

## **Risk Analysis of Letter of Credit** **-----Based on Principles of 'Independence' and 'Strict Compliance'**

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### **Abstract**

*Based on the UCP 500 and UCP 600, this paper analyses the two principles of letter of credit, in order to prepare the theory basis for the risks analysis afterwards. For the different parties (exporter, importer, banks), possible risks and frauds are shown with case studies. The paper also puts forward the advice for various risks and intends to indicate that risks still exist in letter-of-credit transaction even it is the safest method of payment nowadays in international trade. Those risks may happen on each party, which is not only the exporter, but also the importer and banks. Rights for each party always come with the appropriate obligations.*

**Keywords:** letter of credit, principle of independence, principle of strict compliance

### **1. Introduction**

As the payment instrument, letter of credit has become widely used in international trade. Letter of credit is even described as '...the life-blood of international commerce...' <sup>1</sup>. Letter of credit takes care of the interests of both the exporter and importer, so it is considered to be the most effective and safest method to secure the payment in an international trade transaction. The legal basis of letter of credit is UCP 500, which is published by ICC. As the international convention for the letter-of-credit transaction, UCP 500 holds the most important doctrines for the using of letter of credit --- the two principles --- principle of independence and strict compliance. <sup>4</sup> In the real practice, these two principles are the amulet that can secure the payment for both exporter and importer, but also the main source that can cause the risks for a letter-of-credit transaction.

### **2. Two Essential principles about Letter of Credit**

From the technical review, there are two essential principles when people use letter of credit as the transaction way. The first one is the principle of independence, which is clearly indicated in Art. 3 of UCP 500; another principle is strict compliance, which is described in Art.4 of UCP 500. <sup>5</sup>

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<sup>1</sup> R D Harbottle (Mercantile ) Ltd V National Westminster Bank Ltd [1977] 2 All ER 862 at 870 b.

<sup>2</sup> UCP stands for Uniform Customs and Practice for Documentary Credits. UCP were originally formulated in 1933 by the International Chamber of Commerce, the most recent revision came into effect in 1994 (ICC publication 500).

See Hugo CF ' The Development of Documentary Letters of Credit as Reflected in the Uniform Customs and Practice of Documentary Credits' (op cit) 52.

See Hugo CF' The Development of Documentary Letter of Credit as Reflected in the Uniform Customs and Practice of Documentary Credits' (op cit) page 53.

<sup>3</sup> ICC stands for International Chamber of Commerce.

<sup>4</sup> Ramberg (International Commercial Transactions) pages 142;144.

<sup>5</sup> Ramberg. Jan, international commercial transactions, Stockholm 2000, page 142;144.

## 2.1 Principle of independence

“...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 ...”.<sup>6</sup> The principle of independence comes from a prejudication.<sup>7</sup>

### 2.1.1 The detail significations of independence

#### a. Obligation of payment vs performance of sales contract

The payment obligation of issuing bank to beneficiary (exporter) is separated from the performance of beneficiary based on the sales contract.<sup>8</sup> As long as beneficiary presents the compliant bill of documents, issuing bank should accept even though beneficiary disobeyed the sales contract that made with the applicant (importer).

#### b. Obligation of payment vs obligation of issuing bank

The payment obligation of issuing bank is also independent of the underlying the contract between applicant and bank.<sup>9</sup> For example, applicant goes bankruptcy after the bank issues letter of credit. Although applicant cannot pay the money, issuing bank still cannot reject the payment obligation. Issuing bank has to pay when beneficiary presents the bill of documents in strict compliance. The rule, that letter of credit is independent out of the sales contract between the importer and exporter, is based on two reasons. Firstly, legislation, convention and judicatory case confirm the regulation that issuing bank is not responsible for the performance of sales contract.<sup>10</sup> Because issuing bank is not the party of sales contract<sup>11</sup>. Issuing bank cannot control the contract content, or choose who should be the beneficiary of credit. Secondly, besides knowing the clauses of letter of credit and bill of documents, if the issuing bank try to evaluate the performance situation and the dispute between the contract parties, it is not the tenet of letter of credit, which means letter of credit will lose its sales value as the safest instrument of international settlement<sup>12</sup>.

### 2.1.2 Problems disputed in the real practice

With reference to the principle of independence, there are two problems disputed frequently in the real practice.

#### a. The restriction of sales contract for the letter of credit

From the side of bank, letter of credit becomes effective after it is issued, and it should be considered as the irrevocable letter of credit<sup>13</sup>. Bank will perform its obligation based on the original credit before it receives the amendment notice from the sales parties. According to the principle of independence, banks are only restricted by the letter of credit instead of sales contract.

From the parties of sales contract, commercial parties are not only restricted by the letter of credit, but also restricted by the sales contract. Since payment clause is the basic clause of the sales contract, it is the obligation of importer to issue a letter of credit complying with the sales contract, and also the precondition of exporter to deliver the goods and present the documents. For the sales parties, the precondition for letter of credit is the compliance between credit and contract. Therefore, the principle of independence is only for the relationship between banks and sales parties (importer and exporter), which is not applied on the relationship between sales parties.<sup>14</sup>

<sup>6</sup> Art. 3, UCP 500: “a. credit, 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 a 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 relationships with the issuing bank or the beneficiary. b. A beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the applicant and the issuing bank.

<sup>7</sup> Case “Hamtchmalsa V. British Texex Industries Ltd”, 1958.

<sup>8</sup> Rooy. Frans P, Documentary Credit, Deventer 1984, page 125.

<sup>9</sup> Rooy. Frans P, Documentary Credit, Deventer 1984, page 126.

<sup>10</sup> Ventris. F.M, Banker’s documentary credit, 2<sup>nd</sup> edition, London 1983, page 225.

<sup>11</sup> Ventris. F.M, Banker’s documentary credit, 2<sup>nd</sup> edition, London 1983, page 227.

<sup>12</sup> Ventris. F.M, Banker’s documentary credit, 2<sup>nd</sup> edition, London 1983, page 227.

<sup>13</sup> Art 6, ‘ Revocable V. Irrevocable credits’, UCP 500: ‘ ...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...’

<sup>14</sup> Ramberg.Jan, International Commercial Transactions, Stockholm 2000, page 375.

b. The discrepancy between letter of credit and sales contract

There are two kinds of situations for the discrepancy between letter of credit and sales contract: the beneficiary accepts or refuses the discrepancy between letter of credit and sales contract.

When letter of credit is not uniform with the sales contract, the beneficiary may demur with a requirement of amendment for the letter of credit. The application has to accept this requirement and amend the letter of credit in order to comply with the content of sales contract. In the case of this situation, the discrepancy is not counted as the amendment for the sales contract<sup>15</sup>.

Sometimes, the beneficiary would accept the discrepancy even they found that the letter of credit is not uniform with the sales contract. For this situation, the point is that: the behavior of issuing bank consists a new agreement -- as long as the beneficiary accepts the letter of credit which exists discrepancies directly or indirectly, the beneficiary will forfeit the right to declare the fell back of applicant<sup>16</sup>. Whereas, application does based on the letter of credit, which means that applicant does based on the amended sales contract. This behavior is not considered as a breach of faith. Thereby, issuing the letter of credit, which is not complied with the sales contract, should not be simply considered as a breach of faith. It is obvious that, the principle of independence is only applied after the letter of credit becoming effective to parties. The rules of sales contract cannot influence the right and obligation confirmed by letter of credit for each party. Whereas, under the consensus of commercial parties (exporter and importer), the discrepancies between letter of credit and sales contract are counted the amendment to original contract.<sup>17</sup>

c. Exception for principle of independence

Although the principle of independence is set up steadily, it is not absolutely. There are some exceptions in the real practice. Fraud is the main exception for principle of independence. The 'fraud exception'<sup>18</sup> means that banks obey the principle of independence in general situation; however, if banks keep the obvious evidence of the fraud behavior of beneficiary, banks could refuse to pay. Applicant can require the bank for rejection, or apply the payment injunctive from the court.<sup>19</sup>

From the discussion above and based on the principle of independence, as long as documents appear in compliance with the credit on the face, issuing bank should pay the beneficiary without concerning any restriction of the sales contract. However, the bank audits the documents without examining the goods, this character consists the connatural disadvantage of principle of independence for the letter of credit<sup>20</sup>. The principle itself cannot set the barriers to avoid fraud. Banks cannot protect the applicants from the fraud under the cover of documentary examination instead of goods examination.

Countries under the Anglo-American law system make the argument about this disadvantage<sup>21</sup>. On the one hand, they admit that principle of independence is the milestone of letter-of-credit-transaction. On the other hand, the application of this principle should not ignore the real situation of international transaction. In the case of fraud by beneficiary, application of this principle should be restricted. Applicant can ask the court for the payment injunctive, in order to prohibit the bank's payment. American court has first set the fraud exception theory in the case of 'Sztejn V. J. Henry Schroder Banking Company'<sup>22</sup> in 1941. This theory sets the principle of banks rejection right.

<sup>15</sup> John.D.Daniels & Lee.H.Redebaugh, International Business (environments and operations), 9<sup>th</sup> edition, page 644.

<sup>16</sup> Jack.Raymond, Documentary Credit-the law and practice of documentary credit including stand-by credits, and performance bonds.London/Dubin/Edinburgh 1991, nr 8.48.

<sup>17</sup> John.D.Daniels & Lee.H.Redebaugh, International Business (environments and operations), 9<sup>th</sup> edition, page 644

<sup>18</sup> It may be useful to distil a basic approach in respect of the fraud exception, which is common in most jurisdictions. Most legal systems uphold the independence principle with a great degree of sanctity. However, one can envisage circumstances where it would be unconscionable to insist that a bank makes payment to a exporter, if the exporter has been unscrupulous towards the buyer. The issue of fraud is a perfect example. 'letter of credit-the fraud exception', [http:// www.law-online.co.za/IntTradeLaw/letcredit.htm](http://www.law-online.co.za/IntTradeLaw/letcredit.htm).

<sup>19</sup> Van Houtte, Hans. The law of International Trade, 2<sup>nd</sup> edition, London 2002, page 785.

<sup>20</sup> Sutherland, Pete D. The outlook for world trade, in world economics, Vol. 4, No.3, July-September 2003, page 72.

<sup>21</sup> Sutherland, Pete D. The outlook for world trade, in world economics, Vol. 4, No.3, July-September 2003, page 74.

<sup>22</sup> One of the first cases where the fraud exception was not only recognized but also applied.

In that case, the applicant raised the requirement to court that the court declares the letter of credit is ineffective and prohibit the issuing bank to pay the money. Because the goods (bristle) which are imported by the applicant from the India supplier are all rubbish. The court accepted the requirement based on the obvious evidence. The principle of independence got the further improved in the Britain case 'United City merchants V. City Bank of Canada'<sup>23</sup> in 1983. However, to protect the reputation of domestic bank, and respect the principle of independence for letter of credit, the courts in Britain and American are very cautious when they sign a payment injunctive. Those courts have to obey the four basis: a. within insisting the principle of independence, court cannot interrupt the operation of the letter of credit; b. the accuse should be related with the fraud, and exit obvious evidence of fraud; c. injunctive cannot affect the interest of third party; d. injunctive should send before bank performs the payment<sup>24</sup>.

Although Britain and American admit the fraud exception for the principle of independence, the ICC<sup>25</sup> emphasizes it in UCP 500, that issuing bank must perform the obligation of payment as long as beneficiary presents the reasonable documents. Art.4<sup>26</sup>, UCP 500 rules '...in credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate...'. In spite of Art.4 maintains the interest of bank for keeping away from the sales dispute, ICC feels unreasonable when the bank knows the fraud in the letter of credit. So ICC adds that if a bank finds the fraud, it is his obligation to stop paying. In the letter-of-credit-transactions, the principle of independence is the most essential principle anyhow. It is the footstone of institution for letter of credit. Its most important function is to establish the separated payment responsibility for banks; consequently, letter of credit becomes a more credible and convenient payment tool.

## 2.2 Principle of Strict Compliance

Art.4<sup>27</sup> in UCP 500 rules the regulation for the examination of the documents. The presented documents must be in accordance with the terms and conditions of the letter of credit.<sup>28</sup> Based on the contract between applicant (importer) and issuing bank, the bank has the obligation to observe the borders of the commission given to it and fulfils the request by observing the principle of strict compliance.<sup>29</sup> Issuing bank keeps the rejection right when it meets the documents that disobey this principle.<sup>30</sup>

### 2.2.1 The fundamental rule peculiar to the system of letter of credit

Under the term of letter of credit, issuing bank perform the payment obligation no other than the exporter submits the documents which is strict compliance with the clauses of letter of credit on the appearance. Thereby strict compliance becomes the fundamental principle, which restricts the right and obligation between issuing bank and exporter. The investigation in recent years indicates that: about 50% rejection of payment is resulted from the discrepancies between the documents and credit, which decrease the effectiveness of letter of credit, and cause the financial effects for the parties.<sup>31</sup>

### 2.2.2. Essential condition of strict compliance

ICC has not used the term 'strict compliance' in UCP 500. Art.13 a in UCP 500 stipulates: '...banks must examine all documents stipulated in the credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the credit...'<sup>32</sup>. Although 'strict compliance' cannot be found in UCP 500, it is recognized in the related case law and banking operated practice.

<sup>23</sup> United City Merchants (investments) Ltd. V. Royal Bank of Canada, (1983),1 A.C.

<sup>24</sup> Jack.Raymond, Documentary Credit-the law and practice of documentary credit including stand-by credits, and performance bonds.London/Dubin/Edinburgh 1991, nr 9.25

<sup>25</sup> International commercial committee.

<sup>26</sup> Art.4 is the clause for 'documents V good/services/performances'

<sup>27</sup> Art4 ---" documents v. goods/ services/performances", UCP 500: "in credit operation all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate."

<sup>28</sup> Jack.Raymond, Documentary Credit-the law and practice of documentary credit including stand-by credits, and performance bonds.London/Dubin/Edinburgh 1991, nr.1.40

<sup>29</sup> Goode. Roy,commercial law, 2<sup>nd</sup> edition, London/New York/Victoria and others 1995 page 987.

<sup>30</sup> R .D.Harbottle(Mercantile)Ltd.v.National Westminster Bank Ltd.(1978)QB 146.p.269

<sup>31</sup> UCP 500, translated copy by Chinese international chamber of commerce, Chinese foreign trade publishing, 1994, page 1.

<sup>32</sup> See Art.13, 'standard for examination of documents', UCP 500.

For example, case law in United States is established the strict compliance standard as the appropriated standard for the related cases<sup>33</sup>. However, it makes nonsense to talk about 'strict compliance' abstractly. This principle should be understood when it is applied in real cases.

a. 'strict compliance' Vs 'absolute literal compliance'

Take the case 'Tosco F.D.L.C' as an example,<sup>34</sup> as the requirement of letter of credit, the draft should clearly indicate: this draft is issued according to 'Letter of Credit Number 105' in Clarkesville bank. However, the submitted draft is written that it was issued according to 'letter of credit No. 105'. The issuing bank decided to refuse the payment because the beneficiary (exporter) used the first letter as 'i' instead of the capitalization 'L' and used the abbreviation 'No.' instead of 'Number'. Although the submitted document (draft in this case) exits the wispy discrepancy, this discrepancy makes nonsense for the substance of letter of credit. This discrepancy does not affect the benefit of issuing bank and other parties. The issuing bank considered the literal compliance as the standard for documents compliance on the face. The court of United States in American did not support that argument. The British scholastic agrees this prejudication: the standard of strict compliance cannot be expanded to the discrepancy for the dot position in a omit form such as "I's" and "t's", or the obvious literal error.<sup>35</sup>

b. 'strict compliance' Vs 'substantial compliance'

Some of the discrepancies are not important or non-substantial on the face, however, they will lead to various interpretations. For example, as the requirement of letter of credit, the submitted documents should clearly indicate the delivered goods as 'dried currants', but bank received the documents that indicated the goods as 'raisins'. Withal, the bank must give the rejection<sup>36</sup>. Generally, in the process of international trade, raisins can be or cannot be the dried currants. How can the bank know which raisins was delivered? The bank is neither the manufacture nor the merchandiser. If the bank could make sure that the raisins on the documents is the dried currants on the letter of credit, then bank may perform the payment according to a principle of 'substantial compliance'<sup>37</sup>.

c. Appropriate position of strict compliance

Strict compliance is defined between the literal compliance and substantial compliance. Kozolcyyk has gathered up the strict compliance that: as a reasonable banker, his practice on letter of credit and knowledge about the terms can help him to judge what the inessential discrepancies are. Moreover, he can make the judgment independent that if the documents comply with letter of credit. When he makes the judgment, he completely based on the documents submitted by the beneficiary, instead of concerning the content of sales contract or the payment ability of his client (importer).<sup>38</sup>

### 3. Risks analysis

The main parties, which involve in the process of letters of credit, are exporter, importer, and banks. The same as any payment pattern, all of these parties bear different risks. The author, hereinafter, would like to analysis the risks for each party based on the two principles of credit. The cases, which are provided by bank of China Peking branch, the author takes the analysis with some real case between Chinese companies and foreign companies.

#### 3.1 Exporters risks

As the beneficiary of letter of credit, if there are risks for the transaction, the exporter should be the first one who will bear the risks. Generally, the risks for exporter may come from the importer.

##### 3.1.1 Breach of 'strict compliance'

The importer applies the letter of credit from an issuing bank without strict compliance with the contract. The terms and conditions of credit should be in compliance with the contract. In many cases, however, the importer do not open/issue the credit based on the sales contract because kinds of reasons.

<sup>33</sup> Vertris.F.m, Banker's documentary credits, 2<sup>nd</sup> edition, London 1983, page 307.

<sup>34</sup> T23 F2d 1242 (6<sup>th</sup> Cir. 1983).

<sup>35</sup> Gutteridge and Megrah, The Law of Banker's Commercial Credit, 7<sup>th</sup> ed., 1984, page 120.

<sup>36</sup> Goode. Roy,commercial law, 2<sup>nd</sup> edition, London/New York/Victoria and others 1995 page 983.

<sup>37</sup> Goode. Roy,commercial law, 2<sup>nd</sup> edition, London/New York/Victoria and others 1995 page 983.

<sup>38</sup> Kozolcyyk, 'The Emerging Law of Standby Letter of Credit and Bank Guarantees', (1982) 24 Ariz. L. Rev. page 319.

This behavior makes difficult for the performance of contract difficult, or leads the added loss on exporters. The most frequent situations are: importers do not open the credit on time or do not apply the credit from banks at all. For example, in the case of concerning market change, strict restriction for the foreign currency, the importer will alter the time or delay the time to open the letter of credit. The importer adds some accessional clauses in the credit, for example, the importer may upgrade the kind of insurance; increase the amount of insurance; change the port of destination; change the packing, in order to get the purpose of changing the contract. Or the importer may make many restrictions on the credit, which is considered as the “flexible clauses”<sup>39</sup>.

### 3.1.2 Setting barriers in malice

By using the crucial principle of letters of credit---“strict compliance” of documents and credit, the importer adds some conditions that are hard to achieve, or sets some business trap on purpose. Such as unconfirmed clauses; credit with words mistakes and conflicted clauses on content. It is not only a piece of cake that there are some words mistakes on letters of credit. Those mistakes can be the typing mistakes of the beneficiary’s name, address, shipment, the expiry time, and so on. The mistakes may affect directly the documents that must submit, and sometimes it will be the excuse for rejection of payment by the issuing bank.

### 3.1.3 Bogus letter of credit

If importers use the bogus letter of credit, or steal the letter of credit with vacant form from a bank, or get the credit from a clerk who worked in a bank that has been or is going to be bankruptcy, the exporters may face the calamity of losing both goods and money. There is such a case used to happen in a Chinese company.<sup>40</sup>

A trade company, which is in HeNan province in China, has received a documentary credit from a British bank. The name of the British bank is standard chartered bank, Birmingham branch, England. The amount of the credit is USD 37,200,000 and the advising bank is National Westminsterbank, London. Since the credit cannot be advised by the local bank of beneficiary<sup>41</sup> as usual, it is hard to confirm the authenticity of the credit. After the examination to the credit from a Chinese local bank, there are some doubtful points:

- a. The form of letter of credit is not dated; no consignor address on the face of envelope; it is impossible to recognize the post address because of the ambiguous letter stamp.
- b. The credit appoints the advising bank --- National Westminster bank as the negotiating bank, which is deviant.
- c. The address of accepting bank cannot be found in the “bank yearbook”.
- d. The significant of credit is printing words instead of handwriting, which cannot be identified.
- e. The goods are required to transport by air to Nigeria, where always happen the credit fraud cases.

According to the doubtful points above, the letter of credit is considered to be a bogus credit on the appearance.

### 3.1.4 Requests of especial documents

The importer asks for the documents that are hard to achieve. Some importers regulate the requests that cannot be fulfilled or controlled by the exporters. Such requests may be: under the terms of FOB<sup>42</sup>& CFR<sup>43</sup>, the exporter can ask the payment only within the return receipt of insurance; or the documents with some specific signature.

<sup>39</sup> Flexible clauses are the clauses that can control the beneficiary, and can be revocable in any time. They can damage the benefit of exporter a lot and exporter should try to avoid these clauses.

<sup>40</sup> Case from the bank of china, which provided by the worker in bank of china peking branch.

<sup>41</sup> The advising bank should be a local bank in the country of exporter based on the international convention. In this case the advising bank should be a Chinese bank.

<sup>42</sup> FOB is one of the incoterms of international trade. FOB is ‘free on board’ (...named port of shipment). ‘free on board’ means that the exporter fulfills his obligation to deliver when the goods have passed over the ship’s rail and the named port of shipment. This means that the importer has to bear all costs and risks of loss of or damage to the goods from that point. The FOB term requires the seller to clear the goods for export. This term can only be used for sea or inland waterway transport.

<sup>43</sup> CFR is also one of the incoterms of international trade. CFR is ‘cost and freight’ (...named port of destination). ‘cost and freight’ means that the exporter must pay the costs and freight necessary to bring the goods to the named port of destination but the risk of loss of damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered on board the vessel, is transferred from the exporter to the importer when the goods pass the ship’s rail in the port of shipment. The CFR term requires the seller to clear the goods for export. This term can only be used for sea and inland waterway transport.

For example, according to the clauses of credit, the importer asks the beneficiary to provide the certificates for the quality, quantity, and price of the goods. These certificates must be issued by the “commodity inspection bureau”. Basing on the regulation of commodity inspection authority in most countries, however, the authority can only issue the certificates for the quality and quantity of the commodity. Commodity price is considered to be a business factor, which does not belong the responsibility of the inspection process. This request is the typical example of the clause, which exporters cannot achieve.

### **3.1.5 Conflict between clauses of credit and related law**

The clauses of credit are not accordant with the law of related country. In the real practice of international trade, some clauses in the credit are advantage to the exporter on the appearance. The noticeable point is that if the clauses are allowed according to the law of importer’s country. The exporter should know the law in related country, and negotiated the clauses that cannot be implemented in the importer’s country. Otherwise, the exporter will not only loss the advantage in contract, but also involves in the restriction of another national law. For example, the accrual and final discount fee is responsible by the importer according to the letter of credit. The reasons are: citizens should turn in the income tax of the interest based on the national or state law.

There is a case involving the different tax law between China and France<sup>44</sup>. A Chinese exporter company finances a deferred letter of credit. The French importer company made agreement with the Chinese export company that the French company is going to be responsible for the entire fee caused by the accrual. This agreement is also accordant to the Chinese tax law. Whereas the French tax law is different on such regulation. Based on the French tax law Art.125,<sup>45</sup> Paris National bank made bold to deduct 30% accrual tax from the whole accrual that the beneficiary (the Chinese export company) should get. Both the importer and exporter know that the levied object is the French importer company. Furthermore, Italy and Cyprus have the same tax regulation as France. As the exporters, merchandisers should think more about the law in another country, and negotiate with the importer for the clauses that may involve deducting the income tax of accrual.

Another law problem is on insurance with a case as follows. A British bank issued a letter of credit and the clauses of credit ask for insuring in both London Association insurance company and insurance company of P.R.China. The Chinese exporter should buy the “all risks”<sup>46</sup> from London Association insurance company, and buy the “war risks”<sup>47</sup> in insurance company of P.R.China. Although these two different insurances can insure at the same time, based on the regulation of insurance company of P.R.China, the client cannot insure in a Chinese insurance company and a foreign insurance company in simultaneity. The exporter only can choose one insurance company.

### **3.1.6 Fraud by altering letter of credit**

Importers alter the overdue letters of credit purposely. The exporter may be cheated for their goods by this altered credit. Importers change the amount, the date of shipment, and beneficiary’s name of the overdue credit. With the purpose of finance the money by a credit from the bank, importers may prevail the exporters on issuing the credit. The correlative case in China happened on a trade company in JiangSu province.<sup>48</sup> The JiangSu trade company received a letter of credit, which was delivered by a HongKong client though the bank. The amount of the credit is USD 3,180,000. The branch bank of China found the obvious altered traces on the credit by auditing the credit. The credit has been altered the amount, date of shipment, name of beneficiary. The branch bank of China reminded the beneficiary (JiangSu trade company), and inquired about the credit from the issuing bank immediately.

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<sup>44</sup> Case is provided by bank of china, Peking branch.

<sup>45</sup> See French tax law, French corporate taxation-a brief overview. <http://www.triplet.com/40-10-corporate/40-70-taxlaw.asp>.

<sup>46</sup> The term All Risks stands for a relatively broad form of insurance. It covers property damage and, depending on the wording, the business interruption loss caused by property damage, irrespective of its cause. The scope of cover is defined by the exclusions, these being indispensable in order to guarantee the risks’ insurability. Thrsten Steinmann, ‘exposure (property & engineering)’, issue NO.8, February, 2002.

<sup>47</sup> Those risks related to two (or more) belligerents engaging in hostilities, whether or not there has been a formal declaration of war. Such risks are excluded by the F.C. & S.(free of capture and seizure) warranty, but may be covered by a separate war risk policy, at an additional premium.

<sup>48</sup> Case is provided by bank of china, Peking branch.

At last, it is substantiated as a fraud case by using the overdue credit. The HongKong Company tried to give the overdue credit to the exporter, then use it as a mortgage and get money from the bank.

### 3.1.7 Other risks out of the essential of letter of credit

The content of clauses is not belonging to the essential of letter of credit deal. If the letters of credit regulates that the negotiating bank pay only when commodity arrives the destination, after the eligibility of commodity inspection, or after getting the ratify foreign currency manage authority, these are not the transaction point of credit, and there is no guarantee for the exporters.

### 3.2 Importer's risks

The author discusses the possible risks on the side of exporters; whereas, the importers should also bear some risks when use letter of credit. The author would also choose a case<sup>49</sup> study hereinafter to analysis the risks on the side of importers.

Chinese company A made a contract with a British company B. Company A will import steel from company B. The amount of commodity is USD 5,040,000, and the parties decided to pay with letter of credit. As the importer, company A opened the letters of credit through an issuing bank in China. During the period of validity of shipment, company A received the fax from company B and was informed that the steel had been in shipment on time. Soon, the issuing bank received the whole set bill of documents from negotiating bank. According to the bill of lading<sup>50</sup>, the goods are loaded on a port of Eastern Europe, and transferred to china from a port of Western Europe. There was no discrepancy after auditing the documents. The issuing bank discounted the credit to company B according to the normal procedure. Company A felt weird after waiting for one month without any message of the goods. Company A inquired about the matter to London maritime affairs bureau. The feedback is: there was no named ship loading the steel on the given date that is offered by company A.

The case is concluded as a typical fraud case by forging the bill of documents. When A realized that, issuing bank had discounted and the negotiating bank had paid to the beneficiary. Company A faced a big loss. The key issue of this case is that how much risk to the importers under the transaction of letter of credit. When people talk about UCP 500, the convention protects beneficiary much more than the applicant. That means, exporters get more protection from the UCP 500 more than the importers. From this profile, the author would discuss the risks on importers with the following statement.

#### 3.2.1 Fraud risks

As the case described above, the operation of letters of credit may be considered as an operation of documents. The related parties finish their responsibility based on those bill of documents. The only evidence for issuing bank is the strict compliance between documents and credits. As long as the documents are in strict compliance, the issuing bank has to pay. According to UCP 500 Art.15<sup>51</sup> "...Bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification ... of any document(s)...", "...nor do they assume any liability or responsibility for the ... good faith or acts and/or omissions, solvency, performance or standing of the ..." related parties. Bank forms a tradition that they only examine the authenticity of the documents on their face, and pay no need to the essential reality of the documents. Furthermore, to examine the essential reality of the documents has exceeded the specialty ken of banks, so banks cannot do more on that. Although "...banks must examine all documents stipulated in the credit with reasonable care..."<sup>52</sup>. UCP 500 Art.13, and Art.15 regulate the "...disclaimer on effectiveness of documents..."<sup>53</sup> for the banks. The principle of strict compliance provides the soil for fraud under the terms of letters of credit.

<sup>49</sup> Case is provided by bank of china, Peking branch.

<sup>50</sup> A bill of lading is a document which is issued by the transportation carrier to the shipper acknowledging that they have received the shipment of goods and that they have been placed on board a particular vessel which is bound for a particular destination and states the terms in which these goods received are to be carried. See '21<sup>st</sup> century system for trade and security', bills of lading and air waybills, <http://www.itds.treas.gov/bills-lading.htm>.

<sup>51</sup> Art 15, 'disclaimer on effectiveness of documents', UCP 500.

<sup>52</sup> Art 13, 'standard for examination of documents', UCP 500.

<sup>53</sup> Under the terms of LC, documents are considered as the exclusive evidence to meet the payment.

### 3.2.2 Quality risk

The quality risks, which importers should bear under the term of letters of credit, are that exporters trade importers with the shoddy commodity. From the characteristic of documentary deal<sup>54</sup> under the terms of letter of credit, the importer can get the whole set of documents to pick up the goods only after payment or discount. Before this, the importer cannot know if the exporters provide the commodity with good quality. The importers will stand on the passive side. Moreover, if the importer find the quality problem of the commodity after payment or discount, it is hard to get the protection through the legal way.

### 3.2.3 Exchange rate risk

No matter what kind of letter of credit (insight letter of credit or deferred letter of credit), there is a time distance from issuing letter of credit to the actual payment for importers. This long time distance may cause a big fluctuant of the exchange rate. If under the term of insight letter of credit, there is a time distance from the credit issuing date to consignment, and arrival of document in the issuing bank. Then also the time for documents examination should be plused. If under the term of deferred letter of credit, the time distance will add the time from acceptant date to expiry date.

In international trade, the longer the time lasts, the more exchange rate risks exist. Once the exchange rate of paying currency increasing<sup>55</sup>, the importer has to pay more than the anticipative amount. There is an adage that “exchange rate is more ferocious than tiger”, which describe the big risk caused by exchange rate.

### 3.2.4 Marketing risk

The import commodity may face a marketing risk, whether they are the material for re-machining or the goods which access the trade circulate directly. In case, the price of the same goods in domestic market goes down, then the relative price of import good rises up. It will affect the goods circulation of the market, and causes the overstock<sup>56</sup>. Even the import goods, which used for re-machining, may also cause the high cost of the new finished product.<sup>57</sup> These will lead the loss of importers.

### 3.2.5 Diathesis risk of the issuing bank

Many people have a point in the nature of things that the payment action of issuing bank is so canonical. There are no risks on this action, so this risk is seldom mentioned. But in fact, herein the intensity of works, some issuing bank does not examine the documents which are delivered by negotiation bank. Those issuing bank only transfer the documents to applicants directly. Issuing bank's nonfulfillment and nonfeasance of their obligation cause the damage: importer's interest damage by the unexamined discrepant, the right of applicants cannot be maintenance.<sup>58</sup>

## 3.3 Banks risks

Under the term of letter of credit, a bank may “add its name to a transaction” by providing payment risk security. As the basic principle of letter of credit --- “strict compliance” for the documents and credit, in the author's opinion, examination of the documents is the main risk for banks.

“... there is no room for documents which are almost the same, or which will do just as well ... if the bank does as it is told, it is safe; it declines to do anything else, it is safe; it departs from the conditions laid down, it acts at own risk...”<sup>59</sup>

A British court developed this statement about strict compliance in 1927. The principle of strict compliance is ruled in Art.13 and Art.15 of the UCP 500. Banks are no experts regarding goods and trade. They do not have enough knowledge to judge about goods and they cannot overview the terms and conditions between the applicant (importer) and the beneficiary (exporter).

<sup>54</sup> What is the documentary deal for LC

<sup>55</sup> exchange rate of a currency increasing can be also considered as the appreciation of that currency.

<sup>56</sup> See the following picture No.?

<sup>57</sup> See figure 5.4.

<sup>58</sup> Cranstom.Ross, Principle of banking law, Oxford, New York, Athens 1997, page 158.

<sup>59</sup> Cited in Ramberg (international commercial transactions) page 144.

The risk therefore exists that there are discrepancies on the credit when they found the obviously discrepancies. Those discrepancies may come from the result of fraudulent document, and cause big damage to the bank and beneficiary. Art. 15 of UCP 500 contain a disclaimer for the risks of bank. However, banks can be liable for losses and damages, if a bank does not fulfill its obligation to examine the documents in a reasonable way.

#### **4. Advices and measures**

As the different risks for each party in letter-of-credit transaction, the author gives some advice personally.

##### **4.1 Advices for the exporter**

###### **4.1.1 Choosing the trading partner cautiously**

As the exporter, when they are looking for the trading partner or trading opportunities, they would better do that through a face-to-face way. It means both parties should know each other; at least they should have a meet somewhere and sometime. The beginning of risk for a letter-of-credit transaction is to deal with someone who has ambiguous or bad credit background. Before signing the sales contract, trading parties should investigate the partner themselves or through the consultative company.

###### **4.1.2 Pre-fixing the content of letter of credit in the sales contract**

Sales contract is the basis of letter of credit, so exporter and importer can negotiate the clauses of letter of credit and fix the clauses even in the sales contract. Generally, those clauses include: issuing date; expiry date of letter of credit; fix the issuing bank and confirming bank (if it is possible); fix the type of credit (usually are irrevocable letter of credit, sight letter of credit, transferable letter of credit, etc)<sup>60</sup>; name of presented documents and number of copies; be allowed or not transfer at another port; if the parties could change the content of letter of credit and how.

###### **4.1.3 Arranging the way and conditions for issuing letter of credit carefully**

In the letter-of-credit transaction, exporter must strictly comply with the clauses of letter of credit. After that, exporter can get the payment. Therefore, the exporter may be very careful when arrange or choose the way or conditions for letter of credit. Exporter should pay an attention that he can achieve all the clauses absolutely; otherwise, it is necessary to have a negotiation with importer. Exporter can ask for change those clauses which are hard or cannot be achieved, in order to keep the exporter's interest.

###### **4.1.4 Examining the letter of credit earnestly**

The right of examining the letter of credit is not only held by banks, but also by exporter. During the examination, there are two points that should be noticed: firstly, the content of letter of credit is or not in compliance with the sales contract. Banks and exporter can require the amendment from importer when they find the unreasonable content or clauses. Secondly, the exporter should check the dependability of the credit. For example, credit of issuing bank; types of letter of credit; become effective of letter of credit. The name, address, credit of issuing bank should be compared with bank yearbook. If there is any doubt about that, exporter must check it from the issuing bank to make sure the authenticity, validity, and dependability of issuing bank. According to Art.8<sup>61</sup> in UCP 500, advising bank should audit the authenticity of letter of credit on the appearance. Therefore, advising bank has the responsibility to examine that if the letter of credit is fraud. In the real practice, advising bank usually keeps the signature sample of issuing bank and confirms the authenticity on the appearance through the 'SWIFT'<sup>62</sup>. Exporter can examine the letter of credit depending on advising bank.

##### **4.2 Advices for the importer**

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<sup>60</sup> Cransto.Ross, Principles of banking law, Oxford, New York, Athens and others 1997, page 338.

<sup>61</sup> Art.8, UCP 500, 'revocation of a credit'.

<sup>62</sup> SWIFT stands for Society for Worldwide Interbank Financial Telecommunication. SWIFT is the financial industry-owned co-operative supplying secure, standardized messaging services and interface software to 7,650 financial institutions in over 200 countries. SWIFT's worldwide community includes banks, broke/dealers and investment managers, as well as their market infrastructures in payments, securities, treasury and trade. See the official website of SWIFT, <http://www.swift.com>

#### **4.2.1 Credit investigation**

As the importer, the key issue for avoiding fraud is the credit investigation of the trading partner. The investigation should be done before both parties confirm the letter of credit as the payment method. In real practice, the importer should investigate exporter through the institution such as credit evaluated institution, and sales guild in exporter's country. The investigation information can be used for the demand in the future.

#### **4.2.2 Choosing the appropriated trading terms**

In order to catch the option for carrier, banks, and insurance company<sup>63</sup>, the importer should choose the appropriated trading terms. The terms, which are most frequently used, are FOB & CIF<sup>64</sup>.

#### **4.2.3 Auditing the documents strictly**

When auditing the documents, the importer may in definitude about the clause of LC. Importer should give detail requirement to the bill of lading, policy of insurance, sales invoice, quality certificate, etc. considering the leak of every contract; this measure can avoid exporter presents the documents which are complied with the letter of credit but sales contract.

### **4.3 Advices for the bank**

#### **4.3.1 Recognition of responsibility and obligation**

As the issuing bank or advising bank, banks should recognize the responsibility and obligation on themselves and provide the efficiency and circumspect services. Banks should consummate the internal regulation and self-discipline, and strengthen the consciousness for avoiding risks. Clerks of bank should also improve their consciousness of law and promote the operation diathesis. During the transaction of letter of credit, banks strengthen the examination for the procedure of letter of credit; meanwhile, they should enhance the investigation for credit of client.

#### **4.3.2 Choosing the operation partner within good credit**

When banks try to enlarge their international operation net, they should keep the high guard to choose the operation partner gingerly. Since the letter of credit is implemented through the international operation net of banks, good credit of banks and favorable cooperated relationship between banks will be convenient for the information transfer with no doubt<sup>65</sup>. Good information transfers between banks decrease the occurrence of letter-of-credit fraud.

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<sup>63</sup> Incoterms 1990 published by the international chamber of commerce, Paris, France, is the international standard for defining a trade transaction between importer and exporter.

<sup>64</sup> CIF, cost of insurance and freight.

<sup>65</sup> Cranston.Ross, Principles of banking law, Oxford, New York, Athens and others 1997, page 520.