Pace International Law Review

Volume 7
Issue 1 *Winter 1995*

Article 3

January 1995

Letter of Credit Transactions: The Banks' Position in Determining Documentary Compliance - A Comparative Evaluation under U.S., Swiss and German Law

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LETTER OF CREDIT TRANSACTIONS: THE BANKS' POSITION IN DETERMINING DOCUMENTARY COMPLIANCE. A COMPARATIVE EVALUATION UNDER U.S., SWISS AND GERMAN LAW.

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INTRODUCTION

Recognizing that the letter of credit device plays a dominant role in the execution of a great number of transactions at the international as well as national levels, the intent of this work has been to focus on the bank's position in dealing with documents. Two parties agree on a deal, they know the terms of their agreement and, for different purposes, they decide to involve a third party, generally a bank, to help them in the execution of the respective obligations. The bank is assigned the role of executing the payment when certain documents are delivered and, based on this simple assumption, the parties define the documents to be delivered to enact payment. The approach is the one of setting an intermediary in a neutral position and with only executory powers.

But does it really happen that way? When this issue was first approached, there was only an instinctive perception of the fact that banks are not, and could not, be deprived of any and all judgment power. The question became whether the bank, at the same moment when documents are delivered, loses its neutral and independent position and becomes an interested party to the transaction; an entity that disposes of great power with respect to the parties to the underlying transaction, and a party that has its own interests in relation with the execution of a deal in which it was not originally involved.

External circumstances render that party, originally conceived as neutral, a player actively interested in the development of the transaction. Since the issuance of the letter of credit, many elements may have changed, customers may be experiencing economic difficulties, the guaranties received for the delivery of the letter of credit may turn out to be insufficient, the political situation in the different countries involved may have changed, prices may have dropped, and so on. The bank may face the desire not to comply with the obligations undertaken in the letter of credit, for example experiencing pressure from its customer not to comply with those obligations. On the other side, and for different reasons, the bank may face the pressure or desire to comply with the undertaking of the letter of credit, even if it should not.

Under those circumstances, the bank disposes of an extremely powerful instrument: its right/obligation to examine

the documents' compliance with the terms of the letter of credit. The bank's decision taken in this process determines the satisfaction of the interests of all the parties involved in the documentary transaction, the parties to the underlying transaction as well as the bank itself. Thus, a more detailed examination of the mechanism under which the documentary transaction develops, the rules governing the relationship among the parties, and the principles actually involved in the process of the compliance exam was explored. As a result, it was decided not to limit this study to the U.S., but also to consider the international dimensions of this device. Therefore, a comparison of the doctrines admitted by the law of two European countries particularly involved in this kind of banking activity was in order: Germany and Switzerland.

CHAPTER I
GENERAL ASPECTS OF THE DOCUMENTARY TRANSACTION[1]

Documentary transactions, i.e. documentary credits,[2] documentary collections,[3] and bank guarantees,[4] were conceived under different structures to serve different goals. Depending on the needs of the parties, documentary transactions may involve credit from the bank or have only an executory function. Whichever the choice may be, as the qualification implies, documentary transactions always involve the delivery of documents as a condition for the execution of the bank's obligation, the payment.

Before entering an evaluation of the bank's position in determining the documentary compliance, it is necessary to discuss in general terms the different kinds of instruments

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[1] The literature on the subject of letters of credit is rich and broad. The most recent monograph related to U.S. law is: JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS (2d ed. 1991). Exhaustive references may be found in: F. EISEMANN/R.A. SCHUTZE, DAS DOKUMENTENAKKREDITIV IM INTERNATIONALEN HANDELSVERKEHR (3d ed. 1989), for the German approach; and G. GAUTSCHI, KREDITBRIEF UND KREDITAUFTRAG, MAKLERVERTRAG, AGENTURVERTRAG, GESCHAFTSFUHRUNG OHNE AUFTRAG ARTIKEL 407-424, *in* BAERNER KOMMENTAR, 2. ABTEILUNG, 5. TEILBAND (1964), for the discussion of the Swiss perspective.

[2] *See infra* Chapter I, part B.2.c. "Credit which is extended on documents of title or other legal documents." BLACK'S LAW DICTIONARY 482 (6th ed. 1990).

[3] *See infra* Chapter I, part B.2.a.

[4] *See infra* note 10.

available to the parties to a business transaction, and the most common documents involved in the execution of the bank's undertakings. The following notes are not intended to analyze in detail the different devices, but to provide basic elements for a discussion of the topic.

A. *The Goals of the Documentary Transaction*

Although capable of supporting practically any kind of business operation, documentary transactions have been developed since the Middle Ages in connection with the trade of goods at the international level.[5] Growing economic interdependence and new transportation possibilities have created a market that has no frontiers, thus increasing the need for security both on the part of the seller and buyer. Individuals and companies have found themselves dealing with partners of whom they know little, who are located in distant countries with often insecure political and economic situations. Furthermore, the dynamism of the actual economy creates a need for financing that requires a guarantee of payment at a time and for an amount that must be certain.[6] The principal and most important task of

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[5] The use of bills of exchange in international trade was already developed in Europe by the twelfth century as a consequence of the danger in transporting gold and because of the difficulties in finding currency. A document instructing a third party to pay a certain amount to the bearer for the account of the issuer was of practical use in substituting currencies and was not attractive for brigands and pirates in search of gold. In short, the buyer gave to the seller an order from himself, as a creditor, to one of his debtors directing the payment of the debt to a third party, the third party being the seller. It was not before the seventeenth century that the bill of exchange had matured in England to a negotiable instrument in connection with a form of letter of credit. *See* W. BEWES, THE ROMANCE OF THE LAW MERCHANT 44-51 (1923) (for a discussion of the historical background of the letter of credit).

[6] Practical needs of the business community are emphasized in bank pamphlets illustrating the services provided by financial institutions to assist international trade transactions. These publications are conceived for parties with little or no knowledge of the legal implications of this type of financing, and generally tend to underline the factual mechanisms involved. These pamphlets are very useful in understanding the approach of the bank in terms of its involvement in the operation. Banks recognize the existence of a gap in the business relationship between the parties to a trade and offer to fill it by providing executory assistance while at the same time leaving the parties in control of the transaction. *See also* UNION BANK OF SWITZERLAND, LEAFLET NO. 961.02 e, DOCUMENTARY CREDITS DOCUMENTARY COLLECTIONS BANK GUARANTEES (1988); CITIBANK, N.A., INTRODUCTION TO COMMERCIAL LETTERS OF CREDIT (1987); INTERNATIONAL CHAMBER OF COMMERCE, ICC PUB. NO. 415, GUIDE TO DOCUMENTARY CREDIT OPERATIONS (1990).

documentary transactions is therefore to provide security to the parties with respect to the fulfillment of the reciprocal financial obligations. Next to that, the involvement of the bank as a credit institution through the issuance of letters of credit offers an opportunity to finance the manufacture and the import/export of goods as well as other unrelated projects. Having a guarantee of payment, the seller may find a financing source which would not have been open to him if he had to wait for a future, unguaranteed, payment. At the same time, the buyer has the opportunity of further trade, i.e. selling the goods, before even paying for them.[7] Therefore, at a certain level, the bank assumes a more active role than that of a mere executor of the obligations of a party, i.e. its function is not limited to act in the name and for the account of that party. Through the letter of credit transaction, the bank indirectly enacts a financing process which allows the customer further options to pursue new ventures and new business opportunities, thus actively participating in his business life.

Therefore, next to the security function common to all documentary transactions, the letter of credit device accomplishes a further task, the extension of credit.

B. *Instruments Securing Performance and Payment*

Before entering a description of the letter of credit, it is opportune to briefly mention the general forms of security available to insure execution of an agreement. They all involve delivery of some kind of document but are designed to serve different needs for different relationships. Generally speaking, they are conceived to be an easy mechanism, they are less secure than letters of credit, and they differentiate from the latter by requiring documents in simplified form or personally drafted by the beneficiary.

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[7] The letter of credit may become a financing device by implication and a direct instrument of financing considering that "the most important safeguard of a loan is the likelihood that the borrower will voluntary repay [and that the] evaluation of this likelihood calls for mature judgment of the borrower's character, ability and financial status, and of the business outlook." E. ALLAN FARNSWORTH & JOHN HONNOLD, COMMERCIAL LAW 774 (4th ed. 1985). Conversely, the letter of credit may be used to cause the issuance of a second letter of credit, directly dependant from the first, in a specialized form called "Back to Back." *See infra* note 29.

1. *Devices to Secure the Performance*

The bid bond[8] and the performance bond[9] belong to the broad category of bank guarantees.[10] The basic difference from the letter of credit resides in the fact that the latter is conceived as a device assisting the performance, while bank guarantees are designed to provide their effects in the event of non performance.[11]

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[8] The bid bond is a guarantee established in connection with international tenders and is designed to guarantee the fulfillment of the offer, i.e. that the contract will be executed if awarded. It grants the beneficiary protection against the backing out of the offeror, i.e. against withdrawal of the offer before its expiration date, non acceptance of an awarded contract, or refusal of substitution of the bid bond with a performance bond after the contract has been awarded. *See, e.g.*, Briggs v. Briggs, 432 So. 2d 1265 (Ala. 1983). The bank undertakes to pay on first demand against documents executed by the beneficiary himself: a formal request for payment, a declaration that the offeror has not complied with the conditions of his offer, and a statement certifying that the signatures in the request and in the declaration are sufficient to bind the beneficiary. Generally speaking, the type and qualification of the documents to be delivered is already included in the form provided by the bank and is not subject to negotiation. The simplicity of the documents requested makes the payment automatic and without problems related to the document's contents. *See* UNION BANK OF SWITZERLAND, *supra* note 6, at 87 (to see a specimen of a bid bond form).

[9] The performance bond rests on the same concept as the bid bond, but guarantees the execution of the contract between offeror and beneficiary pursuant to the terms of their agreement. *See, e.g.*, KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10 (2d Cir. 1979). The bank's obligation arises by breach of contract and usually covers 10% of the contract amount (the bid bond generally covers only 1-5% of the amount of the offer, UNION BANK OF SWITZERLAND, *supra* note 6, at 81). Under the terms of the performance bond, payment is caused by delivery of the same documents as for the bid bond, with the difference being that the declaration of the beneficiary has to state the intervening breach of contract. *See* UNION BANK OF SWITZERLAND, *supra* note 6, at 87 (to see a specimen of a performance bond).

[10] The bank guarantee may be defined as the irrevocable obligation of the bank to pay to the beneficiary an amount agreed in advance in case of realization of a certain condition. The condition is the event of non performance of the underlying contract by the bank's customer. The guarantee is independent from the underlying contract, but creates a separate agreement between the bank, its customer and the beneficiary. The particularity of the bank guarantee is the clause of payment on demand, i.e. the mechanism that enacts the obligation of the bank by a mere declaration of non performance issued by the beneficiary. In 1978, the International Chamber of Commerce published the Uniform Rules for Contract Guarantees, but those guidelines did not find wide acceptance. On bank guarantees, *see generally* TUTO ROSSI, La garantie bancaire a premiere demande: Pratique des affaires, droit compare, droit international prive (1990).

[11] In the U.S., banks are not allowed to guarantee the performance of another party. The letter of credit structure has therefore been adopted by U.S. banks to achieve the same result: the standby credit, a specialized type of letter of credit discussed in footnote 24, allows banks to provide the same service without using

2. *Devices to Secure the Payment*

There are three main groups of devices conceived to secure payment from the obligated party: the documentary collection, a device in which the bank acts only as intermediary; the letter of indemnity, which represents another form of bank guarantee; and the commercial letter of credit, the most secure and popular among the documentary transactions, which will be discussed separately. The choice among those options depends essentially on the degree of trust among the parties, although considerations related to the bank's fees and the degree of complexity of the device also play a role.

a. The Documentary Collection

The documentary collection is a request by the seller to his bank to collect from the buyer a certain amount of money,[12] or the accepted bill of exchange,[13] against transfer of the shipping documents, together with the other documents specified in the order, as the case may be. Payment may be made in cash or by acceptance of a bill of exchange. The bank is mere executor of the customer's instructions and does not assume any liability for payment.[14]

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the bank guarantee device. In short, the standby letter of credit is a guaranty derived of the bank's secondary liability which is typical of the guaranty structure. *See* DOLAN, *supra* note 1, at 12.02[1][a]-[c]; ROSSI, *supra* note 10, at n.70-72.

[12] The release of documents against payment is a device in which the collecting bank is allowed to release the documents to the buyer only against cash payment in the prescribed currency. The release of the documents by the bank is conditioned on the ready and free availability of the amount paid. *See* INTERNATIONAL CHAMBER OF COMMERCE, ICC PUB. NO. 322, UNIFORM RULES FOR COLLECTIONS, arts. 11 and 12 (1978).

[13] The release of documents against acceptance is a device that requires the bank to release the documents to the buyer only against acceptance of a bill of exchange. The buyer can take delivery of the goods by simply signing the draft, which represents the only security of payment for the seller. He must therefore be extremely cautious before entering this kind of agreement. *See* INTERNATIONAL CHAMBER OF COMMERCE, ICC PUB. NO. 322, UNIFORM RULES FOR COLLECTIONS, arts. 10 and 15 (1978). A modified version of this device is the so-called collection with acceptance-release against payment in which the bank presents a bill of exchange to the buyer for acceptance but will deliver the documents only at maturity against payment.

[14] In order to facilitate the uniform interpretation of expressions and terms in international trade, the International Chamber of Commerce has published the UNIFORM RULES FOR COLLECTIONS, ICC PUB. NO. 322 (1978). Although not to the same extent as the U.C.P., these rules have obtained broad acceptance especially

This device may be convenient when there are no doubts about the ability and willingness of the debtor to pay and when the political, economic, and legal conditions in the buyer's country are stable.

With respect to the exam of documentary compliance, the rules are somewhat different from the ones applicable to the letter of credit.[15] In the documentary collection, the bank is not involved in the underlying transaction and does not consider it in its performance of the terms and conditions of that contract. Any liability exceeding the violation of the duties of reasonable care and good faith therefore tends to be excluded.[16]

b. The Letter of Indemnity

The letter of indemnity is a payment guarantee which is based on the same principles as the ones applied to the bid and

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in the most active financial countries. *See* INTERNATIONAL CHAMBER OF COMMERCE, DOCUMENT NO. 470/664, UNIFORM RULES FOR COLLECTIONS (1991)(for a detailed listing of the countries and territories in which, as of December 5, 1991, banks have indicated their adherence to the Uniform Rules for Collections).

[15] "Banks must verify that the documents received appear to be as listed in the collection order and must immediately advise the party from whom the collection order was received of any document missing. Banks have no further obligation to examine the documents." INTERNATIONAL CHAMBER OF COMMERCE, DOCUMENT NO. 470/664, UNIFORM RULES FOR COLLECTIONS, ART. 2 (1991). The rule appears to be stricter than the one for the letter of credit, which requires that the bank examine the documents ". . . to ascertain that they appear on their face to be in accordance. . ." with the terms of the credit. INTERNATIONAL CHAMBER OF COMMERCE, ICC PUB. NO. 400, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, art. 15 (1983); hereinafter referred to as U.C.P. It appears that under a documentary collection, the bank has only to verify that the denomination of the documents comply with the description on the agreement with its customer and does not have any obligation to check the contents of said document. The negative consequences of such a strict obligation with respect to the compliance verification is partially mitigated by the express duty of the bank to act in good faith and with reasonable care. INTERNATIONAL CHAMBER OF COMMERCE, DOCUMENT NO. 470/664, UNIFORM RULES FOR COLLECTIONS, art. 1 (1991). The bank can therefore not completely ignore the contents of the documents in cases in which such contents can be easily recognized. The same duty is not provided in the U.C.P., which under art. 15 only requires "reasonable care." *See* INTERNATIONAL CHAMBER OF COMMERCE, ICC PUB. NO. 400, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, art. 15 (1983). For the discussion of the bank's duties of care and good faith in the letter of credit transactions. *See infra* Chapter III.

[16] *See supra* note 15. For a general view of the general exclusion of bank liability see arts. 3, 4, 5, and 6 of the INTERNATIONAL CHAMBER OF COMMERCE, ICC PUB. NO. 322, UNIFORM RULES FOR COLLECTIONS.

performance bonds.[17] The difference here is that the bank's obligation is related to the performance, i.e. the payment of the agreed price and not of an amount of money as compensation for breach of the performance requirements.

The letter of indemnity may secure either the price of the goods in case the buyer refuses the payment or the refund of an installment executed by the buyer prior to the shipment (generally payments executed in order to allow the seller to buy raw materials or otherwise cause the manufacture of the goods sold). In addition, with letters of indemnity, the documents to be delivered to the bank are directly issued by the beneficiary, thus eliminating the main risks of discrepancy and noncompliance.[18]

c. The Commercial Letter of Credit

The commercial letter of credit is a written undertaking by a bank (following the terminology of Article 5 of the Uniform Commercial Code ("UCC"),[19] hereinafter sometimes also referred to as issuer) to the benefit of a beneficiary, generally a seller of goods, at the request and upon instructions of its customer, usually the buyer, to pay at sight or at a pre-determined future date a certain sum of money up to a stated amount, against delivery of the stipulated documents.[20] The issuing bank commits itself to place at the beneficiary's disposal, on behalf of the customer, an agreed amount of money. When the beneficiary receives notification of the issuance of such a credit he knows that a third party, unrelated to the underlying transaction, will cause the payment as soon as he delivers the documents agreed upon. At the same time, the buyer knows that the documentary credit amount will be released only upon delivery of the documents, thus making the execution of the underlying agreement nothing more than a typical cash-on-delivery transaction.[21]

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[17] *See supra* notes 8 and 9.

[18] *See* specimen of letter of indemnity in case of nonpayment *in* UNION BANK OF SWITZERLAND, *supra* note 6, at 83.

[19] *See* U.C.C. art. 5.

[20] *See* INTERNATIONAL CHAMBER OF COMMERCE, *supra* notes 6 and 12.

[21] *See infra* Chapter II for a discussion of the letter of credit's mechanism.

Depending on the degree of trust and confidence, the parties dispose of two different forms of commercial letters of credit: revocable,[22] which does not provide the beneficiary with any particular form of security; and irrevocable,[23] which may involve the undertaking of a second bank, in addition to the issuer, and which represents the most secure among the letter of credit types.

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[22] The revocable letter of credit can be canceled or amended at any time prior to payment, at will and without warning or notification. This form does not give any security to the beneficiary and all the advantages are to the benefit of the buyer, who disposes with absolute flexibility. We cannot agree with the assertion that an advantage of the revocable letter of credit is "the rapid and convenient way they enable payment" unless this advantage is deemed to be common to all unconfirmed letters of credit. *See* UNION BANK OF SWITZERLAND, *supra* note 6, at 15. There is no difference in the rapidity and convenience of payment under the revocable or the irrevocable letter of credit: both devices require the documents to be delivered under the same conditions and examined by the bank with the same level of scrutiny. We can see an increased rapidity of payment comparing both of them to the confirmed letter of credit because the latter requires transfer of the documents and wire of the money through an additional entity, the confirming bank. It is to the banks advantage to issue a revocable, instead of irrevocable, letter of credit. The bank's commitment can then be revoked if the needs of the bank dictate. This could happen in the case of insufficient collateral as well as in other situation in which, despite the willingness of the customer to accept the documents and cause payment of the beneficiary, the bank fears that it may not be able to recover the amount to be paid under the letter of credit. Therefore, the beneficiary will accept a revocable letter of credit not only when he has absolute trust in the buyer, but also when he trusts the issuing bank.

[23] Under an irrevocable letter of credit, the issuing bank commits itself irrevocably to honor its obligation under the letter of credit upon full compliance by the beneficiary with all the credit conditions. There are two forms of irrevocable letters of credit; the unconfirmed and the confirmed. The irrevocable unconfirmed letter of credit offers a commitment to pay only on the part of the issuing bank. When the irrevocable letter of credit involves a third bank, the advising bank, it is only to act on behalf of the issuing bank for administrative purposes, such as the notification of the letter of credit to the beneficiary, the collection and transfer of the documents, and the payment of the money to the beneficiary when received from the issuing bank. For the beneficiary, the irrevocable confirmed letter of credit represents the most secure device because it offers an unconditional undertaking by two entities; the issuing and the confirming bank. In confirming the credit, the advising bank enters into a commitment to pay that is independent of, and in addition to, the issuing bank's commitment. The confirming bank undertakes to honor its commitment regardless of whether the issuing bank is in a position to reimburse it, thus granting the beneficiary an additional guaranty of payment.

d. Specialized Types of Letter of Credit

Although they utilize the same basic mechanism as the standard letter of credit, the specialized types have been designed to satisfy specific needs in the business world. Apart from the standby letter of credit,[24] which has been developed specifically to overcome the legal obstacle of the prohibition for banks to issue guaranties, the specialized types of letter of credit are designed to provide efficiency to certain transactions.[25] Among the most popular specialized letters of credit are the revolving credit,[26] which allows the rationalization of

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[24] The standby letter of credit operates as a traditional letter of credit transaction with the difference that the issuer is called to pay only when the underlying transaction goes wrong. *See* E. ALLAN FARNSWORTH & JOHN HONNOLD, *supra* note 7, at 467. Payment is therefore not automatic but is conditional to an event which is uncertain and, as often the case, the bank may never be called to execute the payment. The standby credit is often used in sales transactions to provide the buyer with a guarantee of performance by the seller, thus providing the same service as the performance bond. *See* American Bell Int'l, Inc. v. Islamic Republic of Iran, 474 F. Supp. 420 (S.D.N.Y. 1979). In the U.S., where the performance bond is a contract dependent on the underlying transaction, the standby letter of credit has the advantage that the bank is not concerned with the determination of the obligor's default. This allows the beneficiary to receive payment upon presentation of a simple declaration of default and without having to go through judicial establishment of the right to be indemnified (note that the mechanism of the standby letter of credit is the same as the one of the performance bond as it is known in Germany or in Switzerland). The development of the surety business by U.S. banks has created a similar structure, though under a different name. Thus, the standby letter of credit serves many purposes: to provide liquidity, to substitute traditional credit forms, to reduce credit costs, to shift litigation costs, and to cause prompt payment. *See* DOLAN, *supra* note 1, at 1.06, for a description of the different options offered by the standby credit and for an illustration of the variety of applications. With the standby letter of credit, the bank provides a guaranty without incurring the risk of having to pay without being indemnified, as may happen to the traditional surety company. If the customer becomes insolvent the bank may be compensated from the security or from the customer's account. The standby letter of credit becomes, in practice, a form of secured loan to the benefit of the customer. *See* Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 Stan. L. Rev. 716, 721 (1973).

[25] In addition to the types of letters of credit generally present in the international market, each country has developed forms connected to the needs of the national clients and the public services. In the U.S. the Agency for International Development utilizes letters of credit to finance the foreign aid, and has done so since the early days of the Marshall Plan. Under the administration of the Department of Agriculture, the Commodity Credit Corporation finances the export of agricultural commodities by mean of special types of commercial letter of credit. *See* CITIBANK, *supra* note 6, at 35.

[26] This form of letter of credit is adopted in cases of transactions involving shipment of goods on a continuing basis and payment of the total price in multiple

medium to long term deals, involving individual payments for multiple shipments; the red clause credit,[27] a high risk form of financing; the transferable credit,[28] which also provides the beneficiary with an indirect financing opportunity; and the back-to-back credit,[29] which is used as a basis for the issuance

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installments of similar amounts. The revolving credit is not designed to cover the full value of goods agreed upon, but the value of the individual shipments to be executed at different times. *See* Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230 (5th Cir. 1983)(an example of revolving credit). Technically the beneficiary receives a letter of credit for the amount of the highest installment. At the execution of each shipment he may draw the corresponding amount without causing expiration of the letter of credit. The credit may revolve in relation to time, i.e. up to a certain amount for a specified number of times during a certain period, or in relation to value, i.e. for a certain amount to be reinstated each time for a certain period. *See* INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 6, at 32.

[27] With the red clause credit, whose name is derived from originally being written in red ink, the beneficiary is provided with the right to draw certain amounts of money prior to the execution of his obligation. It is a form of financing representing a non collateralized loan to the beneficiary. Usually it is applied to the benefit of brokers or dealers, who often do not dispose of the amounts necessary to finance the deal. The red clause credit is also used by manufacturers who need to dispose of funds prior to the shipping of the goods in order to start production. *See, e.g.*, National City Bank of N.Y. v. Oelbermann, 298 U.S. 638 (1936). In consideration of the high risk involved in this type of credit, it is important that the buyer has extreme trust in the beneficiary and in his capability to perform the obligations of the underlying contract. There are different methods that the buyer may use to avoid abuses from the side of the beneficiary; the most secure is the issuance of a letter of indemnity, but the beneficiary who requests a red clause credit is probably not in the condition to guarantee a bank for the issuance of such a device. A second possibility is to request the delivery of documents certifying that the money drawn is used for the purposes for which the red clause credit has been granted. *See* INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 6, at 33.

[28] This form of letter of credit allows the beneficiary to transfer all or part of his rights to a third party. It is a financing device particularly useful to middlepersons who need to pay their supplier for the goods which are sold to the buyer in the underlying contract. *See* INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 6, at 34. To be transferable, a letter of credit must specify it on its face, with this proceeding being normally permitted only once. Generally, this device creates problems because of the possible abuses it allows, and because of the fact that the bank which pays to a second beneficiary does not technically comply with the terms of the credit. *See* McGowan, *Assignability of Documentary Credits*, 13 Law & Contemp. Probs. 666 (1948)(for a discussion on the transfer of letter of credit).

[29] The back-to-back credit allows the beneficiary to use the letter of credit as a financing device. In short, the beneficiary who needs to provide guarantees to a third party may pledge the letter of credit to a bank as collateral for the issuance of a second letter of credit. *See* California Overseas Bank v. French Am. Banking Corp., 201 Cal. Rptr. 400 (1984)(for an illustration of the use of the back-to-back credit as a financing device). In this case, it is the bank, and not the customer, as in the case of the red clause credit, that trusts the beneficiary of the first letter of credit and believes that he will comply with the obligations of the first letter of

of a second, unrelated, letter of credit. Despite the different purposes for which they have been designed, all these types of letters of credit involve the delivery of the same basic documents as conditions to the activation of the banks' undertaking.

C. *The Documents*

The documents represent the key element in the functioning of the letter of credit transaction; their availability in conformity with the conditions agreed upon determines the enactment of the letter of credit's effects, i.e. the payment of the amount promised. Documents that comply with the credit conditions, in all respects, make it possible for the credit to function.[30] On the contrary, as it will later be seen, even a small discrepancy may create problems, which will have as the least damaging effect the delaying of the payment. The following discussion is intended to give a summary description of the complexity of the most common documents and a brief outline of the relevant information that they usually give.[31]

1. *The Invoice*[32]

Generally, the invoice is made out to the person or entity specified in the letter of credit, and is prepared by the beneficiary himself, although the specialized letter of credit may often specify third persons. The invoice must contain exactly the same description of the goods as contained in the letter of credit

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credit. It could happen that the bank is called on to pay the beneficiary of the second letter of credit, but is not able to recover the amount of the first credit because its customer did not comply with his obligations. For this reason, banks do not care for this form of credit, and as a matter of practice tend to refuse to issue second credits. *See* INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 6, at 35.

[30] The U.C.P. are very clear in this respect: "In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate." *See* U.C.P. art. 4. The U.C.P. further states that "[a]ll instructions for the issuance of credits and the credit themselves and, where applicable, all instructions for amendments thereto and the amendments themselves, must state precisely the document(s) against which payments, acceptance or negotiation is to be made," thus completely eliminating any possible elasticity. U.C.P. art. 15. It will later be seen how the combination of those principles with the duties of the bank under U.C.P. art. 15 operates on the execution of the letter of credit transaction.

[31] For a more detailed analysis of each document, *see* DOLAN, *supra* note 1, at 1.07[1][a]-[f].

[32] U.C.P. art. 41.

itself.[33] The same, although not required by the U.C.P., should happen with the price, which must be in the same currency and for the same amount per unit. In addition, the invoice has to be drafted in such a way that all its information, i.e. description of the goods, value, individual prices, and delivery terms, agree with those specified in the credit.[34]

2. *The Bill of Exchange*

The most important of the requisites of the bill of exchange is its compliance with the legal requirements of the country in which it is drawn. It must specify all the clauses and notations prescribed in the letter of credit and, if made out to the order of the beneficiary, it must carry the necessary signatures and endorsements.[35] In addition, banks tend to require that the bill of exchange be drawn up in the language of the credit.[36]

3. *Insurance Documents*[37]

When required, insurance documents must expressly state that the goods are insured, usually for their cost of insurance and freight ("CIF") value,[38] plus 10%, beginning no later than the shipping date. They should list the risks for which the credit requires coverage and be made out in the currency of the credit. The insurance documents must be endorsed, when necessary, and represent a very important step because of the protection they offer to the customer as well as to the bank.[39]

4. *Transport Documents*[40]

There are basically three kinds of transport documents which cover the displacement of goods by sea, air, and ground transportation. The marine bill of lading, a specialized form derived from the common bill of lading generally used for ground

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[33] U.C.P. art. 41(c).

[34] Davidcraft Corp. v. First Nat'l Bank of Md., No. 83 C 5481, 1986 WL 1030 (N.D. Ill. 1986).

[35] North Valley Bank v. Nat'l Bank of Austin, 437 F. Supp. 70 (N.D. Ill. 1977)(holding that the beneficiary's signature is necessary).

[36] *See* UNION BANK OF SWITZERLAND, *supra* note 6, at 33.

[37] *See* U.C.P. arts. 35-40.

[38] *See* U.C.P. art. 37(b).

[39] *See* EISEMANN/SCHUTZE, *supra* note 1, 118-121.

[40] *See* U.C.P. arts. 25-34.

transportation, is by and large the most popular document of this kind and has benefitted from extended attention by courts, as well as by regulators.[41] On the other side, the airway bill has acquired more importance in recent years with the development of commercial aviation.[42] A final mention has to be reserved to the postal documents which, although not so intensively present in letter of credit transactions, bear the character of officiality because of the governmental involvement.[43]

5. *Other Documents*

In the process of the negotiation of the letter of credit the parties will generally stipulate the provision of other documents called for as a function of the particularities of the deal. The most common are the following:

- Certificate of Origin;
- Certificate of Inspection;
- Certification of Weight;

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[41] The marine bill of lading is generally issued in the form of a negotiable instrument, i.e. it stands for the goods themselves, and the holder to whom it has been duly negotiated considers and handles it as the equivalent of the goods. It may be issued in bearer or order form, and must mention the name of the carrier, the number of originals issued constituting the full set, and must meet all other stipulations of the credit. The bill of lading is required in "clean" form, i.e. it must not bear any mention concerning the condition or the packing of the goods. *See* Liberty Nat'l Bank & Trust Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n, 218 F.2d 831 (10th Cir. 1955)(discussing the consequences of the "cleanliness" requirement in the compliance's evaluation). The marine bill of lading must state that the goods have been taken "on board" a specified vessel. This mention does not constitute a requirement for the common bill of lading which is acceptable to the extent it mentions that the goods have been taken in charge. *See* U.C.P. art. 25(a)(ii).

[42] The airway bill is issued by the airline or its agent and is a confirmation that the goods have been received for carriage to the destination. U.C.P. art. 25. This document must give all the information on the transport, i.e. the route of the flight, the handling, the name and address of the consignee and the dispositions for delivery. Also, the airway bill must generally be issued in a "clean" form and must conform to the terms and conditions prescribed in the credit. *See* Cooper's Finer's Foods, Inc., v. Pan Am. World Airways, Inc., 178 So. 2d 62 (Fla. Dist. Ct. App. 1965).

[43] Postal documents are generally accepted to the extent that they bear the stamps and official mention from the place stipulated as place of dispatch. U.C.P. art. 30. Because of their official character, which generally depends upon regulations of the postal service of the country of dispatch, these documents are taken out of the control of the parties. Therefore, extensive descriptions of such documents increase the risk that, in the case of changes in the regulations, the beneficiary will find himself unable to provide a complying document.

- Packing List;
- Consular Invoice; and
- Analysis Certificate.[44]

Those documents are generally required in order to provide a maximum of security to the transaction, but often end up complicating the terms of the letter of credit, thus putting the beneficiary in a high risk position. The more documents required, the higher the risk that a compliance problem will arise.[45]

D. *The Issue of Documentary Compliance*

As previously stated, in order to function, the entire mechanism of the letter of credit transaction depends on documents. The beneficiary must present conforming documents if he wants the duty to pay from the side of the issuer to be enacted. The documents must satisfy the conditions of the credit and the bank has a right to inspect them. Following a summary description of the topic of chapter III, this section is intended to give an illustration of the problems that the parties could face in relation to documents.

1. *The Compliance Rules*

However simplistic the documentary transaction may initially appear, in reality, the process is complex. One thing is to agree on the delivery of a certain document, another is to provide it in a way that satisfies the credit conditions. A superficially evaluated decision on the documents to be offered in order to cause the issuer to pay may determine the impossibility for the beneficiary to recover immediate payment, i.e. the failure of the efforts to secure the deal.[46]

That the document must comply with the terms and conditions specified in the letter of credit credit appears therefore to be an easy yet insufficient statement. The issue that the com-

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[44] Examples of the mentioned documents may be found in DOLAN, *supra* note 1, at App. C.

[45] The U.C.P. in art. 5 calls for banks to "discourage any attempt to include excessive detail" in the letter of credit, which excludes a great number of documents. U.C.P. art. 5.

[46] Among others, this is the reason why the U.C.P. insist in art. 5 that ". . . in order to guard against confusion and misunderstanding, banks should discourage any attempt to include excessive detail in the credit or in any amendment thereto." U.C.P. art. 5.

pliance rules attempt to clarify concerns the process pursuant to which the compliance concept can find a practical meaning, i.e. they are designed to give a practical sense to an abstract principle.

The first and generally accepted method of compliance verification is the strict compliance. Pursuant to this rule, to be acceptable the single document must comply word by word with the description specified in the credit. To avoid the inequities of such a mechanical standard, some courts have developed, especially in the U.S. for reasons to be discussed later, the so-called substantial compliance rule. Pursuant to this theory, a document should be accepted, despite discrepancies, when such discrepancies are not misleading and when the inherent compliance is apparent. This rule is based on principles of contracts' law such as "equity" or "substantiality," that have been criticized and which enjoy only a little acceptance with few courts.[47] Finally, in consideration of the critical position of the issuer, but at the same time completely neglecting the interests of customer and beneficiary, a rule called the bifurcated standard has been developed. Pursuant to this method, the bank has a right to obtain from the beneficiary strict complying documents, but at the same time has a right to impose on the customer documents which are in substantial compliance. Whatever happens, the issuer receiving non-strict complying documents is "covered"; the beneficiary may not require the bank to pay even by giving additional evidence of factual compliance or by delivering a letter of indemnity or similar instruments. Conversely, even if the issuer wrongfully pays by substantially complying documents, the customer is barred from invoking a breach of the letter of credit agreement and is obligated to indemnify the bank.

As it will be discussed, neither of the above rules is completely satisfactory. For that reason, although with little success, a modified substantial compliance rule has been developed in the U.S. based on the same criteria adopted by the Swiss and German courts.

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[47] For a specific discussion, *see infra* Chapter III, parts A.2. and B.1.

2. *The Most Frequent Problems*

There are three basic documentary problems that can arise in dealing with letters of credit: an imprecise or excessively detailed description of the required documents; non-compliance of the delivered documents with the description in the application agreement; and fraud in the essence of the documents.

a. Imprecise or Excessively Detailed Description

The problem of imprecise description is directly connected to the issue of compliance. Whenever the description of the required documents in the application agreement is not sufficiently clear, the chances of providing non-complying documents arise. Expressions like "around the middle of September,"[48] "receipt from our rep (who will be appointed later) signed and proving delivery of goods,"[49] "a copy of each instrument causing this establishment of credit . . . to be called upon,"[50] and other similar descriptions,[51] only increase the chances that payment under the letter of credit may not be called for. The same can be said for too precise descriptions. The specification that the customs invoice must refer to "tariff quota category #645,"[52] for example, does not take into account that customs authorities may change such qualifications.

b. Non-Compliance with the Delivered Documents with the Instructions in the Letter of Credit

The judicial literature is full of cases related to the issue of documentary compliance. This problem is probably the one which has given rise to most of the litigation in the documentary credit area. The solution of each issue is connected on one hand to the standard of compliance required and applied by courts in their decisions and, on the other hand, to the different law applicable to the device in each jurisdiction.

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48 BGE 87 II 234 and BGE 88 II 341.

49 BGE 115 II 70.

50 O'Grady v. First Union Nat'l Bank, 250 S.E.2d 587, 599 (N.C. 1978).

51 For other examples of imprecise description in the application agreement, *see* DOLAN, *supra* note 1, at 2.05[4].

52 Barclay Knitwear Co. v. King'swear Enters., Ltd., 533 N.Y.S.2d 724 (N.Y. App. Div. 1988).

This discrepancy was invoked with respect to a draft which recited that it was drawn "under bank of Clarksville Tennessee letter of credit No. 105" instead of "under bank of Clarksville Letter of Credit number 105."[53] In this case, the simple addition of the specification that the bank of Clarksville was in Tennessee, together with the lower case "1" and the abbreviation of the word "Number" into "No.," were enough to raise the compliance issue.[54]

In two similar cases, courts of two different countries have reached the exact opposed result. The first was decided in North Carolina and concerned the presentation of the invoice: the letter of credit required "Invoice Number 0046" but the parties to the underlying contract agreed to its substitution with a different one. Although goods corresponding to the invoice specified in the letter of credit, i.e. the so-called "Invoice Number 0046," were delivered, the bank refused to pay based on the clear discrepancy of the document delivered. The court upheld the bank's position and the seller was not entitled to recover under the letter of credit the price of the goods.[55] The other issue was decided by the Swiss Supreme Court in a case where one of the required documents was not delivered at all, a clear and absolute example of non-compliance. The bank knew that the contract had been performed by the beneficiary but nevertheless refused to pay based on the non-compliance. The court, based on the rules applicable under Swiss law, protected the plaintiff and the bank had to pay.[56]

The two mentioned cases pose an additional problem related to conflicts that may arise in international disputes when two different national courts, called upon to decide on the same set of facts, end up with opposite decisions. Suppose that the Swiss bank was a confirming bank acting on behalf of the North Carolina issuing bank; the beneficiary would have been protected by the Swiss courts and the confirming bank would have

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[53] Tosco Corp. v. FDIC, 723 F.2d 1242, 1247 (6th Cir. 1983).

[54] The court in this case renounced the application of the strict compliance rule and held, based on the substantial compliance theory, that the draft conformed to the credit conditions. *See infra* Chapter III, part A, for a discussion of the different compliance theories.

[55] Dubose Steel, Inc. v. Branch Banking & Trust Co., 324 S.E.2d 859 (N.C. 1985).

[56] BGE 115 II 67.

had to pay despite the absence of a required document. At that point, the confirming bank would have had to go to North Carolina to require indemnification by the issuing bank; a proceeding with few chances of success considering the impossibility of delivering the missing document.[57]

c. False Documents

The issue of the delivery of forged documents calls for the exam of the duty of care of banks in examining the documents. The extent of the bank's responsibility to recognize a document which complies on its face but is false will be discussed later.

A very common form of fraud arises in cases in which, as often occurs with standby letters of credit, the beneficiary is left in control of the activation of the credit, i.e. when the beneficiary may draw on the letter of credit by simply providing a declaration that he is entitled to do so.[58] Frequently, cases appear in which the beneficiary presents forged documents like invoices or bills of lading describing goods which have never been shipped.[59]

The delivery of a false, i.e. forged, document is also a case of non-compliance, and must be mentioned as such, even though its nature goes beyond the scope of this introductory chapter. It is therefore sufficient to remember that banks, in verifying documentary compliance, cannot ignore the possibility of fraud in the documents and, to the extent required by applicable law, they must exercise a certain duty of care.

CHAPTER II
THE LETTER OF CREDIT TRANSACTION

Before entering the discussion of the legal construction of the letter of credit, i.e. the governing laws and the correlation of the different contractual undertakings, the process itself will briefly be explored.

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[57] *See infra* Chapter III, part C.3., for a further discussion of the Swiss case.

[58] *See* Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399 (1st Cir. 1985)(case of a beneficiary providing a declaration that the customer was in default, when, in fact, there was no default at all).

[59] *See* Sztejn v. J. Henry Schroder Banking Corp., 31 N.Y.S.2d 631 (N.Y. Sup. Ct. 1941)(a landmark case illustrating forgery).

A. *The Structure of the Letter of Credit*[60]

The basic operation involving a letter of credit develops in eight different stages:

1. Customer and beneficiary, generally buyer and seller, enter the so-called underlying agreement. They define the terms of their contract and, together with the terms of the deal, they agree to the execution of a letter of credit to cause payment against delivery of certain documents.
2. The customer contacts his bank and applies for the issuance of a letter of credit in favor of the beneficiary. The bank provides the customer with an application form which includes, preprinted, the general terms of the letter of credit agreement. Usually those terms are decided by the bank unilaterally and include, in the three countries here under discussion, the U.C.P. rules as well as other rules of a contractual nature which determine the relationship between the parties. The customer, next to the general information about the names and the amount of the credit, specifies the documents to be provided by the beneficiary.
3. Upon receipt of the letter of credit application, the bank prepares the instrument, thus causing execution of the letter of credit agreement with the customer and accepting the function of issuing bank. The letter of credit is then sent to a bank in the place where the beneficiary operates. This bank is considered an advising bank to the extent that its role is limited to that of agent for the issuing bank, and is a confirming bank in cases in which it undertakes an independent obligation to pay.
4. The advising/confirming bank forwards the letter of credit to the beneficiary, thus activating the issuing bank's obligation to pay against delivery of conforming documents.[61] The right of the beneficiary to obtain payment from the issuing bank, and/or from the confirming bank, is established in the moment when the letter of credit instrument is delivered.
5. The beneficiary is now in the position to verify the compliance of the letter of credit with the underlying agreement. This is a very delicate moment because the beneficiary must ascertain if the necessary documents can be provided. Furthermore, he has to prepare the shipment, or undertake any other action that has been agreed to, in such a way that he will then dispose

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[60] *See supra* notes 6, 8, 9 and 10.

[61] The irrevocable letter of credit, *supra* note 23, may be amended until the actual delivery of the letter of credit's documents.

of documents that will enable him to obtain payment from the issuing or sometimes confirming bank.

6. After having executed his obligation, the beneficiary presents the draft with the accompanying documents to his bank. If this is an advising bank, the draft and the documents will simply be forwarded to the issuing bank. In the other case, if a confirming bank, then the bank will examine the documents and, if it finds them to be in compliance, it will pay the draft. The documents will then be forwarded by the confirming bank to the issuing bank with a request for indemnification.
7. The issuing bank receives the documents and verifies them to ascertain compliance. In the affirmative case, the issuing or the confirming bank cause payment of the letter of credit amount to the beneficiary.
8. Finally the documents are forwarded to the customer, who also examines them for compliance before executing the indemnification of the issuing bank.

The above sequence of events clearly demonstrates the particularity of the letter of credit transaction; the seller in such a transaction receives payment before the buyer actually pays and, for a certain period of time, the goods are under the control of the bank. In other words, the underlying contract is totally performed before one of the parties, the buyer, has actually executed his obligation. The issuing bank has taken his position, thus substituting the customer and executing the obligation of the underlying agreement in its name, but for his account.

B. *The Governing Laws*

Because of the legal implications that it causes, the determination of governing law is an issue of primary importance. All the countries that will be considered, the U.S., Switzerland, and Germany, have chosen different solutions. The U.S. exemplifies the most developed of regulations specifically designed to govern the letter of credit. Switzerland and Germany, following the civil law tradition, have integrated the letter of credit in the existing body of regulations concerning contracts.

Before entering the analyses of the governing law in the three countries, a characterization of the U.C.P. rules, which are generally applied despite their private character, is in order.

1. *The Uniform Customs and Practice for Documentary Credits (U.C.P.)*

The U.C.P. are a set of rules of conduct embodied in a code of practice which has found general acceptance in a wide section of the business community.[62] Having been issued by a private organization, the International Chamber of Commerce, they do not have the character of law, and even cannot be held as le mercatoria,[63] although, thanks to their worldwide recognition and application, they are perceived as having such a character.[64]

Their private character makes them applicable only when expressly incorporated in the letter of credit.[65] Nevertheless, their worldwide application and recognition in the business world may determine by implication their application to supple-

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[62] The U.C.P. have been adopted worldwide either by the national banks' organizations or by the individual bank institutions. Where the adoption is declared by the national organization, as in the U.S., Switzerland, and Germany, all the banks are bound, i.e. the U.C.P. rules are automatically included in the letters of credit issued by banks in those countries. In the cases of individual adoption, i.e. Puerto Rico, Egypt, the People's Republic of China, etc., the rules will be included only in the credits issued by such banks. Of the 159 countries in which the U.C.P. rules are applied by banks, 76 represent adoption by individual declaration. Recently, the U.C.P. rules have been adopted by East European countries. In addition, in the last part of 1991, three institutions in the former Soviet Union notified the International Chamber of Commerce of their individual adoption. For a list of the countries and territories, as of December 5, 1991, that have notified their adherence to the 1983 version of the U.C.P. *See* INTERNATIONAL CHAMBER OF COMMERCE, DOCUMENT NO. 470/665, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1991).

[63] BLACK'S LAW DICTIONARY 911 (6th ed. 1990). "The law-merchant; commercial law. That system of laws which is adopted by all commercial nations, and constitutes a part of the law of the land. It is part of the common law." *id.*

[64] The large acceptance that the U.C.P. have found in the business and financial communities often create misunderstandings regarding their private character, i.e. they are perceived as a body of law generally applicable. As an example of the recognition received by the U.C.P., *see* the statement by the United Nations Commission on International Trade Law (UNCITRAL) which, in its declaration related to the publication of the 1983 version of the U.C.P., noted that the U.C.P. "constitutes a valuable contribution to the facilitation of international trade" and recommended the use of those rules "in transactions involving the establishment of a documentary credit." *See* U.N. GAOR Supp. (No. 17), U.N. Doc. A/46/17 (1991).

[65] *See* U.C.P. art. 1, "[these articles] shall be incorporated into each documentary credit by wording in the credit," or U.C.P. art. 12(c), "a teletransmission should clearly indicate that the credit is issued subject to UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, 1983 revision, ICC PUB. NO. 400."

ment the terms of a letter of credit that does not refer to them, thus acquiring force of law.[66]

The U.C.P. are not intended to be a general and complete set of regulations on the documentary credit. On the contrary, their scope is limited only to certain aspects and concentrates upon such areas as communications between the parties, the form of the credit, or the conformity of the accompanying documents.[67] For this reason, even when expressly included in the letter of credit, the U.C.P. alone cannot answer all the questions that may arise in a documentary transaction, thus leaving the solution of unregulated issues to the applicable law of the relevant country.[68]

2. *The Regulation under U.S. Law*

The U.S. is the only country with an extensive specific regulation for letters of credit. Article 5 of the UCC creates a particular form of undertaking subject to an independent regulation, which differs in relevant aspects from the traditional contract laws.[69]

Article 5 of the UCC is designed only to codify the fundamental aspects of documentary credit. The impossibility to resolve all problems and the necessity to supplement the UCC regulations through other sources of law are implicitly stated under UCC § 5-102(3).[70]

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[66] *See* Oriental Pac. (U.S.A.), Inc. v. Toronto Dominion Bank, 357 N.Y.S.2d 957 (N.Y. Sup. Ct. 1974)(for an example of supplementary interpretation).

[67] To the extent that numbers make sense in such a legal evaluation, the 55 articles of the U.C.P. are divided into six chapters, including general and miscellaneous provisions. The most detailed regulation concerns the documents with 21 articles (arts. 22-42), followed by the dispositions on liability with seven articles (arts. 15-21), the ones on form of credits with five articles (arts. 7-11) and the ones on notification of credits with three articles (arts. 12-14).

[68] *See* DOLAN, *supra* note 1, at 11.1; EISEMANN/SCHUTZE, *supra* note 1, at 219-227; GAUTSCHI, *supra* note 1, sub art. 407 at No. 33 and 34 (for a discussion of the jurisdiction issue).

[69] *See* the enforceability without consideration, U.C.C. § 5-105; the independent statute of fraud, U.C.C. § 5-104; the special regulation of time at which credit becomes effective, U.C.C. § 5-106; and the rules on liability for damages in the event of dishonor, U.C.C. § 5-115.

[70] *See* Comment 2 to U.C.C. § 5-102 which admits that "no statute can effectively or wisely codify all the possible law of letters of credit without stultifying further development of this useful financing device."

One of the situations completely neglected by the UCC is when documents, in fact and in law, do or do not comply with the terms of the credit.[71]

It therefore becomes apparent that other sources of law are to be called upon to regulate the letter of credit device. The U.C.P., which have been adopted by all U.S. banks and are therefore generally adopted in documentary credits issued in the U.S.,[72] are the most important rules governing the letter of credit. As discussed above, however, the U.C.P. do not answer all the questions connected to letter of credit transactions. A second source of law is therefore necessary and can be found in a well-developed body of case law directly related to the letter of credit. As a consequence of the complexity of this area, credit law is also insufficient, and some U.S. courts have fashioned additional principles specifically for this kind of transaction. In this process they have found inspiration in the common law of contracts, although this has often produced strongly criticized solutions.[73]

In developing credit law, courts have often taken into consideration the lex mercatoria to the detriment of local law. By doing so, they have admitted the existence of a body of rules especially conceived to satisfy the needs of the financial market, thus obliging them to suspend the application of local rules. Therefore, particularly in the international arena, U.S. courts have adopted an additional source of law to strengthen the letter of credit device.[74]

3. *The Regulation under Swiss Law*

Under Swiss law, documentary credits, i.e. commercial letters of credit, have not been specifically regulated. The Swiss commercial code, which has been subject to modifications, was first adopted on March 30, 1911 as the fifth part of the Swiss

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[71] *Id.*

[72] *See supra* note 62.

[73] Criticisms have been raised in connection with the move toward recognition of the standard of substantial compliance. *See* DOLAN, *supra* note 1, at 6.05; Note, *Letters of Credit: A Solution to the Problem of Documentary Compliance*, 50 FORDHAM L. REV. 848, 855 (1980).

[74] *See* the cases cited in DOLAN, *supra* note 1, at 4.01[2].

Civil Code, and named "das Obligationenrecht"[75] (hereinafter referred to as "OR" or "Swiss Code"). At that time, the social and political reality of the country did not require letters of credit and the drafters of the Swiss Code, who were working from the previously applicable version, did not consider it necessary to include the regulation of a device which was rarely known.[76]

As the country developed its financial sector and banks acquired a dominant position in the national economy, courts had to deal first with the qualification of the letter of credit transaction in order to provide the bank industry with a regulation of the device. The solution was found in the prior regulation, the "Kreditbrief."[77] This rule provided for the combination of two special forms of contract already regulated by the Commercial Code: the "Auftrag,"[78] the mandate (hereinafter referred to as "Auftrag"), and the "Anweisung,"[79] the authorization-to-pay contract (hereinafter referred to as "Anweisung"). These two contract forms have elements which characterize the letter of credit transaction, but by themselves alone would not be sufficient to regulate it. Thus, they are applied in a complementary fashion.[80]

The Auftrag is a form of contract under which a party, with or without consideration, assumes the obligation to execute a service or an activity in the interest and for the benefit of the

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[75] In Switzerland there are three official languages, German, French and Italian. They have a constitutionally granted equal position, although most of the legal material is drafted in German. With respect to the laws themselves, they are adopted simultaneously in the three languages, with each version having the same power.

[76] *See* EUGEN BUCHER, SCHWEIZERISCHES OBLIGATIONENRECHT ALLGEMEINER TEIL OHNE DELIKTSRECHT (1979)(for the history and development of the Swiss Commercial Code).

[77] *See* OR art. 407. This form of credit was regulated in a single article which referred to the two contract types discussed in the following. It was an early form of letter of credit which was conceived to allow debtors to cause execution of payment while in travel away from their place of business. The letter of credit, the payment against documents, as it is conceived today was not the main concern of the drafter of the OR. Nevertheless, the formulation in art. 407 has been conceived in such elastic terms that courts did not have any problems in applying it to the commercial letter of credit. *See* GAUTSCHI, *supra* note 1, 5-15 (for a discussion of the Kreditbrief's concept).

[78] *See* OR arts. 394-406.

[79] *See* OR arts. 466-471.

[80] BGE 114 II 45.

other party.[81] He promises the execution of an act without taking any responsibility for the result. He acts independently with respect to the technical execution of the service, thus an independent contractor, but must follow the instructions of the obligee as to the goals to be reached. Under Swiss law the relationship between the attorney and his client is covered by the Auftrag's rules.[82]

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[81] The definition of the Auftrag is given in OR art. 394:

"By accepting a mandate, the agent is obligated to carry out the contractually agreed business transactions or services with which he has been entrusted.

Contracts regarding the performance of work which cannot be classified as a special type of contract under other parts of this Code of Obligations are subject to the provisions of the mandate law (arts. 394-406).

Compensation is payable if agreed on, or if customary." The relationship originates pursuant to the following norm:

"Unless immediately rejected, a mandate is presumed to be accepted if it refers to services which the agent carries out in an official capacity or on a professional basis, or if he publicly offers the performance of such services." (art. 395).

The scope of the mandate is regulated as follows:

"If the scope of the mandate is not expressly stated, it is determined by the nature of the service to be performed.

In particular, the mandate also implies the authority (art. 32 et seq.) to carry out all necessary acts connected with it performance.

The agent must have a specific authorization, subject to the provisions of applicable Federal or cantonal laws of procedure, to commence a legal action, conclude a settlement, consent to arbitration, enter into engagements based upon bills of exchange, sell or encumber real property (art. 216 et seq.), or to make gifts." (art. 396).

Among others, particularly important is the termination rule which provides as follows:

"A mandate may be terminated at any time by either party revoking or giving notice.

If termination is effected at an improper time, however, the party terminating is liable to the other party for any damages caused." (art. 404).

(Translation by the Swiss-American Chamber of Commerce). This contract is not to be confused with the "Werkvertrag," a contract analogous in the basic structure but which creates the obligation to perform a "result." The werkvertrag has been adopted by the German Courts in the qualification of the letter of credit transaction; *see infra* Chapter II, part B.4.

[82] "Agency, which is also known as mandate (Auftrag/mandat) is the type of contract most influenced by the Roman law tradition. The main feature of the contract is the relationship of loyalty and faithfulness between the parties (*see* the latin origin: "mandatum" from "manum dare", give the hand, sc.) in order to affirm the mutual intention of good faith. A consequence of this is the principle of revocability of the mandate: either party may put the contract to an end if he loses confidence. The main duty of the agent is to safeguard the interests of the principal; he has to follow the instructions of the principal but remains responsible for the ef-

The Anweisung is the authorization, not an order, by an issuer to an addressee to cause, for the issuer's account, payment of the sum of money or delivery of commercial papers or other fungible goods to a certain beneficiary.[83] The authorization is issued independently by the issuer and the addressee has no direct obligation to him. The Anweisung operates by conferring two different rights: the addressee has the rights to execute the performance for the account of the issuer; and the beneficiary, once notified by the addressee, has the rights to obtain performance from the addressee for the account of the issuer.[84]

The commercial letter of credit is the result of the combination of the above two legal devices. On one side, the Auftrag does not confer any right to third parties, i.e. to the beneficiary with respect to the payment. On the other side, the Anweisung does not create any obligation for the addressee, i.e. it does not create an obligation of the issuing bank to cause execution of the payment, as well as any other obligations, towards the customer, peculiar to the letter of credit transaction.

4. *The Regulation under German Law*

Also under German Law the documentary credit is not specifically regulated. Contrary to the OR, the German Code, "Das Buergerliche Gesetzbuch" (hereinafter referred to as "BGB" or "German Code"), does not mention letters of credit, thus leaving the regulation completely in the hands of the courts. The German solution adopts two different contracts to be applied to the relation between issuing bank and customer, and to the relation between issuing bank and beneficiency. The relation between issuing bank and customer is regulated by the "Werkvertrag"[85] through the "Geschaeftsbesorgung" rule,[86] the contract for the execution of the transaction (hereinafter referred to as "Werkvertrag").[87] On the other side, the relations between the issuer and the beneficiary has been qualified as "Abstraktes

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fects of his own acts; he is obligated to oppose if the principal is giving inadequate instructions." *see* BUCHER, *supra* note 76.

[83] *See* BUCHER, *supra* note 76.

[84] *Supra* note 76, at 15.

[85] BGB at 631-651.

[86] BGB at 675.

[87] *See* 1958 BGHWm at 1542.

Schuldversprechen,"[88] the abstract promise of a debt (hereinafter referred to as "Abstraktes Schuldversprechen").[89]

The Werkvertrag is a form of contract generally conceived for the production of an object; under this contract the obligor promises a result, the object, as it has been stipulated in the agreement, and not the performance of a specific service. A contract typically regulated by the Werkvertrag rules is the agreement with an architect.[90] The fact that in the specific case of the letter of credit transaction the bank, by undertaking to issue the credit, to verify the documents, and to pay the beneficiary, also provides a service, i.e. a Geschaeftsbesorgung, renders applicable some of the specific Auftrag rules.[91]

The Abstraktes Schuldversprechen is also a contract and provides for the obligation of a party to pay a certain amount of money to the other. The particularity of this contract is that it does not need to be related to any other undertaking; it is issued by a party and is accepted by the other at the moment that the former decides to call for its execution. The common application is either as a process device, to make it easier for the creditor to provide evidence of the credit, or as a device to provide a new right independent from any underlying agreements. The signature on a delivery amount indicated, and no evidence of the existence of a contract must be given.[92]

Thus, under German law, the regulation of letter of credit transactions flows from the combination of rules designed for two different relationships. The particularity of the German solution is that both relationships on the part of the issuing bank, with the customer as well as with the beneficiary, are qualified as contractual. In the following chapter, the consequences of this construction are discussed for issuing banks, when determining the process of executing the letter of credit.

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[88] BGB at 780.

[89] *See* 1955 BGHWm at 765.

[90] *See* W. J. FRIEDRICH, DAS BURGERLICHE GESETZBUCH, TEXT UND ERLAUTERUNGEN 418 (2d ed. 1987)(for a discussion of the Werkvertrag).

[91] BGB at 663, 665-670 and 672-674.

[92] *See* FRIEDRICH, *supra* note 90, at 440.

CHAPTER III
THE STANDARD OF COMPLIANCE AND THE BANKS' DUTIES

In the introductory chapter,[93] it was demonstrated how the verification of the documents' compliance with the terms of the credit represents a key moment in the execution of the documentary transaction. When the documents are delivered to the bank, the letter of credit is expected to display its effects. There are multiple, sometimes conflicting, interests involved: the beneficiary expects payment in order to execute his obligations toward his creditors; for him every delay in payment is an added cost because he needs to find the temporary financing. The bank, on the other hand, needs to recover the amount it pays without incurring any liability toward the customer. Finally, the customer expects delivery of the goods, for which he agreed in the underlying contract, conforming to the terms of that agreement.

All those pressures, directly or indirectly, are involved in the process of verification of documentary compliance. Suppose that the parties have agreed for the sale of "300 Dressers style Louis XV, manufactured from French Robinia maple" and that this description has been inserted in the letter of credit. Suppose then that the beneficiary has delivered to the bank a bill of lading specifying "300 Bureaux Louis XV style, manufactured from French Robinia maple." In current English, the term "dresser" and the term "bureau" are used for the same item, a special kind of closet, but in French the same term "bureau", is used for an office desk. In such a situation, if the goods are in compliance with the underlying contract, the bank faces a risk of damaging the beneficiary by refusing to pay because of the discrepancy in the terminology. On the other side, the bank may face liability toward the customer if it pays and the goods mentioned in the bill of lading reflect the french definition of the word. Furthermore, the bank may face pressure from a customer who, considering the diminution of the market price of this kind of dresser, may try to use the discrepancy to avoid a contract that is no longer interesting in business terms. Finally, the bank may also face pressures of its own if it discovers

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[93] *See supra* Chapter I, part D.

that the letter of credit is undercollateralized and that the customer is close to filing for bankruptcy.

Those as well as other problems render the compliance exam a very delicate procedure that raises a considerable amount of litigation. This chapter will first focus on the three standards of compliance. The standards applied in the countries that are the focus of this research and the solutions that courts have reached in dealing with the issue will follow. Finally, there will be a discussion of the bank's duty of care as well as its duty to act in good faith to see which implications, if any, these principles have on the process of documents' verification.

A. *The Compliance Theories*

1. *Strict Compliance*

Pursuant to this theory, the bank examines the documents in a mechanical way by "superimposing" the delivered document to the letter of credit terms. Under this process, the bank looks at the words as if they did not have any meaning and they were a mere combination of letters. No interpretation is allowed, required, or expected; a document is correct, thus acceptable, only if it bears exactly the same words that are included in the letter of credit, regardless of casual typing mistakes or the misspelling of names. Only a strict "word to word" adherence to the terms of the letter of credit is accepted.[94]

This method of analysis has proven to be too harsh and sometimes unfair to the beneficiary,[95] but it finds its justification in the necessity to grant to the parties maximum security combined with maximum efficiency.[96]

The requirement of strict compliance sets pressures on the parties so that they agree in advance on exactly what kind of documents they expect to receive or they are able to provide. It is a matter of negotiation in which the bank is not involved, and

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[94] The principle has been conceptualized in the famous holding pursuant to which "[t]here is no room for documents which are almost the same, or which will do just as well," in Equitable Trust Co. v. Dawson Partners, 27 Lloyd's List L. Rep. 49, 52 (1927).

[95] *See supra* note 53, at 1242; and the discussion in Chapter I, part D.2.b. *See also* DOLAN, *supra* note 1, at 6.04[3].

[96] *See* DOLAN, *supra* note 1, at 6.03.

that generally puts the customer in a strong position.[97] The standard of strict compliance gives the maximum protection to the bank and to the customer. The latter needs to be sure that the goods he is going to receive are exactly as expected and paid for, i.e. he pays before being able to see the goods so he needs to have all guarantees that the goods are acceptable. However, the customer also ends up being privileged. On one side, if he is eager to receive the goods, he has the right to cause the bank to accept a non-complying document, thus causing payment even in cases in which there could be a refusal.[98] In contrast, the customer has no obligation to accept any amendment of the letter of credit and he can refuse to authorize the bank to pay against non-complying documents.[99]

The bank benefits from considerable protection because it does not have evaluation responsibilities, thus avoiding any risk connected to a misinterpretation of the documents. The rationale behind the strict compliance rule is that the bank is not involved in the underlying transaction and acts only in its function of credit issuer. It does not know the terms of the agreement between the customer and the beneficiary and is therefore not in a position to judge the contents of the documents. Furthermore, the bank is recognized in its function as a services' provider, operational only in the financial sector and therefore neither familiar with commercial practices nor the language.[100]

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[97] If the beneficiary is not careful enough in the negotiation process, he may find out when it is too late that certain documents cannot be provided or that others can only be provided in a form different from the one originally agreed upon.

[98] In such situations, the customer still needs the agreement of the bank because the latter is bound and controls the letter of credit. It can be taken for granted that if the bank has the slightest doubt, for whatever reason, it will not be indemnified after having paid the beneficiary, it will refuse to enter the amendment of the letter of credit, i.e. it will refuse to pay against the non-complying documents.

[99] This situation allows abuses on the part of the customer. Consider this example, under the assumption that the market price of maple dressers has dropped; the customer could refuse to authorize the bank to pay against the non-complying bill of lading even if he knows that the "bureaux" shipped complied perfectly with the underlying agreement, thus forcing the beneficiary into either lengthy litigation or accepting a settlement for a price under the one agreed to in the contract. The seller, in such situations, often does not have any other alternative but to accept the offer of the buyer for a reduced price or incur the risk of losing even more by placing the goods in a foreign country with a deteriorating market.

[100] In the U.S., U.C.C. § 5-109(1)(c) clearly insulates the issuer from any practice and custom which is not related to its activities.

The strict compliance rule, although functional in most cases,[101] does provide a solution which in many situations appears to be unfair. Some alternatives have been studied to avoid inequities by maintaining the strict compliance rule,[102] but they cannot be considered satisfactory, although they have been generally adopted in the practice.[103] The first alternative is to give banks the duty to notify the beneficiary of the discrepancy and to allow him to cure the defects of the documents.[104] This alternative, which has found some support by courts,[105] presents two major problems: first it is not always possible to obtain a substitute document;[106] and second, time may run against the beneficiary.[107] Another alternative, that has been widely adopted in banking practice, is the consultation of the customer.[108] Under this solution the bank, upon delivery of a non-complying document, would inform the customer and ask for a waiver of the discrepancy, thus putting the customer in the

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101 We should remember that the number of controversies related to letter of credit transactions are small in comparison to the volume of transactions supported by the letter of credit device.

102 *See Letters of Credit: A Solution to the Problem of Documentary Compliance*, *supra* note 73, at 875 (minor deviations may be cured by imposing affirmative obligations on all parties not to act in bad faith).

103 *See* Note, *Letters of Credit: The Role of Issuer Discretion in Determining Documentary Compliance*, 53 FORDHAM L. REV. 1519 (1985). *See supra* chapter I, part A.

104 *See* Corporacion de Mercadeo Agricola v. Mellon Bank Int'l, 608 F.2d 43, 48-49 (2d Cir. 1979)(the issuer was required to make full disclosure of all documentary defects with the decision to honor or dishonor. If such disclosure is not offered, the bank is estopped from raising those defects at trial.).

105 *See, e.g.*, Bank of Canton v. Republic Nat'l Bank of N.Y., 509 F. Supp. 1310, 1317 (S.D.N.Y.), *aff'd*, 636 F.2d 30 (2d Cir. 1980).

106 Generally documents are provided by a third party and the beneficiary does not have any power to obtain a modification or a new document. For example, the shipper may object to releasing a document with a different description of the goods, although similar in the meaning of the words, by reason of simple fear of liability. Another example is the case of changes in the codification of goods for custom purposes. *See* Barclay, *supra* note 52, where the beneficiary cannot obtain a document using the custom's codes which are applicable for the same goods at the time of the stipulation of the letter of credit.

107 Because letters of credit have validity for a limited time, if the documents are delivered towards the end of that period, the beneficiary may not have sufficient time to provide complying ones.

108 *See* 3 STATE OF N.Y. LAW REVISION COMM'N, STUDY OF THE UNIFORM COMMERCIAL CODE: ARTICLE 5 - DOCUMENTARY LETTERS OF CREDIT, Legislative Doc. No. 65(F), at 73, *reprinted in* 3 STATE OF N.Y. LAW REVISION COMM'N, REPORT OF THE LAW REVISION COMM'N, at 1641 (1955).

position of authorizing payment against non-complying documents. The unsatisfactory aspect of this solution is that it cannot avoid cases in which the customer seeks to slip the performance of its obligation, i.e. breaches the underlying contract, or situations in which the bank has no interest to pay.[109]

The strict compliance rule therefore leaves open different problems which call for the adoption of alternative standards. Although strict compliance is generally admitted,[110] the frequent issues arising out of its application, especially in the U.S. where the rules of contract law are not applied to this area,[111] have stimulated the development of two modified criteria. They are the substantial and bifurcated standards of compliance.

2. *Substantial Compliance*

This theory, developed to render more flexible the strict compliance standard, was inspired by the desire to promote the equity principle. Pursuant to the substantial compliance standard, a document is deemed to comply with the letter of credit requirements even if it does not conform in every formal respect. In other words, the bank is allowed to look beyond mere technical discrepancies[112] in order to ascertain if the documents delivered "comply with the letter of credit in every material respect,"[113] thus not limiting its intervention to the mere formal inquiry.

The first example deals with the delivery of a certificate which stated that, based on a 10% sample, the goods were "found [as] conforming to the conditions stipulated on the Order-Stock-Sheets"[114] instead of using the formulation "the goods are in conformity with the order."[115] Closely related to the law of contracts and inspired by equity principles, the court declared the certificate acceptable as substantially complying with

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109 For example, in cases of undercollateralized letters of credit, when the customer is close to, or already in, bankruptcy.

110 *See infra* Chapter III, part B.

111 *See supra* Chapter II, part B.2.

112 *See* Banco Espanol de Chedito v. State St. Bank & Trust Co., 385 F.2d 230, 237 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968).

113 Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank of Boston, 569 F.2d 699, 705 (1st Cir. 1978).

114 *See* Banco Espanol de Chedito v. State St. Bank & Trust Co., 385 F.2d 230, 233 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968).

115 *Id.* at 231.

the terms of the credit.[116] In short, the court held that the documents need not follow verbatim the language of the letter of credit.[117]

In the second example, the beneficiary had to deliver a statement declaring that the "draft . . . was in conjunction with [the] letter Agreement dated May 23, 1972."[118] The statement produced stated that the "Letter of credit . . . was in conjunction with [the] letter agreement dated May 23, 1972."[119] The court applied the substantial compliance standard based on the principle ad majore ad minus, i.e. "the greater includ[es] the smaller."[120] In other words, the court admitted that the statement, by referring to the letter of credit, automatically included the reference to the draft, thus materially complying with the credit conditions.[121]

Holdings dealing with the standard of substantial compliance have received strong criticism. The contractual characterization of the relationship between the bank and the beneficiary is seen as colliding with the spirit of the letter of credit. The requirement that credit institutions make discretionary determinations is viewed as a threat to the certainty of the letter of credit, and sufficient to discourage banks from offering this kind of service. The critics consider this standard as undermining the efficiency of the device and as imposing on banks time-consuming obligations, thus preventing the achievement of the goals pursued with letter of credit transactions.[122]

3. *The Bifurcated Standard*

This standard combines the strict and the substantial compliance requirements in a form attractive to banks.[123] Pursuant to this theory, the bank may require strict compliance from

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116 *Id.*

117 *Id.*

118 *See* Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank of Boston, 569 F.2d 699, 701 (1st Cir. 1978).

119 *Id.*

120 *Id.* at 703.

121 *Id.*

122 *See* DOLAN, *supra* note 1, at 6.02 and 6.05; *supra* note 73, 855-856; *supra* note 103; Note, *Judicial Development of Letters of Credit Law: A Reappraisal*, 66 CORNELL L. REV. 144, 153 (1980).

123 *See* T.M. QUINN, QUINN'S UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST (2d ed. 1991)(commentary as it relates to U.C.C. § 5-114[A][5]).

the beneficiary and offer to the customer documents substantially complying.

In the example of the bill of lading calling for "bureau" instead of "dresser," mentioned above, the bank would have had available: both options either to pay the beneficiary and then invoke substantial compliance toward the customer or to refuse the payment because the bill of lading was not in strict compliance. In one particular case, a court expressly applied, exclusively to the customer/issuer relationship, the standard of substantial compliance;[124] the beneficiary never provided the declaration, required under the terms of the letter of credit, that he had paid under a certain guaranty. He simply notified the bank that he was going to pay if the letter of credit was not extended. The letter of credit was not extended, the beneficiary paid under the guaranty, and the bank paid the beneficiary without requesting any further statement. When the bank tried to recover that amount, it found the opposition of the customer who invoked non-compliance. The court held that: the "payment pursuant to that [nonstrict complying] demand was reasonable and proper under the circumstances."[125]

In the above, as in other cases, courts did not disavow the application of the strict compliance standard in the letter of credit. The adoption of the bifurcated standard was simply the consequence of the application of the law of contracts to the relationship, based on the application agreement, between the customer and the issuing bank.[126]

This solution accords flexibility to banks but also permits abuses. It gives the issuer a defense, which ever decision it takes, and makes it virtually impossible for the parties to charge the bank with liability. It therefore becomes particularly appealing to banks in cases of misjudgment by their own employees or by changes of circumstance which make payment conflict with the bank's interest. This standard, as strict and substantial compliance, does not completely satisfy the pur-

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[124] Transamerica Delaval, Inc. v. Citibank N.A., 545 F. Supp. 200 (S.D.N.Y. 1982).

[125] *Id.* at 203-204.

[126] *See also* Morgan Guar. Trust Co. v. Vend Technologies, Inc., 474 N.Y.S.2d 67 (1st Dep't 1984).

poses of the letter of credit and gives no satisfactory answer to the compliance issue.

B. *The Currently Accepted Doctrines*

Generally speaking, the standard of strict compliance is applied in all three countries, i.e. the U.S., Switzerland, and Germany. Nevertheless, as a consequence of the different constructions of the relationship between the bank and the beneficiary, the solutions in its application appear to be different.

1. *In the U.S.*

Recognizing and admitting the mercantile character of the letter of credit device, a large majority of courts follow the strict compliance rule and leave "no room for documents [that] are almost the same or which will do just as well."[127] The rigid application of that rule in some cases has resolved in rulings which clearly hurt the equity feeling.[128] Such sentences were applauded by the supporters of the characterization of letters of credit as a device of mercantile law,[129] absolutely detached from the law of contracts. Those voices do not expect the letter of credit to be a fair and equitable instrument, but simply a mechanical device created to satisfy certain business necessities. For the sake of efficiency of the letter of credit, for the certainty of the device, the dominant group of courts and scholars have supported the strict compliance rule.[130]

In consideration of the inequities that the rigid application of the strict compliance rule may create, a slight minority of courts have adopted the substantial compliance rule.[131] This

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[127] Equitable Trust Co. v. Dawson Partners, 27 Lloyd's List L. Rep. 49, 57 (1927).

[128] *See* Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 528 F.2d 802 (4th Cir. 1975). In this case, the beneficiary had to deliver, among other documents, an invoice mentioning the product as "100% Acrylic Yarn." The invoice, correct in all its other contents, specified "100% Imported Acrylic" and had attached the packing list which mentioned "Cartons Marked: 100% Acrylic." The court held that the bank was only required to verify the invoice and could ignore the attachment, regardless that the goods were 100% acrylic and that the beneficiary could have produced a correct document, if not for certain time constraints.

[129] *See* DOLAN, *supra* note 1, at 6.02, 6.05[1][a] and 4.01[2].

[130] *See Letters of Credit: A Solution to the Problem of Documentary Compliance*, *supra* note 73, at 861.

[131] *See* DOLAN, *supra* note 1, at 9.03[1][a].

standard, when applied to the benefit of the beneficiary, has been viewed as frustrating the goals of the letter of credit device.[132] On one side, there has been a risk of increasing litigation as a consequence of the claims of substantial compliance by beneficiaries; on the other side, this standard has been viewed as loosening the incentive for beneficiaries to comply with the terms of the letter of credit. The attempt by courts to insure equity for the beneficiary has been perceived as undermining the essential character of the device.[133]

With respect to issuer/customer relations, in recognition of their contractual relationship, courts have sometimes protected banks that paid against substantially complying documents.[134] Those decisions were inspired by the law of contracts and find their rationale in the search for equity. As it has been noted, factually there is only one standard of compliance and the differentiated solution under the bifurcated standard flows simply from the different relationship existing between the bank and the parties involved.[135]

2. *In Switzerland*

The strict compliance standard is generally admitted and applied by Swiss courts. In their approach Swiss courts recognize that this rule directly applies to the device,[136] thus leaving intact the structure and mechanism of the letter of credit. In the next section,[137] the modification of the results that occur in consequence of the contractual approach to letters of credit will be reviewed.

The application of the standard of strict compliance to the verification of documentary compliance is apparent in a recent case decided by the Swiss Supreme Court.[138] The letter of

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[132] *See Letters of Credit: A Solution to the Problem of Documentary Compliance*, *supra* note 73, at 870 (viewing the standard of substantial compliance as implicitly authorizing the unilateral amendment of the letter of credit, thus "destroy[ing] the certainty of payment—the raison d'etre of both customer and beneficiary participation in the letter of credit transaction").

[133] *Id.* at 855.

[134] *See, e.g.*, Transamerica Delaval, Inc. v. Citibank, N.A., 545 F. Supp. 200 (S.D.N.Y. 1982).

[135] *See* DOLAN, *supra* note 1, at 9.03[1][a].

[136] *See* GAUTSCHI, *supra* note 1, 34-36. *See, e.g.*, BGE 88 II 344-350.

[137] *See infra* Chapter III, part C.3.

[138] BGE 104 II 275.

credit required delivery of an insurance policy covering "all risks, including rust, . . . , and loss." The beneficiary delivered an "all risks" policy which covered, by its terms but without specifying it, also rust and loss. The court held that the document was not complying although the policy itself was issued for the requested coverage.[139] The bank was allowed to refuse the payment because it was impossible, from the reading of the document, to infer that it was complying in substance.

What differentiates the approach of the Swiss courts, to the letter of credit device, is the determination of non-compliance of the documents. The bank must take sufficient steps, required by contract law, before taking a position when confronted with non-complying documents, and eventually it has to make sure that its decision is acceptable under the good faith requirement.

3. *In Germany*

German courts also recognize the strict compliance requirement and approach the issue in the same way as Swiss courts. Documents need to be: (a) complete and conform to the requirements set in the letter of credit; (b) correct in their appearance, i.e. not clearly false or wrong; and (c) of the kind and contents required by, and conform to the credit conditions.[140]

The extent to which strict compliance is given is slightly different than under Swiss law. The German courts admit strictly complying documents which contain "small discrepancies . . . if a careful evaluation [of their contents] lead to a sure conclusion that the goal of the credit conditions has been reached."[141]

The particularity of this approach is that it softens the rigidity of the strict compliance concept even before invoking the principles of contract law. In other words, for German courts the strict compliance standard is less strict than for the Swiss and, without doubt, for the U.S. courts.

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[139] The Swiss Supreme Court held that "if the letter of credit, as in this case, requires a certain description of the insurance coverage, this description is relevant in the verification of the documentary compliance" (translated), *Id.* at 277.

[140] *See* EISEMANN/SCHUTZE, *supra* note 1, 178-179.

[141] *See* 1960 BGHWm at 38.

C. *The Duty of Care and the Duty of Good Faith*

To the extent admitted by the applicable law, the duty of care and the duty of good faith intervene in the process of verification of the documentary compliance. The relationship between the bank and the parties may involve certain duties which display their effects in the determination of the documentary compliance. In other words, the attitude of the bank in the examination of documentary compliance is influenced by the rules applicable to its relationship with the parties; and those rules may indirectly influence the required standard of compliance.

This approach has the particularity of not operating directly on the standard of compliance. In the process of relaxation of the compliance requirement, as it will later be seen, the substantial compliance's goal, i.e., equity may be obtained without deviation from the strict compliance requirement. In the next section the discussion will begin by underlining the extent to which banks owe those duties pursuant to the U.C.P.

1. *Under the U.C.P.*

The U.C.P. do not expressly require a bank to act in good faith. This silence may be interpreted in different ways. On one side, the U.C.P. function is to codify the rules specifically applicable to the letter of credit device. They are not concerned with general principles because they have been conceived to give an answer to specific issues. This interpretation may be held as fragile considering the promptness with which the U.C.P. in Article 15 requires banks to act with "reasonable care," a clear limitation for the purpose of excluding more strict requirements of national law.[142] On the other side, the U.C.P. are a set of rules which benefit the banking industry by limiting its liabilities to the maximum possible extent. A close reading of articles 15 through 21 shows that the intent of these articles

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[142] *See* BGB at 276. Generally applicable to contracts and, therefore under German law, also to letters of credit, which requires the parties to act with the care "necessary in the transaction." *Id.* The difference between the two requirements becomes apparent in the documents verification process: what may be necessary for the execution of the credit transaction may not at the same time be reasonable. The bank is clearly in the better position under the U.C.P. than it would be under German law.

is to avoid all situations which would call for bank responsibility. It may therefore be inferred that the adoption of a good faith requirement has been avoided because it does not conform to the spirit of the U.C.P. as well as the interests of banks.[143] Whatever the reasons have been, the fact remains that the U.C.P. do not require banks to exercise good faith in verifying the documentary compliance. The application of this principle is therefore completely left to national laws and courts.

With respect to the duty of care, the U.C.P. require banks to "examine all documents with reasonable care."[144] Such formulation calls for two basic considerations. The first is that the duty of care is owed only in the process of document verification and not in the decision to pay or not to pay. It is different to require the bank to exercise reasonable care in determining if documents are complying with the credit condition, than to generally call for reasonable care in the execution of the letter of credit itself.[145] Pursuant to the mentioned norm, the bank's duty of care is related only to the verification of the face compliance of documents and may not be used to call for additional acts.[146] The second consideration is related to the intensity of the duty of care. The U.C.P. use the qualification "reasonable" which leaves the requirement in its basic and less intense form, i.e. leaving open to banks all possible defenses. By expressly qualifying the duty of care, in the countries where the definition of such liability is left to the discretion of the parties, the U.C.P. limit to the maximum extent the bank's duty of care, thus cutting off the standard requirements of dispositive law.

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143 It may be speculated that, had it not been contrary to the law, the U.C.P. tendency was to call for the exclusion of any good faith requirement on the side of banks. The U.C.P. stop short of stating that the bank may pay in bad faith when it receives complying documents.

144 *See* U.C.P. art. 15.

145 A general requirement of reasonable care in the execution of the letter of credit would set obligations for banks such as the notification of the beneficiary when documents are non-complying or the request for the customer's approval of discrepancies.

146 *See* Instituto Nacional de Comercializacion Agricola (INDECA) v. Continental Ill. Nat'l Bank & Trust Co., 858 F.2d 1264 (7th Cir. 1988); Five Star Parking v. Philadelphia Parking Auth., 703 F. Supp. 20 (E.D. Pa. 1989).

2. *Under U.S. Law*

Being of a contractual nature, the relationship between issuer and customer is governed not only by Article 5 but also by the General Provisions of Article 1 of the UCC, as well as by the common law of contracts.[147] UCC Section 5-109(1) sets forth a specific obligation to act in good faith. This requirement goes in addition to the general obligation of good faith imposed by Section 1-203 and its disclaimer is governed by Section 1-102(3). With respect to the duty of care, Section 5-109(2) requires that the issuer verifies the documentary compliance with "care" but leaves open any further qualification, i.e. the extent of the standard of care required. This obligation is strictly related to the verification process and has been interpreted as not imposing on the bank a duty to consider any unrelated factor.[148]

On the other side, with respect to the relationship of banks with the beneficiary, there has been dispute about its legal qualification.[149] The actual tendency is to deny the contractual characterization, therefore denying application of the UCC as well as the law of contracts in general.[150] The consequence is that banks do not owe the beneficiary any duty in addition to the duty to pay against complying documents. Although the tendency of a minority of courts is to apply contracts law to this relationship,[151] in certain cases it is still admitted that the bank may act in bad faith in dealing with beneficiary, i.e. the beneficiary in specific situations has no right arising out of the bad faith dealings of the bank.[152]

Generally speaking, under U.S. law the standard of strict compliance, despite attacks by some courts and scholars, benefits from a solid recognition. The duties of care and of good faith contribute to some extent to the relaxation of the strict compli-

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[147] The 1963 New York amendment of U.C.C. § 5-102 excludes the automatic application of Article 5 to the letter of credit "if by its terms or by agreement, course of dealing or usage of trade such letter of credit is subject in whole or in part to the [U.C.P.]." *Id.* In consideration of the importance of New York as a financial center and of the extended adoption of the U.C.P., this amendment significantly limits the impact of U.C.C. Article 5 to letter of credit transactions.

[148] *See* QUINN, *supra* note 123, (discussing U.C.C. § 5-109[A][2]).

[149] *See* U.C.C. § 5-109[A][1].

[150] *See* DOLAN, *supra* note 1, at 2.01.

[151] *See supra* Chapter III, part B.1; and Chapter II, part B.2.

[152] Intraworld Indus., Inc. v. Girard Trust Bank, 336 A.2d 316 (Pa. 1975).

ance standard in the relationship between issuer and customer. With respect to the obligations of the issuer toward the beneficiary, the duties of care and good faith do not help the beneficiary require from banks more than payment against strictly complying documents. The strict compliance requirement remains therefore applicable to extreme consequences and does not benefit from any relaxation.

The necessity to grant banks discretionary power, i.e. the positive effects of the bifurcated standard model, which gives to the letter of credit transaction the flexibility necessary to ensure the proper functioning of the device, has been admitted at different levels.[153] Based on those considerations, in recent years a model has been developed which combines the bifurcated standard with a contractual conceptualization of the relationship between issuer and beneficiary.[154] The end result leads basically to the theory applied in Switzerland and Germany under civil law. The process starts with viewing the letter of credit as an option contract in which the issuer is bound by the irrevocable offer to perform, under certain conditions, at the option of the beneficiary, who is not under any obligation.[155] The next step is the replacement of the strict compliance requirement in the relationship of the issuer with the beneficiary, with the law of conditions applicable to the option contract.[156] This modification of the bifurcated standard maintains the standard of substantial compliance in the relationship between the issuer and the customer, but "impose[s] the law of conditions in suits by the beneficiary against the issuer."[157] Thus, the end result is the application of the contractual duty to exercise good faith in order to correct the inequities of the rigid application of the strict compliance rule.

3. *Under Swiss and German Law*

The situation in these two countries is different especially with respect to the duties owed to the beneficiary. They may be

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153 *See* QUINN, *supra* note 123, at U.C.C. § 5-114[A][5]; 3 STATE OF N.Y. LAW REVISION COMM'N, *supra* note 108, at 66.

154 *See* Note, *Letters of Credit: The Role of Issuer Discretion in Determining Documentary Compliance*, 53 FORDHAM L. REV. 1519, 1539 (1985).

155 *Id.* at 1533-1534.

156 *Id.* at 1536.

157 *Id.*

treated jointly because of the similarity of their construction, although the available case law shows the Swiss Supreme Court as the more extreme in the application of contract law to the letter of credit device.

In Switzerland and in Germany, letters of credit are conceived as a combination of two contract types and both countries admit therefore the application of the general obligation of good faith and the duty of care to the relationship between issuer and customer, as well as that between issuer and beneficiary. The consequence is that, although courts of those countries recognize the strict compliance principle, they avoid the inequities of its rigid application by invoking contract law.[158]

In both countries the duty of care is derived from the regulation of the applicable contract forms.[159] Not only the customer but also the beneficiary may hold the bank liable for the violation of the obligation of care because both relationships are governed by the law of contracts.

To a large extent, the most impressive results are obtained through the obligation of the parties to perform in good faith. A recent decision of the Swiss Supreme Court clearly stated that trend in a case that has extreme implications.[160] A bank refused to honor its obligation under the letter of credit because of the missing document, i.e. a receipt proving the delivery of the goods. The Court admitted that this was a case of noncompliance and did not dispute the requirement of strict compliance,[161] but refused to protect the bank because it had knowl-

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[158] Though criticized by some scholars, this approach is well established and has been followed since the late fifties. *See* 1958 BGHWm at 291. In applying the strict compliance principle to protect a bank, the German Supreme Court declared that the application of the strict compliance standard could be avoided "if it was quite obvious to each person judging the case, without resorting to expert knowledge of any kind, that discrepancy was insignificant and that no disadvantages for the customer could result." *See also* BGE 88 II 341, 345. The Swiss Supreme Court imposed an obligation on a bank to interpret the conditions of the letter of credit "in good faith, like for all the other contracts, by considering their function and connection." *Id.* at 345.

[159] *See* OR art. 398 for Switzerland and BGB at 276 for Germany.

[160] BGE 115 II 70. This is the last case on letters of credit that has been decided by the Swiss Supreme Court and in the last twenty years less than two dozen cases in this area have been submitted to the Court.

[161] *Id.* at 70-71. The Swiss Supreme Court stated that the standard of strict compliance is applicable in the relationship between issuer and customer as well as in the one between issuer and beneficiary.

edge that the goods had in fact been delivered. The Swiss Supreme Court reasoned that the strict compliance requirement did not prevent the application of the general prohibition to act in bad faith[162] and that when the strict compliance requirement is used in violation of the obligation to act in good faith, the latter requirement prevails.[163] This decision clearly evidenced the approach of Swiss courts to the issue of documentary compliance; the rule is protected up to the point where basic principles of law are relaxed. The credit device is not granted a special status, i.e. mercantile character does not supersede contract law, and the necessities of the device, i.e. efficiency and security, do not come before basic principles such as equity and good faith.

The German Supreme Court took a similar approach in a decision in the late fifties; pursuant to the terms of the credit, in this case, the beneficiary was required to deliver the bill of lading in two copies. The bank received only one copy and therefore refused to honor the letter of credit. The German Supreme Court ruled that the second copy of the bill of lading was missing only from a technical, not from a legal, perspective because "slight discrepancies had to be admitted when the evaluation of the available documents lead to the conclusion that the scope of the credit conditions has been reached."[164] As a matter of law, the principle of strict compliance remains applicable, and German courts also admit its validity.[165] Thus, pursuant to the above mentioned reasoning, the lack of strict compliance does not allow the bank to deny payment under the letter of credit when such denial would violate the good faith requirements. The rigidity and the inequities of the strict compliance standard are therefore avoided by the denial of a special regulation for the letter of credit device, and by the consequent application of contract law.

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[162] *Id.* at 74. The court invoked the prohibition to abuse the law, a principle derived from the general duty of good faith.

[163] *Id.* at 72. "The insistence of the [bank] in requiring delivery of the receipt when it knew that the fact [the receipt] was intended to prove had intervened is an attempt to exploit a formal requirement of law in violation of the principle of good faith." *Id.*

[164] *See* 1960 BGHWm at 38.

[165] *See* 1971 BGHWm at 158; 1984 BGH at 914.

FINAL CONSIDERATIONS

Letters of credit are an instrument of national as well as international trade. In all three countries examined,—the U.S., Switzerland, and Germany,—the device is structured following the directives set by the U.C.P. and well-established international banking practices.

Nevertheless, similarities in the structure and the tendency to create uniformity in the process of fulfillment of letter of credit goals have not removed the device from the rules of national law. In the U.S., a very pragmatic approach submits letters of credit to the rigid application of the strict compliance standard. The desire to provide the market with an instrument of extreme efficiency at low cost prevails over concepts such as equity and good faith. In Switzerland and in Germany, on the contrary, letters of credit do not benefit from the special treatment reserved to mercantile devices and, following the civil law tradition, are considered subject to contract law. Therefore, although recognizing the principle of strict compliance, these countries do not allow the efficiency requirement of letters of credit to violate the fundamental principle of good faith.

The problems of such different approaches become particularly apparent in relation to the international level on which letters of credit operate. Assume for example that a Swiss court, based on good faith reasoning, rules that a confirming bank must pay against non-complying documents, and that the same bank is barred from indemnification on the side of the issuer by a U.S. court applying the strict compliance standard. In this case the seller would recover the price, the buyer would not be obliged to pay because the issuer would also not be obliged to pay, and the confirming bank would only have the option to attach the goods in control of the buyer in a foreign country. In such situations, the difference in the national courts' approaches operates to completely frustrate the goal of the letter of credit transaction.

The tendency of some U.S. courts to consider the substantial compliance standard, as well as the development of a modified bifurcated standard, seems to lead toward a unification of the two approaches. Nevertheless, this process is far from complete, and two such fundamentally different legal conceptions of the letter of credit are not easy to consolidate.