

## **TO EXAMINE THE CONTRACTS ARISING UNDER THE COMMERCIAL CREDIT TRANSACTION (LETTER OF CREDIT)**

Commercial credits are most commonly used in the international transactions areas. Its main feature is that; it gives security both the exporter (seller) and the importer (buyer). The Seller knows that, he will get paid if he completes his duty properly. The buyer, on the other hand, can ensure to part his money before the goods are received. According to Professor RM Goode, describes it as “the most successful harmonising measure in the history of international commerce.”<sup>1</sup>

A letter of credit can be explained, as an undertaking by a bank to make payment to the beneficiary within specified time, against the presentation of the documents, which is described in the underlying contract.

The most significant feature of the letter of credit is that all parties in the commercial credit transaction deal with documents and not goods.

A commercial credit transaction involves a number of stages. First one is the underlying contract for the sale of goods act between the buyer and the seller. Second is that, the contract between buyer and issuing bank. Third stage is the contract between the issuing bank and the intermediary bank. Next stage is the contract between the issuing bank and the seller. The last one is that, if the credit has been confirmed, the contract between the confirming bank and the seller.

The underlying contract must determine of the credit requirements in details such as the type of the credit, whether it is revocable or irrevocable, confirmed or unconfirmed.

In addition, according to the principle of the autonomous, those contracts, which have been made under the commercial credit transaction, are independent from underlying contract and also separate transaction of each other. This means, if any dispute existed

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<sup>1</sup>RM Goode, Commercial Law, 2004, Butterworth.

between the seller and the buyer, it would not direct effect to the commercial credit transaction.

### ***1- The Contract Between the Buyer and the Issuing Bank***

Second stage of the commercial transaction is that the contract between the issuing bank and the applicant.

According to the contract of sale, the applicant has to request his own bank (the issuing bank) to open a letter of credit in favour of the beneficiary. The issuing bank must follow the instructions given by the applicant. Those instructions must be clear, precise, and unambiguous. When he does not give clear instructions, the issuing bank has to refer back to the applicant for further instructions and clarification. The banks duty is to comply with the applicant's instruction strictly.

Furthermore, the issuing bank must also follow the instruction; when he is in the acceptance or rejection of the documents. So he has to check the documents which tendered by the beneficiary for payment, with reasonable care to ascertain that it comply with the terms and conditions of the credit. According to the UCP article 13(b) "the examination must be conducted within a reasonable time not to exceeding seven banking days following the receipt of the documents." So the issuing bank fails to follow the instructions with reasonable care, he is in a position of breach of the contract with the applicant.

On the other hand, the applicant's main duty is to reimburse to the issuing bank the amount which the bank has already paid to the beneficiary under the letter of credit. However, the right to reimbursement is not accurate. The bank's duty is only not to open the credit and also operate and complete it. If the bank failed to comply with it, he would be lost the right to reimbursement.<sup>2</sup>

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<sup>2</sup> Equitable Trust Co. of Newyork v Dawson Parteners Ltd. (1927)27 L1 LR 49

Moreover, the issuing bank can benefit from exempting clauses, which exempt the issuing bank from liability for matters arising to his out of control. Such as by act of god, wars, riots or any other causes.

In addition, the issuing bank's duty is not to check the condition of the goods. He has to deal with documents. Important thing is to constitute a good tender of documents. If the documents are faulty, the bank cannot claim to reimbursement.

## ***2- The Contract between the Issuing Bank and the Correspondent Bank***

The other stage of the letter of credit is the contract between the issuing bank and the correspondent bank. The issuing bank instructs the corresponding bank where is employed from the beneficiary' country. The corresponding bank role has been given by the issuing bank and has to follow his instruction under the letter of credit. As I mentioned before, when the correspondent bank has received unclear instruction, he has to give primary notification to the beneficiary for information only and without responsibility. After that the correspondent bank must request to necessary information from the issuing bank. The credit will be acted only when clear instruction have been received.

According to the role of the correspondent bank given by the issuing bank, he has to work as an advising or confirming bank. If the issuing bank instructs the correspondent bank to confirm the credit, the correspondent bank is then known as the confirming bank. The confirming bank has to add his undertaking to honour the credit. On the other hand, when the correspondent bank has not added his undertaking to honour the credit, he is known as the advising bank. His role is only to accept the tendered documents and to make payment against to these documents.

The differences between the advising bank and the confirming bank is that, the former works as an agent of the issuing bank, but the latter assumes the role of the principle. In addition to this that there are three different situation for the confirming bank;

First one is that, when the confirming bank makes a payment to the beneficiary against to the confirming documents, he has a right to be reimbursement. However, the issuing bank fails to reimburse to the confirming bank, the former could be liable to the latter in damages between the amounts paid to the beneficiary and the amounts recovered on the sale of the goods act.

Second one is that, according to the Mance J “if the confirming bank pays on a late presentation of documents where time had not been properly extended under article 44(a) UCP 500 or by agreement, the issuing bank could clearly recover any money paid to the confirming bank as money paid under a mistake of fact.”<sup>3</sup>

The last one is that, when the confirming bank has accepted a nonconforming documents as a result of mistake, they can take an action against the beneficiary.

### ***3- The Contract Issuing Bank and Seller***

According to the underlying contract, the applicant has to inform the issuing bank to open a letter of credit. After that, the issuing banks’ duty is to notice the beneficiary that the credit has been opened. Having received to notice, the beneficiary can obtain a payment when he tendered the documents in which must comply with the terms and conditions of the letter of credit.

The credit can be either revocable or irrevocable credits. It should be stated in the contract whether revocable or irrevocable. If there was no indication a type of the credit, it presumed to be irrevocable credit.

In the case of revocable credit, the issuing bank can cancel the credit at any time and without given notice the beneficiary. On the other hand, an irrevocable credit has not been cancelled without given prior notice the beneficiary. Moreover, opening an irrevocable credit makes the contract independent between the issuing bank and the

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<sup>3</sup> Bayerche Aktienge Sellschaft v National Bank of Pakistan (1997) 1 Lloyd’s Rep. 59.

beneficiary. According to Rowlatt J.”An irrevocable credit is not qualified by or subject to the terms of the contract of sale made between the buyer and the seller.<sup>4</sup>

As regards to the principle of the autonomy, those contracts are separate from each other. In the any event of a dispute between the seller and the buyer will not effect to the contracts which have been made under the commercial transaction. The only exception to this rule occurs in the case of fraud. When the credit is procured by the beneficiary, the bank has a right to refuse payment. However, the fraud must be properly proved and not to be merely alleged.<sup>5</sup> According to Sir John Donaldson MR said “but the evidence must be clear, both as to the fact of fraud and as to the banks knowledge...”<sup>6</sup>

On the other hand, the fraud did not properly proved or it was not committed by the beneficiary, the issuing bank has to pay against confirming documents, because, in this case, the beneficiary was deemed to be innocent.<sup>7</sup>

Furthermore, if the issuing bank refuses the documents as a result of the non-conformity with instructions, the issuing bank must give notice the beneficiary without delay and no later than seventh banking days. However, the issuing banks’ decision was made wrongly about refusing the documents; the beneficiary could bring action against the bank for the value of the credit together with interest. When the beneficiary has been received payment which is an indefensible delay, the bank is responsible for the loss or damage is happened to the beneficiary as a result of the delay payment.

In addition, when the issuing bank accepts a faulty tender of documents, it will be rejected by the applicant. On this basis, according to the common law, the issuing bank has a right of recourse against the beneficiary. Alternatively, it can be argued that, under the UCP 500, article 14(e), the issuing bank does not have a right to recourse against the

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<sup>4</sup> Urguhart , Lindsay & co. v Eastern Bank Ltd. (1922) 1. KB 318.

<sup>5</sup> Discount Recards Ltd. V Barclays Bank Ltd. [1975] 1 ALL ER , 071.

<sup>6</sup> Bolivinter Oil SA v Manhattan Bank [1984] 1 Lloyd’s Rep. 255.

<sup>7</sup> United City Merchant v Royal Bank of Canada [1983] 1AC 168.

beneficiary, because the issuing bank has been accepted a tender of documents, the beneficiary's right to the amount of credit in respect of the documentary credits.

#### ***4- The Contract between the Confirming Bank and the Seller***

Relationship between the correspondent bank and the beneficiary depends on the role of the former, which has been given to him by the issuing bank.

As I mentioned before, when the correspondent bank is performed as a confirming bank, his duty is similar the position of the issuing bank. He promises to make a payment to the beneficiary. According to Jenkins LJ, "the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there maybe between the parties as to whether the goods are up to contract or not..."<sup>8</sup>In this situation, the beneficiary can by no means look at the bank for payment and he can in no circumstances look to the applicant.

On the other hand, the advising bank cannot be a party of the contractual relationship, because he does not confirm the credit.

In addition, the confirming bank can accept the documents under the reserve. The documents could be tendered by faulty. On this basis, the problem only arises between the beneficiary and the confirming bank, because such a contract between the confirming bank and the beneficiary is independent. So the beneficiary would be bound to repay the amount on demand, if the faulty documents were rejected by the issuing bank or the applicant.

In conclusion, letters of credit are still important instruments in the field of international trade. They provide security for both the buyer, which he can ensure to get the goods and for the seller, which he can ensure to get payment when he sends the goods. The

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<sup>8</sup> Hamzeh Malas and Sons v British Imex Industries Ltd. [1958] 2. QB 127.

instrument of letters of credit also makes the international transactions to work smoothly. It gives the mechanism stability; especially from the buyer's and the seller's perspective. For instance, there is little or no previous trading relationship among the parties; the letters of credit provide them to work with confidence and security.

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