

## Documentary credit operations – the complex of contracts

A commercial letter of credit is a contractual agreement between a bank, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payee.

Documentary credits are known and used around the world as an instrument to secure proper payment of cross-border transactions<sup>1</sup>.

In a typical international commercial transaction in which an irrevocable documentary credit is used as the payment method give rise to a number of separate contracts and undertakings as shown in Figure 1., and explained below the contractual relationship involved.

Contract number **1** creates the business relationship between the exporter and importer, and specifies the payment subject to documentary credit. It is a contract of sale between the buyer (the applicant of credit) and the seller (the beneficiary) pursuant to which one party (the applicant) is obligated to obtain the credit for the benefit of the other (the beneficiary).

Contract number **2** creates a business relationship between the importer (applicant) and the issuing bank (importer's bank). The applicant is seeking his bank (issuing bank) to establish a conditional guarantee of payment in favour of the beneficiary (exporter), via the documentary credit instrument. Under these conditions, the bank is undertaking the credit risk of the applicant by providing an undertaking to pay the beneficiary, subject to certain conditions specified in the credit (these are discussed at contract number 3). As the issuing bank is assuming the credit risk of the applicant, a commercial risk assessment on the applicant will be performed and if the bank agrees, the application will be accepted and the documentary credit issued. It should be noted that it is common practice for banks to avail themselves of security from the applicant prior to issuing the credit. Depending on the results of the commercial risk assessment, the applicant may need to provide 100% security to the issuing bank, or a lesser amount, as the case may be. The form by which the security is provided is a matter decided between the bank and the applicant, and is not limited to such amount only.

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<sup>1</sup> „Documentary credit law throughout the world”, by A. Schütze and G. Fontane, ICC Publication No.633, ICC Paris 2001, p.9

Contract number **3** and undertaking number **3'** gives rise to the payment undertaking contract between the issuing bank and the beneficiary via intermediary (advising) exporter's bank. The issuing bank guarantees payment to the exporter if all documents are presented in exact conformity with the terms of the documentary letter of credit<sup>2</sup>.

As banks are neither a party to the contract nor do they deal in the trading of goods, the requirements of the credit are documentary. That is, the issuing bank will pay the beneficiary as long as the specified documents, with particular data contents, are provided by the beneficiary within the stipulated time frames of the documentary credit (D/C). As the documentary credits are typically challenged through the banking system, and not sent direct from the issuing bank to the beneficiary - a practice developed to reduce possible fraudulent activities - the issuing bank enters into another contract.

It should be noted that the role of the advising bank is to act, as instructed, on behalf of the issuing bank (contract number 3). The actions taken by the advising bank are, at minimum, to advise the credit to the beneficiary; and to accept and check the documents tendered to it by the beneficiary (undertaking towards the beneficiary to notify the credit without own liability to payment on basis D/C - see undertaking number 3'). However the role of the advising bank may also include, by agreement, a number of additional roles, such as: paying bank - paying the beneficiary and claiming reimbursement from the issuing bank; or confirming bank - underwriting the issuing bank's payment guarantee by substituting it with its own guarantee of payment (see contract number 4).

Because the advising bank performs functions designed to link it with the beneficiary, the last contract is formed.

Contract number **3** established a relationship between the advising bank and the beneficiary. The advice of a documentary credit only happens when the advising bank is satisfied as to the genuineness of the D/C. A number of security and verification check are conducted by the advising bank prior to release of the credit to the beneficiary. This is simply a matter of practice developed to counteract fraudulent activities. There is nothing preventing an issuing bank and a beneficiary from dealing directly with each other thereby by-passing the involvement of an advising bank. The problem with this approach, however, is that the beneficiary cannot check the validity of the letter of credit, simply because the beneficiary does not have access to the banks security systems. Therefore, a beneficiary acting in good faith against a credit received directly from a bank in a foreign country may unwittingly become the victim of fraud. Thus, from a risk management perspective, a

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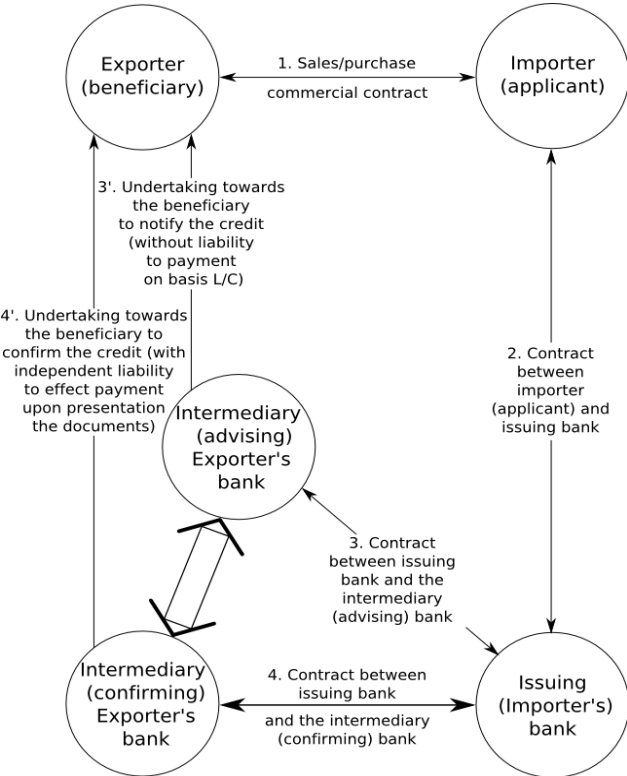
<sup>2</sup> C. Nelson, "Import/Export: How to get started in international trade", McGraw-Hill, New York (3<sup>rd</sup> ed.), 2000, p. 91

documentary credit received directly should be treated with caution and suspicion, at least until due diligence checks have been conducted and the genuineness of the credit verified.

Contract number 4 establishes a service and agency contract between the issuing bank and intermediary (confirming) bank in the exporter’s country (other than advising). In practice the confirming bank is usually the exporter’s advising bank.

Confirmation of the letter of credit is a contract number 4 between the issuing bank and the bank which has confirmed the credit, constituting the confirming bank mandate as to only confirmation of the documentary credit, collection of documents and payment or acceptance or negotiation on own risk (without the payment or acceptance or negotiation on own risk (without the recourse to beneficiary).

The undertaking number 4’ is a undertaking towards the beneficiary to confirm the credit with own, independent liability to effect payment upon presentation the documents, or accept or negotiate exporter’s draft(s) provided that the seller has presented the stipulated documents in accordance with the terms of the credit<sup>3</sup>.



Intermediary bank is instructed to act as nominated bank

<sup>3</sup> R. King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits" (8<sup>th</sup> edition), Routledge, Taylor & Francis Group, New York, 2001, pp. 98-99

**Figure 1.: Typical contracts arising from a usual documentary credit transaction (advising bank may be the same as confirming bank),**

The contracts and undertakings discussed above provide a contextual background for an explanation the following question relation relating to letter of credit important problem:

**Can an issuing bank be a nominated bank?**

If we try to analyze this core question in the context UCP (Uniform Customs and Practice for Documentary Credits) history and also from “availability” (of credit) point of view, we can conclude that **Article 2** definition of nominated bank under UCP 600 (2007) should read as follows:

“Nominated bank means the **bank** (other than issuing bank) with which the credit is available or **any bank** (other than issuing bank) in the case of a credit available with any bank”<sup>4</sup>.

The concept of changing nominated bank’s name on the basis of availability of credit has still been going to either in an explicit or oblique manner. This new definition acknowledges, by the use of the term “available with any bank”, the fact that a documentary credit can be made available by payment, acceptance, deferred payment or negotiation with any bank.

The UCP 600 Drafting Group of ICC Banking Commission saw no reason why, with the correct structure with respect to the conditions for reimbursement, a credit available by payment, acceptance or deferred payment could not be made available **with any bank**, provided a reimbursing bank was authorized to honour a claim from any bank<sup>5</sup>.

With reference to above mentioned Article 2 UCP 600, it was revealed that the name of the nominated bank keep changing with the availability of the credit, i.e. paying bank, accepting bank, negotiating bank, etc.

It should be noted that the term “nominated” was first introduced in UCP 290 (1974) and the concept of **nomination** seriously developed in UCP 400 (1983). The word “nominated bank” was used more extensively in UCP 500 (1993) than of its predecessor (sub-article 10 b i).

A nomination (Article 12 of UCP 600) entitles the person nominated to act under the credit and embodies an undertaking by the issuer and any confirmer to reimburse the nominated bank. The nomination empowers the nominated bank to act within the scope of the nomination and to

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<sup>4</sup> „ICC Uniform Customs and Practice for Documentary Credits – 2007 Revision”, ICC Publication No. 600 E, International Chamber of Commerce (ICC), Paris 2007, Article 2 (Definitions – Nominated bank).

<sup>5</sup> “Commentary on UCP 600 – Article – by – Article Analysis by the UCP 600 Drafting Group”, ICC Publication No 680, International Chamber of Commerce (ICC), Paris 2007, p. 23.

undertake any act not inconsistent with it.

In accordance with the view of Professor James E. Byrne, it is arguable that a **nomination** can effect to whom presentation may be made, the status of the bank: with respect to amendments, to revocable credits and in the event of claims of fraud on the part of the beneficiary or forged or fraudulent documents, or the ability of the bank to effect the transfer of drawing rights, and the entitlement to reimbursement. Nomination of a bank under an irrevocable credit gives an irrevocable right to a beneficiary to present documents to that bank for purposes of satisfying the condition that documents be timely presented prior to the expiration of the letter of credit whether or not it takes up its nomination. A nominated bank is not obligated to act by virtue of being nominated and may elect not to do so. With the exception of a confirming bank, a nominated bank does not make any engagement by advising the credit or by receiving a presentation, examining the credit, or forwarding it to the confirmer or issuer unless it expressly so indicates<sup>6</sup> ( see Article 12, UCP 600 ).

The undertaking of the issuer in the documentary credit, however, is primary and must be honored without any claim, counter claim, set off or defence that the issuer or the applicant may have against the beneficiary. This “independence” of the letter of credit from the transaction between the applicant and the beneficiary is its special feature<sup>7</sup>.

Central to the letter of credit system is the concept of **independence**: the bank’s obligation on the documentary credit is completely separate from any of the contractual obligations of the underlying transaction, either the obligation of the buyer to pay the seller under ordinary principles that govern sales transactions, or any obligation that the buyer might have under an agreement or common-law principles to reimburse the bank for payments made on its behalf under the letter of credit<sup>8</sup>.

The bank’s obligation depends entirely on the beneficiary’s presentation of the documents that conform to the requirements of the documentary credit<sup>9</sup>. Indeed, the rules governing letters of credit so thoroughly separate the bank’s obligation to pay from ordinary context-laden principles of contract law, that it is best thought of, as an “abstract payment undertaking” – an enforceable undertaking to make payment wholly abstracted from the underlying transaction.

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<sup>6</sup> J. E. Byrne, „Negotiation in Letter of Credit Practice and Law: The Evolution of the Doctrine”, Texas International Law Journal, 2007, Vol. 42 (No. 3), pp. 567 – 568.

<sup>7</sup> R. Bergami, “Will the UCP Provide Solutions to Letter of Credit Transactions”, International Review of Business Research Papers, Vol. 3, No. 2, June 2007, p. 45.

<sup>8</sup> R. J. Mann “The Role of Letters of Credit in Payment Transactions”, in: 2001 Annual Survey of Letter of Credit Law & Practice, Institute of International Banking Law & Practice Inc., Montgomery Village, MD, USA, 2001, pp. 120-121;

<sup>9</sup> N. Enonchong, “The Independence Principle of Letters of Credit and Demand Guarantees”, Oxford University Press, Oxford 2011 (see Chapter 4-the nature, rationale and scope of the independence principle).

The bank on the exporter or seller's side plays a different role. The seller hopes to receive the funds offered by the documentary credit as a payment for the anticipated shipment, and is thus identified as the "beneficiary" of the documentary credit. Because the beneficiary and applicant ordinarily are in different countries, the beneficiary often has its own bank to help process the letter of credit when it is issued by the applicant's bank overseas and then forwards the documents that seek payment for the issuer when the seller ships the goods. The beneficiary bank ordinarily assumes one of two roles. If it only "advises" the beneficiary of the issuance of the documentary credit, it just processes the documents and has no direct liability on the letter of credit. Alternatively, it might "confirm" the documentary credit, in which case the beneficiary's bank directly obligates itself on the letter of credit, pays the beneficiary directly, and then forwards the documents to the issuer for reimbursement<sup>10</sup>.

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<sup>10</sup> See: G. Collyer, "Uniform Rules for Bank-to-Bank Reimbursement", ICC Publication No. 725 (effective date October 1, 2008), International Trade Newsletter, Issue 20, 2008.