

EVALUATION OF THE CONDITIONAL – ABSOLUTE PAYMENT ISSUE IN LETTERS OF CREDIT: IDENTIFYING WHICH POSITION PROVIDES MAXIMUM PARTY AUTONOMY, CERTAINTY, FLEXIBILITY, FAIRNESS AND GOOD FAITH.

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ABSTRACT

Evaluation of the conditional –absolute payment issue in letters of credit: Identifying which position provides maximum party autonomy, certainty, flexibility, fairness and good faith

Parties to the underlying contract (contract of sale) are free to expressly or impliedly agree on whether payment by letter of credit is absolute or conditional. Since the underlying contract is usually silent on the issue of whether payment by letter of credit is absolute or conditional, it will be a matter of deduction for a court to decide what the intentions of the parties should be taken to be in all circumstances. However, in English law if the contract is silent as to this issue, there is a rebuttable presumption that it is conditional rather than absolute¹. The Qatari Trade Act 2006, the UCP 600 rules as well as Article 5 of the UCC are silent on the issue. Despite its theoretical “independence”, the buyer’s procurement of the letter of credit is treated by the courts, more often than not, as conditional payment². Although considering a letter of credit as a conditional payment goes against the principle of independency, the resulting fairness, certainty and flexibility which it brings about is judged to outweigh non-conformity with the independency principle. Other than the seller’s fault or being late in tendering the correct documents, there are two situations whereby the seller might not get paid while he is entitled to: one is when the bank rejects the seller’s documents due to technical discrepancies; another is on the banker’s bankruptcy. This paper will answer the position in the four legal regimes with which we are concerned (English law, the Qatari Trade Act, the UCP rules (600)³ and the revised Article 5 of the UCC (1995)⁴. with regard to the absolute-conditional issue? It also deals with the differences between “Conditional” Payment vs. “Absolute” Payment doctrine and the question of which of them provides maximum party autonomy, fairness, certainty, flexibility and good faith. The paper ends with a conclusion where an attempt is made to formulate a number of proposals which are designed to make the law more sensitive to questions of fairness but without sacrificing the certainty that is essential for commercial dealing. Which rule should be adopted? Should it be a rule for absolute or conditional payment? In the interests of good faith and fairness, both good faith and fairness are preserved under conditional payment. It is suggested, therefore, that the better explicit rule is that conditional payment is the default position. Having suggested the conditional payment option, it is to be emphasised that conditional payment does not in any way jeopardise certainty.

Key words: Letters of credit, Conditional-Absolute Payment, the underlying contract, party autonomy, flexibility, certainty, good faith and fairness. Qatari Law, UCP, UCC.

Introduction

Parties to the underlying contract (contract of sale) are free to expressly or impliedly agree on whether payment by letter of credit⁵ is absolute or conditional. Since the underlying contract is usually silent on the issue of whether payment by letter of credit is absolute or conditional, it will be a matter of deduction for a court to decide what the intentions of the parties should have been in all circumstances. However, in English law if the contract is silent as to this issue, there is a rebuttable presumption that it is conditional rather than absolute. In contrast, the Qatari Trade Act, the UCP and the UCC rules have been silent on the issue. Therefore, the aim of this paper is to explore the absolute – conditional payment in the four legal regimes in light of the five basic principles, which govern commercial law. These principles are; party autonomy, flexibility, certainty, good faith and fairness.

¹ See generally, *Newman Industries Ltd v Indo-British Industries* [1956] 2 Lloyd's Rep 219; [1957] 1 Lloyd's Rep 211.

² *Ibid.*

³ UCP 600 are the latest revision of the Uniform Customs and Practice that govern the operation of letters of Credit. UCP 600 comes into effect on 01 July 2007

⁴ The American Uniform Commercial Code, Article 5- Letters of Credit (Revised 1995).

⁵ Article 386 of the Qatari Trade ACT 2006 defines letter of credit as “A letter of credit is a contract which the bank undertakes at the request of a customer, known as the 'applicant' to a specified value for a specified period for the benefit of another person known as the 'beneficiary', the bank shall guarantee by its possession of documents representing transported/movable goods or ready for transportation”

Section one: Conditional vs. Absolute payment

Despite its theoretical “independence”⁶, the buyer’s procurement of the letter of credit is treated by the courts, more often than not, as conditional payment. It is a principle of letter of credit law that the letter of credit is completely independent⁷ of the underlying sale of goods contract. Nonetheless, as will be examined below, according to the line of well-established case law, in the absence of an express stipulation to the contrary, there appears to be a strong presumption in favor of construing letters of credit as conditional payment. So, in most cases, the seller does have recourse to the buyer should he fail to obtain payment from the banks, if he has performed and there is no fault on his part. Therefore, it is presumed that the intention of the parties to a sales contract is to treat the furnishing of the documentary credit, and thus the subsequent acceptance of drafts, as conditional rather than absolute payment.

Having said so, the author contends that although the Qatari Trade Act, the UCP and the UCC are silent upon the issue of absolute-conditional payment, since they express the independency principle, it could be inferred that absolute payment is to prevail. Therefore, this raises the question of which rule should be adopted? Should it be a rule for absolute or conditional payment?

To further explore this question, it is apparent in most cases, that the transaction comes to an end when the bank discharges the credit⁸. However, following the principle of independence, the payment effected by the bank does not necessarily discharge the mutual rights and duties of the parties to the contract of sale. Therefore, there remains a right of an action in deceit⁹ or a breach of contract against the seller if it later discovered that the documents the seller has tendered are not genuine.

Other than the seller’s default or being late in tendering the correct documents, there are two situations whereby the seller will not be paid despite being entitled to it: one is when the bank rejects the seller’s documents due to technical discrepancies; another is on the banker’s bankruptcy. These two situations will be addressed later in the paper under Section 2.2.

So what is the position in the four legal regimes with which we are concerned (English law, the Qatari Trade Act, the UCP 600 and the revised Article 5 of the UCC) with regard to the absolute-conditional issue?

Under English Law, if the contract is silent as to the payment clause, there is a strong presumption that payment by letters of credit is a conditional payment¹⁰. However, the Qatari Trade Act, UCP and the UCC are again silent upon the issue.

Section Two: Evaluation of absolute-conditional payment issue with reference to the five criteria

This section will be examining the absolute conditional issue against the five basic principles that govern commercial law in general.

2.1. Party Autonomy in relation to absolute-conditional payment

Parties should be free to explicitly agree that payment by letter of credit is either absolute or conditional. Where the parties so agree, the principle of party autonomy dictates that such terms should be held sacred. Hence, the law may adopt either one of the two doctrinal options, conditional payment or absolute payment, as default positions. Either way, party autonomy is respected because the contracting parties can alter the default position by express agreement. This conclusion can only be inferred from Common Law cases¹¹. The UCP is silent upon the issue but since the UCP rules are default rules, there is no reason why parties cannot agree to whether payment is absolute or conditional. As far as the Qatari Trade Act is concerned, although it is silent on the issue, there is no reason why the parties can not agree in the underlying contract to whether payment is absolute or conditional. The UCC rules are also silent upon the issue but since Article 5 allows variations of its sections if the contracting parties so agree, then the principle of party autonomy is also preserved.

2.2. Fairness¹² in relation to absolute-conditional payment

⁶ Article 5 of the UCP states one of the fundamental principles of documentary credits which is the principle of autonomy which reads as follows:

‘Banks deal with documents and not with goods, services or performance to which the documents may relate’.

Article 387 of the Qatari Trade Act confirms this independency principle by saying: A letter of credit will be separate from contracts related to the goods it pertains to, and under no circumstances shall the bank be a party to these contracts. For more on the principle of Independence see; Hao, Y & Xiao, L., Risk Analysis of Letter of Credit -Based on Principles of ‘Independence’ and ‘Strict Compliance’, International Journal of Business and Social Science, Vol. 4 No. 9; August (2013), 199.

⁷ Although considering a letter of credit as a conditional payment goes against the principle of independency, the resulting fairness, certainty and flexibility, which it brings about, is judged to outweigh non-conformity with the independency principle.

⁸ *Benjamin's Sale of Goods*, Fifth edition. (edited by A.G. Guest) (Sweet & Maxwell, London, 1997) n15 at t§ 23-120 p. 1712 *et seq*

⁹ See, *cg Famourel v Dialord Ltd* (1983) 133 NU 153

¹⁰ *Ibid*

¹¹ *Ibid*

¹² For further reading on the principle of fairness see; Kleinberger, D.S. Delaware’s Implied Contractual Covenant of Good

Next, we will be measuring the absolute conditional payment issue against fairness with regards two possible scenarios. The first is when the seller is refused payment due to minor defects in the goods. The second possible scenario is the impact of the banks insolvency on the buyer.

As far as the first scenario is concerned, treating the payment by letter of credit as absolute may according to the distributive theory¹³, produce unfairness, since the seller has no rights against the buyer for payment in case of the banker's fault even if the tender was rejected due to minor defects. Under these circumstances, although the seller is, no doubt, entitled to appeal to the buyer, if the (seller) has lost control over goods, the buyer can often delay the payment for a few months and thus take advantage of the most trivial irregularities. Now where the applicable compliance rule is the "strict compliance" rule, the bank is right to reject the seller's documents, even if the discrepancies are trivial. The problem then lies with the absolute payment rule in conjunction with a strict compliance rule. In contrast, treating a letter of credit as conditional payment is fair (more in line with the distributive theory) since in most cases the seller will have recourse to the buyer should he fail to obtain payment from the bank, provided that he has performed and there is no fault on his part. In other words, in order to determine whether a seller is allowed to have a direct recourse against the buyer upon the bank finding technical defects in the documents, it is important primarily to establish whether payment is conditional or absolute and to ascertain the standard of compliance in place.

Now the second scenario of the banks insolvency and its impact on the buyer will be addressed. Two situations have to be distinguished: the first situation is whereby the bank has become insolvent before the buyer pays the bank, and the second is where the buyer places the bank in funds before its insolvency.

In the first situation, according to the distributive theory, gross unfairness is apparent if the payment by letter of credit is treated as absolute, since the buyer can then escape payment, leaving the seller to claim his liquidating dividend as a general creditor of the bank, which would not make up the purchase price. By treating the letter of credit as a conditional payment, however, in accordance with the distributive theory, the result will be fair; and both the buyer and seller will neither lose nor gain anything.

The second situation is where the court is forced to do an injustice. The dilemma is that, where the payment by letter of credit is conditional rather than absolute and the seller is usually held to be a general creditor that is to impose the loss due to the bank's insolvency on the buyer rather than on the seller. This makes the buyer pay twice: once to the banker and once to the seller, which is, according to the distributive theory, grossly unfair to the buyer. By treating the payment by letter of credit as absolute, the seller will be left with getting less than the contracted price, as being a general creditor; he gets only the pro rata liquidating dividend, which is unfair to the seller.

McNair J.¹⁴ was of the view that, only in the event of the issuing bank's insolvency may the seller be able to tender documents to the buyer directly. However, that would make the buyer who has already paid the bank pay twice. There is a sound argument supporting this position if the bank is chosen by the buyer, which is what happens in the majority of the cases because he should be in a better position to know the financial soundness of the banker than the seller should¹⁵.

A better solution is by considering the seller a preferred creditor of the bank to the extent of the buyer's payment, as suggested by Berger¹⁶. In doing so, it becomes easier to determine which party is to suffer the loss, which resulted from the insolvency on the part of the issuer¹⁷. Neither of the parties will incur any loss in that case since the buyer has already settled the amount due upon receiving the merchandise and the seller has been paid in full, for the draft "which measured his claim against the bank or the buyer"¹⁸. Consequently, this would ensure that the documentary credit provides guarantee of the payment to the seller, as well as ensuring that the documentary character of the transaction continues to clearly define the duty of the buyer in terms of its meaning and specificity. In the US, the issuing bank's insolvency problem is dealt with under Section 5-117 of the UCC¹⁹. It is well established that once the bank opens the credit it acts as a principal, not as agent. Thus, when the bank becomes insolvent

Faith and Fair Dealing - (2015), accessible at: <http://www.nybusinessdivorce.com/wp-content/uploads/sites/94/2015/11/Kleinberger-Implied-Covenant-Article.pdf>

¹³ According to the distributive theory, the question of how the contract outcome is distributed between the parties is the main concern. See Buckley, F.H., 'Three Theories of Substantive Fairness' 19 Hofstra Law Review (1990) 33

¹⁴ *Soproma S.p.A v Marine and Animal By-Product Corporation* [1966] 1 Lloyd's Rep 367, 386

¹⁵ See *ED. And F Man Ltd. v Nigerian Sweet and Confectionery Co. Ltd.* [1977] 2 Lloyd's Rep SO

¹⁶ pp 174-80. Berger, S.R., 'The Effects of Issuing Bank Insolvency on Letters of Credit' 21 *Harvard International Law Journal* (1980) 161 at pp 174-80.

¹⁷ It should be noted that Article 5-117 of the Uniform Commercial Code deals specifically with the circumstance of an issuer, and advising or confirming bank becoming insolvent before the final payment of the credit. The drafts or demands are entitled to payment in preference over depositors or other general creditors of the issuer or confirming bank to the extent of any funds turned over after or before the insolvency as indemnity against drafts or demands for payment drawn under the designated credit. These provisions would be applicable where the Code does not have the force in law.

¹⁸ See Gutteridge and Megrah, *The Law of Banker Commercial Credit* p. 36.

¹⁹ It is to be noted here that this insolvency Section (5-117) of the (pre-1995 version) has not been added to the (1995) version of the UCC.

before the credit transaction is completed, the outstanding liabilities, the security held by the bank and funds provided to indemnify against those liabilities are regarded as separate from deposit liabilities and general assets. Nonetheless, the beneficiary is not to receive a preferred treatment unless the applicant has earmarked a deposit to pay the credit or has pledged collateral to secure payment. The beneficiary is given a preferred treatment by virtue of (pre-1995) UCC and the common law²⁰.

2.3. Good faith²¹ in relation to absolute-conditional payment

By treating a letter of credit as a conditional payment, good faith, in its objective sense, is promoted because the law then reflects the reasonable expectations of commercial people. It is important, at this point, to justify why the 'objective sense' has been used here. In the underlying contract, since it is not governed by the law of letter of credit, i.e. the UCC Article 5, but governed by applicable law whereby the concept of fair dealing is incorporated. By contrast, treating a letter of credit as an absolute payment overlooks good faith. The buyer can take advantage of the most trivial irregularities in the goods to delay payment if goods are delivered. A case, which is even worse, is when the goods have not yet been shipped to the buyer and the price of goods in the market has fallen, the buyer simply rejects the goods. The only thing the seller can do is to sell the goods in the market at the best price he can in an effort to mitigate his loss, and then sue the banker for damages for breach of contract, which is a lengthy, expensive and unreliable process²².

2.4. Certainty in relation to absolute-conditional payment

If the law holds that where the contract is silent as to the payment clause, there is a strong presumption that payment by letters of credit is conditional, then, commercial people know where they stand. Likewise, if a letter of credit payment is to be regarded as absolute, unless otherwise expressly or impliedly agreed to, the law is also certain²³. Certainty is apparent from the clear statement of law, which was put by Lord Denning: MR. where he stated that; "a letter of credit is not to be regarded as absolute payment, unless the seller stipulates, expressly or impliedly, that it should be so."²⁴ In fact, it is well established that the opening of a credit does not discharge the buyer's obligation to pay. As Ackner J. put it clearly in *Maran Road Saw Mill v. Austin Taylor & Co. Ltd.*²⁵, providing a 'source of payment' by letter of credit is different from the promised 'paying by letter of credit', and what the bank promised was to pay by letter of credit, not to provide by a letter of credit a source of payment which did not pay²⁶. In the leading case of *Newman Industries Ltd v. Indo-British Industries*²⁷, payment was merely conditional. The same line of judgments was also followed in *El Nasr*²⁸ and *Maran Road Saw Mill v. Austin Taylor Ltd*²⁹. In other words, the law governing letters of credit (English law) is certain as to payment because commercial people would be certain that payment by a letter of credit is, without doubt, not absolute at all unless otherwise expressly or impliedly agreed to. Therefore, if the beneficiary agreed that payment by a credit was to be absolute, he would know beforehand that in case of the issuing bank being unable to pay, he could not claim payment from the applicant.

As has been discussed above, the position of English law is certain on this issue, whereas it appears that the UCP is silent. This feature of silence may be construed as uncertainty. Although the UCP takes an international approach, it is evident that individual practices vary and therefore such individualised practices play a part in determining the way in which it is interpreted. The Qatari Trade Act is silent on the issue and this may cause uncertainty. As far as the UCC is concerned, it is also silent upon the issue. This again may be construed as uncertainty.

2.5. Flexibility in relation to absolute-conditional payment

The common Law is flexible as to the nature of payment under letters of credit (whether absolute or conditional). There is more than one position that the law may take. Under common law, parties are free to agree explicitly that payment by letter of credit is either absolute or conditional payment. In other words, the law is perceived as flexible in this situation. Thus, in between the

²⁰ See Section S-117 UCC, em Dolan, *The law of Letter of Credit. Commercial and Standby Credit.* p. (12-12) et seq.

²¹ For further reading on the principle of good faith see; Kleinberger, D.S. Delaware's Implied Contractual Covenant of Good Faith and Fair Dealing - (2015), accessible at: <http://www.nybusinessdivorce.com/wp-content/uploads/sites/94/2015/11/Kleinberger-Implied-Covenant-Article.pdf>

²² *Benjamin's Sale of Goods*, Fifth edition. (edited by A.G. Guest) (Sweet & Maxwell, London, 1997) n15 at § 23-064 p.1684. See also Tiplady, D., *Introduction to the Law of International Trade* (London, 1989) p.176.

²³ *Ibid*

²⁴ *W.J. Alan & Co. Ltd. v. El Na.sr Export and Import Co.* (1972) 2 Q.B. 189 at 220 See also *Newman Industries Ltd v Indo-British Industries* [1957] 1 Lloyd's Rep 211, at 236

²⁵ *Maran Road Saw Mill v. Austin Taylor Ltd* [1975] 1 Lloyd's Rep. 156 at 159

²⁶ Gutteridge, M, II.C., and Megrah, M., *The Law of Banker's Commercial Credit.* p. 35.

²⁷ *Newman Industries Ltd v Indo-British Industries* (1956) 2 Lloyd's Rep 219; [1957] 1 Lloyd's Rep 211; See also *Soproma S.p.A. v Marine and Animal By-Product Corporation*, .supra. In the U.S.A. See: *Lamborn v Allen Kirkpatrick*, 135 A 541 (1927); *Greenough v Munroe*, 53 F. 2d 362 (1931).

²⁸ *WJ Alan & Co v El Na.sr Export and Import Co* (1972) 2 Q.B. 189.

²⁹ *Maran Road Saw Mill v. Austin Taylor Ltd* (1975) 1 Lloyd's Rep. 156.

expanded reliance upon the existing common law rule in relation to the nature of the payment clause as a default rule and the ordinary ability of the parties to vary that rule, the common law grants commercial people the maximum flexibility to tailor their relationships under letters of credit. Likewise, since almost the entirety of Article 5 of the UCC in its revised or original form is variable by agreement, and the provisions of the UCP are default rules, parties may agree to whether payment by letters of credit be absolute or conditional. The same analysis applies to the Qatari Trade Act on this matter.

Conclusion

In the course of writing this research paper, the researcher has been able to draw a few inferences. This paper sought to examine the absolute-conditional payment by letters of credit and to determine which position (whether absolute or conditional) goes more in line with the five basic principles that govern commercial law. These are namely; party autonomy, certainty, flexibility, fairness and good faith in the four main legal regimes (Common Law, Qatari Law, UCP and UCC), which govern letters of credit.

In conclusion, it is evident that party autonomy remains preserved either way, regardless of whether the payment is absolute or conditional as parties are free to agree on which position to take. In the interests of good faith and fairness, both good faith and fairness also remain preserved under conditional payment, as discussed in the main body of the paper.

In terms of certainty, it is evident from the English law that it allows either party to agree amongst themselves as to whether payment is conditional or absolute and upon failure to agree – the presumption is that payment is conditional. This is in place to promote certainty as it allows parties to know where they stand. Whereas, the Qatari Trade Act, UCC and UCP who are silent on the issue, this inevitably leads to uncertainty. This paper therefore recommends that this issue should be dealt with explicitly in the next review of the Qatari Trade Act, the UCP and the UCC Rules. An explicit rule regarding this issue would remove any misunderstanding and make the law transparent. Therefore, in summary the author recommends that a better explicit rule is that conditional payment is the default position. In advocating the conditional payment option, it is to be emphasised that conditional payment does not jeopardise certainty in any way.

Finally, in relation to the question of flexibility, it remains preserved under the Common Law as parties can agree to the nature of the payment whether it is conditional or absolute. This is also the case under the UCC and UCP as they use default rules and people can agree to the contrary, which allows ultimate flexibility to be preserved. Concerning Qatari Law, parties to the underlying contract may be able to agree on whether payment by letters of credit is absolute or conditional, in which case flexibility is preserved.

In addition, for those regimes such as the English Law who have dealt with this matter, they have not illustrated a firm position on the matter by stating the decision can be 'rebuttable'.

However, despite these limitations, the paper has clearly demonstrated its attempt to address the main objectives as set out in the introduction by reviewing the absolute conditional payment in the four regimes.

The author covers one of the most important subjects in law and clearly presents an effective comparison of local legislation with international legal set of rules. This paper will help to provide valuable insight for Islamic Sharia law researchers both locally in Qatar as well as internationally to investigate the question of absolute-conditional payment by letters of credit from an Islamic perspective as well as add considerable value to the Arabic and English libraries.

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