

## **Putting the “Document” in Documentary Sale Transactions**

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A commercial letter of credit is most often used when the parties to a sale of goods find that the risks of proceeding without this payment mechanism are high enough to justify the relatively minor cost. The leading type of transaction is an international sale of goods, where the parties often face higher risks than in a domestic transaction. The parties may not know each other well, they may find it difficult to evaluate credit risks, they may be unfamiliar with each others' legal systems, and the seller may have concerns over the buyer's ability to obtain a sufficient amount of the currency specified in the sales contract.

There are two general concepts underlying letter of credit transactions, which minimize these risks. First, the payment is separated from the sale transaction (“independence principle”). Second, the risks are partially distributed to third parties, namely the banks which issue and in some cases confirm the letter of credit. The necessary consequence is that payment is made in exchange for documents, not goods, thus it is a “documentary transaction.” A further legal consequence follows from the structure of the documentary transaction, a rule of strict compliance applied to the review of documents submitted by the seller-beneficiary in requesting payment under the letter of credit.

Each party to the sale transaction (seller and buyer) will typically deal with a bank which it trusts to undertake the payment transaction. All parties, including the banks, are related by a series of contracts, but not every party to the transaction is a party to each contract and each party only bears the risks of its own contracts. Thus, each party to the payment transaction bears only a portion of the risks.

The bank appointed by the buyer issues a commercial letter of credit, which is a direct promise by the issuing bank that it will pay a specified amount to the beneficiary (seller), if the seller presents the documents described in the letter of

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credit. Typically, these are documents demonstrating that the seller has performed its obligations under the contract regarding the sale of goods, including a commercial invoice, quality certifications (which, according to the sales contract, may be required to be issued by independent third parties), and an on-board bill of lading or other transportation document showing the goods are in transit.

The letter of credit will normally be “advised” to the seller by a local bank, providing a convenient location to submit documents, and from which payment can be obtained. Additionally, the seller often requires the letter of credit be confirmed, either by a specified bank, or one located in the seller’s jurisdiction. Confirmation is a direct promise by the confirming bank to the seller that it will honor the letter of credit upon presentation of the required documents.

No matter whether a bank is the issuing, advising or confirming bank, it will base its decision to pay solely on its assessment of the presented documents and their conformity to the requirements of the letter of credit. This is a direct result of the independence principle. As expressed in UCP 600<sup>1</sup> Article 4(a): “A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit.” Accordingly, UCP 600 Article 5 stipulates: “Banks deal with documents and not with goods, services or performance to which the documents may relate.”

The separation of the letter of credit from the underlying transaction leads naturally to the judicial doctrine of strict compliance: the documents presented to the bank must conform precisely to the terms of the letter of credit. For example, in the renowned English case of *J.H Rayner v. Hambros Bank Ltd.*,<sup>2</sup> a Danish bank had issued a letter of credit for the sale of nuts by an English company to a

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<sup>1</sup> The Uniform Customs and Practice for Documentary Credits (UCP 600) is published by the International Chamber of Commerce and is incorporated by reference in the great majority of commercial letters of credit. The UCP functions as a set of contract terms, setting forth in detail the responsibilities of the parties.

<sup>2</sup> Court of Appeal [1943] 1 K.B. 37.

Danish company. The nuts were to be shipped from India to Denmark and the letter of credit required “invoice, clean on board bills of lading in complete set...covering a shipment of about 1400 tons Coromandel groundnuts in bags.” The presented invoice was for Coromandel groundnuts. The bill of lading however described the goods as “17,724 bags machine-shelled groundnut kernels, each bag said to weigh 177 lb nett.” and had a note in the margin: “O.T.C. C.R.S.” Evidence at trial in the action brought by the English sellers against the English confirming bank showed “machine-shelled groundnut kernels” were the same as “Coromandel groundnuts,” universally understood in the trade in England, and that “C.R.S.” was an abbreviation for Coromandels. However, the appellate court held that the phrase “Machine-shelled groundnut kernels” was not the same as “Coromandel groundnuts,” even if abbreviations in the margin of the document and general trade usage show they are the same. The *Rayner* court relied on the earlier 1927 decision in *Equitable Trust Co. of New York v. Dawson Partners, Ltd.*, where Lord Sumner explained: “there is no room for documents which are almost the same, or which will do just as well.”<sup>3</sup>

Minor errors in spelling are common in international transactions, where it is easy to overlook a discrepancy due to linguistic differences. When this occurs in documents to be submitted under a letter of credit, however, especially in the commercial invoice, the strict compliance standard often cannot be met. For example, in *Hanil v. Pt. Bank Negara*,<sup>4</sup> the Indonesian bank BNI was instructed to issue a letter of credit to “Sung Jun” in Korea, but misspelled the name as “Sung Jin.” Sung Jun sold the letter of credit to Hanil, which requested payment, presenting authentic documents carrying the correct name of the beneficiary. BNI rejected the documents, partly because of the discrepancy in the name, which it said the applicant refused to accept. The court upheld the rejection of the documents, even though the root cause of the discrepancy was BNI’s error.

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<sup>3</sup> 27 LI L Rep. 49, at 52.++

<sup>4</sup> 2000 U.S. Dist. LEXIS 2444; 41 U.C.C. Rep. Serv. 2d 618 (S.D.N.Y 2000).

Under UCP 600, a distinction is drawn between the standard of strict compliance required of the commercial invoice and that required of all other documents. Article 18(c) provides: “The description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit.” Other documents submitted in connection with the demand for payment are reviewed under Article 14 for “consistency,” not necessarily exact identity with the letter of credit, however, given the long line of judicial authorities holding in favor of strict compliance, the beneficiary is well advised to review the terms of a letter of credit carefully when it is first received, in order to be sure that all of the documents it describes are ones which the beneficiary will be able to submit, and that the requirements stated in the letter of credit conform to the terms of the sales contract. The time to request amendment is before the seller has incurred the costs of producing, packaging and shipping the goods, not once they are in transit.

The commercial letter of credit should be distinguished from standby letters of credit, which secure payment after default of one party. The beneficiary of a standby letter of credit may request payment by the issuer upon proof in the required form, with specified documents stating that the applicant did not perform its duties under the relevant agreement, which could be a sales contract. The standby letter of credit therefore functions as a form of protection against default, unlike the commercial letter of credit, which the parties intend as the primary payment mechanism under their sales agreement.

Letters of credit, whether commercial or standby, must also be distinguished from guarantees. Guarantees are secondary obligations and unless waived in the instrument, it is often a defense to the guarantor’s liability that the underlying debt has been discharged or that the debtor has other defenses to the underlying liability. Under a letter of credit however, the issuer’s liability is independent of the underlying obligation, due again to the independence principle. As expressed in the Uniform Commercial Code applicable to letters of credit in the U.S.: “That

the beneficiary may have breached the underlying contract and thus have given a good defense on that contract to the applicant against the beneficiary is no defense for the issuer's refusal to honor."<sup>5</sup> Similarly, Article 4(a), UCP 600 provides: "the undertaking of a bank to honor, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defenses by the applicant resulting from its relationships with the issuing bank or the beneficiary."

The documentary sale transaction has a long history and serves well the purposes for which it was created, however a seller who cannot satisfy the requirements stipulated by the letter of credit, or who submits non-conforming documents, has essentially wasted the valuable attributes offered by this instrument and instead is left only with the remedies against the buyer that would have been available in the absence of a letter of credit. The documents are therefore the key to a documentary sale.

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<sup>5</sup> Comment 1 to Rev. UCC 5-103