

Documentary Letters of Credit

ARTHUR L. DOUGAN AND HUGH CALKINS*

The documentary letter of credit is a little known but highly useful instrument of commercial dealing. Long the standard method of financing international sales transactions, it is now becoming recognized as a convenient means by which sellers in domestic markets who do not know or trust their buyer's credit may secure protection during manufacturing or processing for him.¹ Article 5 of the proposed Commercial Code is a codification of the essential principles underlying the documentary letter of credit. Although it has been subjected to some deserved criticism, it merits adoption by the Ohio Legislature and attention by Ohio commercial lawyers.

I.

THE FUNCTION OF THE DOCUMENTARY CREDIT

The only letter of credit in the experience of many is the instrument by which a traveler who does not wish to be burdened with travelers' checks obtains cash in a foreign country. This is indeed one type of credit letter. But it is not the documentary letter of credit, and it is not the credit with which the proposed Article 5 is concerned.

The commercially important documentary letter of credit, and the instrument which is the subject of Article 5, is a contract under which a person, usually a bank, undertakes on behalf of the other party to the contract for a period of time to honor drafts drawn by a person named in the contract, on presentation by such person of certain prescribed documents. Its most typical use is in connection with international sales contracts. An Ohio manufacturing company, for instance, contemplating the manufacture and sale of equipment to a European customer, may wish assurance before undertaking the manufacture that it will be paid—and paid in dollars—on shipment. It is rarely feasible for the manufacturer to insist that its European customer pay in advance. The desired assurance is therefore obtained by requiring the customer to obtain a letter of credit. This the customer arranges with its local European bank, by obtaining the undertaking of that bank to pay the

* Both of the Cleveland Bar.

¹ Increased use of documentary letters of credit in domestic transactions has been reported in a Comment, 62 YALE L.J. 227 (1953). This is the best critical analysis of the proposed Article 5. For other discussions of Article 5, see Harfield, *Trade Without Tears, or Around Letters of Credit in 17 Sections*, (1952) WIS. L. REV. 298; McLaughlin, *The Letter of Credit Provisions of the Proposed Uniform Commercial Code*, 63 HARV. L. REV. 1373 (1950). An excellent statement of the law and practice of the letter of credit is contained in WARD AND HARFIELD, *BANK CREDITS AND ACCEPTANCES* (3d ed. 1948), referred to in this article as Ward and Harfield.

manufacturer, in dollars, upon presentation to the bank of documents in proper form evidencing delivery of the equipment to a transportation company. If the European bank (usually called the "issuer") does no business in the United States, it will forward the letter of credit to a correspondent bank in New York or Ohio. The correspondent bank may merely notify (or "advise") the manufacturer of the credit, in which event it assumes no obligation to pay. Or it may "confirm" the credit, thereby obligating itself to honor the draft upon presentation of the documents. Upon completion of the equipment and its delivery to a transportation company, the manufacturer (commonly called the "beneficiary") will present an appropriate draft to the confirming or issuing bank, together with a bill of lading, invoice and insurance policy, and will be paid. Unless this has already been done, the confirming bank will obtain reimbursement from the issuing bank, which will in turn be reimbursed by the European customer.

This basic pattern may be varied to suit the convenience of the parties. It is common, for instance, for the letter of credit to provide for acceptance rather than payment upon delivery of the prescribed shipping documents. Since a draft accepted by the Ohio or New York bank is prime commercial paper, it may be discounted by the Ohio manufacturer (beneficiary) at nominal rates. The letter of credit thus becomes a device by which the manufacturer may be paid upon completion of the goods, while the customer is not required to pay for them until delivery to him. If the European bank has sufficient confidence in its customer, payment by the buyer may be deferred until after the buyer has had an opportunity to realize its profit upon the goods in question. In jurisdictions where the trust receipt or a similar device is available to protect the bank's security interest, the letter of credit may permit such deferred payment without reliance upon the buyer's general credit.² Similarly, under some circumstances, the Ohio manufacturer may be able to use the assurance that it will be paid upon completion of the goods to finance the manufacturing process itself.³

² WARD AND HARFIELD, *ibid*, p. 84, calls attention to the important fact that trust receipts are not recognized in many European jurisdictions, and that there apparently are no equivalent devices available there.

³ Such financing is discussed *ibid* at pp. 128-146. It may be illustrated by the use of what is called a "secondary credit". An Ohio manufacturer, for instance, who is the beneficiary of a letter of credit from its European customer, may require component parts for the equipment to be manufactured. It may, therefore, request a bank, perhaps the issuing or confirming bank under the other letter of credit, to issue a separate credit addressed to the supplier of the component parts. The supplier will obtain payment under this second credit upon delivering an order bill of lading and appropriate accompanying documents to the issuing bank under that credit. That issuing bank will release the parts to the Ohio manufacturer upon a trust receipt.

The utility of a documentary letter of credit is apparent from this illustration. The credit fully protects the seller from the risk of unavailable dollar currency; it supplements the unknown or doubtful credit standing of the customer with the resources of a European or, if the credit is confirmed by a domestic bank, a United States bank. If the credit calls for a draft which is to be accepted rather than paid, it permits the beneficiary-manufacturer to be put in funds at the beginning of transit, while the European customer is compelled to pay only at or after delivery to him. Coupled with other commercial devices, the letter of credit permits a bank to finance a succession of steps in a manufacturing process, advancing the funds required for each step, while retaining effective protection. Patently, most of these advantages are independent of the international character of the transaction. The documentary letter of credit can be, and increasingly is, used in domestic transactions where the buyer's credit standing needs the reenforcement of a bank, or the parties desire financing during the period of manufacture or processing. The letter of credit is an economic substitute for a guaranty and may be permissible for the issuer where a guaranty is not.⁴

The limitations of the letter of credit are equally clear from the illustration given. Its use is a dealing in documents only. It is a contract calling for payment by a bank upon delivery to it of documents in prescribed form. That the goods themselves do not comply with the sales contract is immaterial to the obligation of the bank to pay upon presentation of the documents or the duty of the customer to reimburse the bank. The letter of credit therefore gives a buyer no protection against faulty performance by the seller, or the seller's dishonesty.

II.

PRESENTLY APPLICABLE LEGAL PRINCIPLES.

Most commercial instruments require a body of commercial law to give them meaning or to make them effective. The typical bill of exchange is only a few lines long; a Negotiable Instruments Law is essential to define the rights and duties of the parties to it. The holder of a chattel mortgage or of a warehouse receipt depends upon a body of statutory law to define his rights and powers. Not

Upon completion of assembly, and delivery of a new bill of lading to the issuing bank under the first credit, the manufacturer will be paid and the bank issuing the first credit reimbursed.

⁴This is true of national banks, *infra*, note 7, which have power to issue letters of credit. Many national and state banks do not, however, have power to guarantee letters of credit. See WARD AND HARFIELD, pp. 183-184; See *infra*, note 7.

so with the documentary letter of credit. It has been in use for years with no foundation other than the law of contract.

Most of the reported cases involving letters of credit were decided prior to the First World War. Many dealt with the still-current problems of the sufficiency of compliance of the documents with the terms of the credit and the effect of discrepancies between the goods themselves and the underlying sales contract; some were concerned with the question whether informally-worded letters should be regarded as binding instruments.⁵ "Confusion" in the decisions was often noted,⁶ and, despite the fairly widespread use of letters of credit, doubts were occasionally expressed whether banks were authorized to issue them.⁷ The case law of the letter of credit does not do much to recommend it to general use.

More useful than the case law to those now employing letters of credit has been a body of regulations adopted by the International Chamber of Commerce. Originally completed in the early 1930's, the regulations were revised in 1951. They have been adopted in at least twenty-nine countries; among the important commercial nations, only Great Britain has not adhered, and British practice is substantially consistent. The regulations are uniformly adhered to by American banks with respect to export transactions, and are regarded by many American banks to be applicable as well to transactions initiated by United States importers.⁸

The Uniform Regulations briefly classify certain types of documentary credits. They acknowledge the bank's obligation to examine with care documents submitted in accordance with the credit, and contain explicit provisions for relieving the bank of other types of liabilities. They also set forth a detailed set of rules of interpretation, in which is prescribed the presumed understanding of the parties in the absence of contrary provisions in the letter of credit. These rules relate to the documents which will be considered sufficient compliance with the terms of the credit, the period of time during which credits are deemed to remain in force, and the time within which the bank must act upon presentation of documents. The Uniform Regulations have no legal force other than as evidence of custom or as specifically incorporated by reference into the terms of a letter of credit. While they are presumably of considerable value in standardizing practice among those familiar with the letter of credit, they are of only limited

⁵ See Annotations, 30 A.L.R. 353, 1310 (1924); 39 A.L.R. 755 (1925).

⁶ See, e.g., McCurdy, *Commercial Letters of Credit*, 35 HARV. L. REV. 539 (1922).

⁷ For a recent discussion of this problem, see Harfield, *The National Bank Act and Foreign Trade Practices*, 61 HARV. L. REV. 782 (1948).

⁸ The uniform regulations are printed in WARD AND HARFIELD, pp. 185-199. For a discussion of the 1951 revision, see Note, 65 HARV. L. REV. 1420 (1952).

helpfulness in instructing the uninitiated in the use of this instrument.

III.

TEXT OF ARTICLE 5.

Examination of the text of the proposed Article 5 reveals the objectives which its draftsmen had in mind. It is apparent that one was to set out clearly the character of the documentary letter of credit, so that all might become familiar with its use and confident of its validity. A second objective was to conform the fundamental law of the letter of credit to present international practice embodied in the Uniform Regulations, while leaving matters of detail and application free from statutory crystallization. Finally, the text indicates an attempt to adopt explicit provisions defining the rights of the parties among themselves, and to fix the liabilities of banks at a minimum. These objectives may best be appraised by considering the nature of the letter of credit as it appears from Article 5, the treatment in the Article of the points at which difficulty most frequently arises in using the letter of credit, and the liability provisions there set forth.

A. *Nature of the Letter of Credit.*

At the outset, Article 5 sets forth a uniform terminology for the parties to a letter of credit contract.⁹ It provides that a credit must be a writing (including a telegram) signed by a bank or other issuer, and that no consideration is needed to establish the credit or to modify its terms.¹⁰ It states that, with one important exception, no particular phraseology is necessary to constitute a credit. That exception is that the credit must clearly stipulate that it is irrevocable, if that is the intention. It merits examination, for it raises one of the few points in letter of credit practice where inattention may lead to disappointment.

The presumption of revocability appears in the Uniform Regulations, and its inclusion in the Code is justified, if at all, on grounds of consistency. It has been roundly criticized in comments on both the Regulations and the Code.¹¹ The criticism is based upon the fact that a so-called revocable credit is not a letter of credit at all, in the sense in which that term is usually employed. A revocable credit is merely a notice signed by the "issuing" bank that it is authorized to honor documentary drafts drawn by a

⁹The definitions are contained in Sec. 5-103 of Article 5. See Uniform Laws Annotated, Uniform Commercial Code, Official Draft, Text and Comments (1952). The other provisions referred to in this paragraph are Secs. 5-102(2), 5-103(1)(a), 5-104, 5-106, 5-105.

¹⁰Under existing Ohio law, consideration is probably essential to the validity of a letter of credit. *Sherwin & Co. v. Brigham*, 39 Ohio St. 137 (1883).

¹¹See Comment, 62 *YALE L.J.* 227, 239-42 (1953); Note, 65 *HARV. L. REV.* 1420 (1952).

named person complying with the terms of the credit. The revocable credit may be revoked by the bank at any time, without notice either to the person named in the notice or to the person at whose request the notice was given. It therefore cannot be fully relied upon as an assurance of payment. There is much force to the suggestion that the unwary would be less apt to be misled if the presumption were reversed so that a letter of credit not clearly specifying that it was revocable was held to be irrevocable. Nevertheless, so long as the Uniform Regulations contain the contrary presumption, the decision to adopt the international practice in internal law cannot be regarded as an unreasonable one, particularly since, typically, the issuer has not been paid or secured in advance for the amount of the credit.

The remaining provisions in Article 5 setting forth the function of the letter of credit are in skeletal form.¹² It is made clear that the letter of credit provides for payment upon the delivery of documents rather than upon the delivery of goods, that a documentary draft which meets the terms of an irrevocable credit must be honored, and that, unless otherwise agreed, a bank paying pursuant to a letter of credit is entitled to immediate reimbursement, and a bank accepting a draft pursuant to a credit is entitled to be put in funds the day before maturity of the draft. It is provided that a person presenting a documentary draft under a credit relinquishes upon its honor all claims to the documents. The period of time within which a bank must act upon a documentary draft is prescribed, together with the procedure to be followed upon proper dishonor. It is provided that, except where explicitly agreed to the contrary, a credit may not be assigned, and provisions are included with respect to the insolvency of a bank holding funds for a documentary credit.

All of these provisions are reasonably explicit, and have received little if any criticism. As a handbook to the use of the letter of credit, they are adequate and are clearly to be preferred to the Uniform Regulations if only because they have the force of law instead of custom only.

B. *Problems Most Frequently Arising in
Use of the Letter of Credit.*

It is to be expected from the nature of the letter of credit that the problem most frequently arising in its use is the sufficiency of the documents presented pursuant to the credit. Should a bank pay or accept a draft accompanied by a set of bills of lading from which a single copy is missing? What discrepancy between the description of the goods stated in the invoice and the description

¹² The provisions referred to in this paragraph are Secs. 5-102(1), 5-111, 5-107, 5-109, 5-112, 5-115, 5-117.

stated in the credit should be regarded as sufficiently material to justify rejection of the documents? Should a bank reject documents when the bill of lading indicates that the containers are slightly damaged? Questions such as these frequently cause no difficulty so long as price levels are rising and goods are in short supply. When, however, buyers are on the alert for means to avoid their obligations, issues of this kind frequently arise.

The proposed Article 5 sets out only the most general principles for the resolution of controversies of this nature. It provides in § 5-107 that "a documentary draft which meets the terms of the relevant irrevocable credit must be honored." It states that "unless otherwise agreed a bank called upon to pay or accept under a credit is required to examine documents with care so as to ascertain that on their face they appear to conform to the terms of the credit . . ." These provisions suggest that literal correspondence between the documents and the credits is contemplated. Section 5-102 (3), however, provides that "in construing this Article reference may be had to uniform customs among banks." The comment to this section indicates that the Uniform Regulations of the International Chamber of Commerce are to be regarded as "excellent evidence" of custom, but that it is the custom "actually existing" when the question arises and not that set forth in the Uniform Regulations which is to govern. It is at least arguable that it is customary among banks to accept something less than literal correspondence of the documents to the credit. The precise degree of compliance contemplated by Article 5 is thus left an open question.

Article 5 contains only two specific provisions which are of assistance on this issue.¹³ It provides that an issuing bank is not excused from honor of a documentary draft which meets the terms of an irrevocable credit by reason of a general term that all documents must be satisfactory to it. And it authorizes a bank seeking to obtain payment, acceptance, negotiation or reimbursement under a credit to give indemnities to induce such action. This provision does not resolve the much discussed question whether payment of a draft must be made when the accompanying documents have slight deficiencies but an indemnity from a bank guaranteeing against loss arising from them is supplied.¹⁴ It does, however, dispose of lingering doubts about the power of certain banks to make guarantees of this kind.

The failure of the draftsmen of Article 5 to spell out the circumstances under which banks should accept documentary drafts not strictly complying with the terms of the credit has been criti-

¹³ Sections 5-107 (1) and 5-113.

¹⁴ For a discussion of this problem see Backus and Harfield, *Custom and Letters of Credit*, 52 COL. L. REV. 589 (1952).

cized. In view of the detail of the Uniform Regulations, the decision to include only the general principles in the Code must have been a considered one. It seems to us to have been a wise one. Even if it were possible to formulate standards of sufficiently universal applicability to be included in an American uniform code without creating undue confusion in international practice, the letter of credit has until recently been too little used to make it desirable to crystallize its use.

Apart from the question whether the documents submitted meet the terms of the credit is the question whether the goods which are represented by the documents comply with the contract of sale. As pointed out above, it is fundamental to the operation of the letter of credit that it is a dealing in documents and not in goods. Article 5 therefore provides that nonconformity of the goods to the underlying contract is immaterial to the obligation of the bank to honor documentary drafts which comply with the credit and does not excuse a bank or a customer from reimbursement for such drafts.¹⁵ The buyer is not, however, left entirely remediless against the dishonest seller. If the documents are forged or fraudulent the buyer is authorized to obtain an injunction against honor or reimbursement, unless the person demanding honor or reimbursement has himself honored or paid in good faith reliance on the documents. If enjoined, a bank must refuse payment; in the absence of such injunction an issuing or confirming bank has the option either of paying upon the documentary drafts, or refusing payment and relying upon forgery or fraud as a defense in an action by the beneficiary.

These provisions, while on the surface unusual, make the best of a difficult situation. What constitutes "fraud" is not spelled out in Article 5; presumably, it is such a wide discrepancy between the goods themselves and those specified in the documents as is beyond the bounds of honest mistake. Quite properly, banks are not required at their peril to determine whether such a discrepancy or a forgery exists. Equally properly, a buyer is given as much protection from dishonesty of the seller as is consistent with limiting the bank's responsibility to the apparent condition of the documents.

C. *Liabilities of the Parties.*

A second point of criticism of the proposed Article 5 is that it relieves banks from responsibilities which are properly theirs.¹⁶ In its liability provisions Article 5 reflects the terms of the Uniform Regulations. Under these sections a bank which has entered into an irrevocable credit with its customer cannot avoid its obliga-

¹⁵ Section 5-111.

¹⁶ Section 5-116. Apparently through oversight, the liability of a confirming as well as an issuing bank was not made explicit.

tion to pay or accept the prescribed documentary drafts without the consent of the customer, and, if he has been notified of the credit, the beneficiary. Except where otherwise provided in the letter of credit, liability is imposed upon a bank for accepting documents which do not comply with terms of the credit and for rejecting documents which do comply with its terms. Banks which merely advise a beneficiary of a credit, without confirming the credit, assume obligation for the accuracy of their statements. So far as these provisions go, they are merely a statement of familiar contract principles. The criticism of Article 5 is directed to limitations on the extent of these liabilities, and to the fact that Article 5 does not afford remedies not available at common law.¹⁷

The most important of these limitations is that in no event shall recovery against a bank for improper dishonor or repudiation of a credit exceed the amount of the draft or credit as the case may be. The limitation does not restrict recovery through any of the remedies of a seller other than a damage action, and such remedies—generally sale of the goods—are expressly made available. But the limitation does prevent a buyer from recovering against the bank perfectly foreseeable damages resulting from the improper honor or improper dishonor of documents presented to it. This limitation makes the bank's liability less for a default with respect to a letter of credit than for the dishonor of a simple check. In the latter case, both the present Ohio Code and the proposed Uniform Commercial Code permit the recovery of actual damages even though the bank acted in good faith.¹⁸ It is difficult to see the justification for this difference, particularly since the letter of credit transaction is more nearly tailor-made than the honoring of a check, and the consequences of an error should be more clearly apparent to the issuing or confirming bank.

Two defects of omission in the liability sections have been charged. One is based on the undeniable fact that it is often procedurally difficult for a seller or buyer to bring an action against a bank in another country. The remedy for this—making a bank responsible for mistakes of its correspondents—is worse than the disease, for it could only tend to restrict letter of credit business to larger institutions. The other asserted defect is the possibility that lack of privity of contract may defeat a buyer seeking to recover from a confirming or advising bank. It has more substance, and the risk might well have been averted by explicit recognition

¹⁷ For a statement of these criticisms see Comment, 52 *YALE L. J.* 227, 254-62 (1953).

¹⁸ Uniform Commercial Code Sec. 4-402. *OHIO REV. CODE* § 1105.11 (710-132).

that each bank participating in a letter of credit transaction is responsible for injury caused to any party to the transaction.

CONCLUSION

No statute can please everyone. The defects of the proposed Article 5 are not substantial when weighed against its accomplishments. On the whole, the proposed uniform Article on Documentary Letters of Credit is successful in making this useful commercial device understandable and reliable. The Article is not a set of rules that will answer every question that will arise. It is a framework which will permit the letter of credit to be widely used with confidence without either preventing further development in letter of credit practice or injecting inconsistency between users of documentary credits in this country and abroad.