial Credit*. (London, Europa Publications Limited, 1984) p. 18. For more details about revocable and irrevocable credits and confirmed and unconfirmed credits see Berman, H., & Kaufman C., ‘The Law of International Commercial Transactions (Lex Mercatoria)’ 19 *Harvard International Law Journal* (1978) 221 pp 248-49; Bradgate, R., *Commercial Law* 2nd ed (London, Butterworths, 1995) pp. 672-4; Goode, R., *Commercial Law*, 2nd ed, (Harmondsworth: Penguin, 1995) pp. 970-984.

albeit of a special character. Further, according to English contract law, a contract is not legally binding unless it is supported by some consideration or made in a deed.² Again, this does not seem to be the case in relation to a letter of credit. There are several theories which attempt to explain the legally binding nature of a letter of credit. However, since letters of credits have always been regarded as legally binding contracts and since these matters are not essential to the main argument of the thesis, such theories do not merit any lengthy description but can be merely listed as follows³:

1. Offer and Acceptance Theory
2. The Guarantee Theory
3. The Estoppel or Trustee Theory
4. The Assignment and Novation Theories
5. The Theory that the Buyer is the Seller's Agent
6. The Seller's Offer Theory.

3: Conflict Between Parties to a Letter of Credit

3.1. The Beneficiary's Remedies

The issuer's repudiation of credit can take place at two different times: first upon

² See Generally, Treitel, G.H., *The Law of Contract* 10th ed (London, Sweet & Maxwell, 1999) 63.

³ See generally, Gutteridge & Megrah, *The Law of Bankers' Commercial Credits* (1979) pp. 29-32; Sarna, L., *Letters of Credit: The Law and Current Practice* p. (2-1); Hershey, O.F., 'Letters of Credit' *Harv Law Review*. (1918) 1 at 3; For more details about this theory and the other theories regarding the letter of credit see. Trimble, R., 'The Law Merchant and the Letter of Credit' 61 *Harv Law Review* (1948) 981 at 997; Mead, C.A., 'Documentary Letters of Credit'. 22 *Columbia Law Review* (1922) 297 at 301; Goode, R., *Commercial Law* p. 987; Rowe, M., *Letters of Credit*, 2nd ed (Euromoney, 1997, London) p 58. For more on the various theories concerning the legal nature of a letter of credit contract, see generally Dighe, K., 'Mercantile Speciality: A Theory by Which to Enforce Letters of Credit Under the Common Law' 69 *University of Detroit Mercy Law Review* (1992), 211; Davis, A. G, 'The Relationship Between Banker and Seller under a Confirmed Credit' 52 *L. Q. R.* (1936) 225 at 227; Penn, Shea, Arora., *The Law and Practice of International Banking Law*. vol 2 (London, Sweet & Maxwell, 1987) 295; for more details about the contractual relationship between the issuing bank and the seller see McCurdy, W., 'Commercial Letters of Credit' 35 *Harv Law Review* (1921-2) 539 at pp. 563-572; Thayer, P.W., 'Irrevocable Credits in International Commerce: Their Legal Nature' 36 *Colum Law Review*' (1936) 1031 at 1039.

presentation of documents (wrongful dishonour) and second, after establishment of the credit but before presentation of documents (anticipatory breach or repudiation).⁴ In order to determine the remedies for repudiation, these two situations have to be distinguished.

3.2. Dishonour Upon Presentation of Documents

3.2.1. The Beneficiary's Remedy in General

An issuing bank's dishonour of a beneficiary's draft or demand for payment on presentation of the required documents gives the beneficiary the right to either claim specific performance or accept the repudiation and sue the bank for damages. Section 5-115 (1) of the UCC expressly provides for such remedy. There is also ample British and American case law authority for this remedy.⁵

The seller's choice to accept a breach of the banker's contract and sue for damages is similar to those awarded for a breach of the buyer's obligation to accept delivery under a contract of sale. In the case of Urquhart Lindsay & Co. Ltd. v Eastern Bank Ltd.⁶, an irrevocable credit covering several shipments of machinery was opened. Although the draft and documents conformed to the terms of the

⁴ The issue of damages will be dealt with under the UCC in detail. However, it is to be noted here that if the bank fails to pay an accepted draft or honour a deferred payment undertaking, the damages will be determined by the law of negotiable instruments not by letter of credit law. See UCP Article 10(a) and (d) which indicates that acceptance of the beneficiary's draft constitutes realisation of the credit. See Gutteridge and Megrah, *The Law of Banker's Commercial Credit* p. 234. See Ziadat, A.N.M., 'Non-compliance in Letters of Credit Law: A UCP and Anglo-American Survey'. A Ph.D. Thesis, (London University, 1989). fn 1 p. 488.

⁵ For example, *Belgain Grain & Produce Co. Ltd v. Cox & Co. (France) Ltd.* [1919] 1 Lloyd's Rep. 256, 257; *Stein v. Hambro's Bank of Northern Commerce* [1921] 9 Lloyd's Rep. 507, 507; *British Imex Industries Ltd. v. Midland Bank Ltd.* [1958] 1 Q.B. 542; *Ozalid Group (Export) Ltd. v. African Continental Bank Ltd.* [1979] 2 Lloyd's Rep. 231, 234; *Siporex Trade S.A. v. Banque Indosuez* [1986] 2 Lloyd's Rep. 147, 164; *Pringle-Associated Mortgage Corp. v. Southern National Bank of Hattiesburg*, 23 UCC Rep. Serv. 1271, 1278 (5th Cir. 1978); *Datapoint Corp. v. M & I Bank of Hilldale*, 4 UCC Rep. Serv. 829, 836 (W.D. Wis. 1987); *Beckman Cotton Co. v. First National Bank of Atlanta*, 34 UCC Rep. Serv. 966, 969-70 (N.D.Ga. 1982); *East Cirard Saving Association v. Citizens National Bank & Trust Co.*, 26 UCC Rep. Serv. 475, 484 (5th Cir. 1979). For more details see Ziadat supra note 4, fn 3 pp. 488-489.

⁶ *Urquhart, Lindsay & Co. Ltd. v Eastern Bank Ltd* [1922] 1 K.B. 318. For American authority in relation to anticipatory breach, see *Zeevi & Sons Ltd v. Grindlays Bank (Uganda) Ltd*, 371 N.Y.S. 2d 892 (1975).

documentary credit, the issuing banker wrongfully dishonoured one draft on the ground that the amount exceeded the sum agreed upon in the contract of sale. The bank's dishonour of the draft was treated by the seller as a repudiation of the entire documentary credit. Rowlatt J., said:

"The damages to which the plaintiffs are entitled are the difference between on the one hand the value of the materials left on their hands and the cost of such as they would have further provided, and, on the other hand, what they would have been entitled to receive for the manufactured machinery from the buyers, the whole being limited to the amount they could in fact have tendered before the expiry of the letter of credit".⁷

In fact, the beneficiary's right to claim specific performance⁸ (as opposed to a claim for money due)⁹ is not the normal remedy available under the general rule relating to a breach of commercial contract. This exception is awarded to the beneficiary because a letter of credit as a commercial device has special characteristics. This is illustrated in the case of Belgian Grain & Produce Co. Ltd v. Cox & Co. (France) Ltd¹⁰, where the issuer argued that the only remedy available to the beneficiary for wrongful dishonour was a remedy in damages. Bankes L.J, rejected this argument stating that:

"This contention, if sound, would defeat the object of letters of credit in this form, which as I understand it, is to secure payment of the amount of the purchase price of the goods or of the actual amount named in a letter of credit, in exchange for the particular

⁷ *Urquhart, Lindsay & Co. Ltd. v Eastern Bank Ltd* [1922] 1 K.B. 318, 324-25. Cf. The American approach as expressed in section 5-115 of the UCC, under which the damages may be up to the full amount recoverable for an anticipatory breach by a buyer of a contract of sale. See further, *Second National Bank of Hoboken v. Columbia Trust Co.*, 288 F. 17 (1923); *Maurice O'Meara Co. v. National Park Bank of New York*, 146 N.E. 636, 640 (1925). See generally, *Benjamin's Sale of Goods*, fn 43, at § 23-125 p. 1732.

⁸ Generally speaking, the remedy to specific performance is not usually available. It is only awarded in certain cases where the damages for breach of contract are an inadequate remedy. By awarding such remedy, the contract breaker will be forced to do exactly the same thing that had been agreed upon. See, Atiyah, P.S., *An Introduction to the Law of Contract* 5th ed., (Clarendon Press: Oxford, 1995) p. 424.

⁹ A claim for money due is more like a claim for specific performance than an action for damages. Upon such a claim, the defendant is forced to perform precisely what he had agreed upon which is to pay a specific amount of money. However, that is not to say that a claim for money due is being treated like a claim to specific performance. They differ in two respects: First, a claim for money due is available as of right whereas a claim to specific performance is subjected to judicial discretion. Secondly, generally speaking, they are not awarded where damages are only an inadequate remedy unlike a claim to specific performance, which is available if damages are an inadequate remedy. See, Atiyah, P.S., *An Introduction to the Law of Contract* 5th ed., (Clarendon Press: Oxford, 1995) p. 431.

¹⁰ *Belgian Grain & Produce Co. Ltd v. Cox & Co. (France) Ltd* [1919] 1 Lloyd's Rep. 256.

documents mentioned therein, and one of the objects is to avoid any controversy in reference to the amount of damages and to secure that, as against the documents, if they are in order, the amount of money named in the letters of credit should be paid over".¹¹

Indeed, it has also been held that a wronged beneficiary is not required to show damages in order to claim the face value of the credit in exchange for the required documents¹². The rationale behind this ruling is to prevent the issuer from dishonouring the credit merely because the beneficiary cannot show damages. Holding otherwise would undermine the purpose of a letter of credit as a means of secure and prompt payment.¹³

3.2.2. Recovery of Interest and Incidental Damages

A wrongful refusal of a draft accompanied by the required documents by the banker gives the seller a right to sue for the amount of the documentary credit and, where appropriate, for interest, either if a wronged seller claims specific performance or elects to mitigate.¹⁴ Of course, the recoverable interest runs from the time payment becomes due.¹⁵ Thus, if the bank dishonours a sight draft or demand for payment, interest runs from the time of dishonour.¹⁶ In cases of time drafts, the interest runs from the date of maturity of the draft. The rate of interest depends on the applicable law. In the United States, the beneficiary is entitled only to interest at the statutory rate even though he can prove that he would have

¹¹ Ibid at 257.

¹² *Siporex Trade S.A. v Banque Indosuez* [1986] 2 Lloyd's Rep. 147, 164; *East Girard Saving Association v. Citizens National Bank & Trust Co.*, 26 UCC Rep. Serv. 475, 483 (5th Cir. 1979); *Colorado National Bank v. Board of County Commissioners*, 31 UCC Rep. Serv. 1681, 1690 (Colo 1981).

¹³ Ziadat, supra note 4, p. 427, see also fn 9 p. 490 in the same source.

¹⁴ Ibid at 433.

¹⁵ See e.g. *Tosco Corp. v. Federal Deposit Insurance.*, 37 UCC Rep. Serv. 1660, 1666 (6 th Cir. 1983). For more details see Ziadat, supra note 4, fn 33 p. 492; Goode, R., *Commercial Law* pp. 1013-5.

¹⁶ The date of dishonour from which the interests run is three banking days after receipt by the bank of complying documents under UCC s 5-112(1), or a reasonable time under UCP article 13(b).

obtained a higher rate had he employed the money himself.¹⁷ By contrast, the situation in England is that the rate of prejudgment interest is subject to the discretion of the court.¹⁸ It can be inferred that English courts award interest, at a rate which the beneficiary would have had to pay to borrow over the period in question.¹⁹

Regarding the right of claiming incidental damages, which is referred to in UCC Section 5-115 (1) such damages are those available to an aggrieved seller under UCC Section 2-710 which provides:

“Incidental damages to an aggrieved seller include any commercially reasonable charges, expenses or commissions incurred in stopping delivery, in the transportation, care and custody of goods after the buyer’s breach, in connection with return or resale of the goods or otherwise resulting from the breach”.

These incidental damages can be incurred by the beneficiary in attempting to cure the alleged defect and to re-present the documents. Also, incidental damages can be travel expenses incurred by the beneficiary in trying to negotiate a settlement with the buyer.²⁰ An example to illustrate how incidental damages are obtained can be seen in the case of Beckman Cotton Co. v. First National Bank of Atlanta²¹. The beneficiary paid the buyer the difference between the contract price and the prevailing market price in order to induce it to waive the alleged discrepancy upon which the issuer based its refusal to pay. After payment, the beneficiary sued the bank for damages and claimed, among other things, the amount paid to the buyer as being an expense reasonably incurred in mitigation of its damages. It was held

¹⁷ See e.g. *Tosco Corp. v. Federal Deposit Insurance.*, 37 UCC Rep. Serv. 1660, 1666 (6 th Cir. 1983). *Datapoint Corp. v. M & I Bank of Hilldale*, 4 UCC Rep. Serv. 829, 836 (W.D. Wis. 1987); *Republic National Bank of Dallas v. Northwest National Bank of Fort Worth*, 578 S.W. 2d 109, 117 (Tex. Supr. 1979).

¹⁸ This discretion is provided for by the Supreme Court Act, 1981, Section 35A (inserted by Administration of Justice Act, 1982, Section 15 (1) and Schedule 1 part 1).

¹⁹ See the judgment of Donaldson J., in *Ozalid Group (Export) Ltd. v. African Continental Bank Ltd.* [1979] 2 Lloyd’s Rep. 231, at 232.

²⁰ *Datapoint Corp. v M & I Bank of Hilldale*. 4 UCC Rep. Serv. 829, 836, 969-70 (W.D. Wis. 1987).

²¹ *Beckman Cotton Co. v. First National Bank of Atlanta* 32 UCC Rep. Serv. 1586 (5th j Cir, 1982); 34 UCC Rep. Serv. 966 (N.D. Ga. 1982).

that, in the circumstances, the beneficiary's act was an "appropriate and commercially reasonable" method of mitigation and, therefore, the amount paid was recoverable²².

However, although attorneys' fees appear to fall within the scope of the last clause of Section 2-710 of the UCC, they are not recoverable unless the credit expressly provides for their recovery. The justification given by American courts towards the exclusion of attorneys' fees from the scope of this Section is based on the general American rule under which attorneys' fees are not recoverable as damages unless provided for by contract or statute. Obviously, they are not referred to specifically under section 2-710 and therefore, it cannot be read as an exception to the general rule. "Had the drafters of the UCC intended attorneys' fees to be included as incidental damages, they could easily have mentioned them and no doubt would have, since the exclusion of attorneys' fees is such a well known exception to the general rule of damages".²³

Moreover, in English law the above expenses as well as legal costs may be obtained if they satisfy the reasonableness test.²⁴

3.2.3. Consequential Damages

UCC Section 5-115 is silent regarding the availability of consequential damages.²⁵ Such damages are available, under English law, to the wronged beneficiary if the test in Hadley v. Baxendale²⁶ is satisfied. Alderson, J, in this case, stated:

²² 32 UCC Rep. Serv. 1586 (5th Cir. 1982); 39 UCC Rep. Serv. 966 (N.D. Ga. 1982).

²³ *Beckman Cotton Co. v. First National Bank of Atlanta* 32 UCC Rep. Serv. 1586 (5th Cir. 1982); 34 UCC Rep. Serv. 966 at 969 (N.D. Ga. 1982). However, see UCC Section 5-111(e) (1995) revision in Appendix C for update. See also the discussion in section (11) in Appendix D.

²⁴ *Ozalid Group (Export) Ltd. v African Continental Bank Ltd.* [1979] 2 Lloyd's Rep. 231, 234 (awarding the beneficiary fees paid to its banker for "their services in seeking to obtain payment from the defendants").

²⁵ Note that under the revised (1995) Article 5 of the UCC, Section 5-111(a) consequential damages are expressly not allowed. See Appendix D, Section (11).

²⁶ *Hadley v. Baxendale* (1854) 9 Ex. 341. See also Danzig, R., 'Hadley v. Baxendale: A Study in the Industrialization of the Law' 4 *Journal of Legal Studies* (1975) 249.

“The damages ... should be such as may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract as the probable result of the breach”.²⁷

So, losses incurred in the ordinary course of business are recoverable under the first limb of Hadley. Moreover, losses which are not incurred in the ordinary course of business are recoverable too if the defendant reasonably were supposed to have known such a result by special knowledge.

Ozalid Group (Export) Ltd v. African Continental Bank Ltd²⁸ illustrates the possibility of obtaining such damages. This case involved the opening of a letter of credit for the sum of US\$125,939.33 in favour of a British exporter. However, despite the exporter tendering the required documents on time, the bank was found to have delayed making payment for about two months. Due to a depreciation of the US dollar against the pound sterling, during this period of delay, the exporter obtained £.Stg.2987.17 less for the amount eventually paid in US dollars. This amount was considerably lower than he would have obtained, had he converted at the time the payment had been originally agreed. In accordance with Donaldson J.’s judgment, it was noted that the bank ought to have realised that the British exporter intended to convert promptly any amount paid in US dollars into pounds sterling. Judgment was given to the exporter for this amount plus interest and disbursements and the exporter, the beneficiary of the credit, had the option of claiming judgment in US dollars or in pounds sterling. His Lordship said:

“Notwithstanding that in the present case the price of the goods was agreed to be paid in US dollars, it is clear that the [exporter’s] loss was incurred in sterling and that this was foreseeable by the [issuing bank].”²⁹

²⁷ *Hadley v. Baxendale* (1854) 9 Ex. 341, 354.

²⁸ *Ozalid Group (Export) Ltd v. African Continental Bank Ltd* [1979] 2 Lloyd’s Rep. 231.

²⁹ *Ibid* at 234.

3.3. Dishonour After Establishment of the Credit but Before Presentation of Documents

3.3.1. General

The view of anticipatory breach under English law is that the beneficiary has two options. First, he may accept the repudiation and sue the bank for damages. Second, he may not accept the repudiation, continue performance and sue the bank for wrongful dishonour if it refuses to pay upon presentation of the required documents.³⁰

Under the UCC, the beneficiary's remedy for anticipatory repudiation depends on when he learns of the repudiation. UCC s 5-115(2), which basically provides for the beneficiary's remedy for anticipatory repudiation, distinguishes between two situations.

First, if the beneficiary has not learnt of the repudiation "in time reasonably to avoid procurement of the required documents", it has "an immediate right of action for wrongful dishonour".³¹

Second, if the beneficiary learns of the repudiation "in time", it has "the right of a seller after anticipatory repudiation by the buyer under Section 2-610".

According to section 2-610³², in conjunction with other associated sections, the beneficiary is allowed to request the full sum of the credit in substitute for the

³⁰ Ellinger, E.P., *Documentary Letters of Credit, A Comparative Study* (Singapore, University of Singapore Press, 1970) pp. 211-212, Gutteridge and Megrah, *The Law of Banker's Commercial Credit* p. 234.

³¹ See, Ziadat, *supra* note 4, at 437.

³² UCC s 2-610 provides that "When either party repudiates the contract with respect to a performance not yet due the loss of which will substantially impair the value of the contract to the other, the aggrieved party may

(a) for a commercially reasonable time await performance by the repudiating party, or

(b) resort to any remedy for breach (Section 2-703 or Section 2-711), even though he has notified the repudiating party that he would await the latter's performance and has urged retraction; and

(c) in either case suspend his own performance or proceed in accordance with the provisions of this Article on the seller's right to identify goods to the contract notwithstanding breach or to salvage unfinished goods (Section 2-704).

documents. This is the case, in certain situations where the goods are described in the contract (as demonstrated in s 2-610(c) and s 2-704) and it has been “unable after reasonable effort to resell them at a reasonable price or the circumstances reasonably indicate that such effort will be unavailing”.³³

Having given the beneficiary the right of a seller after anticipatory repudiation by the buyer under the above section, the beneficiary is under a duty to take any reasonable steps to mitigate his damages. This is because, “[I]t cannot, as a rule, ignore the repudiation, procure and present the required documents and claim specific performance”³⁴.

The beneficiary has one of two options, under the English legal system, one of which entitles the beneficiary to accept repudiation and sue the bank for any damages incurred. The other choice, is to refuse the repudiation, continue performance and ultimately sue the bank for wrongful dishonour, if on presentation of the required documents, it fails to pay.³⁵

3.3.2. Damages for Anticipatory Breach

As mentioned above, if the beneficiary does not accept the repudiation and continues to perform, his damages for the bank’s refusal to pay against the documents are those available for wrongful dishonour. However, if the beneficiary chooses to accept the repudiation and regards it as a breach of the credit contract, his remedies against the repudiating bank are similar to those available to a seller against a buyer for breach of a sale contract.³⁶ The damages the beneficiary may

³³ UCC 2-709 (1) (b).

³⁴ Ziadat, supra note 4, at 438.

³⁵ See generally, Ellinger, *Documentary Letters of Credit, A Comparative Study*, pp. 211-212; Gutteridge & Megrah, at 234; Ziadat, supra note 4, fn 58 in at p. 494.

³⁶ UCC 5-115(2); *Doelger v. Battery Park Bank*, 194 N.Y.S. 583, 588 (App. Div. 1923); *Ernesto Folgino & Co. v. Webster*, 216 N.Y.S. 225, 238 (App. Div. 1926); *Urqhart Lindsay & Co. v. Eastern Bank Ltd.* [1922] 1 K.B. 318, 325.

usually recover are lost profit, incidental damages, interest, consequential damages and (exceptionally) punitive damages. Punitive damages will be dealt with in detail below (section 3.3.3.).

3.3.3. Punitive Damages

Neither Article 5 of the UCC nor the UCP deals with claims for punitive damages against an issuing bank or confirming bank for wrongfully dishonouring a withdrawal on a documentary letter of credit. Under English and American law, punitive damages are not awarded for any breach of contract. This is because the purpose of contractual damages is to compensate the aggrieved party by putting him, as far as money can do, in as good a position as if the contract has been fully performed. On the other hand, the purpose of punitive damages is to punish the wrong party for a tortious conduct.³⁷ However, it can be inferred from some reported decisions under English law that punitive damages were permitted in some cases of tort until 1964 when the House of Lords in Rookes v. Barnard³⁸ severely restricted their use in such cases by specifying only two categories when they may be awarded at common law. First, in case of “oppressive, arbitrary or unconstitutional actions by the servants of the government”³⁹. Second, in cases “in which the defendant’s conduct has been calculated by him to make a profit for himself which may well exceed the compensation payable to the plaintiff”.⁴⁰ In the USA, obtaining punitive damages is also possible under certain circumstances.⁴¹

³⁷ Treitel, G.H., *The Law of Contract*, 10th ed. (Sweet & Maxwell, London, 1999). pp. 872-73; Note, ‘Letters of Credit Litigation-Bank Liability for Punitive Damages’ 54 *Fordham Law Review* (1986) 905, 905. See also UCC § 1-106 and Comment 1 thereto.

³⁸ *Rookes v. Barnard* [1964] AC 1129.

³⁹ *Ibid* at 1226.

⁴⁰ *Ibid*.

⁴¹ Arzt, R.J., ‘Punitive Damages for Wrongful Dishonour or Repudiation of a Letter of Credit’ 24 *Uniform Commercial Code Law Journal* (1991) 39 at 39. In the case of *Bank of Canton Ltd, v. Republic National Bank* 636 F. 2d 30, 31 (2d Cir, 1980) (negotiating bank awarded exemplary damages because issuer’s appeal from a judgment in favour of the former was frivolous). Further, in *Habbarad Business Plaza v. Lincoln Liberty Life Insurance Co.*, 40 UCC Rep. Serv. 1011, 1013 (D. Nev. 1984) Punitive

Having observed the restrictions on obtaining punitive damages, it has to be pointed out that an allegation of a mere breach of contract cannot support a claim for punitive damages. It was put in one case that “punitive damages are not available for mere breach of contract, for in such a case only a private wrong, and not a public right, is involved.”⁴² In another case, regarding recovery of punitive damages, it was held that it is limited to “cases where the wrong complained of is morally culpable, or is actuated by evil and reprehensible motives...”⁴³ In a similar case it was held that a bank must exhibit a “high degree of moral turpitude and wanton dishonesty” in order to “warrant an award of punitive damages”.⁴⁴ To sum up, so far as the application of the American law is concerned, even the States that consider themselves to be among the few that permit an award of punitive damages for breach of contract require either (1) a serious harm resulting from the conduct that independently establishes a tort or (2) elements of fraud, malice, or gross negligence in which the public interest will be served by the deterrent of punitive damages.⁴⁵

In the case of Hubbard Business Plaza v. Lincoln Liberty Life⁴⁶, the district court concluded that “the fact that the tort alleged incidentally involves a breach of contract does not preclude the recovery of punitive damages.”⁴⁷ Yet, the beneficiary must show fraud or malice on the part of the issuer in order to obtain

damages has been awarded against beneficiaries and their assignees for fraudulently drawing under the credit. See generally Arzt, p. 39 et seq.

⁴² *Williamson, Picket, Gross, Inc. v. Hirschfeld*, 92 A.D.2d 289, 295, 460 N.Y.S.2d 36 (1st Dep’t), appeal dismissed, 60 N.Y.2d 585 (1983) quoting *Gordon v. Nationwide Mut. Ins. Co.*, 30 N.Y.2d 427, 437, 334 N.Y.S.2d.601 (1972), cert. denied, 410 U.S.931, 93 S. Ct. 1374 (1973).

⁴³ *Walker v. Sheldon*, 10 N.Y.2d 401, 404, 223 N.Y.S.2d 488 (1961); *Beir v. Manufacturers Hanover Trust Co.*, 110 A.D.2d 529, 488 N.Y.S.2d 1 (1st Dep’t 1985).

⁴⁴ *Greenwood Packing Corp. v. Triangle Meat & Provisions Corp.*, 120 A.D.2d 701, 703, 502 N.Y.S.2d.770 (2d Dep’t 1986) Accord *Beir*, 110 A.D.2d at 529, 488 N.Y.S.2d at 1.

⁴⁵ See *J.Yanan & Assoc., Inc. v. Integrity Inc. Co.*, 771 F.2d 1025, 1033 (7th Cir. 1985) (Indiana); *Cuson v. Maryland Cas. Co.*, 735 F.Supp. 966, 970 (D. Hawaii 1990).

⁴⁶ *Hubbard Business Plaza v. Lincoln Liberty Life*. 596 F. Supp. 344 (D. Nev. 1984).

⁴⁷ *Ibid* at 346.

punitive damages.⁴⁸

Similarly, in the case of Decor by Nikkei International v. Nigeria⁴⁹, the beneficiary's punitive damages claim was rejected on the grounds that the beneficiary failed to prove that the issuer and account party acted maliciously in repudiating the letters of credit prior to the presentation of any drawings. In this case the district court noted that the "UCP is silent...as to the remedies available to a beneficiary of a letter of credit where there has been a unilateral amendment of an irrevocable letter of credit by the issuer".⁵⁰ So, since the letters of credit were expressly made subject to the UCP, it was ruled that application of the rights and remedies given in the Article 5 of the UCC was impeded by Section 5-102(4) of the New York UCC and that the beneficiaries had a cause of action "for the anticipatory repudiation of the credits under applicable pre-Code state law".⁵¹ However, the district court then, dismissed the beneficiaries' claim for punitive damages on the grounds that they did not establish that the breach was malicious. To conclude, a beneficiary can claim punitive damages and call for a tortious action against the issuing bank if the bank bases its decision of dishonour on an improper interest in satisfying its customer and not on the bank's determination that the documents presented did not comply with the letter of credit terms.⁵²

4. The Independency of Irrevocable Credits

Under English law, the question of a letter of credit's independence is illustrated by the Court of Appeal's decision in the case of Malas (Hamzeh) & Sons v British

⁴⁸ Ibid.

⁴⁹ *Decor by Nikkei International v. Nigeria*. 497 F. Supp. at 911-912, aff'd, 647 F. 2d at 316.

⁵⁰ Ibid at 906.

⁵¹ Ibid.

⁵² *Arzt, R.*, supra note 41, at. 53. It is submitted in *Travis Bank & Trust v. State of Texas*, 38 UCC Rep. Serv, 300, 301 n. 1 (Tex. App. 1983) that the bank duty of good faith in performing its letter of credit undertaking runs to both its customer and the beneficiary.

Imex Industries Ltd.⁵³ Here, the plaintiffs entered into a sale of goods contract to buy two shipments of reinforced steel rods from the defendants. Two confirmed credits were opened in favour of the defendants, who thereupon sent the first shipment and realised the first confirmed credit. The plaintiffs alleged defects in the goods and applied for an injunction to stop the defendants from drawing on the second letter of credit. Jenkins L.J., said:

“We were referred to several authorities, and it seems to be plain that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes on the banker an absolute obligation to pay, irrespective of any dispute which there may be between the parties on the question of whether the goods are up to contract or not. An elaborate commercial system has been built upon the footing that bankers’ confirmed credits are of that character, and in my judgment, it would be wrong for this court in the present case to interfere with that established practice. It has also to be remembered that a vendor of goods selling against a confirmed letter of credit is selling under the assurance that nothing will prevent him from receiving the price. That is no mean advantage when goods manufactured in one country are being sold in another. Furthermore, vendors are often reselling goods bought from third parties...That system of financing these operations, as I see it, would break down completely if a dispute between the vendor and the purchaser were to have the effect of “freezing”, if I may use the expression, the sum in respect of which the letter of credit was opened”.⁵⁴

Under American law, too, an irrevocable credit is independent from the underlying contract.⁵⁵ Thus, the independency principle of the letter of credit arrangement is confirmed in the UCC, section 5-114. Likewise, the same notion is adopted in the UCP Article 3(a).

5. Bank Defences Against Payment of a Letter of Credit

There are four situations in which the bank should not honour letters of credit, namely, fraud, consent of the parties, public policy and non-compliance. These four exceptions will be discussed below in detail.

⁵³ *Malas (Hamzeh) & Sons v British Imex Industries Ltd* [1958] 1 All E.R. 262.

⁵⁴ *Ibid* at 263-64.

⁵⁵ See *North American Manufacturers Export Associates Inc. v. Chase National Bank of City of New York*, 77 F. Supp. 55 (1948).

5.1. The Fraud Exception

The banker's obligations are autonomous unless there is a clear case of fraud. Nonetheless, the issue of fraud is a controversial one, since statutes and case law are unclear about "when the independence rule stops and the fraud defence starts."⁵⁶ This leads to an important question: does the fraud exception operate absolutely or are there exceptions to its application? To put it clearly, who should be immune from the fraud exception?

The UCP is silent upon the issue and thus does not provide a solution to the issue of beneficiary fraud. Conversely, according to Section 5-114(2)(b) of the UCC, the issuer acting in good faith, has the option to honour or dishonour the demand for payment upon an allegation of fraud by the account party. Although Section 5-114(2)(b) allows an issuer acting in good faith to honour the draft or demand for payment, neither the statute nor the official commentary on the UCC indicates the standards which the court should apply in deciding whether to grant injunctive relief.⁵⁷ (See Chapter Six for more on applicant's right for injunction).

However, according to Ryan⁵⁸, the situation is different where the draft is held by a holder in due course. In this case, the bank should pay even if there is fraud. This can be illustrated by the Sztejn case.⁵⁹ In this case, the beneficiary of credit presented the documents (invoices and bills of lading) describing the goods as being bristles but in fact the shipment contained cowhair, other worthless material and rubbish. The UCC authorises the bank to refuse payment when the document does not conform to the legal warranties in a sale contract. This includes when the insurance policy is defective, or when the document is forged or fraudulent, or

⁵⁶ Ryan, R., 'Who Should Be Immune From The "Fraud In The Transaction" Defense In A Letter of Credit Transaction?' 56 *Brooklyn Law Review* (1990) 119 at 119.

⁵⁷ Rendell R. S., 'Fraud and Injunctive Relief' 56 *Brooklyn Law Review* (1990) 111 at 111-112. See Appendix D, Section (14).

⁵⁸ Ryan, supra note 56 at 119.

⁵⁹ *Sztejn v. J. Henry Schroder Banking Corp* 31 N.Y.S. 2d 631 (1941 S.C.).

when there is fraud in the transaction. However, the section clearly highlights three points:⁶⁰

- (1) a bank has an option to effect payment or refuse even if it took cognisance of fraud, as long as the documents conform on their face to the tenor of the credit.
- (2) in cases where the documents were presented by a holder in due course for value and without notice of fraud, a banker must make payment. Under such a situation the holder must prove his position as a holder in due course.
- (3) The procedure open for the account party to pursue is an action for an injunction.⁶¹

The court, in Sztejn, stated that “if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud”.⁶² Moreover, a holder in due course benefits by getting the draft paid, by virtue of Section 5-114(2)(a) of the UCC.⁶³ Due to ambiguity in interpreting the above Section, different court decisions have resulted. For instance, whereas the Sztejn case established a “gross” or “egregious” test of fraud, some other courts suggested that under the UCC a more flexible standard should be adopted relying on the term “fraud in the transaction”.⁶⁴

⁶⁰ See the official comment on Section 5-114.

⁶¹ In order to be a holder in due course the bank must take for value, in good faith, and without notice of irregularities. See UCC § 3-302 (1). Negotiating banks often fail the test by virtue of the fact that they do not give value. In particular, the bank that takes the seller’s draft under reserve has not given value and is not a holder in due course. See UCC § 4-210; cf, section 4-208.) Dolan, J.F., ‘The Correspondent Bank in the Letter of Credit Transaction’ 109 *Banking Law Journal* (1992) 396, 413, fn 36.

⁶² per Shientag .J., *Sztejn v. J. Henry Schroder Banking Corp* 31 N.Y.S. 2d 631, 633-634 (1941 S.C.).

⁶³ 5-114(2) (a) UCC.

⁶⁴ As seen in the cases of *Dynamics Corp. of America v. Citizens & Southern National Bank* 356 F. Supp. 991, 998; *NMC Enterprises Inc. v. CBS Inc* 14 UCC Rep. Serv. 1427. Those decisions show very clearly the rejection of the “gross” fraud test by US courts., Van Houten maintains that both a strict and liberal approach can be found in the U.S., while both are consistent with the provisions of the UCC. Van Houten 62 *Canadian Bar Review* (1984) 371, 381.

English cases clearly follow a narrow approach in determining whether or not the fraud exception should be limited or expanded in application. In R.D Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd⁶⁵, the English plaintiffs were required to establish guarantees confirmed by a bank in favour of the buyer to secure performance of the seller's obligations under the contracts. The guarantees were issued by the English bank to an Egyptian bank, which then confirmed the guarantees to the buyer. The buyer then called on the guarantees because they were not extended. So the plaintiff seller alleged fraud and sought to restrain the issuing bank from making payment, despite the broad and unconditional wording of the guarantees. The fraud claimed was that the buyer had failed to have an irrevocable letter of credit issued for the purchase of the goods. Kerr J. held that it was not a case of established fraud at all, but he took a restrictive view as to the circumstances in which an issuing bank might justifiably refuse to pay. He said that it is "only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks".⁶⁶ Kerr J., clearly demonstrated a great reluctance to intervene between bank and seller unless there is clear fraud.

According to Schmitthoff⁶⁷, three situations have to be distinguished, in ascertaining whether the fraud exception is admissible.

First, "there is only an *allegation*, communicated by the buyer to the bank, that fraud has occurred". Or simply such a suspicion may be recognised by the bank itself, without actuation by the buyer. If no more can be established, the *bank should pay*. In Discount Records v. Barclays Bank⁶⁸, the plaintiffs, a British company, procured an irrevocable confirmed credit in favour of a French company-Promodisc-for the purchase of gramophone records and cassettes. The

⁶⁵ *Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd*, [1977] 3 W.L.R. 752; [1978] 1 Q.B. 161.

⁶⁶ Per Kerr J., *ibid* at 761; [1978] 1 Q.B. 161, 165 (per Kerr. J

⁶⁷ Schmitthoff, C.M., *Schmitthoff's Export Trade: The Law & Practice of International Trade*, 442.

⁶⁸ *Discount Records v Barclays Bank*, [1975] 1 W.L.R. 315.

plaintiff's allegation was that on checking, the goods were found to be cartons filled with rubbish or goods that had not been ordered. The court dismissed the motion on the grounds that the evidence adduced, showed only an allegation of fraud and that to invoke the fraud exception, fraud must be established. It was held that:

“the court would not grant an interlocutory injunction to interfere with bankers' irrevocable credits unless a sufficiently grave cause was shown; that as the evidence stood the fraud, though alleged, had yet to be established,...nothing in those circumstances constituted a sufficiently grave cause for granting the injunction claimed”.⁶⁹

Secondly, “it is clearly established to the satisfaction of the bank that a fraud has occurred”. Therefore the bank has evidence that the documents are fraudulent or forged but there is no evidence before the bank which shows *that the beneficiary (the seller) knew of the fraud*.⁷⁰ One possibility is that the fraud was perpetrated by a third party, e.g. a forwarder or loading broker, in cases where they attempt to conceal the fact that the goods were shipped out of time, and that the beneficiary himself was unaware of this fraud. It is clear from the case of United City Merchants (Investments) Ltd. v Royal Bank of Canada⁷¹, that the bank must pay. This case will be examined in more detail under Section (5.1.2.).

Thirdly, the bank, in order to apply such a defence, should have *positive proof that fraud* has been committed and *the beneficiary knew of this fraud*. If both these facts existed, the bank is allowed to reject payment.

A more liberal approach, as to the standard of proof required for the purpose of obtaining relief in allegations of fraud, was urged by Mr Justice Hirst in Tukan

⁶⁹ Ibid at 316.

⁷⁰ A transferee is also protected by Section 5-114(2). See also *Cromwell v. Commerce & Energy Bank of Lafayette*, 452 So. 2d. 1 (Ct. App. 1984). See Ryan, supra note 56, at 127.

⁷¹ *United City Merchants (Investments) Ltd. v Royal Bank of Canada, The American Accord* [1983] 1 AC 168. Further, *Tukan Timber Ltd. v Barclays Bank plc* [1987] 1 Lloyd's Rep 171. See also the important decision of the Supreme Court of Canada in *Bank of Nova Scotia v Angelica-Whitewear Ltd.* (1987) 36 DLR (4th) 161.

Timber v. Barclays Bank⁷². He suggested that the test to be applied by the courts is “the standard of the hypothetical reasonable banker in possession of all the relevant facts”.⁷³ In this regard, he argued that it would be

“an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as ‘fraud unravels all’ would become meaningless”.⁷⁴

It can be concluded from the three situations mentioned above by Schmitthoff that a mere allegation of fraud cannot present its effect in prohibiting the issuing bank from payment. However, the decision taken by Mr Justice Hirst favours a relaxed application of the fraud exception similar to that taken by some American courts, as will be discussed later. Professor Goode presented the English approach by saying:

“the banker’s action must depend upon the strength of its knowledge. It can take no account of mere suspicion except, perhaps to delay payment until the suspicion is confirmed or dispelled, even so, it can not delay for long and if it cannot ascertain what the position is within a short time, and the documents are on their face in order, it must pay.”⁷⁵

5.1.1. Fraud by the Parties

The most noticeable decision concerning fraud of one of the parties to the contract, can be seen in the case of Sztejn v. J. Henry Schroder Banking Corp⁷⁶, which has been mentioned earlier in this chapter. Shientag J. stated in his judgment:

“the application of this doctrine [of autonomy] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit... However, I believe that a different situation is presented in the instant

⁷² *Tukan Timber v Barclays Bank*, [1987] 1 Q.B, 171.

⁷³ *Ibid* at 175.

⁷⁴ *Ibid*.

⁷⁵ Goode, R.M., ‘Reflections on Letters of Credit *Journal of Business Law* (1980) 291 at 292, see also *Bolivinter Oil S.A. v. Chase Manhattan Bank N.A.S.* [1984] 1 Lloyd’s L. Rep. 251. by Sir John Donaldson, M.R., at 257; see also *United City Merchants Ltd. v Royal Bank of Canada, [The American Accord]* [1983] 1 A.C. 1 68; Goode, R., *Commercial Law* pp. 1007-10.

⁷⁶ *Sztejn v. J. Henry Schroder Banking Corp* 31 N.Y.S. 2d 631 (1941 S.C.).

action ... on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation ... the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller ... No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish, ... If it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud."⁷⁷

As to the definition of fraud, the New York Court of Appeal, in United Bank Ltd. v. Cambridge Sporting Goods Corp⁷⁸ held that the shipment of old, unpadded, ripped and mildewed gloves rather than the new boxing gloves ordered by the customer, constituted fraud within the meaning of section 5-114(2):

It can be difficult to draw a precise line between cases involving breach of warranty (or a difference of opinion as to the quality of goods) and outright fraudulent practice on the part of the seller. To the extent, however, that Cambridge established that Duke was guilty of fraud in shipping, not merely non-conforming merchandise, but worthless fragments of boxing gloves, this case is similar to *Sztejn*".⁷⁹

Indeed, it seems difficult to draw a line between fraud in the transaction and fraud in the documents because of the fear of unscrupulous or over-anxious customers who would be inspired to press claims of fraud for the purpose of postponing payment.⁸⁰

Further, the fear here is that reading 'transaction' to exclude fraud in the underlying contract, not only protects the fraudulent beneficiary but also ignores the reality that a fraudulent scheme usually affects both the documents and the shipment.⁸¹ As mentioned by Sarna⁸² "a forged certificate of inspection which

⁷⁷ Ibid at 633-34.

⁷⁸ *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 41 N.Y. 2d 254, 360 N.E. 2d 943, N.Y.S 2d 265 (1976).

⁷⁹ Ibid at 392, per Gabrielli J.

⁸⁰ Note: 'Letters of Credit: Injunction as a Remedy for Fraud in UCC, Section 5-114' 63 *Minn. L.R.* (1978-79). 487 at 507.

⁸¹ See generally *Bossier Bank & Trust Co. v. Union Planers Nat. Bank of Memphis*, 550 F. 2d 1077 (1977); *Pringle-Associated Mtge. Corp. v. Southern Nat Bank of Hattiesburg, Mississippi*, 571 F. 2d 871 (1978, U.S.C.A.); *Roman Ceramics Corp.v. Peoples Nat. Bank*, 714 F. 2d 1207 (1983), where submission of an invoice certified unpaid when to the knowledge of the beneficiary it was paid

disguises the absence or impropriety of a shipment cannot be categorised as a fraud in the documentation without at the same time alluding to fraud within the transaction". It is evident from reported case law that the reasoning in the Sztejn⁸³ case has been expressly approved in English courts.⁸⁴ It is to be noted here that the standard of proof which is required by the English courts is very strict. In United City Merchants, the House of Lords eventually decided that the fraud exception did not extend to fraud to which neither the seller nor the beneficiary was party, and accordingly the bank was obliged to make payment in the face of third party fraud. (See discussion under Section 5.1.2. below, for more on fraud by a third party).

For example, in the case of Edward Owen Ltd. v. Barclays Bank Int. Ltd.⁸⁵, both Lord Denning and Browne L.JJ. approved the Sztejn decision, the former stating:

"That case shows that there is this exception to the strict rule; the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment.

I would in this regard quote the words of Browne L.J., in an unreported case when he was sitting at first instance. It is Bank Russo-Iran v. Gordon Woodroffe & Co. Ltd.⁸⁶ He said:

'In my judgment, if the documents are presented by the beneficiary himself, and are forged or fraudulent, the bank is entitled to refuse payment if the bank finds out before payment, and is entitled to recover the money as paid under a mistake of fact, if it finds out after payment''⁸⁷.

Browne L.J., (referring to Lord Denning's judgment) went on further to say:

"But it is certainly not enough to allege fraud; it must be 'established', and in such

constituted fraud in the transaction.

⁸² Sarna, L., *Letters of Credit: The Law and Current Practice* p. (5-12).

⁸³ Sztejn v. J. Henry Schroder Banking Corp 31 N.Y.S. 2d 631 (1941 S.C.).

⁸⁴ See for example, United City Merchants (Investments) Ltd. v Royal Bank of Canada [1983] A.C. 168; and Establissement Esefka International Anstalt v. Central Bank of Nigeria [1979] 1 Lloyd's Rep, 445. Limitation applied to cases concerning first demand guarantees: Harbottle (R.D.) (Mercantile) Ltd. v. National Westminster Bank [1977] 3 W.L.R. 752, 761. (per Kerr J.), [1978] 1 Q.B. 161, 165 (per Kerr J.); Edward Owen Ltd. v. Barclays Bank Int. Ltd [1978] 1 All E.R. 976 (C.A.).

⁸⁵ Edward Owen Ltd. v. Barclays Bank Int. Ltd [1978] 1 All E.R. 976 (C.A.).

⁸⁶ Bank Russo-Iran v. Gordon Woodroffe & Co. Ltd. (1972) 116 S.J. 921.

⁸⁷ [1978] 1 All E.R. 976 at 982 (C.A.).

circumstances I should say very clearly established”.⁸⁸

5.1.2. Fraud by Third Parties

Fraud in the area of letters of credit can be committed by either the beneficiary (or his agent) or a third party who is not known to the beneficiary. In the former case, the issuing bank may refuse payment, basing its decision on the grounds of fraud. However, in the latter case, the issuing bank is not allowed to refuse payment upon the credit. Such fraud of third parties may take place where a third party, e.g. a carrier, forges the bill of lading or the date of shipment in terms different from that stipulated under the credit. This principle has been expressly adopted in an English decision, United City Merchants (Investments) Ltd. v Royal Bank of Canada⁸⁹ In this case, fraud was committed by the shipping agent with regard to the bill of lading's date. It was issued on the 16th of Dec. but dated on the 15th of Dec. instead. The sellers were unaware of this fraud. Referring to Sztejn's case, Mocatta J. observed that

“Where there has been personal fraud or unscrupulous conduct by the seller presenting the documents under the letter of credit, it is right that a bank should be entitled to refuse payment against apparently conforming documents on the principle *ex turpi causa non oritur actio*. But here I have held that there was no fraud on the part of the plaintiffs, nor can I, as a matter of fact, find that they knew the date on the bills of lading to be false when they presented the documents.”⁹⁰

On appeal by the plaintiffs, Mocatta's findings were upheld. The Court of Appeal held that:

“Fraud such as to entitle a banker to refuse to pay under a letter of credit notwithstanding the strict general rule requiring payment when the documents were in order on their face, did not extend to fraud to which the seller or beneficiary was not party, and accordingly, prima facie the defendants should have paid on the presentation of the documents”.⁹¹

⁸⁸ Ibid at 984.

⁸⁹ *United City Merchants (Investments) Ltd. v Royal Bank of Canada.*, *The American Accord* [1979] 1 Lloyd's Rep. 267.

⁹⁰ Ibid at 278, per Mocatta J.

⁹¹ *United City Merchants (Investments) Ltd. v Royal Bank of Canada.* *The American Accord* [1983] 1 AC 168, at 169.

In other words, the beneficiary, in order to be protected, should not be aware of such forgery or fraud, otherwise he loses his right as a beneficiary. The rationale behind protecting the beneficiary, in relation to fraud committed by a third party without his knowledge, is due to the absence of any warranty of accuracy in the documents submitted.⁹² (See Chapter Six for more cases on fraud).

5.1.3. The Rationale Behind the Fraud Exception

Borrowing the words of Lord Diplock, on the rationale behind the fraud exceptions in the case of United City Merchants (Investments) v. Royal Bank of Canada⁹³, he said:

“The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, “fraud unravels all”. The courts will not allow their process to be used by a dishonest person to carry out fraud”.⁹⁴

In the American case Intraworld Industries v. Girard Trust Bank⁹⁵, the court said:

“A court of equity has the limited duty of guaranteeing that the beneficiary not be allowed to take unconscientious advantage of the situation and run off with the customer’s money on a pro forma declaration which has absolutely no basis in fact”.⁹⁶

From the above mentioned cases the justification of the fraud exception is that if the banker is obliged to pay the beneficiary against tender of documents which seem to be conforming only on their face, irrespective of the beneficiary’s fraud, then the account party’s financial interest will be jeopardised.⁹⁷ In this regard, buyers will feel no incentive to resort to a device that will not work in their

⁹² See generally, Sarna, L., *Letters of Credit: The Law and Current Practice* p. (5-22).

⁹³ *United City Merchants (Investments) Ltd. v Royal Bank of Canada, The American Accord* [1983] 1 AC 168.

⁹⁴ *Ibid* at 184.

⁹⁵ *Intraworld Industries v Girard Trust Bank* 46 Pa. 343, 336 A. 2d 316, 324-25 (1975), discussed by Macintosh, K.L., ‘Letters of Credit. Dishonour When a Required Document Fails to Conform to the Section 7-507 (b), warranty’ 6 *Journal of Law and Commerce* (1986) 7.

⁹⁶ *Ibid*.

⁹⁷ Adam, M.I., ‘The Perceived Problems in the Utilisation of Letters of Credit: A Comparative Study’. A Ph.D Thesis (Aberdeen University, 1991). p. 230.

interests. Also, not only is the interest of the account party jeopardised, the banker's interest is jeopardised as well in cases of fraud. That is to say the fraud exception serves the banker's security in the documents of title tendered under the credit. Contrary to the above suggestion, if the banker pays under fraudulent documents which he is aware of being fraudulent, he loses his right of reimbursement of the amount paid against the fraudulent documents.

Although the justification behind the fraud exception can embody both fraudulent documents and fraud in the underlying transaction, it is suggested by Dolan⁹⁸ that it should be restricted to cases of fraudulent documents only in order to avoid a floodgate of disputes and narrow the role of the banker's inquiry within the scope of the alleged forged documents. In this regard, Professor Dolan says:

“There is a significant body of case law that extends the fraud defence substantially beyond the credit transaction, broadens the inquiry to include commercial disputes, and alters the credit device to the point that it becomes the equivalent of a performance bond. Courts that fashion this rule usually offer justifications for their departure from the independence principle, but the justifications are unpersuasive; and, in a disconcertingly large number of cases, the courts make a perfunctory bow to the independence principle and then ignore it with abandon.”

5.1.4. Fraud and Electronic Letters of Credit

It should be noted that a letter of credit can be communicated through SWIFT⁹⁹. The UCP¹⁰⁰ in articles 11, 12 and 16 shows the availability of teletransmission of letters of credit. (See for update in the UCC provisions (1995) Revision, Appendix D, Section (1) where, under section 5-102(6) of the UCC, a document may be a record). Under paragraph (14) of the same section, a record is defined as “information that is inscribed on a tangible medium, or that is stored in an electronic or other medium and is retrievable in perceivable form”.

It is submitted that since telecommunications through private lines, and Value

⁹⁸ Dolan J.F, ‘Standby Letters of Credit and Fraud. Is the Standby another Invention of the Goldsmiths?’.7 *Cardozo Law Review* 1 (1985) p. 13.

⁹⁹ Society for Worldwide Interbank Financial Telecommunications.

¹⁰⁰ UCP 1993 Revision.

Added Networks are being extensively used in banks operations, this raises a question as to liability in the event of fraud.¹⁰¹ UNCITRAL¹⁰² defines fraud in relation to EFT¹⁰³ as (i) “an unauthorised instruction, (ii) alteration of the account to which an entry is to be made or (iii) alteration of the amount of the entry”.¹⁰⁴ Fraud can be committed by bankers’ employees and by a beneficiary (or his employees).

Recently fraud with paper documents has become a major problem because of adding false data input on the document. “This may, perhaps, be even more a potential hazard with data produced, transmitted and stored electronically”.¹⁰⁵ The fear is said to be that the existing law based on paper-borne data does not fully tackle the problems of fault, change or fraud in input, storage and transmission of data.¹⁰⁶

5.2. Consent of The Parties

The risk which an issuing bank undertakes upon its issuance of the credit, may be decreased or increased depending on the business sphere and consent of the customer and the bank. When it is not sure about being involved in risk, the issuing bank may choose to become involved in seeing the implementation of the contract or retaining such options by so stipulating. Actually, it is not the normal practice of the issuing bank to be involved in the underlying contract since it deals in documents, but it is not unusual to find reference to performance in the letter of

¹⁰¹ See Lass, J., ‘Fraud, Error and System Malfunction’ A Banker’s Viewpoint. in *Electronic Banking: The Legal Implications*, edited by Goode R. M (London, The Institute of Bankers, 1985) p. 57.

¹⁰² (United Nations Commission on International Trade Law).

¹⁰³ (Electronic Fund Transfer).

¹⁰⁴ See Lass, J., *supra* note 101, at 59.

¹⁰⁵ See Wheble B, ‘International Trade Data Interchange System’ in *Electronic Banking: The Legal Implications*. edited by Goode R. M (London, The Institute of Bankers, 1985) p. 126.

¹⁰⁶ *Ibid* at 127.

credit.¹⁰⁷

5.3. Public Policy and Illegality

Illegal contracts, including demands for payment made thereunder, would not be enforced by the court. A letter of credit will not be enforceable if its opening is tainted with illegality¹⁰⁸. The rule that a bank is not obliged to make payment upon a letter of credit, which is issued in furtherance of an illegal monetary transaction contrary to exchange control regulations, is indicated by the case of United City Merchants (Inv't.) Ltd. v. Royal Bank of Canada.¹⁰⁹ In that case, a sale agreement was entered into to secure the transfer of funds by the buyer out of its native Peru, in contravention of that nation's exchange control regulations. The maintenance or establishment of deposits in a foreign currency and in banks outside Peru were banned by those regulations. There was evidence showing that the invoice price of the goods had been doubled by agreement between the buyer and seller which provided that part of the payment should be transferred to an account in the United States, and thus a breach of the currency regulations had been committed. Payment under the letter of credit was therefore refused on the ground of illegality. Mocatta J. in the first instance asserted that the letter of credit was not enforceable as contrary to public policy, even where the independency between the letter of credit contact between confirming banks and the beneficiary and the contract of sale were evident. His Honour said "After a considerable hesitation I have come to the conclusion [that] the court should not, by enforcing the confirmed credit, enable the Bretton Woods Agreement Order in Council to be avoided".¹¹⁰ Furthermore, in

¹⁰⁷ e.g. *Davis O'Brien Lumber Co. v. Bank of Montreal* (1951), 28 M.P.R. 22 (N.B.C.A.) and *N.M.C. Enterprises Inc. v. Columbia Broadcasting System Inc* 14 UCC Rep. 1427 (1974, N.Y.S.C.). Sarna, L., *Letters of Credit: The Law and Current Practice* p. (5-4.1).

¹⁰⁸ Sarna, L., *Letters of Credit: The Law and Current Practice* p. (5-6).

¹⁰⁹ *United City Merchants (Investments) Ltd. v Royal Bank of Canada, The American Accord* [1983] 1 AC 168.

¹¹⁰ *United City Merchants (Investments) Ltd. v Royal Bank of Canada, The American Accord* [1979] 2 Lloyd's Rep. 498, 505.

response to the argument which suggests that it may be possible to sever the plaintiff's claim here, in order that they would be able to recover one half of their claim under the letter of credit, the learned judge observed that: "I do not consider it possible for this Court to sever this letter of credit; it is either enforceable in full according to its terms or not at all".¹¹¹

Based on the Bretton Woods Agreement Order in Council 1946¹¹², the House of Lords' judgment demonstrated that there was a duty, on their part, to reject any enforcement of any part of the agreement which encompassed the illegal exchange commitment. However, at the same time, it was accepted that the other half of the invoice price was recoverable by the seller as it represented the true price of the goods in addition to the whole of the 'freight', as the amounts in question were not classed as a monetary transaction in disguise. Lord Diplock said:

"In the instant case there is no difficulty in identifying the monetary transaction that was sought to be concealed by the actual words used in the documentary credit and in the underlying contract of sale. It was to exchange Peruvian currency provided by the buyers in Peru for U.S. \$ 331, 043 to be made available to them in Florida; and to do this was contrary to the exchange control regulations of Peru. Payment under the documentary credit by the confirming bank to the sellers of that half of the invoice price (viz. \$ 331,043) that the sellers would receive as trustees for the buyers on trust to remit it to the account of the buyer's American company in Florida, was an essential part of that monetary transaction and therefore unenforceable; but payment of the other half of the invoice price and of the freight was not; the sellers would receive that part of the payment under the documentary credit on their own behalf and retain it as the genuine purchase price of goods sold by them to the buyers. I agree with the Court of Appeal that there is nothing in the Bretton Woods Agreement Order in Council 1946 that prevents the payment under the documentary credit being enforceable to this extent".¹¹³

Utilising the words of Sarna¹¹⁴, in relation to the above mentioned case, it is

¹¹¹ Ibid.

¹¹² According to the Bretton Woods Agreements Order in Council 1946, made under the Bretton Woods Agreements Act 1945, gives the force of law in England to article VIII section 2 (b) of the Bretton Woods Agreement, which provides as follows:

"Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this agreement shall be unenforceable in the territories of any member...".

¹¹³ *United City Merchants (Investments) Ltd. v Royal Bank of Canada, The American Accord* [1983] 1 AC 168, at 190.

¹¹⁴ Sarna, L., *Letters of Credit: The Law and Current Practice* p. (5-6).

evident that the House of Lords did not declare that the banker was “under an obligation not to pay in any circumstances under an illegal credit”. In clarifying this point further, Sarna commented on how there was presently “no absolute judicial authority declaring that a banker who does pay under an otherwise unenforceable credit is liable in damages to the applicant.”

To illustrate this suggestion, it was submitted (by Sarna) that “To say that a court will not hear a plaintiff who is a party to an illegal contract in his claim for damages against the bank is to sidestep the principal issue, that is the issue of whether the bank which issues or confirms a credit should at all be drawn into the vagaries of the underlying transaction between the parties and their countries in situations which are tantamount to fraud”. It was inferred by Sarna that it should not be left to the banker to determine both the true motives for the underlying contract and the application of currency restrictions of the various nations, with regards to the nationals that they may deal with. This is still applicable in situations where the currency control regulations announce the prescribed currency offence to be one of fraud, as is evident in this case.

Conversely, there is a remarkable approach represented by the case of Group Josi Re v. Walbrook Insurance Co.¹¹⁵ in which the question of illegality of letters of credit would be no defence. The Court of Appeal held that performance of the reinsurance contracts by the reinsurers was not illegal and refused to grant the injunctions. (Facts are set out in Chapter Six, section 4.2.2.). It was held that “the illegality of the underlying reinsurance contracts did not taint the letters of credit”¹¹⁶.

¹¹⁵ *Deutsche Rückversicherung AG. v. Walbrook Insurance Co Ltd and Others. Group Josi Re* (formerly known as Group Josi Reassurance SA) *v. Walbrook Insurance Co Ltd and Others* [1994] 4 All ER 181. See more on whether a letter of credit can be affected by illegality of the underlying transaction, the judgment of Staughton LJ. [1996] 1 WLR 1152, CA.

¹¹⁶ [1994] 4 All ER 181, at 182. This was at an earlier hearing before Clarke J.

5.4. Non-Compliance

The issuing bank may be entitled to refuse payment on the ground of non-compliance with terms of the credit by the seller. This follows from the basic nature of conditions precedent to the liability of the bank¹¹⁷. The important doctrine of strict compliance will be dealt with in detail in Chapter Five.

6. Banker's Right of Recourse Against Seller

Where the issuing bank pays against faulty tender of documents and is denied reimbursement by its customer, it is dubious whether it has a recourse against the seller. The issue is to be tackled both from the point of view of the law of negotiable instruments and of the general principles of the law of contract. The provisions of the UCP and UCC will also be examined correspondingly.

6.1. Position Under Law of Negotiable Instruments

Regarding the law of negotiable instruments, there are three ways in which the banker may promise to pay. In the first case, a cash payment may be promised against the tender of the appropriate documents, or alternatively such payment may be promised at a later date. In the second case, a promise of acceptance of a draft drawn on him may be offered, provided that the documents are also included. The third case, a promise to negotiate a draft drawn by the seller on the buyer, accompanied by the documents may be made¹¹⁸.

Clearly, the law of negotiable instruments does not apply in the first case. The law of negotiable instruments does not confer on the banker a right of recourse against the seller in the second case.

Problems arise in the third case where the seller is the drawer and the banker is indorser or holder. Section 43(2) or 47(2) of the Bills of Exchange Act 1882 gives

¹¹⁷ Gutteridge and Megrah, *The Law of Banker's Commercial Credit* p. 75.

¹¹⁸ See generally *Benjamin's Sale of Goods*, at § 23-144, pp. 1726-7.

the issuing banker a right of recourse against the seller in case the draft is dishonoured by the drawee (the buyer). Moreover, it is clear from Sassoon (MA) & Sons Ltd. v International Banking Corporation¹¹⁹ that one should not assume that it is impossible to claim a right of recourse, in situations where a draft is said to have been drawn under a documentary credit. In this case, following the dishonour of a draft on the part of the buyer, it was demonstrated that the discounting bank had attempted to claim recourse against the seller.¹²⁰ A suggestion by an American authority was that;

“the general provision... which permits the holder or any subsequent indorser of a negotiable instrument dishonoured to maintain an action thereon against the drawer is not applicable... because the drafts here involved specifically state that they are drawn under the irrevocable letter of credit, and by that the bank was required to pay when a draft and other documents specified were presented.”¹²¹

This is a satisfactory conclusion from a commercial point of view, as there is no good purpose in conferring on the banker a right of recourse against the seller if the buyer dishonours the draft. Indeed, if such a right of recourse is available to the banker, the main object of the transaction would be jeopardised.

6.2. Position at Common Law

To know whether the general principles of the common law may help bankers to have a right of recourse against the seller, three types of case must be distinguished.¹²²

¹¹⁹ *Sassoon (MA) & Sons Ltd. v International Banking Corporation* [1927] AC 711.

¹²⁰ *Ibid* at 731.

¹²¹ *Bank of East Asia Ltd. v Pang* 249, P.1060, 1063 (1926). *Benjamin* states that “thus, the Supreme Court of Washington treated the statement, that a draft was drawn under a documentary credit, as adequate to an exclusion of a right of recourse”. At § 23-144 pp. 1727. He further continues that “as to which exclusion, in England, see s.16(1) of the Bills of Exchange Act 1882. But the section applies only if the drawer inserts an express stipulation excluding a right of recourse”. *Benjamin's Sale of Goods*, fn 26 at § 23-144 pp. 1727.

¹²² *Benjamin's Sale of Goods*, talks about the issuing bank's right of set-off in § 23-149. p. 1730. But Hirst J in *HK and Shanghai Banking Corp v Kloeckner & Co. AG* [1990] 2 QB 514 rejected the argument as such a set-off was incompatible with the doctrine of independency of the letter of credit. His Lordship concluded: “... it would seem to me anomalous that such a set off should be unavailable in letter of credit cases, but available against bills of exchange which ... are closely analogous in that a bill of

First, if the tender was affected with fraud,¹²³ the banker might recover an amount paid to the seller. The banker in this situation, could potentially claim against the seller, based on him having acted in deceit¹²⁴.

Secondly, although it is not without debate, the banker may wish to reclaim payment from the seller if the buyer fails. Nonetheless, the difficulty arises when there is no clear principle upon which such a claim may be based, bearing in mind that a letter of credit forms a security as provided by the banker to the seller.

Thirdly, if the banker has accepted, by mistake, a faulty set of documents tendered by the seller¹²⁵, he may wish to seek recourse against the seller. Where a beneficiary obtains payment against forged or fraudulent documents, an issuing or confirming bank *may* recover the amount paid as paid under mistake of fact under English law or for breach of warranty under American law.¹²⁶ However, it is debatable as to whether the money paid under 'a mistake of fact', can be claimed back by the banker¹²⁷. This is because it does not always justify recourse against the beneficiary if payment was made against genuine documents which contain a discrepancy apparent on their face from reasonable examination.

In the case of United City Merchants¹²⁸, the bill of lading was not that which the

exchange is also virtually equivalent to cash." ([1990] 1 QB 514 at 526.)

¹²³ If payment was made against forged or fraudulent documents the issuing bank may recover the money paid as paid under mistake of fact. See below.

¹²⁴ See *Benjamin's Sale of Goods*, at § 23-145, fn 27 p. 1728.

¹²⁵ *Edward Owen Engineering Ltd v. Barclays Bank International Ltd.* [1978] 1 All E.R. 976, 982-3; *Establissement Esefka International Anstalt v. Central Bank of Nigeria* [1979] 1 Lloyd's Rep. 445, 448. Both cases quoted with approval *Bank Russo-Iran v. Gordon Woodroffe Ltd* (1972) 116 S.J. 921. Under the UCC payment against forged or fraudulent documents is recoverable on the ground of breach of warranty of UCC s 5-111(2). Further, Article 9(a) and 14(e) support the argument that the issuing banker does not have a right of recourse against the seller after the acceptance of documents tendered. However, if the beneficiary is fraudulent, and the bank has no knowledge of it, it must pay and is protected by Article 8 of the UCP and where later the fraud is discovered the money may be recoverable by deceit or as money paid by mistake.

¹²⁶ *Pubali Bank v. City National Bank*, 42 UCC Rep. Serv. 266, 269 (9th Cir. 1985).

¹²⁷ Goode, 'Reflection on Letters of Credit-III' (1980) *Journal of Business Law* 443 at 444. See also, Goode, R., *Commercial Law* pp. 1012-3.

¹²⁸ *United City Merchants (Investments) Ltd. v Royal Bank of Canada, The American Accord* [1983] 1 AC 168.

credit called for; it bore a wrong date. The document on its face was acceptable under the credit which was subject to the UCP and this would justify the bank in honouring the credit. The decision came in favour of the seller and indicated that only if he himself (the seller), is responsible for any defect in the document and can be vested with knowledge at the time of tender, can he fail to be paid. It was held that:

“Fraud such as to entitle a banker to refuse to pay under a letter of credit notwithstanding the strict general rule requiring payment when the documents were in order on their face, did not extend to fraud to which the seller or beneficiary was not party...”¹²⁹

Gutteridge and Megrah are of the opinion that if the fraud is discovered *after* payment, the bank *may* recover from him (for what that may be worth) as money paid under mistake of fact.¹³⁰ Under English law there appears to be no case law on the point. However, Gutteridge and Megrah continue to state that “except where the beneficiary has in good faith altered his position as the result of payment ... the bank would have a right of recovery against him for payment under mistake”.¹³¹ Professor Goode argues that once the bank accepts the documents, it loses its right to reject them even though the beneficiary did not irretrievably change its position. This is because recovery of money paid under mistake is a restitutionary remedy, which cannot be pursued unless there is total failure of consideration.¹³² Since payment against defective documents does not constitute total failure of consideration, allowing the bank to recover its payment would be contrary to principle.¹³³

¹²⁹ Ibid at 169.

¹³⁰ Gutteridge and Megrah, *The Law of Banker's Commercial Credit* p. 70.

¹³¹ Ibid at 86.

¹³² Goode, *supra* note 127, at 445; See also. Ellinger, E. P., *Documentary Letters of Credit, A Comparative Study* pp. 206-207

¹³³ Goode, *supra* note 127, at 445. It is to be noted here, however, that there are case where the bank loses its action in restitution against a seller who change their position by parting with the documents against the banker's acceptance. This situation happened in the case of *Lipkin Gorman v Karpnale Ltd* [1991] AC 548. Furthermore, there are some authorities which goes to the effect that the banker should be

6.3. Application of the UCP

It is evident from Articles 9(a) and 14(e) of the UCP, that they clearly support the fact that the issuing banker has no right of recourse against the seller once the documents that have been tendered have been accepted. Article 9(a) makes it clear that once the bank has decided to commit itself, the decision is final. Moreover, in situations where the banker's undertaking is understood to be in the shape of a promise, in order to negotiate a draft drawn on the buyer, it can be said to be an undertaking to negotiate without recourse. It may be inferred from the emphatic language used in the Article, that the draftsman's intention was not to use the right of recourse in the only situation in which he thought it might arise. A similar tone of language is found in Article 14(e), in which the issuing bank is precluded from claiming that the documents are not in accordance with the terms and conditions of the credit if the banker fails to comply with the procedure prescribed for the rejection of non-conforming documents. If the banker is given the opportunity to claim a right of recourse against the seller, upon acceptance of the documents under the credit, this may be one way of overcoming that which is prescribed by the principle. However, if the beneficiary is fraudulent and the bank has no knowledge of it, it must pay and is protected by Article 8 of the UCP and where later the fraud is discovered the money may be recoverable by deceit or as money paid by mistake.¹³⁴

estopped from claiming that the money was paid under a mistake of fact. In a situation where the banker accepts the tender documents, he may be deemed to have waived the irregularities. See, *Cf. Beevor v Marler* (1898) 14 TLR 259. required for establishing an estoppel are present and whether the acceptance of the documents by the banker may constitute a representation resulting in an estoppel. *Benjamin's Sale of Goods*, at § 23-145, p. 1728. By contrast, there are clear American authorities supporting the view that if the banker accepts a tender of documents he is not entitled to reclaim payment from the seller, even if the banker, due to a mistake, overlooked the irregularity of the documents. See *National City Bank of New York v. Partola Manufacturing Co.*, 181 N.Y.S. 464, 465 (1920); *Hibernia Bank and Trust Co. v. J. Aron & Co. Inc.*, 233 N.Y.S. 486 (1928). But under s. 5-111 of the UCC the banker may have an action for breach of warranty relating to the genuineness and regularity of the documents. No such warranty is recognised in English Law. See *Benjamin's Sale of Goods*, fn, 32, at § 23-145, p. 1728.

¹³⁴ Gutteridge and Megrah, *'The Law of Banker's Commercial Credit'* p. 69.

6.4. Application of the UCC¹³⁵

Section 5-111(1) of the UCC provides:

“Unless otherwise agreed the beneficiary by transferring or presenting a documentary draft or demand for payment warrants to all interested parties that the necessary conditions of the credit have been complied with”.¹³⁶

Unlike the UCC, under both the UCP and the general principles of English law there is no basis for such a warranty.¹³⁷ See for more detail on warranty in Chapter Seven.

7. Position of Holders of Seller's Drafts

7.1. Holder's Relationship with Issuing Banker

It is reported that the seller (beneficiary), may experience difficulty with tendering the documents himself due to the possibility of having a vast volume of transactions to process, therefore, he may on occasions, find it more convenient to utilise his own banks' services to handle all of his documents. In addition, as Benjamin¹³⁸ observes, in some cases where the seller is the bank's own customer, the seller may be offered preferential treatment with regards to credit terms in relation to time of payment. For instance, in situations where the terms of a letter of credit fall due at a later time i.e. 90 or even 180 days after sight, the seller “may require bridging finance for such periods”.¹³⁹

The banker can be perceived to occupy dual roles, in situations where it receives the drafts and documents from the seller. One such role is evident when he is instructed by the seller, to present the draft and accompanying documents to either

¹³⁵ See further Chapter Seven ante.

¹³⁶ Subsection 2 of this section deals with warranties made by banks. See *Infra* section 3 (c) (1). This is in addition to any warranties arising under Articles 3, 4, 7 and 8. See Appendix D for update.

¹³⁷ *Benjamin's Sale of Goods*, at § 23-145, n.32 p. 1728.

¹³⁸ *Ibid* at § 23- 167-8. pp. 1740-1.

¹³⁹ *Ibid*.

the issuing or to the confirming banker, specifically in situations where an advance is not required by the seller. In this situation, he is perceived as the seller's agent (for collection) and in most cases, under the documentary credit, holds no right of his own.¹⁴⁰ The other potential role that the banker occupies, derives from the probable agreement of making an advance to the seller against the drafts. Thereby in acting as the seller's key 'negotiator' or a 'purchaser' of the seller's drafts, the banker can be seen as maintaining the role of a 'holder' and is thus, generally referred to as a 'negotiation banker'.

Concerning the holder's rights against the issuing banker, there are two cases that have to be identified. Firstly, if the draft is drawn under a "straight credit", the undertaking is moved exclusively towards the seller, and as a result, such a holder of a draft drawn under it will consequently fail to secure any of his own rights against the issuing bank. In the second case, in addition to the seller, bona fide holders, purchasers and discounters of the seller's drafts are also addressed within a negotiation credit, where the issuing bank promises to honour drafts and their accompanying documents. After the negotiation banker has purchased the drafts drawn under such a credit, it is only at this point that both himself and the issuing banker are considered to have entered upon a contractual relationship and can consequently, progress onto enforcing the letter of credit.

In order to understand the second situation, it is important to consider the decision of the recent case of Banco Santander SA v Bayfern Ltd & Ors.¹⁴¹ On 5 June 1998 a deferred payment letter of credit was issued by Paribas and confirmed by Santander. The maturity date was 27 November. On 9 June 1998 Bayfern (the beneficiary) asked Santander to discount the full value of the credit and to pay the discounted sum to their account with the second defendant ('RBS'). Subsequently the letter of credit was discounted and fully paid to the RBS. In light of this,

¹⁴⁰ Ibid at p. 1741.

¹⁴¹ *Banco Santander SA v Bayfern Ltd & Ors* (1999) L.T.L. 25/6/99. LAWTEL 1999.

Bayfern assigned its rights under the letter of credit to Santander. However, when the documents were sent to the issuing bank, they were rejected on the grounds that they were considered as false.

Following this, the court deliberated whether it was the responsibility of the issuing bank or the confirming bank to deal with any risk of fraud on the part of the beneficiary of a confirmed deferred payment letter of credit, especially where the confirming bank had discounted its own payment obligations to the beneficiary and paid over the discounted sum to it, and the fraud was discovered only after it had done so but before the maturity date of the letter of credit.

In the course of delivering judgment, it was held that both Articles 10(d) and 14 (a) of the UCP (1993 Revision) confirmed that 'the obligation to reimburse a party who had incurred a deferred payment obligation fell to be discharged when that latter obligation had itself been discharged by payment at maturity.' It was also affirmed that because Santander had not been expressly authorised by the issuing bank to discount the letter of credit and since the letter of credit had not been open to negotiation as defined in art. 10 (b) (ii) then the issuing bank, would in turn have a defence. Consequently, there was no obligation to 'reimburse' Santander for having incurred a deferred payment obligation at some date other than at maturity. It was established that in cases where the a confirming bank discounted its own obligations at maturity, there were two available routes of action. It could either make its payment at the specified date or could claim as assignee of the rights of the beneficiary. It was argued that as an assignee, Santander could also claim the rights of the beneficiary, because in discounting its own obligations to make payment, it did not in essence extinguish the debt. In addition to this, Santander would have the right to refuse making such a payment, by claiming that fraud had taken place, if Bayfern had attempted to enforce the obligation at maturity. Based on the assumed facts which were available at the time, Santander failed to establish a claim as an assignee of Bayfern, because Bayfern could not have enforced

payment at the specified maturity date, and thus Santander could not prove to be in a more advantaged position over them.

In referring back to the second point, concerning the holder's rights against the issuing banker, the negotiating banker, in order to avail himself of the credit, should tender the exact required documents. However, a bank cannot enforce a credit if it has discounted bills drawn, based purely as a result of it holding an agreement with the seller. This is demonstrated in the case of Banco Nacional Ultramarino v. First National Bank of Boston¹⁴², where a banker purchased a draft under a negotiation credit. At the time of tender, the draft was not accompanied by the necessary documents, but was later forwarded by the seller, prior to the credit expiring. Following the judgment, it was held that as the draft had failed, upon purchase, to comply with the terms as set in the credit, the negotiation banker, as a result, could not enforce the documentary credit. It was thus, evident from the case that the negotiation banker was restricted in how he enforced the documentary credit, if he purchased a draft which was accompanied by documents which did not exclusively conform to it¹⁴³.

That is to say, the doctrine of strict compliance is applicable to a negotiation banker.¹⁴⁴ The supposition is, therefore, that if the issuing bank fails to comply with the requirements and procedures, in line with Article 14 of the UCP, it will

¹⁴² *Banco Nacional Ultramarino v. First National Bank of Boston* 289 F. 169 (1923).

¹⁴³ *Banco Nacional Ultramarino v. First National Bank of Boston* 289 F. 169, 175-176 (1923). See *Courteen Seed Co v. Hong Kong and Shanghai Banking Corporation*, 215 N.Y.S. 529 Three points should be noted about Article 10 of the UCP here. First, Article 10(b)(ii) affirms that *negotiation* means the giving of value for the documents by the bank authorised to negotiate and, further, that the mere handling of the documents does not constitute negotiation. Secondly, Article 10(c) confirms that the negotiation banks' *receipt and examination* of the documents does not, in itself, render it liable to effect payment. In practice, the negotiation bank incurs such a duty only when it plays also the role of a confirming bank. Thirdly, Article 10(d) states that by "nominating another bank, or by allowing for negotiation by any bank", the issuing bank authorises such bank to pay against a regular set of documents and undertakes to reimburse it. On this point, paragraph (d) supplements articles 9(a) and 14(a).

¹⁴⁴ See *United Bank Ltd. v Banque Nationale de Paris* [1992] 2 SLR 64 (Supp. Ct.S'pore, Chao Hick Tin J) for a particularly neat summary of all authorities on this point.

consequently fail to secure the right to reject the documents. Having tendered the documents which are not in order, the negotiating banker cannot contend that he has negotiated them “under reserve” or taken them up on a collection basis. This above suggestion can be illustrated in the following case. In Harlow and Jones Ltd. v American Express Bank Ltd.¹⁴⁵, a set of discrepant documents, after the expiry of the letter of credit, was delivered to the negotiating bank by the beneficiary. It was suggested, using a covering letter when forwarding the documents, that the issuing bank ought to handle them on a ‘collection basis’. The facts of the case illustrate how the account party initially accepted the draft accompanying the documents, but on acquiring the accompanying documents, subsequently violated the draft by refusing payment. Gatehouse J. allowed the beneficiary’s action to recover the amount of the documentary credit from the issuing bank. His Honour initially relied on expert evidence as to the effect of discharging discrepant documents to the issuing bank on a ‘collection basis’:

“the expert witnesses for all parties were agreed that the words ‘on a collection basis’ or ‘for collection’ are equivocal and must take their meaning from their context. The experts were also agreed that it is common practice that documents which are discrepant, including documents presented after the expiry date of a letter of credit, are sent to the issuing bank for collection or on a collection basis under the letter of credit which will be expressly or impliedly extended if, after inspection, the opener and his bank decide to accept the documents and thus waive the discrepancies. In this event, in the strict analysis, it is probably a re-negotiation of the credit in which the opener may, but will not necessarily, require allowances”.¹⁴⁶

With regards to the statement above, his Honour summarised that discrepant documents would still be tendered under documentary credit, even in situations where they had initially been tendered on a collection basis. As a result the bank would be summoned to settle the amount due under that particular documentary credit. Indeed, article 14(f) of the UCP¹⁴⁷ provides that, if:

“the Remitting bank draws the attention of the Issuing bank and/or Confirming bank, if any, to any discrepancy(ies) in the document(s) or advises such banks that it has paid ...

¹⁴⁵ *Harlow and Jones Ltd. v American Express Bank Ltd* [1990] 2 Lloyd’s Rep. 343.

¹⁴⁶ *Ibid* at 348.

¹⁴⁷ Article 14(f) of the UCP 1993.

or negotiated under reserve or against indemnity ... the Issuing bank and/or Confirming bank ... *shall not be thereby relieved from any of their obligations* under any provision of this Article.” (emphasis added)

Therefore, if one refers to Article 14, the duties of the issuing bank appear to remain unaltered even in situations where it has been informed that the negotiating banker has acted under reserve or has acquired an indemnity. Commenting on the decision by Gatehouse J., Benjamin¹⁴⁸ asserts that this principle could be utilised to encompass other cases which involved handling discrepant documents on a collection basis.

7.1.1. Fraudulent Documents

Having assumed the right of the negotiating bank to claim payment under the credit, the next issue is to determine, if upon accepting a draft accompanied by documents which initially appear to be legitimate but are later found to be forged or deceptive, the negotiating banker is entitled to claim the amount of the credit from the seller, where the transaction has occurred in good faith. The answer is that since the issuing bank is obliged to take up the documents when tendered by the seller, he, *a fortiori*, is obliged to take them up when tendered by the negotiation banker for two reasons. Firstly, the negotiation banker, when purchasing drafts accompanied by regular documents, does so in the belief that the issuing bank will pay. Consequently, there is no requirement on the part of the negotiation banker to verify whether the documents are genuine and as the negotiation banker is a holder, it does not therefore, upon him submitting a draft, indicate that the documents have been warranted¹⁴⁹. Secondly, under article 14(a), when the issuing bank authorises another bank to negotiate against documents which appear on their face to be in compliance with the terms and conditions of the

¹⁴⁸ *Benjamin's Sale of Goods*, at § 23-171 p. 1743.

¹⁴⁹ *Guaranty Trust Co. of New York v Hannay & Co.* [1918] 2 K.B. 623, 631-632. See also *Sztejn v. v J. Henry Schroder Banking Corporation*. 31 N.Y.S.2d 631, 635 (1941). See further the Uniform Commercial Code, s. 5-111.

credit, the issuing bank and the confirming bank are bound to reimburse the nominated bank which has negotiated, and to take up the documents. That is to say, the banker, under the negotiation credit, is authorised to purchase a draft accompanied by documents which are regular on their face. It appears, upon reflecting on the case of Discount Records Ltd.v Barclays Bank Ltd¹⁵⁰, that Megarry J. is applying the same principle to cases where the draft was submitted by a holder in due course and it also appeared to be irrelevant as to the type of credit being used, for example a straight or a negotiation credit. His Honour said:

“Somewhere there is a bill of exchange which has already been accepted by the Discount Bank. That bill may well have been negotiated; it may indeed have passed into the hands of a holder in due course. That bill will be presented for payment, and the Discount Bank is bound to pay it...”¹⁵¹.

However, the issue becomes questionable, because the holder of a draft drawn under a straight credit, is not a promisee of the letter of credit¹⁵².

7.1.2. Right of Recourse

Regarding the right of recourse, the initial question to be answered is whether a right of recourse can be claimed on the part of the issuing banker, against the negotiation banker, in situations where the documents are refused by the buyer. The answer is dependent upon whether the issuing bank had been given an opportunity to check the documents. If the answer is positive, the issuing bank is not allowed to claim such a right, it should claim reimbursement from the seller instead. If the answer is negative, it can claim reimbursement from the negotiating bank. The same principle should apply where a draft is negotiated under a straight credit.

While the “mere holder” is not entitled to claim payment in his own name, he may

¹⁵⁰ *Discount Records Ltd.v. Barclays Bank Ltd* [1975] 1 W.L.R. 315.

¹⁵¹ *Ibid* at 319.

¹⁵² *Benjamin's Sale of Goods*, at § 23-172, n5 p. 1744.

claim payment on the grounds of the issuing bank's acceptance of the tender of the documents. Principles such as waiver and estoppel may be useful to him.¹⁵³

7.1.3. Right of Reimbursement

There are several ways in which the issuer's correspondent or a negotiation bank can be reimbursed for the payment made to the beneficiary. For example, such a bank may be requested to debit the issuing banker's account and occasionally may even be requested to draw on the issuing banker or on some other designated bank.

The latter arrangement is regulated by Article 19 of the UCP. Primarily the terms "Claiming Bank" and "Reimbursing Bank" are defined within the provision. The former is the paying, accepting or negotiation bank which claims reimbursement. The latter means that the bank is authorised to effect reimbursement. Paragraph (a) of the Article, illustrates the issuing banker's duty, in which he is requested to provide the Reimbursing Bank with adequate instructions or alternatively authorisation to honour such a reimbursement claim. Paragraph (b) clearly instructs the issuing bank to refrain from asking for a certificate of compliance, which incorporates the terms and conditions of the Credit to the Reimbursing Bank, from a Claiming Bank. The principle that a party who presents a documentary draft does not warrant the genuineness of the documents attached is fortified in this section.¹⁵⁴

If the Reimbursing Bank fails to meet a claim, the issuing banker is neither relieved from his obligations to the correspondent nor to the negotiation bank, according to Article 19 (c) of the UCP. As a result, if the reimbursing banker becomes bankrupt

¹⁵³ Ibid.

¹⁵⁴ Article 19 of the UCP does not, however, invalidate an instruction requiring the reimbursing bank to demand the delivery or communication of such a certificate as a condition precedent to its making payment. Such instructions have remained common in modern practice. See also *Benjamin's Sale of Goods*, at § 22-097 p. 1621.

after receiving funds which are necessary for him to meet a demand on the documentary credit, it follows that the issuing banker is not relieved from his duty to reimburse the correspondent or the negotiation bank. In addition to this, under paragraph (d), where loss to the correspondent or the negotiation bank was due to the Reimbursing Bank's default, the issuing banker would be held liable and would subsequently be responsible for any compensation.

7.2. Holder's Rights against Seller

The banker and the seller's relationship can be seen to be that of a holder of a draft and its drawer, who have a role in purchasing commercial paper based on the credit of the drawer and the security that is offered¹⁵⁵. The banker who purchases the seller's draft combines the roles of a discounting banker and of a collecting banker. His contract with the seller is therefore governed by the principles applying to the discount and collection of negotiable instruments.

Two points are noteworthy here. The first point, is that the holder is not necessarily excluded from seeking recourse against the seller, where the seller's draft has been drawn under a documentary credit, i.e. the drawer, if the draft is dishonoured by the drawee. The second point, is that the banker can only claim a right of recourse against the seller, if he presents the documents to the issuing banker with due diligence and prior to the credit expiring. The rule in Polak v. Everett¹⁵⁶ is followed in this principle. Blackburn J. said:

“Where a person is a creditor with a pledge or surety he is in equity bound to account not only for the money he has actually made out of the pledge, but also for the moneys he might, ought, and should have made out of the pledge, and he must allow for that whether he made them or not, and if by laches he has diminished the value of the pledge he is bound to allow for the sum he ought to have made”.¹⁵⁷

From this rule, it can be established that the creditor is accountable to the debtor to

¹⁵⁵ *Benjamin's Sale of Goods*, at § 23-175 p. 1745.

¹⁵⁶ *Polak v. Everett*, [1876] 1 Q.B.D. 669 (C.A.).

¹⁵⁷ *Ibid* at 675-76.

more than just the money he had initially given to obtain security. It is clear that as well as this, the creditor is also accountable for the funds which he failed to obtain due to laches or due to negligence associated with handling a security. In relation to the meaning of this rule, the documentary credit can thus be perceived as a form of security¹⁵⁸.

7.3. Holder's Rights against Buyer

When deliberating the contractual relationship between the negotiation banker and that of the buyer, it is apparent that it is non-existent¹⁵⁹. The buyer's relationship with the negotiation banker is perceived to be more distant in comparison to his relationship with the correspondent banker, probably due to the fact the negotiation banker is appointed by the seller and not by the issuing banker. Benjamin¹⁶⁰ casts doubt over the buyer's ability to succeed against the negotiation banker where negligent statements are involved. For example, it would prove difficult for the negotiation banker to guarantee that the information supplied to him was accurate and therefore, in essence, could not be held fully responsible. This applies a fortiori to a mere holder of a draft drawn under a straight credit, where the holder has no intention to act under the documentary credit¹⁶¹. Benjamin highlights an American authority which suggests that where the buyer advises the issuing banker to reject regular documents, based on deceit, the banker can subsequently sue him in quasi contract. Although such a view does not seem to be recognised by English courts, it is suggested that in certain situations, similar to that described above, it may be possible for the negotiation banker to prevail

¹⁵⁸ Benjamin's *Sale of Goods*, at § 23-176 p. 1746.

¹⁵⁹ For more details see *Courteen Seed Co. v. Hong Kong and Shanghai Banking Corporation*, 157 N.E. 272, 274 (1927).

¹⁶⁰ Benjamin's *Sale of Goods*, at § 23-176 p. 1746.

¹⁶¹ Ibid.

against the buyer in tort¹⁶².

¹⁶² For inducing breach of contract, see generally, *Clerk and Lindsell on Torts* 17th ed (Sweet & Maxwell, London, 1995).

Section Two: Evaluation of Punitive Damages, “the Independency Principle and its Fraud Exception”, and the Strict Compliance Rule

1. Introduction

As between the issuing bank and the beneficiary, the most problematic questions are: (i) should the law ever allow the beneficiary to recover punitive damages against the bank where the bank has wrongly failed to pay; (ii) should the law ever allow fraud in the underlying sale transaction to be a good defence for a bank’s refusal to pay the beneficiary; and (iii) should the law ever allow fraud by a third party to be a good defence for a bank’s refusal to pay the beneficiary? The answer to these questions should be reached in accordance with the way in which each issue interacts with the basic principles. The doctrine of strict compliance, as the main source of disputes between banks and beneficiaries, is briefly referred to here but it is fully discussed in Chapter Five.

2. Punitive Damages

2.1. The Position of Punitive Damages in Law

What is the position in the three legal regimes with which we are concerned (English law, the UCP and the UCC) with regard to the availability of punitive damages for breach of contract?

English contract law does not award punitive damages for breach of contract, since damages are awarded to put the aggrieved party in the same position as if the contract had been fulfilled. Damages are to compensate the innocent party, not to punish the contract-breacher.

The UCP is silent as to the remedies available to a beneficiary of a letter of credit where there has been a unilateral amendment of an irrevocable letter of credit by the issuer.

Article 5 of the UCC is also silent regarding the award of punitive damages. Despite the fact that there is nothing in the UCC that suggests that a breach of Section 5-114 is the only cause of action that is available to the beneficiary, section 5-102(3) of the UCC itself makes it clear (and, thus, confirms) that Article 5 is not comprehensive to all issues related to letters of credit and thus reference to other applicable law is possible. Further, section 103 of the UCC guarantees the right of reliance on other applicable law. Nonetheless, both sections (5-102(3) and 103) have to be read in conjunction with section 106 of the UCC which generally forbids the award of punitive damages (see more about those UCC sections under section 2.2.1.1).

2.2. Conflict of Party Autonomy, Fairness, Flexibility and Certainty in the Imposition of Punitive Damages

Essentially a legal regime could adopt one of three options with regard to the availability of punitive damages: (i) punitive damages always awarded; (ii) punitive damages awarded in some cases; and (iii) punitive damages never awarded. It is to be mentioned here that these options are to be understood as rigid non-default fixed rules. Under fixed rules, the parties (by definition) cannot bargain around them and party autonomy is compromised in the sense that it restricts the parties' power to set their own remedial regime. (See table 1 below for summary of conflict of the basic principles in relation to punitive damages).

2.2.1. Certainty in Relation to the Three Options Concerning Punitive Damages

2.2.1.1. Certainty as to Each Option

In relation to option (i), punitive damages never awarded: if this is the legal position, this would provide certainty and parties would know where they stand. Regarding option (ii), punitive damages are awarded in some cases: that would provide certainty only if there is a clear-cut criterion upon which such damages are

allowed, as parties would then know where they stand. In relation to option (iii), punitive damages are always awarded: if this is the position of the law, then it would again provide certainty and each party would know where he stands.

2.2.1.2. Certainty of the Current State of Laws

The position of English Law in relation to punitive damages is certain because it is generally accepted that punitive damages (penal damages) are not to be allowed except in certain circumstances which do not even concern letters of credit as there seems to be no case so far on the issue.¹⁶³

The UCP is silent upon the issue of punitive damages. This feature of silence could be construed as uncertainty in the UCP rules. For example, in the case of Decor by Nikkei International v. Nigeria¹⁶⁴, the district court relied on Section 1-106 of the New York UCC, under which the court found that punitive damages may be obtained for the common law cause of action for anticipatory repudiation of the letters of credit.¹⁶⁵ Although punitive damages did not stand in this case because the bank's breach was not proved to be malicious, the court's reliance on grounds other than the UCP is a clear example of the uncertainty caused due to its silence. Further, as far as the UCP is concerned, courts may rely on the international practice standard as to whether or not to allow punitive damages. In sum, the rules being silent on punitive damages could be construed as producing uncertainty since courts may refer to international practices as well as to other applicable laws under which such damages may be recognised.

Article 5 of the UCC is silent on the issue. However, Article 5 itself, section 5-

¹⁶³ See, Section One, (4.3.3.).

¹⁶⁴ *Decor by Nikkei International v. Nigeria* 497 F. Supp. at 911-912, aff'd, 647 F. 2d at 316.

¹⁶⁵ *Ibid* at 907.

102(3), provides the possibility of reliance on other applicable law. Further, reliance on law other than the UCC is also guaranteed by virtue of section 1-103 of the UCC.¹⁶⁶ Yet, this right to rely on other applicable law given by Section 1-103 should be read in conjunction with section 1-106 which disallows either consequential and penal damages except as specifically provided in this act or by other rules of law.¹⁶⁷ It can be understood from this section that it goes in line with the common law in which punitive damages are not generally allowed except in some special cases as provided in section 106 or other applicable law. To this point, one could argue that the UCC rules are certain on the issue.

Having said that the UCC generally disallows punitive damages, in the USA, some cases have shown that a breach of contract which involves a serious harm resulting from either (1) conduct that independently establishes a tort or¹⁶⁸ (2) fraud, malice, or gross negligence might justify the imposition of punitive damages.¹⁶⁹ Punitive damages are of course not available for mere breach of contract, since there is no public right involved. So, only where the wrong complained of is either considered morally culpable or is actuated by evil and reprehensible motives, these kind of

¹⁶⁶ Section 1-103 of the UCC which reads in part: "Unless displaced by the particular provisions of this Act [the UCC], the principles of law and equity, including the law merchant and the law relative to the capacity to contract, principal and agent, estoppel, *fraud, misrepresentaion*, duress, coercion, mistake, Bankruptcy, or other validating or invalidating cause shall supplement its provisions". [emphasis added].

¹⁶⁷ Section 1-106 reads: "(1) The remedies provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed but neither consequential nor penal damages may be had except as specifically provided in this Act *or by other rule of law*". [emphasis added].

¹⁶⁸ Arzt, believes that tortious acts committed by a bank against the beneficiary could be in cases where the applicant becomes insolvent after the letter of credit is issued but before the beneficiary's draft is honoured. See Arzt, *supra* note 41, p. 47. Moreover, the beneficiary may have a tort claim against an issuing bank where the bank places the interests of its customer ahead of the bank's duty to the beneficiary by not honouring the credit for other personal reasons suggested by the applicant, Arzt, *supra* note 41, p. 51. To the same effect, Sarna., believes that the fact that a paying bank pays with deemed knowledge of fraud may be constitute negligence. Sarna, L., *Letters of Credit: The Law and the Current Practice* 3rd ed (Toronto: Carswell, 1989) pp 5-25.

¹⁶⁹ See *J.Yanan & Assoc., Inc. v. Integrity Inc. Co.*, 771 F.2d 1025, 1033 (7th Cir. 1985) (Indiana); *Cuson v. Maryland Cas. Co.*, 735 F.Supp. 966, 970 (D. Hawaii 1990).

damages would be awarded¹⁷⁰. In practice, there are hardly any cases in which punitive damages are granted in relation to letters of credit and, thus, it cannot be claimed that certainty is affected.

2.2.2. Party Autonomy in Relation to the Three Options Concerning Punitive Damages

Party autonomy is compromised by fixed rules. This is true even in the case of option (ii), punitive damages awarded in some cases. Having said that punitive damages may be awarded in some certain cases, this would produce a different rule but it would still be considered as fixed—no punitive damages except in this special case. This still restricts party autonomy. Party autonomy is preserved only if punitive damages are always awarded where the parties have so agreed.

2.2.3. Fairness in Relation to the Three Options Concerning Punitive Damages

2.2.3.1. Fairness as to Application

In relation to option (i), punitive damages never awarded; from the point of view of fairness, it seems to be in line with the following considerations. In accordance with the distributive theory, it is felt that the availability of punitive damages would be unfair to the wrongful party as there is no general principle that suggests that there can be punitive damages imposed on him in case of breach of contract. Moreover, such damages are (by definition) beyond the level of compensation and are unfair as a result. i. e. the outcome of the contract would be severely distorted in favour of one party against the other. As to the second option, punitive damages awarded in some cases; adopting this option may preserve fairness. Having said that punitive damages are generally unfair, this option could provide fairness so far as the innocent (aggrieved) party is concerned and, as suggested by some

¹⁷⁰ *Walker v. Sheldon*, 10 N.Y.2d 401, 404, 223 N.Y.S.2d 488 (1961).

American authorities, only upon the occurrence of one of the following:

- where the bank acts in bad faith (where the bank acts fraudulently or maliciously); or
- where the bank acts with gross negligence. The importance of this category is that, on the one hand, it would enhance sanctity of contract, since parties would act diligently thus assuring the fulfilment of legal obligations. On the other hand, it would bring fairness to the aggrieved party against whom the grossly negligent acts have been practised.¹⁷¹

Although the general rule suggests that punitive damages are not to be awarded since damages are meant to compensate the innocent party, not to punish the contract-breacher, it is appropriate to award such damages, in exceptionally restricted cases. In comparison between option (i) and option (iii) it seems that option (i) is more in line with the consideration of fairness, and thus, it is better. Now, when compared with the better of these two extremes, option (ii) seems to be better than option (i) and, thus, is considered the best of all.

Having justified the award of punitive damages, which are not generally awarded for breach of contract committed by the issuing bank, it is not to suggest they may be awarded where the customer deliberately and wrongfully withholds payment. Punitive damages should not be extended to the reimbursement contract because this arrangement is a normal contract and should be governed by the normal contract law rules which are already said to prohibit such damages. The main concern is, however, with the letter of credit arrangement which has a special character. If the seller is not protected, then international trade will be disturbed.

As to the third option, where punitive damages are always awarded, it is

¹⁷¹ See, Section One, (2.2).

considered as unfair according to the distributive theory, because such damages go beyond the level of compensation to reach the level of punishment. If they are to be awarded all the time, this would result in gross unfairness because they cause unjust enrichment.

2.2.3.2. Fairness as to Rule

Having dealt with fairness of each option, it can be said that English law is in line with considerations of fairness. Likewise, Article 5 of the UCC can be said to be in favour of fairness since Section 106 makes it clear that penal damages are not to be awarded except as specifically provided in this act or by other rules of law. Thus, it may be argued that the UCC is in line with fairness. So far as American case law is concerned, since some courts are of the view that punitive damages may be awarded in certain circumstances, this would be against fairness, at least to the wrongful party, for the reasons given above in the chapter. According to the distributive theory, the aggrieved party will be over-compensated whilst the guilty party will be significantly punished. However, it may be seen as fair, from the aggrieved party's point of view, because of the huge amount of losses suffered. By contrast, the UCP rules, as they are silent on the issue, may be regarded as not favouring the consideration of fairness. In other words, the rules being silent on punitive damages could be construed as producing unfairness since courts may refer to international practices as well as to other applicable laws under which such damages may be recognised.

2.2.4. Flexibility in Relation to the Three Options Concerning Punitive Damages

2.2.4.1. Flexibility as to Application

In relation to option one, punitive damages never awarded; it is not considered as flexible at all, because the legal doctrine is rigid. As to option two, punitive damages awarded in some cases; it is also not flexible because, first, the option

itself is understood to be a fixed rule and a fixed rule (by definition) cannot be flexible. Secondly, punitive damages are still awarded only where the case falls within the confines of a prescribed category of wrongs. With regard to option three, punitive damages always awarded; it is not flexible at all because it does not take into account the intention of the parties. Again, this option can be seen as inflexible as it does not allow any scope for the parties to agree to the contrary.

2.2.4.2. Flexibility as to Rule

With regard to the flexibility of law, in relation to punitive damages, it can also be said that English law is inflexible i.e. rigid. The law, in order to be flexible, has to initially be less rigid as well as modifiable and adjustable. In other words, the law in order to be flexible, should assume more than one form. Since the UCP is silent upon the issue, it may be regarded as flexible because courts may refer to another applicable law whereby such damages may be recognised. In other words, there may be room for more than one position. So far as the UCC is concerned, and having examined its position in relation to such damages above, it may be stated that the UCC is flexible. This is because although section 106 prohibits the award of such damages, the section itself allows for a narrow exception whereby such damages may be awarded. This may be regarded as flexible since there is more than one option. Moreover, where some courts in the USA are in the view of awarding punitive damages in specific circumstances, this would demonstrate a more flexible approach in the law.

2.2.5. What Should the Rule Be in Relation to Punitive Damages?

As a matter of general principle, what position should the law take with regard to the availability of punitive damages? Also, what answer can be given to question (i) should the law ever allow punitive damages?

Having examined the position of punitive damages under the laws governing letters of credit, and having illustrated how does each option interacts with the five basic

principles, the answer will be reserved to the Concluding Chapter in which a proposal for reform will be made.

3. The Independency Principle and the Fraud Exception: Fraud by the Seller in Relation to the Performance of the Underlying Sale Contract

Respecting the spirit of the independency principle, it is clear that an irrevocable credit is an independent contract between the issuing banker and the seller. It operates at a distance from the terms of the contract of sale, made between the buyer and the seller. As explained earlier in this Chapter, there are four situations in which letters of credit may be dishonoured by the bank. The fraud exception (Section 5.1) is the most important and the most controversial one, since statutes and case law are unclear about when the independence rule stops and the fraud defence starts.

3.1. The Position of Fraud in Laws

Provisions in the UCP are unhelpful in answering the question of whether the bank can refuse to pay against conforming documents when there is an underlying fraud. If the letter of credit is issued subject to the UCP rules, the issue of fraud puts courts in real difficulty in finding the applicable law, since the UCP rules are silent upon the issue. Under Section 5-114 of the UCC, in the event of an allegation of fraud by the account party, it gives the issuer the option to dishonour the demand for payment, provided that the issuer acts in good faith.

A narrow approach is adopted by the British courts in determining whether or not the fraud exception should be limited or expanded. Fraud is a defence for non-payment only where the bank has positive proof that fraud has been committed *and* that the beneficiary knew of this fraud. Thus, English law treats fraud in the underlying contract in the light of the narrow limitation to apply the fraud

exception.¹⁷²

3.2. Conflict of Certainty and “Good Faith and Fairness” in Relation to Fraud in the Underlying Sale Arrangement.

3.2.1. Certainty of Law in Relation to Fraud

The position of the UCP in relation to the question of fraud is unhelpful due to its silence. This feature of silence could be construed as uncertainty. So far as the UCC is concerned, although the related Section 5-114(1) mentions the phrase “fraud in the transaction”, it gives no clear guidance as to what constitutes fraud in the transaction.¹⁷³ This source of confusion could be construed as uncertainty. It is to be noted that in the Revised Article 5, the phrase “fraud in the transaction” has been eliminated. Thus, this potential source of confusion has been removed.¹⁷⁴ The position of English law in relation to fraud is certain because fraud is a defence for non-payment only where the bank has positive proof that fraud has been committed and that the beneficiary knew of this fraud.

3.2.2. Good Faith and Fairness in Relation to the Fraud Exception

In the interest of fairness, as demonstrated by the distributive theory, fraud in the transaction should affect payment under the credit arrangement. This is because if such fraud is not detected due to the adoption of the independency principle, gross unfairness will emerge against the innocent party i.e. the issuing bank. In other words, if fraud is not to affect payment under letters of credit, that would encourage sellers, acting in bad faith, not to fulfil their contractual obligations in

¹⁷² *Discount Records Ltd. v. Barclays Bank Ltd* [1975] 1 W.L.R. 315, discussed in Chapter Six, Section One, (1.2.2).

¹⁷³ See Chapter Six.

¹⁷⁴ See, Appendix C, UCC – 5-109; Appendix D, Section (10).

which case the interests of other party to a contract is unfairly affected. It is to be noticed here that fairness, in its substantive meaning, is used to describe fraud in relation to the underlying contract. However, it is felt that fairness in relation to fraud in the tender documents, on the part of the beneficiary, is concerned with procedural fairness. This is because it is related to the way in which the beneficiary has presented his documents. The question of good faith on the part of the beneficiary is therefore, concerned with good faith in its subjective sense.

3.2.3. Striking the Balance

As shown in table 2, in the interests of certainty, a mere allegation of fraud in the underlying sale transaction should not be allowed as a defence to the bank to reject payment to the beneficiary. Quite simply, this is to ensure that the law should not encourage the bank to look for reasons to dishonour the letter of credit arrangement. As has been obvious throughout this research, certainty is one of the most fundamental principles that form the characteristics of letters of credit as a special commercial device. It is submitted that the independence of the credit is an important feature of certainty. If the independency principle is to be applied unconditionally, fairness in the credit transactions, such as evident within the distributive theory, may be jeopardised. So, in order to keep a balance between both certainty and fairness, the fraud exception has come into existence. Fraud in the underlying sale transaction should be allowed as a defence for a bank's refusal to pay to the beneficiary where the beneficiary has knowledge of fraud and thus acts in bad faith. To acknowledge the fraud exception is to overlook the independency principle, but to support the notion of good faith. Both good faith and the independency principles are important basic principles in the law of letters of credit. Hence, the exceptions to the independency principles need to be applied carefully. What is vital here is to distinguish between three levels of belief and knowledge. First, mere allegation of fraud; secondly, actual knowledge of fraud;

and thirdly, reasonable ground for suspecting fraud. The law governing letters of credit does not adopt the first position; mere allegation of fraud, but insists on the second position; actual knowledge in order to enhance certainty. In between these two positions, there is the third approach. A full discussion of this third approach, alongside with the other approaches, will be reserved to the Concluding Chapter, in which a proposal for reform will be made.

4. Fraud by a Third Party, Acting for the Seller, in Relation to the Performance of the Underlying Sale Contract

Although the fraud exception has become well established in letters of credit transactions, it is still controversial as to where to allocate consequential loss in situations of third party fraud, which are unknown to the beneficiary. Some commentators argue that the beneficiary must shoulder the loss.¹⁷⁵ The banker is not in a position to determine whether the beneficiary took cognisance of the fraud or not.

4.1. Position of Fraud by a Third Party in Law

Both of the UCP and the UCC rules are silent upon the issue of fraud committed by a third party. In contrast to this, under English Law, in United City Merchants (Investments) v. Royal Bank of Canada¹⁷⁶, the House of Lords ruled that in circumstances of fraud committed by a third party, which do not render a document a nullity, the inaccuracy in the tendered document cannot be taken against an innocent beneficiary. Yet, the beneficiary is answerable for fraud committed by a third party of which the beneficiary took cognisance whatever the magnitude of the fraud. The responsibility of the beneficiary under a credit is confined to placing the merchandise on board a ship or any other mode of

¹⁷⁵ See Smith, G.W.L., 'Irrevocable Letters of Credit and Third Party Fraud' 24 *Va. J. Int'l Law* (1983) 55.

¹⁷⁶ *United City Merchants (Investments) Ltd. v Royal Bank of Canada, The American Accord* [1983] 1 AC 168, 169.

transport as the tenor of the credit prescribes. As a corollary to this, he should procure regular confirming transport documents, showing shipment of the goods and warranting that the goods are in accord with the terms and conditions of the underlying transaction. Hence, the beneficiary's responsibility could not be extended to the limit of monitoring the acts of independent contractors such as carriers or their agents. On the other hand, the role of the banker is not to undertake the role of the investigator. The bank's role is to undertake a reasonable construction of the documents without delay. Payment in situations of minor inaccuracy of a document, not attributable to fraud on the part of the beneficiary or his agents, is apt to establish certainty in letters of credit transactions rather than undermining their efficacy.¹⁷⁷

4.2. Conflict of Certainty and "Good Faith and Fairness" in Relation to Fraud by a Third Party

The issues which have arisen from discussing fraud by the seller in relation to the performance of the underlying sale contract in section 3.2.3., are found to exactly apply in the same way under this section.

5. The Doctrine of Strict Compliance

The principal reason why a bank will refuse to pay the beneficiary (and the main source of disputes between banks and beneficiaries) is because the documents are alleged not to comply with the particular letter of credit arrangement. This issue is fully discussed in Chapter Five.

¹⁷⁷ Adam, *supra* note 97, at 233.

Table 1: Evaluation of Punitive Damages in Light of the Basic Principles

Features	Punitive Damages
Certainty	<p>The UCP is silent upon the issue and thus, may be construed as uncertain unless the contrary is supported by the <i>international standard banking practice</i>.</p> <p>Article 5 of the UCC is also silent on the issue and may be regarded as uncertain.</p> <p>English law position is certain in relation to punitive damages as such damages are never awarded.</p>
Party Autonomy	<p>Since the rules concerning punitive damages are fixed rules, party autonomy is compromised by such fixed rules. Moreover, the fact that punitive damages may be awarded only in some certain circumstances does not fully respect party autonomy. After all, a fixed rule is a fixed rule.</p>
Good Faith and Fairness	<p>The availability of punitive damages is unfair to the wrongful party, as demonstrated by the distributive theory, as there is no general principle that there can be punitive damages imposed on him in case of breach of contract. However, punitive damages may be awarded in very limited cases</p>
Flexibility	<p>With regard to the flexibility of law, in relation to punitive damages, it can also be said that English law is inflexible i.e. rigid. The law, in order to be flexible, has to initially be less rigid as well as modifiable and adjustable. In other words, the law in order to be flexible, should assume more than one form. Since the UCP is silent upon the issue, it may be regarded as flexible because courts may refer to another applicable law whereby such damages may be recognised. In other words, there may be room for more than one position. So far as the UCC is concerned, and having examined its position in relation to such damages above, it may be stated that the UCC is flexible. This is because although section 106 prohibits the award of such damages, the section itself allows for a narrow exception whereby such damages may be awarded. This may be regarded as flexible since there is more than one option. Moreover, where some courts in the USA are in favour of awarding punitive damages in specific circumstances, this would demonstrate a more flexible approach in the law.</p>

Table 2: Conflict of Certainty, Party Autonomy and “Good Faith and Fairness” in Relation to Fraud in the Underlying Sale Arrangement and Fraud by a Third Party

Features	Fraud in the Transaction	Fraud by a Third Party
Certainty	The UCP is silent upon the issue. Unlike the UCP, the UCC allows the bank to either honour or dishonour provided the bank acts in good faith. Yet, as there is no clear guideline, the related section of the UCC may create uncertainty. The position of English law is certain as it follows the narrow approach in relation to fraud. It does not seem to be involved in fraud in the transaction issue.	Both of the UCP and the UCC are silent upon the issue. Conversely, English law provides that the beneficiary is not answerable for fraud committed by a third party provided that he has not taken cognisance of it.
Party Autonomy (Sanctity)	Fraud in the underlying sale transaction should not be allowed as a defence to the bank to reject payment to the beneficiary simply because the law should not encourage the bank to look for reasons to dishonour the letter of credit arrangement.	Fraud by a third party should not be allowed as a defence to the bank to reject payment to the beneficiary because the law should not encourage the bank to look for reasons to dishonour the letter of credit arrangement.
Good Faith and Fairness	Fraud in the underlying sale transaction, according to the distributive theory, should be allowed as a defence for a bank's refusal to pay to the beneficiary where the beneficiary has knowledge of fraud and thus acts in bad faith.	Fraud by a third party should be allowed as a defence for a bank's refusal to pay the beneficiary where he (beneficiary) has knowledge of fraud and thus acts in bad faith. This is more in line with the distributive theory.

Conclusion

In this Chapter, we have focused on disputes between the bank and the beneficiary. As we have said, such disputes most commonly turn on documentary compliance (or non-compliance) and this is such an important matter that we will reserve discussion of it until Chapter Five. Questions of compliance apart, the law needs to address several particular issues.

First, the law must determine the remedies to be available to a beneficiary whose draft or demand is wrongfully or dishonestly dishonoured by the bank. The common law generally favours compensatory awards of damages but some American authorities support the award of punitive damages where the bank has acted in bad faith or has been guilty of gross negligence. Whilst a strict rule against punitive damages has certainty on its side, it might be thought that limited availability of punitive damages would strengthen confidence in letters of credit and respond to cases of manifest unfairness between the parties.

Secondly, the law must decide whether a bank is to have a defence against non-payment based on fraud in the underlying sale transaction. In general, the independence principle preserves certainty by separating the sale contract from the credit contracts. However, the common law recognises a very narrow fraud exception. Fraud, in order to be effective, has to be done by the beneficiary (with his knowledge) and it has to be established.

Third, the law must decide whether the bank has a right of recourse against the seller. In general, the bank's right of recourse is not definite and varies from one governing law to another. For instance, the UCP is silent upon the issue, which may be construed as a sign of uncertainty. Nonetheless, the issuing bank, under the law of negotiable instruments, may have the right of recourse against the seller if the draft is dishonoured by the drawee (the buyer). Further, the issuing bank may recover, under common law, the amount paid to the seller if the tender was

affected with fraud or if there has been a mistake from the banker's side in accepting the documents.¹⁷⁸ Finally, under the UCC rules the issuing bank may recover payment by virtue of the warranty duty that is imposed on sellers. None of these governing legal regimes have a firm standing on the issue and thus, the indecisiveness of legal position could be construed as uncertainty.

Fourth, the law seems to be certain on whether a holder of seller's draft has a right of recourse against the issuing bank. Those holders have no right of recourse against the issuing bank if the draft is drawn under a straight credit. However, they do have such right against the issuing bank under a negotiable credit.

¹⁷⁸ See the authority cited in *supra* note 125.

Chapter Five: The Doctrine of Strict Compliance

Chapter Five: The Doctrine of Strict Compliance

Introduction

Documentary credits are the most effective method of financing export contracts, since they provide security to the parties to the agreement and their operation is relatively simple and quick. As spelt out from the name itself, documentary credits rely on the use of documents frequently involved in most export transactions, hence it is important to buyer, seller, and the bank involved, that the documents conform precisely to the buyer's instructions. This requirement is known as 'strict compliance'. Some studies have shown that, despite the importance of strict compliance, at least 90 percent of all letters of credits are refused on first presentation due to discrepancies in the documents tendered by the beneficiary.¹ The chapter will concentrate on issues surrounding the doctrine of strict compliance.

The chapter consists of two sections. Section one deals with the following doctrines, namely, (i) the doctrine of strict compliance (ii) the doctrine of substantial compliance and (iii) the doctrine of qualified strict compliance. Examination of each of these doctrines will be conducted according to English law, the UCP rules and Article 5 of the UCC.

Section two, deals with the differences between the three rival tests of compliance and the question of which of them provides maximum fairness, certainty, flexibility and good faith.

¹ Survey carried out in 1987 by the Letter of Credit Update, cited by Kozolchyk, B., 'Strict Compliance and the Reasonable Document Checker' 56 *Brooklyn Law Review* (1990) 45, at pp 47-48. For more statistical studies see Gallagher, S., 'Crisis and Opportunity' 111 *Global Trade* . No 3. March (1991) 34 at 36.

Section One: The Doctrine of Strict Compliance in the U.C.P. 1993 Revision

1. General Introduction to the UCP

The 1993 Revision (I.C.C. Brochure No. 500) of the Uniform Customs and Practice for Documentary Credits² came into force on 1 January 1994, substituting the 1983 Revision of the Code (I.C.C. Brochure No. 400). The success of the UCP and its universal status, in the present commercial world, are largely owed to the reforms introduced both as regards the substance and the form of its provisions in the course of the several revisions to which it has been subjected since its 1933 promulgation.³ Ellinger advocates that the latest revision is a step forward in the right direction. It may be fairly described as an innovative consolidation, which has clarified many of the points left in doubt under the 1983 Revision. Changes in the UCP 500 have affected both standby and commercial letters of credit. It has further tidied up the set of standard contract terms.⁴ It is, thereby, described as “the most successful harmonising measure in the history of international commerce”.⁵ However, bankers in the United Kingdom had not adopted the UCP rules until after the 1962 revision which came into force in 1963.⁶ Nonetheless, the UCP rules have no legal force within the UK, and cannot be applied unless the parties to the credit agree to their adoption, but they may also be applied from the previous course of dealings between the parties⁷. The major changes which the 1993 Revision of the UCP rules have made are summarised by Ellinger as follows⁸:

² Hereinafter the “UCP”.

³ Ellinger, E.P., ‘The Uniform Customs and Practice for Documentary Credits-The 1993 Revision’ *LMCLQ* (1994) 377 at 377.

⁴ *Ibid* at 382.

⁵ Goode, R., ‘The New ICC Uniform Rules for Demand Guarantees’ *LMCLQ* (1992) 190 at 190.

⁶ Ellinger, *supra* note 3 at 379.

⁷ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials*, 2nd ed (London, Butterworths, 1999) p 765.

⁸ Ellinger, E.P., *supra* note 3 at 382.

- “(i) the classification of documentary credits and the definition of the liabilities of the parties to them has been clarified to a considerable extent.
- (ii) the procedure respecting the rejection of non-conforming documents has been further clarified and more neatly defined. In this regard Arts 13 and 14 of the 1993 Revision have tidied up the provisions of Art. 16 of the 1983 Revision.
- (iii) the provisions respecting transport documents have been subjected to a far-reaching revision. Unlike the earlier revisions, the new U.C.P. cover in detail the different types of documents used in the transport of the goods by sea as well as the documents used for carriage by air and over land.
- (iv) the provisions respecting transferable credits have been revised and augmented with a view to facilitating the mechanism used in such transactions”.

2. The Doctrine of Strict Compliance

The meaning of the doctrine of strict compliance cannot be put more simply, in fact, the term is self explanatory: the documents which are to be tendered by the beneficiary of the credit must comply strictly to the terms of the credit. The doctrine applies to all contracts emerging from a documentary credit transaction⁹, however, the beneficiary/bank relationship will be the main focus of this chapter, in relation to strict compliance.

3. Discrepancy of Documents in Documentary Credit Transaction

According to Schmitthoff¹⁰, discrepancies of documents can be classified into two main groups, namely (i) irrelevant irregularities of documents and (ii) genuine discrepancies of documents.

3.1. Irrelevant Irregularities of Documents

Occasionally, upon tendering the documents, the bank may find that they are irregular as they are not in accordance with the terms and conditions of the credit, but nonetheless, the bank may be willing to overlook them. This irregularity can be sub-divided into three groups:

⁹ Goode, R., *Commercial Law*, 2nd ed, (Harmondsworth: Penguin, 1995) pp 992-3.

¹⁰ Schmitthoff, C.M., ‘Discrepancy of Documents in Letter of Credit Transactions’ *Journal of Business Law* (1987) 94 at 95.

3.1.1. Irregularities Irrelevant under the UCP

Since the credit is mostly operated under the U.C.P., the beneficiary can invoke the U.C.P. provisions regarding irregular documents. For instance, in a sale of a certain commodity, 100 tons was the required shipment according to the credit but 97 tons was shipped and this figure appeared in both the invoice and the bill of lading. Article 39(b) of the U.C.P. tolerates the undershipments where the credit does not require that there should not be a reduction in the quantity of goods as specified. In this situation, therefore, the bank is expected to accept such documents but in doing so, can decrease the sum due as required under the credit. In some cases, express prohibition on transshipment may appear on the credit. Notwithstanding this, Article 28(d) of the U.C.P. allows the bank to accept a road, rail or inland waterway transport document which indicates that transshipment will or may take place, provided that the entire carriage is covered by one and the same transport document and within the same mode of transport.

3.1.2. Irrelevant Variations in the Documents

Difficulties may arise on irregularities relating to commercial invoices. One of the requirements of the commercial invoice states that it must carry a specific classification [the description] of the goods as well as permit other tendered documents to be linked, some of which include those relating to transport, pre-shipment inspection, insurance. Under Article 37 (c) of the UCP, it is stated that: “the description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit”. Sometimes the literal descriptions of the goods in the credit are different from that in the invoice although there is no doubt that both documents are describing the same goods. This is supported in the decision of Glencore International AG v.

Bank of China¹¹. It was held by the Court of Appeal that a packing list need not include a detailed description of the goods.¹² Their Lordships were of the view that:

“The description of the goods in the commercial invoice did in our view correspond with the description in the credit so as to satisfy art. 37(c) of the UCP 500... In the present case we do not consider the additional information in the commercial invoice to be detrimental to or in any way inconsistent with the requirement in the credit and in our view it is acceptable”.¹³

In other words, the requirement of literal compliance is equally unessential in the description of the goods even in the commercial invoice.¹⁴

An example provided by Schmitthoff,¹⁵ which demonstrates such an irregularity, is where a credit may indicate that it requires a “20 cm pipe cutting machinery”, whereas the invoice reports “two 20 cm pipe-cutting machines”. He contends: “In my view, the bank should accept the invoice in spite of the slight irregularity. On the other hand, if the credit refers to ‘two machines’ but the invoice specifies only ‘machinery,’ the bank should reject the documents because ‘machinery’ may cover only one machine”. Schmitthoff¹⁶ therefore, maintains that:

“If the tendered documents are ambiguous, the tender is, in practice, a bad tender. But the bank, when examining the tendered documents, should not insist on the rigid and meticulous fulfilment of the precise wording in all cases. If, ‘properly read and understood,’ the words in the instructions and in the tendered documents have the same meaning, if they correspond though not being identical, the bank should not reject the

¹¹ *Glencore International AG v. Bank of China* [1996] 1 Lloyd’s Rep. 135. As to what constitute part of the description, see *Astro Exito Navegacion SA v Chase Manhattan Bank* [1986] 1 Lloyd’s Rep 455, affd [1988] 2 Lloyd’s Rep 217. See as regards an earlier article in point, in the 1962 version: *Courtaulds North America v North Carolina National Bank* 528 F 2d 802 (1975).

¹² *Glencore International AG v. Bank of China* [1996] 1 Lloyd’s Rep. 135, at 155.

¹³ *Ibid* at 154.

¹⁴ In that case the documentary credit provided, inter alia: “Origin: Any Western Brand”. The invoice tendered in due course described the origin of the goods shipped as “Any Western Brand – Indonesia (Inalum Brand)”. The issuing bank argued that, as the words used in the invoice departed from the plain language of the letter of credit, the invoice was a bad tender. Reversing Rix J’s decision on this specific point, the Court of Appeal rejected this argument. In the words of Bingham MR: “It seems to us quite the precise brand of the goods, it being implicit that the brand fell within the broad generic description that was all that was required. The additional words could not, on any possible reading of the documents, have been intended to indicate that the goods did not fall within the description ‘Any Western Brand’.” [1966] 1 Lloyd’s Rep, at 154.

¹⁵ Schmitthoff, C.M., *supra* note 10 at 97.

¹⁶ Schmitthoff, C.M., *Schmitthoff’s Export Trade: The Law & Practice of International Trade*. 9th ed., (London: Stevens, 1990) p 411.

documents. It was said in an Opinion of the Banking Commission of the ICC that 'banks could not act like robots, but had to check each case individually and use their judgement'. But the margin allowed to the bank in interpreting the documents is very narrow and the bank will be at risk if it does not insist on strict compliance".

Occasionally, it is provided that some of the instructions stipulated within credits, prove impossible to achieve and amount to nothing less than nonsense. Schmitthoff¹⁷ states that great care must be taken by the bank in these cases. Although the case of Gill & Duffus S A v. Berger & Co Inc.¹⁸, as offered by Schmitthoff by way of example, did not directly relate to a documentary credit, it was suggested that difficulties would have developed, in the event of the parties considering that specific method of payment. This case involved the sale of Argentine bolita beans, via an ordinary c.i.f. contract, where it had formerly been agreed that payment would be made using the method of net cash, upon presentation of the documents via the Bank in question. However, a condition as stipulated by the contract, was that the documents up for tender were to be accompanied by a certificate, which had to be presented by GSC¹⁹, and which described its quality at port, at the time it had been discharged. It proved impossible to provide such a certificate which had to be given at discharge, under the c.i.f. contract. In response to this, Lord Diplock was in agreement that:

"... a certificate by GSC as to the quality of the goods at port of discharge under the certification clause in the contract is not, and is indeed incapable of being, included among shipping documents which a seller is required to tender to his buyer in return for payment of the price under a contract of sale in ordinary c.i.f. terms."²⁰

Where it was evident that the bank's mandate for a letter of credit should contain such a stipulation, the bank should warn the buyer (the applicant for the credit) immediately that the instructions are unattainable and that amendment is needed.²¹ Therefore, as seen in this case, since these stipulated documents could never be

¹⁷ Schmitthoff, C.M., supra note 10 at 97.

¹⁸ *Gill & Duffus S.A v. Berger & Co. Inc.* (No. 2) [1948] A.C. 382.

¹⁹ General Superintendence Co. Ltd.

²⁰ *Gill & Duffus S.A v. Berger & Co. Inc.* (No. 2) [1948] A.C. 382 at 389.

²¹ On ambiguous instructions to open letters of credit, see *Schmitthoff's Export Trade: The Law & Practice of International Trade* 9th ed (Stevens & Sons, London, 1990), p. 409-410.

tendered, it was recommended that the bank took action at the start rather than initially staying quiet and then afterwards refusing such documents.

3.1.3. Irregularities that are Treated as Irrelevant According to Court Decisions

It is apparent that there are situations where the courts appear to dismiss particular irregularities, for the purpose of compliance, despite the fact that there may be some documents which are significantly irregular in nature. The case of Golodetz & Co Inc. v. Czarnikow-Rionda Co Inc.²², gives a classic example. The sale of sugar from Kandia in India to Iran was concerned in this case, where the sale contract was based on the terms c. and f. an Iranian port. The sellers entered into a supply contract with the State Corporation of India Ltd (STC) to buy in a certain quantity of sugar, to fulfil the supply of the initial sales contract. The supply contract was f.o.b. an Indian port, payment by letter of credit. The letter of credit was opened in favour of STC, by the buyers in the supply contract (sellers in the Iranian contract). As a result of a fire on board, during the process of loading, a significant quantity of sugar, was lost. The following message was observed within the bill of lading after the damaged cargo of sugar had been released:

“Cargo covered by this bill of lading has been discharged Kandia view damaged by fire and/or water used to extinguish for which general average declared.”

The confirming bank, The Chase Manhattan Bank NA, in view of the above note on the bill of lading, refused to accept the bill on the ground that it was a claused bill. The Court of Appeal held that as the note on the bill had referred to an event which had occurred following loading of the goods, and which had been [before loading] at that time, of satisfactory condition, it was to be considered as being correct. According to the court, the legal view was perceived as being more favourable to the commercial perspective, and therefore, a bill would not automatically be deemed as a claused bill where it was found to include either a notation or clausing. According to Schmitthoff, the reason for this preference was

²² *Golodetz & Co Inc. v Czarnikow-Rionda Co Inc.* [1980] 1 W.L.R. 495.

that whereas when using the commercial view, the documents would be simply rejected for the reason that they were out of the ordinary, when utilising the legal test, however, the banks would be required to investigate whether the discrepancy was both genuinely legal and relevant.²³

Another classic example is where a bill of lading is found to comprise of statements which are classed as contradictory upon presentation. This is illustrated by the Privy Council decision in Westpac Banking Corporation v. South Carolina National Bank²⁴. The case was initially an appeal from the Court of Appeal in New South Wales. The National Railway Utilisation Corporation of South Carolina bought some truck side frames from an Australian steel company. The South Carolina National Bank (SCNB, the respondents) was appointed to open an irrevocable letter of credit in the sellers' favour. The availability of the letter of credit was dependent upon delivery of 'shipped' bills of lading. The credit was subjected to the UCP (1974 Revision), 'except so far as otherwise expressly stated.' Westpac Banking Corporation, who were the first appellants, advised the sellers of the credit. As well as the bills of lading, which were presented for consultation to Westpac by the sellers, comprising of the phrase 'received for shipment', it also included another statement, asserting that the goods were to be 'Shipped on Board Freight Prepaid'. No objection was made by Westpac to the bills of lading and they negotiated a bill of exchange drawn on the issuing bank (SCNB). However, the issuing bank rejected the bills of lading on the ground that they bore notations which were not signed or initialled and dated, contrary to what is now Article 29(b) of the 1993 Revision of the UCP. In both the Court of Appeal and the Privy Council, the argument which established that the bills of lading were 'received for shipment' bills and which were also not notated adequately, was distinctly rejected by the SCNB²⁵. They chose to rely solely on the assertion that

²³ Schmitthoff, C.M., *supra* note 10 at 99.

²⁴ *Westpac Banking Corporation v South Carolina National Bank* [1986] 1 Lloyd's Rep. 311.

²⁵ *Westpac Banking Corporation v South Carolina National Bank* [1986] 1 Lloyd's Rep. 311 at 315. On

the documents comprised of underlying statements which were inconsistent, which became apparent when they stated in their tenor that they were 'received for shipment' and 'shipped on board' bills. Their argument was accepted by the Court of Appeal, but received no credit from the Privy Council. Lord Goff could not find any inconsistency in these bills of lading. His Lordship said:

"True, this bill of lading was, in form, a "received for shipment" bill; but with the words "Shipped on Board" forming part of the stencilled wording inserted in the bill and present at the time of its signature and issue. It was plain on the face of the bill that the goods had at that time been shipped on board the intended ship, Columbus America."²⁶

Following the ruling, his Lordship demonstrated his approval with Westpac for accepting the bills of lading, in contrast to the response of SCNB, who in rejecting the bill, had been seen to have acted inappropriately.

In examining the outcome of these two cases, one aspect that the banks can take away for future reference, whilst they are dealing with irregular documents, is that it is more preferable if the legal test is applied rather than the commercial test. That is to say, banks should not too readily discard any documents, based on the simple fact that they are unusual, but are strongly advised to initially establish whether there is a genuine discrepancy relevant in the legal sense.²⁷ A further example to illustrate irrelevant irregularities can be seen in the case of Equitable Trust Co. of New York v. Dawson Partners Ltd.²⁸ The argument in that case was that a certificate of quality had been countersigned by the "Handelsvereniging te Batavia" (which means "Chamber of Commerce" of Batavia in Dutch) and not as stipulated, by the "Chamber of Commerce" of Batavia. Relying on the evidence, Bateson J. held that the two bodies were known to be the same and thus, the departure was not considered a discrepancy. The decision was affirmed by the

notation, Schmitthoff, C.M., supra note 10 at 100.

²⁶ *Westpac Banking Corporation v South Carolina National Bank* [1986] 1 Lloyd's Rep. 311, 316.

²⁷ Schmitthoff, C.M., supra note 10 at 99.

²⁸ *Equitable Trust Co. of New York v Dawson Partners Ltd* (1927) 27 Ll.L.R. 49. For another American authority treating a patent error as irrelevant, see *Vew Braunfels National Bank v Okorne*, 780 SW2d 313 (Tex App 1989).

Court of Appeal²⁹ and although the House of Lords³⁰ reversed judgment on other grounds, this specific finding was left undisturbed. If, simply by describing the certifying body in Dutch rather than in English makes the certificate defective, the transaction will be absurdly frustrated on the ground of a meaningless technicality. The Supreme Court of Hong Kong in Hing Yip Fat Co. Ltd. v. Daiwa Bank Ltd.³¹ also came to the conclusion that a minor typographical mistake could not be classed as a discrepancy. The applicant for the credit was described as “Cheergoal Industries Ltd.” but the drawing substituted “*Industries*” for “*Industrial*”. If a situation arose where a document contained a name which appeared to vary in the way it was presented, Kaplan J. believed that this could constitute an obvious typographical mistake. This judgment of classifying such an error as minor in nature, was based on the notion that such a mistake was “the sort of mistake that could easily occur in a society where English is not the first language of 98 per cent. of the population”.³² As the issuing bank already knew that the errors were simply an oversight as well as the fact that these errors were also evident in communications between the parties, in relation to the credit, this was also relied upon by the judge in his judgment.

4. Genuine Discrepancies of Documents

There are two major situations, one relevant under the UCP, and the other concerning linkage of documents, where genuine discrepancies are often an issue. However, in cases where genuine discrepancies are an issue, but are not confined to these two situations, they will also be discussed under this section as well.

²⁹ (1926) 25 Ll.L.R. 90, 92-95, per Bankes L.J. affg. (1926) 24 Ll.L.R. 261, at 265.

³⁰ See, in particular, (1927) 27 Ll.L.R. at 51 (Viscount Cave, LC) and 54 (Viscount Sumner).

³¹ *Hing Yip Fat Co. Ltd. v. Daiwa Bank Ltd* [1991] 2 H.K.L.R. 35.

³² Per Kaplan J., Cited in *Benjamin's Sale of Goods*, Fifth edition. (Edited by A.G. Guest) (Sweet & Maxwell, London, 1997) at § 23-180 p. 1749.

4.1. Discrepancies Relevant under the UCP

If the UCP is incorporated, it is a must that the tendered documents meet the conditions laid down in it. According to Schmitthoff, in order to achieve this, the banker is expected to refer to the UCP on a regular basis³³. As most of the stipulations of the UCP are made based on them being complied with, unless the credit states the contrary, the banker is advised to refer back to the mandate, should any unusual incidents surface from the documents. This should be done to establish whether it covers any practice which is deemed as deviating from the usual. If the mandate does not appear to offer protection for any such practice which deviates from the norm, it is then expected that the banker would refer directly to the provisions of the UCP, in order to determine if the documents are compliant with the terms of the credit.

If the credit requires 'shipped on board' bills of lading and the tendered documents are only 'received for shipment' bills, then that is a clear and gross discrepancy. Indeed, by a notation, a 'received for shipment' bill can be converted into an 'on board' bill, but straight compliance to Article 29(b)(ii) of the UCP is required. The date of the notation is highly significant in situations where the credit contains a provision stipulating the time when the goods are to be shipped, as this will most definitely result in the refusal of such documents.³⁴

4.2. Linkage of Documents

It is submitted that the courts have not played a part in inventing the requirement of linkage with regards to documentary credits, and in fact, it originated from Article 13(a) of the UCP. In simple language, "linkage means that the documents must make it plain and clear that they all refer to the same goods".³⁵ Identification

³³ Schmitthoff, C.M., supra note 10 at 100.

³⁴ Ellinger, E.P., supra note 3 at 389.

³⁵ Schmitthoff, C.M., supra note 10 at 101; *Elder Dempster Lines Ltd. v Ionic Shipping Agency Inc.* [1968] 1 Lloyd's Rep 529, 535-536. Some American cases construe the credit so as to uphold the transaction: *Venizelos SA v Chase Manhattan Bank*, 425 F.2d 461 (1970); *CNA Mortgage Investors*

of the goods is the main object in the description, so other than the commercial invoice, the goods need not be described with particularity in the documents. Nevertheless, it is not a requirement that the documents themselves are linked together by either reference numbers or otherwise. An example to demonstrate how an ambiguity may arise, is apparent where if certain documents describe other goods, the tender is regarded as defective. It follows, that the bank is obliged to refuse acceptance of the documents or alternatively acceptance of them is dependent upon there being in place, some form of 'protective mechanism'³⁶. In the recent Seaconsar Far East Ltd v. Bank Markazi Jomhuri Islami Iran³⁷ case, mentioned in section 6.1.1., it has been clarified that the requirement of linkage has to be requested by the credit. It is therefore, not open to the beneficiary, who presents non-conforming documents, to argue that a non-conforming document may be cured by another. Lloyd L.J. stated:

"Mr. Clarke [for the beneficiary] ...argues that the discrepancy, even if cannot be regarded as trivial, can be cured by reference to the other documents, such as the certificate of inspection and the certificate of quality, with which it is clearly linked. Again he relies on a sentence of Parker J. in the *Banque de l'Indochine* case where he said³⁸:

'I have no doubt that so long as the documents can be plainly seen to be linked with each other, are not inconsistent with each other or with the terms of the credit, do not call for inquiry and between them state all that is required in the credit, the beneficiary is entitled to be paid.'

But in that case Parker J. was dealing with an argument that the tender was bad because some of the documents could not be linked with each other. He was saying that a deficiency in one document could be cured by reference to another. It was held by the Court of Appeal that linkage, as such, was not necessary provided each of the documents referred unequivocally to the goods. Here, by contrast, there is an express requirement that the documents should be linked in the sense that each of them should contain the letter of credit number and the name of Bank Markazi's principal. Whatever the reason

Ltd. v Hamilton National Bank, 540 SW 2d 238 (Tenn. 1975); *West Virginia Housing Development Fund v Sroka*, 415 F.Supp. 1107 (1976) (which also emphasises that the credit needs to be construed contra proferentem); *Bank of North Carolina v Rock Island Bank*, 570 F.2d 202 (1978). But it is be noted that only in exceptional circumstances a court may imply a term into a bank's irrevocable undertaking: *Cauxell Ltd. v Lloyd's Bank plc*, *The Times*, December 26, 1995.

³⁶ The case of *Banque de l'Indochine et de Suez SA v. JH Rayner (Mincing Lane) Ltd* [1982] 2 Lloyd's Rep. 476, [1983] Q.B. 711, illustrates the strictness of the requirement of linkage. For more detail see Schmitthoff, C.M., *Schmitthoff's Export Trade: The Law & Practice of International Trade* pp 415-416.

³⁷ *Seaconsar Far East Ltd v. Bank Markazi Jomhuri Islami Iran* [1993] 1 Lloyd's Rep. 236.

³⁸ *Banque de l'Indochine* [1982] 2 Lloyd's Rep. 476, [1983] 1 All.E.R. 468.

for this, the requirement is clear. I do not see how Bank Melli could ignore that requirement. It may be that the proces verbal in fact related to the same goods, and that one can see this by inference from the other documents. But the absence of the letter of credit number and the name of Bank Markazi's principal on the proces verbal called for some explanation. The bank was therefore entitled to reject."³⁹

4.3. Other Relevant Discrepancies

There have been many other cases in which genuine discrepancies of the documents were an issue. Soproma SpA v. Marine & Animal By-Products Corporation⁴⁰ is an example of a well known case where the sale was related to Chilean fish full meal. It was a requirement, under the credit, that a 'freight prepaid' bill, in addition to an analysis certificate, was to certify that there should be a minimum protein content of 67 per cent. Nonetheless, upon tendering such required documents, the bank rejected them on the grounds that they were defective. Whether the rejection was justified was never an issue, in this case it turned on another point. In this case, the seller made a second tender of correct documents directly to the buyers after the expiration of the credit. The issue which then arose for the court to determine and which was later rejected, was subsequent to an agreement being made to make payment by letter of credit, whether it would be justifiable for a direct tender being made to the buyer.⁴¹ A similar situation arose in Shamsher Jute Mills Ltd v. Sethia Ltd⁴², where Bingham J. was of the view that those sellers, who were not able to or incapable of presenting correct documents, should not be allowed to claim from the buyer, the amount of the goods which had failed to reach him, even though payment under letter of credit is usually assumed to be a conditional payment.⁴³

³⁹ *Seaconsar Far East Ltd v. Bank Markazi Jomhuri Islami Iran* [1993] 1 Lloyd's Rep. 236, [1993] 1 Lloyd's Rep. 236, 240 (col.1).

⁴⁰ *Soproma SpA v Marine & Animal By-Products Corporation* [1966] 1 Lloyd's Rep. 367.

⁴¹ *Soproma SpA v Marine & Animal By-Products Corporation* [1966] 1 Lloyd's Rep. 367, at 386 (per McNair, J.). Cf *Sale Continuation Ltd v Austin Taylor & Co Ltd* [1967] 2 Lloyd's Rep 403. In exceptional circumstances a direct tender is admissible.

⁴² *Shamsher Jute Mills Ltd v. Sethia Ltd* [1987] 1 Lloyd's Rep. 388.

⁴³ *Ibid* at 391-92 See Chapter Seven about conditional and absolute payment.

In Panchaud Freres SA v. Etablissement General Grain Co⁴⁴, although it was apparent that the issue of the buyer and the seller's relationship was the main focus, the case also raises interesting questions related to documentary credits. It is obvious that both the bill of lading and the certificate of loading are in conflict with each other. This is apparent where, upon accepting two documents which stipulate that shipment is expected to take place in June/July, the advising bank finds that the bill of lading is dated for July 31st whereas the certificate of loading, which is issued by the port superintendent, indicates that loading actually occurred between the 10th and 12th of August. This is clearly an excellent example illustrating that genuine discrepancies have occurred in relation to tendered documents and the bank is thus, under a duty not to honour them.⁴⁵

5. Possible Response of Banks to Non-Conforming Documents⁴⁶

It is a common situation where the tendered documents may be found to be noncomplying by a confirming bank, but the beneficiary takes the view that they do conform. There are several possible responses that the bank may take in an attempt to reach a compromise with the beneficiary. The bank may either refuse to pay, pay under reserve or pay under indemnity. These responses are regarded as protective mechanisms which give the paying bank the full right of recourse against the wrongful beneficiary.

⁴⁴ *Panchaud Freres SA v. Etablissement General Grain Co* [1970] 1 Lloyd's Rep 53.

⁴⁵ *Ibid* at 57-58 per Denning L.J. See generally in this regard Schmitthoff, C.M., *supra* note 10 at 103.

⁴⁶ Hedley, W., *Bills of Exchanges and Bankers' Documentary Credits*. 3rd ed (Lloyd's of London Press Ltd, 1997) pp 313- 316; See Todd, P., *Bills of Lading & Bankers' Documentary Credits*. 3rd ed. (Lloyd's of London Press Ltd, 1998). pp. 224-25; See also, Forte, A.D.M., 'United Kingdom: "Payment Under Reserve"' 17 *Journal of World Trade Law* (1983) 355; Goode, R., *Commercial Law*, p. 663; Chiaw, L.C., 'Reflection on Payment Under Reserve: Waiver, Estoppel and Implied Term'. 2 *JIBL* (1988) 80 at 81; Jack, R., *Documentary Credits*, (Butterworths, London, 1993). at § 5-55 p. 102; Bennett, H., 'Documentary Credits: A Reasonable Time For What?'. *LMCLQ* (1992) 169; Also Arora, A., 'The Dilemma of an Issuing Bank: to Accept or Reject Documents Tendered Under a Letter of Credit'. *LMCL* (1984) p. 81; Day, D. M., *The Law of International Trade*. 2nd ed, Butterworths (1993 p 167; Schmitthoff, C.M., *supra* note 10 at 105.

5.1. Refuse Payment

The bank is no doubt, entitled to reject the documents, but then it takes the risk of being sued by the beneficiary. Moreover, it is suggested that any decision on the part of the bank, to reject a document, merely due to the presence of insignificant reservations, may prove detrimental to commercial efficacy.⁴⁷ Moreover, another consequence of such action, would almost certainly result in the beneficiary experiencing problems with the credit and thereby negatively affecting the strong relationship that he holds with the bank as well as potentially jeopardising his business reputation.⁴⁸ Nonetheless, the time within which the bank is to refuse payment is very important. As Lord Diplock pointed out in the case of Commercial Banking Co of Sydney v. Jalsard Pty⁴⁹:

“Both the issuing banker and his correspondent bank have to make quick decisions as to whether a document which has been tendered by the seller complies with the requirements of the credit at the risk of incurring liability to one or other of the parties to the transaction if the decision is wrong”.

To conclude, if banks do not react quickly, it may well amount to ratification of the documents and the banks may then lose their right of rejection.⁵⁰ The way in which the term ‘quickly’ is interpreted is dependent upon individual circumstances.⁵¹ However, according to the UCP⁵², banks are required to react within seven banking days.

⁴⁷ Todd, P., *Bills of Lading & Bankers' Documentary Credits* p. 224.

⁴⁸ Schmitthoff, C.M., *supra* note 10 at 105.

⁴⁹ *Commercial Banking Co of Sydney v. Jalsard Pty* [1973] AC 279, 286. See also UCP, Article 14, paras (b), (c), (d), and (e).

⁵⁰ See the following cases where rejection of the documents which took five days was held not to be within a “reasonable time”. *Bank Melli Iran v. Barclays Bank Ltd* [1951] 2 Lloyd's Rep 367; *Bankers Trust Co v. State Bank of India* [1991] 2 Lloyd's Rep. 443. However, these cases occurred before the emergence of the 1993 Revision of the UCP which allows seven working days for examination of the tendered documents.

⁵¹ Hedley, W., *Bills of Exchanges and Bankers' Documentary Credits* p. 314.

⁵² UCP Article 14(d) states the means and to whom a rejection should be communicated to. See the related section under the UCC Section 5-114(b) in Appendix B and Section 5-108(b) in Appendix C.

5.1.1. Time for Raising Objections⁵³

It is evident, under some American authorities that the bank, upon receiving the tender documents, must raise all of its objections in relation to the documents at the time of their rejection. Any defences at a later stage, that the bank may raise would amount to preclusion.⁵⁴ English courts took the opposite opinion⁵⁵ until the implementation of article 16(d) of the 1983 revision, currently article 14(d) of the UCP 1993, which followed the American position. Under this provision, it is clear that the banker is required to declare any irregularities which have resulted in the rejection of such documents⁵⁶. Failure to do so, according to article 14(e), will prohibit him from disputing the regularity of the documents. The Court of Appeal in Bankers Trust Co. v. State Bank of India⁵⁷ gave effect to this provision and distinguished the earlier cases. It was made clear by their Lordships that it was of significance that the bank's notice had to be immediately released, upon deciding that such documents were to be rejected, as stated in article 16(d).⁵⁸ In accordance with Kaplan J's perspective, in relation to the case of Hing Yip Fat Co. Ltd. v. Daiwa Bank Ltd⁵⁹ (cited under Section 3.1.3.), the consequence of a bank failing

⁵³ As regard to the procedure for rejection, See *Benjamin's Sale of Goods*, at § 23-140 p. 1725.

⁵⁴ *Ibid* at § 23-183, n.39. p. 1751.

⁵⁵ *Skandinaviska Kreditaktiebolaget v Barclays Bank* (1925) 22 Ll.L.R. 523, 525; *Westminster Bank v Banca Nazionale Di Credito* (1928) 31 Ll.L.R. 306, 311; *Soproma S.p.A. v Marine and Animal By-Products Corporation* [1966] 1 Lloyd's Rep 367, 387. Cf. *Kydon Compania Naviera SA v National Westminster Bank Ltd. (The "Lena")* [1981] 1 Lloyd's Rep 68, 78-80 which suggested that article. 8(e) of the 1974 Revision had not changed the position. The wording of the new article. 14(d), though, is clearer. And note that it would be too late to raise a point for the first time at the stage of an appeal: *Gian Singh & Co. Ltd. v Banque de L'Indochine* [1974] 2 Lloyd's Rep. 1, 12.

⁵⁶ *Benjamin's Sale of Goods*, at § 23-183, p. 1751.

⁵⁷ *Bankers Trust Co. v. State Bank of India* [1991] 1 Lloyd's Rep 587, affd. [1991] 2 Lloyd's Rep 443 (CA) followed recently in *Bayerische Vereinsbank AG v National Bank of Pakistan* [1997] 1 Lloyd's Rep 59 (Mance J).

⁵⁸ *Bankers Trust Co. v. State Bank of India* [1991] 1 Lloyd's Rep 587, 601.

⁵⁹ *Hing Yip Fat Co. Ltd. v. Daiwa Bank Ltd* [1991] 2 H.K.L.R. 35; see also *Kerr-McGee Chemical Corp v Federal Deposit Insurance Corp* 872 F 2d 971 (11th Cir. 1989); *Paramount Export Co. v Asia Trust Bank* 238 Cal Rep 920 (App. 1987). In certain cases waiver may also be inferred from the bank's conduct. See for example, *Floating Dock Ltd. v Hong Kong and Shanghai Banking Corporation* [1986] 1 Lloyd's Rep 65.

to declare any apparent discrepancies, would result in such discrepancies being waived.⁶⁰

'Time for raising objection' on the part of the bank was considered also in the case of Credit Agricole Indouez v. Generale Bank⁶¹. The facts of the case involve General Bank [defendant] having responsibility for overseeing the terms of agreement on which the letters of credit would be issued to the requesting third party [S Inc.], who wished to finance purchase by a company in the same group [C Inc.]. The agreement granted that the General Bank would not be held liable to the borrower for any bona fide acts or exclusions related to any credit or documents. The letter of credit also stipulated a final shipment date, permitting the beneficiary to submit a forwarders' receipt if the purchaser failed to nominate a suitable vessel within a 21 day grace period of the goods arriving. The dispute stemmed from the beneficiary presenting a notice of readiness to the plaintiff, dated one day before final shipment date as well as a forwarders' receipt dated 21 days after notice of readiness. The issues under discussion were whether the documents were discrepant, and whether the defendant could qualify for compensation from third parties.

From the judgment it was held that with regards to the letter of credit, the current shipment date could not be ignored. Article 46 of the UCP supported the notion that if a bill of lading was dated after this date, it could be more justifiably discarded.

David Steel J. delivered the following judgment, initially by stressing the importance of referring back to the main purpose of the forward receipt provision in the letter of credit, which was to protect the beneficiary in the event that the

⁶⁰ See *Wing On Bank Ltd. v American National Bank and Trust Co.* 457 F.2d 328 (1972), "which suggests, however, that a failure to raise an objection might not result in an estoppel if the tender was beyond correction". See also *Flagship Cruises Ltd. v New England Merchants National Bank of Boston*, 569 F.2d 699 (1978). cited by *Benjamin's Sale of Goods*, at § 23-183, n.41 p. 1751.

⁶¹ *Credit Agricole Indouez v. Generale Bank* [1999] 2 All ER (Comm) Q.B.D. 1016.

applicant failed to nominate a suitable vessel within the 21 days of the notice of readiness. The aspect of partial shipments was also under discussion, whereby it was offered by Steel J., that as they were allowed in the letter of credit, it was therefore logical to assume that partial drawings should also be accepted. This was provisional on the 21 day grace period being adhered to as stated in the letter of credit. One of the allegations put forth by Generale was that the terms of the credit, in relation to conformity with the stipulated date, had not been complied with and therefore the documents were discrepant. In resolution, one of the issues that the parties agreed to determine was whether Generale Bank was prevented by Article 14 [e] of the UCP, from relying on any discrepancies in the documents presented to it by Credit Agricole under the letter of credit issued by the defendant bank.

In relation to this point it was held that:

“...Generale Bank was indeed prevented from relying on the discrepancies. This was on the basis that, regardless of the merit of the alleged discrepancies, the defendants were not entitled to keep the documents whilst in the same breath claiming to reject them on the ground of discrepancies”.⁶²

5.1.2. Subsequent Tenders⁶³

Upon accepting the documents, one reason for requiring the bank to insist upon all objections to be raised at the time the documents had been formally rejected, was to ensure that the tenderor had the opportunity to make any adjustments prior to the expiry date and before such documents were resubmitted. The right to retender is recognised in both the United States⁶⁴ and the United Kingdom⁶⁵.

⁶² Ibid at 1022.

⁶³ *Benjamin's Sale of Goods*, at § 23-184 p. 1751.

⁶⁴ *Kingdom of Sweden v New York Trust Co.*, 96 NYS 2d 779, 790-91 (1949).

⁶⁵ For UK authority see *Basse and Selve v Bank of Australasia* (1940) 90 LT 618 “in which the documents were originally rejected by the banker due to a defect in a certificate of analysis but were held to comply with the requirements of the credit when retendered by the seller after the correction of the certificate”. Cited by *Benjamin's Sale of Goods*, at § 23-184 p. 1751. See also *United City Merchants (Investments) Ltd. v Royal Bank of Canada* [1979] 1 Lloyd's Rep 267, 275 “unaffected

5.2. Payment Under Indemnity⁶⁶

What the bank can do alternatively, is to pay, taking indemnity from the beneficiary or his bank in respect of any loss or damage resulting from the defect in the documents. "This practice prevents the delay and inconvenience occasioned by the necessity for the bank or the seller obtaining the buyer's consent to the acceptance of the documents".⁶⁷ The indemnity should state the circumstances in which the bank may hold the indemnitor liable. For instance, if the documents are not taken up

on this point by the decision of the House of Lords: [1983] AC 168". See *Benjamin's Sale of Goods*, fn 46 at § 23-184 p. 1751.

⁶⁶ An example of the wording of an indemnity clause (modelled on the West of England P. & I. Club's letter of indemnity):

(1) The Charterer declares that:

(a) The cargo to be loaded at on the M/T by the (the name of the supplier at the loading port) in execution of this charterparty will become his property F.O.B. (the name of the loading port).

(b) The said cargo has been purchased by him for payment by means of a confirmed banker's documentary credit so that no original of the Bill of Lading will be available at (the name of the discharge port) on the arrival of the said vessel

(c) The said cargo will be discharged into his own storage at (the name of the discharge port) on the arrival of the said vessel.

(d) he will deliver to the ship's agent at one original of the bill of Lading duly discharged by the Charterer as soon as the latter receives the Bill of Lading from his bank.

(2) In consideration of (1) supra and (3) infra the Owner undertakes to instruct his Master to deliver the said cargo into Charterer's storage at without the presentation of an original of the Bill of Lading.

(3) In consideration of (2) supra the Charterer undertake to:-

(a) Hold the Owner, his Master and his agents, every one of them, indemnified against all claims which may be made upon them, or any one of them, under the said Bill of Lading or any one of the set of which it forms part, and against all loss, cost (as between attorney or solicitor and own client) damages, expenses which they, or any one of them, may suffer incur by reason of the delivery of the said cargo in accordance with (2) supra.

(b) In respect of any arbitration/court proceedings commenced concerning the said cargo, to provide them from time to time and when requested by any one of them with sufficient funds to defend the same.

(c) To provide bill to prevent arrest or to obtain release of the vessel or property in case of the arrest of the vessel or any property belonging to them in connection with the said delivery of the cargo, and to indemnify them for any loss, cost, damages and expenses caused to them or any one of them by arrest, whether such arrest is justified or not.

(4) For the purpose of the interpretation of this clause, and of this clause alone, the expression 'Owner', in the case where this charterparty is concluded between the Charterer and a disponent Owner, shall mean the head Owner and/or the disponent Owner(s).

⁶⁷ Day, D., *The Law of International Trade* p. 168.

by either the issuing bank or the applicant of the credit within a reasonable time, the indemnitor shall repay the amount paid by the advising bank. The bank may find itself in trouble if reimbursement is refused from the issuing bank. If there is a real deficiency in the documents, the bank must sue on the indemnity to recover its money from the beneficiary. However, if it is found that the documents are not defective, it must proceed instead, against the issuing bank. Since it is doubtful as to whether a deficiency exists, to pay under indemnity is very risky for the bank. In addition, it is submitted that this may lead to a delayed adjudication which would result in the bank not being able to readily access its money for a significant period of time.⁶⁸ Further, the beneficiary should satisfy himself prior to giving an indemnity, that the discrepancies can be explained and corrected immediately, otherwise the indemnity may well prove limitless as to time. If this is the case, perhaps the paying bank had better refuse the documents in any event. It is clear that the advising bank cannot be freed from its obligation to examine the tendered documents, 'with the same reasonable care as it is bound to apply if not so protected'.⁶⁹ The giving of an indemnity is based on certain premises: (i) there has been a failure in performance by the beneficiary; (ii) the failure requires an indemnity to shift the burden of obligation from the paying party to the presenter.⁷⁰

⁶⁸ Todd, P., *Bills of Lading & Bankers' Documentary Credits* p. 224; See also about indemnity's conditions, Backus, D.C., and Harfield, H., 'Custom and Letters of Credit: The Dixon, Irmaos Case' 52 *Columbia Law Review* (1952) 589, 592-602. The paying bank is advised to take some safety measures before accepting an indemnity: "(1) that the indemnitor is of good credit standing (ii) that the indemnity is drawn in a satisfactory form and (iii) that the discrepancy is one which has a reasonable chance of avoiding challenge by either the issuing bank or the account party"., at p. 593.

⁶⁹ Schmitthoff, C.M., *supra* note 10 at 105-106; See Jack, R., *Documentary Credits* at § 5-55 et seq pp. 102-105 for more detail about Payment under reserve and against indemnity; Schmitthoff, C.M., *Schmitthoff's Export Trade: The Law & Practice of International Trade* p. 438.

⁷⁰ Backus and Harfield, *supra* note 68 at p. 593, fn 16 advance that: "Before the indemnity is tendered, the paying bank is the obligor and the presenter is the obligee-subject to the terms of the credit. When the presenter gives the paying bank an indemnity agreement, their roles are reversed. The presenter becomes the obligor, and his obligation is to pay in accordance with the terms of the indemnity. Clearly there must be a real failure of performance to warrant so complete a reversal of the original roles".

5.3. Payment Under Reserve⁷¹

Payment under reserve, as Todd⁷² has suggested, is a solution. However, Forte⁷³ commented that the precise scope of the bank's right of recovery, under this situation, is something of a 'mystery'. It is submitted that the bank will be prepared to make payment under reserve, if the beneficiary is a valued customer and a genuine dispute has arisen with him whether the documents are in order. In Banque de l'Indochine v. J H Rayner Ltd⁷⁴, the payment for the goods was agreed to be made by documentary credit. The buyers instructed their bank to open an irrevocable credit for the sellers (defendants). The precise credit was issued and confirmed by the plaintiff confirming bank who advised the sellers accordingly. When the relevant documents were presented by the sellers, the confirming bank rejected them and refused payment on the ground that they did not conform to the terms of the credit. The sellers disputed the discrepancies but were content to accept payment made under reserve. The issuing bank subsequently rejected the documents because irregularities were found in them. The confirming bank demanded immediate repayment from the sellers but they refused. The sellers argued that they were only obliged to make repayment if it was proven that the alleged irregularities actually constituted a valid ground for refusing payment in the first place. Parker J. held, at the first instance, that the confirming bank was entitled to demand its money if the documents were rejected by the issuing bank, but only if the discrepancies were a valid reason for not making payment in the first place. On the question of the meaning of 'under reserve', Parker J. approached it fairly practically. If this phrase intended that the correspondent bank was entitled to automatic repayment of the sum advanced under the credit, then the result is

⁷¹ See for details Chiaw, L.C., supra note. 46 pp 81-84.

⁷² Todd, P., *Bills of Lading & Bankers' Documentary Credits* p. 224.

⁷³ Forte, supra note 46 at 356.

⁷⁴ *Banque de l'Indochine v. J H Rayner Ltd* [1983] 1 All ER 468.

quite absurd. This is because the seller would be obliged to repay a sum which the bank was, in fact, obliged to pay in the first place, and he would then have to sue the bank for a payment which he had always been entitled to. Hence, “a more natural and ... commercially sensible meaning to give to the words is that the bank reserves the right to have the money back if it was not at the date of payment contractually payable”⁷⁵. The discrepancies relied on by the issuing bank in that case were serious enough as to entitle the confirming bank to have rejected them in the first place. So, the confirming bank was in fact entitled to demand its money back anyway. Parker J.’s decision was therefore affirmed in the Court of Appeal⁷⁶ but his judgment as to the effect of a payment made under reserve was rejected. Kerr L.J. commenting on Parker J.’s approach stated that:

“this approach is too legalistic and wrong. The commercial reality of the situation is that, while holding opposing views, both the bank and the beneficiary hope that, whichever of them is right, the issuing bank and the buyer abroad will raise no objection to the documents. It is therefore with this hope uppermost in its mind that the confirming bank agrees to pay, but only ‘under reserve’. However, in agreeing to do so, the confirming bank cannot be realistically taken to have agreed to become involved in legal proceedings, if the documents are rejected, by having to sue the beneficiary to recover the money and establishing that the documents did not comply with the credit, or possibly by suing the issuing bank on the ground that they did, after all, comply with it. This would be the effect of the decision of Parker J, but on reflection I do not think that either party could have intended that this should be so. What the parties meant, I think, was that payment was to be made under reserve in the sense that the beneficiary would be bound to repay the money on demand if the issuing bank should reject the documents, whether on its own initiative or on the buyer’s instructions. I would regard this as a binding agreement made between the confirming bank and the beneficiary by way of a compromise to resolve the impasse created by the uncertainty of their respective legal obligations and rights. For the present purposes it is then unnecessary to go further and decide whether such a demand would only be effective if the grounds of the rejection included at least one of the grounds on which the confirming bank had relied in refusing to pay otherwise than under reserve. But I incline to the view that this should be implied, since the agreement to pay and accept the money under reserve will have been made against the background of these grounds of objection”.⁷⁷

From the judgment, it was apparent that the confirming bank should anticipate legal proceedings, (which goes against commercial reality), where it chose to make

⁷⁵ [1983] 1 All ER 468, at 472, per Parker J.

⁷⁶ [1983] 1 All ER 1137.

⁷⁷ *Ibid*, per Kerr LJ, at 1144.

payment under reserve. Consequently, it was decided that where this method of payment was selected, and as a result the documents were subsequently rejected, the sellers would have a duty to recompensate the bank on demand. This could either be as a result of the seller's own initiative or following the direct request on the part of the bank, "for reasons which include at least one of the discrepancies relied on by the confirming bank for making payment only under reserve in the first place".⁷⁸ It is claimed that it is immaterial, whether the discrepancies are sufficient reasons in law for one to refuse payment⁷⁹. In fact, both the issuing bank and the confirming bank have the same choices, and the only issue which arises from this particular case is whether or not the buyer should accept the documents.

The obligations between the issuing bank and the buyer are not affected by the arrangement of payment under reserve or against indemnity, which is made by a confirming bank. The relationship between the confirming bank and the beneficiary is, however, affected, by virtue of such arrangement, as Article 14(f) of the UCP reveals. Yet, the expression "payment under reserve" has not been defined therein.

6. The Tests of Compliance⁸⁰

In applying the test of strict compliance, different courts adopt different levels of strictness. There are, strictly speaking, three types of test: (i) the strict compliance test, (ii) the substantial compliance test and (iii) the qualified strict compliance test. All English courts follow the strict compliance test while a small numbers of states in America are noted to follow the latter two. Below is a discussion of the strict compliance test under English law, which is seen as the mainstream test, followed

⁷⁸ Todd, P., *Bills of Lading & Bankers' Documentary Credits* p. 225.

⁷⁹ *Ibid.*

⁸⁰ See Hotchkiss, C., 'Strict Compliance in Letter-of-Credit Law: How Uniform is the Uniform Commercial Code?' 23 *Uniform Commercial Code Law Journal* (1991) 288 at pp 292-301; See also Rosenblith, 'Letter-of-Credit Practice: Revisiting Ongoing Problems' 24 *Uniform Commercial Code Law Journal* (1991) 120 at pp 121-126; See also Givray, Brande, Brody, Doub, Gabriel, Hisert, Soshuk, Wunnicke, 'U.C.C. Survey: Letters of Credit'. 47 *The Business Lawyer*, August (1992) 1571 at 1573; Gustavus, J.D., 'Letter of Credit Compliance under Revised UCC Article 5 and UCP 500' 114 *Banking Law Journal* January (1997) 55 at 71; Kozolchyk, B., 'supra note 1 at 50.

by the American position which seems to absorb the three tests. After that, the question of strict compliance in relation to the UCP, will be outlined in order to assist the discussion in Section Two on the comparison of the position of the compliance test in the statute and the common law.

6.1. Position under English Law: The Strict Compliance Test⁸¹

Under English law, in the case of Equitable Trust Co. v. Dawson Partners⁸² (discussed in section 3.1.3.), Lord Sumner stated that “[t]here is no room for documents which are almost the same, or which will do just as well.”⁸³ Although the dispute was between a banker and its customer in this case, the rule of strict compliance was applied. That is to say, the doctrine of strict compliance is applied to all contracts concerning letters of credit under English law.⁸⁴ Under this rule, the issuing bank reviews the face of the beneficiary’s draft and accompanying documents to decide whether or not they comply with the requirements of the credit. If they do, the bank should honour them, and vice versa. Baihache J. in English, Scottish and Australian Bank v. Bank of South Africa⁸⁵ commented:

“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

⁸¹ For details about the applying of the doctrine of strict compliance test in standby letters of credit law see, Kozolchik, ‘The Emerging Law of Standby Letters of Credit and Bank Guarantees’ 24 *Arizona Law Review* (1982) 319 at 360; See also Yong, C.H., ‘International Trends in Documentary Credit Transactions’ 14 *Singapore Law Review* (1993) 171 at 174; Bradgate, R., *Commercial Law*. 2d ed. (London, Butterworths, 1995) p 682; Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits*. Revised Edition. (Warren, Gorham and Lamont 1996) pp. 11-55.

⁸² *Equitable Trust Co. v. Dawson Partners* [1927] L.L.R. 49 (H.L.).

⁸³ *Ibid* at 52. See further on strict compliance the case of *Midland Bank v. Seymour*, [1955] 2 Lloyd’s Rep. 147; *Bisler v. Nations Bank*, 686 A2d 561 (D C Cir. 1996).

⁸⁴ Thus, *Equitable Trust Co. of New York v Dawson Partners Ltd.* (1927) 27 L.L.R. 49 (this was an action between a banker and a buyer) has been cited in *Rayner (JH) & Co. Ltd. v Hambro’s Bank Ltd.* [1943] 1 KB 37 (an action by a seller against a banker). The general application of the doctrine is emphasised in *Camp v Corn Exchange National Bank*, 132A. 189, 191 (1926). Contrast *Far Eastern Textile Ltd. v City National Bank and Trust Co.*, 430 F.Supp. 193 (1977), which supports strict compliance in respect of the contract of banker and seller but postulates substantial compliance in respect of the contract of banker and buyer. For an argument in support of this view, see Dolan, J.F., ante 260 at 385.

⁸⁵ *English, Scottish and Australian Bank v. Bank of South Africa* (1922) 13 L.L.R. 21, 24. For more on the principle see *Bhojwani v Chung Khiaw Bank* [1990] 3 MLJ 260 (CA S’pore).

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”.

If the credit required that a certificate should be signed specifically by experts, then in contrast a certificate would be held as defective⁸⁶ if it was found to be signed only by one expert. By the same token, a bill of lading would also be regarded as defective or discrepant⁸⁷ upon it being drawn on the issuing bank rather than by the buyer, contrary to the requirements as set by the credit. Indeed, the test is so strict that the tendered documents can be regarded as having to be the “mirror image”⁸⁸ of the requirements in the credits.

Another example that can be utilised to demonstrate the doctrine of strict compliance can be seen in the case of J.H.Rayner & Co. v. Hambros Bank Ltd.⁸⁹ Here, the credit required a bill of lading for “coromandel groundnuts”. However, what was tendered under the credit was a bill of lading for “machine shelled groundnut kernels”. Such a tender did not qualify under the doctrine of strict compliance. MacKinnon L.J. stated:

“The words in that bill of lading clearly are not the same as those required by the letter of credit. The whole case of the plaintiffs is, in the words of Lord Sumner, that ‘they are not almost the same, or they will do just as well’. The bank, if they had accepted that proposition, would have done so at their own risk. I think on pure principle that the bank were 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.”⁹⁰

Furthermore, Bank Melli Iran v Barclays Bank DCO,⁹¹ shows another example of the application of the doctrine of strict compliance, where a set of documents which contain any contradictory statements, constitute a bad tender. In this case it was required under the credit that a document evidencing the shipment of “100

⁸⁶ *Equitable Trust Co. of New York v Dawson Partners Ltd.* (1927) 27 Ll.L.R. 49.

⁸⁷ *Kydon Comparñia Naviera SA v National Westminster Bank Ltd. (The “Lena”)* [1981] 1 Lloyd’s Rep 68.

⁸⁸ Kozolchyk, B., *supra* note 1 at 50.

⁸⁹ *J.H.Rayner & Co. v. Hambros Bank Ltd.*, [1943] 1 K.B. 37.

⁹⁰ *Ibid* at 40.

⁹¹ *Bank Melli Iran v Barclays Bank DCO* [1951] 2 Lloyd’s Rep 367. And see also Article 13(a) of the UCP.

new Chevrolet trucks” was to be tendered. The tendered documents comprised of an invoice, a certificate and a delivery order, and each were found to have characterised the goods in slightly different ways. For example, in the invoice they were described as ‘in new condition’, in the certificate they were described as ‘100, new Chevrolet ... trucks’ and finally in the delivery order they were described as “new (hyphen) good....”. The tender was held to be faulty because of these inconsistent descriptions amongst the statements. McNair J. observed that:

“I consider that the document is clearly defective in two respects: (1) The description of the trucks as “new (comma) good” may clearly connote something different from the description “new.” It may have special trade meaning in relation to motor vehicles. It is sufficient to say that it is not the same. (2) But the more important defect, in my judgment, is that the certificate does not purport to relate to any specific trucks; the trucks as to which the certificate is given are not identified as the trucks covered by the invoice or a *fortiori* by the delivery order, which did not come into existence until some five or six weeks after the date of the certificate....In my judgment, this certificate plainly did not comply with the terms of their mandate. (3)The delivery order (apart from not identifying the trucks) described the trucks as “new (hyphen) good.” It was suggested that the phrase “new-good” comes into existence by the accident of the typist striking the wrong key. This may be so; but the result was that in this delivery order this composite word “new-good” appeared. In my judgment, this description, like the description “new, good” or “in new condition” is not the same as “new.”⁹²

Again, in the recent case of Seaconsar Far East Ltd. v Bank Markazi Jomhouri Islami Iran⁹³, the doctrine of strict compliance is demonstrated, where a contract for the sale of artillery shells was agreed to between Seaconsar (seller) and the Iranian Ministry of Defense (buyer). Payment was to be made by letter of credit. It was a condition under the letter of credit that all the documents that needed to be submitted to the bank should bear the letter of credit number and the buyer’s name. The condition reads that ‘Our L.C. no. and our principal’s name should appear on all documents and packages’.⁹⁴ Subsequently, the plaintiffs made two shipments of the subject matter of the contract in respect of each shipment. Having presented the documents to the advising bank in respect of each shipment, the beneficiary (seller) was refused payment on the grounds that one of the documents,

⁹² *Bank Melli Iran v Barclays Bank DCO* [1951] 2 Lloyd’s Rep 367, 375.

⁹³ *Seaconsar Far East Ltd. v Bank Markazi Jomhouri Islami Iran* [1993] 1 Lloyd’s Rep 236, CA.

⁹⁴ [1993] 1 Lloyd’s Rep 236.

namely the list of the goods shipped, did not comply with the credit terms and conditions in that it did not carry the letter of credit number and the buyer's name. Following such refusal of payment, the beneficiary applied for leave to serve proceedings on the issuing bank out of the jurisdiction. The majority of the Court of Appeal favoured the defendant's position in considering the tender documents as bad tender and therefore leave to serve out of jurisdiction was refused. Where the question of compliance is concerned, Lloyd LJ. stated that:

"There is no dispute between the parties as to the doctrine of strict compliance, and the reasons for it. They are to be found in the speech of Viscount Sumner in *Equitable Trust Company of New York v. Dawson Partners, Ltd.*,⁹⁵ and the judgment of Parker J. and Sir John Donaldson M.R. in *Banque de i'Indochine et de Suez S.A. v. J.H. Rayner (Mincing Lane) Ltd.*⁹⁶ It is no good asking why the credit required the letter of credit number and the buyer's name to appear on each of the documents. As Lord Diplock said in *Commercial Banking Co of Sydney Ltd. v. Jalsard Pty. Ltd.*⁹⁷ .:

'The banker is not concerned as to whether the documents for which the buyer has stipulated serve any useful commercial purpose or as to why the customer called for tender of a document of a particular description. Both the issuing banker and his correspondent bank have to make quick decisions as to whether a document which has been tendered by the seller complies with the requirements of a credit...'

Mr. Clarke relies on the observation of Mr. Justice Parker in the *Banque de i'Indochine* case⁹⁸:

'I accept...that Lord Sumner's statement cannot be taken as requiring rigid meticulous fulfilment of precise wording in all cases. Some margin must and can be allowed...'

He argues that the absence of the letter of credit number and the buyer's name was an entirely trivial feature of the document. I do not agree. I cannot regard as trivial something which, whatever may be the reason, the credit specifically requires. It would not, I think, help to attempt to define the sort of discrepancy which can properly be regarded as trivial. But one might take, by way of example, *Bankers Trust Co. v. State Bank of India*⁹⁹ where one of the documents gave the buyer's telex number as 931310 instead of 981310. The discrepancy in the present case is not of that order."

Since the credit was subject to the UCP 1983 revision, the beneficiaries argued that, according to the language of Art. 16, the advising bank should not be entitled to reject such documents because the article referred only to the issuing bank in

⁹⁵ *Equitable Trust Company of New York v. Dawson Partners, Ltd* (1926) 27 Ll.L. Rep. 49

⁹⁶ *Banque de i'Indochine et de Suez S.A. v. J.H. Rayner (Mincing Lane) Ltd* [1983] Q.B. 711, [1983] 1 All.E.R. 1137, [1983] 1 Lloyd's Rep. 228.

⁹⁷ *Commercial Banking Co of Sydney Ltd. v. Jalsard Pty. Ltd* [1973] A.C. 279, 286.

⁹⁸ *Banque de i'Indochine et de Suez S.A. v. J.H. Rayner (Mincing Lane) Ltd* [1983] Q.B. 711, 721, [1982] 2 Lloyd's Rep. 476, 482.

⁹⁹ *Bankers Trust Co. V. State Bank of India* [1991] 2 Lloyd's Rep. 443.

relation to the right to reject documents but did not refer to any other banks. This contention was rejected by the Court of Appeal, in contrast to the judgment of Saville J. at first instance. Lloyd L.J. stated:

“Mr. Clarke’s last argument [for the beneficiary] on authority turns on Art. 16 of the Uniform Customs. Even if, contrary to this argument, Bank Melli would have had authority to reject the documents if the Uniform Customs had not been incorporated, nevertheless the effect of Art. 16 is, he says, to exclude such authority.

I need not repeat the terms of Art. 16 *verbatim*. Paragraphs (b)-(f) set out the obligation of the issuing bank to examine the documents and to determine, on the basis of the documents alone, whether to take them up or refuse them. If the issuing bank decides to refuse the documents it must do so without delay. There is nothing in Art. 16 which entitles any bank other than the issuing bank to refuse the documents. Therefore, says Mr. Clarke, the authority of Bank Melli to refuse the documents is expressly, or at any rate by implication, excluded. He prays in aid the judgment of Saville J. who observed that the Uniform Customs did not confer on Bank Melli, as advising bank, the authority to reject on behalf of Bank Markazi.

I do not accept Mr. Clarke’s argument. It may be the case that the Uniform Customs do not positively confer authority on the advising bank to reject the documents. But where authority is conferred *dehors* the Uniform Customs, there is nothing in Art. 16 to negative such authority. It is curious...that Art. 16 nowhere refers to the confirming bank. yet the article, if it is to make sense in the case of a confirmed credit, must apply to the confirming bank in the same way as it applies to the issuing bank, even though the confirming bank is not mentioned. Similarly it must apply to the advising bank in the case of an unconfirmed credit, where the advising bank has been authorized to pay, and is therefore ‘nominated bank’ under Art. 16(b). Mr. Clarke argued that in every case where an unconfirmed credit is subject to the Uniform Customs it is necessary to confer express authority on the nominated bank to reject non-conforming documents, and to secure the consent of the beneficiary for that purpose. I cannot agree. A decision to that effect would, I suspect, cause great concern. The *lacuna* in Art. 16 (for that is all it is) does not compel us to reach so inconvenient a result.”¹⁰⁰

It is to be noticed that Article 13(b) of the UCP 500 has no such confusion. Under this article, not only is the issuing bank expressly referred to, but also the confirming and any other nominated banks are to be entitled to reject payment in the case of discrepant documents being tendered.¹⁰¹

When the case returned to the Court of Appeal¹⁰² on its merits, it was evident that there were discrepancies in the documents. Sir Christopher Staughton, argued that:

“the discrepancies in the documents do not appear to be of any great significance. But that is neither here nor there. It is hornbook law for bankers that the documents must

¹⁰⁰ [1993] 1 Lloyd’s Rep 236, at 241.

¹⁰¹ See for authorities commenting on this point, Todd, P., *Bills of Lading & Bankers’ Documentary Credits* pp. 200-201.

¹⁰² *Seaconsar Far East Ltd. v Bank Markazi Jomhuri Islami Iran* [1999] 1 Lloyd’s Rep 36.

appear on their face to be precisely in accordance with the terms and conditions of the credit".¹⁰³

In the case of Credit Agricole Indouez v. Generale Bank, (facts were set out under section 5.1.1.) one of the points to decide was whether, upon demonstration that the General Bank was indeed precluded, the documents were discrepant.

With regard to this point, Rix J. concluded that the documents, in relation to this case, were in fact discrepant and although he acknowledged that the terms of the credit were somewhat strange, his Honour affirmed that his judgment was largely based upon his concerns which originated from:

"[T]he proximity of the notice of readiness to the last date for shipment and the proximity of the forwarding receipt to the expiry date of the letter of credit".¹⁰⁴

6.2. Position under US Law

So far as the UCC is concerned, it is to be noted here that the phrase "strict compliance" does not appear in the UCC Section 5-109(2). One American commentator in acknowledging this finding, states that "[G]aps in the coverage of Article 5 of the UCC have allowed state and federal courts to create new inconsistent standards for documentary compliance with letters of credit".¹⁰⁵ Such inconsistent standards are represented in three tests, namely; (i) the strict compliance test, (ii) the substantial compliance test and (iii) the qualified strict compliance test. The following discussion will be devoted to examining these tests. (See Appendix D for update regarding Revised Article 5 UCC where the phrase "strictly comply" has been added to Section 5-108(a) mentioned in section 4. See also the standard of practice provision which was introduced in the revised Article 5 under which an issuer becomes obliged to observe the standard practice of financial institutions that regularly issue letters of credit, mentioned in section 9 of

¹⁰³ Ibid at 38.

¹⁰⁴ *Credit Agricole Indouez v. Generale Bank* [1999] 2 All ER (Comm) Q.B.D. 1016, at 1023.

¹⁰⁵ Hotchkiss, C., *supra* note 80, at 288.

the same Appendix.)

6.2.1. The Strict Compliance Test

In the USA, one group of courts still uses a strict compliance test which originated from the case of Dawson Partners, Ltd.¹⁰⁶ For example, where the credit called for a presentation of a full set of clean on board bills of lading, but the seller shipped the goods by air and submitted air waybills instead, the court in the course of judgment, ruled in favour of the bank, holding that: “the issuer of a letter of credit should not be placed in the position of having to determine whether an unauthorised method of shipment is material.”¹⁰⁷

Since the strictness of the strict compliance rule can become a weapon for buyers who no longer value their bargain and bankers who attempt to avoid their obligations, some courts, in an attempt to attain maximum fairness, try to dilute the strictness of the rule by applying the substantial compliance test or the qualified strict compliance test. Having said this, it should be noted that, so far, only a few of the United States courts have recognised these tests and no English court has ever even tried.

6.2.2. Substantial Compliance Test¹⁰⁸

The substantial compliance test requires bankers “to look beyond the face of the

¹⁰⁶ *Equitable Trust Co. of New York v Dawson Partners Ltd.* (1927) 27 Ll.L.R. 49. For American authorities see *Board of Trade of San Francisco v. Swiss Credit Bank*, 728 F. 2d 1241 (9th Cir. 1984).

¹⁰⁷ *Board of Trade of San Francisco v. Swiss Credit Bank* 728 F. 2d at 1243; See also McLaughlin, G.T., ‘On the Periphery of Letter of Credit Law: Softening the Rigors of Strict Compliance.’ *Banking Law Journal* (1989) 4 at 4-9 for more discussion about strict and substantial compliance; See also Goldstein and Nathan, ‘How Strict is Strict Compliance.’ 92 *Business Credit* May/June (1990) 39 at 40

¹⁰⁸ See also McLaughlin, G.T., supra note 107 at 5-7; For more details about tensions between “strict compliance” and “substantial compliance” see Givray. A.J., Brande. M.J., Brody. M., Chapman. C., Jr., Doub. J., Gabriel. H., Hisert. G., Soshuk. J, and. Wunnicke. B. supra note 80 at 1573-1574; See also Yong, C.H., supra note 81 at 176; Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits* at 4-62.

documents, investigate the realities of the transaction, and weigh the credibility of documents, customers and beneficiaries.”¹⁰⁹ This test was applied in the case of Crocker Commercial Servs., Inc. v. Countryside Bank¹¹⁰, where the bank was seen as attempting to “palter with justice” by nitpicking through the beneficiary’s documents and raising a “hypertechnical argument”.¹¹¹

The substantial compliance standard was supported by an older case of Banco Espanol de Credito v. State Street Bank & Trust Co.¹¹² Here, the credit called for an inspection certificate tendered which recited that “the goods are in conformity with the order”.¹¹³ Instead, the beneficiary tendered a certificate which recited that based on a 10 per cent sample, the “whole ... [was] found conforming to the conditions stipulated on the Order-Stock-sheets”¹¹⁴, which therefore did not strictly comply with the requirements in the credit. Nevertheless the certificate tendered was held to have complied with the terms of the credit, since the court said that the “Order-Stock-sheets” mentioned in the certificate were certain stock sheets of the parties’ previous dealings, and hence initiated the original order. Furthermore, the inspection of only a sample of the goods was reasonable since no reasonable inspector could be expected to examine each garment in an order that covered \$118,000. Dolan has suggested that the court’s holding is rather unconvincing. He said, “a certificate representing that a sample is conforming is substantially different from a certificate representing that an entire order is conforming. The latter imposes on the inspector the duty to select a sufficient sample to insure that his representation, behind which he must stand, is correct.”¹¹⁵

¹⁰⁹ Hotchkiss, C., *supra* note 80 at 295.

¹¹⁰ Crocker Commercial Servs., Inc. v. Countryside Bank, 538 F. Supp. 1360, 1362 (N.D.III. 1981).

¹¹¹ *Ibid.*

¹¹² Banco Espanol de Credito v. State Street Bank & Trust Co 385 F. 2d 230 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968).

¹¹³ *Ibid* at 231.

¹¹⁴ *Ibid* at 233.

¹¹⁵ Dolan, J.F., ‘Strict Compliance With Letters of Credit: Striking A Fair Balance’. *Banking Law Journal*

Moreover, in a third leading case, Flagship Cruises, Ltd. v. New England Merchants National Bank¹¹⁶, the credit required the beneficiary's statement to state that its *draft* related to an identified agreement. Instead, the statement cited that the *letter of credit* related to the agreement, which did not strictly comply with the term of the credit. The court, however, held that the statement did comply with the requirement of the credit, since if the letter of credit is related to the agreement, the draft must also be related to it.

6.2.3. Qualified Strict Compliance Test

A third group of courts, in the USA, claims to be applying the strict compliance rule but it will allow minor or immaterial variation from the terms of the letter of credit.¹¹⁷ The Court of Appeal of Maryland in the case of Mercantile Safe Deposit and Trust Co.v. Baltimore County,¹¹⁸ upheld a bank's dishonour of a letter of credit based on four discrepancies between the documents presented and the letter of credit. It can, however, be inferred from the court's decision that it recognised the qualified test. The court stated:

“While we recognise a potential for abuse in a super or hypertechnical application of the strict compliance test, the cases which apply this rule are not so rigid as to permit an issuer to dishonour if it finds, for example, an obvious and immaterial typographical error. Courts will not permit a bank in such circumstances to use such a discrepancy to protect itself from an insolvent customer or to protect its customer from payment....”¹¹⁹

Courts have been using this qualified strict compliance test. This can be inferred from some decisions which allow variations that are “insignificant”¹²⁰, “obvious and immaterial”¹²¹, or “inconsequential”.¹²²

(1985) 18, at fn 28 p. 23.

¹¹⁶ *Flagship Cruises, Ltd. v. New England Merchants National Bank* 569 F.2d 699, 703 (1st Cir. 1978).

¹¹⁷ *Hotchkiss, C.*, supra note 80 at 296.

¹¹⁸ *Mercantile Safe Deposit and Trust Co.v. Baltimore County* 526 A. 2d 591 (Md. 1987).

¹¹⁹ *Ibid* at 596.

¹²⁰ *Brown v. United States Nat'l Bank*, 371 N.W. 2d 692. 701 (Neb. 1985).

¹²¹ *Mercantile Safe Deposit and Trust Co.v. Baltimore County* 526 A. 2d at 591.

¹²² *Beyene v. Irving Trust*, 762 F. 2d at 7.

By adopting standard practice as a way of measuring strict compliance, the court in New Braunfels Nat. Bank v. Odiorne,¹²³ held that the beneficiary could collect when drafts requested payment on 'Letter of Credit No. 86-122-5' and the letter of credit specified 'Letter of credit No. 86-122-S', holding that strict compliance does not demand oppressive perfectionism.¹²⁴

The question of whether such discrepancies are material or immaterial is a consequential issue in adopting such a test, since bankers are not expected to know the technical terms particular to a business, nor abbreviations or alternate designation of trade terms. In the case of Beyene v. Irving Trust,¹²⁵ the misspelling of the name "Sofan" as "Soran" in a bill of lading was held to be a material discrepancy. On the contrary, in the case of Kelley v. First Westroads Bank,¹²⁶ the credit required a draft signed by an officer of Penn Square Bank. The tendered draft that was signed by an assistant liquidate at the Federal Deposit Insurance Corp instead, was held to be immaterial. Further, in the case of Tosco v. FDIC¹²⁷, the letter of credit required, inter alia, that the beneficiary's draft state that it was drawn under the bank's "Letter of Credit Number 105." However, the beneficiary's draft, when presented, stated that it was drawn under "Letter of Credit No. 105."¹²⁸ The court rejected the bank's strict compliance argument on the basis that these discrepancies in the draft were trivial and, therefore, did not justify dishonour. The leading case adopting qualified strict compliance, sums up the approach as follows: "A variance between documents specified and documents submitted is not fatal if there is no possibility that the documents could mislead the

¹²³ *New Braunfels Nat. Bank v. Odiorne*, 780 SW 2d 313 (Tex. Ct.App. 1989).

¹²⁴ *Ibid* at 318.

¹²⁵ *Beyene v. Irving Trust*, 762 F. 2d at 7.

¹²⁶ *Kelley v. First Westroads Bank* 840 F. 2d 554 (8th Cir. 1988).

¹²⁷ *Tosco v. FDIC* 723 F. 2d 1424 (6th Cir. 1983).

¹²⁸ *Ibid* at 1247.

paying bank to its detriment.”¹²⁹.

To sum up, there is no definite rule governing the qualified strict compliance rule. Therefore, whether a document is complying with the requirements of the credit is left to the court’s judgement in determining the issue of whether the discrepancies are material or not.

6.3. Position under the UCP

It has already been stated at the beginning of this thesis, that the author favours the qualified strict compliance test over both the strict compliance and the substantial compliance tests. Since the UCP, as will be demonstrated below, is said to be more akin to the qualified strict compliance, it is appropriate to look at some of its provisions in order to demonstrate this supposition.

Under the UCP, the standard of compliance is considered less strict than that under the Common Law. The UCP rules have introduced certain measures which alleviate the harshness of such a rule (see for instance articles 37(c) discussed under section 3.1.2, 39(b) discussed under sections 3.1.1. and 7.1., 20 and 21 respectively discussed below under sections 6.3.1 and 6.3.2.

6.3.1. Original Documents Definition in the UCP

The UCP, as stated in Article 20(b), demonstrates that banks will only accept original documents produced, (i) by a reprographic system (e.g. photocopying machine); (ii) via a computerised or automated system (i.e. SWIFT); or (iii) as a carbon copy.

These methods are defined in order to ensure all eventualities are covered including technological advancement. This part of the article also reinforces the notion that the documents need to be marked and appear to be signed as original.

For example, the issuing bank, who were the defendants in the case of Glencore

¹²⁹ *Flagship Cruises, Ltd.*, 569 F. 2d at 705.

International AG v. Bank of China,¹³⁰ rejected documents presented to them under two letters of credit by Glencore (the plaintiffs), based on the following three justifications: (i) that one of the commercial invoices was not appropriately described, (ii) the packing lists failed to describe the goods and finally (iii) that a certificate that Glencore had been asked to provide was not an original document. It had not been considered as an original, despite it bearing an original handwritten signature, as it was found to have been produced by reprographic means. This is clearly dealt with within Article 20(b), of the UCP which has been designed to inform both beneficiaries and banks in what circumstances they could treat documents as originals. Therefore, it was held that that when producing documents either by electronically or by photographic reproduction, a signature on any one of the copies did not make it an original, it merely became an authenticated copy.¹³¹

Similarly, in the case of Kredietbank Antwerp v. Midland Bank Plc,¹³² where a word processed insurance policy, had been presented as an original, Judge Diamond QC had to determine whether the document should be seen as an original even though it was not explicitly marked as such. Although his Lordship initially felt obliged to use the outcome of the Glencore case in his ruling, he further commented that his decision was significantly based on the fact that the documents had appeared to share particular characteristics which suggested that they were original in nature. One such feature was that the paper utilised to print on was equivalent to that which the insurer used for original documents. The other point was that the document encompassed a clause where it clearly indicated whether the document was either an original or a duplicate, therefore they were easily distinguishable. Evans L.J., the judge involved in the Court of Appeal decision, put forth another reason for accepting the document as an original, different to that as

¹³⁰ *Glencore International AG v. Bank of China* [1996] 1 Lloyd's Rep. 135.

¹³¹ *Ibid* at 136.

¹³² *Kredietbank Antwerp v. Midland Bank Plc* [1999] 1 All E.R. (Comm) 801 at 806, CA).

offered by HH Judge Diamond QC. He reviewed the phrase within article 20 (b) where it was clearly indicated that original documents were to be produced using either 'automated or computerised systems'. In Evans LJ's interpretation, this would only cover documents produced by such means which were copies of other documents, that could be regarded as their original. Thus, he perceived the phrases 'reprographic systems' and 'carbon copies' as being consistent with his interpretation. In summing up the case, Evans L.J. concluded that in relation to article 20(b), he felt that the bank therefore, was not entitled to reject any word processed document which was offered as an original, as long as it included all the relevant data describing the contract and was not a copy of another document¹³³. Whilst referring to the Glencore case, the judge expressed his opinion on the judgment of this case, stating that he felt that it did not infer that a document produced by word processor and printer and which was clearly the original document required by the credit, was to be rejected by the bank unless it was marked as original. If the judgment did infer this then he recommended that the judgement ought to be dismissed as obiter dictum because it would indicate that the document in the Glencore case would have been a photocopy. In sum, Evans L.J. emphasised that the need for strict compliance was not equal to a test of exact literal compliance in all situations and with regards to all documents. He further maintained that it could be seen as the banker's discretion to judge whether or not he was contented with the documents supplied to him¹³⁴. In other words, the banker would be allowed to adopt a reasonable interpretation and to have regard to the commercial function of the required document where it was found that the credit stipulations or the documentation tendered in relation to it were vague. It was stressed that the approach utilised should be neither rigid nor literal but should be functional.

¹³³ Ibid at 813.

¹³⁴ Ibid at 806.

6.3.2. Description and Identification of the Goods in Documents Other Than the Commercial Invoice

Article (21) of the UCP offers the following principles which control the associated certificates and covers all documents excluding other documents of carriage, insurance papers and invoices.

The first principle agrees that the credit should specify the person who has issued a certificate as well as specify its wording or data content. If this is clearly evident in the credit, the documents will be taken at face value in the event that their data content is consistent with any other agreed document which has been presented.

Moreover, when the principles of common law are applied to this situation, where equal demands for compliance with certain fundamental requirements are evident, agreement is demonstrated. In relation to certificates, the document must primarily confirm and certify that for which it has been issued, for example a certificate of inspection must certify that the goods have been inspected and are of a satisfactory quality. Compromise in dealing with documentary credits and application forms may be required in situations where a defined method of inspection is prescribed or where particular information relevant to the result of the inspection are requested.¹³⁵ Moreover, confirmation of details which are not within their usual scope can be omitted.

This is demonstrated in the case, Societe Metallurgique & Villerupt v. British Bank for Foreign Trade¹³⁶, where it was illustrated that a certificate of weight was not requested to make known the condition of the goods.

The second principle asserts that the certificate must be written by the person assigned in the credit and that in situations where no name was mentioned by the

¹³⁵ *Commercial Banking Co. of Sydney Ltd. v Jalsard Pty Ltd.* [1973] AC 279. See also *Bank Melli Iran v Barclays Bank DCO* [1951] 2 Lloyd's Rep 367, 375 (a certificate must identify the goods); *Overseas Union Bank Ltd. v Chua* (1964) 30 MLJ 165 and see *Benjamin's Sale of Goods*, at § 19-055 p. 1290.

¹³⁶ *Société Metallurgique D'Aubrives & Villerupt v. British Bank for Foreign Trade* [1922] 11 Ll.L.R. 168, 169.

credit, then it should be by the type of firm envisaged.¹³⁷ Furthermore, the bank holds no responsibility in verifying the genuineness of the signature of the person in whose name the certificate is supposed to be written.

The third principle authorises that the certificate must recognise the goods in question, by describing certain characteristics [e.g. identifying marks on the parcel].¹³⁸ It is accepted that it is not necessary to test the whole consignment of goods, but suggested that taking a small sample which is thoroughly and vigorously tested is acceptable.¹³⁹

The final point is that all the necessary certificates should be included within the document, although an offer of fractional certificates instead of a global one may be permitted in certain situations.¹⁴⁰

In relation to the UCP, it is evident that the phrase “strict compliance” does not appear in the UCP Article (13) and the degree of strictness is left to be decided in accordance with the “international standard banking practice *as reflected in these articles*”.¹⁴¹ From this article there are three indications which demonstrate that the phrase ‘as reflected in these articles’ does not mean that international standard banking practice is confined to the UCP itself. By contrast, in a contest between actual international standard banking practice and such practice “as reflected in

¹³⁷ *Equitable Trust Co of NY v Dawson Partners Ltd.* (1927) 27 Ll.L.R. 49. As to whether the certificate may be made out by an agent of the designated person, see *Dynamics Corporation of America v Citizens and Southern National Bank* 356 F.Supp 991 (1973); *Far Eastern Textile Ltd. v City National Bank and Trust Co* 430 F.Supp 193 (1977).

¹³⁸ *Basse and Selve v Bank of Australasia* (1904) 90 LT 618 (first tender rejected as goods not identified); *Bank Melli Iran v Barclays Bank DCO* [1951] 2 Lloyd’s Rep 367, 375.

¹³⁹ *Basse and Selve v Bank of Australasia* (1904) 90 LT 618, at 620. *Chairmasters Inc. v Public National Bank and Trust Co.*, 127 NYS 2d 806 (1954); *Banco Español de Credito v State Street Bank and Trust Co.*, 385 F.2d 230 (1967); and see further proceedings in case: 409 F.2d 711 (1969).

¹⁴⁰ See, *Benjamin’s Sale of Goods*, at § 23-185 p. 1752. And note that the bank cannot demand additional documents in order to verify the certificate as shown in the case of *Bank of Canton v Republic National Bank*, 509 F.Supp 1310 (1980), affd. 636 F.2d 30 (1980).

¹⁴¹ For more on ‘The International Standard Banking Practice’, see, Appendix D, Section (9).

these article”, it is likely that the latter would prevail.¹⁴² This contention is illustrated in the following example: Under Article 20(b) of the UCP, the rule for determining whether documents are considered as originals or copies is that a document produced by reprographic means, in order for it to be regarded as an original, must be marked as “original”. However, according to Dolan¹⁴³, this Article is in conflict with actual banking practice as evident in the Glencore case, which has already been discussed. The practice had been that documents could be issued in multiple copies either electronically or by photographic reproduction and that only one of the copies could be signed and used as the original. This was based on the belief that the original signature would suffice to render the signed copy an original. Whereas, in Article 20 (b) it was evident that a copy required more than simply a signature to render it as an original, it was also required to be clearly marked as such. Nonetheless, it is clear that the language of Article 20(b) prevails over actual practice.

In sum, according to Dolan, so far as the international standard banking practice is concerned, it can be said that in relation to the confines of such standard, the following three points should be taken into consideration. “(1) that not all international standard banking practices are indeed reflected in the UCP; (2) that to the extent practices are codified in the UCP, those practices and not any inconsistent practices are the practices that come within the standards; and (3) that regional practices may supplement the international standards, though probably may not conflict with them”.¹⁴⁴

6.4. Strict Compliance and the Move Towards Electronic Commerce

In the light of the current and potential development in electronic commerce,

¹⁴² Dolan, J.F., ‘Letters of Credit: A Comparison of UCP 500 and the New U.S. Article 5’ *Journal of Business Law* Nov (1999) 521, 524.

¹⁴³ *Ibid.*

¹⁴⁴ *Ibid* at 525.

documentary credit practices need to be updated to meet both business and technical demands.

Following the emergence of electronic commerce, a letter of credit can now be issued electronically. In other words, the traditional form of paper based letter of credit can now be replaced by a paperless letter of credit. Having said that an issuance of an electronic letter of credit is already possible in practice, the major concern now is to look carefully at the nature and content of electronic messages required to trigger payment in accordance with the terms and conditions of the credit.¹⁴⁵

The UCP 500 does not cover the handling of electronic documents, but solely deals with paper produced documentation. Having said this, Article 20 of the current UCP 500, (mentioned above under section 6.3.1.) does allow for electronically issued documents, yet the structure of the UCP rules does not contemplate an electronic environment in which they may operate. As a result the ICC have formulated, in draft form, a set of rules, "Uniform Rules for Electronic Trade and Settlement" (UTERUS), which will deal specifically with electronically produced documents and which should be approved at the ICC's semi annual meeting in May 2000. At this point a definite decision will have to be made with regards to the development of the UCP i.e. one for paper, one for electronic. Until that time, banks will be required to formulate the standard within the letter of credit advice in order to achieve the standard of compliance. With the advent of electronic commerce and strides in international trade documentation, such as the Bolero project covering the issuance and control of electronic bills of lading, the issue that faces banks and companies trading internationally is whether or not within an electronic environment a letter of credit, as we know it now, will exist. Following discussion with the ICC on whether the standard of compliance is bound

¹⁴⁵ An article submitted by SITPRO, Feb. 1995 ' Electronic Commerce: Towards Replacing the Paper Based Letter of Credit-A Conceptual Model', Web site http://www.unicc.org/unece/trade/itt/r1134_a.htm

to be affected by the move towards electronic commerce, Mr. Gary Collyer, a technical adviser to the ICC, has pointed out that “Obviously, in an electronic world compliance will be an easier achievement than the current paper world where a document not only includes the information required by the credit but also extraneous information which is usually the cause of a bank establishing non-conformity i.e. weights on one document differing from that on another - the question being did that or those documents actually require the weight to appear?”¹⁴⁶

6.5. General Observation About the Doctrine of Strict Compliance

As has been obvious throughout the chapter, the doctrine of strict compliance kills two birds with one stone: first, it refuses to relax the duty of the beneficiary to present conforming documents; and, second, it refuses to relax the duty of the bank to pay, when the documents do conform. Even if the account party and the bank are dissatisfied with the beneficiary’s performance either in relation to the letter of credit or the underlying contract, courts which apply the strict rule are unwilling to let the bank impose additional conditions on the beneficiary.¹⁴⁷ That is why the doctrine of strict compliance has gained widespread acceptance.¹⁴⁸

¹⁴⁶ This information was obtained from email exchange with Mr. Gary Collyer, Technical Adviser to the ICC. Email Address: gary.collyer@citicorp.com. It is to be noted that the standard of compliance is bound to be affected by the move towards electronic commerce. The ICC has produced a series of books called ‘Queries and Responses’ of which two address various issues surrounding the UCP 500. The first, ‘More Queries and Responses on the UCP 500-Opinions of the Banking Commission 1997 (No. 596)’. The second, is ‘Opinions of the Banking Commission on UCP 500 (1995-1996) (No.565)’. Thus, according to ICC guidelines on the application of the compliance standard, banks can consult the ICC for an opinion in cases where the matter under consideration does not appear to be regulated by the explicit Articles of the UCP. The ICC would then help in determining the question of compliance with the advent of electronic commerce.

¹⁴⁷ Dolan, states that “The leading case is *Maurice O’Meara Co. v. National Park Bank*, 239 N.Y. 386, 146 N.E. 636 (1925), in which the court refused to let the bank inspect the beneficiary’s shipment to determine whether the goods complied with the underlying transaction. The opinion is remarkable in light of the majority’s clear rejection of the dissenting position of the judge Cardozo who argued that the bank had an interest in the quality of the merchandise by virtue of its security interest. The *O’Meara* majority squarely rejects that view, holding that it is more important to protect the integrity of strict compliance than to protect the bank’s collateral”. Dolan, *supra* note 115, fn 18 pp. 21-22.

¹⁴⁸ For cases in which the courts use the strict compliance rule to find a beneficiary’s presentation

However, there are several drawbacks with this rule: (i) A beneficiary cannot complain even when the credit calls for a document in the control of the account party. In this case, the beneficiary may have not agreed to take such a credit. (ii) The account party who ultimately must reimburse the bank if it pays, might refuse to execute the document and thereby deprive the beneficiary of payment under the credit.¹⁴⁹ (iii) When the beneficiary's documents fail to comply with terms of the credit, the issuer may, under the doctrine of strict compliance, object to payment regardless of the account party's satisfaction with the beneficiary's documents.¹⁵⁰ (iv) Most importantly, it is open to be abused by the account party, through his bank, by seizing on minor defects in the seller's documents to refuse payment on the letter of credit.¹⁵¹

6.6. Justifications and Protective Mechanisms for the Strict Compliance Standard

Despite the possibility of being abused, the doctrine of strict compliance still

nonconforming and therefore justifying dishonour, see, e.g., *Board of Trade v. Swiss Credit Bank*, 728 F. 2d 1241 (9th Cir. 1984) (airway bills not valid substitutes for on board bills); *Banco Nacional De Desarrollo v. Mellon Bank, N.A.*, 726 F.2d 87 (3d Cir. 1984) (missing document); *Philadelphia Gear Corp. v. Central Bank*, 717 F. 2d 230 (5th Cir. 1983) (shipping notices no substitute for bill of lading); *Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, N.A.*, 707 F.2d 680 (2d Cir. 1983) (documents indicating goods loaded two to seven days late); *Consolidated Aluminum Corp. v. Bank of Va.*, 544 F. Supp. 386 (D. Md. 1982), *Aff'd*, 704 F. 2d 136 (4th Cir. 1983) (late presentment because of mail); *Bank of Southeast v. Jackson*, 413 So. 2d 1091 (Ala. 1982) (missing documents); *Eximetals Corp. v. Pinheiro Guimares, S.A.*, 73 A.D. 2d 526, 422 N.Y.S. 2d 684 (1979), *aff'd*, 51 N.Y. 2d 865, 414 N.E.2d 399, 433 N.Y.S.2d 1019 (1980) (missing signature and incomplete language on inspection certificate). For cases using the strict compliance rule to prevent banks or account parties from imposing requirements on the beneficiary greater than those specified in the credit, see, e.g., *United States v. Sun Bank*, 609 F.2d 832 (5th Cir. 1980) (bank cannot require certification of the use of the funds); *Colorado Nat'l Bank v. Board of County Comm'rs*, 634 P. 2d 32 (Colo. 1981) (bank cannot require beneficiary to prove loss); *First Nat'l Bank v. Rosebud Hous. Auth.*, 291 N.W.2d 41 (Iowa 1980) (bank cannot complain that one of the beneficiary's documents was superseded); cf. *Mount Prospect State Bank v. Marine Midland Bank*, 121 Ill. App. 3d 295, 459 N.E. 2d 979 (1983) (invoices and bills of lading showing sale and shipment to the wrong party violate both the strict compliance and the substantial compliance rules). Cited by Dolan, J.F., *supra* note 115, fn 20 p. 22.

¹⁴⁹ Dolan, J.F., *supra* note 115 at 21.

¹⁵⁰ For more details see the case of *AMF Head Sport Wear, Inc. v. Ray Scott's All-American Sports Club*, 448 F. Supp. 222 (D. Ariz. 1978).

¹⁵¹ Dolan, J.F., *supra* note 115 at 25; For more details see Kozolchyk, B., *supra* note 1 at pp. 50-55.

retains its important values. The justification for strict compliance runs along the following lines:

- (i) Why should it be assumed that an issuing bank, acting in good faith, would abuse the strict compliance test in all cases, given that the test provides certainty? The normal, non-abusive bank issuer needs the strict rule. The argument in support of this point is that banks, acting in good faith, need the strict standard to protect their integrity and international reputation. This would be achieved by assuring that payment by letters of credit, as efficient method of payment, would not be challenged, thus emphasising certainty. There is no doubt that some banks and their customers, acting in bad faith, abuse the strict compliance test in order to avoid their obligations. However, as submitted by Dolan, “[I]f there were no reason for the strict standard other than to protect these banks and their customers, the strict standard would have to go”.¹⁵²
- (ii) There are two ways to limit abuse of the strict rule. First, beneficiaries should insist on credit terms that facilitate cure of defective presentations. Second, courts can use the powerful tool of strict estoppel to prevent issuers from raising the most of spurious objections.
- (iii) The strict compliance standard promotes promptness and certainty of payment without inquiry de hors the credit.¹⁵³
- (iv) The substantial compliance standard, as an alternative, is not a standard that will work. It will increase costs, take time and require the impossible of bank documents examiners. Also, it may involve some inspection into the underlying contract which is independent of the credit contract.¹⁵⁴

In order to safeguard against unfair objection by the bank or the account party, a reasonably diligent beneficiary should, first of all, insist while drafting the

¹⁵² Dolan, J.F., *supra* note 115 at 26.

¹⁵³ *Ibid* at 27.

¹⁵⁴ *Ibid*.

underlying contract that the credit require only those documents that he can supply,¹⁵⁵ and if the credit imposes impractical conditions, he should suspend performance until the issuer amends the credit. Secondly, he should also insist on a confirmed credit which permits presentation of his documents at a bank local to him, so that if a document is defective he will have the chance to cure the defects easily. Lastly, he should insist on an expiry date in the credit that permits him to present his documents early, so that if the bank rejects a document as defective, the beneficiary will have time to cure it.¹⁵⁶ The second protective mechanism will be dealt with under the doctrine of estoppel.

The harshness of the principle of strict compliance is mitigated in the following respects:¹⁵⁷

1. Article 39 of the UCP provides for various degrees of tolerance.
2. The credit must be interpreted as a whole.
3. Article 37(c) of the UCP provides some tolerance (in relation to the description of the goods (in documents other than the commercial invoice)).¹⁵⁸
4. A mere typographical error, or other obvious slip or omission, does not constitute a discrepancy in the document.¹⁵⁹

7. Some Exceptions to and Qualification of Judicial Strict Compliance¹⁶⁰

McLaughlin¹⁶¹ states that there are some principles, drawn mainly from contract law, equity and banking custom which can work in conjunction with the doctrine

¹⁵⁵ Cf Article 5 of the UCP 1993 Revision. It encourages banks to discourage their customers from including "excessive detail" in any credit.

¹⁵⁶ Dolan, *supra* note 115 at pp. 28-29.

¹⁵⁷ Sealy, L.S., & Hooley, R.J.A., *Commercial Law: Text, Cases and Materials* pp. 771-72.

¹⁵⁸ For more on strict compliance under the UCP, see Todd, P., *Bills of Lading & Bankers' Documentary Credits* p. 221.

¹⁵⁹ See Gutteridge & Megrah, *The Law of Bankers' Commercial Credits*. 7th ed.(London, Europa Publications Limited, 1984), p 120; see also the case of *Hing Yip Hing Fat Co Ltd v. Daiwa Bank Ltd* [1991] 2 HKLR 35.

¹⁶⁰ See. Hotchkiss, C., *supra* note 80 at 292 n 11; See also. McLaughlin, G.T., *supra* note 107 at 9-38.

¹⁶¹ McLaughlin, G.T., *supra* note 107 at 4.

of strict compliance in which they dilute the stringency of the strict compliance standard.

7.1. The de minimis Rule

It is a principle of contract law that notwithstanding the rule that any failure to perform is a breach of contract, the law does not regard minute failure as departures from the contractual obligation. This is known as the “de minimis” rule.¹⁶² Under article 39(b) of the UCP, the doctrine of strict compliance has, to some extent, been diluted in a way which makes it much more flexible than the trend that the common law follows. Indeed, most provisions of the 1993 Revision of the UCP sustain some softness to the rigidity of the doctrine of strict compliance.

7.2. The Rule of Contra Proferentem

Given that a letter of credit has frequently been described as a special contract, courts still treat it as a contract. A fundamental rule of contract interpretation requires that where the language of a contract is ambiguous, the interpretation should be against the party who drafted or proffered the contract¹⁶³. Accordingly, since a letter of credit is drafted by the issuing bank and not by the beneficiary, according to this rule, in a dispute between the beneficiary and the issuing bank, all ambiguities in the credit contract should be construed against the issuing bank. Marino Industries Inc. v. Chase Manhattan Bank N.A.¹⁶⁴ illustrated this point. In this case, it was a condition under the credit that the beneficiary was required to present a certificate of receipt signed by a Mdica representative. However, the

¹⁶² Carter, J.W., *Breach of Contract*. 2d ed. (Sweet & Maxwell, London, 1991) pp 21-22. See also § 30 of the Sale of Goods Act 1979.

¹⁶³ See Article 12 of the UCP which provides a way for the issuing banks to protect themselves when they receive “incomplete or unclear” instructions from applicants.

¹⁶⁴ *Marino Industries Inc. v. Chase Manhattan Bank* 686 F. 2d 112 (2d Cir. 1982); See also *Venizelos, S.A. v. Chase Manhattan Bank*, 425 F. 2d 461, 465-466 (2d Cir. 1970); *Banco Espanol de Credito v. State St. Bank & Trust Co.*, 385 F. 2d 230, 237 (1st Cir. 1967). These cases have applied this contra proferentem rule.

signature on the receipt did not comply with any one of the signatures on file with Chase. Chase relied on the doctrine of strict compliance to reject the payment. The beneficiary sued Chase for wrongful dishonour of the letter of credit. The Court of Appeal for the Second Circuit was of the opinion that since there was an ambiguity in the letter of credit as to whether the receipt could be signed by any M dica representative or only by one of the three M dica representatives whose signatures were on file with Chase, the letter of credit had to be interpreted against the party generating the credit, hence, Chase. As a result, the receipts would have strictly complied with the terms of the letter of credit, had the beneficiary tendered receipts signed by any M dica representative, and thus entitling him to payment¹⁶⁵. Whether the terms of a letter of credit are ambiguous or not is a matter for the courts to decide.¹⁶⁶ For example, in Fair Pavilions, Inc. v. First National City Bank¹⁶⁷, the applicant was entitled to cancel the credit if, at least ten days prior to any drawing date under the credit, an officer of the applicant presented the issuing bank with an affidavit certifying that “one or more of the events described in clause XV” of the underlying contract had occurred.¹⁶⁸ The applicant did present the required affidavit to cancel the credit but without specifying in the affidavit which particular event, described in clause XV of the underlying contract, had occurred. The issuing bank proceeded to cancel the credit. When the case was brought to the New York trial court, motions for summary judgment were rejected, because the

¹⁶⁵ Since the magistrate below had not determined whether the signature on the certificates of receipt was actually a signature of a M dica representative, the Second Circuit ordered, on remand, that the magistrate make such a determination. *Ibid.* at 117, Cited by McLaughlin, G.T., *supra* note 107 at 11n 22.

¹⁶⁶ McLaughlin advances that some courts will apply the rule of *contra proferentem* only if ambiguities in a contract still exist after applying other rules of contract interpretation and construction, such as the “plain meaning” rule. See *Exxon Co., U.S.A. v. Banque de Paris et des Pays Bas*, 828 F. 2d 1121, 1127 (5th Cir. 1987) (Appendix A-Decision of the United States Federal District Court, *cert. granted*, 56 U.S.L.W. 3723 (April 19, 1988). “A contract is ambiguous only where its meaning remains uncertain after application of the rules of construction.” Cited by McLaughlin, G.T., *supra* note 107 at 11n 22.

¹⁶⁷ *Fair Pavilions, Inc. v. First National City Bank* 24 A.D. 2d 109, 264 N.Y.S.2d 255 (1965), *rev.d*, 19 N.Y. 2d 512, 227 N.E.2d 839, 281 N.Y.S. 2d 23 (1967).

¹⁶⁸ 24 AD 2d at 110, 264 NYS 2d at 256.

court was of the opinion that there was an issue presented as to whether any of the events specified in clause XV had occurred and thus whether the credit had been validly cancelled.¹⁶⁹ However, the decision was reversed by the New York appellate division because the court could not find any ambiguity in the credit. According to the appellate division, it was a requirement of the affidavit that the credit need only state that one or more of the events described in clause XV of the contract had occurred, not specifically which of the events had occurred. A modification of the credit would be necessary if there was a demand for the event to be specified in the affidavit.¹⁷⁰ The case was brought to the New York Court of Appeals, which reversed the appellate division's decision on the ground that the terms of the credit were ambiguous.¹⁷¹ According to the Court of Appeals by reading the credit in conjunction with clause XV of the underlying contract, there was a contemplation that if the applicant certified that one of the events in clause XV had occurred, the beneficiary would be given an opportunity to correct its defective performance. The Court of Appeal was of the opinion that to provide the beneficiary with a meaningful right of cure, it was necessary to interpret the credit as requiring the applicant to state in the affidavit, which specific event or events enumerated in clause XV had occurred.¹⁷² Since the affidavit as presented by the applicant, did not specify which event had occurred, the bank could not cancel the credit. The summary judgment was granted to the beneficiary.¹⁷³ McLaughlin¹⁷⁴ states that this case is a good example of how courts can differ over whether or not the terms of a credit are ambiguous. Moreover, the rule of *contra proferentem* can also be used to prevent issuing banks from adding payment conditions to

¹⁶⁹ 19 N.Y. 2d 512, 516, 227 N.E. 2d 839, 840, 281 N.Y.S.2d 23, 25.

¹⁷⁰ 24 A.D. 2d at 112, 264 N.Y.S. 2d at 258.

¹⁷¹ 19 N.Y. 2d 512, 227 N.E. 2d 839, 281 N.Y.S. 2d 23.

¹⁷² *Ibid* at 518, 227 N.E. 2d at 841-842, 281 N.Y.S. 2d at 26-27.

¹⁷³ *Ibid* at 518, 227 N.E. 2d at 842, 281 N.Y.S. 2d at 27.

¹⁷⁴ McLaughlin, G.T., *supra* note 107 at 13

letters of credit. In the case of United Bank of Denver, N.A. v. Citibank, N.A.,¹⁷⁵ the credit required a signed, written statement certifying that “the applicant for the credit has failed to pay U.S. \$ 200,000 on the due date pursuant to Section 4 of the Technology Sale Agreement....”¹⁷⁶ Subsequent to the issuance of the credit, an arbitral tribunal declared the Technology Sale Agreement void due to mutual mistake of the parties. After complex procedural manoeuvrings in the courts of two states, the beneficiary finally drew on the credit. The beneficiary presented the necessary signed written statement certifying that “the applicant has failed to pay U.S \$ 200,000 on the due date [April 12, 1985] pursuant to Section 4 of the Technology Sale Agreement....”¹⁷⁷ Citibank (the issuing bank), refused payment, arguing that because of the arbitral decision, the Technology Sale Agreement did not exist on April 12, 1985, and thus, payment under this agreement could not be due on this date. A New York federal district court rejected Citibank’s argument. What Citibank was claiming, in the court’s view, was that the terms of the letter of credit required the beneficiary to certify two things: first, that the applicant had not paid on April 12 and second, that the applicant was legally required to pay on April 12.¹⁷⁸ According to the letter of credit, what was required was that: the beneficiary was to certify only the first point and the rule of *contra proferentem* prevented Citibank as the issuer of the credit, from making the second point a condition of payment. Therefore, since the credit explicitly required the beneficiary to certify only non-payment on April 12, the court ruled that Citibank could not also require the beneficiary to certify that payment was in fact legally due on that date.¹⁷⁹ Moreover, from the decision of the Court of Appeals for the Fifth Circuits in

¹⁷⁵ *United Bank of Denver, N.A. v. Citibank, N.A.* No. 85 Civ. 5636 (CBM) (S.D.N.Y. Dec. 9, 1987).

¹⁷⁶ *Ibid*, opinion at 3.

¹⁷⁷ McLaughlin, G.T., *supra* note 107 at 10.

¹⁷⁸ *Ibid* at 10-11.

¹⁷⁹ *Ibid* at 11.

Exxon Co., USA. v. Banque de Paris et des Pays Bas¹⁸⁰, it can be inferred that the rule of contra proferentem can only be used when there are ambiguous terms in a credit, but cannot be used where the terms of the credit are seen to be inconsistent.¹⁸¹

7.3. The “Render Performance Possible” Rule

It is a standard rule of contract construction that when a contract is open to two interpretations, “one that will render performance possible and the other impossible, the former interpretation should be preferred”.¹⁸² The courts often refer to this principle when assessing whether the doctrine of strict compliance has been satisfied.¹⁸³ In the above mentioned case of Exxon,¹⁸⁴ the federal district court had applied this principle to permit Exxon to draw on the letter of credit after the October 31 expiration date. The district court realised that since the credit allowed Houston to satisfy its delivery obligation through to the end of December, Exxon could not certify Houston’s default by the October 31 expiration date. Therefore, the inconsistency in the terms of the credit should be construed so as to render Exxon’s performance under the credit possible. The simplest way to do this was to have an extension in the expiration date of the credit. The Fifth Circuit, in overruling the district court’s decision, agreed to the principle that inconsistent terms should be construed so as to render performance possible, but simply that it did not find the principle applicable in the case, as no inconsistent terms were

¹⁸⁰ Exxon Co., USA. v. Banque de Paris et des Pays Bas 828 F. 2d 1121 (5th Cir. 1987) , cert. granted, 56 U.S.L.W. 3723 (April 19, 1988).

¹⁸¹ 828 F.2d at 1124.

¹⁸² McLaughlin, supra note 107 at 15.

¹⁸³ Ibid; see Venizelos, S.A. v. Chase Manhattan Bank, 425 F. 2d 461, 466 (2d Cir. 1970); Liberty Nat’l Bank & Trust Co. v. Bank of Am. Nat’l Trust & Sav. Ass’n, 218 F. 2d 831, 840 (10th Cir, 1955); Dynamics Corp. v. Citizens & Southern Nat’l Bank, 356. Supp. 991, 999 (N.D.Ga. 1973); Temple-Eastex, Inc. v. Addison Bank, 672 S.W.2d 793, 798 (Tex. 1984); Republic Nat’l Bank v. Northwest Nat’l Bank, 578 S.W. 2d 109, 115 (Tex. 1978).

¹⁸⁴ Exxon Co., USA. v. Banque de Paris et des Pays Bas 828 F. 2d 1121 (5th Cir. 1987) , cert. granted, 56 U.S.L.W. 3723 (April 19, 1988).

found. Willow Bend National Bank v. Commonwealth Mortgage Corporation¹⁸⁵ further shows a different possible application of the “render performance possible” rule, as decided by the Texas state Court of Appeals. The letter of credit in this case did not contain two inconsistent terms as in the Exxon case; instead the credit contained two terms, one of which was subject to two constructions. The letter of credit (i) stated that it was available through sight drafts drawn on the issuing bank and (ii) required that “the amount of the draft must be endorsed on the reverse hereof by a negotiating bank.”¹⁸⁶ When the beneficiary presented an unindorsed draft, the issuing bank refused to honour it, claiming that the draft required an indorsement by a negotiating bank. It was the court’s view that the indorsement term was open to two constructions: first, the indorsement term could be construed as a condition precedent requiring that all sight drafts drawn under the credit had to be negotiated to a second bank before being presented to the issuing bank for payment. Second, the indorsement term could be construed as requiring an indorsement by a negotiating bank only if the beneficiary decided to negotiate the draft. The court, in an attempt to avoid a forfeiture and to render the beneficiary’s performance in compliance with the terms of the credit, construed the indorsement term as requiring an indorsement by a negotiating bank only when the beneficiary chose to present its sight draft through a negotiating bank, which the beneficiary had not chosen to do in this case.¹⁸⁷

7.4. The Plain Meaning Rule

According to the Texas Court, in Travis Bank & Trust v. State¹⁸⁸, the standby credit required the presentation of “drafts”. When the beneficiary presented a non-

¹⁸⁵ *Willow Bend National Bank v. Commonwealth Mortgage Corporation* 722 S.W.2d 12 (Tex. Ct. App. 1987).

¹⁸⁶ *Ibid* at 13-14.

¹⁸⁷ *Ibid* at 14. McLaughlin states that The Texas court could have also reached this same result by applying the *contra proferentem* rule (i.e., construing the endorsement term in the way most favourable to the beneficiary) *supra* note 107 at 17 n 47.

¹⁸⁸ *Travis Bank & Trust v. State* 660 S.W. 2d 851 (Tex. Ct. App. 1983).

negotiable draft, the issuing bank refused to pay, claiming that the letter of credit required the presentation of a negotiable draft. It was held that: “A word used in a contract is to be given its ordinary meaning unless the contract reveals a strong reason for assigning to the word a different meaning.”¹⁸⁹ McLaughlin contends that the ordinary meaning of “draft” covers both a negotiable and a non-negotiable draft and “thus, using the plain meaning rule, the beneficiary strictly complied with the terms of the letter of credit when it presented a non-negotiable draft”.¹⁹⁰ The plain meaning rule could not save all cases, for instance, in Armac Industries Ltd v. Citytrust¹⁹¹, presentation of a draft was required by the credit, but the draft presented was not signed by the drawer. Article 5 of the UCC expressly incorporates the UCC’s Section 3-104 definition of draft, which expressly required the drawer’s signature in order to validate a negotiable draft.¹⁹² Thus, what the beneficiary presented in Armac could not satisfy the plain meaning of the word “draft”. That is to say, the beneficiary’s payment demand was an incomplete negotiable instrument that was not enforceable as a draft until completed.¹⁹³

7.5. Reformation of the Written Terms of a Letter of Credit

This rule can be defined as “the remedy by which writings are rectified to conform to the actual agreement of the parties”.¹⁹⁴ Two examples can be given to illustrate this rule: (1) “two parties wish to enter into a contract on certain specified terms but mistakenly express one or more of these terms in their writing”;¹⁹⁵ and (2) “one

¹⁸⁹ Ibid at 855.

¹⁹⁰ McLaughlin, G.T., supra note 107 at 17.

¹⁹¹ 525 A 2d 77 (Conn. 1987).

¹⁹² “UCC § 3-104(1) (a). According to the court, a signature on the back of the unsigned draft could not constitute the drawer’s signature. Under UCC § 3-402, a signature in an ambiguous capacity is deemed the signature of an indorser. To the same effect, see *North Valley State Bank v. National Bank*, 437 F. Supp. 70, 73 (N.D. Ill. 1977)”. Cited by McLaughlin, G.T., supra note 107 at 17, fn 51.

¹⁹³ UCC § 3-115(1).

¹⁹⁴ Calamari, J., & Perillo, J., *The Law of Contracts* (3rd ed. 1987). 392.

¹⁹⁵ McLaughlin, G.T., supra note 107 at 19.

party to a contract is charged with reducing the contract to writing and in so doing, fraudulently changes one or more terms of the agreement".¹⁹⁶ In these cases of mutual mistake or fraud, the law allows the aggrieved party to reform the terms of the writing to reflect the true intention of the parties. However, in order to apply the equitable doctrine of reformation to a letter of credit, some necessary prerequisites for reformation must exist. Firstly, there must be both a prior agreement between the parties, and secondly, there must be a writing that is at variance with the terms of that prior agreement.

Although the letter of credit is an independent contract between the issuing bank and the beneficiary, the actual terms of a letter of credit are not directly negotiated between them. The beneficiary and the applicant of the credit agree on the payment terms of the credit, the issuing bank is then instructed by the applicant to include these terms in the credit. There is hence, no direct agreement between the issuing bank and the beneficiary with respect to the payment terms of the credit. Mistaken or fraudulent instructions by the applicant as to what to include in the credit might influence a court to allow reformation of the written terms of the credit as against the issuing bank. The issuing bank would have to be deemed as the agent of the applicant for the credit for these purposes. In Fina Supply, Inc. v. Abilene National Bank¹⁹⁷, Fina Supply entered into an oil exchange agreement with Biro. Biro instructed Abilene National Bank to issue a standby letter of credit in Fina's favour in order to cover any oil exchange imbalances. The original letter of credit covered exchange imbalances during October 1981 and expired in November 1981.¹⁹⁸ An amendment specifically extended the coverage of the letter of credit to include exchange imbalances during both November and December 1981 and extended the expiration date of the credit to January 1982. Subsequent amendments extended the expiration date of the credit to May 31, 1982, but unlike the first amendments

¹⁹⁶ Ibid.

¹⁹⁷ *Fina Supply, Inc. v. Abilene National Bank* 726 S.W. 2d 537 (Tex. 1987).

¹⁹⁸ Ibid at 539.

did not specifically extend the credit to cover oil imbalances arising after December 1981. Nevertheless, a representative of Abilene Bank stated that by extending the expiration date of the credit, the number of months of oil imbalances covered by the credit was extended as well.¹⁹⁹ However, the representative turned out to be wrong and the extension of the expiration date did not automatically extend the credit to cover post-December oil imbalances. When Fina sought payment under the credit for oil imbalances that arose after December 1981, Abilene refused payment, as the draw did not strictly comply with the terms of the amended credit. Fina sued Abilene and sought to reform the credit. The issue was whether the beneficiary could reform the terms of an amendment to a letter of credit based on the alleged fraud of a representative of the issuing bank. The Supreme Court of Texas rejected Fina's fraud argument, as the bank representative's statements were "mere statements of opinion which will not support an action for fraud."²⁰⁰ Neither was the court persuaded by Fina's mistake argument. Since Fina could have determined on its own, the effect of the extension of the expiration date, it chose not to make its own determination. Fina did not really make a mistake as to the legal effect of the amendments; instead it made a mistake by relying on the opinions of Abilene's representative,²⁰¹ which was not the type of mistake that triggers reformation of a credit. The Supreme Court thus rejected the use of reformation in this case²⁰², however, the court still implicitly accepted the notion that reformation would be an acceptable remedy in an appropriate letter of credit case.²⁰³

¹⁹⁹ Ibid.

²⁰⁰ Ibid at 541.

²⁰¹ Ibid.

²⁰² See the decision of Supreme Court of Nebraska in *Brown v. United States Nat'l Bank*, 371 N.W. 2d 692, 701 (Neb. 1985).

²⁰³ "*Bank of Montreal v. Federal Nat'l Bank & Trust Co.*, 622 F. Supp. 6 (W.D. Okla. 1984), might be construed as a case that allowed the beneficiary to reform the terms of a credit. Although the term "reformation" was not mentioned by the court, the court did stress that in granting the beneficiary relief, it was only carrying out the presumed intent of the parties. This seems to mean that the court rectified the letter of credit to express the true agreement of the parties. The court, however, did

7.6. The Parol Evidence Rule²⁰⁴

The parol evidence rule states that terms in a written contract that are intended by the parties to be the final expression of their agreement cannot be varied or contradicted by prior oral or written agreements or by contemporaneous oral agreement.²⁰⁵ However, “the rule does not preclude a written contract from being modified or affected by a contemporaneous written agreement executed as part of the same transaction”.²⁰⁶ That is to say, assuming a side covenant is agreed to in writing between the issuing bank and the beneficiary when a letter of credit is issued, this covenant may affect the terms of the letter of credit. For instance, suppose a side covenant requires the beneficiary to give the issuing bank a ten-day written notice before making any draw under the letter of credit; and that the beneficiary fails to give this ten-day notice but presents the issuing bank with complying documents two days before the expiry of the credit. A court, basing itself on the side covenant, would very likely allow the issuing bank to refuse payment although the documents presented comply strictly with the payment terms stated in the credit. However, McLaughlin²⁰⁷ claims that this practice is not typical in letters of credit and the issuing bank will be loath to enter into a contract with the beneficiary because any covenant that changes the terms of the letter of credit will in all probability affect the bank’s ability to obtain reimbursement from its customer, i.e. the applicant.²⁰⁸ Instead of entering into a side covenant with the beneficiary, a prudent issuing bank would obtain the customer’s consent to the

not stress the presence of fraud or mutual mistake as the reason for the rectification of the terms of the credit. This is usually required for reformation. Perhaps the case is better read as a form of *contra proferentem* case”. Cited by McLaughlin, G.T., *supra* note 107 at 22 n 64.

²⁰⁴ See for more details Beale, H., Bishop, W., Furmston, M., *Contract Cases and Materials*, 3rd ed, (Butterworths, London, 1995) pp 316-320; see also Carter, J.W., *Breach of Contract* p. 23; ‘Law of Contract: The Parol Evidence Rule’ (No 154), Law Commission (Cmnd 9700, 1986), paras. 2.7, 2.10-13, 2.15, 2.17, 2.22-24.

²⁰⁵ See, eg, UCC § 2-202.

²⁰⁶ McLaughlin, G.T., *supra* note 107 at 22.

²⁰⁷ *Ibid* at 22-23.

²⁰⁸ See, e.g., *Chase Manhattan Bank v. Equibank*, 550 F 2d 882, 886 (3d Cir. 1977).

terms of the side covenant and incorporate these terms into an amended letter of credit,²⁰⁹ so that the customer would be precluded from successfully objecting to any change in the terms of the credit. Indeed, sometimes there are documents other than an issuing bank-beneficiary covenant which may create parol evidence problems. For example, in the case of American Airlines, Inc. v. FDIC²¹⁰, a letter of credit required the presentation of a sight draft, but the beneficiary presented a draft which did not mention the issuing bank as the drawee.²¹¹ Along with the draft, the beneficiary presented the letter of credit and a covering letter, both of which mentioned the proper drawee.²¹² The court allowed the accompanying documents to supply the name of the drawee, which had not been written on the draft itself since “there was no possibility that the issuing bank could have been misled by the documents submitted to it by the beneficiary”.²¹³ The federal district court ruled that when the draft and the accompanying documents were read together, the strict compliance standard was satisfied. However, it cannot be inferred from this case that an issuing bank is bound to consider collateral documents not specified by the terms of the credit, as demonstrated by the case of Courtaulds North America, Inc. v. North Carolina National Bank²¹⁴. The letter of credit in this case called for the presentation of an invoice stating that the goods were “100% acrylic yarn.” Although the invoices presented stated that the goods were “imported acrylic yarn,” packing lists which referred to the goods as “100% acrylic” were stapled to these invoices.²¹⁵ The Court of Appeals for the Fourth

²⁰⁹ See UCC §§ 5-106(2), 5-114(3); UCP article 14(a).

²¹⁰ American Airlines, Inc. v. FDIC 610 F. Supp. 199 (D. Kan. 1985).

²¹¹ “See UCC § 3-104(2) (a), which states that a draft must contain an order. In its turn, UCC. § 3-102(1)(b) states that an “order” within the meaning of Article 3 “must identify the person to pay with reasonable certainty.” The absence of the name of a drawee would thus affect the character of the instrument as a draft”. McLaughlin, G.T., *supra* note 107 at 23, fn 71.

²¹² 610 F. Supp. at 200.

²¹³ *Ibid* at 202.

²¹⁴ Courtaulds North America, Inc. v. North Carolina National Bank 528 F. 2d 802 (4th Cir. 1975).

²¹⁵ *Ibid* at 803.

Circuit ruled that the invoices with the packing lists stapled to them did not strictly comply with the terms of the credit. It was the court's opinion that the invoices themselves had to comply with the terms of the credit and that the bank "was not expected to scrutinise the collateral papers, such as the packing lists".²¹⁶

7.7. Waiver²¹⁷

Before honouring the beneficiary's draft, the issuing bank has the right to insist on the strict compliance of documents with the terms of the credit. However, according to the doctrine of waiver, an issuing bank, by word or by action, may relinquish its right to insist on strictly complying documents.²¹⁸ In the case of Chase Manhattan Bank v. Equibank²¹⁹, the beneficiary, Chase, presented the necessary documents to Equibank ten days after the credit expired, and Equibank refused to honour them for late presentation. Chase argued that on the due date of the credit, a Equibank employee had telephoned Chase saying that the necessary documents required by the credit could be forwarded through domestic collections, a process that was commonly known to take several days. The employee of Equibank in his affidavit, however, maintained that he "never waived the requirements necessary to draw on the credit". The federal court granted summary judgment for Equibank. The Court of Appeals, however, reversed and remanded the case for a hearing on the waiver question. It was held that "We decide that the possibility of an estoppel or waiver on the part of Equibank has been raised and it was error to enter summary judgement with that issue

²¹⁶ Ibid at 806.

²¹⁷ See Givray, A. Brande, M., supra note 80 at 1578; Avidon, M., 'Letters of Credit-New U.C.P. 500 to Take Effect January 1, 1994' *Banking Law Journal* (1994) p 83 at 84; Pugh-Thomas and Chapman, 'The Effect of the Decision of the Court of Appeal in the Rabobank Case on the Law and Practice of Documentary Credits' 1 *JIBL* (1989) 30; See also Jack, R., *Documentary Credits* at § 5-52 p. 101; See also the case of *Co-operative Raiffeisen Boereleenbank BA v. The Sumitomo Bank Ltd, The Royan, Abukirk, Bretagne and Auvergne* [1987] 1 Lloyd's Rep 345; For more details about waiver by the creditor see Penn, Shea, Arora *The Law and Practice of International Banking Law*. vol 2 (London, Sweet & Maxwell, 1987) P 314.

²¹⁸ McLaughlin, G.T., supra note 107 at 24.

²¹⁹ *Chase Manhattan Bank v. Equibank*, 550 F. 2d 882 (3d Cir. 1977).

unresolved”²²⁰.

7.8. Estoppel²²¹

The doctrine of estoppel can also influence a court when applying the doctrine of strict documentary compliance. In the area of letter-of-credit practice, as can be seen in the UCP, a distinction must be drawn between two different forms of estoppel, namely (i) notice estoppel and (ii) prior conduct estoppel. They are explained through the UCP Article 14, as follows:

(i) Notice Estoppel.

Under Article 14(d) the issuing bank is required to give expeditious notice of documentary discrepancies to the beneficiary or to the bank presenting them. Should the bank fails to do so, it will be precluded from relying on these discrepancies to justify dishonour, by virtue of Article 14(e). Therefore, having rejected the documents on citing the discrepancies, the issuing bank will be estopped from relying on any other discrepancies which are not clearly mentioned in its first rejection form for dishonour. The estoppel sustains even if the beneficiary knew about such discrepancy when he presented the documents and even if the beneficiary could not have cured such discrepancy had the proper notice been given. The classic example to illustrate this scenario is the case of Banker's Trust Co. v. State Bank of India²²². The issuing bank, upon the receipt of discrepant documents from the beneficiary, spent more than the time limit for checking the documents. Nonetheless, State Bank of India (the defendants) had already been reimbursed by (the plaintiffs) Bankers' Trust. Although it is clear that the plaintiffs were entitled to reject the documents due to the discrepancies, the

²²⁰ Ibid at 887; See also *Colonial Cedar Co. v. Royal Wood Prods., Inc.*, 448 So. 2d 1218 (Fla. Dist. App. 1984).

²²¹ See McLaughlin., 'Letters of Credit: Basic Principles and Current Controversies' 17 *Australian Business Law Review* (1989) 302 at 305 (Estoppel, Waiver, Good Faith and Parol Evidence Rule); See also Barnes, 'Nonconforming Presentations under Letters of Credit: Preclusion and Final Payment' 56 *Brooklyn Law Review* (1990) 103-109.

²²² *Banker's Trust Co. v. State Bank of India* [1991] 1 Lloyd's Rep. 587.

plaintiffs were barred from rejecting the documents. Both Hirst J., at first instance,²²³ and the Court of Appeal gave judgment in favour of the defendants grounding their decision on the estoppel rule of Article 16 of the UCP 1983 Revision.²²⁴

(ii) Prior Conduct Estoppel.

Unlike notice estoppel, “prior conduct estoppel” is not predicated on the issuing bank’s failure to give expeditious notice of discrepancies. Even if the issuing bank did notify the beneficiary of a, b, and c discrepancies²²⁵, the issuing bank might still be estopped from relying on these discrepancies if on prior occasions it had accepted from the beneficiary documents containing the same discrepancies.²²⁶ Disregarding its intention to relinquish any of its rights, if an issuing bank has, as a matter of practice, accepted nonconforming documents in the past, it may be estopped from refusing such documents in the future, at least until the beneficiary is notified of a change in its policy. An example to illustrate this point can be seen in the case of Schweibish v. Pontchartrain State Bank²²⁷, where the issuing bank dishonoured the beneficiary’s draw due to the beneficiary’s failure to present a sight draft drawn on the bank as required by the terms of the letter of credit. According to the standard of strict compliance, the absence of the required sight draft was enough to justify dishonour. But on previous occasions, the issuing bank had honoured the draft although the beneficiary had not strictly complied with the documentary terms of the credits. Because of this prior conduct, the court ruled that the bank was estopped from demanding strict compliance in this case. To quote the court:

“While the bank can impose conditions in the credit and demand complete compliance with them, it cannot, in a series of dealings based upon credits, arbitrarily select those

²²³ [1991] 1 Lloyd’s Rep. 587.

²²⁴ Article 16 of the UCP 1983 Revision has been modified in the 1993 Revision to be Article 14.

²²⁵ pursuant to Article 14(d) of the UCP.

²²⁶ McLaughlin, *supra* note 107 at 36. See further, Dolan, J.F., *The Law of Letters of Credit. Commercial and Standby Credits*, at § 6-58.

²²⁷ *Schweibish v. Pontchartrain State Bank* 389 So. 2d 731 (La. Ct. App. 1980).

credits which must conform to the requirements therein stated and those which may be paid without complete compliance.”²²⁸

However, the same reasoning does not always apply. In the case of Security State Bank v. Basin Petroleum Services, Inc.,²²⁹ for instance, the Supreme Court of Wyoming refused to apply estoppel in circumstances similar to those in Schweibish. Here, the issuing bank had not insisted on strict compliance with respect to discrepancies in four prior purchase orders. Nonetheless, the court ruled that the bank was not estopped from demanding strict compliance with respect to a fifth purchase order. The Court noted that the beneficiary had to prove, *inter alia*, a lack of knowledge about the documentary terms of the letter of credit or inability to discover the nature of these terms.²³⁰ Since the beneficiary could not prove it, the issuing bank was entitled to insist on strict compliance.

The issuing bank may still be able to insist on *strict* compliance if it can justify its prior inconsistent conduct. In the case of Courtaulds,²³¹ it was proved that the issuing bank had previously honoured noncomplying drafts. The issuing bank, however, countered this evidence by showing that before honouring these drafts, it had always consulted its customer regarding any discrepancies. So, the previous discrepancies were waived with the customer’s consent.²³² It was submitted that where a customer waived discrepancies, it was the usual practice for the issuing bank not to notify the beneficiary that there had been discrepancies and that these discrepancies had been waived.²³³ However, if the issuing bank seeks waiver but is refused by the customer, as happened in Courtaulds, the issuing bank has to notify the beneficiary of the discrepancies. It was therefore clear that in Courtaulds, the bank’s prior practice of paying over discrepant drafts should not be deemed to

²²⁸ Ibid at 737.

²²⁹ *Security State Bank v. Basin Petroleum Services, Inc.* 713 P. 2d 1170 (Wyo. 1986).

²³⁰ Ibid at 1172.

²³¹ *Courtaulds North America v North Carolina National Bank* 528 F 2d 802 (4th Cir. 1975).

²³² Ibid at 807.

²³³ Ibid.

constitute an estoppel.²³⁴

7.9. Course of Dealing and Course of Performance²³⁵

If an issuing bank has previously accepted discrepant documents presented by a particular beneficiary over a period of time and then without the beneficiary's consent, it suddenly insists on strict documentary compliance, two results might be drawn: firstly, the bank is estopped from rejecting the non-complying documents due to its prior inconsistent conduct or secondly, the bank's course of dealing with the beneficiary regarding discrepancies in prior letters of credit must be read as an integral part of its agreement with the beneficiary regarding discrepancies in this letter of credit. Section 1-205(1) of the UCC defines a course of dealing as "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." In light of this, it can be concluded that by giving specific meaning to documentary terms in a letter of credit, a course of dealing can obviously affect the application of the doctrine of strict documentary compliance.²³⁶ It is submitted that if a course of dealing involves a sequence of previous conduct between the issuing bank and the beneficiary regarding prior letters of credit, a "course of performance" refers to repeated occasions of performance regarding one letter of credit.²³⁷ For example, if a commercial letter of credit permits five consecutive monthly drawings, the

²³⁴ McLaughlin, G.T., *supra* note 107 at 28; See also McLaughlin, G.T., *supra* note 221 at 305 advances that the party asserting the estoppel must show that he relied on the issuing bank's previous actions in paying against non-complying tender and that, based on the issuing bank's previous actions, he continued to present such non-complying documents.

²³⁵ See more about the principle of course of dealing, in contract law, in Beale H.G, Bishop. W.D, and Furmston. M.P. *Contract: Cases and Materials* p. 308; MacDonald, 'Incorporation of Contract Terms by a 'Consistent Course of Dealing' 8 *Legal Studies* (1988) 48.

²³⁶ McLaughlin, G.T., *supra* note 107 at 28.

²³⁷ "Course of performance" is defined in UCC § 2-208(1). Unlike "course of dealing," course of performance is arguably limited to sale-of-goods cases governed by Article 2. Section 5-102(3), however, would undoubtedly permit the borrowing of this doctrine in letter-of-credit cases. Cited by McLaughlin, G.T., *supra* note 107 at 29, fn 92.

performance of the two parties with respect to the initial drawings under the credit will constitute part of their agreement with respect to subsequent drawings under the credit. Titanium Metals Corporation v. Space Metals, Inc.²³⁸ demonstrates how both a course of dealing and a course of performance can dilute the rigorous strict compliance standard. In this case, three letters of credit, each allowing for multiple presentations, had been issued to the beneficiary by the issuing bank. “Although the text of the credits seemed to require that drafts be presented to obtain payment, the issuing bank processed all of the beneficiary’s invoices with respect to the first two letters of credit and one invoice with respect to the third letter of credit without demanding separate drafts from the beneficiary. Instead the bank simply stamped the invoices presented as ‘paid’ and also filled out a voucher calling the completed transaction a ‘sales draft’”.²³⁹ The bank, nevertheless, refused to pay the six remaining invoices presented under the third letter of credit, claiming that the beneficiary failed to present a draft.²⁴⁰ The beneficiary argued that the bank’s previous course of conduct with respect to the first two letters of credit, constituted a waiver to the need to present a separate draft. The trial court accepted the beneficiary’s argument as to waiver. The Supreme Court of Utah upheld the trial court, however, not on a waiver theory. The Supreme Court stated that, “the long course of conduct of the parties, with numerous shipments, acceptances, orders to remit and compliances therewith” is a clear manifestation of what the beneficiary and issuing bank thought the terms of the letter of credit were to be.²⁴¹ In effect, what the court meant was that the parties’ course of dealing (with respect to the first two letters of credit) and their course of performance (with respect to the first invoice of the third letter of credit) had to be read as

²³⁸ *Titanium Metals Corporation v. Space Metals, Inc.* 529 P. 2d 431 (Utah 1974).

²³⁹ Facts as cited by McLaughlin supra note 107 at 29.

²⁴⁰ Ibid at 432. McLaughlin advances that the bank’s decision seemed to have been motivated by a fear that the bank might not be reimbursed, supra note 107 at 29 n 95.

²⁴¹ Ibid at 433.

permitting the draft called for by the credit to be incorporated into the invoice itself. No separate draft was required to be presented. As a result, the issuing bank had to pay the six remaining invoices presented under the third letter of credit.

7.10. Banking Customs

Banking or trade customs may also affect how the doctrine of strict compliance will be applied by the court. Here, the relevant trade customs are banking customs.²⁴² Supposing that the beneficiary presents to the issuing bank a document that does not strictly comply with the terms of the letter of credit. Nonetheless, if there is a local banking custom that allows banks to routinely accept what is presented in lieu of what should be presented under the terms of the credit, the issuing bank will most likely have to accept the noncomplying documents.²⁴³ An example to illustrate this rule can be seen in the case of Dixon Irmaos & Cia v. Chase National Bank²⁴⁴. The beneficiary in this case presented the issuing bank with a guarantee from a leading New York bank in lieu of a missing bill of lading. Expert testimony showed that it was a “general and uniform” custom of New York banks to accept such a guarantee.²⁴⁵ Due to the existence of this custom, it was not justifiable for Chase to use the doctrine of strict compliance to reject the guarantee in lieu of the bill of lading.²⁴⁶

²⁴² “Banking customs with respect to letter-of-credit practice are generally contained in the provisions of the UCP discussed under section “the de minimis rule”. Sometimes, however, a local banking custom not included in the UCP can still affect letter-of-credit practice. These local banking customs are covered in this section”. Cited by McLaughlin, G.T., supra note 107 at 30, fn 97.

²⁴³ It is submitted by McLaughlin that differences in local banking customs can cause conflicts. For example, what may constitute a banking customs in the locale of the beneficiary cannot be used to bind a foreign issuing bank to pay a straight letter of credit but they may be used to bind a foreign issuing bank to pay a negotiation credit., supra note 107 Cf. *Bank of Canton, Ltd. v. Republic Nat'l Bank*, 509 F. Supp. 1310, 1315-1316 (S.D.N.Y.), *aff'd*, 636 F. 2d 30 (2d Cir. 1980). McLaughlin, G.T., supra note 107 at 30, n 98.

²⁴⁴ *Dixon Irmaos & Cia v. Chase National Bank* 144 F.2D 759 (2d Cir. 1944).

²⁴⁵ *Ibid* at 761. For the position of the usual banking custom in England. See Gutteridge & Megrah, *The Law of Bankers' Commercial Credits* p. 117 fn. 3.

²⁴⁶ McLaughlin, G.T., supra note 107 at 31.

7.11. Good Faith

The issuing bank, under Section 5-114(1) of the UCC, is obliged to “honour a draft...which complies with the terms of the relevant credit...” To put it another way, the issuing bank has to honour the beneficiary’s draft upon receipt of a facially complying document. Along with executing this duty, the issuing bank is also under an obligation to act in good faith.²⁴⁷ Minimally, this obligation requires the bank to deal with the documents honestly. So understood, this obligation to act in good faith can considerably affect the way in which the doctrine of strict compliance is judicially applied. Assume that the beneficiary presents a facially complying document but the issuing bank after executing a meticulous check, points out some trivial discrepancies in an attempt to justify its unwillingness to honour the credit. If the beneficiary can show the dishonesty of the bank’s action in raising these trivial discrepancies (usually because the customer no longer has the funds to reimburse the issuing bank), a court should hold that the bank has abandoned its Section 1-203 obligation of good faith by so doing. Once this violation of the previous Section has been proven, Section 1-106(2) of the UCC affords the aggrieved party (beneficiary) a cause of action to enforce that obligation.²⁴⁸ That is to say, if there is a bad faith denial to honour the credit, the beneficiary should be able to enforce Section 1-203 by way of a wrongful dishonour action and demand the issuing bank to accept the documents even though they include trivial discrepancies. Further, it is submitted that if the beneficiary can show that the issuing bank not only wrongfully dishonoured the credit but did so dishonestly, the beneficiary may be able to recover punitive

²⁴⁷ UCC § 1-203 provides that “every contract or duty within the UCC imposes an obligation of good faith in its performance or enforcement”.

²⁴⁸ UCC § 1-106(2) provides that “any right or obligation declared by the UCC is enforceable by action unless the provision declaring it specifies a different and limited effect.” McLaughlin maintains that since § 1-203 does not specify a different or limited effect, the obligation of good faith can be enforced by action. Cited by McLaughlin, G.T., *supra* note 107 at 31, n.102.

damages from the issuing bank.²⁴⁹

7.12. Duty to Notify the Beneficiary of Oppressive Term

Sometimes, banks issue irrevocable letters of credit which stipulate that payment should be conditional on the presentation of a document executed by the applicant.²⁵⁰ These kinds of conditions may cause trouble due to their internal inconsistency²⁵¹. The inconsistency or contradiction occurs when, on one hand, the issuing bank tells the beneficiary that the letter of credit is irrevocable, while on the other hand, it includes a documentary payment condition in the credit that allows the applicant to “veto irrevocability” simply by refusing to execute a required document. This scenario was in issue in Fair Pavilions²⁵², where the court expressed serious reservation about this kind of credit. The credit in this case was particularly one-sided because it allowed the applicant to cancel the credit simply by submitting an affidavit certifying the occurrence of one or more events specified in a collateral contract. The appellate decision contended that this provision was so broad and its potential for abuse so vast that “the characterisation of the credit’s irrevocability becomes either a misnomer or an overgenerous description.”²⁵³ Given this and certain other terms of the credit, the court was of the opinion that the issuing bank might “have had at least a moral obligation to point out the possible deficiency to the beneficiary in view of the beneficiary’s risk and exposure to possible damage. The beneficiary could then have elected to accept or reject the

²⁴⁹ See the relevant judgment in the case of *Hubbard Business Plaza v. Lincoln Liberty Life Ins. Co.*, 596 F. Supp. 344 (D. Nev. 1984), cited in Chapter Four, Section One, 4.3.3. Nonetheless, punitive damages were awarded against the beneficiary and an assignee of the proceeds of the credit in *Holmberg v. Morrisette*, 800 F. 2d 205 (8th Cir. 1986), *cert. denied*, 107 S. Ct. 1953 (1987), and *Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat’l Bank*, 757 F. 2d 399 (1st Cir. 1985).

²⁵⁰ See in this regard *Far E. Textile, Ltd. v. City Nat’l Bank & Trust Co.*, 430 F. Supp. 193 (S.D. Ohio 1977).

²⁵¹ See Feldman, “Revocable Letters of Credit,” *Letters of Credit Rep.*, Jan-Feb. 1988, at 1-2; opinion of the appellate division in *Fair Pavilions*, 24 A. D. 2d 109, 264 N.Y.S.2d 255.

²⁵² *Fair Pavilions* 24 A.D. 2d 109, 264 N.Y.S.2d 255.

²⁵³ *Ibid* at 112, 264 N.Y.S.2d at 258.

proffered credit.”²⁵⁴ McLaughlin states that “imposing a duty on issuing banks to notify beneficiaries of oppressive or one-sided letter-of-credit terms does not seem to be a wise policy decision”.²⁵⁵ The beneficiaries are very often sophisticated business entities which constantly receive legal advice. They are, therefore, well equipped and therefore should be deemed to be able to understand the effect of the credit’s terms. The view expressed by the appellate division in Fair Pavilions, however, leaves it open for the courts to impose such a duty on an issuing bank in appropriate cases.²⁵⁶ Indeed, the imposition of notification obligations on issuing banks is not totally without precedent in letter-of-credit litigation.²⁵⁷ If such a notification obligation were imposed and the issuing bank failed to comply with it, the bank might be forced to accept discrepant documents, particularly if the discrepancies related to the oppressive payment terms that were the subject of the notification obligation.²⁵⁸

7.13. The UCC Presentment Warranty

Although the strict compliance doctrine is not dealt with in section 5-111(1)²⁵⁹ of the UCC, the section does deal with the issue of whether the losses resulting from the presentation of discrepant documents should be borne by the beneficiary or the issuing bank. Suppose, for the sake of illustration, that documents containing patent discrepancies were tendered by the beneficiary. The issuing bank made a

²⁵⁴ Ibid.

²⁵⁵ McLaughlin, G.T., supra note 107 at 33.

²⁵⁶ In a related situation, however, the Fifth Circuit in the *Exxon* case (828 F. 2d 1121) stated that it could find no authority “that imposes on an issuer a duty to the beneficiary to ‘make sense’ of the customer’s application.” Ibid at 1126.

²⁵⁷ For more on authorities in which injunctions requiring issuing banks to draw the attention of their customers to draws made under their letters of credit were issued in several cases arising out of the Iranian Revolution such as *Harris Int’l Telecommunications, Inc. v. Bank Melli Iran*, No 79-802 (S.D.N.Y. Feb. 22, 1979) (Transcript at 35). *Accord, Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530, 532 (S.D.N.Y. 1979); *Pan Am. World Airways, Inc. v. Bank Melli Iran*, No. 79-1190 (S.D.N.Y. Apr. 3, 1979) (slip op. at 9). Cited by Weisz & Blackman, ‘Standby Letters of Credit After Iran; Remedies of the Account Party.’ *U. Ill. L. Rev.* (1982) 355, n 30 at 362.

²⁵⁸ McLaughlin, G.T., supra note 107 at 33.

²⁵⁹ § 5-111(1) of the UCC.

cursory examination and failed to discover the discrepancies and thus honoured the credit. Subsequently, the discrepancies were discovered by the applicant and he refused to reimburse the bank. Section 5-111(1) can be interpreted in a way which allows the issuing bank²⁶⁰ to sue the beneficiary for breach of warranty regarding the discrepant documents.²⁶¹ Since a letter of credit contains documentary conditions, it is debatable that the beneficiary has warranted a facial compliance of the presented documents with the documentary requirements of the credit. Recourse can be sought against the beneficiary if this warranty is breached. Hence, the interpretation of section 5-111(1) is of great interest to the issuing bank, as it may have a breach of warranty action against the beneficiary of the credit in spite of its negligence. In other words, care should be taken in interpreting the Section 5-111(1) warranty provision. It has been argued that the section should not be interpreted to allow a bank to have recourse against the beneficiary if it pays over documents that contain patent, as opposed to latent, defects.²⁶² It is submitted that even if Section 5-111(1) is generally interpreted to cover patent discrepancies, the beneficiary should still be able to raise many of the principles discussed above to block the bank's recovery.²⁶³ For instance, an issuing bank fails to discover a discrepancy and pays the beneficiary and as a result, it cannot obtain reimbursement from its customer. The bank should not be able to rely on the breach of warranty action for recovery if the beneficiary can prove that the discrepancy in the document resulted from an ambiguity in the terms of the credit. This is because the rule of *contra proferentem* provides that an ambiguity in the

²⁶⁰ Issuing bank is "an interested party" See in this regard. Dolan, 'Letters of Credit, Article 5 - Warranties, Fraud and the Beneficiary's Certification' 41 *Bus. Law* (1986) 347, 355.

²⁶¹ In addition to breach of warranty, in the cases of *Delta Brands, Inc. v. M Bank Dallas, N.A.*, 719 S.W. 2d 355 (Tex. Ct. App. 1986); *Philadelphia Gear Corp .v. Central Bank*, 717 F.2d 230 (5th Cir. 1983)., other theories, such as allowing an issuing bank to recover from the beneficiary letter-of-credit payments made against defective documents, was also manifested.

²⁶² See Dolan, J.F., *supra* note 260 at 351.

²⁶³ McLaghulin, G.T., *supra* note 107 at 35.

terms of the letter is to be construed against the issuing bank.²⁶⁴

The extent to which these exceptions dilute the rigidity of the strict compliance test and whether such exceptions make the strict compliance test more akin to the substantial compliance test or the qualified strict compliance test will be discussed more in depth in this chapter under section 6.

²⁶⁴ *Ibid.*

Section Two: Difference Between the Three Rival Tests and the Question of Which of Them Provides Maximum Fairness, Certainty, Flexibility and Good Faith

1. The Position the Law Takes in Relation to the Three Rival Tests of Compliance

What is the position in the three legal regimes with which we are concerned (English law, the UCP and the UCC) with regard to the three rival tests of compliance, namely (i) strict compliance; (ii) substantial compliance; and (iii) qualified strict compliance?

The position at Common Law is that it applies the “strict compliance” standard in relation to the position between the beneficiary and the bank. Under the UCP, the standard of compliance is less strict than that under the Common Law. The UCP rules have introduced some measures which alleviate the harshness of such a rule. See for instance articles 21, 37(c) and 39(b) of the UCP. Moreover, the phrase “strict compliance” does not appear in the rules and the degree of strictness is left to be decided in accordance with *international standard banking practice*.²⁶⁵ Thus, the standard of compliance, under the UCP, has become more akin to the qualified strict compliance standard.²⁶⁶ The UCC Article 5 (original version) was silent on the issue, which resulted in confusion in the US courts; different courts applying different standard of compliance due to the vagueness of the related section of compliance. Thus, under the original Article 5 the question of the standard of compliance depended on the individual case. In fact, the majority of US courts interpreted the section as strict compliance; some courts construed it to mean substantial compliance; and a few courts applied the qualified strict

²⁶⁵ See, Section One, (6.3.).

²⁶⁶ See the discussion under (5), *ante*.

compliance standard.²⁶⁷ This confusion has been eliminated now by virtue of the revised Article 5 of the UCC in which the phrase “strictly to comply” appears in the text.

2. Evaluation of the Three Rival Tests of Compliance With Reference to the Five Basic Principles

2.1. Party Autonomy in Relation to the Three Rival Tests

For the purposes of this discussion, it is to be noted that the compliance standard in letters of credit law (between bank and beneficiary and in disputes between them) is understood to be a fixed rule. Whether the rule should be strict compliance, qualified strict compliance, or substantial compliance is another matter—whatever rule we decide to have, it is fixed. Since the compliance standard is a fixed rule the parties (by definition) cannot bargain around it and thus party autonomy is compromised.

2.2. Fairness in Relation to the Three Rival Tests

2.2.1. Fairness With Regard to Each Test

From a fairness point of view, in relation to the distributive theory, the strict compliance test is not fair at all because some innocent beneficiaries can lose their right of payment due to trivial discrepancies within the documents. The strict interpretation of the phrase “strict compliance” would result in potential frustration to the reasonable expectations of parties.

So far as the substantial compliance test is concerned, it provides more fairness than the strict compliance test and is more in line with the distributive theory. This is because some innocent beneficiaries can get payment despite trivial discrepancies within the documents, by virtue of the fact that bankers are allowed to look behind the documents in their course of verification of discrepant tender, of course,

²⁶⁷ See, Section One, (6.2.).

without harming the significance of the credit as well as not affecting the buyer's position.

From a fairness standpoint, in relation to the distributive theory, the qualified strict compliance test is fairer than the strict compliance test but it is not as fair as the substantial compliance test. This is due to the fact that although some innocent beneficiaries can get paid despite trivial discrepancies within the documents, the courts look upon immateriality in a much tougher way than in the substantial compliance test.

2.2.2. Fairness in Law

Since the English law position on the issue of compliance adopts the strict compliance test, it may, then, be said that English law is not in favour of fairness in this context, as is demonstrated by the distributive theory. So far as the USA law is concerned, since some courts have applied both the substantial compliance and the qualified strict compliance tests, the law may thus be regarded as both fair and in line with the distributive theory, in terms of equality in distributing benefits and losses between contracting parties. So far as the UCP is concerned, although it is silent on the issue of compliance, the study revealed that it adopts a standard of compliance that is akin to the qualified strict compliance. Thus, the UCP may be regarded as fair and again, more in line with the distributive theory.

2.3. Certainty in Relation to the Three Rival Tests

2.3.1. Certainty With Regard to Each Test

The strict compliance test provides a high degree of certainty.²⁶⁸ "There is no room for documents which are almost the same, or which will do just as well."²⁶⁹ One might inquire how is it that the application of the doctrine of strict compliance is in

²⁶⁸ See about tensions between certainty and fairness, Stoufflet, J., 'Payment and Transfer in Documentary Letters of Credit: Interaction Between the French General Law of Obligations and the Uniform Customs and Practice' 24 *Arizona Law Review* (1982) 267 at 270.

²⁶⁹ per Lord Sumner, *Equitable Trust Co. v. Dawson Partners*, [1927] L.L.R. 49 (H.L.). at 52.

favour of certainty? By applying the doctrine of strict compliance, every party to the letter of credit contract will know where each of them stands. Namely, the beneficiary will be sure of being paid upon tender of the exact documents; the bank will be sure of being reimbursed by its customer upon honouring the credit following the receipt of strictly complying documents; the buyer also will be sure that his instructions to the issuing bank will be exactly complied with.

The substantial compliance test provides the parties to a letter of credit with an uncertain result as there are no clear-cut cases of compliance. In consequence, parties are confused as to where they stand. This will lead to the result that every case is to be decided on its own merits. The main problem that this test suffers from is that bankers should not be expected to look beyond the documents, otherwise, it will take a long time for the bank to decide whether or not to honour the drafts, thereby defeating the function of letters of credit. Kozolchyk²⁷⁰ supports the position that bankers should be equipped to know both the banking and commercial practices. He contends that the distinction between the “banking” and the “commercial” type of discrepancy is “at odds with banking and legal realities” and thus, the bank should be “charged with knowledge of the commercial impact that the absence of a given document or requirement may have upon the terms of the credit”²⁷¹. Of course, it is an ideal that bankers should be familiar with both the banking and commercial practices, however, it is hardly practicable because the letter of credit as a mechanism of prompt payment will be undermined.

Regarding certainty, in relation to the qualified strict compliance test, the decisions where this test is being applied are not reconcilable, as illustrated by the cases of Beyene v. Irving Trust²⁷² and Kelley v. First Westroads Bank²⁷³, which have already been discussed in Section One. That is to say, this test is less certain than

²⁷⁰ Kozolchyk, B., supra note. 1 at pp 62-65.

²⁷¹ Ibid at 65.

²⁷² Ibid.

²⁷³ *Kelley v. First Westroads Bank* 840 F. 2d 554 (8th Cir. 1988).

the strict compliance test, but more certain than the substantial compliance test.

2.3.2. Certainty in Law

English law is certain because it adopts the strict compliance test only and in all cases. Having said the UCP is more akin to the qualified strict compliance test, then the UCP would be regarded as certain only where international practice is seen to be united in accepting such a contention. Yet, if people interpret the rule differently this would add uncertainty to it. The USA courts, due to the silence of the UCC have adopted different tests of compliance, as explained earlier in the text. This would provide uncertainty as to law since there is more than one option to adopt. However, after the emergence of the (1995) version of Article 5 of the UCC, such uncertainty no longer exists. This is because the phrase 'strict compliance' is incorporated within the text.

2.4. Flexibility in Relation to the Three Rival Tests

2.4.1. Flexibility as to Rule

English law is not perceived as being flexible as there is only one position to deal with the test of compliance. As a result of the vagueness of the UCC provisions on this issue, the USA law is seen to be flexible, as there is more than one position to adopt. Also, reference to other applicable law is possible. Since the UCP rules may refer to other applicable law, they can be described as flexible. Flexibility comes from the fact that there may be more than one option to adopt.

2.4.2. Flexibility as to Application

The strict compliance rule is not flexible at all, since some minor technical discrepancies will be caught.

The flexibility of the substantial compliance test is very high. There is no rigid standard and compliance is judged case by case by reference to business standards. Indeed, the extent of flexibility of this test can be found in Dolan's comment: "In

short, the substantial compliance standard is no standard at all.”²⁷⁴

The qualified strict compliance test, *prima facie*, appears to be the most desirable, since it cures the problem in the strict compliance test by tolerating hypertechnical defects and hence provides a certain degree of flexibility. However, in comparison with the above two tests, it can be said that this test is more flexible than the strict compliance test because technical errors are tolerated, but less flexible than the substantial compliance test.

2.5. Good Faith in Relation to the Three Rival Tests

2.5.1. Good Faith as to Application

In so far as the relationship between the doctrine of strict compliance and the principle of good faith is concerned, it has been submitted that, “while the doctrine of strict compliance like any other legal principle is limited by the requirements of good faith, the formal character of this doctrine calls for considerable restraint in invoking the principle of good faith”.²⁷⁵ That is to say, the doctrine of good faith (in an objective sense) is overlooked, thus leaving potential abuse unchecked on the part of both the buyers and the bankers who do not act in good faith.

Under the present English law, because the doctrine of strict compliance allows the person to whom the documents are tendered to raise any lawful objections against the documents, this, according to the distributive theory, demonstrates the unfairness of the doctrine itself. “Any lawful objections” includes purely technical errors, regardless of the true motive for the rejection, and even if the true motive is to be found in a falling market or in some irrelevant circumstances.²⁷⁶ Hence, if a

²⁷⁴ Dolan, *supra* note 115 at 28.

²⁷⁵ Canaris, *Bankvertragsrecht* (1975), App., para. 357, annotation 378. (Cited by Eberth, R., ‘Documentary Credits in Germany and England’. *Journal of Business Law* (1977) 29, at 39.

²⁷⁶ See for English authorities on the subject Adams, J., and Brownsword, R., *Key Issues in Contract* (Butterworths, London, 1995). Ch 6 (Breach and Withdrawal), also Brownsword, R., (Bad Faith, Good Reasons and Termination of Contracts) in *Termination of Contracts* edited by Birds,

banker suspects that the buyer is unable to take up the documents, he may raise against the seller, minute discrepancies in the documents and rely on the most trivial and insignificant technicalities in order to justify their rejection. Thus, it is clear that this principle can be used by the applicant for the credit as a weapon in dealing with the beneficiary and is therefore most frequently used in an abusive manner by the applicant. By inserting within the application form, some requirements that are difficult to meet, and which result in the tendered documents failing, the applicant will, as a condition to waive the discrepancies, ask for a price reduction of the goods. (Similar argument is dealt with in Chapter Six, when dealing with the bifurcated compliance standard, in relation to the reimbursement contract).

Opportunistic behaviour is not caught even if the true motive for the issuing bank's rejection of the tender documents is tainted by bad faith for unrelated reasons. Potential abuse of this test can be exercised by either the issuing bank or the applicant.²⁷⁷

Whilst English law tolerate such unfair tactics, other legal systems, such as the Swiss²⁷⁸, will in appropriate circumstances, disallow such acts by demanding the exercise of good faith. The Swiss law has in fact been given effect to in the United Kingdom in a case concerning a letter of credit governed by the law of

Bradgate, Villiers. (Wiley Chancery. A Division of John Wiley & Sons, London, 1995). p 225. *Guaranty Trust Co. of New York v Van Den Berghs Ltd.* (1925) 11 Ll.L.R. 447, 455. As regards the position in the USA, see *Liberty National Bank and Trust Co. v Bank of America*, 116 F. Supp. 233, 237, 243 (1953), affd. 218 F.2d 831 (1955); *Couraulds North America v North Carolina National Bank*, 387 F.Supp. 92 (1975), rvsd. 528 F.2d 802 (1975); *Far Eastern Textile Ltd. v City National Bank and Trust Co.*, 430 F.Supp. 193 (1977); *AMF Head Sports Wear Inc. v Ray Scott's All-American Sports Club Inc.*, 448 F.Supp 222 (1978); cf. *Exotic Transfers Far East Buying Office v Exotic Trading USA Inc.* 717 F.Supp 14 (Mo 1991); See in this regard, Yong, C.H., supra note 81 at 175.

²⁷⁷ See also, Chapter Five, Section Two, about how some issuers rely on a hypertechnical examinations in order to prevent the loss that they could confront due to the applicant's insolvency. See Chapter Six about bad faith actions by the applicant.

²⁷⁸ *Société de Suisse v Société Generale Alsacienne de Banque* [1989] JT 1342.

Switzerland.²⁷⁹ In spite of the fact that the English law has not committed itself to a similar doctrine yet, in Benjamin's opinion²⁸⁰, the same result may be reached in extreme cases in the light of Phillips J.'s decision in Transpetrol Ltd. v. Transöl Olieprodukten Nederland BV²⁸¹. In accordance with this particular case, the judge refused to consider a contractual term based on the fact that the requisite within the contract was nonsensical²⁸². Although the doctrine of strict compliance did not apply in that case, as the term in question was not a term of the letter of credit itself but one of the requisites spelt out in the documentary credit clause of the contract of sale, Benjamin found it "difficult to see why Phillips J's robust common sense approach should not be equally applied to the commercial facility – the letter of credit – the opening of which is bargained for in the documentary credit clause of the contract of sale."²⁸³

Since bankers, according to the substantial compliance test, can look beyond the face of the documents, this allow the motives of both buyer and the bank to be disclosed, and thus promote the doctrine of good faith (in its objective sense). Put more clearly, the point about substantial compliance is that if the bank uses this test properly it will not reject documents for trivial non-compliance. Carrying out all those investigations, the bankers seem to be acting as a detective of fraud, and this will no doubt indirectly promote the doctrine of good faith. This means that the buyer cannot hold things up for trivial defects and indirectly bad faith by the buyer is controlled in this way. It could be termed as an *indirect* test of good faith since bankers act as a detective of fraud (in the sense of acting as detectors of bad faith by the buyer).²⁸⁴

²⁷⁹ *Mannesman Handel AG v Kaunlaran Shipping Corp* [1993] 1 Lloyd's Rep 89.

²⁸⁰ *Benjamin's Sale of Goods*, at § 23-182 p. 1750.

²⁸¹ *Transpetrol Ltd. v. Transöl Olieprodukten Nederland BV*. [1989] 1 Lloyd's Rep. 309.

²⁸² *Ibid* at 310-311.

²⁸³ As commented on by *Benjamin's Sale of Goods*, at § 23-182.

²⁸⁴ See, Chapter Five, Section Two, (2).

The qualified strict compliance test promotes good faith more than the strict compliance test but less than the substantial compliance test. This is because some of the buyers who deal in bad faith are caught. An indirect test of good faith is analogous to the *indirect* approach represented in the Hong Kong Fir case.²⁸⁵

2.5.2. Good Faith as to Rule

Since English law insists on strict compliance, it appears to overlook the principle of good faith. Whereas, the USA law utilises more than one option, therefore, it can be described as recognising the principle of good faith. Finally, as the UCP is described to be akin to the qualified strict compliance test, it can also be regarded as adopting good faith to some extent.

3. Which Option Should the Law Adopt?

As a matter of general principle, what position should the law take with regard to the three rival tests of compliance? In other words, what option should be adopted?

Having examined the position of each option under the laws governing letters of credit, and having illustrated how each option interacts with the five basic principles, the answer will be reserved to the Concluding Chapter in which a proposal for reform will be made.

4. Pitfalls Arising From the Application of the Three Rival Tests of Compliance

The existence of inconsistent approaches to questions of compliance has three commercial implications: (i) the multiple tests slow down the processing of letters of credit since banks have to inquire deeply and go into details; (ii) the risk that a bank will be involved in a lawsuit due to adoption of either the substantial

²⁸⁵ *Hong Kong Fir Shipping Co. v. Kawasaki Kisen Kaishi Ltd.* [1962] 2 QB 26; see, Chapter Five, Section Two, (3).

compliance or the qualified strict compliance test is increased, as a result of deviating from the independency rule; (iii) applying different tests of compliance may result in the emergence of different rules and thus cause uncertainty. The legal effect of the transaction is different in different jurisdictions.²⁸⁶ Therefore, it is in fact desirable to have a uniform standard of compliance²⁸⁷. No matter whether the standard of compliance is strict compliance, substantial compliance, or qualified strict compliance, it is desirable to have a uniform rule upon this issue. Since this study will suggest that the qualified strict compliance standard is the most ideal standard of compliance, this call for uniformity may be said to have been achieved because, first of all, the UCP which is almost globally adopted, is more akin to the qualified strict compliance standard. Secondly, even the UCC which adopts (in its latest revision) the standard of strict compliance, gives the parties the right to subject their letters of credit to the UCP. Thirdly, even after the emergence of the United Nations Convention on Independent Guarantees and Standby Letters of Credit, it still (in its Article 16 (1)) reads as follows:

“(1) The guarantor/issuer shall examine the demand and any other, accompanying documents in accordance with the standard of conduct referred to in paragraph (1) of article 13. In determining whether documents are in facial conformity with the terms and conditions of the undertaking, and are consistent with one another, the guarantor/issuer shall have due regard to the applicable *international standard* of independent guarantee or stand-by letter of credit practice”.

This would provide uniformity to the law governing letters of credit. Parties, under the Convention, are still free to decide whether or not to subject their letters of credit to it i.e. they can agree to incorporate the UCP. This would also bridge the gaps and uncertainties regarding some unsettled issues e.g. strict compliance.²⁸⁸

²⁸⁶ Hotchkiss, C., *supra* note 80 at 299-300.

²⁸⁷ By contrast, Hotchkiss suggested, a uniform strict standard of compliance *Ibid* at 301.

²⁸⁸ The United Nations Convention on Independent Guarantees and Standby Letters of Credit was approved by the General Assembly of the United Nations in December 1995. Turner, P.S., ‘The United Nations Convention on International Standby Letters of Credit: How Would it Change Existing Letter of Credit Law in the United States?’ 114 *Banking Law Journal* (1997) 790. The same author, in answering the question of to what extent would UCC Article 5 continue to apply to credits subject to the Convention, states that the Convention itself is silent on the question of its impact on

5. After the Implementation of the UCP 500, Is Strict Compliance Any Closer to Substantial Compliance or Qualified Strict Compliance?

It is useful to discuss here whether the test of compliance in the new UCP 500, is any closer to the substantial compliance test or qualified strict compliance test. It should be noted that, the phrase “strict compliance” does not appear in the UCP 500 and the rule seems to have arisen from operational practice that the courts have adopted as a rule of law.²⁸⁹ Article 13(a) of the UCP 500 states that: “...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”. The phrase “as reflected in these Articles” should not confine the source of international standard banking practice for ascertaining documentary compliance solely to the UCP 500, since there are many international banking practices that are not codified in it.²⁹⁰ Moreover, with a strict interpretation of the phrase, potential frustration of reasonable expectations is likely. Reasonable expectation, as explained in Chapter Two²⁹¹, is the most common standard of fairness in commercial transactions law which requires one party to treat the other or others as a regular participant in that transaction, in a way which they would wish to be treated when viewing their own advantage. Since a codification of all international banking practice which is continuously evolving is impossible, excluding uncodified practices is contrary to the test of

the existing letter of credit law of a country that adopts the Convention and leaves the question to be answered on a country-by-country basis by the courts. Ibid at 792. Nonetheless, so far as USA is concerned, Turner believes that if the USA is to adopt the Convention, the Convention and UCC Article 5 should coexist well. Ibid. For more details on how the Convention would apply to US law, assuming that the US adopts the Convention, see same source, pp. 790-808. Further, to answer the question of how would the Convention interact with the UCP rules where there are real differences between them the same author states that the Convention does not resolve such a problem but, he believes, that a court, by analogy to Section 5-116(c) of the UCC or the emphasis of the Convention on flexibility, may hold that the incorporated rule prevails. Ibid at 800.

²⁸⁹ Rosenblith, R., supra note 80 at 121.

²⁹⁰ Gustavus, supra note 80 at 62.

²⁹¹ Chapter Two, Section One, (5.6.).

reasonable expectation.

The additional requirement that the banks should take into account the “international standard banking practices” is clearly moving away from the strict compliance test, since it embodies considerations other than just facial examination of the documents. But the issue of whether it is closer to the substantial compliance test or the qualified compliance test still remains. In addition, it may be inferred from Articles 37 and 39 of the UCP that trivial discrepancies are not caught. This goes in line with what the qualified strict compliance standard requires.

The substantial compliance test requires the banker to look beyond the face of the documents, investigate the realities of the transaction, and weigh the credibility of documents, customers and beneficiaries. To fulfil this requirement, the banker needs to know not only the banking practices, but also the commercial impact of a discrepancy in the document. This is far beyond what the banker is expected to do under the UCP 500.

The qualified strict compliance test, on the other hand, tolerates hypertechnical and thus immaterial deviations. The new UCP 500 is more akin to this test than the other two, since it should be an international standard banking practice, and thus a commercial expectation, that hypertechnical deviations should be disregarded for the benefit of having smooth commercial transactions, and also not to undermine the importance of letters of credit as a mechanism of payment.

6. Exceptions that Dilute the Doctrine of Strict Compliance

Saying that these exceptions can dilute the rigid strict compliance test is only a general observation.²⁹² To say precisely which one of the exceptions can make it

²⁹² McLaughlin, *supra* note 107 at 4. McLaughlin states that by applying the equitable principles, some contract law principles and banking custom, the rigors of the strict compliance rule will be diluted and come closer to substantive compliance, with no reference to the qualified strict compliance rule since he has not differentiated between the substantial compliance test and qualified strict

more akin to the substantial compliance test or the qualified strict compliance test, proves more difficult. Simply by concluding from what the academics and commentators have said provides no clue, since some of them do not even make a distinction between a substantial compliance test and a qualified strict compliance test. The position of this thesis is that there should be a distinction, because the substantial compliance rule is seen to be pushing the standard too far by requiring the banker to look too far from the document and thus is not considered as desirable.

It can be said that by applying the *de minimis* rule, plain meaning rule and banking customs in conjunction with the strict compliance test, the result will be more akin to the qualified strict compliance test. Since these three exceptions assist bankers in using their diligence, common sense and their specialised knowledge in the field of banking, to judge whether the discrepancies are material or not, is exactly what the qualified strict compliance test asks for.

In contrast, the principle of good faith, the *contra proferentem* rule, render performance rule, course of dealing and course of performance rule ask the banker to look beyond the documents and investigate the real motive of the parties in the dealing in order to determine whether the discrepancies are consequential and substantial. This is exactly what the substantial test asks for, as discussed in Section One.

The rest of the principles discussed, namely, duty to notify the beneficiary of oppressive terms, the UCC presentment warranty, reformation of the written terms of a letter of credit, parol evidence rule, waiver and estoppel, are applicable to all three tests, since they are only some exceptions which are independent of the question of whether the discrepancies are material or not. Furthermore, they can hardly be discovered even on investigation by the banker under the substantial compliance test. These exceptions can no doubt soften the rigidity of the strict

compliance test, but they do not make the test more akin to either the substantial or the qualified strict compliance test.

7. Comparison Between the Strict Compliance Test and Breach of Condition in the Law of Contract

As mentioned earlier in Section One, according to some surveys,²⁹³ 90 percent of the documents initially tendered contained discrepancies, therefore, it is not difficult for banks to insist on strict compliance. It can be said that, by so doing, the autonomy of the contracting parties is respected, as they have agreed that the credit is to be conditional upon the presentation of certain documents. This closely resembles the traditional strict approach to breach of condition in general contract law.

As mentioned in Chapter Two, under Section One, (2.3.), there are three types of terms: conditions, warranties and intermediate terms. Conditions are the major terms in a contract, breach of which entitles the innocent party to terminate the contract and sue for damages. Warranties are minor terms in a contract, breach of which entitles the innocent party to sue for damages but not to rescind.²⁹⁴ The concept of an intermediate term was first introduced in the Hong Kong Fir²⁹⁵ case, where the Court of Appeal held that there were many terms which were neither seen as conditions nor as warranties, but which could be placed in an intermediate category. If the result of a breach is serious, the term will be considered as a condition; if the result of a breach is minor, the term will amount only to warranty. Before this case, the court had to decide whether a term was a condition or

²⁹³ Survey carried out in 1987 by the Letter of Credit Update, Cited by Kozolchyk, B., 'supra note 1, at pp 47-48. For more statistical studies see Kozolchyk, B., supra note 1 at 48. See also Professor Byrne, *Editor of Letter of Credit Update*, 7, 14 (July 1987). The Statistic in 1987 showed a 90% non-complying documents on first tender. See also Byrne, 'UCC Survey: Letters of Credit' 43 *Bus Law* 1353, at 1355-56 (1988).

²⁹⁴ Treitel, G.H., *The Law of Contract*, 10th ed. (Sweet & Maxwell, London, 1999). pp. 731-32.

²⁹⁵ *Hong Kong Fir Shipping Co. v Kawasaki Kisen Kaishi Ltd.* [1962] 2 QB 26.

warranty according to the intention of the parties. The flexible approach in the Hong Kong Fir case allows the court some room in handling cases whereby the so-called “innocent party” is clearly using a trivial breach to escape the consequences of a contract, that turns out not to be as profitable as it initially thought it would be.²⁹⁶ An analogy can be made here to a buyer in a letter of credit engagement who no longer values the dealing and wants to get out of the contract by insisting on strict compliance on the presented document. Since it is proven by statistics that out of 10 documents presented, 9 of them would consist of discrepancies, whether major ones or hypertechnical ones, it is easy for the buyer to raise an objection to the documents for non-compliance. Therefore, in order to attain fairness and promote good faith, it may be argued that the court should copy the Hong Kong Fir approach and apply the compliance test in a flexible manner. Following such an approach, the issue should be whether the discrepancies seriously affect the position of the parties. If the answer is “yes”, it means that the deviation is a material one, and thus the document should be rejected. If the answer is “no”, the banker should accept the documents in order to preserve commercial efficacy.

Although there is some parallel between the Hong Kong Fir test and the qualified strict compliance test, they appear to be different. The Hong Kong Fir case addresses the seriousness of the consequences to the buyer. Now, although the qualified strict compliance test is a possible indirect test of good faith, it does not deal with the question of seriousness of the consequences to the buyer. The qualified strict compliance test is simply concerned with allowing margin for trivial discrepancies without referring to the consequences to the buyer. However, the substantial compliance test is a possible indirect test of good faith which resembles the Hong Kong Fir approach. This is because it is concerned with enquiries into the harm to the buyer — seriousness of consequences of non-compliance, as in the

²⁹⁶ *Cehave NV v Bremer Handelgesellschaft HbM* [1976] QB 76. See generally, Adams & Brownsword, *Key Issues in Contract* p. 45.

Hong Kong Fir case.

The analogy can be taken a little further in the following way. In the general law of contract, the *Hong Kong* approach is seen as representing an indirect way of dealing with bad faith; an alternative (not adopted in English law) would be to have a direct test of good/bad faith through a general doctrine of (objective) good faith. Similarly, in letters of credit law, a test of qualified strict compliance or a test of substantial compliance could be linked to an indirect/ *Hong Kong* approach. Having said this, in the general law of contract, the *Hong Kong* approach has been perceived to be highly threatening to certainty and so, in *Bunge v Tradax*, we find the traditional condition/warranty distinction being revitalised (and this is the parallel to strict compliance). In other words, the analogy is at two points as follows:

(i) strict compliance: *Bunge v Tradax*

(2) qualified strict compliance or substantial compliance: *Hong Kong Fir* (an indirect test of good faith).

An American commentator, Dolan, has drawn a similar analogy between the strict compliance rule and the perfect tender rule, where he says, “When the goods arrive, the buyer picks through them and often is able to find some slight defect in the seller’s performance. In that event, the buyer, who does not want the goods even if the tender is perfect, seizes upon the slight defect to declare the seller in breach and avoid the contract.”²⁹⁷ However, the perfect tender rule is not popular in the states, and the legislature has riddled it so that one may conclude that it has been abolished.²⁹⁸ Yet, Dolan continues to say that, “[c]ourts that resort to the substantial compliance rule in credit cases may view their decisions as consistent

²⁹⁷ Dolan, *supra* note 115 at 25. The perfect tender rule also relates to the seller’s time and manner of delivery and to documents in a documentary sale transaction.

²⁹⁸ Gilmore, *The Death of Contract* (edited by, Collins, R.) (Ohio State University Press, Columbus, 1995). p 88 “[The rule] is undermined to a considerable degree in the Sales Article of the Uniform Commercial Code”. See also UCC §§ 2-504, 2-508, 2-601, 2-612.

with this tradition against perfect tender abuse.”²⁹⁹

8. Does the Qualified Strict Compliance Test Examine a Customer’s Good Faith? Can the Bank Disregard an Assertion Made by its Customer, Which Suggests that a Discrepancy is Material?

With regards to the first question, the answer is negative. This is because the qualified strict compliance test is only an indirect test of good faith. Thus, if such a test is to be adopted it would *not* be realistic to expect a bank to examine the good faith of its customer, otherwise it would be regarded as a direct test of good faith. The answer to the second question is also negative. This is because the qualified strict compliance test is a documentary test, and therefore the main aim of it is to keep as close to the documents as possible.

²⁹⁹ Dolan, *supra* note 115 at 25.

Table 1: Differences Between the Three Rival Tests for Compliance

	Strict Compliance Test	Substantial Compliance Test	Qualified Strict Compliance Test
Features	There is no room for documents which are almost the same or which will do just as well.	Bankers need to look beyond the face of the documents, investigate the realities of the transaction, and weigh the credibility of documents, buyers and beneficiaries.	Courts allow variations that are "insignificant", "obvious and immaterial" or "inconsequential".
Problems	Potential abuse by buyers and bankers as slight defects can usually be found in documents.	Bankers should not be expected to look beyond the documents, otherwise it will take a long time for the bank to decide whether or not to honour the drafts, thereby defeating the function of letters of credit.	The consequential issue of whether discrepancies are material or immaterial cannot have a predictable answer, since banks are not required to know, and not in a position to know the importance of some technical terms.
Fairness as to Rule	English law, since it adopts only the strict compliance test, may be regarded as unfair, as demonstrated by the distributive theory.	Since the USA law adopts more than one option, it is arguably fairer, and more in line with the distributive theory.	Once the UCP is described as akin to the qualified strict compliance test, it can be regarded as fair, and more in line with the distributive theory.
Fairness as to Application	Less, because some innocent beneficiaries can end up without payment for trivial discrepancies in the documents.	More fairness, because some innocent beneficiaries can get payment despite trivial discrepancies in the documents	Fairer than the strict compliance test but it is not as fair as the substantial compliance test because although some innocent beneficiaries can get paid despite trivial discrepancies in the documents, the courts look upon immateriality in a much tougher way than in the substantial compliance test.
Certainty as to Rule	English law is certain because it adopts the strict compliance test only and in all cases.	The USA courts, due to the silence of the UCC have adopted different tests of compliance. This would provide uncertainty as to law since there is more than one option to adopt.	Having said that the UCP rules are more akin to the qualified strict compliance test, the UCP rules could only be regarded as certain if people interpret them as akin to such a test.
Certainty as to Application	High, parties to the letters of credit will know where each of them stands.	Almost not certain at all, because the result will be dependent on the merit of each case.	Less certain than the strict compliance test, but more certain than the substantial compliance test.

Flexibility as to Rule	English law is not flexible because there is only one position to deal with the test of compliance.	As a result of the vagueness of the UCC provisions on this issue, the USA law is flexible, as there is more than one position to adopt. Also, reference to other applicable law is possible.	Since the UCP rules may refer to other applicable law, they can be described as flexible. Flexibility comes from the fact that there may be more than one option to adopt.
Flexibility as to Application	Not flexible at all, since some minor technical discrepancies will be caught.	Very high. There is no standard at all. It is judged case by case.	More flexible than the strict compliance test, but less flexible than the substantial compliance test because the technical errors are tolerated.
Good Faith as to Rule	Since English law insists on strict compliance, it overlooks the principle of good faith.	Since more than one option may be utilised in the USA law, it can be described as recognising the principle of good faith.	Since the UCP is described to be akin to the qualified strict compliance test, it can be regarded as adopting good faith to some extent.
Good Faith as to Application	This test overlooks the parties' good faith throughout the transaction, since no consideration given to the motives of the parties. (Opportunism)	Since bankers can look beyond the face of the documents, this promotes fair dealing. "An indirect test of good faith."	Promotes good faith more than the strict compliance test but less than the substantial test. This is because some of the buyers who deal in bad faith are caught. "Indirect test of good faith."

Conclusion

The terms of the letter of credit, as elaborated by the terms implied by law, shape the contractual obligations between a beneficiary and the issuing bank and the confirming bank. The duty of both the issuing and confirming banks to the creditor-beneficiary is to honour the credit on fulfilment of the requirements under that documentary credit. The seller will be required to present the buyer or his bank, with a clean bill of lading for the goods specified in the credit, an invoice and other documents expressly required to be presented under the terms of the credit. That is to say, in commercial documentary credit transactions, the bank deals in documents not in goods, as provided for by Article (4) of the UCP 1993 Revision.

Although the doctrine of strict compliance is the orthodox starting point, we can remark that the value of documentary credits to businessmen would be seriously jeopardised if banks routinely rejected documents on the slightest doubt as to their validity. Therefore, it is arguable that the bank, when examining the tendered documents, should not insist on rigid and meticulous fulfilment of the precise wording in all cases, indeed as provided for by the new provisions of the UCP which have been described above as qualified strict compliance. In fact, the bank's duty is to construe the terms of the credit as well as to consider the documents presented to it. Speculation as to what may have been in its customer's mind is not within its duty. This view has been adopted by the courts which have recently used concepts of honesty, fairness and reasonableness to relax the rigidity of strict compliance.³⁰⁰ This trend has been represented above by the test of substantial strict compliance. These new approaches, which soften the harshness of strict compliance as represented by the "substantial standard" and the "qualified

³⁰⁰ The *de minimis* rule, the rule of contra proferentem, the render performance possible rule, the plain meaning rule, reformation of the written terms of a letter of credit, the parol evidence rule, waiver, estoppel, course of dealing and course of performance, banking customs, good faith, duty to notify the beneficiary of oppressive terms and finally, the UCC presentment warranty are considerations courts have taken into account as well in relaxing the rigidity of the strict compliance doctrine. Cited by McLaughlin, G.T., supra note 107 at 4.

standard”, have been adopted by some American courts. English law does not appear to have any application of these substantial or qualified standards.

In fact, the doctrine of strict compliance may give rise to unjust results. Having understood the distinction between the strict compliance test and the substantial compliance test (in respect of the principles of good faith, certainty, flexibility, and fairness), a compromise between them is represented by the qualified strict compliance test. In the Concluding Chapter to this thesis, we will return to the question of the appropriate test of compliance in the context of striking the right doctrinal balance between certainty and fairness.

**Chapter Six: Disputes Between the Issuing Bank and the
Account Party**

Chapter Six: Disputes Between Issuing Bank and Customer (On the Reimbursement Contract)

Introduction

This chapter deals with disputes between the issuing bank and the customer on the reimbursement contract. The main cause of such disputes is when the banker pays the amount of the credit where the tendered documents are not in conformity with the terms and conditions set out in the applicant's application form. As a corollary to this, there appears the issue of the banker's reimbursement from its applicant. This chapter consists of two sections. The first section is concerned with the contract between the issuing bank and the applicant. Specifically, the law in relation to the opening and acknowledgment of the credit, duties and rights of both issuing bank and the applicant, and lastly securities taken by the issuing bank against documents of title i.e. bill of lading, will be discussed.

The second section evaluates some key issues namely (i) the impact of the seller's fraud on both the innocent buyer and the bank and (ii) the bifurcated compliance standard, in light of the basic principles.

Section One: Contract Between Issuing Bank and Applicant

1. The Legal Nature of the Contract Between Bank and Account Party

The relationship between the issuing bank and the account party is a contractual one. It is not, as has been occasionally thought in practice, a principal and agent relationship. The agency relationship is obvious, however, where one bank is requested to advise or to advise and honour a credit issued by another bank¹. As a result, in any dispute between the bank and its customer, the liability will be based upon a breach of contract. Here, in commercial letters of credit, the banker's

¹ Harfield, H., *Bank Credits and Acceptance* 5th ed. (The Roland Press Company, New York, 1974) p 103.
See generally, Jack, R., *Documentary Credits*, (Butterworths, London, 1993) § 4-2. pp. 63-65.

undertaking is independent, primary and direct to a beneficiary selected by the customer.² If the bank breaches its obligation towards the beneficiary, it becomes directly and primarily liable to him. Indeed, the bank's position here is unlike the position of an agent since the banker owes no fiduciary or quasi-fiduciary obligation to his customer in a commercial credit transaction because, by nature of the transaction, it was entered into at the customer's request. The banker is, therefore, obliged to be impartial in dealing with the equal but opposed parties (the beneficiary and the account party). In other words, the issuing banker's faithfulness should be directed to the commercial credit agreement and to the commercial credit itself rather than the parties.³

1.1. The Application Form

The next step which follows the accomplishment of the so-called "underlying contract" is that the buyer requests his own bank to open a documentary credit in favour of the seller. The buyer, for his part, completes an "application form" provided by the banker. There are some important requirements which the applicant should specify in the application form. The importance of such requirements is that they shape the legal relationship between the applicant and the issuing bank in their future disputes, if any. They are described by Jack as follows:⁴

² Harfield, H., *Bank Credits and Acceptance* p. 104. Professor Kozolchik states that "the UCP rules are silent on the nature of the issuing bank-customer relationship, as well as on the existence and scope of rights and duties pertaining to stages that precede or follow the issuance, notification or payment of the credit". Kozolchik B., *International Encyclopedia of Comparative Law. Letters of Credit* Vol. IX (1979) Chapter 5. p. 38. See also more details about the legal nature of this contract at pp. 39-44 from the same source. See for more detail on the process of opening of the credit, Bradgate, R., *Commercial Law* 2nd ed (London, Butterworths, 1995) p. 678; Sarna, L., *Letters of Credit: The Law and Current Practice*, 3rd ed (Carswell, 1989) pp. (3-1)-(3-7); Gutteridge and Megrah, *The Law of Banker's Commercial Credits* (Europa Publications Limited, London, 1984) pp. 57-64.

³ Harfield, H., *Bank Credits and Acceptance* p. 104.

⁴ Jack, R., *Documentary Credits* at § 4-4 p. 65; See also *Benjamin's Sale of Goods*, Fifth edition. (edited by A.G. Guest) (Sweet & Maxwell, London, 1997) at § 23-095 p. 1698; Goode, R., *Commercial Law*,

- “1. whether the credit is to be revocable or irrevocable, confirmed or unconfirmed;
2. whether the credit is to be transferable;
3. whether the credit is to be available by sight payment, deferred payment, acceptance or negotiation- Article 10(a) of the U.C.P.⁵, (this involves a decision as to whether the documents to be presented should include a bill of exchange and consideration of the function, if any, which it will fulfil);
4. the sum to be available under the credit, currency, unit prices;
5. the advising (confirming) bank- it is most often left to the issuing bank to choose its own correspondent in the country of the beneficiary;
6. the description of the goods: this will be required to be stated on the invoice- see Article 37 (c) of the UCP;
7. the documents to be presented, which should be concisely but sufficiently described - the description of the transport document is of particular importance;
8. latest date for shipment, period for presentation from date of transport document, last date of validity of credit;
9. are part shipments to be allowed;
10. is there any need to prohibit transshipment;
11. the means of transmission of the credit: whether by airmail or a form of teletransmission;
12. whether it is necessary to exclude any of the articles of the U.C.P. because their effect would be contrary to the intention of the parties”.

In short, the arrangement between the issuing bank and the applicant for the credit can be best described as a contract, whereby the issuing bank agrees to issue the credit and notify it to the beneficiary. Notification could take place via the issuing bank itself or through a correspondent bank. The issuing bank's obligation under such an arrangement is to pay to or to the order of the seller against presentation

2nd ed, (Harmondsworth: Penguin, 1995) p. 966; Rowe, M., *Letters of Credit* 2nd ed (Euromoney Books, London, 1997) pp. 94-96.

⁵ Article 10 of the U.C.P, 1993 Version. For more detail about (i) sight payment (ii) deferred payment (iii) acceptance credit and (iv) negotiation credit, see Bradgate, R., *Commercial Law* p. 9; Hedley, W., *Bills of Exchanges and Bankers' Documentary Credits*, 3rd ed (Lloyd's of London Press Ltd, 1997) pp. 270-1.

of stipulated documents. The buyer's obligation is, therefore, to reimburse the issuing bank for payments made in accordance with the credit terms. Banks, in order to safeguard their right to reimbursement, ask their applicants to pledge their stipulated documents, such as documents of title i.e. bill of lading, so as to constitute a security to the issuing bank against the applicant's bankruptcy.⁶

2. The Issuing Bank's Obligations to the Buyer

2.1. Introduction

Once the issuing bank opens a letter of credit, a direct contractual relationship between the issuing bank and the applicant develops. It is evident that in addition to the common law, the party's obligations can also be regulated by both the UCP or the American UCC, if they are incorporated. Providing that the shipping documents, as requested by the documentary credit, are presented and strict compliance with the terms of the credit are adhered to, the issuing bank's main duty is to make payment to the beneficiary based on the specific instructions provided by the applicant⁷. In order to explore those obligations, an attempt is made initially, to examine them under Common Law. Such duties include, first of all, the bank's obligation to issue the credit and pay in accordance with the buyer's mandate. Secondly, the section will deal with issuing bank's responsibility for acts of the correspondent bank. Thirdly, the issuing bank's duty of care will be examined. Then the focus will turn to the issuing bank's obligations under the UCP. Finally, the bank's duties under the UCC will be explored.

⁶ Ch'ng Huck Yong, *International Trends in Documentary Credit Transactions*, 14 *Singapore Law Review* (1993) 171 at 173. See generally about the issuing bank-applicant contract, Goode, R., *Commercial Law* p. 998.

⁷ Penn, Shea, Arora, *The Law and Practice of International Banking Law* vol 2 (London, Sweet & Maxwell, 1987) pp. 336-7.

2.2. The Common Law Rules

The issuing bank, under common law rules, not only owes the applicant the duty to issue the credit in accordance with his instructions and therefore, honour drafts presented by the beneficiary, provided that the draft conforms with the terms of the credit, but also, is liable to the buyer if it honours unconfirming documents.⁸

Thus, the issuing bank is liable to the buyer in damages for any loss he suffers. In other words, the bank is liable if it disregards its instructions under the letter of credit or if it acts negligently. Having said that the bank may be liable to the buyer in damages, it should be noted that consequential damages are not recoverable.

Consequential damages are not applicable to commercial credit transactions. Regarding the issuer-applicant contract, the customer has two options when dealing with the issuer; either to accept or reject the documents against which the bank has improperly honoured. Obviously, if he accepts, the transaction between him and the bank is closed. If he rejects, he is entitled to claim back any prepayment or collateral, but consequential damages are not recoverable⁹. This proposition can be illustrated in the case of Linden v. National City Bank,¹⁰ where it was said that:

“In any event, it is clear that the plaintiff [account party] may not recover the consequential damages which are alleged to have been sustained by him by reason of defendant’s [issuing bank’s] alleged breach of the conditions of the first letter of credit”.

⁸ Ibid at 337; For more about bank’s duties, see Jack, R, *Documentary Credits* at § 4-9 et seq. pp. 68-75.

⁹ Harfield, H., *Bank Credits and Acceptance* p. 108. See for more detail § 5-109(b) of the UCC. cmt.

¹⁰ *Linden v. National City Bank*, 12 A.D. 2d 69, at 71, 208 N.Y.S. 2d 182 at 184 (1 st Dept. 1960).

Harfield¹¹ adds that consequential damages are not the kind of risk a bank would assume when it issues a commercial credit¹². If consequential damages are to be allowed, the bank's interests will be put at risk where situations prove difficult to evaluate or even control. Indeed, banks would therefore be generally advised to protect themselves by taking certain safety measures. Such measures include the banks increasing their commercial credit rates to safeguard their interests against such risks, that do not form part of the banks' business. The current practice is that banks charge a very small fraction of one percent of the amount involved.¹³ Allowing consequential damages would then, result in destroying the low-cost character of a letter of credit because such damages would be reflected in the credit rate.

Also, the issuing bank may be held liable in negligence, if it takes up documents which do not conform to the applicant's instructions. Nonetheless, it is submitted¹⁴ that, if the disparity is not obvious, the bank is liable only if a competent bank, exercising reasonable care, would not have accepted the documents tendered. An example to illustrate this can be seen in the case of Borthwick v. Bank of New Zealand¹⁵, where the issuing bank was required to ensure that the insurance policy covered the risk of loss of subject matter of the underlying contract. However, the documents that the issuing bank accepted included an insurance policy which excluded the insurer's liability for a total loss of the goods unless the ship carrying the goods was also lost. In his course of delivering judgment, Mathew J. observed

¹¹ Harfield, II., *Bank Credits and Acceptance* p. 108.

¹² Ibid at 109.

¹³ Ibid.

¹⁴ Penn, Shea, Arora, *The Law and Practice of International Banking Law* p. 337.

¹⁵ *Borthwick v. Bank of New Zealand* (1900) 6 Com. Cas. 1.

that “the policy should be an all risks policy, which, on the evidence, I am satisfied is the ordinary policy in business of this kind”¹⁶. In this case, as the bank had failed to perform its obligations, in ensuring that acceptance of the insurance policy had been based on it having accounted for any anticipated risk, such as the loss of goods, he was therefore found negligent and consequently liable in damages to the applicant. Mathew J. observed that:

“In my opinion the defendants’ contention [that the defendants are not responsible for the loss, and that there had been some negligence on the part of the plaintiff which had misled the bank] fails, and the defendants are liable to make good to the plaintiff the loss which he has incurred through the defendants having negotiated the drafts without first seeing that the documents were in order”.¹⁷

Having said this, it is not to be said that the issuing bank has to be familiar with the specified terms and practices used in the trade.¹⁸

2.2.1. Responsibility For Acts of Correspondent

The issuing bank is responsible for wrong acts committed by employees appointed by it. For example, where the issuing bank employs another bank to advise or confirm the credit, the acts of such a bank are attributed to the issuing bank and the issuing bank is liable to the buyer, even though it exercised due care in selecting the other bank as its agent. In Calico Printers Association v. Barclays Bank Ltd¹⁹, the issuing bank was held responsible upon the advising bank’s failure

¹⁶ Ibid at 4.

¹⁷ *Borthwick v. Bank of New Zealand* (1900) 6 Com. Cas. 1, at 5. See generally about the bank -applicant relationship Penn, Shea, Arora, *The Law and Practice of International Banking Law* p. 337.

¹⁸ See in this regard the judgment of Goddard J. in *Rayner (J.H.) & Co. Ltd. v. Hambro's Bank Ltd* [1943] C.A. 1 K.B. 37, at 42.

¹⁹ *Calico Printers Association v. Barclays Bank Ltd*, (1939) 36 Com. Cas. 71. Further, in *Equitable Trust Co. v. Dawson Partners Ltd*, (1926) 25 Lloyd’s L.R. 90, the confirming bank accepted shipping documents which did not conform to the buyer’s instructions due to an error which occurred in the transmission of the instructions by the confirming bank to one of its own branches. Although the issuing bank was held to be responsible to the buyer, it was entitled to be reimbursed by the confirming bank for the amount for which it was liable.

to act in accordance with the applicant's instructions which was to insure the goods. Wright J. observed that:

“to accept the contention that the defendants Barclays were not responsible for the acts of the defendants the Anglo-Palestine Bank, their foreign correspondents...would be, in my judgment, to go contrary to the whole commercial understanding of a transaction like this”.²⁰

In this case, the consequence of the bank's failure to insure the goods was that the issuing bank was consequently held liable to the applicant for the total value of the goods which were destroyed, despite the fact that the advising bank had been adequately instructed²¹.

The issuing bank is responsible if it disregards the applicant's interests by not taking reasonable steps to protect him or indeed, where it does not exercise due diligence while dealing with the advising bank (with whom he is in clear privity), in order to prevent it from honouring the credit in circumstances where such action might have prevented payment to the beneficiary²². An advising banker should be held liable to the applicant for damages in tort, in cases where the advising bank disregards the applicant's interests where a right of recovery would have been conferred. Sassoon²³ adds that the above mentioned principles must be implemented carefully so as not to harm the beneficiary's rights under the credit. Also, the advising bank's interests should not be jeopardised where it has acted properly and has not destroyed the applicant's interests.

²⁰ *Calico Printers Association v. Barclays Bank Ltd*, (1939) 36 Com. Cas. 71, 80.

²¹ Penn, Shea, Arora, *The Law and Practice of International Banking Law* p. 338.

²² Sassoon, D.M., 'Documentary Credits: The Applicant and the Advising Bank' *Journal of Business Law* (1986) 33 at 35.

²³ *Ibid* at 36.

In the case of Bank Leumi Le-Israel Ltd. v. M. G. Brin & Sons Ltd²⁴, it was held that the issuing bank was responsible for payment, by its correspondent bank to the beneficiary, where such an issuing bank had not taken the proper procedures to inspect the documents which have already been checked by its correspondent bank. The Israeli bank (the issuer), was found to be negligent in that it had found no discrepancy between the documents which were tendered to it by the supplier (beneficiary) through its overseas correspondent bank. It was a condition in the credit that a release of such money should have been subsequent to a complete compliance of the documents. Moreover, it was argued, that the issuing bank already knew that the merchandise destined for the buyers (coat manufacturers), had been sent to Africa. Further, what was sent to the buyers was considered as worthless for coat manufacturing. Thus, it was found that the bank breached its obligation in that it did not advise its clients concerning possible legal actions which could have been taken. The District Court of Tel-Aviv ruling, called on the issuing bank to return money to two of its clients, Israeli coat manufacturing companies, due to the issuing bank's negligence against the interests of its clients. Indeed, the Supreme Court also rejected Bank Leumi's appeal, holding that the bank's clients must be paid the sums of credit which they had been charged for but which had been transferred to the seller in Hong Kong instead.²⁵

Commenting on this case, Fisher²⁶ states that the bank should conduct a thorough scrutinising of the documents. A technical comparison of documents does not suffice.

²⁴ *Bank Leumi Le-Israel Ltd. v. M. G. Brin & Sons Ltd.*, (1992) LMLN 342.

²⁵ Fisher, G., (Case and Comment) 'Israeli bank's liability under documentary credit' *Lloyd's Maritime and Commercial Law Quarterly* (1993) 28 at 28.

²⁶ *Ibid* at 29.

In the previous case, the fact that the correspondent bank did not inspect the documents did not relieve the issuing bank from its obligation to its clients. Regarding the defence of applying an exemption clause, which was put in the letter of credit contract, it was stated that it may only be invoked if negligence on the part of the issuing bank did not exist. Shamgar, C. J., said:

“The opening bank must take all reasonable steps at its disposal in order to defend the interests of the applicant. Therefore, if there were negligence in the instructions given to the advising bank or in actions which could have been taken to insure the fulfillment of such instructions, the issuing bank will not be able to use the exemption clause.”²⁷

It was stated that the issuing bank does not fulfill its obligation by merely sending a letter to the correspondent bank. It should also have taken the initiative of taking legal measures against the correspondent bank overseas. Moreover, still dealing with the Bank Leumi Le-Israel Ltd. v. M. G. Brin & Sons Ltd case, the Israeli bank may not transfer this burden of litigation to its client. The rationale behind this policy is stated to be that the client who hires the bank's services, due to its purported proficiency in matters concerning letters of credit and in entrusting the bank with his financial matters, should not be left alone against the correspondent bank which was appointed by the issuing bank.²⁸ To sum up, the Supreme Court of Israel ruled that as far as letters of credit are concerned, the issuing bank owes contractual duties towards its client to safeguard him against cases in which the money has been transferred to the supplier but the conditions of the credit have not been met. Further, the fact that that the correspondent bank is involved, and thus, authorised to act, does not terminate the issuing bank's duties. The issuing bank

²⁷ Cited by Fisher, G., *Ibid*.

²⁸ Fisher, G., *supra* note, 25 at 29.

must do something to prevent its customer from being charged for the goods to which the letter of credit did not apply.²⁹

2.2.2. Issuing Bank's Duty of Care

The issuing bank has a duty of care to its buyer. Such a duty requires the bank to caution the customer with regards to the documents to be tendered by the seller. The reason for imposing this duty on the issuing bank is due to the fact that banks tend to deal with letters of credits more frequently than their customers, and as a result, they are expected to be experts in that field and, therefore, to give advice to their customers. But, from the issuing bank's point of view, the issue of why it should be a legal duty is argued. According to Benjamin, the existing case law is inconclusive³⁰. In Midland Bank Ltd v. Seymour³¹, the question of the bank's duties to its customer was raised in an interesting way. Here, upon opening of a credit, the customer pleaded that the bank had failed to pass him some repugnant information concerning the exporter. Devlin J., relying on the facts of the case, was not satisfied that the customer had actually asked for information and that the bank had not been negligent. He went on further to say:

“After all, a bank is not employed as a private inquiry agent. Its field of inquiry is normally limited to what it gets from other banks, and I am not satisfied that there is any duty upon it to prosecute inquiries with due diligence, subject, of course, to this, that it must not give information which, owing to an inadequate inquiry, may well be misleading”.³²

²⁹ Ibid at 30.

³⁰ *Benjamin's Sale of Goods*, at § 23-102 p. 1702. See also Jack, R., *Documentary Credits* at § 4-20 et seq pp. 74-75.

³¹ *Midland Bank Ltd v. Seymour*[1955] 2 Lloyd's Rep. 147. 155.

³² Ibid at 158.

Moreover, in the case of Commercial Banking Co. of Sydney Ltd. v. Jalsard Pty. Ltd³³, a buyer of a consignment of Christmas lights refused to reimburse the issuing bank on the grounds that the issuing bank should have advised him, in connection with a shipment of battery-operated electrical lights, to require a certificate that the goods had been tested electrically. There, the Privy Council found on the facts that the bank had not broken a duty of care, because the importer when consulted by the bank as to the way in which payment in respect of such transaction could be made, expressed the wish that the shipping documents to be provided, should include a certificate of inspection issued by a designated surveyor. Their Lordships, decided that the claim for negligence did not succeed and went on to say that:

“Since [the importer] was in a position to require that any certificate of inspection called for by the contract of sale should be made by [the designated surveyors] and also to give them instructions...about the kind of examination or inspection which she wanted them to make of any goods procured for her by them, it was not negligent of the [bank] to acquiesce in her suggestion”.³⁴

Although the above cases [Commercial Banking Co. of Sydney Ltd.v. Jalsard Pty. Ltd and Midland Bank Ltd v. Seymour], do not impose a clear duty of care on the issuing bank, it has been argued³⁵ that a bank in specific cases, owes a duty of care to its new customer, and in doing so is in the position of advising him to utilise documentary credits thus ensuring payment is secured. This in turn, will ensure that international trade transactions run more smoothly.

³³ *Commercial Banking Co. of Sydney Ltd.v. Jalsard Pty. Ltd* [1973] A.C. 279.

³⁴ *Ibid* at 288

³⁵ *Benjamin's Sale of Goods*, at § 23-103 p. 1702.

To answer the question of whether the bank owes this duty or not, Ellinger³⁶ maintains that it is evident that banks are usually more familiar with documentary credit transactions than their clients. What happens in practice is that some issuing banks attempt to obtain a confidential report about the reputation of the new businessman with whom their client wishes to deal with. Moreover, some banks offer some guidelines to their customers clarifying to them, the type of documents to be stipulated in the credit, such as certificate of origin, a certificate of weight and certificate of quality etc., and moreover, to transmit to their clients the name of a standing surveying firm. Having said this, these protections from bank to client cannot prevent, completely, the beneficiary's fraud. The answer to the question is that it is not that clear enough in law, whether a bank owes such a duty of care to its client.³⁷ Ellinger³⁸ states that it would be groundless to impose a general duty of care on banks to advise their clients in relation to letters of credit arrangements. The answer, however, depends on the facts of each individual case. In particular, it appears to matter whether the client is seen to be experienced or not.

Woods v. Martins Bank³⁹ could be an authority to introduce a duty of care on banks in cases where banks provide their customers with brochures claiming to be experts in the field and to offer some help as regards the opening of the credit. Here, the applicant of the credit appeared not to be familiar with the credit transaction, and accordingly, put his entire affairs into the hands of the banker. As the bank manager gave careless advice on financial matters to his new customer,

³⁶ Ellinger, E., 'Fraud in Documentary Credit Transactions' *Journal of Business Law* (1981) 258 at 267.

³⁷ *Ibid* at 268.

³⁸ *Ibid*.

³⁹ *Woods v. Martins Bank*, [1959] 1 Q.B. 55.

the courts held that the bank was liable. Salmon J. in his course of delivering judgment observed:

“I find that it was and is within the scope of the defendant bank’s business to advise on all financial matters and that, as they did advise him, they owed a duty to the plaintiff to advise him with reasonable care and skill...”⁴⁰

Commenting on such a duty of care, Ellinger⁴¹ hopes that the question of the banker’s duty of care, as regards advising clients, is to be reconsidered by courts.

That is the position of the issuing bank’s duties under common law. So, what about the position under the U.C.P. and UCC?

2.3. The Issuing Bank’s Obligations Under the UCP

The position of the U.C.P. in relation to the responsibility of the issuing bank regarding failure in transmission to the advising bank towards the applicants⁴², seems to be that it is the applicant who bears the risk and not the (issuing or advising) bank as is the case in the common law. The following are the issuing bank’s duties under the UCP.

2.3.1. The Issuing Bank is not To Bear the Risk

The U.C.P. attempts to place the entire cost and risk of failures, due to errors and omissions, on the applicant’s shoulders. He (the applicant), and only he, is to bear the consequences both in the event that the advising bank was nominated by him,

⁴⁰ Ibid at 71.

⁴¹ Ellinger, *supra* note 36 at 269.

⁴² Article 18 of the UCP. For commentary on this Article see for example, Sassoon, D.M., *supra* note 22 at 34. See for more discussion on bank’s limited liability, Hedley, W., *Bills of Exchanges and Bankers’ Documentary Credits* p. 304.

as well as where the advising bank is selected by the issuing bank and is virtually unknown to the applicant. This can be seen in both articles 16 and 18(a) and (b).

Under both of these articles of the U.C.P., an applicant is subjected to a very serious grievance as he must suffer a loss. In other words, the U.C.P. rules, (in addition to the lack of privity obstacle, which obstructs the applicant from being able to claim rights against the advising bank on the grounds that there is no legal contractual relationship between them), appear to leave the applicant with no redress in cases where fraud is committed by the advising bank. Had the issuing bank been responsible for actions of an advising bank, reimbursement would have been rejected from their customers.⁴³

Sassoon⁴⁴ has raised the following question: can it be that the applicant is really left without any redress in situations such as these? He states that it has been submitted, by most of those who are familiar with letters of credit, that such cases of hardship have been encountered where it seemed wrong and unjust to leave the applicant with no remedy. The solution for them is that articles 16 and 18 of the U.C.P. should not be permitted to operate in circumstances where the issuing bank has been negligent. For example, where the issuing bank is negligent in transmitting or formulating instructions to the advising bank or in avoiding any measures that may have been available to it to ensure compliance therewith⁴⁵.

2.3.2. Banker's Duty to Take Up Documents

When a documentary credit is opened, it means that the issuing banker owes the buyer a duty to accept, from the seller, a draft accompanied by the required

⁴³ Sassoon, D.M., *supra* note 22 at 35.

⁴⁴ *Ibid.*

⁴⁵ *Ibid.*

documents. The buyer, in return, will repay the bank for any advances initially paid to the seller. However, the banker must take up a faultless tender otherwise his right of reimbursement will be lost.

It is however, acceptable in certain situations, for the bank to waive conditions. One such situation is where conditions are added to the application form simply to protect the issuing bank⁴⁶. Nevertheless, sometimes it proves difficult to decide whether a specific stipulation is aimed at protecting the issuing banker or the buyer. However this argument can be dismissed when taking the contractual perspective, as it is assumed that both banker and seller have already agreed on all the terms and therefore the banker cannot refuse to abide by any of them..⁴⁷

2.3.3. Banker's Duty to Examine the Documents

In accordance with article 13 (a) of the U C P, it is the bank's duty to inspect, with reasonable care, that the documents, appear to be, prima facie, in agreement with the terms and conditions of the credit.

The wording of article 13(a) of the U.C.P. seems to be saying that, if there is a defect in the documents, a failure to notice the defect by the issuing bank does not mean that it is responsible unless the defect is discoverable on reasonably careful examination.

It is crucial to know what is meant by reasonably careful examination. Examination basically relates to how the goods are classified and the consistency of the documents. The bank is neither obligated to consider the legal effect of the terms

⁴⁶ As in the case of *Guaranty Trust Co of New York v Van Den Berghs Ltd* (1925) 22 Ll.L.R. 447, 454.

⁴⁷ *Benjamin's Sale of Goods*, at § 23-107 p. 1704. Nonetheless, see the argument in the USA above under section 1.4.1.2. regarding applying the "bifurcated" standard in the reimbursement agreement.

incorporated within the documents, nor is it compelled to scrutinise them.⁴⁸ In cases where the document may hold unusual characteristics, in contrast, the bank is now compelled to thoroughly examine the documents in order to ensure that all the terms of the documentary credit and the application form have been complied with.⁴⁹

2.3.4. Genuineness of Documents

The banker is not responsible for the genuineness, accuracy or legal effect of the documents as long as he has exercised a reasonable degree of care and skill during the examination. This position is clear, both under the UCP⁵⁰ and at common law⁵¹. In fact there are two situations to be considered⁵². First, where the bank pays out on forged documents which are apparently genuine. Second, where the bank pays out on one which the bank knows to be false. In the former instance, the bank is entitled to debit its customer's account with the amount paid. This can be gleaned from the case of Gian Singh v. Banque de L' Indochine⁵³. Upon payment on apparently genuine documents, it was held that "The issuing bank had, through the notifying bank as its agent, fulfilled its duties towards the customer and was entitled to debit the customer's account with the sum paid".⁵⁴ In the latter instance, however, the bank would lose its right to reimbursement. Further discussion of legal position will follow under section 2 of this chapter.⁵⁵

⁴⁸ *National Bank of Egypt v Hannevig's Bank Ltd.* (1919) L.L.R. 69.

⁴⁹ *Benjamin's Sale of Goods*, at § 23-108 p. 1705.

⁵⁰ See Articles 15, 16 (b) and 17 of the UCP.

⁵¹ *Gian Singh & Co. Ltd. v Banque de L'Indochine* [1974] 1 W.L.R. 1234.

⁵² See, Section 2, in relation to the bank's responsibilities.

⁵³ *Gian Singh v. Banque de L' Indochine* [1974] 1 W.L.R. 1234.

⁵⁴ *Ibid* at 1235.

⁵⁵ See the argument under Section 4.2.1. and Section 2 in this Chapter accordingly.

2.3.5. Condition of Goods

It is evident under article 4 of the UCP and from other relevant cases⁵⁶, that in documentary credit operations, in relation to the banker's duty, strict compliance does not specifically relate to the goods, but to the documents. The effect is twofold. If the documents are sound, the condition of the goods become insignificant. In situations where the documents are not up to satisfactory level, it proves difficult for the banker to assert a demand for reimbursement, as it cannot confidently state that the goods in question are those that were mentioned in the original contract of sale.⁵⁷

2.3.6. Exemption Clauses

In most application forms, bankers are exempted from responsibility for matters which are out of their control⁵⁸, and banks will not usually effect payment acceptance or negotiation when business is resumed if the credit has expired during the period of interruption.

2.3.7. Wider Clauses

It is possible to uncover wider exemption clauses, apparent in certain application forms. Some bankers, for instance, purport to claim reimbursement even if an error of their clerk, results in the acceptance of a non-conforming tender. However, it appears that this form of provision tends to confuse the main aim of the contract between the banker and the buyer and it is suggested therefore, that such

⁵⁶ *Basse and Selve v Bank of Australia* (1904) 90 LT 618.

⁵⁷ *Benjamin's Sale of Goods*, at § 23-110 p. 1706.

⁵⁸ Article 17 of the UCP.

exemption provisions are seen and understood laterally rather than simply overriding article 13(a) of the UCP.⁵⁹

2.4. The Issuing Bank's Duties Under the UCC

2.4.1. Duty to Honour Upon Compliance of Documents

Under section 5-114 of the UCC, the issuing bank must honour a draft or demand for payment which complies with the terms and conditions of the credit, regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.⁶⁰

2.4.2. Issuer's Duty of Good Faith to Its Customer

Under section 5-109(1) of the UCC, the issuing bank owes its customer a duty of good faith and observance of any general banking usage.

The issuing bank owes its customer a duty of care when examining the documents so as to ascertain whether on their face, they appear to comply with the terms of the credit. Nonetheless, such a duty cannot be enforced unless it is agreed to. In other words, unless otherwise agreed, banks assume no liability or responsibility for the genuineness, falsification or effect of any document which appears on such examination to be regular on its face.⁶¹

⁵⁹ *Forestall Mimoso Ltd v Oriental Credit Ltd*. [1986] 1 WLR 631.

⁶⁰ UCC § 5-114.

⁶¹ UCC § 5-109(2). The issuing bank's duty of good faith was satisfied in the case of *Exxon Co., U.S.A. v. Banque de Paris et des Pays-Bas*, 828 F. 2d 1121, 4 U.C.C. Rep. Serv. 2d (Callaghan) 1134 (5th Cir. 1987), where the bank informed its customer twice of the conflict in the credit terms where such conflicting terms were incapable of being performed.

Byrne⁶² states that there is only one decision that has clearly settled the meaning of good faith in section 5-114(2)(b) of the U.C.C. This ruling has empowered an issuer, “acting in good faith,” to honour notwithstanding notification of fraud. In First National Bank v. Carmouche⁶³, a standby credit was concerned. Following its issuance the credit was transferred, and when a default occurred, the beneficiary presented the bank with the required conforming documents. Upon finding a possible overstatement of the amount certified, both the applicant and the beneficiary requested the bank for extension of the credit. The bank, however, rejected their request and honoured the credit. Subsequently, the issuer brought an action against the applicant for reimbursement. The action was dismissed by the trial court and the bank appealed. The Louisiana Court of Appeal affirmed the decision, ruling that the issuing bank had acted in bad faith since both the beneficiary and the applicant had notified the bank of their concerns regarding the certificate and the bank was therefore deemed to have held actual knowledge of the inaccuracy of the certificate. On appeal, the Louisiana Supreme Court reversed the previous ruling and held that the issuer had no duty to conduct an investigation.

2.4.3. Bank’s Duty to Inform the Applicant For Amendment Under the UCC

In harmony with section 5-106(2) of the UCC, the case of Fina Supply, inc. v. Abilene National Bank⁶⁴, required the customer’s consent to an amendment. The court took the view that any agreement between the beneficiary and the issuer, as to amendment of the credit, should not be enforceable by the beneficiary if the

⁶² Byrne, J., ‘UCC Survey: Letters of Credit’ 43 *Bus Law* (1988) 1353, at 1368.

⁶³ *First National Bank v. Carmouche*, 515 So. 2d 785 (La. 1987).

⁶⁴ *Fina Supply, inc. v. abilene National bank*. 726 S.W. 2d 537, 541-42,3 .U.C.C. Rep. Serv. 2D (CALLAGHAN) 1856, 1859-60 (Tex. 1987).

customer's consent is absent⁶⁵. Unlike the UCC, the UCP has not committed itself to such a rule due to the fact that the obligation of the issuer to the beneficiary, under the credit, is independent of its relationship to the customer.⁶⁶

3. The Applicant's Duties to the Issuing Bank

3.1. The Duty to Give Clear Instructions

Having explained the bank's duty towards the buyer, the focus of attention should then move to the buyer's duty to give clear instructions. Otherwise, in cases of ambiguity, the issuing bank would be entitled to reimbursement provided that it had given the buyer's instructions a reasonable interpretation and had acted accordingly⁶⁷. This need for clarity of the instructions is set out in the UCP. Under article 5(a) and (b), all instructions must be complete and clear and, in order to guard against confusion, banks should discourage any attempt by the buyer to include excessive details in the application form.

This point is further stressed in Article 5 of the U.C.P, by demonstrating that the credit and any associated instructions, in relation to the credit amendment, should be clear and precise when the applicant opens a credit.⁶⁸

Moreover, article 12 of the U.C.P⁶⁹ appears to be more helpful, whereby it gives detailed instructions to the issuing bank in cases where the applicant's instructions are not clear, or are vague.⁷⁰ That is to say, if the credit terms set out by the

⁶⁵ U.C.C. § 5-106(b).

⁶⁶ Byrne., *supra* note 62 at p 1369.

⁶⁷ Ellinger, *supra* note 36 at 256. See also Jack, R., *Documentary Credits* at § 4-5 et seq pp. 64-68.

⁶⁸ The U.C.P, Article 5 (1993) Version.

⁶⁹ Article 12 of the UCP (1993) Version.

⁷⁰ Jack, R., *Documentary Credits* at § 4-5 p. 65; see Article 12 of the U.C.P.

applicant are not clear, the issuing bank should not accept them and ask for correction from the applicant. But what happens if the issuing bank finds some unclear instructions, but has already notified the credit to the beneficiary?

In the cases of Midland Bank Ltd.v. Seymour⁷¹, and Ireland v. Livingston⁷², and also Commercial Banking Co of Sydney Ltd. v. Jalsard Pty. Ltd⁷³, it has been held that:

“when an agent acts upon ambiguous instructions he is not in default if he can show that he adopted what was a reasonable meaning”⁷⁴

“It is a well-established principle in relation to commercial credits that if the instructions given by the customer to the issuing banker as to the documents to be tendered by the beneficiary are ambiguous or are capable of covering more than one kind of document, the banker is not in default if he acts upon a reasonable meaning of the ambiguous expression or accepts any kind of document which fairly falls within the wide description used”.⁷⁵

Therefore, in a situation where the buyer’s instructions are unclear or vague, as long the issuing banker addresses this problem by ensuring that the instructions are given reasonable structure and acts in accordance with it, it is entitled to a refund. This principle is perceived as inappropriate if the ambiguity is obvious⁷⁶. The rationale behind this exception is that the bank cannot simply make its own decision as to the buyer’s intention and is therefore required to refer back to him for further instructions or clarifications.

⁷¹ *Midland Bank Ltd.v. Seymour*, [1955] 2 Lloyd’s Rep. 147, 153, 168.

⁷² *Ireland v. Livingston* (1872) L.R. 5 H.L. 395.

⁷³ *Commercial Banking Co of Sydney Ltd. v. Jalsard Pty. Ltd* [1973] A.C. 279.

⁷⁴ *Midland Bank Ltd.v. Seymour*, [1955] 2 Lloyd’s Rep. 147, per Denning J., at 153.

⁷⁵ *Commercial banking Co of Sydney Ltd. v. Jalsard Pty. Ltd* [1973] A.C. 279, at 285-286. per Diplock J.

⁷⁶ *Benjamin’s Sale of Goods*, at § 23-099 p. 1700.

3.2. The Buyer's Duty to Put the Issuing Bank in Funds

The applicant is under a duty to put the issuing bank in funds in order to allow it to honour credit upon maturity⁷⁷. The rationale behind imposing this duty on the applicant is to make sure that the issuing bank has sufficient funds to pay⁷⁸. Nonetheless, this duty does not become automatically enforceable unless the issuing bank expressly stipulates that its customer furnish it with the amount payable to the beneficiary of the credit before or at the time the credit is issued. The reason why the issuing bank asks the applicant to put it in funds is to avoid its own funds being at risk. The mechanism of such operation works like this: if the applicant has an account at the issuing bank, he then authorises the issuing bank to debit his account with the amount of the credit. By contrast, if the applicant does not hold a sufficient balance at the bank to cover the amount of the credit, the issuing bank may then agree to pay from its own funds and rely on its right to be reimbursed of the amount it paid, in addition to its expenses and charges. That is to say, that if the applicant fails to put the bank in funds, and the bank pays out the credit from its own funds, the bank is entitled to charge the applicant the current rate of interest from the date it paid or purchased the bill⁷⁹.

Related to this point, is where the applicant has already put the issuing bank into funds before the seller's draft is presented, and the issuing bank pays exceeding its mandate, the applicant becomes entitled to the return of his money. However, one exception to this should be considered. If the buyer waives his rights of strict compliance, then he is not entitled to the return of his money where the issuing

⁷⁷ In the case of *Reynolds v. Doyle* (1840) 1 M. & G. 753, it was held that a customer at whose request the credit is issued is under a duty to advance the amount of the credit at a reasonable time before the stipulated date of payment.

⁷⁸ Penn, Shea, Arora, *The Law and Practice of International Banking Law* p. 340.

⁷⁹ *Re Ludwig Tillman* (1918), 34 T.L.R. 322.

bank has deviated from his mandate. Also, according to sections 1-103 and 2-605 (2) of the U.C.C., concerning waiver and estoppel principles, a buyer is precluded from complaining after payment, about apparent defects in the seller's documents. Indeed, the reimbursement agreements make it clear that the applicant is precluded from defending a claim for reimbursement, unless the applicant promptly specifies the discrepancies in the presentation and returns the documents to the issuer⁸⁰. In Stinebaugh v. Fifth Third Bank of Western Ohio, N.A.⁸¹, the preclusion approach aided the court to reach its judgment against an applicant that waited months after honour and reimbursement, to claim that the issuer should have dishonoured on grounds of late presentation. Under the U.C.P. however, there is no such principle. Article 13 clearly provides for preclusion in the context of issuer examination of documents but does not cover this issue in the context of applicant examination of the documents. Barnes and Byrne support the view that the UCP rules should explicitly adopt a preclusion rule to govern in both contexts, in order to be in line with letter of credit policy favouring certainty.⁸²

4. Issuer's Right to Reimbursement

4.1. Introduction

Thus, the issuer, after honouring the credit, is entitled to seek reimbursement from the applicant in accordance with the terms of their reimbursement agreement and applicable law⁸³. Such an applicable law under the U.C.C. is section 5-114(3),

⁸⁰ Cited Ibid (under fn 56).

⁸¹ *Stinebaugh v. Fifth Third Bank of Western Ohio, N.A.*, No 2-93-2, 1993 Ohio App. LEXIS 3021 (Ohio Ct. App. June 16, 1993).

⁸² Barnes, J., and Byrne, J., 'Letters of Credit'. 49 *The Business Lawyer* (1994) 1907 at 1916.

⁸³ Ibid at 1915. See generally about the bank's right to reimbursement Kozolchik, B., International Encyclopedia of Comparative Law. *Letters of Credit* pp. 45-50. Indeed, some issuers go further to request their applicants to complete a special note evidencing their reimbursement obligations. The

under which the bank is entitled to immediate reimbursement of any payment under the credit. Furthermore, under section 5-109 of the UCC, an issuer who honours an apparently complying demand, is entitled to reimbursement providing it has acted in good faith.⁸⁴ It has been submitted that most issuers rely on this section, when asked by their customers to dishonour on the basis of fraud, unless the request is supported by court order. There are two (US) cases in which the courts protected issuers that relied on subjective good faith, in honouring fraudulent draws.⁸⁵

It is to be noted that this right to reimbursement is bound to be affected by two requirements namely, (i) whether there has been fraud by the beneficiary and (ii) whether the bank has paid out the credit in compliance with the applicant's mandate. Under the first point, both questions of applicant's injunction in relation to fraud as well as the limitation for the application of the defence of fraud, will be examined. With regard to the second point, both the strict compliance and the bifurcated compliance standards will be explored.

rationale behind this policy is that in case of the issuing bank's insolvency, the note may be enforced by the FDIC (this is in USA) against the applicant in accordance with its terms despite the equities. See *FDIC v. Plato*, 981 F. 2d 852 (5th Cir. 1993); *FDIC v. Bodin Concrete*, 869 S. W. 2d 372 (Ct. App. Tex. 1993); *FDIC v. Rhee*, No. 92 Civ. 7110, 1993 U.S. Dist. LEXIS 9332 (S.D.N.Y. July 12, 1993); *Castleglen, Inc. v. RTC*, 984 F. 2d 1571 (10th Cir. 1993). Moreover, section 5-102(3) makes it clear that the UCC rules regulate some aspects of letters of credit but not all. This section provides that there is another applicable law to which banker and applicant may refer to settle their reimbursement disputes.

⁸⁴ Barnes, J., and Byrne, J., *supra* note 82 at 1916.

⁸⁵ See *Michigan Nat'l Bank v. Metro Institutional Food Serv., Inc.*, 497 N.W. 2d 225, 20 UCC Rep. Serv. 2d (Callaghan) 577 (Mich. Ct. App. 1993) (dissent would remand for trial as to issuer's good faith); *Merchants Nat'l Bank of Winona, N.A. v. Terry*, No. C4-93-440, 1993 Minn. App. LEXIS 1127 (Minn. Ct. App. Nov. 8, 1993) (jury found that issuer acted in good faith) Cited by Barnes and Byrne, *supra* note 82 at 1916 (fn 61 at p 1916).

4.2. Independency of the Contract Between the Issuing Bank and the Applicant

Having said that the application form for the credit forms the basis of the contractual relationship between the buyer and the issuing bank, then it follows that, their relationship should depend entirely on the terms of that contract and should be independent from any other contractual relationship related to the documentary credit transaction. In other words, following the issue of an irrevocable credit, the buyer is bound by its terms, even in cases where a dispute may later arise between himself and the seller⁸⁶.

As a general rule, the relationship between the issuing bank and the customer is that, if the issuing bank is satisfied on reasonable grounds that the documents tendered by the seller (beneficiary) do, on their face, appear to be in accordance with the terms of the credit, then the issuer has the right to pay even though the goods themselves are defective. This is grounded on article 4 of the U.C.P., which provides that banks deal in documents not in goods. Similarly, section 5-114 of the UCC provides for the same effect.

However, Benjamin⁸⁷ offers an ideal strategy for banks to avoid them being involved in disputes between applicants and sellers (beneficiaries), in relation to their underlying contract. Namely, if a buyer rejects a tender of documents based

⁸⁶ *Benjamin's Sale of Goods*, at § 23-096 p. 1699. See in this regard *Sovereign Bank of Canada v. Bellhouse, Dillon & Co.* (1911) 23 Que. K.B. 413. And in the USA see *Moss v. Old Colony Trust Co.*, 140 N.E. 803, 808 (1923); *Kingdom of Sweden v New York Trust Co.*, 96 N.Y.S. 2d 779, 791 (1949); *Liberty National Bank and Trust Co. v Bank of America*, 116 F.Supp. 233, 236-237 (1953) affd. 218 F 2d 831 (1955); Uniform Commercial Code, § 5-106; See also the case of *Howe Richardson Scale Co. Ltd v. Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd's Rep 161, CA. See also, Goode, R., *Commercial Law* p. 987.

⁸⁷ *Benjamin's Sale of Goods* at § 23-029 p.1717. This advice to buyers is feasible from the observation of sellers L.J. in *Malas (Hamzeh) & Sons v. British Imex Industries Ltd*, [1958] 2 Q.B. 127, 130.

on his belief that the seller has been fraudulent, it is recommended that the banker invites the buyer to apply for an injunction in order to restrict the seller from utilising the credit and obstructing the payment on the bank's part.

4.2.1. Fraud and Injunction From the Applicant

Having said that the reimbursement contract is independent from the other contractual relationships in the credit transaction, there are certain exceptions to this rule. As has already been discussed earlier in Chapter Four, the main exception i.e. fraud, applies to the (issuing bank-applicant) contractual relationship. The main focus of this section is to examine (i) whether the applicant has to reimburse the issuing bank for payment against fraudulent documents and (ii) whether the applicant has a right to be reimbursed by the issuing bank, regardless of fraud committed by the beneficiary.

Starting with the American case of Sztejn v. Henry Schroder Banking Corporation⁸⁸, mentioned in Chapter Four, where the buyer, upon discovering that fraud had occurred, applied for an injunction to restrain the issuing banker from accepting documents. Shientag J. held that in

“such a situation, where the seller's fraud has been called to the bank's 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 the unscrupulous seller”⁸⁹.

The author believes that, in such a case, if the issuing bank pays the amount of the credit, it would not be entitled to reimbursement from its customer.

⁸⁸ *Sztejn v. Henry Schroder Banking Corporation* 31 N.Y.S. 2d 631 (1941). For more detail on the *Sztejn* case see, Symons, E.L., 'Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief' 54 *Tulane Law Review* (1980) 338.

⁸⁹ *Sztejn v. Henry Schroder Banking Corporation* 31 N.Y.S. 2d 631, 634 (1941).

The second case, is Etablissement Esefka International Anstalt v. Central Bank of Nigeria⁹⁰. The issuing bank paid a substantial part of the credit against a set of documents including a bill of lading and a certificate of origin. With regard to the bill of lading, it was tainted with forgery and the certificate of origin was found to incorporate a fraudulent misstatement. Having discovered that the ship, which intended to carry the subject-matter of the contract, had not arrived at the port of loading, the bank refused to pay and it was sued by the seller as a result. When the bank applied for security for costs, Lord Denning M.R. observed, in respect of the question of fraud, that

“documents ought to be correct and valid in respect of each parcel. If that condition is broken by forged or fraudulent documents being presented-in respect of any one parcel-the [bankers] have a defence in point of law against being liable in respect of that parcel”.⁹¹

Ellinger⁹² maintains that his Lordship was of the opinion that the bankers could have counterclaimed in respect of money already paid against the tendered forged documents. Therefore, had the buyer applied for an injunction, the court would have granted it on the grounds of the evidence available.

4.2.2. Limitations For Application of the Defence of Fraud

What Common Law cases revealed in the above section in relation to fraud should not be taken as absolute. In this section, some limitations for applying the fraud exception will ensue. This means that the buyer can rarely prove cases of fraud, in order to get an injunction, in the light of the limitations.

⁹⁰ *Etablissement Esefka International Anstalt v. Central Bank of Nigeria*, [1979] 1 Lloyd's Rep. 445.

⁹¹ *Ibid* at p 447.

⁹² Ellinger, *supra* note, 36 at 261. See also *Benjamin's Sale of Goods*, at § 23-125 pp. 1715-16. See for detail about injunctive relief, Goode, R., *Commercial Law* pp. 1010-1012.

This conclusion was derived from Harbottle (R.D.) (Mercantile) Ltd. v. National Westminster Bank,⁹³ (a case concerning a performance bond) where Kerr J. said:

“ Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts. The courts are not concerned with their difficulties to enforce such claims; these are risks which the merchants take. In this case the [account party: viz. the buyer] took the risk of the unconditional wording of the guarantees. The machinery and commitments of banks are on a different level. They must be allowed to be honoured, free from interference by the courts. Otherwise trust in international commerce could be irreparably damaged”.⁹⁴

Under English Law, the customer will be allowed to interfere only in the most extreme and clear-cut cases of fraud. For example, in Discount Records Ltd. v. Barclays Bank Ltd⁹⁵, the plaintiffs purchased a quantity of records and cassettes from French sellers. The defendant bank was asked to issue a letter of credit in the sellers' favour. The goods turned out to be defective and therefore the plaintiffs sought an injunction to restrain the defendants from making payment. Their allegation was that the French sellers were involved in committing fraud. Megarry J. dismissed the plaintiffs' motion on the grounds that he “would be slow to interfere with bankers' irrevocable credit...unless a sufficiently grave cause is shown”.⁹⁶ Indeed, in the case of Boliventer Oil SA v. Chase Manhattan Bank⁹⁷, Sir John Donaldson MR. went even further when he emphasised that both the fraud and the bank's knowledge of it must be clearly demonstrated⁹⁸. He said:

“The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may therefore

⁹³ *Harbottle (R.D.) (Mercantile) Ltd. v. National Westminster Bank* [1978] 1 Q.B. 146.

⁹⁴ *Ibid* at pp. 155-156.

⁹⁵ *Discount Records Ltd. v. Barclays Bank Ltd* [1975] 1 W.L.R. 315.

⁹⁶ *Ibid* at 320.

⁹⁷ *Boliventer Oil SA v. Chase Manhattan Bank* (1984) 1 All E R 351.

⁹⁸ *Ibid* at 352.

be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge"⁹⁹.

Thus, there are three primary reasons by which courts are induced to act carefully before granting an injunction in cases of fraud:

1. Generally speaking, courts work on the assumption that banks must be permitted to honour their undertakings. To act otherwise, banks' reputation as well as international trade may be damaged.
2. Courts believe that disputes between the buyer and the seller should be resolved in litigation against one another.
3. Courts believe that banks should not be enjoined from performing their obligations except in clear cases of fraud of which banks have notice.¹⁰⁰

In support of the above three limitations against injunctions, reference has to be made to the following cases: First, in the case of Harbottle, an injunction against the domestic bank of the British customer and against the (second) bank in the exporter's country was first granted but then later lifted.¹⁰¹ Secondly, in the case of Edward Owen Engineering Ltd. v. Barclays Bank International Ltd & Umma Bank¹⁰², a temporary injunction was first granted but again was lifted. Thirdly, in Discount Records Ltd. v. Barclays Bank Ltd¹⁰³ the motion for injunction was

⁹⁹ Ibid.

¹⁰⁰ Ellinger, supra note 36 at 265.

¹⁰¹ Kerr J. said that "Having heard full argument, and having had the opportunity of considering the whole position for the first time inter partes, I feel bound to say that I doubt whether I should ever have granted any of these injunctions in the first place, even ex parte". Q.B. (1978) 146, at 157.

¹⁰² Edward Owen Engineering Ltd. v. Barclays Bank International Ltd & Umma Bank [1978] 1 Lloyd's Rep. 166. Lord Denning said "I think Mr. Justice Kerr was quite right in discharging the injunction. The bank must honour its bond". Ibid at 172.

¹⁰³ Discount Records Ltd. v. Barclays Bank Ltd [1975] 1 W.L.R. 315.

discharged.¹⁰⁴ Fourth, in Hamzeh Malas & Sons v. British Imex Industries Ltd¹⁰⁵, a contract for the delivery of steel rods in two installments was entered into and payment was to be made by a confirmed letter of credit. The plaintiffs complained that the first installment was defective and applied for an injunction to restrain the defendants from drawing on the credit in relation to the second installment. Donovan J. granted the injunction *ex parte* but then discharged it *inter partes*.¹⁰⁶ Similarly, in the recent case of Czarnikow-Rionda v. Standard Bank¹⁰⁷, where it was demonstrated that as a result of the courts generally avoiding intervening in cases involving letters of credit, to ensure that international trade was not jeopardised, it followed therefore, that in all the cases that were referred to¹⁰⁸ injunctions were generally not granted. The facts of this particular case involved a request made on the part of the plaintiff (Rionda) for a pre-trial injunction against the first defendant [Standard Bank]. The aim of the injunction was to stop Standard from paying out to two Swiss Banks, the profit of three letters of credit at maturity, which they had opened at the request of its customer, Rionda and which the Swiss banks had at Standard's request, advised and confirmed. The injunction was sought by Rionda based on the fraud exception rule, which when

¹⁰⁴ Megarry J., said "I would be slow to interfere with bankers' irrevocable credits, and not least in the sphere of international banking, unless a sufficiently grave cause is shown....The present case falls far short of establishing any ground upon which it would be right for the court to intervene by granting the interlocutory injunction claimed, even in its revised form. The motion accordingly fails and will be dismissed". [1975] 1 WLR 315, at 320.

¹⁰⁵ *Hamzeh Malas & Sons v. British Imex Industries Ltd* [1958] 2 Q.B. 127.

¹⁰⁶ Donovan J. said "although the court had a wide jurisdiction to grant injunctions, this was not a case in which, in the exercise of its discretion, it ought to do so; an elaborate commercial system had been built up on the footing that a confirmed letter of credit constituted a bargain between the banker and the vendor of the goods, which imposed upon the banker an absolute obligation to pay, irrespective of any dispute there might be between the parties whether or not the goods were up to contract". [1958] 2 Q.B. 127.

¹⁰⁷ *Czarnikow-Rionda v. Standard Bank* [1999] 2 Lloyd's Rep. 187.

¹⁰⁸ Cases referred to are such as *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, [1983] 1 A.C. 168; *Bolivinter Oil S.A. v. Chase Manhattan Bank N.A.*, [1984] 1 Lloyd's Rep. 251; *Deutsche Ruckversicherung AG. v. Walbrook Insurance Co Ltd*, [1995] 1 Lloyd's Rep. 153, col 1.

applied to this case, indicated that an 'obvious' or 'established' fraud had taken place, as the bank was aware of its occurrence.

However, it was evident that Rionda had sought the injunction despite the fact that it had not directly claimed relief against the other banks, and despite the other banks having already discounted the profit of the letters of credit either directly to the beneficiary or indirectly under back to back letters of credit issued to the suppliers to the beneficiary. The following issues were also highlighted; one of which was that it became apparent, prior to any suspicion of fraudulent activity taking place, that such discounting had already occurred. Another issue highlighted was that the documentary sales, in respect of which the letters of credit were opened, had been performed. The final issue was that the shipping documents, associated with such sales, had been negotiated and accepted well in advance by Standard Bank. The main issues raised as a result of this case, were whether the fraud exception had been made out and whether an injunction should be allowed to continue.

Rionda alleged that the contract between themselves and Standard Bank had stated that Standard would not pay out under the letters of credit, if it became aware of any fraudulent behaviour taking place with regards to the financing. Some of the issues which were raised by United European Bank (UEB) were whether there were any real issues between Rionda and Standard and it was also maintained that the proceedings amounted to an 'abuse of process' because there was a lack of disclosure in relation to the background to Rionda's application.

It was also disputable whether Rionda was aware of the details in relation to the back-to-back credit arrangements. The main argument centered around whether UEB could treat Standard's credits as credit by negotiation and whether the fraud exception rule operated under a deferred payment credit at any time up to the

maturity date or only up to such a time, as the nominated or confirming bank may have committed itself to making payment, either by accepting the documents as good documents under the credit or by discounting the payment due on maturity.

Commenting on Kerr J.'s analysis of the R. D. Harbottle (Mercantile) Ltd, Rix J. summarised that the case had held that either a letter of credit applicant was entitled to the protection of an injunction, such as where he may have a substantive cause against the bank, or he was not entitled to one where no cause of action existed against the bank. As a direct consequence of this case, it was stressed that the banks should in fact be allowed to continue, without unnecessary interference on the part of the courts, to ensure that the trust in international commerce was maintained.¹⁰⁹

Following the hearing of the Rionda case, Rix J. held¹¹⁰ that as the responsibility of the banks was tremendous and they were held highly accountable, they were therefore held responsible for ensuring that any banking contracts were seen as honest, especially where fraud was concerned. Exceptions to this were dependent upon the time of when any fraudulent activity was first known to the bank or when it was first noticed. This was evidently portrayed as significant in Rix J.'s judgment, where he stated that fraud could only be utilised as a valid excuse by the bank for not holding themselves accountable on the letters of credit, where they had been notified of fraud having occurred in the following situations; a] prior to payment being made to the beneficiary and b] in any way that it could be proven that the bank were knowledgeable to the occurrence of fraud.

¹⁰⁹ *Czarnikow-Rionda v. Standard Bank* [1999] 2 Lloyd's Rep. 187, at 190.

¹¹⁰ *Ibid* at 202.

The second main issue raised by Rix J. was that it could not be left solely to the bank's discretion, to determine whether or not it dealt with or was responsible for payment made in a fraudulent manner. Rix J. offered that the bank needed to clearly define its mandate and obligations in relation to this.

The third point, was that those parties partaking in fraudulent activity, would not be able to use or dispose of the 'fruits of their alleged fraud', as prescribed by the Mareva injunction.

Following the trial, the injunction which would prevent Standard paying the other two banks where they were alleged to have acted fraudulently, was refused by the court.

In summing up, injunctions were first granted and then discharged due to the adoption of an extremely narrow interpretation of fraud, leaving the buyer practically with no adequate legal protection.¹¹¹ This is the position of fraud taken by British Courts.¹¹² This means that the issuing banks were entitled to reimbursement from their applicants. However, under section 5-114(2)(b) of the UCC, the applicant's application for an injunction, to stop the issuing bank from honouring the credit would succeed, if a required document is 'forged or fraudulent or there is fraud in the transaction'. Yet, there are certain ambiguities surrounding the concept of fraud here, as it may be concluded that 'fraud in the

¹¹¹ Horn, N., 'Securing International Commercial Transactions: Standby Letters of Credit, Bonds, Guarantees and Similar Sureties' in Horn, N., and Schmitthoff, C.M., *The Transnational Law of International Commercial Transactions*. (N. Horn, Eds.) (Vol 2.) (Antwerp; Boston: Kluwer-Devanter The Netherlands, 1982) p. 275 at 291.

¹¹² Horn, N., *supra* note 111 at 291; see also Dolan, J., *The Law of Letters of Credit. Commercial and Standby Credits*. Revised edition. (Warren, Gorham and Lamont, 1996) pp. 7-6 till 7-9; Fellingner, G.A., 'Letters of Credit: The Autonomy Principle and the Fraud Exception' *Journal of Banking and Finance Law & Practice* (1990) 4 at 18 states: "English courts do not approach the framework of analysis from a preliminary injunction perspective...".

transaction' also includes the underlying contract.¹¹³ Given that a letter of credit requires the presentation of a document, commonly a draft, for payment, according to section 5-114(2)(b), if the draft was considered to have been fraudulent, in some aspect or forged, the issuer's reaction may vary according to the circumstances. However, in those situations where it was left to the issuer's discretion as to whether to honour the draft or not, the customer could petition the appropriate court to enjoin honouring the draft.¹¹⁴ The UCP is found to be silent upon the issue.

Again, there is a remarkable approach, represented by the case of Group Josi Re v. Walbrook Insurance Co.¹¹⁵, in which the question of illegality of letters of credit could not be used as a defence to grant an injunction. Here, a Belgian reinsurance company entered into a number of insurance contracts with the defendant insurance companies. The agreement took place between 1974 and 1976 where such a reinsurer company was not authorised, under the Insurance Companies Act 1974, or subsequently under the Insurance Companies Act 1982, to carry on business in the UK. In the course of business, the reinsurers opened a letter of credit in favour of the assured companies. The reinsurers, in order to stop payment under the credit, alleged that such reinsurance contracts were void, based on their assumption that these contracts were illegal according to the UK laws. Although they were granted interlocutory injunctions, restraining the assured companies

¹¹³ Horn, N., *supra* note 111 at 292. See for more detail on the subject Rendell, R.S., 'Fraud and Injunctive Relief' 56 *Brooklyn Law Review* (1980) 111. Also, Thorup, A.R., 'Injunctions Against Payment of Standby Letters of Credit: How Can Banks Best Protect Themselves?' *Journal of Banking Law* (1984) 6. See § 5-109 of the UCC. cmt.

¹¹⁴ UCC § 5-114(b), cmt. See also Appendix D for comparison between original and revised UCC Article 5 in relation to applicant's right to an injunction, Section (13).

¹¹⁵ *Deutsche Rückversicherung AG. v. Walbrook Insurance Co Ltd and Others. Group Josi Re* (formerly known as Group Josi Reassurance SA) *v. Walbrook Insurance Co Ltd and Others* [1994] 4 All ER 181. [1996] 1 WLR 1152.

from drawing on the letters of credit, the Judge discharged the injunction. Having initially failed in maintaining their interlocutory injunctions, the reinsurers amended their pleading, by basing their allegation on the grounds of fraudulent misrepresentation and/or non-disclosure of material circumstances on the part of the directors of H.S. Weavers (Underwriting) Agencies Ltd. This particular agency, which had handled the administration of the reinsurance, had been accused of taking an overriding commission, which had been paid to Walbrook. Once again, the interlocutory injunctions restraining the assured companies from drawing on the letters of credit was dismissed. With regard to the allegation of fraud, it was held that such fraud, in relation to the main contracts of reinsurance, would not affect the letter of credit “where the dishonest conduct has no impact on the risks being reinsured”.¹¹⁶ Phillips J. concluded saying that “Such relief would clot what has been described as the lifeblood of international commerce as surely as an injunction restraining drawing on the credit”.¹¹⁷

4.3. Strict Compliance to Application Form

Under this section, an attempt will be made to examine the doctrine of strict compliance in relation to the contract between the applicant and the issuing bank. The first three cases will illustrate the position under English law whereas the final case will explain the approach taken by the majority of the American courts.

The issuing banker, once having agreed to open the credit, has to adhere strictly to the buyer’s instructions. Otherwise, such an issuing bank must act at its peril and bear the responsibility of non-reimbursement from the buyer. To illustrate this

¹¹⁶ [1994] 4 All ER 181, at 198.

¹¹⁷ [1994] 4 All ER 181, 202.

point, consider the case of Midland Bank Ltd.v. Seymour¹¹⁸. Here, the applicant requested the issuing bank to open a documentary credit in favour of the seller, which was to be available in Hong Kong. Instead, the issuing bank opened the credit in London. While delivering judgment, Devlin J. held that if the banker was authorised to pay only in Hong Kong, then “although the place of payment might be commercially immaterial the banker had exceeded his mandate and could not recover”.¹¹⁹

Similarly, in the case of Rayner (J.H.) & Co. Ltd. v. Hambro's Bank Ltd.¹²⁰, the issuing bank rejected a bill of lading which described the goods in different terms from those used in the trade. It was held that the issuing bank was entitled to reject such bill of lading, regardless of the conformity between goods and the sale contract. Goddard L.J. was of the view that the bank was not required to exercise a discretion that gives the buyer the best protection. By contrast, the banker was only required to comply with the instructions given to it. He said:

“The person who requests the bank to establish the credit can impose what terms he likes. If he says to the bank: “I want a bill of lading in a particular form,” he is entitled to it. If the bank accepts the mandate which its customer gives it, it must do so on the terms which he imposes...if [the bank] has only been authorised by its customer to pay on certain terms it must see that those terms are included in the notification which it gives to the beneficiary, and it must not pay on any other terms. If it does pay on any other terms, it runs the risk of its customer refusing to reimburse it”¹²¹.

The ruling made it clear that the same decision would be taken even if a person, familiar with the trade, would have realised such terms to be identical. Goddard went on further to say:

¹¹⁸ *Midland Bank Ltd.v. Seymour*, [1955] 2 Lloyd's Rep. 147.

¹¹⁹ *Ibid* at 168.

¹²⁰ *Rayner (J.H.) & Co. Ltd. v. Hambro's Bank Ltd* [1943] C.A. 1 K.B. 37.

¹²¹ *Ibid* 42.

“I protest against the view that a bank is to be deemed affected by knowledge of the trade of its various customers, but, quite apart from that, even if the bank did know of this trade practice by which “Coromandel groundnuts” can be described as “machine-shelled groundnut kernels,” I do not think that would be conclusive of the case”.¹²²

Furthermore, in Credit Agricole Indouez v. Generale Bank¹²³, (facts were set out in Chapter Five) one of the issues for consideration was whether Generale Bank was entitled to indemnity from the third parties in regard of any sums which it was liable to pay Credit Agricole or any of its own costs, which were incurred as a result of the proceedings. Steel J. concluded that Generale Bank were not in entitlement to any indemnity from the third parties¹²⁴, which was supported by some authors¹²⁵. This was based mainly on the fact that Article 18 of the UCP did not indicate the need, by way of a stipulation, that an applicant was required to both accept and pay for documents which were non-conforming with his initial instructions.

Turning to the American case of Gulf South Bank & Trust Co. v. Holden¹²⁶, we find another example of an issuing bank-customer dispute on the reimbursement contract. Here, the issuer who made payment, upon receiving non-complying documents from the beneficiary, was not entitled to recover reimbursement from its customer. The Louisiana Fourth Circuit Court of Appeal based its holding on the following grounds:

1. the issuer breached the terms of the credit agreement, by funding without complying strictly with all of its requirements;

¹²² Ibid.

¹²³ *Credit Agricole Indouez v. Generale Bank* [1999] 2 All ER (Comm) QBD. 1016.

¹²⁴ Ibid at 1024.

¹²⁵ David Steel J preferred the view taken by Jack, R., *Documentary Credits* (2nd ed, 1993) Para 4.18.

¹²⁶ *Gulf South Bank & Trust Co. Holden*, 562 So. 2d 1132 (La. App. 4th Cir. 1990).

2. the issuer paid on the letter of credit after the term of the agreement had expired.¹²⁷

To conclude, the doctrine of strict compliance with regard to the issuing bank and buyer contract, should focus on four major points, which are as follows:

1. Stipulated documents must be tendered in full.
2. Each document must be valid, effective and regular, to the extent that no convincing objections can be made.
3. All documents must be conforming with each other.
4. The goods must be accurately described in the commercial invoice; the other documents may describe them in general terms.¹²⁸

4.3.1. Some Relaxed Decisions “the Bifurcated Standard”

In disputes between the issuer of the letter of credit and the customer, from the customer's point of view, he will argue that payment should not take place unless there is strict documentary compliance. Alternatively, if payment took place against non-conforming documents, the bank has no right of reimbursement. This view rests on the opinion that even in the bank - applicant context, the letter of credit transaction is one involving documents and not goods. So, according to this notion, if the tender documents were discrepant, the applicant has the right not to reimburse the bank even if the goods conform in actual fact, with the conditions of

¹²⁷ Howard, T., Note, 'Gulf South Bank & Trust Company v. Holden: A Warning to Bankers Honouring Letters of Credit' 52 *Louisiana Law Review* (1991) 437 at 437.

¹²⁸ Ellinger, *supra* note 36 at 260.

the underlying contract.¹²⁹ From the issuer's point of view, on the other hand, the "bifurcated standard" should be applied. A "bifurcated standard" means "a less rigorous standard of documentary compliance where the issuer is seeking reimbursement from the applicant rather than the beneficiary seeking honour from the issuer."¹³⁰ In other words, 'bifurcated' requires strict compliance in the letter of credit context (the beneficiary relationship), but only requires substantial compliance in the reimbursement agreement context (in the customer relationship).¹³¹ Since the relationship between the issuer and the customer is a contractual one, the normal rules of contract law should apply to disputes between the customer and the issuer.¹³² In an attempt to avoid the harshness of the strict interpretation, some commentators have suggested that a banker should be entitled to accept documents which embody some irregularities if, in fact, the non-conformity does not result in any loss to the buyer.¹³³ This bifurcated standard can be supported (by what common law cases reveal) only if the following conditions are present: (i) "whether the issuer's misconduct damaged the customer, and (ii) whether the issuer acted in good faith".¹³⁴

¹²⁹ Dolan, J.F., 'The Correspondent Bank in the Letter-Of- Credit Transaction', 109 *Banking Law Journal* (1992) 396, at 417.

¹³⁰ Barnes, J., and Byrne, J., 'Letters of Credit' 48 *The Business Lawyer* (1993) 1635 at 1642; Kozolchik conducted a survey in relation to the application of the doctrine of strict compliance in different jurisdictions. The survey showed that "courts were inclined to take more seriously a banker's objection of noncompliance raised against a beneficiary's tender of documents than a customer's objection raised against the issuing bank's verification". Kozolchik B., *International Encyclopedia of Comparative Law. Letters of Credit* p. 82; See for more details about the doctrine of strict compliance in some of the English leading text books in the subject. e.g., Gutteridge and Megrah, *The Law of Banker's Commercial Credits* p. 116; Michael, R., *Letters of Credit* 2nd ed (Euromoney Publications Limited, London, 1997) p. 57. For more comparative information in the subject, see Sarna, L., *Letters of Credit: The Law and Current Practice* p. (3-7).

¹³¹ Dolan, 'Letter-of-Credit Disputes Between the Issuer and its Customer: The Issuer's Rights under the Misnamed "Bifurcated Standard"' 105 *The Banking Law Journal* (1988) 380, at 383.

¹³² *Ibid* at pp. 380-383.

¹³³ *Ibid* at 383.

¹³⁴ *Ibid* at pp. 383-4.

In sum, proponents to the bifurcated standard, base their view on the fact that the applicant is essentially buying goods, not documents. So, if the documents are not in conformity with the credit terms but the goods in actual fact comply to the terms and conditions of the underlying contract, then the bank may force the applicant to accept non-conforming documents as long as the defects do not cause any loss to the buyer. Dolan goes further to argue that the applicant cannot establish a breach-of-contract cause of action, unless he can prove losses have been incurred by the bank accepting non-conforming documents. Since the bank-applicant agreement is a normal contract, it is governed by the general rules of contract law. According to contract law, the aggrieved party is not given a cause of action unless he suffers damage. In other words, even if the bank pays out the credit against non-complying documents, the applicant still cannot be given a breach of contract cause of action unless he proves losses suffered.¹³⁵ Dolan concludes by saying that

“while the beneficiary relationship is peculiarly a creature of letter-of-credit law and demands strict documentary compliance, the customer relationship is contractual, normal rules of contract breach should apply, and liability should turn not on the nature of the documentary breach but on its consequences and on the bona fides of the issuer”.¹³⁶

4.3.1.1. Position of Law in Relation to the Bifurcated Standard

The cases of Midland Bank Ltd.v. Seymour, and J H Rayner and Co Ltd. v. Hambros Bank Ltd (mentioned under section 4.3.), demonstrate that there is no general acceptance of this standard under English law. This means that the doctrine of strict compliance prevails under English law, in the issuing bank-applicant agreement. Likewise, the majority of USA courts would not apply such a standard. For example, in Bank of Cochin, Ltd. v. Manufacturers Hanover Trust

¹³⁵ Dolan, J.F., supra note, 129 at 419.

¹³⁶ Dolan, J.F., supra note 131 at 381.

Co.¹³⁷ the bifurcated standard was rejected by the court and indeed, it was assumed that the strict standard, with no inquiry into the consequences of the defects, was the only substitute. It appears that the court in the above mentioned case, only by way of suggestion, demonstrated the bifurcated substantial compliance standard as a preferred approach, although the New York courts appeared not to implement it into practice at all. In the concluding statement, the court in the Bank of Cochin case recommended that a strict standard should be utilised, to judge cases which involved wrongful dishonour on the part of the confirming bank. The court also determined that the confirming bank would not be entitled to claim compensation from the issuing bank in situations where the confirming bank, on finding any discrepancies within the drafts, were found to have waived them. The final significant point of the judgment, was that a strict compliance standard would be utilised to govern an issuing bank's action for wrongful honour against a confirming bank.¹³⁸

Likewise, in the case of Seattle-First National Bank v. FDIC¹³⁹, the court also rejected the bifurcated standard. Here, the confirming bank had accepted the tender documents, in violation of clause 4, which in effect, stated in the letters of credit, that the original letter of credit must be presented with the documents. Since the original letters of credit were not presented at the time of the draft, this would render the beneficiary's presentment deficient under the strict compliance standard. It was held that the confirming bank could not waive the discrepancies because it owed both its customer and the issuing bank, a duty of careful documentary examination under UCC section 5-109, similar to that of the issuing

¹³⁷ *Bank of Cochin, Ltd. v. Manufacturers Hanover Trust Co.*, 612 F. Supp. 1533 (S.D.N.Y. 1985), aff'd, 808 F.2d 209 (2d Cir. 1986).

¹³⁸ *Ibid* at 1540.

¹³⁹ *Seattle-First National Bank v. FDIC*, 619 F. Supp. 1351 (W.D. Okla. 1985).

bank who owed that duty to its customer, the account party on the letter of credit. Both cases involved the efforts of a confirming bank to obtain reimbursement from the opening bank. In the second case, the court said that the confirming bank would lose its right of reimbursement for paying over documentary defects.¹⁴⁰

However, the bifurcated standard has been occasionally applied by some American courts only where the above two conditions are present namely, that the customer has not been damaged and that the bank has acted in good faith. Section 4.3.1.2 gives some detail.

4.3.1.2. Cases in Which the Bifurcated Standard is Applied

According to the common law rules (in the USA), the bifurcated standard *may* be adopted. Here, there are, according to Dolan¹⁴¹, some cases favouring the view that “the issuer’s right of reimbursement turns not on the standard of documentary compliance it exacts from the beneficiary but on its honesty and on the damage, if any, its payment causes the customer”.¹⁴² The leading case was Bank of Montreal v. Recknagle¹⁴³, where the credit called for bills of lading, covering bales of hemp. Payment took place upon tendered bills of lading in which the goods were referred to as bales of merchandise. Yet, the goods turned out to be hemp mixed with other worthless materials. The issuing bank was allowed to recover from the customer, the payment made to the beneficiary only up to an amount equal to the value of the hemp delivered and not for the balance. Here, the breaching issuer was not deprived of all the reimbursement. It was only deprived of reimbursement to the

¹⁴⁰ Ibid at 1363.

¹⁴¹ Dolan, *supra* note 131 at 394.

¹⁴² Ibid pp. 394-95.

¹⁴³ *Bank of Montreal v. Recknagle*, 109 N.Y. 482 (1888).

extent that its breach damaged the customer¹⁴⁴. Upon reviewing both the conditions of payment within the credit and the agreement between the issuer and the customer, the court perceived the bill of lading terms as being “material and important”¹⁴⁵. As a result of this, the issuer was held to have “departed from an important condition of the credit and of the agreement”¹⁴⁶. The base of this judgment is similar to contract law in cases, where the breach of an important and material condition by the issuer relieves the customer from the duty to perform its independent promise to reimburse¹⁴⁷.

In the case of RTC v. Kimball¹⁴⁸, an action for reimbursement was brought by the issuer of certain letters of credit, and the issue under deliberation was based on the defendant’s claim that the issuing bank should not have honoured the draft under the letter of credit in question. It was held¹⁴⁹ that the issue here was not whether the letter of credit was properly honoured or presented, but whether under their contracts with the issuing bank, the defendants had reason to reject reimbursement. However, it was added that the former issue of whether the issuing bank had properly honoured the draft, was perceived as only relevant in a suit between the issuing bank and the beneficiary, under the letter of credit contract.

Some of the issues which arose from the appeal, as provided by the applicants will now be briefly explored. The first argument put forward by the appellants was that

¹⁴⁴ Ibid at 487.

¹⁴⁵ Ibid at 492.

¹⁴⁶ Ibid.

¹⁴⁷ Dolan, supra note 131 at 394-95.

¹⁴⁸ *RTC v. Kimball*, 963 F. 2d 820, 17 UCC. Rep. Serv. 2d (Callaghan) 1244 (5th Cir. 1992). See the following web site for facts and decision. :<http://www.ca5.uscourts.gov:8081/ca5/isysmenu.htm>

¹⁴⁹ *RTC v. Kimball*, 963 F. 2d 820, 17 UCC. Rep. Serv. 2d (Callaghan) 1244 (5th Cir. 1992). Judgment is obtainable from this web site: <http://www.ca5.uscourts.gov:8081/ca5/isysmenu.htm>, p 2.

there was a failure on the part of the appellee (bank), to comply with the credit terms in relation to the letters of credit because the draft upon presentation was done in a way that the amount once calculated, exceeded the amount provided for in any individual letter of credit. It was also pointed out that there appeared to be an absence of any supporting terms within the letters, thus “prohibiting the proration of the draw among the three letters”, as well as preventing the three letters of credit being included on one draft¹⁵⁰.

Another complaint exerted by the applicants was that prior to any drafts being honoured, the letters of credit initially required the presentation of the letters themselves. The argument stemmed from how the terminology was interpreted. An example is when the term “may be drawn” was used in relation to the need for the presentation, which according to the applicants, was interpreted as meaning that such presentation was ‘permissive’. The final point of argument was that:

“the equal apportionment of the draft between the three letters of credit constituted a partial draw in direct contravention of the express language of the letters of credit prohibiting partial draws.”¹⁵¹

According to the court, the defendant’s interpretation of the phrase “partial draws are not permitted” was perceived as being incorrect, when it was reviewed alongside the generally accepted interpretation. The phrase was wrongfully taken to mean “the full amount of the letter of credit must be drawn in any draft”, whereas the accepted interpretation took it to mean “forbids multiple drafts on a letter of credit and requires that any draft on the letter of credit seek the full amount currently due pursuant to the agreement underlying the letter of credit

¹⁵⁰ <http://www.ca5.uscourts.gov:8081/ca5/isysmenu.htm>, p. 4.

¹⁵¹ Ibid.

obligation.” In the judgment, all of the above issues were abandoned as not having any due merit.¹⁵²

The main point that can be derived from this case is that, the court expresses the application of “a less rigorous standard of documentary compliance where the issuer is seeking reimbursement from the applicant rather than the beneficiary seeking honour from the issuer”.¹⁵³

5. Securities Taken Against Documents

5.1. Trust Receipts

If the buyer fails to deposit funds in the issuing bank in advance, it is the issuing bank which has to ensure the costs and its own commission are recuperated from the buyer. In most cases, however, the customer [buyer] is unable to secure the funds until the goods are re-sold, which proves difficult without possession of the bill of lading. The bank however, prefers to offer the bill of lading, only where the buyer provides some form of security, in order to rule out the possibility of bankruptcy on the part of the customer.¹⁵⁴

¹⁵² The district court relied on language in *Travis Bank & Trust* 660 S. W. 2d at 855 that “[t]he issuer of a letter of credit, if it pays the credit in good faith and with no notice of fraud or forgery, obtains the right of immediate reimbursement from its customer, who bears alone the risk of any misinterpretation of the beneficiary’s demand for payment.” See <http://www.ca5.uscourts.gov:8081/ca5/isysmenu.htm>. pp. 2-3.

¹⁵³ Barnes and Byrne, *supra* note 130 at 1642.

¹⁵⁴ Todd, P., *Bills of Lading & Bankers’ Documentary Credits* 3rd ed. (Lloyd’s of London Press Ltd, 1998) p. 48; See also Bradgate, R., *Commercial Law* p. 685; Kozolchyk, B., *International Encyclopedia of Comparative Law. Letters of Credit* pp. 51-66.

5.2. Security Against Bankruptcy of Buyer

In summarising the view of Todd, with regards to security on selling of the goods, it is stated that the bank has legal title where it obtains special property in the goods as pledgee, whilst in possession of the bill of lading. The bank holds this special property until the buyer is able to secure the initial funds, regardless of whether or not the bill of lading is released to the buyer. Therefore, if the buyer becomes bankrupt, prior to the goods being sold, the bank, having acquired a legal entitlement to the special goods, can alternatively recuperate the funds from selling on the goods. It is suggested that this form of security is sufficient.¹⁵⁵

This is evident in the case of North Western Bank Ltd. v John Poynter, Son & McDonalds¹⁵⁶, where a bill of lading for a cargo of phosphate rock, which was at sea and was pledged by P Co., with a Liverpool bank, its appellants, was used as security for obtaining an advance of £5,000. The bank, in accordance with the terms of the pledge, acquired the authority to seize the goods as pledgee and to sell them on, should P. Co. fail to pay off the amount initially borrowed:

“[the bank] are to have immediate and absolute power of sale, and that under that power [the bank] authorise and empower [the pledgors] to enter into contracts of sale of merchandise on [the bank’s] behalf in the ordinary course of business...”¹⁵⁷

In this situation, the bank’s position resembled precisely that of an issuing bank, where documents of title had been placed under a documentary credit, and which accordingly had enabled them to obtain the special property in the goods. Based on a contract of sale which had previously been made, the bank later transferred the

¹⁵⁵ Todd, P., *Bills of Lading & Bankers’ Documentary Credits* p. 48; See for more detail pp. 54-60 in Kozolchik B., *International Encyclopedia of Comparative Law. Letters of Credit* pp. 54-60; See also Gutteridge and Megrah, *The Law of Banker’s Commercial Credits* pp. 210-226.

¹⁵⁶ *North Western Bank Ltd. v John Poynter, Son & McDonalds* [1895] AC 56.

¹⁵⁷ *Ibid* at 57.

bills of lading to the pledgors, enabling them to resell the goods. The documents were released, based on the strong assumption, on the part of the bank, that this would enable the pledgors to act as their agents whilst selling the goods. It was apparent from the House of Lords' judgment that the bank's position was not biased by either its rights as pledgee or as its special property as pledgee, from releasing the documents. Lord Herschell LC commented that:

"There can be no doubt the pledgee might hand back to the pledgor as his agent for the purpose of sale, as was done in this case, the goods he had pledged, without in the slightest degree diminishing the full force and effect of his security."¹⁵⁸

Referring back to the case, as C. Co. [of Glasgow] had purchased the goods from P. Co. but had not at the time, made payment to both P. Co nor the bank, P. Co. consequently failed to repay the bank. The respondent in this case, a creditor of P. Co., took arrestment proceedings against the debt, which C. Co. still held. The House of Lords, argued that because P. Co. were acting only as agents for the bank, in selling the goods, the debt was directly owed to the bank, and thus, could not be attached by a creditor of P. Co.

It is apparent from this judgment, according to Todd¹⁵⁹, that the decision was based on the bank acquiring special property in the goods, as pledgee. This case was perceived as unique, as the proceeds of the sale were still held in an identifiable fund and were therefore distinguishable from the buyer's general account. On transferring the proceeds of the sale into the buyer's account, the bank would have lost the protection of its special property and as a result, the entire property in them would automatically be passed on to the buyer.

¹⁵⁸ Ibid at 68.

¹⁵⁹ Todd, P., *Bills of Lading & Bankers' Documentary Credits* p.49.

It is imperative that the bank ensures that there is in place, adequate security in the proceeds of the sale, prior to releasing the documents, in case the buyer goes bankrupt following sale of the goods. Todd suggests that one way to achieve this, is for the bank to request a trust receipt at the time of releasing the bill of lading. In normal circumstances, the trust receipt has two functions. Initially, prior to the sale taking place, it makes the buyer a trustee to the bank, of both the documents of title and the goods. Following the sale, its second function is that it constitutes the proceeds of sale.

In other words, the bank therefore retains equitable title, as beneficiary, in the goods and following the sale, any proceeds as a result of the sale. Should the buyer, as the trustee, go bankrupt, either prior to or following the sale, the bank can be perceived as being a preferred creditor.

When discussing the issue of protection against a buyer's fraud, trust receipts do not appear to give any real protection.¹⁶⁰ As previously stated, although a trust receipt may provide the bank with an equitable title in the goods and the proceeds of the sale, however, in releasing the bill of lading, the bank will lose its constructive possession in the goods, regardless of whatever the trust receipt can offer the bank.

If a situation arose where the buyer fraudulently used the bill of lading to obtain the goods or used the proceeds from the sale of the goods in a dishonest manner, the bank is helpless and may find itself in a situation of having to locate the parties who had come into possession of the documents, in order to have some chance of recuperating losses.

¹⁶⁰ Ibid at 51.

This point was illustrated in the case of Lloyds Bank v Bank of America National Trust and Savings Association¹⁶¹, where a trust receipt was released to the buyer in exchange for the shipping documents. The facts of the case illustrate that the buyer had utilised the documents in a dishonest manner by pledging the documents with another bank [the defendant] and in doing so, generated extra money in the goods. As a result of the buyer later going bankrupt, Lloyds Bank attempted to recuperate its losses by suing the defendant bank, in order to regain control of the shipping document. MacKinnon L.J. observed:

“In this case Strauss & Co., Ltd., in breach of good faith, and in breach of their contract, pledged the goods and thereby improperly obtained money upon the value of them; but if they had sold the goods and misappropriated the purchase price, they would only have been acting in a rather different way in breach of their duty and in breach of their contract. In that case the plaintiffs would have had no shadow of a claim against anybody except Strauss & Co., Ltd. I have no doubt that this very convenient business method will continue, and can do so because the whole basis of business rests upon honesty and good faith, and it is very rarely that dishonesty or bad faith undermines it”.¹⁶²

Following the Court of Appeal’s judgment, it was established that the defendant bank had, in fact, been acting in good faith, with no prior knowledge of Lloyds Bank’s interest. This was despite the fact that ownership had been transferred directly to them, as a result of accepting the documents.

Therefore, based on general equitable principles, the defendant bank can be seen as a *bona fide* purchaser for value without notice, because it had obtained legal title to the goods and would defeat any prior equitable title which Lloyds Bank had acquired. Therefore, the terms of the trust receipt were seen to be irrelevant in relation to the final decision.¹⁶³

¹⁶¹ *Lloyds Bank v Bank of America National Trust and Savings Association* [1938] 2 K.B 147.

¹⁶² *Ibid* at 166.

¹⁶³ See for more on the case facts, Todd, P., *Bills of Lading & Bankers' Documentary Credits* pp. 51-53.

5.3. The Banker's Lien

On initially committing to make payment under the bills of exchange, subsequent to it receiving the shipping documents from the beneficiary, the issuing bank is authorised to retain such documents, until it has been repaid. Such a lien, apparently operates at a distance from any other security, which the bank may take by any other alternative agreement. Basically, the bank, under such a lien, is entitled to hold the shipping documents. Where other documents are concerned and where the bank also has a lien, there is an omission of any suggested power of sale or realisation¹⁶⁴. In the case of Brando v. Barnett¹⁶⁵, Lord Campbell said:

“Bankers most undoubtedly have a general lien on all securities deposited with them, as bankers, by a customer, unless there be an express contract, or circumstances that show an implied contract, inconsistent with lien...”¹⁶⁶.

Similarly, in the case of Halesowen Pressworks and Assemblies v. Westminster Bank Ltd¹⁶⁷, it was evident upon delivering the judgment, that the court, on addressing both a lien and a right of set-off, held that they were distinguishable, and decided therefore that banks generally have a lien on all securities that have been given to them by their customers. In the House of Lords, Lord Cross of Chelsea observed that: “in the absence of agreement to the contrary a banker has a lien on all securities in his hands for the general balance owing to him on all

¹⁶⁴ Penn, Shea, Arora, *The Law and Practice of International Banking Law* p. 347.

¹⁶⁵ *Brando v. Barnett*, (1846) 12 Cl. & Fin. 787).

¹⁶⁶ *Ibid.*

¹⁶⁷ *Halesowen Pressworks and Assemblies v. Westminster Bank Ltd* [1972] A.C. 785, [1972] 1 All E.R. 641.

accounts”.¹⁶⁸ Furthermore, in the Court of Appeal in Halesowen Presswork v. Westminster Bank¹⁶⁹, Lord Denning M.R. said:

“The lien which we call a “banker’s lien” has no resemblance to any other kind of lien. In the ordinary way a lien gives a creditor a right to retain possession of a thing until his account is paid. If the creditor lets it out of his possession he loses his lien. The creditor has no right to sell the thing or dispose of it. He is only entitled to retain possession”.¹⁷⁰

5.4. Bankruptcy of the Applicant

5.4.1. Prior to Acceptance of Application

If the applicant for the credit becomes bankrupt prior to the bank’s acceptance of an application for the issuance of a letter of credit, he is, then, rendered incapable of contracting in law. Let us suppose in this hypothetical example that the applicant submits an application for the issuance of a credit, but in the meantime between processing the application and before the bank’s approval of the credit, the applicant, without the knowledge of the issuer, either files an assignment for a receiving order or is declared bankrupt. Suppose following the effective date of bankruptcy, a letter of credit is issued and accepted by the beneficiary. Here, it may be suggested that neither the trustee nor the issuer can contest the validity of the credit. Sarna¹⁷¹ claims that “the ready response to their arguments must be that neither can oppose against the beneficiary any irregularity or defect in the application for issuance, whether or not it goes to its nullity”. So, the issuing bank

¹⁶⁸ [1972] A.C. 785, 810; [1972] 1 All E.R. 641, 653. For more on banks lien see Penn, Shea, Arora, *The Law and Practice of International Banking Law* pp. 347-349.

¹⁶⁹ *Halesowen Presswork v. Westminster Bank* [1971] 1 Q.B. 1.

¹⁷⁰ *Ibid* at 33.

¹⁷¹ Sarna, L., ‘Letters of Credit: Bankruptcy, Fraud and Identity of Parties’ 65-66 *The Canadian Bar Review* (1986-87) 303 at 311; See also Dolan, *The Law of Letters of Credit. Commercial and Standby Credits*. Revised edition. pp. 7-13 till 7-24.

has to pay the beneficiary upon strictly complying tender of documents, and the issuing bank has the right of being reimbursed by the trustee.

5.4.2. Prior to Issuance

Suppose that the applicant instructs his banker to issue a letter of credit to a beneficiary, but due to some delays the letter of credit is issued sometime later and the credit is advised to the beneficiary. Yet, before the credit is issued, the applicant becomes bankrupt. Now, suppose that before the documents being submitted to the bank, the trustee advances the issuer with a notice stating that any property or account of funds belongs to the applicant, which are supposed to cover the credit, now form part of the bankrupt estate. In such circumstances, from the issuer's standpoint, it has interests in endeavoring to stop the beneficiary from drawing on the credit. The reason for such an escape from payment is that the issuing bank does not want to be involved in disputes with an insolvent customer. Moreover, the trustee may also seek to prevent the beneficiary from receiving payment, as if it were a secured creditor. Sarna seems to adopt the view that,

“the bankruptcy of the applicant has no effect on the right of the beneficiary under the letter of credit... Even if, as a result of the retroactive setting of the effective date of bankruptcy the applicant was deemed to be bankrupt as of the date of the application contract, the issuer could not oppose a defect in that contract against the beneficiary...The letter of credit is a separate contract not involving the applicant after its issuance, except perhaps for the purpose of amendment”.¹⁷²

In such a situation the issuer, having issued the credit and paid thereunder, “has a claim against the estate which may be subject to a statutory preference”.¹⁷³

¹⁷² Sarna, L., *supra* note 171 at 312.

¹⁷³ *Ibid* at 311-12.

5.4.3. Following Issuance

If the beneficiary is paid, and neither the confirming bank nor the issuing bank are put into funds, but paid from their revenues, the paying bank will seek reimbursement out of the account of the bankrupt. If the issuing bank has acquired a charge over some property of the bankrupt, it then, takes reimbursement from its secured property. In such a situation the banker has to file a proof of claim as an ordinary creditor, or, if a secured creditor, may simply ignore the bankruptcy.¹⁷⁴

¹⁷⁴ Ibid at 313.

Section Two: Evaluation of “the Impact of Seller’s Fraud and Risk Allocation Between Innocent Bank and Innocent Buyer in Relation to Right to Reimbursement” and the Bifurcated Standard, in Light of the Basic Principles

1. Introduction

The two issues that this section deals with are related to causes of disputes between the banker and the applicant on the reimbursement contract. The first problem under examination is to what extent the law protects an innocent issuing bank and innocent buyer in case of fraud by the beneficiary. Secondly, there is the question of the application of the bifurcated compliance standard.

2. Risk Allocation Between Buyer and Bank in Case of Seller’s Fraud

There are three scenarios to be considered here. They are as follows:

(1) where the bank is aware of the seller’s fraud but acting in bad faith, honours the credit: it is obvious that the bank is not entitled to reimbursement from its customer in such a case, according to the basic rules of the law of obligations.

(2) where the bank is not aware of the seller’s fraud and honours the credit but could have avoided payment if it had exercised the standard of care of a reasonable banker. Although the issuing bank is not supposed to act as a detective of fraud, in such a case, the bank would be responsible to the extent that any reasonable banker would have in detecting a seller’s fraud. It seems that the position of the Common Law and the UCP regarding this issue, is not to protect the bank when paying out the credit without applying the standard of care that a reasonable banker would have practised. It seems that the bank is to bear the risk as it honours the credit in violation of Article 13(a) of the UCP, under which the bank’s

duty, in respect of all documents, is to examine them with *reasonable care*. Despite the fact that the UCP does not attempt to be involved in the issue where tender documents are forged or otherwise fraudulent¹⁷⁵, it may be inferred from this Article, that since the bank has not applied the required standard of reasonable care, then it follows that it is not entitled to reimbursement. Likewise, the Common Law position, in relation to seller's fraud, depends on whether the bank has exercised *reasonable diligence* before honouring the credit. Similarly, Section 5-109(1) of the UCC provides that the extent of the bank's obligation to its customer is based on their agreement.¹⁷⁶ However, under subsection (2), the bank's duty of verifying the tender documents, is limited to apparent regularity on the face of the documents. The bank's duty to examine the documents with care is the basic standard and it cannot be disclaimed by virtue of Section 1-102(3), but standards of performance can be determined by agreement.

(3) where the bank is not aware of the seller's fraud and has exercised the standard of care of a reasonable banker. In such a case, the bank is obviously entitled to reimbursement from its customer by virtue of section 13(a) of the UCP. Then, having applied the standard of care of a reasonable banker, if the documents appear on their face to be corresponding to the terms of the credit, the bank paying against them is entitled to reimbursement from its customer by virtue of Article 14(a) of the UCP. Likewise, under English Law, the buyer is to bear the risk as long as the bank has exercised the standard of a diligent and reasonable bank. This is supported by the English case of Gian Singh v. Banque de L' Indochine¹⁷⁷, where the House of Lords affirmed the Court of Appeal's decision to allow the

¹⁷⁵ Jack. R., *Documentary Credits* at § 9-4 p. 209.

¹⁷⁶ UCC Section 5-109, cmt.

¹⁷⁷ *Gian Singh v. Banque de L' Indochine* 1974 1 W.L.R. 1234, 1235.

bank to be reimbursed by its customer on the grounds that, although the documents the bank paid against included a forged certificate, the bank was entitled to reimbursement because it exercised reasonable care and diligence and such forgery would not have been detected. Similarly, under section 5-114(2)(b), if the issuer acts in good faith, he is given the privilege of honouring the draft as against its customer. This indicates that the bank is entitled to reimbursement against its customer. It is to be noted here that the bank's duty of good faith in this regard, unless otherwise agreed to, extends to include objective good faith imposed by Section 1-201(3), which requires the observance of any course of dealing or usage of trade made applicable by Section 1-205.

3. Position of Law in Relation to the Third Scenario

In relation to the third scenario, the question is: what position does the law take in case of seller's fraud where the bank acts reasonably?

This question concerns disputes between the bank and the buyer on the reimbursement contract. The question in Chapter Four, by contrast, concerns disputes between the bank and the beneficiary.

The Common Law, UCP and UCC, take the same position, namely that the buyer is to bear the risk. The law is then certain in relation to this issue. So far as the Common Law is concerned, the buyer and bank enter into their contract in the belief that, in case of fraud by the seller, the bank is entitled to reimbursement as long as it (i) did not know about the fraud (acting in good faith) and (ii) has exercised the reasonable care of a reasonable banker. Under Article 13(a) of the

UCP and Section 5-109(b) of the UCC, the customer is also to bear the risk as long as the risk is beyond the reasonable bank's capacity.¹⁷⁸

This, according to the distributive theory, may infer that there is some unfairness as the buyer is to bear the risk alone. However, this cannot be utilised as an argument at all since the beneficiary was selected by the customer and not by the bank. "Even though this assumption fails, however, as where the issuer selects the advising bank, the customer by entering into the underlying transaction has assumed the risks inherent in it".¹⁷⁹ Furthermore, the small charge for the issuance of the credit usually indicates that the issuer assumes minimum risks as against its customer. If the buyer is to insist on re-allocating the risk between him and the bank that would, obviously, add to the costs of issuing letters of credit. Banks who spend more time in processing, inspecting and reviewing the tender documents, must also spend more in financial terms for doing so, in which case such banks would need to charge higher fees.¹⁸⁰ Nonetheless, although a line of well established case law maintains that the buyer is to bear the risk, where the seller acts fraudulently against an innocent bank acting reasonably, there is no reason why parties to a contract should not agree to the contrary. At first glance, the rule may seem to be a fixed rule. Yet, as the relationship between the buyer and the bank is a contractual one, parties should be able to shift the risk. As discussed above, any agreement to shift such a risk would imply increasing the bank's fees and commission which would result in jeopardising one of the most important characters of a letter of credit (i.e. being cheap). Further, although both the UCP and the UCC rules make it clear that the buyer is to bear the risk, parties may

¹⁷⁸ UCC § 5-107(4) provides the same effect.

¹⁷⁹ UCC § 5-109(b), cmt.

¹⁸⁰ Kozolchik, B., 'Strict Compliance and the Reasonable Document Checker' 56 *Brooklyn Law Review* (1990) 45 at 49.

exclude any section which they view as harmful to their interests as such provisions are considered as default rules.¹⁸¹

Following this discussion, and having justified the unfairness resulting from seller's fraud on both innocent bank and buyer, where the bank honours the credit using the standard of care and diligence that a reasonable bank would use, it is important to note that the balance between certainty and fairness, in relation to this issue, appears to be rightly struck. This also appears to be the case where fraud is committed by an advising bank which is explained as follows. Although, under Article 18 (a) and (b) of the UCP, the customer seems to shoulder the risk of acquiring no remedies in cases of fraud committed by the advising bank, it is submitted¹⁸² that, such Article should not protect the issuing bank where it has been negligent. Indeed, Sassoon goes on further to say "where the advising bank disregards the interests of the applicant in circumstances where, but for the lack of privity, a right of recovery would have been conferred, the advising banker should be held liable to the applicant for damages in tort"¹⁸³. This is, indeed, fair. Fairness, as demonstrated by the distributive theory, is inferred from the fact that although there is no privity between them, the applicant can obtain a remedy.

¹⁸¹ As can be seen from most of Articles and Sections of both of the UCP and the UCC, they begin with "Unless otherwise agreed..."

¹⁸² Sassoon, *supra* note 22 at 35.

¹⁸³ Sassoon, *supra* note 22 at 35. Bradgate states that such a tortious duty of care that the advising/confirming bank owe the beneficiary has never been established. Bradgate, R., *Commercial Law* p. 681. For the position of tortious liability under English Law, see Ward, A., and Wight, R., 'Tortious Liability of an Advising Bank in the Letter of Credit Transaction' 4 *JIBL* (1995) 136. The same authors move on, at p 139, to say that "it could therefore be argued that to impose tortious liability on an advising bank would detract from the contractual nature of the documentary credit device and defeat the expectations arising from the parties own choice of that form". Nonetheless, they argue that since such a UCP Articles (16 and 18) preclude any contractual claims against the issuing bank for causing economic loss it is questionable whether such Articles infringe the 'reasonableness' requirement of section 3 of the Unfair Contract Terms Act 1977.

In sum, the law appears to be certain; and parties know where they stand. Moreover, the law is, arguably fair. Therefore, as the balance between these two conflicting considerations appears to be rightly struck, there will be no proposal for reform, regarding this particular issue, in the Concluding Chapter.

4. How Far Should the Buyer be Protected?

It is important to note that banks deal in documents and not in goods.¹⁸⁴ Thus, to answer the question, there are three considerations to be viewed:

(1) to what extent has the customer relied upon the bank's skill and knowledge, for example, whether the customer is professional or new in business (as discussed in the case of Woods v. Martins Bank¹⁸⁵ under section 2.2.2.). A newly practising customer is more likely to have more protection and attention from his banker than a professional customer.

(2) whether under section 5-113(1) of the UCC, a buyer is protected by virtue of the indemnity that the issuing bank may give to the buyer in return for inducing reimbursement. If such an indemnity is given by the bank to the buyer, it could be applied to both defects in the documents and the goods.

(3) what kind of instructions have been agreed upon. So far as the reimbursement contract is considered a normal contract, parties, by agreement, can stipulate the degree of protection that they seek.

Thus, in light of these three considerations, the answer to the question is that new customers who are less professional in business practise, customers who obtain an

¹⁸⁴ See UCP Article 4. See also § 5-109(c) of the UCC.

¹⁸⁵ *Woods v. Martins Bank*, [1959] 1 Q.B. 155.

indemnity from the issuing bank in return for inducing reimbursement and customers who stipulate complex terms to safeguard their interests, are more likely to be protected than customers who do not seem to be involved in any of these situations.

5. The Reasonable Banker Checker: An Opinion

Having said that the issuing bank is not expected to act as a detective of fraud then there should be a criterion upon which the bank has to decide whether to accept or reject the tender documents and here is where the reasonable care standard comes into play, explained as follows.

The issuing bank, in its course of verifying the tender documents, is not expected to go beyond the standard of care of a reasonable banker. Indeed, it is unfair to expect that from a bank. Kozolchyk defines the reasonable banker as one who “applies a requisite knowledge of the letter of credit trade in his careful verification of a beneficiary’s tender and who discharges his duties as a trusted intermediary between the customer and the beneficiary with fiduciary fairness or in good faith to either parties”.¹⁸⁶ Moreover, according to Article 13 of the UCP, the banker is not responsible for the sufficiency, accuracy, genuineness, falsification or legal effect of any document(s), as long as he has exercised a reasonable degree of care and skill during the examination. This is also the position at Common Law. To put it more clearly, the banker’s decision is expected to have been reached, in accordance with the standard of care of a reasonable banker. e.g., whether any bank acting with reasonable care and diligence would have concluded the same decision. Similarly,

¹⁸⁶ Kozolchyk, B., ‘Is Present Letter of Credit Law up to its Task?’ *Letters of Credit: Current Thinking in America*, at p. 258.

in First National Bank v. Carmouche¹⁸⁷ (mentioned above under section 2.4.2.), it was held that there was no obligation, on the part of the issuer, to conduct an investigation.

The reasonable banker standard is the version of strict compliance that offers the greatest potential uniformity or harmonization. A reasonable banker should be competent enough to help in preventing wrongful honour or dishonour liability. They should be fully trained and well supervised until they become highly qualified professionals with specialised knowledge of the function and significance of commercial letters of credit and standby documents, their processing and bookkeeping, their defects, correction and cure.¹⁸⁸

An archetype of commercial reasonable care enjoys strong statutory, decisional and doctrinal support in the world's major trading centres.¹⁸⁹ However, the standard of a reasonable banker should not go so far as requiring him to be a detective of fraud. As the Federal District Court for the Northern District of Illinois commented, “[the confirming bank] is not required to play detective; if it must act in a Holmesian manner at all, the nature of its duties draws more from Oliver Wendell than from Sherlock.”¹⁹⁰

This reasonable care banker standard is supported by some influential commentators. For example, a leading German commentator found that, the “reasonable care” standard of UCP article 13 is consistent with section 347 of the German Commercial Code’s “due diligence requirement of a prudent business

¹⁸⁷ *First National Bank v. Carmouche*, 515 So. 2d 785 (La. 1987).

¹⁸⁸ Kozolchyk, *supra* note 180 at 78.

¹⁸⁹ *Ibid* at 79.

¹⁹⁰ *Instituto Nacional de Comercializacion Agricola (INDECA) v Continental Illinois Nat'l Bank*, 675 F.Supp 1515, 1520 (ND Ill. 1987), quoted in Kozolchyk, B., *supra* note 180 at fn 109 p.80.

man" (*Sorgfalt eines ordentlichen Kaufmanns*).¹⁹¹ The same position holds for a review in 1984, on the judicial and doctrinal authorities in France, England, Germany, Italy and Spain.¹⁹²

6. The Bifurcated Standard

It is submitted that the standard of compliance may vary from one contractual relationship to another.¹⁹³ Having dealt with the doctrine of strict compliance in the letter of credit context in the previous chapter, the point under examination here is to establish which standard of compliance is to prevail in disputes between the issuing bank and its customer (the reimbursement contract)? Given that the buyer is obliged to reimburse the bank provided that the documents are in strict conformity with the requirements set out in the application form,¹⁹⁴ the question emerges: how strict is the doctrine of strict compliance in relation to buyer and banker arrangement? The position under both English and US law will be dealt with accordingly.

6.1. The Position the Laws Takes in Relation to the Bifurcated Compliance Standard

Under English Law, the standard of compliance in the reimbursement agreement is very clear. As has been obvious from the two English cases, Midland Bank Ltd. v.

¹⁹¹ See Zahn, J., *Zahlung Und Zahlungssicherung im Aussenhandel*, 6th ed., (1986), pp. 147-8; quoted in Kozolchik, B., *supra* note 180 at 80.

¹⁹² Fernandez-Aremesto, J., *Los Creditos Documentarios Irrevocables* 160, 161 (1984), quoted in Kozolchik, B., *supra* note 180 at 80.

¹⁹³ See Goode, R., *Commercial Law* p 993.

¹⁹⁴ See Ellinger, 'Letters of Credit' in *'The Transnational Law of International Commercial Transactions'* edited by Horn, N., and Schmitthoff, C.M., Vol 2 (Antwerp; Boston: Kluwer-Devanter The Netherlands, 1982) p. 241 at 257; See also Sarna, L., *Letters of Credit: The Law and Current Practice* pp. 3-7 till 3-21.

Seymour and Rayner (J.H.) & Co. Ltd. v. Hambro's Bank Ltd., (discussed under section 4.3.), the strict compliance test is not only to prevail in the letter of credit contract (contract between issuing bank and beneficiary) but also to prevail in the reimbursement contract (contract between the issuing bank and the applicant) too. So far as American law is concerned, it seems that US courts are divided over the applicable standard of compliance in the reimbursement agreement. On the one hand, some courts follow the strict compliance standard (as discussed under section 4.3.). On the other hand, there are some courts which prefer to apply the so called "bifurcated standard" (as shown under section 4.3.1.1.).

6.2. Evaluation of the Bifurcated Compliance Standard by Reference to the Basic Principles

6.2.1. Good Faith in Relation to the Bifurcated Compliance Standard

As shown in table 1, the strict compliance test, as it is the case in the issuing bank-beneficiary contract, overlooks good faith. It is to be noted here, as has been expressed in Chapter Three, that in the reimbursement agreement context, the concept of good faith in its subjective sense, applies only to the extent that the reimbursement contract is governed by the law governing letters of credit, i.e. where, for instance, the provisions of Article 5-201 of the UCC are involved. By contrast, regarding the part which is governed by other laws, the definition of good faith in such other law would apply. For instance, where the general principle of contract law is involved, the notion of good faith, in its objective sense can be applied. Indeed, according to the strict compliance standard, buyer's and banker's bad faith actions are even encouraged. Consider the following two examples: first, bad faith actions by the buyer. As the doctrine of strict compliance allows the buyer to raise any lawful objections against the documents, this may be for economic reasons, thus demonstrating the unfairness of the doctrine itself. Here,

by virtue of the strict compliance test, the buyer may exercise bad faith actions, in which case good faith is overlooked. Buyers, acting in bad faith, can insist upon the trivial discrepancies in the tender documents, as being non conforming to their application form and thus avoid reimbursing the issuing bank. The issuing bank has no legal cover to protect itself in such a situation. The second example is that in applying the strict compliance test to the reimbursement contract, this may lead to some bad faith actions on the part of the issuing bank. Some issuers rely on a hypertechnical examination in order to prevent the loss that they could potentially face as a result of the applicant's insolvency.

From the standpoint of good faith, having said that the bank is entitled, by virtue of the bifurcated standard, to reimbursement even though there are some trivial defaults as to his customer's instructions, this would tend to protect the bank against bad faith refusal by the buyer, to reimburse the bank. As has been discussed in Chapter Three, since the relationship between the bank and the applicant is governed partially by the law of letters of credit and partially by general contract law, then it follows that the concept of good faith may apply in both senses (subjective and objective), according to the governing law.

6.2.2. Flexibility in Relation to the Bifurcated Compliance Standard

As to flexibility, the strict compliance test has proven to be inflexible because some minor technical discrepancies will be caught. In this regard, the issuing bank is not in a position to employ its discretion, as to whether the tender document would suffice or not. Therefore, the law which adopts the strict compliance standard (in this regard English law) is not seen to be flexible i.e. rigid by not being adjustable.

As shown in table 1, if the bifurcated standard is to be adopted, this would infer that flexibility has been introduced into the law of letters of credit, regarding

disputes between the issuing bank and its customer. With the adoption of such a standard, courts would look to disputes between the banker and applicant, in a less rigid way. Trivial departures from the application form will therefore, not be caught.

6.2.3. Certainty in Relation to the Bifurcated Compliance Standard

Under English Law, because the strict compliance test predominates in the reimbursement agreement, this demonstrates certainty. Thus, buyers and issuing bankers would be certain as to what standard of compliance is to govern their contract. In other words, the buyer would know beforehand that should the bank depart from strictly adhering to the application form, he would then not be required to reimburse the issuing bank. Likewise, the issuing bank would know in advance that any departure from the buyer's instructions and thus honouring the credit against noncomplying documents, would result in it not being entitled to reimbursement from the applicant.

Since the adoption of the bifurcated standard remains a matter of debate, certainty has been undermined. Courts in the US are inconsistent in applying such a standard. Different courts apply different rules, thus leaving both buyers and issuing banks uncertain as to what standard of compliance governs their reimbursement contract. In other words, buyers who had entered into a contractual relationships with their issuing banks, instructing them to honour the credit *only* if the tender documents complied strictly to their instructions in the application form, would be considered as uncertain if no fixed standard was to govern their relationship and if an express contractual agreement did not fix the standard.

6.2.4. Fairness in Relation to the Bifurcated Compliance Standard

With regards to the distributive theory, the strict compliance test is, indeed, unfair. This is because, although the bank has paid against documents with trivial discrepancies which do not harm the applicant's interests, it would lose the right of reimbursement and thus shoulder the risk alone. The only chance the bank is left with, in such a situation, is to dispose of the goods.

From the standpoint of fairness, one of the main reasons for adopting the bifurcated standard, in relation to the reimbursement contract is as follows; suppose the bank fails to operate the credit in accordance with the buyer's instructions, if the strict compliance standard is to prevail, the buyer can refuse to reimburse the bank even though the breach is trivial. So, if any breach by the bank allows the buyer to avoid reimbursement, then this is, according to the distributive theory, arguably unfair to the bank as it invites bad faith non-reimbursement by the buyer where the breach is trivial. On the other hand, if the bifurcated standard is to prevail in the same scenario, the bank can acquire reimbursement minus the loss incurred by the buyer (as a result of his breach). This is arguably fairer and is also more in line with the distributive theory. In support of the bifurcated standard, Dolan states that the bank, who pays against imperfect documents, must lose their right of reimbursement only to the extent of loss, to the customer caused by its fault. This supposition is based on the considerations of commercial efficiency, as well as the reasonable expectations of both the parties using the credit, and the financial institutions that issue them.¹⁹⁵

¹⁹⁵ Dolan, *supra* note 131 at 402.

6.2.5. Party Autonomy in Relation to the Bifurcated Compliance Standard

Having said that the prevailing standard of compliance, as between the bank and its customer, is the strict standard, it is noteworthy here to emphasise that should the parties to the reimbursement agreement agree to the contrary, then the strict compliance standard would not apply. The strict compliance standard has been applied only because parties insist on it.

From the standpoint of party autonomy, so far as the reimbursement agreement is concerned, it is a normal contract entered into by the will of both parties. Thus, parties are free to agree on which standard of compliance is to govern their contract. Suppose that the buyer and the bank expressly stipulated that a strict non-bifurcated standard is to govern their reimbursement contract. Now, if the bifurcated standard is applied by courts despite such stipulation, the objection here would not be that the bifurcated standard created uncertainty, but that it interfered with the autonomy of the contracting parties.

6.3. Arguments in Favour of the Bifurcated Standard

There are certain reasons for applying such a standard described as follows:

(i) by applying the bifurcated standard, bad faith buyers cannot shift the risk of a bad bargain to the paying bank, as it may be the case under the strict compliance standard, where bad faith buyers can reject the tender documents on trivial discrepancies to escape the consequences of a bad bargain.

(ii) as Dolan¹⁹⁶ emphasised, it is to be noted at the outset that the bifurcated standard has not been introduced as an alternative standard to defeat the strict

¹⁹⁶ Ibid at 381.

compliance standard. In other words, the strict compliance standard still applies in the bank/beneficiary relationship. Conversely, the bifurcated standard emerged from the especial legal nature of the reimbursement agreement. That is to say, the duties owed, by the issuing bank to its customer, are governed by a source of law other than the law of letters of credit. Hence, if the issuing bank negligently departs from certain terms of the credit when paying the beneficiary, the customer, according to their reimbursement agreement, is entitled not to reimburse the bank, (unless of course it has otherwise agreed to authorise the issuing bank's payment regardless of accepting faulty documents).¹⁹⁷ Yet, depending on the nature of each case individually, the issuing bank may be able to acquire reimbursement or limit its liability even though it has not followed the customer's instructions strictly.

(iii) the argument favouring adoption of the bifurcated standard is based on the exception advanced by Dolan¹⁹⁸ which supports the view that "the issuer's right of reimbursement turns not on the standard of documentary compliance it exacts from the beneficiary but on its honesty and on the damage, if any, its payment causes the customer"¹⁹⁹.

6.4. Arguments Against the Bifurcated Standard

Three further arguments against the bifurcated standard should be noted.

(i) Kozolchyk claims that one of the problems of the bifurcated standard and its remedy of damages, is presumptual. If the beneficiary, that was refused payment on the ground of strict compliance, can demonstrate that the non-paying bank can still obtain reimbursement from the buyer by resorting to a lesser standard, why

¹⁹⁷ Kozolchyk, *supra* note 180 at pp. 70-71; Dolan, *supra* note 131 at 381.

¹⁹⁸ Kozolchyk, *supra* note 180 at pp. 70-71.

¹⁹⁹ Dolan, *supra* note 131 at 395.

should not such a beneficiary be allowed to seek the remedy that the non-paying bank can secure from its customer on the same tender?²⁰⁰

(ii) Kozolchik argues that the supposition of the buyer's bad faith should not be relied upon as a loophole to avoid strict compliance. He asks, why it should be assumed at all, that an applicant who refuses the faulty documents, acting in good faith, be understood to be trying to shift the risk of a bad bargain to the bank?²⁰¹

(iii) Since the issuing bank is entitled to have a right of applying strict compliance in relation to tender documents, why should such a right be denied to the customer in its refusal to reimburse the issuing bank?²⁰²

²⁰⁰ Kozolchik, *supra* note 180 at 54.

²⁰¹ *Ibid* at 71.

²⁰² *Ibid* at 54.

Table 1: Comparison between the “strict compliance” standard and the “bifurcated standard” in relation to the reimbursement agreement in light of the basic principles

Features	Strict Compliance Standard	Bifurcated Compliance Standard
Party autonomy	Parties are free to agree that the strict compliance standard is to govern their reimbursement agreement.	Parties are also free to choose if the bifurcated compliance standard is to govern their contract. [default rules]
Fairness	In accordance with the distributive theory, this test is arguably unfair. This is because the issuing bank would lose its right of reimbursement against its customer even though the deviation from his mandate is so trivial and does not affect his financial interests at all. The only chance the bank is left with in such a situation is to dispose of the goods.	In accordance with the distributive theory, this is arguably fairer. The bank can get reimbursement minus the loss incurred by the buyer (as a result of his breach). The bank who pays against imperfect documents must lose their right of reimbursement only to the extent of loss to the customer caused by its fault. This supposition is based on the considerations of commercial efficiency, as well as the reasonable expectations of both the parties using the credit, and the financial institutions that issue them.
Certainty	Certain if it is to be applied consistently. Thus, buyers and issuing bankers would be certain as to what standard of compliance is to govern their contract. In other words, the buyer would know beforehand that if the bank departs from strictly adhering to the application form, he will be entitled not to reimburse the issuing bank. Likewise, the issuing bank would know in advance that in the event of any departure from the buyer's instructions and thus honouring the credit against noncomplying documents, it would not be	Certain if it is to be applied consistently. Both bank and buyer would know where they stand. Banks know that they can get reimbursement to the extent of damages caused by their deviation from the applicant's mandate, provided that they act in good faith. Buyer would know that he is entitled to reimburse the bank only up to the extent of the damages caused by the bank. Uncertainty occurs where courts are inconsistent in applying such a standard.

	entitled to reimbursement from the applicant.	
Flexibility	The law, by adopting only the strict compliance test, appears to be inflexible. This is because there is only one option.	The law, by adopting more than one option, in relation to the question of compliance, seems to be flexible. This is because there is more than one option of legal doctrine..
Good faith	Overlooks the principle of good faith. The strict compliance test, as it is the case in the issuing bank-beneficiary contract overlooks the principle of good faith. Indeed, buyer's and banker's bad faith actions are even encouraged. Good faith here is used in its objective sense. [Bad faith acts contrary to fair dealing].	From the standpoint of good faith, having said that the bank is entitled, by virtue of the bifurcated standard, to reimbursement even though there are some trivial defaults as to his customer's instructions, this would tend to protect the bank against bad faith refusal by the buyer, to reimburse it (i.e. the bank).

Conclusion

In this Chapter, we have focused on disputes between the bank and the applicant as related to the reimbursement contract. As previously mentioned, such disputes appear to evolve from the following situations, (i) where there is uncertainty as to whether the bank is obliged to pay the credit, regardless of fraud on the part of the seller and (ii) whether the bank has the right to reimbursement if it pays out the credit in non-compliance to the applicant's mandate. On the one hand, it is evident, under the Common Law, the UCP and the UCC, that the issuing bank has some duties and responsibilities towards its applicant. On the other hand, the applicant also has some rights and duties towards the issuing bank. Both parties to the contract should abide by their duties and responsibilities and their rights should be judged accordingly.

As far as the first point is concerned, the question of credit independency is not absolute. The bank is entitled not to honour the credit if the beneficiary has acted fraudulently. Yet, the applicant's right to be granted an injunction, which acts to stop the bank from paying the credit in cases of fraud, is not without limitations, as demonstrated in case law. It is clear that the tension between certainty and fairness is the dominant issue in the topics under discussion. The feature of certainty stems from adopting the independency principle, in which the bank should pay, regardless of any disputes between the beneficiary and the applicant over the underlying contract. Furthermore, the law is certain on the question of bank's right to reimbursement in relation to fraud by the seller. In such cases, the buyer and the bank enter into the contractual relationship, based on the assumption that, should a case of fraud take place by the seller, the bank is entitled to reimbursement, so long as it had acted in good faith and exercised the reasonable care of a reasonable banker. Nonetheless, this trend of certainty could be said to go against the

principle of fairness, to the extent that the buyer is to bear the risk alone. This may seem to pull against the distributive theory of fairness which has been adopted. Nonetheless, since the UCC and the UCP are default rules²⁰³, parties can exclude any article which they view as being harmful to their interests. Moreover, the innocent parties, the issuing bank and the buyer, have the right to agree on certain precautions in order to minimise the effect of the seller's fraud. This is achieved by stating, within their contract for the standard of care, precisely what is expected from a reasonable banker. In addition to this, they could also agree on any other measures which they believe would enhance protection of their interests.

With regard to the question of the bank's compliance to the applicant's application form, it is evident that the bank would lose its right to reimbursement in cases of non-compliance. This is the case under both English law and in most of US courts. However, some American courts have applied the bifurcated compliance standard as between the bank and the applicant. This standard of compliance resembles the 'substantial' compliance test, which was examined earlier in Chapter Five. In comparing the strict compliance test with the bifurcated compliance test, in relation to reimbursement agreements, it can be stated that in allowing the parties to adopt the bifurcated standard, it provides them with autonomy and flexibility in the law. However in doing so, it may damage certainty if there is no clear test of compliance as between the banker and the applicant. Indeed, according to the distributive theory, this test enhances fairness by making the bank entitled to reimbursement only where any discrepancies within the documents did not result in the buyer incurring any losses and that the bank had been seen to have acted in

²⁰³ As can be seen from most of Articles and Sections of both of the UCP and the UCC, they begin with "Unless otherwise agreed...".

good faith. Consequently, the principle of good faith would be promoted as a result.

Having already discussed the bank's right to reimbursement in both cases of fraud by the seller and in the case where the bank pays out the credit against its mandate, the issuing bank's right of reimbursement, in cases of applicant's bankruptcy, is also safeguarded by virtue of taking securities against the documents of title. Indeed, such a bank is entirely entitled to reimbursement from its applicant's estate.