

Letter Of Credit – A Cash In Hand and Lifeblood of International Trade? Golam Sarwar (19)

The international trade between an exporter and an importer has been developed to present state over the years and methods of payment between the parties (seller and buyer) has become a significant issue in the world of import-export trade. There are many methods of payment prevailing, out of them 'letter of credit' has become the most popular method of payment, originated in concrete form in 1932 in commercial practice;¹ it has wide-spread international acceptability now in the trade world; because it is a safe method of obtaining payment.



A letter of credit (L/C) is a banking mechanism which allows importers to offer secure terms to exporters while transacting a 'export-import contract' between them.

The issuing bank's role is two-fold²:

* to guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due. This offers security to the seller - the bank says in effect "We will pay you if you present documents (XYZ)".

* to examine the documents, and only pay if these comply with the terms and conditions set out in the letter of credit. This protects the buyer's interests - the bank says "We will only pay your supplier on your behalf if they present documents (XYZ) that you have asked for"

The stages of the letter of credit are³:

1. Buyer and seller agree terms, including means of transport, period of credit offered (if any), latest date of shipment, Incoterm to be used.
2. Buyer applies to bank for issue of letter of credit. Bank will evaluate buyer's credit standing, and may require cash cover and/or reduction of other lending limits.
3. Issuing bank issues L/C, sending it to the Advising bank by airmail or (more commonly) electronic means such as telex or SWIFT
4. Advising bank establishes authenticity of the letter of credit using signature books or test codes, then informs seller (beneficiary). Advising bank MAY confirm L/C, i.e. add its own payment undertaking
5. Seller should now check that L/C matches commercial agreement, and that all its terms and conditions can be satisfied, If there is anything that may cause a problem, an AMENDMENT must be requested.
6. Seller ships the goods, then assembles the documents called for the L/C (invoice, transport document etc.) Before presenting the documents to the bank, the seller should check them for discrepancies with the L/C, and correct the documents where necessary.

7. The documents are presented to a bank, often the Advising bank. The Advising bank checks the documents against the L/C. If the documents are compliant, the bank pays the seller and forwards the documents to the Issuing bank.

8. The Issuing bank now checks the documents itself. If they are in order (and it is a sight L/C), it reimburses the seller's bank immediately.

9. The Issuing bank debits the buyer and releases the documents (including transport document), so that the buyer can claim the goods from the carrier.

The International Chamber and Commerce has developed certain rules concerning letters of credit and are known as UCP (Uniform Customs and Practice for Documentary Credits) 500 revision or UCP 400 revision. The English law does not recognize that UCP has the force of law or the status of a trade customs. Article 1 states that :

"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....They are binding on all parties thereto, unless otherwise expressly stipulated in the credit." ⁴, Thus UCP will be applied in English Law if the parties have incorporated them into their contract.

The law relating to Letters of credit is founded on two principles ⁵ :

- a) The autonomy of the credit ; and
- b) The doctrine of strict compliance.

When the seller presents the documents under the letter of credit for payment, he is assured of payment as long as the documents are conforming and all other conditions in the credit have been properly met. It is not open to anyone (including the buyer) to argue that there has been a breach of the underlying contract of sale and hence, deny the seller payment under the letter of credit. The buyer is not entitled to prevent payment. His only recourse is to take legal action subsequently. The separation between the contract and letter of credit is known as principle of the autonomy of credit, which is explained in Article 3, UCP below.

Article 3 – Credits v Contracts

" Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the credit. Consequently, the undertaking of the bank to pay, accept and pay draft(s) or negotiate and/or to fulfill any other obligation under the credit, is not subject to claims or defenses by the Applicant resulting from his relationship with the issuing bank or beneficiary."

Article 4, UCP explains relationship between documents and goods, services, performances as below :

" In credit operations all parties concerned deal with documents, and not with goods, services and/or performances to which the documents relate." ⁶

The autonomous character of a letter of credit became inevitable in that banks deal in finance, not in goods. Thus, a bank which agrees to operate a credit is solely concerned with the documents tendered by the seller which have been referred to in the contract; it is not concerned with the nature of merchandise in the underlying contract. A letter of credit contract may be described as a money contract which is solely concerned with payment; thus its validity as payment contract is to be confirmed, and the bank agreeing to accept the contract is concerned with the validity of the letter of credit of the contract, which entails examining the documents related to that contract.⁷

By virtue of its autonomous character, a letter of credit is compared with a bill of exchange. In *Power Curber International Ltd. v National Bank of Kuwait*, Lord Denning said that :

“A letter of credit is like a bill of exchange given for the price of goods. It ranks as cash and must be honoured.”⁸

Thus, an undertaking to honour a letter of credit unless fraud exists, is of absolute nature, and the relevant banks is in “no way concerned with any dispute that the buyer may have with the seller”.⁹

It is evitable from the above discussion on the legal autonomous characteristics of the letter of credit, in the eyes of law, the court treats a letter of credit as equivalent to cash in hand; only thing is that documents submitted by the seller to the bank must conform with the documents asked and conditions are met as per the letter of credit contract.

If a letter of credit is not treated by the court as cash in hand, the international trade could become impossible and standstill like thrombosis (prevention of blood flow and formation of blood clots) occurs in our blood stream. Obtaining payment is the vital part of any trade; where the international trade involves with the cross-border trade transactions, no law of any country could guarantee the payment of the trade if the letter of credit is not developed and honoured as cash in hand.

1. Post Graduate Diploma In Maritime Law, Module 7, Dr. Charles Chatterjee, pg 7-13, para 2.5
2. http://www.bizhelp24.com/export_import/letter_of_credit.shtml
3. http://www.bizhelp24.com/export_import/letter_of_credit.shtml
4. Post Graduate Diploma In Maritime Law, Module 7, Dr. Charles Chatterjee, pg 7-84, para 8.5(7-313)
5. Post Graduate Diploma In Maritime Law, Module 7, Dr. Charles Chatterjee, pg 7-85, para 8.5(7-315)
6. Post Graduate Diploma In Maritime Law, Module 7, Dr. Charles Chatterjee, pg 7-85, para 8.5a (7-316)
7. Post Graduate Diploma In Maritime Law, Module 7, Dr. Charles Chatterjee, pg 7-85, para 8.5a (7-317)
8. Post Graduate Diploma In Maritime Law, Module 7, Dr. Charles Chatterjee, pg 7-86, para 8.5a (7-317)
9. Post Graduate Diploma In Maritime Law, Module 7, Dr. Charles Chatterjee, pg 7-86, para 8.5a (7-318)

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