

The development of commercial letters of credit & how they can be enhanced through limited government control.*

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Abstract

This research paper discusses how minimised government interference in the operation of commercial letters of credit can actually improve their development as they are regulated by the Uniform Customs and Practice of Documentary Credits (UCP600). Government interference takes shape in foreign exchange control legislation, which does impede both payment and financing. Illegality attaches where the credit fails to meet legal requirements at place of payment or performance. Illegality is an established exception to the principle of autonomy under UCP600. Exceptions to the independence of the credit are necessary to safeguard against abuse. Illegality should not be extended to include government control as it distorts the operation of the credit. Illegality should be interpreted narrowly to include only parties to the agreement. Letters of credit are popular payment methods due to the security they offer and they are an autonomous transaction. Various negative implications arise where illegality is raised as a result of foreign exchange control; parties may attempt to defeat such illegality even through unlawful means. The research tracks the historical development of the standardisation of the commercial credit vis-a-vis common law. It is argued that the introduction of UCP has contributed little to the common law as UCP is not drafted in legal terms as it is intended as a code of practice for banks. It does not cover crucial legal consequences, rights and obligations. In the interests of trade facilitation WTO member states should review current exchange control regimes in their jurisdictions, to allow for free flow and uniform trade financing.

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EXECUTIVE SUMMARY

CHAPTER ONE

INTRODUCTION

“The absence of an adequate trade finance infrastructure is, in effect, equivalent to a barrier to trade. Limited access to financing... (is) likely to hinder the trade and export potential of an economy... Therefore, governments whose economic growth strategy involves trade development should provide assistance and support in terms of export financing and development of an efficient financial infrastructure.”³

1.1 Scope of study

This research paper covers the development of the commercial letter of credit as it is regulated under the *Uniform Customs and Practice for Documentary Credits* (UCP600), with analysis into the contribution of UCP600 to judicial decisions since its rules were first incorporated by the International Chamber of Commerce (ICC) in 1933. The writer shall provide an evaluation of this development by exposing the changes that the ICC has made especially from UCP500 to UCP600 in an attempt to address the inconsistencies within the regulatory system.

Illegality as an exception to the independence (autonomy) principle shall be examined against the main argument that illegality should only be restricted between parties without including governments. The aspect of foreign exchange control shall be explored as the means by which governments interfere with documentary trade financing, through restrictions on the movement of money, which in turn gives rise to illegality.

This paper is comprised of five chapters. The first chapter gives a general introduction of all aspects of the problem that the researcher wishes to tackle. The second chapter is an investigation into the development of commercial letters of credit under common law before and after the introduction of the UCP, such that the effectiveness of the standardisation of the UCP can be evaluated alongside court decisions. The third chapter discusses illegality as an exception to the independence principle in its entirety; its importance, current judicial interpretation, limitations of interpretation under UCP, relationship of illegality to the validity of the financing contract and of the enforcement of foreign illegal contracts. The fourth chapter is a critical analysis of the effects of illegality due to foreign exchange control, as a form of government control, which results in avoidance by legal and illegal means. Chapter Five is a summary of the findings of the entire investigation, while providing recommendations to address the highlighted problems.

1.2 General Background; History and development of commercial letter of credit

What is a commercial letter of credit and how does it operate?

³ *Trade facilitation handbook for the greater Mekong Subregion*-Chapter 8; introduction to international trade financing

UCP600 defines credit as “any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.” UCP500 defines it more comprehensively as;

“Any arrangement, however named or described, whereby a bank (the issuing bank)”, acting at the request on the instructions of a customer (the applicant) or on its own behalf

- (i) Is to make payment to or to the order of a 3rd party (the beneficiary) or is to accept and pay bills of exchange (drafts) drawn by a beneficiary.
- (ii) Authorises another bank to effect such payment ;or to accept and pay such bills of exchange (drafts)or
- (iii) Authorises another bank to negotiate against stipulated documents provided that the terms and conditions of the credit are complied with.”

A commercial letter of credit is a financing agreement involving mainly four parties; the importer, exporter, the confirming or corresponding bank and the issuing bank. The importer (the applicant) sends an application to his bank (issuing bank) for the issue of a documentary credit⁴. The information he gives on the application form must specify the total amount for which the documentary credit is to be issued, and the pre-arranged terms. The confirming bank will make payment either immediately, if it is ‘*payment on site*’ or at a prescribed date, if it is ‘*deferred payment*’ upon presentation of stipulated documents.⁵ Usually, the importer will request shipping and insurance documents, commercial invoices, bill of lading and certificates of quality.⁶ The importer's bank issues the documentary credit and sends it - generally by electronic means - to the exporter's bank.⁷ The exporter's bank checks that the documentary credit conforms to the code and sends the documentary credit to the exporter. The exporter checks that the terms of the documentary credit conform to those of the sales contract and that they can be met. UCP600 provides for the standard of examination of the documents as whether or not they appear to the bank as a complying presentation *on their face*.⁸ If all is in order the issuing bank is bound to *honour*⁹ the credit.¹⁰

Security is paramount for all parties involved; therefore under UCP600 all credits are deemed irrevocable whether or not it is express in the written agreement.¹¹ Irrevocability means that a credit can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank, if any, and the beneficiary¹².

⁴ Articles 7 and 8

⁵ *Equitable Trust Company of New York v Dawson* [1927] 27 LR 49

⁶ See Articles 17 to 28 which highlight the specific regulation of presented documents as complying presentation under the code. See also *Commercial Banking company of Sidney Ltd v Jalsord (Pty) Ltd* [1973] AC 279 on the position of certificates of quality.

⁷ See Article 13 on Bank to Bank reimbursement.

⁸ Article 14

⁹ That is to pay against the purchase price if the credit is available either at sight or by deferred payment. Article 7 (a), 8 (a)(i)

¹⁰ See Appendix 1 which has templates of typical credit agreements.

¹¹ This position is different from UCP 500, the predecessor, which assumes all credits to be revocable.

¹² Article 10 (a).

CHAPTER FIVE

CONCLUSION

“Laws for the regulation of trade should be most carefully scanned. That which hampers, limits, cripples and retards must be done away with.”¹³

5.1. Purpose of the study

The main objective of this paper was to critically evaluate the development of the commercial letter of credit as it is regulated under the *Uniform Customs and Practice for Documentary Credits* (UCP600) from its inception in 1933 to date alongside common law. To that end, the writer focused on the challenges of UCP as a code of banking practice that fails to provide for important legal consequences that arise during the operation of commercial letters of credit as well as the need to develop common law further as it remains far more advanced in interpreting commercial letter of credit contracts. Illegality as an exception to the independence principle is one such legal consequence needing development in interpretation as both UCP and common law still struggle with it. It is the writer's opinion that where there is government interference in documentary credit financing especially through foreign exchange control, credit financing under UCP600 is distorted. The operation of the illegality principle is defined too widely if government control is taken into consideration. There is a need to restrict the interpretation of illegality to the parties to the credit only to avoid such distortion and ensuing inconveniences.

¹³ Elbert Hubbert (1856-1915) Notebook, 1927