



RESEARCH PAPER

Letter of Credit and its Significance in International Commerce

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PAPER INFO

ABSTRACT

Received:

August 26, 2017

Accepted:

December 13, 2017

Online:

December 30, 2017

Keywords:

Possession,
Negotiability,
Documentary
Credit,
Guarantee

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In the world of commerce and trade, trust and confidence form the basis of transactions. However such confidence cannot be left at the discretion and conduct of the parties thereto. It necessarily requires a prudent device or mechanism to materialize the process aptly. The international trade requires a fair, safe and speedy system of delivery and payment as its necessity. The parties in business especially in international business are usually not known to one another and hardly come across. All the agreements between them may mainly be made electronically while sitting far apart. In order to achieve the goal, an instrument popularly called "Letter of Credit" came into existence and developed accordingly with the passage of time and needs of commerce. The said instrument ensures the delivery of goods or services as well as the payment in consideration there of safely and simultaneously. The corresponding banks act as agents for the respective parties and payments are release on production of original documents called Bills of lading which are generally negotiable and play a dynamic role in international trade and commerce. In this paper, an attempt has been made to study the significance of the said instrument of documentary credit called letter of credit (L/C).

Introduction

It is the ability of a merchant or a business man to borrow money or procure desired goods or services when desired and on time, depending upon his credibility in the market and business community. It includes confidence of a particular lender of money or services on the basis of his reliability and sound solvency (People v. Wasservogle, 1888 & Dry Dock Bank v. Trust Co., 1850).

It is a trust or confidence reposed in a buyer of goods or services or a borrower of money that he would repay the amount due to be paid by maintaining

his solvency. It is more dependent upon a person's reputation in the course of business including his conduct in the past which leads a seller to trust his performance in the future after receiving the goods or services as appropriate; it is also referred to the duration of time which a seller may grant to a buyer for making payment. Although on concluding a contract of sale, in absence of a contract to contrary, the performance becomes necessary but it may be postponed for either party with the consent of the other party to the contract. The party given time to perform remains obliged to perform later on the specified time but till that time performance or debt does not become due; A debt and a credit exist together or a credit allowed by one person called 'creditor' takes the form of a debt for the other party called debtor; the credit by an individual is also termed a trust reposed by him in the debtor who deals with him that he has ability to meet his commitments; and one of the basis for such trust is the legal remedy available which allows and protects such transactions. While crediting to government however, is on the basis of firm confidence reposed from its ability of making compliance with its promises. Also such confidence plays an important role that a government in maintaining its credibility will respond to its commitments voluntarily which may not be compellable otherwise (*Owen v. Branch Bank, 1842*). The relevant laws provide for the credit in terms of deferred payment, delivery or both in commercial dealings (The Sale of Goods Act 1930, Section 5(1)). In facilitating commercial activities, law recognizes the need and import of credit in business and makes provisions for deferred deliveries and/or payments or both and protects them if the terms agreed upon are violated. The parties competent to entering into a contract are at liberty to agree mutually any terms and conditions they feel fit to themselves, provided the object and consideration are lawful. A payment in advance and deferred delivery at a time agreed upon in future as well as immediate delivery with deferred payment at a time agreed upon in future are equally common having their benefits in commerce and trading worldwide. The relevant laws regard credit and provide protection for unpaid seller and recovery of his debts when they become due (The Sale of Goods Act 1930, Section 47). However, if the goods have been sold on credit or deferred payment, the seller is barred from retaining goods for exercising his rights under possessory lien against the payment of price till the period of credit expires. However, a seller is fully entitled to exercise his rights of possessory lien against a debtor who becomes insolvent before taking delivery of the goods sold to him or when the period of credit expires if the goods are still in his possession or control. Such possession or control is not limited to actual possession or control but also includes constructive possession and control of the goods.

Literature Review

Possession

Ruffin, J. declares it as exercise of control over the thing and its use which extends to taking the proceeds and coming out of it in its present state (*Simpson v. Blount, 1831*). According to Gaston J. Possession signifies the exercise of acts of dominion over the property in question ordinarily being use extending to taking

the profits ordinarily of which it is subjected in its existing state and such acts of repetition must amount to show the character of ownership in contrast to the act or acts of an occasional trespasser (*Williams v. Buchanan*).

According to Black's Law Dictionary, possession is effective detention and control of the subject property or the physical or ideal custody of anything in question free for one's usage at his pleasure and discretion. Such use or enjoyment may be either in capacity as owner or as an administrator of a qualified right in it, and it may be held personally or by another in his (user's) name. It is an ideal state where an individual or an entity may exercise his rights and power on a thing if he desires excluding all others.

A possession may be either actual or constructive (*State v Shaw, 2001*).

Constructive possession occurs when a person knowingly has the authority and intent at some instant as his domain having control over an object directly or through others (*United States v. Craig, 1975*). Williams, refers to Constructive Possession as the ability to condense an object to actual possession (*United States v. Martinez, 1979*).

Constructive possession, thus, appears as a legal fiction describing a situation where a person (natural or legal) has actual control or dominion over a property (both moveable as well as immovable) without essentially having physical control of the same assets. Law regards both possessions, actual and constructive possession the same.

For example, a person having goods in his own warehouse or storage has actual or physical possession of them but the goods delivered to a buyer which may still be lying in seller's warehouse which can be removed by the buyer at his discretion any time without further approval (of the seller) amounts to constructive possession (of the buyer).

The concept of confiscation or seizure of goods by public or private organizations without removing them from their positions is also regarded as taking constructive possession. For example, large structure pledged against a loan. On default of the borrower in paying the debt, the creditor may by notice to the borrower take constructive possession of the structure, which effectively prevents the borrower from further using the property or dealing with it till the creditor takes further steps. Any further use or dealings in respect of the structure by the borrower would be unlawful and trespassing.

Credit and Qur'anic Commands

The Quranic injunctions and precepts of the Prophet (SAWW) give special regards to lending or *Qardh*. Islam forbids *susury* or *Riba* and advances trade and commerce through loans. However, performance of promise as agreed between the

parties has been made strict and mandatory except in special circumstances. *“If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity that is best for you if ye only knew”* (Al-Qur’an, Al-Baqra, 280).

It clearly recognizes not only the necessity and significance of loan or credit in Islam but facilitates the return of debts. The debtor is duty bound to return the money borrowed or pay for the goods delivered or to be delivered to him or any services rendered or to be rendered to him in accordance with the contract between the parties and its terms and conditions. However, in exceptional circumstances, when a debtor is experiencing extraordinary situations disabling him to pay back the debts, the creditor has been directed to grant leniency in time for payment or relax the terms thereof. It continues to the extent of remitting the debt and discharging the debtor for Allah. The said course has been described “the best” for the lender. It is partly commercial and partly based on belief. Commercially, the debtor would get time to survive a distress enabling his revival. It will also help the creditor to recover his credit in a better manner. And it is belief based as the believers firmly believe that whatever, more or less, we have, is from Allah and is without any guarantee and can be taken back by Him on His sole discretion. Therefore, mankind should be generous and kind to other human and creatures.

Qur’an has also described the safest and the most secure manner of lending and credit transactions. Holy Qur’an has described the most appropriate manner when entering a deed creating future obligations including a letter of credit in financial matters:

“O believers, when you negotiate a debt for a fixed term, draw up an agreement in writing, though better it would be to have a scribe write it faithfully down; and no scribe should refuse to write as God has taught him, and write what a borrower dictates and have fear of God, his Lord, and not leave out a thing. if the borrower is deficient of mind or infirm, or unable to explain, let the guardian explain judiciously; and have two of your men to act as witnesses; but if two men are not available, then a man and two women you approve, so that in case one (woman) of them is confused the other may remind her. when the witnesses are summoned they should not refuse (to come); but do not neglect to draw up a contract, big or small, with the time fixed for paying back the debt; this is more equitable in the eyes of God and better as evidence and best for avoiding doubt; but if it is a deal about some merchandise requiring transaction face to face, there is no harm if no (contract is drawn up) in writing; have witnesses to the deal, (and make sure) the scribe or the witness is not harmed. If he is (harmed), it would surely be sinful on your part; and have fear of God, for God gives you knowledge, and God is aware of everything” (Al-Baqra, 282).

The Divine directions in this regard are divided into two parts: First, general directions in financial matters creating contracts or obligations. It includes

dealings of sale/purchase of goods and rendering services on credit or deferred payments, advance payments for goods to be delivered in future, pledges and lending money. A vast variety of investments made in various sectors, for example, insurance, mutual funds and similar businesses may be included in these directions. Such matters, on conclusion are advised to be drawn into writing preferably by a scribe. In preparing such deeds preferably by a scribe, it is desired to be dictated by the borrower who owns the obligation. It is an appropriate course of commercial dealings to avoid any exploitation or undue upper handedness of the lender. However, free consent of the lender is necessary for a valid contract.

Second, as translator describes in his note, the Divine directions deal with special kinds of monetary matters and dealings. Such transactions include those resulting from promissory notes; more appropriately referred to as Letter of Credit (L/C) in modern world of commerce, trade and finance. The modern commercial and financial agreements being readily available on printed forms prepared by experts and modified to contemporary demands have made the transactions easier and simple. It also helps in construing and constructing the contracts and resolution of disputes arising during or in consequence of performance of contracts by means of precedents available in writing. However, at the time of revelation of the said Divine Commands, writing was not common and only limited number of people capable of writing and understanding such deeds were available. Employment of scribes for writing such obligations, on one side helps sharing wealth in the society and on the other promotes the literacy. Developments in relevant laws subsequently made provisions for necessary writing, witnessing and registration of such agreements as appropriate.

The significance of business loan and its security is evident from another verse of the Holy Qur'an (*Al-Baqra*, 283). The importance of lending (loans), performance of promises (contracts) and appropriate security for repayment of debts have made specific places in the Divine Commands. In special circumstances like journey, it provides an alternative manner of obtaining loan or credit when writing of deeds may not be possible due to non-availability of a scribe or other facilities. In such cases, a pledge of goods may serve the purpose for performance of promises and security of repayments.

The re-payment of debts have been given high priority while distributing deceased's property i.e. the distribution would take place only after the payment of *legacies and debts* due to the deceased (*Al-Qur'an*, Surah An-Nisa', 11) It was repeatedly stressed that all distributions of inheritance would take effect only after the payments of *legacies and debts* (*Al-Qur'an*, Surah An-Nisa', 12). Thus, the promises creating obligations and debts bind not only the promisor but his/her property which becomes liable in case of bankruptcy or death of the borrower.

Documentary Credit

Documentary credit with its vast advantages and convenience has become one of the most important instruments in modern commerce and trade. A Letter of Credit popularly called (L/C) in commercial world of trading pledges through an issuing bank to pay a beneficiary named in the document through his bank, who may be a seller of goods or rendering services, on submission of supporting document confirming performance of the contract, for example, evidence of delivery of goods to the carrier for onward carriage to the destination for delivery to the buyer or his bank; the documentary credit in the modern age is common in international commerce and trade and bills of lading generally serve the purpose as evidentiary documents of performance; it is also referred as "documentary draft in some countries.

International trade requires safe and secure procedures ensuring payments and delivery of goods or services agreed upon between the parties. In order to meet such requirements, the credit worthiness or ability of a merchant or a buyer is substituted by a bank guaranty for a specific transaction. Under such arrangements, a bank usually in buyer or importer's country undertakes to pay for a specific shipment on condition of exporter submitting the required documents which may include clean bills of lading, certificate of insurance, certificate of origin and certificate of quality etc. within a specific period of time. In United States this arrangement is often termed as commercial letter of credit.

Letter of Credit (L/C)

The document referred to as a letter of credit or in short, (L/C) describes a contract between the parties named therein and may be defined as a document which may be a sealed or open document. The said document bears a specified limit of credit mentioned therein. A merchant intending to buy goods or services from another party presents it in lieu of payment in advance or tendering the payment. The document directs at the desired place requiring the payment to a specified amount of money may be made for procuring goods or services or otherwise requiring money on meeting terms and conditions of the letter (3 Chit.Com).

It can also be defined more precisely as, an instrument drawn in writing, by one person (buyer's bank) for the benefit of another person (seller's bank), to make payment to the other person (beneficiary) whose name appears in the letter (Civ. Code Cal, 1872).

The letter termed as a letter of credit forms a contract or a future obligation resembling a guarantee. The agreement is between three parties namely; issuing bank which guarantees payment of the said amount on compliance of conditions mentioned in the letter and rules applicable thereupon; holder of the letter, who obtains the letter on application; and the beneficiary of the letter who is entitled to

receiving the payment on demand on fulfilling the conditions of the letter and rules applicable thereupon.

Commercial dealings particularly international, due to differing foreign exchange laws in different countries, distances apart, parties dealing not known to each other and chances of fraud thereof, require a safe and secure instrument to ensure pre-agreed exchanges or performance of contracts. A letter of credit serves the purpose as an effective tool in such trades. It ensures payment to the seller of goods and delivery of goods to the buyer in performance of the contract between the parties. It is issued by buyer's bank which guarantees the buyer's payment to the seller to be made on time and in agreed amount. In the case of default in payment from the buyer on the purchase of goods or other debt, the issuing bank will be required to make the payment in full or for the remaining amount due to the seller/creditor. These characteristics make a letter of credit, a safe and effective instrument in international commerce and trade.

Governing Laws

Documentary credit or more commonly known as "Letter of Credit" being a letter of guarantee is governed by the provisions of the Contract Act 1872 (Section 126). Under the relevant laws, liability of a surety is the same and extending to the same extent as that of the debtor (The Contract Act 1872, Section 128).

In the case of a letter of credit the holder of the L/C stands as debtor, the named beneficiary as a creditor and the issuing bank as surety. Terms of the letter of credit define and regulate the relationships and modes of performance of the contract between the parties.

Letter of Credit-Indemnity or Guarantee

It seems necessary to discuss distinctions between a letter of indemnity and a letter of credit. Although, both are contracts involving three parties whereby one of the parties is the beneficiary but they differ entirely from each other. In case of indemnity contract there exists no contract between an indemnifier and claimant. But on the other hand in a guarantee contract, privity of contract exists expressly between all the three parties i.e. surety, creditor and principal debtor being parties to the contract (*Habib Bank Limited v. Waheed Textile Mills Limited and others*, 1989). In a guarantee or surety-ship, a tripartite agreement is necessary between the parties namely creditor, principal debtor and surety. Another distinction is that in case of an indemnity the indemnifier is not necessarily required to respond at the demand of the third party whereas in case of a guarantee the surety is duty bound to discharge his obligations at the request of the creditor. In the former case, it is direct agreement between the two parties thereto which are Indemnity holder and indemnifier, while, in the later case, there are three parties, a creditor, a debtor and a surety who undertakes at the request of the creditor to answer any default made by the debtor (*Pfizer Laboratories Limited*, 2003) While considering the question

whether an executed bond which was before the court was an indemnity bond or a guarantee, it was held that:

“the document before the court did not show that the Judgment Debtor was at all a party to the arrangements embodied in the document purporting relationship.....this being so, one of the essential elements present in every contract of guarantee is the presence of three parties joining the execution of the deed of guarantee was found missing in the case. This was taken as a clear answer against the contention that the document (before the court) should be taken as a deed of guarantee & not a mere indemnity bond”.

Based on such distinction the bond was declared a mere indemnity bond not a guarantee.

The obligations of a surety under such contracts bind him to perform his promise in discharging the liabilities of principal-debtor in the event of his default." Thus a "default" of a third person (principal debtor) is a pre-condition and a foundation for the liability of a guarantor or surety to arise (*MT. Radha Kunwar v. Ram Narain and Ors, 1952*).

For example a contract of insurance fulfills the criterion as an indemnity policy. In such a case insurer undertakes to indemnify the assured in a way and extent agreed between the parties to the contract in the event of the incident insured against the losses (*M/s Master Sons v. M/s. Ebrahim Enterprises and Another, 1988*).

However, it has been observed that general law of contracts of indemnity covers greater area than the provisions as defined for an Indemnity contract under the Contract Act 1872 (Section 124). It is well established law that a contract of fire insurance or marine insurance always falls under the ambit of contracts of indemnity whereas under the provisions of Contract Act 1872, these contracts have been listed under and referred to as contingent contracts (*Tropical Insurance Co. Ltd. v. Zenith Life Insurance Co. Ltd. 1941*).

A letter of indemnity, often a formal letter is issued in consequence of an agreement and forming a “contract of indemnity”. A letter of credit is a guarantee; an indemnity bond is between two parties wherein, the indemnifier promises to indemnify the other party called indemnity holder, against any damage by the conduct of the indemnifier or by third person; a letter of credit on other hand is a contract of guarantee having privity of contract between three parties namely, the holder of the L/C as a debtor, the bank which issues the letter as surety or guarantor and the beneficiary as creditor.

The question of commencement and extent of liability of indemnifiers not well defined. It may be assumed on the basis of English and Pakistani authorities based on English Common law that an indemnifier could not be called in to indemnify till the indemnity holder incurs actual loss agreed to be indemnified.

But the recent practice based on equity now prevailing is not limited merely to mean repay in respect of payments made, but extends to protect the holder of indemnity from any loss occurring in the event of responsibility against which the bond has been given. If it be interpreted in a way that payment by the indemnity holder is necessary as condition precedent for successful claim (from the indemnifier), the indemnity holder may find it of little worth in the commercial world due to his inability to meet the claim in the first instance.

In contrast a guarantee serves a two-fold purpose and is not simply a legal binding between a bank and a creditor who loans on the assurance of the guarantor, but it may additionally be supported by a security given to the creditor/beneficiary by the debtor. In consequence of default, a creditor has to deliver the valid guarantee back to the surety in consideration of his payment. Thus in order to enforce the guarantee, beneficiary/creditor applies to release security furnished by the debtor and then in turn that third party/surety gets *locus standi* to enforce the security against the debtor (M.L International Pvt. Limited c. Habib Bank Limited, 1991). The liability under a guarantee necessarily means a liability which is enforceable at law. A surety generally, is not liable on a guarantee barred by the law of limitation.

As mentioned above, the liability of a surety extends to the same extent as that of the principal debtor which is referred to as co-extensive liability. Unless the contract contains contrary stipulations, the surety would be liable for the same extent of liability as principal debtor would be. It would include the principal amount of loan with interest thereon. At the same time the liability against surety must be proved in the same way as against the principal debtor (*National Bank f Pakistan v. M.M Agencies*, 1991).

Banking Arrangements

A prospective buyer, entering into an agreement with a seller (of goods or services) requests to a commercial bank or a financial institution for a letter of credit. The said bank on written request of the prospective buyer of goods or services, issues a letter guaranteeing payment of a specific amount to the bank nominated by the seller which is authorized to receive the payment of the sale proceeds. On delivering goods to the carrier nominated by the buyer or other bailee as per agreement, the shipping bills which may include bills of lading or similar documents are presented by the seller to his nominated bank. The presentation of these documents amounts to evidence that the goods described therein have been delivered to the carrier or other bailee for their delivery to the buyer. On producing the evidence of delivery to the carrier, seller's bank demands the buyer's bank to remit the payment into seller's account. After fulfilling the pre-agreed and customary formalities, the buyer's bank makes payment into seller's (bank) account. In other words, the transaction is carried out by the banks in the capacity of guarantors (agents as well to some extent) instead of the parties themselves which are buyer and seller respectively. The banks as well as other

finance institutions are much more familiar with such transactions and known in the financial markets than the trading parties. The chances of mishaps such as fraud or misrepresentation become lesser.

Additional Costs

In order to protect the interests of guaranteeing bank for any additional cost or due payment, if any, the goods are consigned in the name of buyer's bank and/or order. The buyer is usually mentioned as "notifying party" in the Bill of lading. On receipt by the original bill of lading by the buyer of the goods described in the B/L, presents it to his bank which after ensuring the necessary payments and customary formalities, endorses it in the name of the buyer or its assign or transferee for consideration.

Negotiability

A letter of credit is normally an instrument which is negotiable guaranteeing the payment and the bank which issued the L/C is bound to pay the beneficiary or any other person including a bank nominated by the beneficiary. The L/C may be transferable and in such cases the beneficiary is placed at liberty to assign his rights to another person including, a corporate parent, and a subsidiary or a third party with the rights to draw the bill.

Funding of a Letter of Credit (L/C)

On application for issuance of a letter of credit, bank usually requires a pledge for security or collaterally an equivalent amount of cash in the bank during life of the L/C. A fee may be charged by banks as service charges depending upon the quantum of the letter and bank policy.

International Chamber of Commerce Uniform Customs and Practice (ICC UCP) and Letter of Credit

The International Chamber of Commerce Uniform Customs and Practice for Documentary Credits (ICC UCP) is an international institution which supervises matters relating to the L/Cs in transactions mainly international transactions. Practitioners of Letter of Credit worldwide use and make reference to the institution and its rules as the most useful private commercial rules developed for major trades especially international trade. These rules are popular among bankers, carriers/transporters, lawyers, accountants, academics and others dealing with letters of credit transactions worldwide. Reference to ICC UCP 600 rules in all relevant transactions is on routine basis (ICC, 2006).

UCP 600 first introduced on 01 July 2007 has gone through significant changes and improvements during passage of time which are available for use.

Conclusion

On basis of the study, it can be concluded that commercial activities necessarily require credits without which they may suffer considerable drawback. At the same time, mechanism for safe return of debts and payments is equally important and desired. It is not limited to the debts and payments but delivery of goods and services on the time agreed also needs to be regulated.

For this purpose, introduction and role of the instrument called Letter of Credit strongly supports and advances commercial activities. It has proved to be a tool for safety in the trade and business where chances of fraud and misrepresentation cannot be ruled out. Both the buyer and seller, equally benefit from the instrument. It is therefore, considered useful exercise to highlight and discuss various aspects and types of the instrument which would definitely help readers understanding and enabling dealings with commercial transactions.

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