# CHAPTER SEVEN

## THE FINANCE OF INTERNATIONAL TRADE TRANSACTION

**Introduction.**
There are two central elements to the financing of international trade transactions. Firstly there is the issue of the international transfer of funds from the seller to the buyer which clearly involves the banking system in some way or another since it is not practicable to transport cash around the world. Secondly, because of the delays inherent in international trade due to the time factor involved in transporting the goods from seller to buyer, the cash flow of either the buyer or seller will be adversely affected unless the banks provide one or the other of the parties with credit to finance the transaction. The banking system can, in addition to financing transactions, provide security mechanisms for the joint benefit of buyers and sellers, acting as quality controller in respect of documentation. A further complication is that often the original buyer is merely a commodity trader, with no interest in receiving the goods themselves. The commodity trader needs to be able to exchange the goods freely upon the commodity market, which is facilitated by a negotiable bill of lading. However, the trader also requires a freely negotiable mechanism of payment both from himself to the seller and from the next buyer in the chain to himself.

**Negotiability**
It is a general rule of English law, that the true owner of an item of property is the only person capable of transferring to anyone else, an indisputable legal title to that property.[1] Currency has always been exempt from this rule. If currency could not be handled free from doubts about ownership, it would cease to useful as a means of exchange. Commerce has customarily treated certain types of document, evidencing an entitlement to receive money, as being as free from doubt as bank notes. Such documents are said to be negotiable. A person who acquires a negotiable instrument in good faith is entitled to ignore all previous claims to the document. Negotiability has been established by custom. It is recognised by the Courts.

**Requirements of negotiability.**
For the holder of a negotiable instrument to possess all the rights which such a document can give, certain conditions have to be satisfied, namely :-

(a) value must have been given, that is to day, consideration.[2]
(b) the holder of the instrument must have acted in good faith;
(c) the instrument must be complete and regular;
(d) the instrument must be deliverable.

**Characteristics of negotiable instruments**. The three essential characteristics of negotiable instruments are:

1) the instrument can be put into a state in which title will pass by mere delivery or by indorsement and delivery;
2) good title to the negotiable instrument is transferred to the person who has acted in good faith even though the transferor and a defective title or no title to it.
3) the person to whom the instrument is negotiated can sue all prior parties in his own name.

Unless an instrument possesses these three essential characteristics it is not a negotiable instrument A particularly important type of negotiable instrument is the bill of exchange. A cheque is one kind of a bill of exchange. Postal orders, share certificates and insurance policies are **NOT** bills of exchange.

1 The principle of Nemo Dat Quod Non Habet.
2 Note that past consideration is good consideration for these purposes.

## CHAPTER SEVEN

### THE LAW RELATING TO CHEQUES

**Introduction**

Whilst the dominance of the humble cheque is under threat today from the various forms of electronic banking, in particular the direct debit and credit card, it continues to be a major vehicle for the finance of large transactions. The cheque provides a transparent and traceable method of payment. Cheques are a convenient method of payment avoiding the risk inherent in carrying large quantities of currency, Cheques are not entirely immune from fraudulent dealings, but are nonetheless relatively secure. The major drawback for the cheque is the time it takes to process through the banking system, which results in delays in access to funds by the payee. From this point of view the various forms of electronic / plastic payment are favoured by payees. However, despite widespread use, electronic payment systems are very vulnerable to fraud and the cheque is likely to continue to pay an important role in commerce pending the provision of secure electronic means of payment by the international banking community.

**The Nature of Cheques**

By virtue of **s73 Bills of Exchange Act 1882** a cheque is a bill of exchange drawn on a banker payable on demand. Hart,[3] gives a definition of a cheque which is analogous to the definition of a bill of exchange given in the **Bills of Exchange Act 1882** as follows :

> *"A cheque is an unconditional order in writing, drawn on a banker signed by the drawer requiring the banker to pay on demand a sum certain in money to, or to the order of, a specified person or to bearer, and which does not order any act to be done in addition to the payment of money."*

**Some characteristics of a cheque :**

- it is payable on demand.
- it is drawn on a banker
- the amount payable is a sum certain.

**Differences between cheques and other bills.**

a) A cheque must be drawn on a banker and must be payable on demand whereas a bill may be drawn on anyone and may be payable either on demand or at a fixed or determinable future time.

b) No acceptance of a cheque is required: the banker, as drawee, must honour the cheque if it appears to him to be in order and it is received in the ordinary course of business and the drawer has sufficient funds in his account or an authorised overdraft limit.[4]

c) Unlike a bill, a cheque does not have to be presented for payment by the date on the cheque itself. Even when a cheque is not presented for payment within a reasonable time,[5] then the drawer is still not discharged ***unless*** he has suffered some damage by the delay. **Bills of Exchange Act 1882 s74**.[6]

**Crossings on cheques.**

Unlike an indorsement on the back of a bill a crossing on a cheque must be on the face of the cheque. A crossing, i.e. two parallel lines drawn across the face of a cheque, is an instruction to the banker on whom the cheque is drawn to pay the cheque only into a bank account, not over the counter.

Crossing takes a number of forms, namely :

- **General :** simply requires the paying bank to pay only through another bank.
- **Special :** the name of a particular bank is inserted between the lines. The cheque must be paid into that bank alone and no other.
- **Not negotiable** *:* the cheque may be transferred or assigned but the transferee will take no better title than his transferor.
- **A/C Payee (only) :** This is not a statutory crossing but is recognised and obeyed by banker's custom.

[3] Hart : The Law of Banking,

[4] Contrast with a bill - which must be "accepted" by the drawee, who thereby shows his willingness to pay the bill, before payment can be enforced against him.

[5] 6 months is usually regarded as reasonable.

[6] e.g. the bank on which the cheque was drawn has become insolvent: Note however that a drawer of a bill that is *not* a cheque *is* discharged if the bill is not duly presented for payment.

The words '***account*** (or A/C) ***payee***' do not concern the paying banker. They are an instruction to the collecting bank. A collecting bank, which collects for some person other than the payee named may therefore be liable for negligence.

**Statutory protection of the paying bank.**
A bank has a duty to honour its customer's cheques. If a bank wrongfully fails to honour them or if it pays someone not entitled to payment it could be liable. When payment has been made the paying bank is protected in the following ways:

**s60 Bills of Exchange Act 1882** : the paying bank is protected if it pays an *uncrossed* cheque in good faith and in the ordinary course of business to a person other than the true owner of it where the defect in the title of the person who receives payment is the forgery of an indorsement on the cheque.

**s80 Bills of Exchange Act 1882** : where a bank on which a crossed cheque is drawn pays it in good faith and without negligence the bank paying the cheque is placed in the same position and has the same protection as if the cheque had been made to the true owner.

**s1 Cheques Act 1957** : This gives protection to the paying bank if it pays a cheque in good faith and in the ordinary course of business when the cheque is not indorsed or is irregularly indorsed.

**Statutory protection of the collecting bank.**
The collecting bank, i.e. one which presents a cheque to the drawee bank on behalf of a customer, would be liable to the true owner if it collected for its customer a cheque to which he had no title.

**s4 Cheques Act 1957** provides that if a bank in good faith and without negligence:
a) receives payment of a cheque for a customer; or
b) having credited its customer's account with the amount of the cheque, collects payment for itself, then the collecting bank does not incur liability by reason only of having collected payment.

The bank must prove it was not negligent. This is a question of fact in each case. Instances of negligence include amongst others :-
a) Where an account has been opened for a person, without the bank making inquiries as to his identity and circumstances.
b) Where the banker has received payment for a customer's account of a cheque payable to the customer's employer, without inquiring as to the customer's title to the cheque.
c) Where the banker has received payment for a customer's private account of a cheque made payable to the customer in a representative capacity, without making suitable inquiries.
d) Where the banker has received payment for a customer's account of a cheque, drawn by the customer's employer in favour of a third party or to bearer, without inquiring as to the customer's title to the cheque.
e) Where the banker has received payment for a customer's account of a cheque drawn by the customer as agent for a third party but made payable to the customer personally, without enquiring as to the customer's title to the cheque.
f) Where the banker has received payment for a customer's account of a cheque, drawn in favour of a third party and marked 'account payee', without inquiring as to the customer's title to the cheque.
g) Where the banker has failed to examine a customer's account from time to time in order to consider whether or not it appears to be a genuine one.

If the same bank is both paying and collecting a cheque, then it must satisfy both sets of conditions in order to claim protection: it must pay in due course and good faith and must collect for a customer in good faith and without negligence according to **Carpenters Co v British Mutual Banking Co**.[7]

**s4 The Protection of Cheques Act 1957** is available only if the banker collected the cheque or payment mandate 'for a customer' or credited 'a customer's account' with the value of the instrument.

[7] **Carpenters Co v British Mutual Banking Co. Ltd** [1938] 1K.B. 511.

'*Customer*' was defined in **Ladbroke v Todd.**[8] as someone who....'goes to the bank with money or a cheque and asks to have an account opened in his name, and the bank accepts the money or cheque and is prepared to open an account in the name of that person'.

**The relationship between banker and client.**
The relationship of a banker and his customer is subject to duties by both parties.

**Duties of the banker.**

a) To pay out money deposited by the customer as indicated to him to the extent of the funds in his account. If the customer has agreed overdraft facilities he may order payments to the limit of such facilities.
b) To collect payments on cheques paid into the customers account.

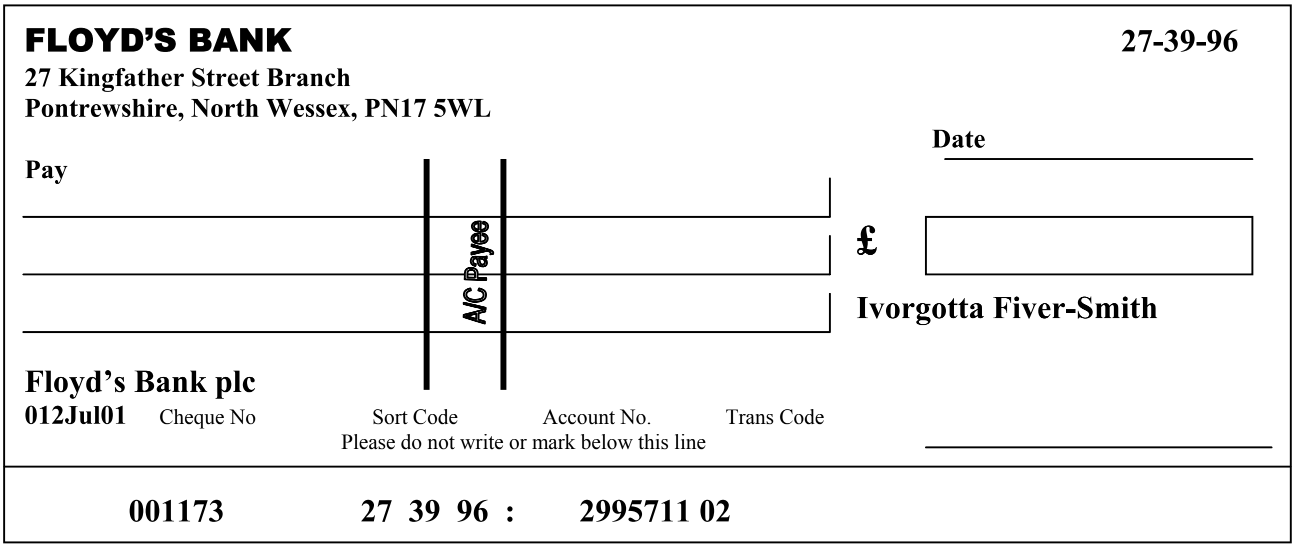
The duty to pay cheques ends (i.e. the banker's authority is revoked) when:

a) the customer countermands payment (i.e. "stops" the cheque before it has been paid) or;
b) if the customer dies; or
c) if the customer is declared bankrupt.

**Duties of the customer.**

a) If his account is overdrawn then his obligation is to pay back the amount of the overdraft plus interest.
b) The principal duty is to ensure care is taken when writing cheques so that they cannot be misinterpreted or altered. Any losses incurred as a result of such carelessness may have to be borne by the customer according to **London Joint Stock bank v MacMillan & Arthur**.[9]

**A Typical Cheque**




8 **Ladbroke v Todd** (1914)
9 **London Joint Stock Bank v MacMillan & Arthur** (1918)

## METHODS OF PAYMENT IN INTERNATIONAL SALES

Any of the methods of payment such as cash, cheques, promissory notes and other negotiable instruments used in domestic contracts may also be used in international dealings, but because of the special problems encountered in export sales many of these methods are unsatisfactory. Consequently merchants have developed a number of methods of payment which seek to reconcile the conflicting interests of the seller and the buyer.

The four principal methods of payment are

- 'payment on open account' –
- 'bill of exchange' –
- 'documentary letter of credit'
- 'bank guarantee'.

Each has its own special features and advantages and disadvantages for the seller & the buyer. Which is used depends on the creditworthiness, bargaining power of the parties, currency rates and exchange control regulations, the nature of the contract of sale and political realities including local state controls and regulations.

## PAYMENT ON OPEN ACCOUNT

The buyer instructs his bank to request its correspondent bank in the exporter's country to pay the contract price into the exporter's account. This may be by mail transfer (M/T) or telegraphic transfer (T/T) where the buyer is requested by his bank to complete a Customer Lodgement Form for international money transfer.

The precise time of transfer depends on the terms agreed between the exporter and the buyer. If the parties agree on ***'cash with order'*** the buyer will remit a lump sum, representing the contract price into the account of the exporter when he makes the order.

Sometimes the parties agree on ***'sight payment'*** instead of 'cash with order'. Here the buyer has to remit or pay the purchase price into the account of the exporter when presented with the documents of title of the goods sold. When the exporter is acquainted with the financial status of the buyer and entertains no doubt about his solvency, he will send the documents to the buyer who then remits the agreed price to the exporter. Sight payment is usual where an exporter sells goods to his own overseas branch or subsidiary.

On the other hand, if the exporter is not so acquainted with the financial status of the buyer, or other circumstances demand it, he is likely to arrange that the purchase price be paid ***'cash on delivery'*** or ***'cash against documents***'. These clauses are particularly suitable when delivery of the goods sold is to take place ex-works. This method of payment enables the exporter to obtain the price in cash at the doorstep of his own factory or in his own country before the goods are shipped abroad, and gives the seller total security. It also places all the risks of non-performance on the buyer.

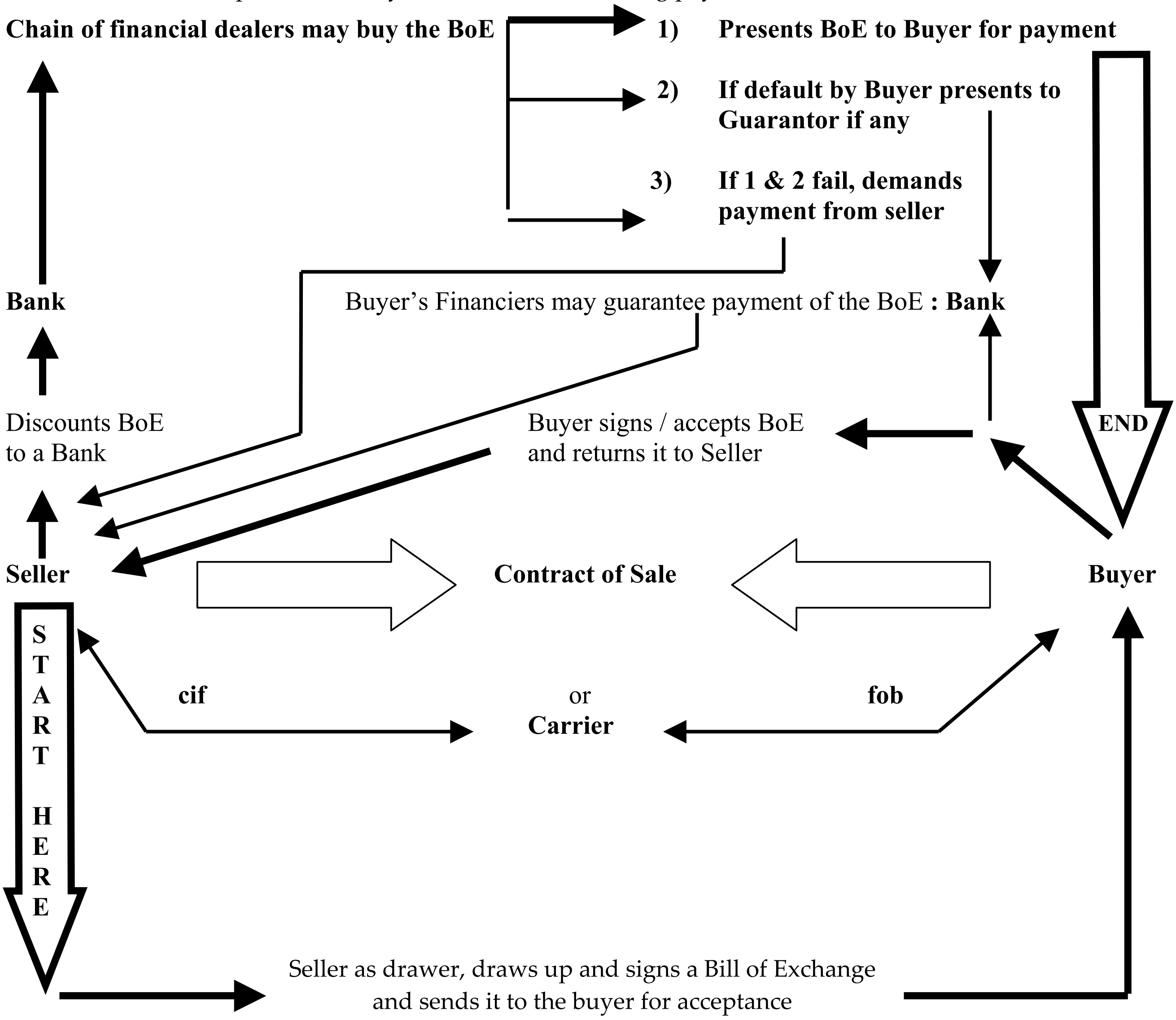
A ***'cash with order'*** term in a contract, indicates that the seller's negotiating strength is nearly overwhelming and that the buyer for whatsoever reason is almost at the mercy of the seller and that the buyer desires the goods so desperately that he will agree to such a payment term and bear the risk.

This method of payment offers advantages to the seller alone. The buyer usually would not take it unless there is no other choice open to him. Moreover, it hinders the buyer's ability to market goods since he is not allowed a period of credit in which to resell the goods and finance the transaction. This places constraints on the buyer's cash flow and consequently is not a popular method of payment in international trade.

CHAPTER SEVEN

## BILLS OF EXCHANGE

**Introduction :** A BoE provides a very useful device for settling payment in international transactions.




The normal procedure is for the seller to draw the bill and lodge it with his bank together with the original bill of lading and other contract documents. In order to empower the bank to implement the documentary collection method of payment the seller is required to complete and submit a Customer Lodgement Form for the Foreign Bill and or Documents for Collection (*it follows the Bill of Exchange through the banking system*) which gives the bank precise and detailed instructions regarding whether to forward the bill by cable or air mail; whether the proceeds are to be released against payment or acceptance of the bill; whether the bill is to be 'protested' if dishonoured; whether the goods should be stored and insured if not taken up by the buyer. The seller's bank then forwards the Bill of Exchange and the relevant documents to its corresponding bank in the buyer's country, passing on the exact instructions received from the seller. The corresponding bank (collecting bank) notifies the buyer of the arrival of the Bill of Exchange and the relevant documents and releases it in accordance with the instructions received.

If the bill is drawn at 'sight', which requires the buyer to pay the amount in full immediately, the instruction is to release documents against payment (D/P). If a period of credit has been agreed the instruction is for the documents to be released against acceptance by the buyer of the bill (D/A). In this case the buyer signs his acceptance across the face of the bill, which is not due for payment until its maturity, enabling him to obtain the relevant documents of title to the goods. The collecting bank informs the remitting bank of the date of acceptance and holds the bill and presents it to the buyer for payment at its maturity.

If the collecting bank releases the documents to the buyer contrary to the seller's instructions, by for example not insisting on payment or the acceptance of a term bill, the bank is liable in damages to the seller for breach of contract and for conversion of the documents **Midland Bank v Eastcheap Dried Fruit.**[10]

The Bill of Exchange has, until recent times been a popular method of payment in international trade. It offers both advantages to the seller and B. the buyer is effectively afforded a credit period between the purchase of the goods and maturity of the bill. the seller can obtain his money before its maturity date by '***selling***' the bill. However, this system offers the seller relatively little security since the bill may not be honoured by the buyer even after acceptance. If this is the case, the seller having transferred it to the bank will be liable on it and may be sued by the bank. Also, the seller will almost always receive less than the face value of the bill by discounting it to a bank. Therefore, its popularity has in recent times been replaced by documentary credits.

**s3 Bill of Exchange Act 1882** describes a Bill of Exchange as "*an unconditional order in writing addressed by one person to demand, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or to bearer.*"

Once a Bill of Exchange is used as a payment method in international trade a new contract on the bill is created in addition to the original sale contract. If the bill is not paid the seller can sue the buyer either under the original contract or on the dishonoured bill.

The essential characteristic of the Bill of Exchange is its negotiability. As a negotiable instrument the payee can sell it, at a discount to a bank to raise some cash immediately, albeit at less than the full face value of the bill. There is a discount on the bill since it will not be redeemable at face value until maturity. The purchaser is entitled to earn a profit for holding the bill till it matures and for undertaking the possible risk of non-payment. The seller will take this into account when fixing the price for the goods. Alternatively he may require the buyer to open a Documentary Credit with a bank under which the bank undertakes to accept a Bill of Exchange drawn on it by the seller; the bank's acceptance will increase the discount value of the bill. The person in lawful possession of the bill is its holder and can enforce the bill either against the indorser(s) or the drawee of the bill.

The obligation to pay is unconditional which makes it especially attractive as a means of payment in commercial transactions. The payment obligation under the bill is independent of the underlying sale contract. The original drawer can enforce the obligation of the drawee regardless of any alleged breach of the underlying sale contract. This makes the bill as good as its current cash value. Once the payee presents the bill to the drawee for payment at the time of maturity the drawee must carry out his obligation to honour the bill. He cannot withhold payment of the bill by alleging breach of the sale contract, for example, by claiming late delivery or defects in goods. Once he has accepted the bill by signing it he must discharge his obligation to honour it unconditionally. If there is a breach of the sale contract he can nonetheless sue the original drawer for damages. If the buyer were to be allowed to raise any defences under the sale contract in relation to the Bill of Exchange it would undermine the marketability of the bill and hence its commercial value.

The justification for not allowing the buyer to raise the defences under the sale contract is attributed to the deep root concept of English Law, which treats the bill itself as a contract separate from the underlying sale contract. Moreover if the buyer were allowed to raise alleged breaches of the sale contract there would be no benefit to the seller in taking a bill and so it would defeat the intentions of the parties. Russell L suggested in **Nova Knit v Kammgarn**,[11] the buyer can be exempted from honouring the bill unconditionally in situations where the breach of the sale contract gives rise to a total failure of consideration for which the bill was given or a partial failure of consideration for which the bill was given or a partial failure in a quantified amount. However this has not been confirmed by later authorities. If this were to be the case the characteristic of the Bill of Exchange as an unconditional order would be undermined.

10 **Midland Bank v Eastcheap Dried Fruit** [1962] 1 Lloyd's Rep 359.

11 **Nova Knit v Kammgarn** [1977] 2 All E.R. 483

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**Liability on the Bill**

The liability created by a Bill of Exchange is contractual. The drawee of a bill is primarily liable on it if he accepts the bill by signing it whereas the drawer's liability is normally secondary. The drawer's liability is not to pay the bill but to pay compensation in the event of its dishonour which will normally include the vale of the bill plus interest and the cost of enforcement. In addition the drawer is estopped from denying to a holder in due course the existence of the payee and his capacity to indorse the bill.

**s55(1) Bill of Exchange Act 1882** - *the drawer of a bill by drawing it*

a) *engages that on due presentment it shall be accepted and paid according to its tenor, and that if it be dishonoured he will compensate the holder or any indorsee who is compelled to pay it, provided that the requisite proceedings on dishonour be duly taken;*

b) *Is precluded from denying to a holder in due course the existence of the payee and his then capacity to indorse.*

A holder in due course is defined in **s29(1) Bill of Exchange Act 1882** as a holder who has taken a bill, complete and regular on the face of it, under the following conditions; namely

a) *that he became the holder of it before it was overdue, and without notice that it had been previously dishonoured, if such was the fact:*

b) *that he took the bill in good faith and for value and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it.*

By signing the bill, each indorser becomes a party to it and gives the same undertaking as the drawer. An indorser is estopped from denying to all subsequent indorsees that the bill was good title valid at the time of his indorsement and that he had a to it at that time.

**s55(2) Bill of Exchange Act 1882** - the indorser of a bill by indorsing it:

a) *engages that on due presentment it shall be accepted and paid according to its tenor and that if it be dishonoured he will compensate the holder or a subsequent indorser who is compelled to pay it, provided that the requisite proceedings on dishonour be duly taken;*

b) *is precluded from denying to his holder in due course the genuineness and regularity in all respects of the drawer's signature and all previous indorsement;*

c) *is precluded from denying to his immediate or a subsequent indorsee that the bill was at that time of his indorsement a valid and subsisting bill, and that he has then a good title thereto.*

However, the drawer or an indorser can negative his liability by adding the words 'without recourse', but, this is not a common practice because the value of the bill could be depreciated.

If a bill is dishonoured, notice of dishonour must be given to the drawer and to each endorser against whom it is desirable to retain recourse.

**s51(1) Bill of Exchange Act 1882** - *where an inland bill has been dishonoured it may, if the holder think fit, be noted for non-acceptance or non-payment, as the case may be; but it shall not be necessary to note or protect any such bill in order to preserve the recourse against the drawer or indorser.*

If the bill is a foreign bill, an additional step is required in order to provide adequate evidence of dishonour. The holder must have it re-presented by a public notary. If the bill is again dishonoured, the notary must note that fact on the bill and draw up a formal protest, which he signs in the presence of a witness.

**s51(2) Bill of Exchange Act 1882** - *where a foreign bill, appearing on the face of it to be such, has been dishonoured by non-acceptance it must be duly protested for non-acceptance, and where such a bill, which has not been previously dishonoured by non-acceptance is dishonoured by on-payment it must be duly protested for non-payment. If it be not so protested the drawer and indorsers are discharged. Where a bill does not appear on the face of it to be a foreign bill, protection thereof in case of dishonour is unnecessary. This procedure provides evidence of dishonour in a court f law both in the UK and in foreign countries. In some countries, publicity is given to protested bills to discourage traders from dishonouring bills.*

As a general rule, the basis of liability on a bill is the signature. A person who signs a bill is prima facie liable on it. By virtue of **s24 Bill of Exchange Act 1882** a forged or unauthorised signature on a bill is wholly inoperative and any person taking such a bill has no title to it and is unable to sue on it.

**s24 Bill of Exchange Act 1882** - *subject to the provision of this Act where a signature on a bill is forged or placed thereon without the authority of the person whose signature it purports to be, the forged or unauthorised signature is wholly inoperative and no right to retain the bill or to give a discharge thereof or to enforce payment thereof against any party thereto can be acquired through or under that signature, unless the party against whom it is sought to retain or enforce payment of the bill is precluded from setting up the forgery or want of authority. Provided that nothing in this section shall affect the ratification of an unauthorised signature not amounting to a forgery.*

A distinction must be drawn between an unauthorised and a forged signature since an unauthorised signature can be ratified and is wholly effective after ratification under the law of agency, **Spiro v Lintern.**[12] However, there is a statutory exception to this rule.

**s55(2) Bill of Exchange Act 1882** provides that an indorser is precluded from denying to a holder in due course the genuineness and regularity in all respects of the drawer's signature and all previous indorsements. In addition to the statutory estoppel a party may be estopped at common law from setting up a forgery of his own signature. Such an estoppel may arise if a man knows that his signature has been forged and by his actions or his silence willingly leads others to believe that the forgery is his genuine signature. He cannot later plead his signature was forged - **Greenwood v Martins Bank**.[13]

A third party who takes a bill after a forged indorsement may be protected by **s7(3) Bill of Exchange Act 1882** which provides that if a bill is payable to a fictitious or non-existing payee, it may be treated as payable to bearer, and can therefore be transferred by delivery**.**

Since the bill is treated as payable to bearer, the forged indorsement is superfluous. No indorsement is required to transfer a bearer bill. This provision becomes important in cases where a bill is drawn for the purpose of fraud. If a realistic name is used it will generally be possible to find someone with that name even though the name chosen is fictitious. The effect of this depends on the intention of the person drawing the bill. If the drawer of the bill intends the person named in the bill to receive payment, the payee is not fictitious according to **Vinden v Hughes**.[14] If the drawer never intended the named payee to receive payment, the payee is fictitious even though there may be a real person of that name according to **Clutton v Attenborough**.[15] The decisions extending the meaning of fictitious and non-existent are clearly beneficial to innocent third parties who may take the bills in such cases. However, a test based on the drawer's intention and the attributes of the payee may require some difficult distinctions to be drawn by the courts.

***An aval*** is the signature on a bill of exchange buy a person who wants to 'back' it and to guarantee its payment to the holder in due course. By **s56 Bill of Exchange Act 1882** the guarantor incurs the liabilities of an indorser to a holder in due course. Thus, **s56 Bill of Exchange Act 1882** - *where a person signs a bill otherwise than as drawer or acceptor, he thereby incurs the liabilities of the indorser to a holder in due course.*

**Montage v Irvant**,[16] held that the liability of the guarantor depends on the distinct status of the guarantor under an avalised bill. If his status had been treated as that of an indorser under s56 the plaintiff would have lost his action against the guarantor as no notice of dishonour was given with respect to these bills and also the protest was not carried out in the time required by s51 Bill of Exchange Act 1882. Saville J held that s56 Bill of Exchange Act 1882 was not applicable to a guarantor under an avalised bill. An avaliser is a stranger who becomes a party to the bill. He is not an indorser for the purposes of notice or of other rules about dishonour where these refer to indorsers.

**Is an avaler liable only to holders in due course ? Bank Lenmi Le Israel v Coniplan,**[17] per Caulfield .J Bills had been signed by third parties as follows 'We guarantee this draft Bon Pour Aval'. the action was brought by the payees, who were not the drawers of the bills. The judge considered the right of the plaintiffs as holder for value.

12 **Spiro v Lintern** 1973 3 All ER 319.

13 **Greenwood v Martins Bank** 1932 KB 371

14 **Vinden v Hughes** 1905 1 KB 795.

15 **Clutton v Attenborough** [1897] AC 90.

16 **Montage v Irvant** [1987] Q.B.D. 23rd July.

17 **Bank Lenmi Le Israel v Coniplan** [1987] QBD 31st July 1987

**s27(1) Bill of Exchange Act 1881** - valuable consideration for a bill may be constituted by

a) *any consideration sufficient to support a simple contract;*

b) *an antecedent debt or liability. Such a debt or liability is deemed valuable consideration whether the bill is payable on demand or at a future time.*

**s27(2) Bill of Exchange Act 1881** - *Where value has at any time been given for a bill the holder is deemed to be a holder for value as regards the acceptor and all parties to the bill who became parties prior to such time.*

Caulfield J concluded that although the payee could not be a holder in due course, he had the same rights and could not be defeated by personal defences. The cases clarify the status of the guarantor under the avalised bill.

**Fraud**__Fraud may operate in a number of ways as far as bills of exchange are concerned. For example the drawer may be persuaded to give a bill which he would not have issued but for the fraud as in **Jones v Waring & Gillow**[18] or if he mistakenly signs a bill not knowing it is a bill of exchange as in **Lewis v Clay**.[19]

A fraudulent person may alter or tamper with a bill after it has been signed. The parties (drawer and drawee) may conspire to discount falsified bills to obtain a pecuniary advantage by deception. **R v Golechha and R v Choraria**.[20] The bank granted to Golechha (the drawer) a facility to discount bills of exchange drawn n and accepted by Choraria (the drawee). The bills were based upon a fictitious trade transaction and shipment. On the date of the bill's maturity Golechha met his liability by presenting the next bill for discount, rolling-over the liability so as to keep the facility alive and to secure the bank's forbearance to sue under earlier bills. Fraud is possible regarding bills of exchange, but there are not many reported cases of this happening and therefore it could be concluded that Bills of Exchange are a relatively secure method of payment.

## DOCUMENTARY CREDITS (D.C.)

The mechanics of Documentary Credits is similar to that of payment on collection, but the legal implications are not the same. The buyer applies to a bank, The Issuing Bank (I/B) to establish a credit in favour of the seller (S). The Issuing Bank, based in the buyer's country often has direct access to information regarding the buyer's financial status - which if it satisfies the bank enables it to confidently draw up a letter of credit which it sends to a second bank, the Confirming Bank (C/B) in the seller's country.

The confirming bank contacts the seller and delivers the letter of credit to him. On delivery, the seller ships the goods and simultaneously collates all the other documents relevant to the letter of credit, including the sight or time draft, appropriate invoices, export and import permissions (if applicable) documents of insurance and bill of lading and presents these to the Confirming Bank which normally pays the draft and then forwards the documents to the Issuing Bank for final collection.

The Issuing Bank reimburses the Confirming Bank. The Issuing Bank can give the bill of lading to the buyer in exchange for a trust receipt which enables the buyer to resell the goods and pay the bank out of the proceeds of the sale. Under the legal principles applicable to letters of credit, that is to say, the autonomy of the credit and strict compliance, if the documents presented are in order the Issuing Bank must pay the draft in the case of a confirmed irrevocable Documentary Credit irrespective of any change of mind by or excuse of the buyer.

Documentary Credits offer a number of advantages to both parties. The buyer need not pay cash immediately and the bank advances credit giving him the opportunity to resell the goods. The seller has the security offered by a promise of payment given by a bank in his own country - eliminating potential disputes with foreign financiers. The bank’s obligation is absolute and the buyer may use this assurance to negotiate favourable purchase terms - extended credit or even a discounted price. Both parties benefit from improved cash flow. The bank holds the documents as a security so it is relatively safe and the bank can stand clear of any contractual disputes between the parties to the underlying sales contract because of the doctrine of autonomy of the credit.

18 **Jones v Waring & Gillow** [1926] AC 670

19 **Lewis v Clay** [1897] 67 L.J.Q.B. 224.

20 **R v Golechha and R v Choraria**.

## BANK GUARANTEES (BG)

Bank guarantees serve a similar function to Documentary Credits and can also be used to secure performance of obligations over and above the payment of money. A Bank Guarantee may be procured by either the buyer or the seller. In a sale or construction contract the buyer may want some guarantee against the non-performance of the seller whereas the seller may also want some guarantee against the failure of the buyer to pay the contract price.

The mechanics of the Bank Guarantee is similar to that of Documentary Credits. There is a contract between the account party and the beneficiary. The beneficiary requires the account part to arrange the Bank Guarantee in favour of the beneficiary. The account party then instructs the bank to provide the relevant guarantee and indicates in the guarantee the conditions under which payment is to be made and undertakes to reimburse the sums paid out under the guarantee.

In turn the issuing bank instructs a correspondent bank in the beneficiary's own country and undertakes to reimburse the correspondent bank if payment has been made and notifies the beneficiary of the relevant guarantee. The obligation of the correspondent bank to make payment arises when the conditions of the guarantee are satisfied by the beneficiary.

Bank Guarantees are increasingly popular in commercial transactions and different types of guarantee have been developed in recent times. They share similar characteristics and mechanisms and are commonly known as performance bonds. Bank Guarantees offer advantages to both the seller and to the buyer. The beneficiary can obtain immediate compensation from a bank in his own country without the need to resort to the courts or extensive negotiations with the account party.

The parties share the lower cost of this form of security because the bank is t required to expend time and resources investigating the validity of a claim. The banks are not involved in any contractual disputes between the parties or litigation over allegedly unjustified claims. The performance guarantee enables the account party to retain control of his assets thus increasing his cash-flow. In most cases no call is made under the guarantee. Effectively the bank rents out its creditworthiness to its clients.

A ***Bank Guarantee*** or ***Performance Guarantee*** is a payment undertaking by the account party's bank to the beneficiary. In the absence of fraud, the bank is required under the terms of the contract between the bank and the account party to pay the beneficiary when a demand is made in the form specified in the guarantee.

The economic function of a performance guarantee is similar to that of a guarantee or a legally binding comfort letter - **Kleinworth Benson v Malaysian Mining Co**.[21] However, significant legal differences flow from the autonomous nature of the performance guarantee. A Performance Guarantee is a primary and independent undertaking. The bank is required to pay if the conditions of the guarantee are satisfied. A guarantee is a secondary obligation, subsidiary to the underlying contract, which cannot be invoked unless the debtor is in default of the principle obligation. Even if the underlying contract is affected either by discharge, a frustrating event or is rendered void, the PG remains nonetheless valid, because of it's autonomous nature, whereas a guarantee would in similar circumstances become ineffective.

## MODERN FORMS OF GUARANTEE.

### The tender guarantee

A party submitting a tender to obtain a contract, for instance to carry out construction work or to supply goods, may be required to arrange a bond to show that the tender is serious. If the tender is awarded but the tenderer fails to perform, the beneficiary can call on the bank to pay under the bond to cover its losses.

### The performance guarantee and the advance payment guarantee.

The labels ***Performance Guarantee***, ***Performance Bonds*** and ***First Demand Guarantees*** tend to be used almost interchangeably. Under these arrangements, a bank is required to give an undertaking on behalf of its client (***the account party***) to a beneficiary that the bank will make a payment if the account party defaults in performance of an obligation and other conditions are fulfilled. Where a contracting party makes advance or stage payments it will wish to recover them if the other party fails to perform. It may therefore require the other party to arrange for a bank to provide a bond guaranteeing repayment. There is no strict dividing line

[21] **Kleinworth Benson v Malaysian Mining Co** [1989] 1 Lloyd's Rep 556

between them. Each form of guarantee must be individually considered in order to decide its effect. However, they can be distinguished in terms of the 'form of the demand for payment' to determine which are first demand and which are conditional guarantees.

***First demand guarantees*** are normally provided by banks on behalf of their customers, whereas surety or insurance companies are the most important source of conditional guarantees. Such companies are generally unwilling to issue first demand guarantees, since they are generally considered to be commercially unsafe. On the contrary, banks have traditionally preferred first demand guarantees , which enable them to stand clear of any contractual dispute between the parties to the underlying contract. The obligation to make payment in a conditional guarantee is conditional upon the account party being in default under the primary contract. In order to avoid the bank being drawn into any dispute regarding the underlying contract the demand is usually activated on the production of either a certificate of judgement or of an arbitration award or of a certificate from a third party such as a surveyor. Thus the bank is protected provided the correct documentation is produced. This arrangement is closely analogous to that of documentary credits.

***First demand guarantees*** are the most attractive arrangements for the beneficiary. Under a first demand guarantee the bank is required to pay if the beneficiary makes a demand. There is no need to prove a breach of the underlying contract. The bank is therefore insulated against disputes arising under that contract. However, the arrangement clearly exposes the account party to unjustified demands by the beneficiary. Thus it is also rather controversial.

Many of the cases highlight the similarity between documentary credits and performance guarantees, but in fact there are also a number of differences between them. The nature of the payment in documentary credit is a method of payment of the contract price whereas the performance guarantee is a form of penalty payment for default, by the account party of the underlying contract. No document is required to activate the payment under a first demand guarantee, whereas in documentary credits, payment becomes due on endorsement to the buyer by the seller of the relevant sales documents – bill of lading - receipt and insurance certificate. A beneficiary under a conditional guarantee is required to produce third party certificates. The obligation under a documentary credit is to produce a 'certificate of performance' whereas the obligation under a conditional guarantee is to provide a 'default certificate'.

A ***Performance Guarantee*** is a more flexible instrument. In most cases the guarantees are not claims for payment against documents but claims for payment on demand. Therefore, it can be said that it is easier for a beneficiary to bring a claim under a performance guarantee than under a documentary credit. In documentary credits the documents must conform precisely with the terms and conditions of the credit otherwise the bank is not permitted to make payment. The law relating to documentary credits and performance guarantees is founded in both cases on the autonomy of the contract and the doctrine of strict compliance. The Performance Guarantee is completely divorced from the underlying contract. The bank is required to make payment as long as the conditions set out in the guarantee are satisfied notwithstanding the contractual dispute of the parties of the underlying contract.

**The Fraud Exception**

Unfortunately, these two instruments also share the same problem in their course of operation, namely 'fraud'. A fraudulent call can arise in two ways. It may be forged or fraudulent documents are presented by the beneficiary, as also may occur in documentary credits. Or it may be where the request for payment is made fraudulently.

In these circumstances the beneficiary has no right to draw on the payment which is referred to as an ***'abusive or unfair call'***. This type of fraud is unique to first demand guarantees.

The right to withhold the bank from making payment under Performance Guarantee follows the same principle as that regarding Documentary Credits. There must be a clear case of fraud of which the bank has notice, and the beneficiary must be identified as the perpetrator of fraud.

Per Ackner L.J. in **U.T.Y.C. v Allied Arab Bank.**[22] "*Strong corroborative evidence of the allegation is required and should usually take the form of contemporary documents, particularly those emanating from the buyer*."

[22] **Allied Arab Bank** [1985] 2 Lloyd's Rep 554

The most controversial issue regarding the fraudulent cases is 'abusive calls' on first demand guarantees. The major problem is the difficulty to prove a fraudulent case. The courts have refused to inquire into disputes regarding the underlying contact because of the autonomous nature of the Performance Guarantee. Therefore it cannot be discerned whether payment has been demanded in circumstances when there is no right to payment.

In **Howe Richardson Scale v Polymex-Cekop & Nat West Bank**,[23] the beneficiary had failed to fulfil a condition precedent of the underlying contract in opening a DC and this was not regarded as a fraudulent call by the court. Moreover in **Edward Owen Enginering v Barclays Bank International**,[24] Denning L also stated that even though the court had accepted that the beneficiary is prima facie in default of the underlying contract it was not a fraudulent call. It seems that to approach the courts regarding abusive calls goes against the intention of the parties to the Performance Guarantee, which is to make it easier for a beneficiary to be compensated in the event of default by the account party and not to give a right to payment regardless of default.

A more liberal view of the scope of the fraud exception was taken by Eveleigh L.J. in **Potton Homes v Coleman Contractors**,[25] and also by Parker L.J. in **GKN Contractor v Lloyd's Bank,**[26] Eveleigh LJ suggested that if the plaintiff had established that there had been no breach of the underlying contract a demand under the PG would have been fraudulent though this left open the question of the standard of proof required. Parker L.J. put forward an argument that if the invalidity of the claim was known to the bank at the time of making payment it would be guilty of fraud which would justify non-payment of the demand notwithstanding that the demand on its face appeared to be valid. However, Leggatt J did not consider this argument in the appeal of this case but concentrated on the validity of the claim.

There is an absence of cases in which the fraud exception has been successfully invoked. Apart from the principle of the autonomy of the Performance Guarantee, various other factors may account for this. The cases indicate that a high standard of proof is required. No guidance has been given as to what actually constitutes fraud apart from the fact that it must be very clearly established.

Banks regard prompt payment as essential to confidence in the system which could be eroded if a bank is restrained from honouring its bonds. Kerr LJ in **Harbottle v Nat West Bank** described a bank's reputation as part of its stock in trade which depended on prompt and scrupulous fulfilment of its obligation. Perhaps, in protecting the reputation of the bank the courts have undermined protection of the innocent account party. The law of fraud is not static and the courts should adapt it to the changing nature of commercial transactions in our society. In United Trading Corp the plaintiffs extended the life of the guarantees following threats from the beneficiary to call for payment if extensions were not given. Likewise, similar duress may be applied to obtain other benefits from the account party. Therefore the courts should always be required to strike a balance between the principles of equity and the requirements of commercial law.

**Injunctions**

The most valuable remedy to an account party is an injunction to restrain the bank from making payment or to prevent the beneficiary claiming against the bank, thereby restoring the status quo in respect of the bargaining position of the parties. However, even though the account party can establish the personal fraud of the beneficiary obtaining such injunctions is still fraught with difficulties.

There is no room for an injunction if the account party has no knowledge of a claim prior to payment **Esal v Oriental Credit**,[27] held that the bank is under no duty to give this notification prior to payment.

The account party's bank will usually notify the account party before making payment, allowing him a short time to apply for an injunction. However, if the bank chooses not to do so, the account party is likely to lose even the small possibility of obtaining injunctive relief that this would normally afford.

23 **Howe Richardson Scale v Polymex-Cekop & Nat West Bank** [1978] 1 Lloyd's Rep 161

24 **Edward Owen Enginering v Barclays Bank International** [1978] 1 Q.B. 159

25 **Potton Homes v Coleman Contractors** [1984] 28 B.L.R. 19

26 **GKN Contractor v Lloyd's Bank** [1985] 30 B.L.R. 48

27 **Esal v Oriental Credit** [1985] 2 Lloyd's Rep. 546

As a standard precondition of granting an injunction, the account party is normally required to give a cross-undertaking to pay damages if the injunction subsequently proves to be unjustified. This cross undertaking can involve considerable sums of money. In **United Trading v Allied Arab Bank**[28] the plaintiffs conceded that they would be unable to provide a cross-undertaking for damages which exceeded £1m. Therefore such an undertaking may deter the account party from applying for an injunction.

In determining whether or not to grant an injunction, the courts take into account policy reasons, such as the balance of convenience and the possibility of enforcement by a foreign court. In **Harbottle v Nat West Bank,** the injunction was refused primarily on the balance of convenience because the plaintiffs would have an adequate remedy in damages against the bank and the damage that would be incurred by the bank if it failed to honour its international obligations far outweighed the damage likely to be incurred by the plaintiffs. The balance of convenience was hopelessly weighed against the plaintiffs. This reasoning was also followed in **Howe Richardson Scale v Polyinex-Cekop & National Westminster Bank**[29] and **United Trading v Allied Arab Bank.** Furthermore, if the beneficiary is based overseas, the courts would consider the possibility of foreign court enforcement. In **United Trading v Allied Arab Bank** one of the reasons for not granting an injunction against the bank was the likelihood that an Iraqi curt would not recognise an English Injunction. Ackner J also pointed out that if the position were reversed, it would be unlikely that an English court would recognise an interim Iraqi injunction either.

Additionally, the account party can also apply for a Mareva Injunction[30] to freeze funds in the hands of the beneficiary following the payment of a claim under a performance guarantee, pending the outcome of litigation under the underlying contract,[31] and **s37 Supreme Court Act 1981**. The standard of proof is likely to be lower than that required for an injunction restraining an initial claim for payment by the bank, but such an order is likely to be of little use to an account party faced with a demand by an overseas beneficiary claiming under a guarantee issued by a bank outside the jurisdiction. **The Bhoja Trader**.[32]

**Protective mechanisms**

In the light of the difficulties that may be encountered in establishing fraud and in obtaining an injunction businessmen do not like to rely on the courts more than is absolutely necessary. Some precautions can be taken to prevent the fraudulent calls but they all depend on the bargaining power of the parties. The account party should not agree to issue a Performance Guarantee in favour of the beneficiary unless he has used all the means at his disposal to assess the beneficiary's ability and willingness to perform his side of the bargain. The Performance Guarantee should be limited to a fixed amount or percentage of the contract price. It should expire on a specified date or occurrence and the original guarantee should be returned to the bank upon expiry. The amount of the guarantee should be reduced in stages as the work to which it relates progresses and is completed.

The price of the contract can be adjusted to take account of the risk of an abusive call, but this may not be feasible since the account party may price himself out of the bidding for the tender because the contract price would be increased. Ackner J commented in **U.T.D. v Allied Arab Bank** that *'the plaintiff took a commercial risk that the performance bonds might be called in dishonestly .... if, as is apparent, the plaintiffs were prepared to run the obvious risks, then they should have provided for those risks in the contract price*.'

It is advisable that the account party inserts a term in the underlying contract that written notice must be given by the beneficiary to the other party before a demand is made. This would give the account party time to study the demand and consider whether to seek an injunction.

Obtaining insurance against fraudulent calls on the Performance Guarantee through national and international export credit departments such as the Export Credit Guarantee Department is possible. This may be particularly useful when dealing with a party in a country facing a debt crisis or a shortage of valuable foreign exchange. However, this arrangement also increases the contract price.

28 **United Trading v Allied Arab Bank.**

29 **Howe Richardson Scale v Polyinex-Cekop & National Westminster Bank**

30 Now renamed a freeing order by the Civil Procedure Rules 1998

31 **Mareva** [1975] 2 Lloyd's Rep. 50

32 **The Bhoja Trader** [1981] 2 Lloyd's Rep. 256.

A higher degree of protection is provided where payment is conditional on the production of an arbitration award, an independent certificate such as engineer's or architect's notice of default.

However in **Tukan Timber v Barclays Bank**,[33] such a requirement in a letter of credit did not prevent the making of a fraudulent demand. The maximum protection can be achieved by a requirement that the account party himself issue the documents entitling the beneficiary to payment. Furthermore, one should avoid imposing subjective factors such as dependence on the opinion of the beneficiary to trigger the payment. Of course, the greater the protection for the account party the less attractive the arrangement will be for the beneficiary.

Where there is no alternative to a first-demand guarantee the account party can design a form of demand that requires the beneficiary to make allegations of his breach of contract. This may be implied where the guarantee clearly links the bank's obligation to pay on demand with a breach of the underlying contract as in **Esal v Oriental Credit**. Here the performance bond read *'We undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance ...."* It was held that the performance bond was not payable on the beneficiary's bare demand, but that the issuing bank must also be informed that the demand was being made on the basis provided for in the performance bond. Ackner J was of the view that an obligation to state the nature of the default when making a demand 'may prevent some of the many abuses of the performance bond procedure that undoubtedly occur.'

This form of guarantee is a halfway house or hybrid of the first demand and conditional guarantee. Under a first demand guarantee the bank is required to pay simply on the beneficiary's own say so and there is no need to prove any default of the account party. However this form of guarantee in addition to demanding payment requires the beneficiary to notify the bank that the account party has defaulted on the underlying contract. It weakens the demand element, which is intended to compensate the beneficiary more easily in the event of the default of the account party. Furthermore, the bank is embroiled in the contractual dispute of the underlying contract. In determining whether the demand of the beneficiary is valid or not the bank faces the problem of construction of the guarantee.

In **I.E. Contractors v Lloyds Bank**,[34] the decision turned on the construction of the guarantee as to whether it was a pure on demand form or whether something more was required by the wording which read "*an undertaking to pay unconditionally the said amount on demand, being your claim for damages ...*" Leggatt J held that, on the true construction of the bond no valid demand had been made because the words 'your claim' expressly required the beneficiary to assert in the demand that the call was made in respect of damages duly and properly sustained under the relevant contract. The CA confirmed that the bonds were not pure on demand bonds.[35]

The effect is to impose upon banks the difficult task of construction of the guarantee. In order to decide the validity of the demand the bank has to pay close attention to the wording of the demand. Obviously it shifts the burden to the bank. There is also a risk if payment is made in respect of an invalid demand that the bank would not be entitled to re-payment under the counter guarantees from the instructing bank or the account party. However, the bank can make appropriate insurance arrangements for this risk. Of course, in turn the cost of the Performance Guarantee would increase. Therefore the open ended form of wording in this form of guarantee is not necessarily in the account party's interest. Precise and unambiguous terms in a specified form would give both the bank and the beneficiary a degree of certainty.

**China & South Sea Bank v Tan Soon Gin,**[36] Bank guarantee : A debtor borrowed money from a Bank by mortgaging shares in a company. The defendant guaranteed the loan : The shares became worthless & the bank claimed against the guarantor when the debtor failed to repay the loan on time : Guarantor claimed the bank should have foreclosed on the mortgage and sold the shares before the value had fallen. Held Bank owed no duty to the guarantor to minimise its losses. The guarantor had to reimburse the bank.

[33] **Tukan Timber v Barclays Bank** [1987] 1 Lloyd's Rep. 171

[34] **I.E. Contractors v Lloyds Bank** [1989] 2 Lloyd's Rep 205

[35] see also on the construction of Performance Bond contracts **Wardens v New Hampshire Insc** [1992] 2 Lloyd's Rep. 365.

[36] **China & South Sea Bank v Tan Soon Gin** [1990] 1 Lloyd's Rep 113.

CHAPTER SEVEN

## BILLS OF EXCHANGE

**Introduction** :

The prime importance of a bill of exchange is its use in international trade. The main use is to enable a seller or exporter to obtain cash soon after the despatch of the goods and, at the same time, to enable the buyer or importer to defer payment, at least until he is in possession of the goods. This could be effected as follows:

Suppose Taff & Co Ltd in Wales sells electronic components to Yankee Doodle Inc. in the U.S.A. and that the two companies have agreed a credit period of 90 days.

Taff & Co draws a bill of exchange and Yankee Doodle Inc agrees to pay the amount of the bill (say £10000) by writing 'accepted' on the face of the bill and signing it. Taff & Co can then take the bill to a merchant bank or discount house and receive, perhaps, £9500 for it. 90 days later the bank may present the bill to Yankee Doodle Inc who pay the full £10,000. Thus Taff & Co was paid some immediately, Yankee Doodle Inc had the agreed time to pay and the bank made a profit for its part in the transaction.

In international trade a bill of exchange is usually called a draft. The type of bill of exchange described above is also referred to as a 'time bill' or a 'term bill,' whereas a bill, which is due to be settled immediately on presentation, is known as a 'sight bill'.

The Party drawing the order is known as the 'drawer' of the bill.

The person or company making the payment is known as the 'drawee' and the person / company to whom the money is to be paid is the 'payee'.

**Example of a Sole or Single Transaction Bill of Exchange**

Drawn Under Credit Number 01/867/FB/3C
***No*** 1973 of Mercantile Bank, Amman, Jordan, dated 2 November 2001

18 November **20**01 For £250,000

At SIGHT Pay this SOLE Bi// of Exchange

to the Order of OURSELVES

THE SUM OF TWO HUNDRED AND FIFTY THOUSAND POUNDS STERLING
against shipment of 12,500 barrels of Saudi Crude from Bahrain to Fowley UK per vcl Bulkcarrier

Value RECEIVED which place to Account

FIVER-SMITH LIMITED

To FLOYD'S BANK PLC I.Fiver-Smith

Drawee Drawer

## THE BILLS OF EXCHANGE ACT 1882

The Act codified pre-existing case law and is now the principle source of law on bills of exchange. The Act defines precisely what constitutes a bill of exchange and under what circumstances it is negotiable.

**s3(1) Bills of Exchange Act 1882**: *A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand to or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to a bearer.*

**s3(2) Bills of Exchange Act 1882** : *An instrument which does not comply with these conditions, or which orders any act to be done in addition to the payment of money, is not a bill of exchange.*

The statutory definition of a Bill of Exchange gives rise to at least eight elements capable of further analysis

i) **An unconditional order**. ...means there must be an imperative order to pay. A mere request or authority to pay is insufficient. Further, the order to pay must not be subject to any condition. A requirement that a bill must be presented to the drawee for acceptance before payment can be made is not regarded as a condition.

ii) **In writing**....which can be in printed form or hand-written.

iii) **Addressed by one person to another**.. ..i.e. the drawer addresses his order to the drawee and the drawee and payee must be identified with reasonable certainty. If the payee is fictitious or non existent then s7(3) Bills of Exchange Act 1882 provides that the bill may be treated as payable to bearer.

iv) **Signed by the person giving it**...and here the only requirement is that the mark made by the drawer is intended as his signature.

v) **Requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time**....which means that the drawer will require the drawee to pay the amount stated in the bill to the payee: 1) when the payee demands payment; or 2) at a fixed future date; or 3) at a determinable time in the future, after the occurrence of a specified event that is certain to happen, though the time of that happening may be uncertain: e.g. a bill expressed to be payable "one month after the death of Queen Elizabeth II" is valid since the Queen is certain to die at sometime; but a bill payable "one month after Prince William becomes King of England" will be invalid since William might never become King.

vi) **A sum certain in money**....is satisfied not only by a definite amount being expressed in words and figures but also if the amount is ordered to be paid by stated instalments, with interest or in accordance with a particular exchange rate. If the sum payable is expressed in words and figures and there is a discrepancy between the two, the sum denoted by the words is the amount payable.

vii) **To the order of a specified person**....i.e. payable to P or 'to P or order'. This is an 'order bill' i.e. it may be negotiated by P if he writes on the back words indicating he wishes the bill to be paid to someone else e.g. 'pay Joe Soap signed Fred Bloggs'.

viii) **Or to bearer**....which will be so where: 1) it is expressed to be so payable; 2) where the only or last indorsement is an indorsement in blank 3) if the payee is a fictitious or non-existent person.

**Holders and Indorsements.**

Any holder of a bill is entitled to sue for payment of it. The Bills of Exchange Act 1882 defines very carefully what is meant by a 'holder of a bill'.

If a bill is drawn payable to a named person then the first holder of a bill is that named person. He becomes the holder when the bill is issued to him - i.e. when the drawer gives him possession of it.

A named payee may indorse the bill i.e. sign his name on the back of the bill: **Arab Bank v Ross**.[37] If, after indorsing the bill, the payee gives possession of it to another person then that other person becomes the holder of the bill.

[37] **Arab Bank v Ross** (1952).

The new holder may be named in the indorsement, in which case it is referred to as a special indorsement. Only the person named in a special indorsement (the indorsee) can be the new holder of the bill i.e. he becomes the payee of the bill. However, he may indorse it himself and give possession to another person who will thereby become the holder. If a bill is drawn payable to bearer then the person in possession of the bill is the holder of it. If an indorsement does not name a new holder then it is called an indorsement in blank and it makes the bill payable to bearer so that anyone in possession of it becomes its holder.

**Holder in due course**.

**s29 Bills of Exchange Act 1882** provides that a holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions, namely;

a) that he become the holder of it before it was overdue, and without notice that it had previously been dishonoured, if such was the fact; and
b) that he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it.

A bill is overdue if it has been in circulation for an unreasonable length of time or when the date for payment has passed (if any).

A holder can only be a holder in due course if he has given value, i.e. consideration sufficient to support a contract (and even past consideration will suffice).

The advantage of being a holder in due course is that such a holder takes the bill free from any previous defects in title *unless* the bill contains a forged signature. Further, any person taking the bill from a holder in due course "inherits" his good title. The title to a bill is defective if a person negotiates it after having obtained it by fraud, duress, force etc.

**Restricting who can be a holder in due course.**

**s8(1) Bills of Exchange Act 1882** : a bill that contains words prohibiting transfer, or indicating an intention that it should not be transferable, is not negotiable. Either the drawer or an indorser may make a bill not negotiable. In practise, the usual way in which a bill is made not negotiable is to express it to be payable to a named person '***only***', e.g. "***pay X only (signed) D***" - this is a restrictive indorsement.

**Acceptance.** The acceptance of a bill is the signification by the drawee of his assent to the order of the drawer: **s7(1). Bills of Exchange Act 1882**.

An acceptance is invalid unless it complies with the following conditions, viz;

a) it must be written on the bill and signed by the drawee. The mere signature of the drawee without addition is sufficient;
b) it must not express that the drawee will perform his promise by other means than the payment of money: **s17(2) Bills of Exchange Act 1882**.

## RIGHTS AND LIABILITIES OF PARTIES TO BILLS.

**Parties to a bill.**

A party means a person who is liable on the bill i.e. the drawer, acceptor and indorsers. The payee (before he indorses the bill) has rights under it and can also be described as a party.

**Order of liability.**

a) *Before acceptance* the drawer is the principal debtor and primarily liable.
b) *After acceptance* the drawee takes over primary liability.
c) *After indorsement* indorser is liable as a surety for the value of the bill.

The holder can therefore enforce the bill against the drawer, the acceptor (primarily) and any indorsers. He can sue any one or he can sue any combination of them, and each is liable for the full value of the bill.

**The drawer's liability.** He engages that:

a) on due presentment it will be paid according to its tenor
b) if dishonoured, he will compensate the holder or any indorser who has suffered loss thereby (provided proceedings on dishonour are taken).

**The drawee / acceptor's liability**

The person to whom the order is addressed. He is under no liability on the bill unless and until he accepts it, after which he assumes primary liability (and is then called the acceptor). He engages that he will pay the bill on due presentment for payment according to its tenor. Indorsers are people (including the payee) who indorse an order bill so as to transfer it.

They engage:

a) that on due presentment the bill will be accepted and paid according to its tenor; and

b) that if it is dishonoured they will compensate the holder (or any indorser who is compelled to pay it) provided necessary proceedings for dishonour are taken.

**Accommodation Party.**

This is a person who has signed a bill as drawer, acceptor or indorser without receiving value therefor. An accommodation party is liable on the bill to any holder for value, but not to the person whom he has accommodated, i.e. the person to whom he has lent the credit of his name.

**Capacitv of the parties.**

**s22 Bills of Exchange Act 1882 Act** : The capacity to incur liability as a party to a bill is co - extensive with capacity to contract. If a bill is drawn or indorsed by a minor then the drawing or indorsement entitles the holder to receive payment of the bill and to enforce it against any other party (**s22(2) Bills of Exchange Act 1882**) but not against the minor (*even if the bill was given in return for necessaries*).

**Signatures.**

No person is liable as drawer, indorser, or acceptor of a bill who has not signed it as such - provided that:

a) Where a person signs a bill in a trade or assumed name, he is liable on it as if he had signed it in his own name; and

b) **s23 Bills of Exchange Act 1882** the signature of the name of a firm is equivalent to the signature by the person so signing of the names of all persons liable as partners in that firm:

c) A signature by procuration (i.e. by someone acting as an agent, usually signified by 'per pro' or 'pp') operates as notice that the agent has only limited authority to sign and the principal is only bound by such signature if the agent in so signing was acting within the actual limits of his authority (s25 Bills of Exchange Act 1882). However, if the agent was not acting within the limits of his authority then either the principal may ratify the signature or the agent may be sued for damages for breach of warranty of authority.

**Forged or unauthorised signature.**

A forged or unauthorised signature does not convey title in a bill. However, in accordance with the principle that a holder in due course must be able to take a bill at its face value, such a holder may recover the value of the bill from persons who become parties to it after a forged or unauthorised signature was put on it but not from a person whose signature was forged or who signed it before a forged or unauthorised signature was put on it.

**Material alteration.**

Examples of alterations that constitute material alterations to a bill include: the date, the sum payable, the place of payment, etc. A material alteration to a bill discharges any party who did not make or assent to it but it will bind subsequent indorsers.

**Qualified acceptance.**

A drawee or his agent, when presented with a bill for acceptance * may qualify the acceptance in a number of ways as provided for by **s19 Bills of Exchange Act 1882**. In particular an acceptance is qualified which is:

a) ***conditional*** i.e. makes payment by the acceptor dependent on the fulfilment of a condition therein stated;

b) ***partial*** : acceptance to pay part only of the amount the bill is drawn for;

c) ***local*** i.e. an acceptance to pay only at a particular specified place,

d) ***alternate dating :*** by specifying a time for payment different from that expressed in the bill.

# CHAPTER SEVEN

## DISCHARGE OF BILLS.

**Methods of discharge**.

A bill is discharged, i.e. all liabilities on that bill are extinguished by inter-alia,

a) Payment in due course by or on behalf of the drawee or acceptor. This is similar to discharge of a contract by performance i.e. it is the usual way in which a bill is discharged.

b) A holder renouncing his rights against the acceptor absolutely and unconditionally at or after the maturity of the bill and either in writing or by delivering the bill to the acceptor: **s62(1) Bills of Exchange Act 1882.**

c) Where a bill is intentionally cancelled by the holder and the cancellation is apparent on the bill, it is discharged: **s63(1) Bills of Exchange Act 1882**.

**Effect of forgery.**

**s24 Bills of Exchange Act 1882** provides that payment to a holder whose title derives from a forged or unauthorised signature on a bill does not discharge the bill. Anyone who pays on such a bill before the worthlessness of the signature is discovered will probably be entitled to recover the money as money paid under a mistake of fact: **National Westminster Bank v Barclays Bank International**.[38] A person whose signature has been forged or used without authority must denounce the worthless signature on discovery, otherwise he may be estopped (precluded) from denying that it is his signature: **Greenwood v Martins Bank**.[39]

## RULES ON PRESENTATION FOR ACCEPTANCE AND PAYMENT

**Notice of Dishonour**.

In order to ensure that he obtains the rights available to him under the Bills of Exchange Act 1882 there are certain general duties required from the holder of a bill.

**How presentment must be made**.

Presentment must be made: by or on behalf of the holder; to the drawee or to some person authorised to accept or refuse acceptance on his behalf; at a reasonable hour; on a business day; before the bill is overdue.

**When presentment for acceptance is necessary**.

**s39(1) Bills of Exchange Act 1882**. When a bill is payable after sight, presentment for acceptance is necessary in order to fix the maturity of the instrument.

**Where Presentment is to be made**.

**s39 Bills of Exchange Act 1882.** Where a bill expressly stipulates that it must be presented for acceptance, or where a bill is drawn payable elsewhere than at the residence or place of business of the drawee, it must be presented for acceptance before it can be presented for payment:

**Time for presenting a bill payable after sight.**

When a bill payable after sight is negotiated, the holder must either present it acceptance or negotiate it within a reasonable time: **s40(1) Bills of Exchange Act 1882**. If he does not, drawer and all indorsers prior to that holder are discharged: **s40(2) Bills of Exchange Act 1882**. determining what is a reasonable time, the nature of the bill, trade usage and facts of each particular case must be taken into account: s40(3) Bills of Exchange Act 1882.

**Dishonour by non-acceptance**.

**s43(1) Bills of Exchange Act 1882**. When a bill is dishonoured by non-acceptance, an immediate right recourse against the drawer indorser accrues to the holder, and no presentment for payment is necessary: **s43(2) Bills of Exchange Act 1882**. A bill is dishonoured by non-acceptance:

a) When it is duly presented for acceptance, and acceptance is refused or cannot be obtained; or

b) When presentment for acceptance is excused and the bill is not accepted;

Situations where a bill may be treated as dishonoured by non-acceptance include:

a) where the drawee will only give a qualified acceptance: s44 Bills of Exchange Act 1882

b) the drawee is dead or bankrupt, or is a fictitious person or a person not having capacity to contract.[40]

38 **National Westminster Bank v Barclays Bank International** (1975)

39 **Greenwood v Martins Bank** (1933)

40 **s43(1)(b) Bills of Exchange Act 1882** and **s41(2)(a) Bills of Exchange Act 1882**.

**Notice of dishonour**.

Notice of the dishonour of a bill (by non-acceptance or non-payment) must be given by the presenting holder to his immediate transferer and to every prior party whom the presenter wishes to hold liable on the bill. The immediate transferor must, in turn notify all prior parties in order to preserve his rights against them.

**Acceptor for honour.**

If a bill is dishonoured by non-acceptance, the holder usually has recourse to the drawer. However, the drawer may anticipate possible dishonour by including in the bill the name of a person to whom the holder may resort should the drawee fail to accept the bill generally. That person is called a referee in case of need and, if he is asked to accept the bill in place of the drawee, he becomes an acceptor for honour (i.e. the honour of the drawer). The holder does not have to present it to the referee for acceptance.

If the referee accepts for honour, he is liable for payment of the bill provided that

1) it is first presented to the drawee for payment; and
2) it is not paid by the drawee; and
3) it is protested for non-payment; and
4) the acceptor for honour is notified of these facts.

**Protesting**.

A notary (a solicitor carrying out the function of a notary public) prepares a formal document - usually under seal - incorporating a solemn declaration setting out the loss sustained by the holder of the bill as a result of its not being accepted or paid.

The protest contains:

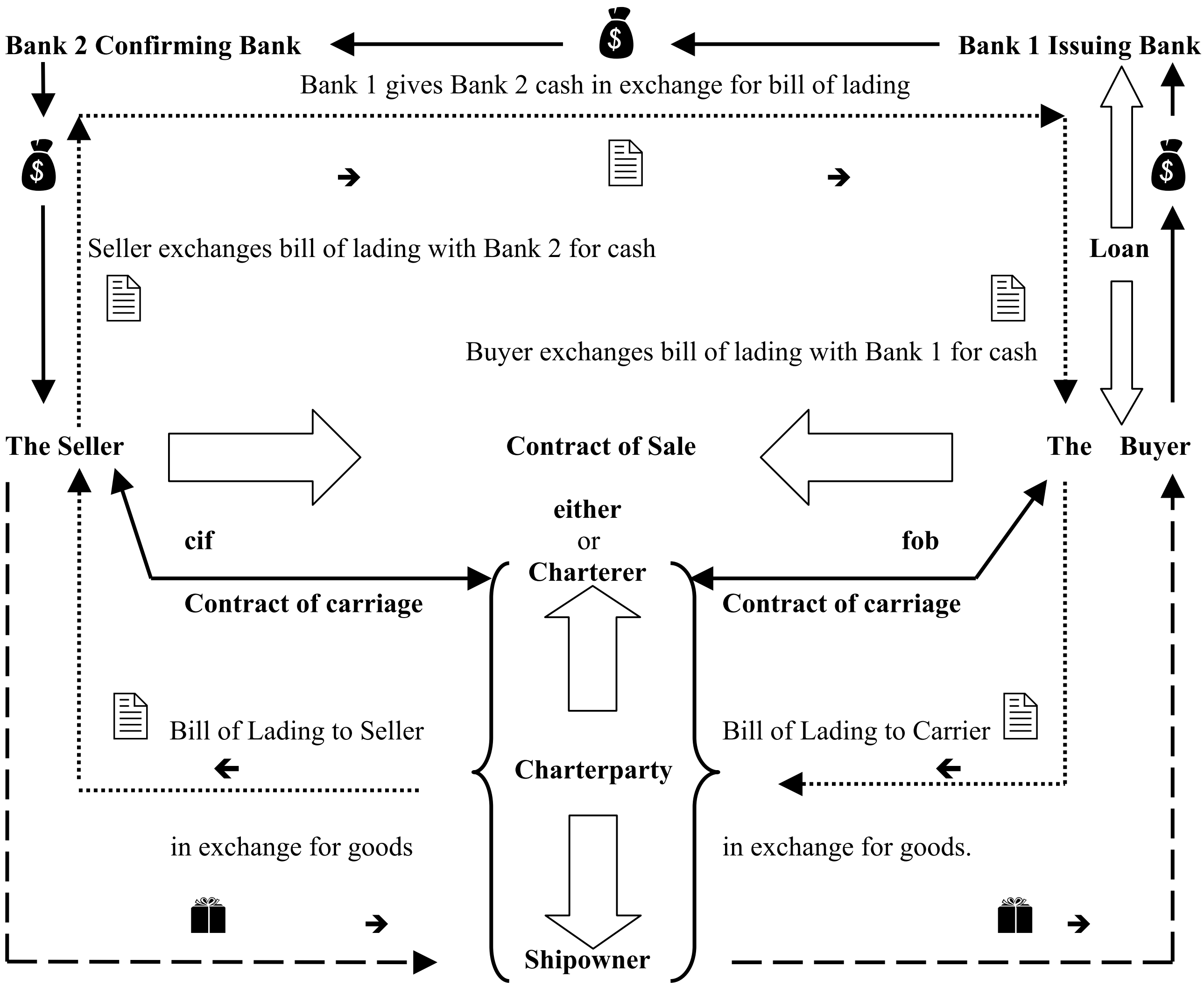
1) A copy of the dishonoured bill;
2) the name of the person requesting the protest;
3) the date and place of the protest;
4) the reason for the protest;
5) the demand made and the answer (if any) received. It is obligatory to protest foreign bills but note that this is not essential for inland bills.

## CHAPTER SEVEN

### BANKERS DOCUMENTARY CREDITS

**Introduction**

Irrevocable letters of credit and bank guarantees given in circumstances such that they are equivalent to an irrevocable letter of credit have been described by Kerr L.J. in **Harbottle v National Westminster Bank,**[41] per Griffiths LJ in **Power Curber International v National Bank of Kuwait,**[42] and per Donaldson J in **Intraco Ltd v Notis S.S. Corp of Liberia,**[43] as "*the life blood of commerce*". Donaldson went on to add that "*Thrombosis will occur if, unless fraud is involved, the courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being equivalent to cash in hand.*"




**Types of Documentary Credit**

Bankers Documentary Credits may be revocable or irrevocable, confirmed or unconfirmed, depending on the requirements of the parties involved.

**Revocability**

Refers to the ability or otherwise of the buyer (as opposed to the issuing bank) to cancel or modify the terms of the credit, without notifying the seller, at anytime prior to presentation of documents by the seller.

**Confirmation**

Refers to notification of the existence of the credit to the seller and has direct implications regarding the ability of the buyer and the banks to withdraw the credit facility in relation to the seller.

41 **Harbottle v National Westminster Bank** [1978] Q.B. 146 at 155

42 **Power Curber International v National Bank of Kuwait** [1981] 2 Lloyd's Rep 394 at 400

43 **Intraco Ltd v Notis S.S. Corp of Liberia** [1981] 2 Lloyds Rep 2567 at 257

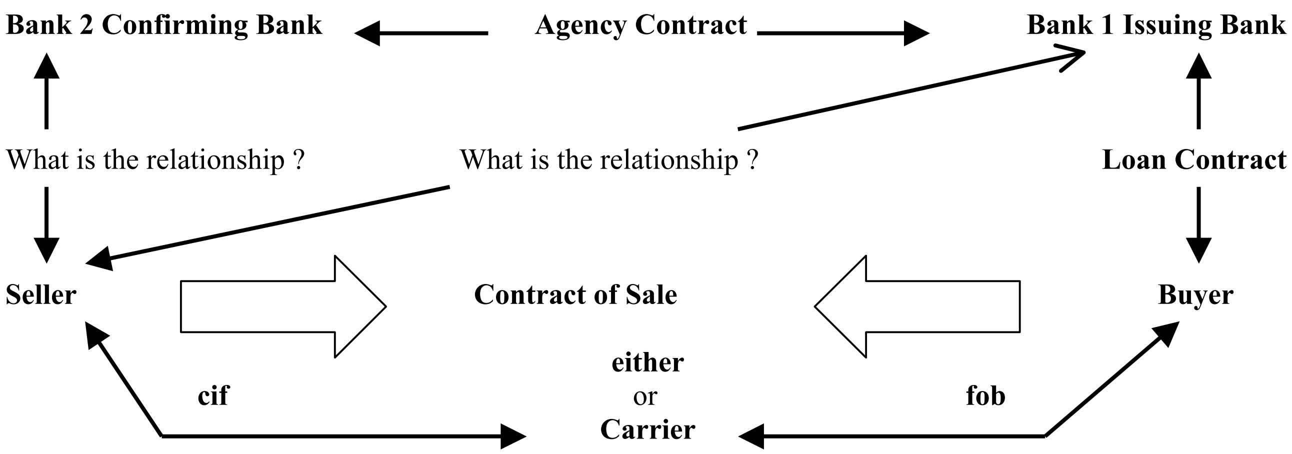
**Irrevocable Credit**
An Irrevocable Credit is a credit to which the advising / confirming bank (at the request of the issuing bank) has added its confirmation that payment will be made to the seller against presentation of documents conforming to the terms of the credit. Only irrevocable credits will be confirmed by Confirming Banks.

**Transferability**
A transferable letter of credit enables the seller to instruct payment to be made to a number of people besides himself.

**The main issues regarding Banker's Documentary Credits are :-**

- What rights do the various parties have under Banker's Documentary Credits ?
- What safeguards if any exist to protect innocent parties when one on the parties involved in Banker's Documentary Credits arrangements acts fraudulently ?

**Contractual relationships regarding Banker's Documentary Credits**




**Buyer's duty to open credit**
It is the buyer's duty under the sales contract to open a conforming letter of credit according to **Bennett v Angrexco**.[44] If the buyer fails to open a credit the seller can sue for breach of condition and claim damages, including loss of profit. **Trans Trust v Danubian Trading**.[45] If the buyer fails to open a credit in time the seller can repudiate the contract for breach of condition.

The duty to open the credit is absolute. The buyer cannot excuse himself because the failure was not his fault according to **Lindsay v Cook**.[46] The actual fault could be traced to inter-bank communications systems, the buyer having done all he could in time scale set out in the contract. Nonetheless, the court held the buyer liable for default. The seller could repudiate the contract for breach of condition.

If the credit does not conform to the sales contract, the seller may reject the credit and refuse to ship the goods. If he nonetheless accepts the credit, he is deemed waived the right to reject according to **Panutsos v Raymond Hadley Corp.**[47] Revocable or unconfirmed credits will not do unless so specified.

The place of the credit was held to be a condition in **Furst v Fischer**.[48] Furthermore, a reservation of a right of recourse by the Issuing Bank against the seller prevents a credit from being a confirmed credit according to **Wahbe Tamari v Colprogeca**.[49]

44 **Bennett v Angrexco** [1990].
45 **Trans Trust v Danubian Trading** [1952] 2 QB 297.
46 **Lindsay v Cook** [1953].
47 **Panutsos v Raymond Hadley Corp** [1917] 2 KB 473..
48 **Furst v Fischer** 1960 2 Lloyd's Rep. 340
49 **Wahbe Tamari v Colprogeca** [1969] 2 Lloyd's Rep. 18.

According to **Giddens v Anglo-African Produce,**[50] if the type of credit is not specified the court will presume it must be irrevocable since revocable credits provide the seller with no security. compare old art 7 UCP 400 which states that if a bank furnishes a credit without specifying its nature then it is to be treated as a revocable credit, with the new UCP 500.

When it became clear that an Issuing Bank would not pay because it was bankrupt in **Sale Continuation v Austin Taylor,**[51] the buyer paid the seller directly having got the documents from the Issuing Bank under a trust receipt. The Issuing Bank claimed the money should have been paid to the Issuing Bank & become part of its general fund for distribution to creditors. The court held that since it was clear the Issuing Bank would not be able to honour its commitments under the Documentary Credit, the Documentary Credit was avoided and so the bank's claim was invalid.

In **Alan v El Nasr Import & Export,**[52] a credit was taken out in the wrong currency. The seller continued with the sale nonetheless. The court held that even though the credit did not conform, the seller could not rely on the breach because by continuing with the transaction in full knowledge of the breach, because he had waived the breach.

Documentary Credits are only a conditional payments according to **Man v Nigerian Sweets & Confectionary**,[53] which concerned a buyer who took out a Documentary Credit and put the Issuing Bank in funds. Unfortunately for him, the bank then went into liquidation. The court held that the buyer still had to pay the seller directly. Similarly in **Maran Rd Saw Mill v Austin Taylor**,[54] the buyer paid twice. compare if the bank is nominated by the seller then the seller should bear the loss of his nominated bank.

The Documentary Credit operates irrespective of a breach of the sales contract according to **Hamzeh Malas v Btsh Imex.**[55] Two consignments of cargo : both subject to DC. When the first consignment proved faulty the buyer sought an injunction to prevent payment of 2nd instalment. The court held that there were no grounds for stopping payment under the Documentary Credit.

Exactly when the credit should be opened depends to a great deal on what the sales contract specifies, though often opening the credit is a condition precedent to delivery of the goods for shipment, as in **Dix v Grainger**,[56] **Garcia v Page**,[57] **Trans Trust v Danubian**[58] and **Lindsay v Cook**.[59] If no express statement then at the very latest it would be the time stipulated in the sales contract for performance of the contract according to **Etablissements Chambaux v Harbormaster**.[60] Thus the credit should have been opened within a few weeks of the conclusion of the sales contract. Goods were required to be delivered within 8 months from 1st July. The court held that that is when credit should have been opened. There is a duty to open the credit in time. A failure to do so entitles the seller to sue from damages for breach of contract. If the seller continues with the contract even after a failure to open the credit then he is deemed to waive the breach - but in this case the buyer failed to provide a credit even by 22nd October when the seller cancelled the contract. The seller was entitled to damages for B's failure to open the credit.

Within a reasonable time is usually counted from time of shipment according to **Bunge Corp v Vegetable Vitamin Foods.**[61] The actual credit is said to be open from the time of communication to the seller.

**Pavia v Thurman-Nielsen**[62] concerned two shipments in specified time bands. The court held that unless otherwise provided, credits should have been opened at the commencement of each time band.

50 **Giddens v Anglo-African Produce** [1923] 14 Lloyd's Rep 230
51 **Sale Continuation v Austin Taylor** [1967] 2 Lloyd's Rep. 403.
52 **Alan v El Nasr Import & Export** [1972] 2 QB 189
53 **Man v Nigerian Sweets & Confectionary** [1977] 1 Lloyd's Rep. 50.
54 **Maran Rd Saw Mill v Austin Taylor** [1975] 1 Lloyd's Rep. 156 & 1977 41 M.L.R. 91
55 **Hamzeh Malas v Btsh Imex** [1958] 2 Q.B. 127
56 **Dix v Grainger** [1922] 10 Lloyd's Rep. 496
57 **Garcia v Page** [1936] 55 Lloyd's Rep. 391
58 **Trans Trust v Danubian** [1952]
59 **Lindsay v Cook** [1953] 1 Lloyd's Rep. 328.
60 **Etablissements Chambaux v Harbormaster** [1955] 1 Lloyd's Rep 303.
61 **Bunge Corp v Vegetable Vitamin Foods** [1985] 1 Lloyd's Rep 613.
62 **Pavia v Thurman-Nielsen** [1952] 2 Q.B. 84

It was held in **Sinason Teicher v Oilcakes & Oilseeds Trading**,[63] that unless otherwise specified the credit should be made available a reasonable time before the shipment date, but compare **Ian Stach v Baker**,[64] regarding a contract requiring August / September shipment, buyers to nominate port and date of shipment, credit to be made available before the seller purchased the goods from a third party. The buyer claimed there was no need to procure credit until the shipment date. The court however held that the credit should have been made available by 1st August.

**Michael Warde v Feedex**,[65] involved a C&F sale, shipment by 20th March, payment on presentation of documents to a Paris Bank nominated by the buyer. the buyer failed to nominate a bank by 20th March. The court held that there had been a breach of sales contract. This case did not actual fact involve a documentary credit payment, but the circumstances are directly analogous.

In **Knotz v Fairclough**, [66] the sale's contract required a provisional invoice to be furnished by the seller before the buyer could take out the Documentary Credit. Until this happened there was no duty on the buyer to set up the credit.

See **Bankers v State Bank of India**,[67] regarding rejection of a letter of credit and see **Midland Bank v Brown Shipley**,[68] regarding conversion.

**Seaconsar v Islam Bank Iran**,[69] concerned a sale by armaments dealer of $193m of artillery shells - in consigments subject to unconfirmed letter of credit payable by Bank Melli Iran / London : credit specified inter alia that documents to contain a proces verbal containing name of the principal and the letter of credit number. 2 consignments worth $6m - DC's rejected by bank because number and name missing : Held : Doctrine of Strict compliance - bank entitled to reject documents and refuse to pay.

**The Future Express**,[70] c&f sale of wheat subject to confirmed Documentary Credit. Bank of Yemen named as consignee in the bill of lading but by prior agreement with bank -subject to an indemnity by the shipper goods delivered to buyer - reservation of title clause retaining title in the seller till presentation of documents to bank a year later documents tendered to Yemen bank : Buyer never repaid the bank which claimed against the shipowner for conversion by false delivery. The court held that the bank never obtained property in the goods and had no title to sue. The bank had never intended holding goods as security - but if it had had title the delivery without production of bill of lading would have been actionable. There was no mention of time bar for some reason !

**First Energy v Hungarian Bank**,[71] regarding ostensible authority of bank employee to sanction a transaction. Held : A senior bank manager at a branch has the ostensible authority to issue a credit - even if he has no actual authority to do so the bank is bound by the agreement.

63 **Sinason Teicher v Oilcakes & Oilseeds Trading** [1954] 1 W.L.R. 1394
64 **Ian Stach v Baker** [1958] 2 Q.B. 130
65 **Michael Warde v Feedex** [1985] 2 Lloyd's Rep. 289.
66 **Knotz v Fairclough** [1952] 1 Lloyd's Rep. 226 :
67 **Bankers v State Bank of India** [1991] 1 Lloyd's Rep. 587 & 2 Lloyd's Rep. 443
68 **Midland Bank v Brown Shipley** [1991] 1 Lloyd's Rep. 576.
69 **Seaconsar v Islam Bank Iran** [1993] 1 Lloyd's Rep 236
70 **The Future Express** [1992] 2 Lloyd's Rep 79 :
71 **First Energy v Hungarian Bank** [1993] 2 Lloyd's Rep 194 .

# CHAPTER SEVEN

## Central Elements of Documentary Credits

**1). Both the seller and the buyer benefit from Commercial Credit.**

The seller benefits because the buyer provides a reliable solvent paymaster. The buyer gains since there is no need to pay cash directly for the goods. He may be able to arrange with the bank not to pay for goods until resale. Because of the mutual benefit, it follows that the seller should not be able to waive the credit. If it was only for the seller's benefit then he might be able to waive, but since the buyer benefits as well it would be unjust to allow him to do so.

Once an Irrevocable Credit has been agreed the seller must tender the sales documents to the bank for payment and perform the terms of the credit and must not tender direct to the buyer. No short circuiting is permitted. However, if the bank for a legitimate reason which does not reach to the root of the contract between the buyer and the seller, rejects the documents and refuses to pay, or if the buyer fails to provide a solvent and reliable paymaster, then the seller may present direct to the buyer. Compare **The Soproma** with **The Galatia.**

**Soproma SpA v Marine & Animal By-Products Corp.**[72] C & F sales contract for Chilean fish meal, payment by CIDC, governed by the 1953 version of the U.C.P. The Sale contract contained none of the details as to documents required for the credit. The credit stipulated *inter alia* that a Certificate of analysis, stating that there was a minimum of 70% protein quantity was required. The bill of lading was to be made out *'to order'* (*i.e. negotiable*) and marked *'freight prepaid'*. There was a time limit for tender, not contained in the sale contract. The seller made two tenders, both of which were rejected. The first tender was to the confirming bank. The certificate of analysis stated that there was only a 67% protein content, and described the goods as fish meal - not as *'Chilean Fish Meal'*. The bill of lading was not to order and carried the instruction to *'collect freight.'* Thus freight was not prepaid (*similar to the concept of cash on delivery for the costs of carriage*). The buyer instructed the bank's to reject. The court held that he was entitled to do so.

***The U.C.P. 400*** applied, allowing a description in general terms. If the only fault had been that the goods were described as Fish Meal & not as Chilean Fish Meal there would nonetheless have been a Full Mandate and the bank would have had to accept the bill of lading as a valid tender. The bill of lading itself was defective regarding the % of protein described therein and also advised the carrier to collect freight charges.

Later, the seller obtained fresh documents and made a 2nd tender. The tender was made out of time. the seller tendered to the buyer directly. the buyer refused to accept documents. the seller then resold the goods at less than contract price and sued the buyer for damages for non acceptance. He lost his action for damages. Held : the seller was not entitled to tender direct to B, on the basis that only one method of payment i.e. by Documentary Credit had been agreed between the parties and so payment had to go through the bank. the seller could not tender directly to B.

**2). The Mandate of the Bank derives directly from the buyer** : *The same applies for the other bank*

The Mandate requires him to deliver the ***'Exact documents'*** : It is a General principle that (at common law) if the documents do not comply exactly with the terms of the credit then the bank need not pay even if the documents tendered are every bit as good as the originals. The mandate is for the exact goods only. The bank **MUST NOT** pay. This would be to exceed the buyer's mandate.

This is known as the **Doctrine of EXACT *I* STRICT Compliance.** The bank need not & must not pay in such circumstances under the common law. Viscount Sumner in **Equitable Trust v Dawson**,[73] stated that there is no room for documents which are almost the same or which will do just as well. The ***de minimis rule*** does not apply to BDCs according to **Moralice v ED & F Manufacturing**.[74] On the other-hand, documents only have to comply on their face, so that a minute examination is not necessary according to **National Band of Egypt v Hennevig 's Bank**,[75] and see also **British Imex v Midland Bank**.[76]

72 **Soproma SpA v Marine & Animal By-Products Corp** [1966] 1 Lloyd's Rep 367. (Whilst the code has since been revised the changes make no difference to the principles propounded in the case).

73 **Equitable Trust v Dawson** [1926] 26 Lloyd's Rep 49 at 52 -

74 **Moralice v ED & F Manufacturing** [1954] 2 Lloyd's Rep 526.

75 **National Band of Egypt v Hennevig 's Bank** 1919 Lloyd's Rep 69

76 **British Imex v Midland Bank** [1958] 1 QB .542.

The banks duty is to act reasonably. It is best for a bank to confer with the buyer in the case of ambiguity - but if it is unable to do so, a reasonable decision in the circumstances will protect the bank according to **Commercial Banking of Sydney v Jalsard Pty**.[77] A confirming bank may accept ambiguous documents under reserve, so that if there is a problem they can reclaim on an indemnity provided to the Confirming Bank by the seller, it was held in **Banque de L'Indochine v Rayner.**[78]

**The Doctrine of Exact / Strict Compliance & the U.C.P.** (*Current regime is UCP 500*)
The rules of The Uniform Customs and Practice For Documentary Credits relax the strict common law rules. Note that the U.C.P. rules usually apply. They state that one need only describe the goods in general terms in the bill of lading - but **NOT** in the invoice. This is the only type of fault in the bill of lading, which was cured by **Article 41(c) U.C.P 400** " *The description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit.*"

**3) General Assumption : banks deal in documents not in goods.**
Banks cannot be expected to know if goods conform to contract requirements. A bank can only judge from the document itself - i.e. do the documents conform ? This is the justification for the Doctrine of Strict Compliance. It also justifies the decision in **U.C.M. v Royal Bank of Canada**.

**United City Merchants Ltd. v Royal Bank of Canada.**[79] Fraud allegation. The court held that if the documents correspond with the description in the credit document then the bank must pay, even if there is a suspicion, or knowledge that the goods do not correspond (as opposed to actual knowledge). This case is the equivalent of the rule in **Gill & Dufus v Berger** under the common law, regarding presentation of the Bill of Lading. However, the justification differs in that Banks deal in documents not goods. The sole exception is where the seller can be proved to be fraudulent. This is because the seller cannot bring an action based on his own fraud. This represents a Public Policy decision.

**Exceptions to the general principle**.
The general principle presupposes that the buyer is providing the seller with all the advantages due under a B.D.C. That is to say that the seller has a reliable and solvent paymaster. If the paymaster is not reliable or solvent the buyer is in Breach of Contract. In such a situation it is probable that the seller can not only sue for damages for Breach of Contract but, unless there is an express stipulation in sale Contract to the contrary, the seller can also tender directly to the buyer as in **The Galatia** and **Alan v Nasr. Alan WJ & Co Ltd v El Nasr Export & Import Co.**[80] The Bank went into liquidation. The C.A. held that the seller could tender directly to the buyer since the buyer was under a duty to provide a solvent & reliable paymaster and having failed to fulfil that duty the buyer had breached the sale's contract.

**The Bank's Liability for Delay**
Clearly, it is important for the parties that documents are cleared through the banking system expeditiously. However, since the doctrine of strict compliance requires the bank to reject documents that do not accord with the sales description it is possible that documents are rejected for minor blemishes which have no real commercial importance, resulting in a loss of business to the detriment of the buyer & seller. In such circumstances it is desirable that the banks confer with the buyer before either accepting or rejecting documents which appear to be imperfect. This however takes time, which in the light of the fact that Banker's Documentary Credits are issued for a limited and specific period of time, is of the essence.

**Bankers Trust Co v State Bank of India.**[81] Under **Art 16 UCP 400 1983**, the reasonable time which an issuing bank had, to examine the documents presented to it before refusing them, on the ground that they appeared upon their face not to accord with the terms of the credit agreement was the time required by the bank to determine on the basis of the documents alone whether to take up or refuse them.

77 **Commercial Banking of Sydney v Jalsard Pty** [1973] A.C. 279.

78 **Banque de L'Indochine v Rayner** 1983 2 W.L.R. 841. See also "Strict Performance in Letter of Credit Transaction." K.V.S.K. Nathan. Business Law Review August/September 1989. pp2ll-213 & p230.

79 **United City Merchants Ltd. v Royal Bank of Canada** [1983] 1 A.C. 168

80 **Alan v Nasr. Alan WJ & Co Ltd v El Nasr Export & Import Co** (1972) 2 Q.B. 189.

81 **Bankers Trust Co v State Bank of India** [1990] Times 4.9.90

Hirst J held Q.B.D. giving judgement for the defendants, The State Bank of India, against a claim by the plaintiffs, Bakers Trust Co, for a reimbursement of $10.335m, being payment made to the defendant on a confirmed irrevocable letter of credit without recourse, for which the plaintiff claimed a refund following their rejection of the relevant documents because of discrepancies.

Hirst J said that he rejected plaintiff's argument that an implied term should be read into Art 16 that a reasonable time included time for the issuing bank to refer to the applicant for whose a/c the letter of credit was opened. That did not prevent consultation with the applicant to determine whether he wished to waive or not, provided (and this was the crucial proviso) that that fell within the reasonable time needed by the issuing bank itself to carry out its function and did not extend it. If the applicant had not made up his mind prior to the expiry of the reasonable time, the issue of the Article 16D rejection notice by the issuing bank would not, as the expert evidence showed, preclude further discussion and possible subsequent waiver; indeed there had been evidence that the giving of the rejection Telex was the most common way of triggering discussion to resolve problems raised by the existence of discrepancies.

**Harlow & Jones v American Express**.[82] Useful case setting out the methods in which a buyer may ensure that he is consulted regarding discrepancies in documents involved in documentary credits and the effect that a failure to follow the correct instructions has on the bank - and its liability to pay the seller. The buyer failed to honour three Bills of Exchange and so the bank had to honour the Bills of Exchange - and was then left to recoup its losses from the buyer - problematical since the buyer claimed that the bank had exceeded its authority.

**Waiver & The Authority of the Banks**__Where a bank consults with the buyer, any waiver of the requirement of strict compliance by the buyer means that his right to refuse to reimburse the bank for a failure to strictly comply is forfeited. **Bank Melli Iran v Barclays Bank.**[83] An intention to ratify may be inferred in appropriate circumstances from prolonged inaction or silence on the buyer's behalf.

[82] **Harlow & Jones vAmerican Express** [1990] 2 Lloyds Rep 343
[83] **Bank Melli Iran v Barclays Bank** [1951] 2 T.L.R. 1057.

## THE FOUR AUTONOMOUS CONTRACTS

The terms of the various credits and the sale contract are independent autonomous contract's according to Diplock in **U.C.M v Royal Bank of Canada**, who identified four autonomous contracts. The terms of the credit do not depend on the Sale contract since the contract of credit is independent.

The documents to be tendered depend on the terms of the credit and not on the terms of the sale contract. Therefore there was a valid rejection by the bank in the circumstances of the case since the right to reject did not depend on Sale Contract.

If the seller had sued the bank he would have lost his action. In fact the seller sued the buyer instead for non acceptance. This was an action based on the Sale Contract, not on the Credit Contract. the seller argued that because the buyer had stipulated such onerous obligations in the credit, this constituted a Breach of the Sale Contract. Should the seller have won on this basis ?

1. It may be that the ground is quite narrow. By making the 2nd tender to the buyer he was estopped, by his conduct, from relying on the terms of the credit being too onerous. or
2. Alternatively, the credit must be fair and reasonable. The terms are established at the time of negotiation of the Credit Contract and the buyer and the seller could negotiate Terms of Credit.

McNair J in the Commercial Court stated that the buyer was not in Breach of the Sale Contract in so stipulating as he did. However, there are limitations. The Credit must be fair and reasonable and not contrary to express terms of Sale Contract. the seller would have to stipulate in the Sale Contract any restrictions to be imposed on the buyer in the Credit Contract. Lord Diplock identified 4 autonomous contracts

1 The underlying contract for the sale of the gods to the buyer from the seller.

2 The contract between the buyer & the issuing bank under which the latter agrees to issue the credit and either itself or through a confirming bank, to notify the credit to the seller and to make payments to or to the order of the buyer (or to pay, accept or negotiate bills of exchange drawn by S) against presentation of stipulated documents; and the buyer agrees to reimburse the lB for payments made under the credit. For such reimbursement the stipulated documents, if they include a document of title such as a bill of lading, constitute a security available to the Issuing Bank.

3 If payment is to be made through a confirming bank, the contract between the Issuing Bank and the Confirming Bank, authorizing and requiring the latter to make such payments and to remit the stipulated documents to the Issuing Bank when they are received. The Issuing Bank in turn agreeing to reimburse the Confirming Bank for payments made under the credit.

4 The contract between the Confirming Bank and the seller under which the Confirming Bank undertakes to pay to the seller (or to accept or negotiate without recourse to drawer bills of exchange drawn by him) up to the amount of the credit against presentation of the stipulated documents.

**Relationship between lssuing Bank / Confirming Bank and the seller**

This final '*contract*' is the problematical contract in Diplock's scheme since it is not negotiated for between the parties. At what stage it comes into being so that the credit cannot be revoked, what the terms of the contract are, and what amounts to consideration have been considerable areas of academic dispute :-

- **Gutteridge & Megrah,**[84] found a bilateral contract in agency - but is unenforceable until the seller complies with the conditions laid down in the credit.
- **Ellinger,** [85]feels that a unilateral contract arises when the seller receives notification, without any more happening.
- **Rowlatt J,**[86] felt that there had to be reliance & part performance before the contract became binding.
- **P.Todd**,[87] feels that either the tort of inducing breach of contract - or the requirements of security of documents should provide solutions so that the credit becomes irrevocable on communication to the seller without the need for proof of part performance.

84 The Law of Bankers' Commercial Credit 6th ed 1979 pp3l-33

85 Documentary Letters of Credit 1970 -

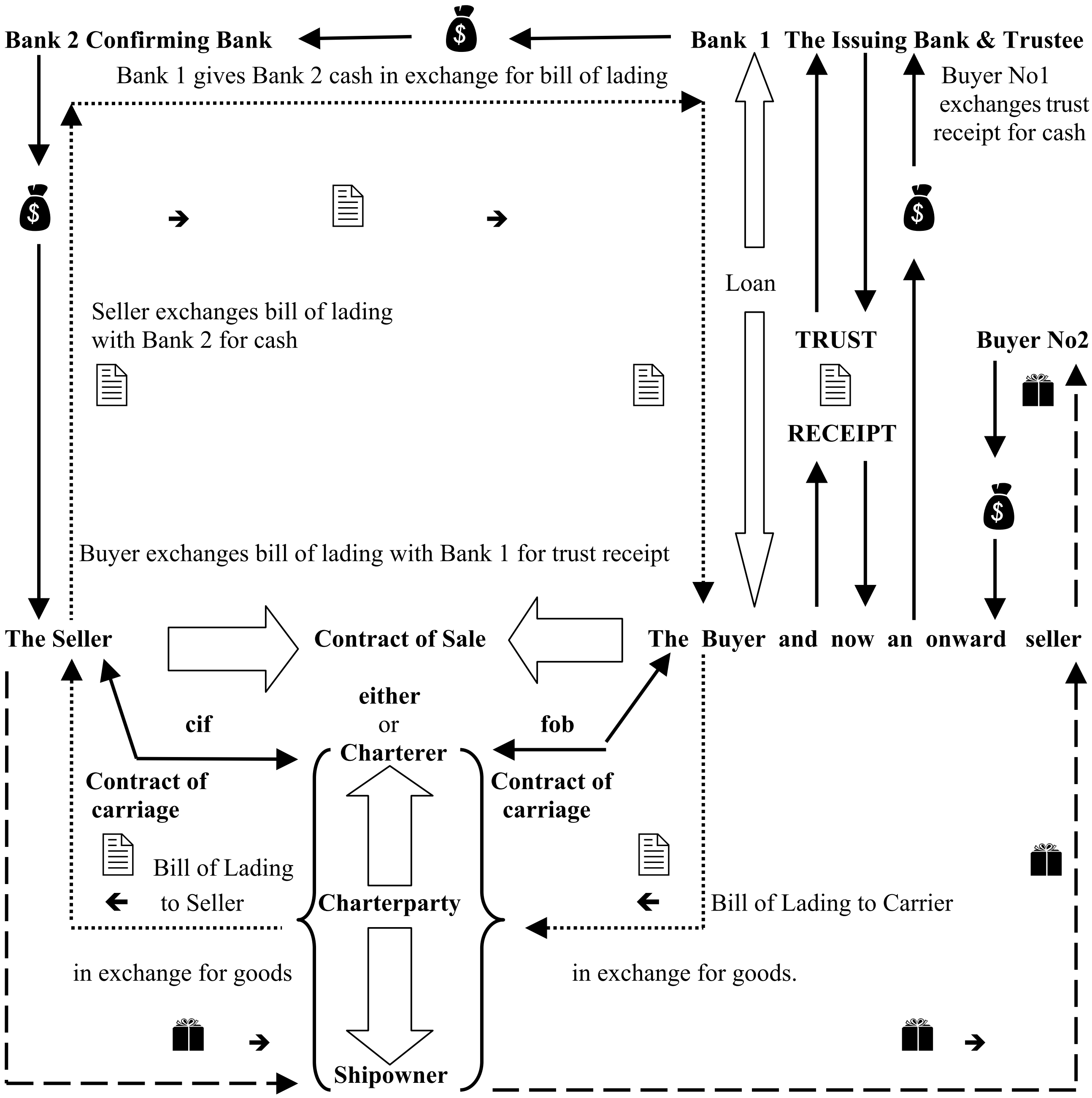
86 in **Urquhart Lindsay** [1922] 1 K.B. 318 at 321

87 Sellers & Documentary Credits [1983] 3BL 468 at 479-81

## CHAPTER SEVEN

### THE TRUST RECEIPT.

The Confirming Bank accepts and pays for documents, passes them on to the Issuing Bank and recovers the money from the Issuing Bank. The Issuing Bank holds the shipping documents. If the Issuing Bank wishes to obtain reimbursement and commission from the buyer there is a problem. The buyer may not be able to reimburse the bank until he has re-sold the goods, but the buyer has no shipping documents and so cannot resell the goods. The Bank will not release the shipping documents without more since the bank looses its security. The solution is for the Shipping Documents to be released in exchange for a Trust Receipt.




This makes the buyer a 'Trustee of the Goods' for the Bank till goods are sold, and 'Trustee of the Proceeds of Sale' once the goods have been sold. The result is that the Bank has 'equitable ownership' of the goods pre-sale and subsequent 'equitable ownership' of the proceeds of sale post-sale. This makes the Bank a secured creditor should the buyer go Bankrupt before or after sale of goods. The Buyer's Trustee in Bankruptcy can't claim the goods because the Bank has equitable ownership of either the goods or the money.[88]

[88] see **N.W Bank v Pynter** (1895) A C 56

## FRAUD AND DOCUMENTARY CREDITS

**Introduction :** The potentially fraudulent parties in relationship to documentary credits are

1 the Buyer - who sells the goods to a third party without any intention of paying the seller or of reimbursing the issuing bank and

2 the Seller who seeks financial benefits without intending to supply goods which accord with the sales contract or within the time limit specified by the sales contract.

The standard of proof required to establish fraudulent grounds for rejecting a credit are high**. Discount Records v Barclays Bank**,[89] states that banks should refuse to honour credits if it is established to the satisfaction of a bank, exercising reasonable care, that the documents are fraudulent ad that the seller or other beneficiary was a party to or connived at that fraud.

Fraud however, should not be confused with instances where the buyer or his financial backers later find that they are unable to pay, or where unknown to the seller goods are shipped late or where unknown to the seller the goods do not accord with the sales contract. Thus in **Urguhart Lindsay v Eastern Bank**,[90] compliance with the credit contracts is obligatory. Even if there are disputes between the buyer and the seller regarding the conformity of goods to the sales contract, to avoid 'freezing the system of financing' per Jenkins L.J. in **Hamzeh Malas v British Imex Industries**.[91]

**The Position of a fraudulent Buyer**

**Lloyds v Bank of America.**[92] The Buyer obtained the shipping documents from the Issuing Bank, in exchange for a Trust receipt. the buyer then used the documents to obtain a further advance from a third Buyer, by fraudulently pledging the documents, and then dissipated proceeds. The decision was based on The Factors Act 1889. If the Bill of Lading had been a Negotiable Instrument then Buyer No 3 would have won since the holder of a negotiable instrument can pass a better title than he has. Thus, whilst the fraud of the buyer would have prevented the passing of an Equitable title nonetheless he would have been able to pass a good title to Buyer No 3 simply because it was a negotiable instrument. However the Bill of Lading was not a negotiable instrument. The actual decision was instead based on s2(1) Factors Act. 1889 which applies where a mercantile agent is in possession of goods with the owners consent.[93] He is able to pass a good title to a 3rd party even though he does not have a good title himself. Buyer No2 was 'The Owner' under The Factors Act even though he was only a Pledgee. The Buyer, though in fact the owner, is regarded as The Mercantile Agent of the Bank for the purpose of The Factors Act. A Mercantile Agent in possession with the consent of the Owner can pass on good title:

**Hong Kong & Shanghai Bank v Kloeckner,**[94] An issuing bank is entitled to reclaim money, under a trust receipt, by way of set off (deduction from cash paid to the borrower's account from dealings with commodities financed by the documentary credit) for monies paid out under a letter of credit even where the reason the money was paid out was because agents of the creditor had exceeded their authority or engaged in fraud.

**The position of a fraudulent seller**

**Korea Industry v Andoll.**[95] A buyer obtained an injunction to prevent the bank paying out on a B.D.C. alleging fraud in that the quality of the goods delivered did not comply with the terms of the sales contract. The court held that a dispute between a seller and buyer is insufficient proof of fraud to allow an injunction to restrain payment of a confirmed B.D.C.[96]

89 **Discount Records v Barclays Bank** [1975] 1 W.L.R. 315. see also Schmitthoff - 1982 JBL 319 at 32

90 **Urguhart Lindsay v Eastern Bank** [1922] 1 KB 318.

91 **Hamzeh Malas v British Imex Industries** [1958] 2 QB 127 at 130.

92 **Lloyds v Bank of America** [1938] 2 K.B. 147.

93 see now s24 and 25 S.O.G.A 1979

94 Hong Kong & Shanghai Bank v Kloeckner [1989] 2 Lloyd's Rep 323. see also National Westminster Bank v Pynter 1895 AC 56.

95 **Korea Industry v Andoll** [1990] 2 Lloyds Rep 183

96 See also **Rafsanian Piustachio Co-op v Bank Lenmi** (1992] 1 Lloyd's Rep. 513 regarding allegations of fraud.

**RPPC v Bank Leumi,**[97] provides **a** classic example of a buyer and seller attempting fraud to get credit from a bank The court held that the bank was fully justified in refusing to accept documents on presentation.

**Mannesman Handel v Kaunlaran S.S.**[98] involved a sale of iron fob Nahodka USSR subject to Irrevocable Documentary Credit. The Swiss bank issued letter of credit to German Company against security of assignment of proceeds of another letter of credit by Hong Kong Bank to a Berudan Company regarding a c&f sale to Shanghai. The same cargo was involved each time. The bank agreed to doctor the documents regarding origin of goods, since the Chinese Government would refuse to accept Russian iron. The Bermudan Company short-circuited the system dishonestly, delivered the goods and got paid. The Swiss Bank then got money from the Hong Kong Bank which it was supposed to pass on to the German Company on presentation of documents. However, since the Bermuda Company had gone bankrupt, The Swiss bank decided to keep the money, to limit its losses, so that when the German Company presented the doctored bill of lading to The Swiss Bank, the bank claimed it was not the original bill of lading and refused to pay

The court held that under doctrine of strict compliance this was true. However, the Swiss bank was a party to the doctored documents in the first place, so the German Company entitled to be paid on presentation of the agreed doctored bill of lading.

**Sources of Law regarding Documentary Credits**

The law regarding the underlying sales contract, and its relationship to and with the credit contract and the legal relationships between the various parties concerned are governed by the general law of contract and mercantile custom. The general terms of the credit contract are normally governed and prescribed by an internationally approved banking code of practice, namely 'The Uniform Customs and Practice for Documentary Credits' developed and revised from time to time by the International Chamber of Commerce. The current regime is the 1993 ICC 500 which started on 1st January 1994. Most credit contracts throughout the world incorporate these rules. If certain of the rules are inapplicable the parties may contract out of that particular rule. The rules cannot contradict the domestic law of any country and this point is now clarified under the UCP 500.

The buyer, if he has inadequate security often pledges the documents of title to the goods involved to the bank - which subject to **s1(5) and s3 Factors Act 1889** is the equivalent to pledging the actual goods to the bank. The result is that the bank is entitled to the documents and can then release them to the buyer in exchange for a security or trust receipt to enable the buyer to deal with the goods.

It is important to be familiar with the terms and conditions inserted into documentary credit contracts by the UCP 500, in particular because they address and provide answers to many of the issues raised by the courts in the past. In particular the U.C.P. make provision in respect of the type of credit required -the types of document required - strict compliance - types of carriage and sales contract - including trans-shipment - through bill of lading and clean bill of lading.

97 **RPPC v Bank Leumi** [1992] 1 Lloyd's Rep 513.

98 **Mannesman Handel v Kaunlaran SS** [1993] 1 Lloyd's Rep 89.

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