

Remedies for Breach of a Buyer's Obligation to Open a Letter of Credit in CISG Contracts—Part I

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A clause in a sales contract requiring the buyer to open a letter of credit creates an obligation for the buyer to have a bank assume an obligation to pay the contract price against documents towards the beneficiary of the credit, i.e. the seller. This obligation to open a letter of credit is enforceable under the law governing the sales contract. Questions arise as to the enforcement and effects of the buyer's obligation under that law. In particular, whether failing to open the letter of credit, or a non-compliant letter of credit, may entitle the seller to claim certain remedies but exclude others. The author submits that the United Nations Convention on the International Sale of Goods ("CISG") offers an effective legal framework for the enforcement of a buyer's obligation to have a bank open a letter of credit under a contract for the international sale of goods. This two-part article discusses the remedies that may follow from a buyer's breach of a contractual obligation to open a letter of credit pursuant to the CISG. This first part introduces the topic. The final part of the article, which will appear in an upcoming issue of The Banking Law Journal, will analyze the remedies that may follow from a buyer's breach of a contractual obligation to open a letter of credit pursuant to the CISG, discuss a buyer's right to suspend performance of a contractual obligation to open a letter of credit and other interdependent obligations, as well as a buyer's right to stop payment after opening of a letter of credit, and provide a reminder of the legal effect of the avoidance of the underlying contract over a letter of credit.

Letters of credit are a creation of international trade practice, which works as the primary legal source.¹ The private codification and standardisation of

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¹ Jurgen Basedow, *The State's Private Law and the Economy: Commercial Law as an Amalgam of Public and Private Rule-Making*, 56 THE AMERICAN JOURNAL OF COMPARATIVE LAW, 719 (2008); David V. Snyder, *Contract Regulation, with and without the State: Ruminations on Rules and Their Sources. A Comment on Jürgen Basedow*, see *id.* at 726; William Patrick Cronican, *Buyer Beware:*

documentary credits has so far been based on uniform soft law rules.² The most important source in this area are the Uniform Customs and Practice for Documentary Credits published by the International Chamber of Commerce (“ICC”),³ the latest version of which was published by the ICC in 2007 (“UCP 600”).⁴ The UCP 600 are generally accepted and widely used.⁵ The first edition of the UCP goes back to 1933.⁶ Certain commentators point out that the application of the UCP 600 is almost universal.⁷ The UCP 600 play an important part in governing documentary credits since domestic law is not uniform in the various jurisdictions and, as is often the case, the same question of law may have a different answer, depending on the jurisdiction one has to consider.⁸ This article discusses the UCP 600 as an example of a set of rules in this area of international trade law.⁹

Electronic Letters of Credit and the Need for Default Rules, 45 McGEORGE LAW REVIEW, 386 (2013).

² Snyder, *THE AMERICAN JOURNAL OF COMPARATIVE LAW*, 726 (2008); Robert Wai, *The Interlegality of Transnational Private Law*, 71 LAW AND CONTEMPORARY PROBLEMS, 122, 126 (2008).

³ Paul B. Stephan, *PRIVATIZING INTERNATIONAL LAW*, 97 VIRGINIA LAW REVIEW, 1601, 1602 (2011); Portia Ndlovu, *Incoterms 2010: a consideration of certain implications of the Amendments to the Traditional Incoterms 2000*, 44 THE COMPARATIVE AND INTERNATIONAL LAW JOURNAL OF SOUTHERN AFRICA, 206 (2011); Wai, *LAW AND CONTEMPORARY PROBLEMS*, 127 (2008).

⁴ Snyder, *THE AMERICAN JOURNAL OF COMPARATIVE LAW*, 726 (2008); Federico Santacruz & Jorge Oria, *Documentary credits*, 27 INTERNATIONAL FINANCIAL LAW REVIEW, 64 (2008); Frank R. Ryder, *Challenges to The Use of The Documentary Credit in International Trade Transactions*, 16 COLUMBIA JOURNAL OF WORLD BUSINESS, 38 (1981).

⁵ Snyder, *THE AMERICAN JOURNAL OF COMPARATIVE LAW*, 737 (2008); A. MUGASHA, *THE LAW OF LETTERS OF CREDIT AND BANK GUARANTEES 1* (Federation Press. 2003).

⁶ Roy Goode, *Rule, Practice, and Pragmatism in Transnational Commercial Law*, 54 THE INTERNATIONAL AND COMPARATIVE LAW QUARTERLY, 550 (2005); David P. Stewart, *Private International Law*, 42 THE INTERNATIONAL LAWYER, 707 (2008); Xiang Gao, *The Fraud Rule in Law of Letters of Credit in the P.R.C.*, 41 *see id.* at 1070, fn 8 (2007).

⁷ Basedow, *THE AMERICAN JOURNAL OF COMPARATIVE LAW*, 709 (2008); JAN RAMBERG, *INTERNATIONAL COMMERCIAL TRANSACTIONS* 142 (ICC Norstedts Juridik AB 4th ed. 2011); Stewart, *THE INTERNATIONAL LAWYER*, 707 (2008).

⁸ Basedow, *THE AMERICAN JOURNAL OF COMPARATIVE LAW*, 709, 710 (2008); Ryder, *COLUMBIA JOURNAL OF WORLD BUSINESS*, 39 (1981); Cronican, *McGEORGE LAW REVIEW*, 389 (2013). In the United States, letters of credit are regulated in Article 5 (5-101 to 5-118) UCC. In Mexico the documentary credits were only recently regulated in 2008 in Article 71 of the Mexico Credit Institutions Act, cf. Santacruz & Oria, *INTERNATIONAL FINANCIAL LAW REVIEW*, 63 (2008).

⁹ In addition to the UCP 600 one further important publication should be borne in mind which is the International Standard Banking Practice for the Examination of Documents under Documentary Credits (“ISBP”) (ICC Publication No. 681 (2007)), which is a complement to the UCP 600.

LETTERS OF CREDIT

Under a letter of credit, or in the UCP's language a documentary credit,¹⁰ a bank¹¹ assumes an irrevocable, primary obligation to pay a credit against the presentation of documents by the beneficiary of the credit.¹² The party instructing the bank is generally the buyer also called the applicant acting pursuant to the terms of a contract of sale.¹³ The applicant's instruction to the bank is to the effect that the bank undertakes to honour a presentation of documents by the seller in accordance with the terms of the credit.¹⁴ The credit is by its nature a separate transaction from the sale contract on which it is based.¹⁵

The bank's undertaking to pay has two important aspects. On the one hand, it does not depend on default by the buyer, and in this sense it is "independent," giving rise to the guarantor's primary duty to pay the beneficiary irrespective of the applicant's default or breach of contract.¹⁶ On the other hand, the bank is the seller's first port of call for payment. Therefore, the bank performs the payment obligation in lieu of the buyer but the bank is not liable under the sales contract for any delay or lack of payment, or other

¹⁰ "Documentary credit" is the term used by the UCP. Other synonyms are "bankers' commercial credits," "bankers' letters of credit," and "documentary credits."

¹¹ Identified with the name of the issuing bank or confirming bank.

¹² UCP 600 defines "credit" and the other words which are part of the definition of "credit" as follows: "Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation. Honour means: a. to pay at sight if the credit is available by sight payment. b. to incur a deferred payment undertaking and pay at maturity if the credit is available by deferred payment. c. to accept a bill of exchange ("draft") drawn by the beneficiary and pay at maturity if the credit is available by acceptance. Issuing bank means the bank that issues a credit at the request of an applicant or on its own behalf." See Ryder, *COLUMBIA JOURNAL OF WORLD BUSINESS*, 36 (1981).

¹³ Cronican, *McGEORGE LAW REVIEW*, 384, 387 (2013); RAMBERG, 143. 2011; MUGASHA, 2. 2003.

¹⁴ Art. 2 UCP 600 defines "complying presentation" as "a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice." See Cronican, *McGEORGE LAW REVIEW*, 384 (2013); MICHEL G. BRIDGE, *THE INTERNATIONAL SALE OF GOODS 276* (Oxford University Press Third ed. 2013); Ryder, *COLUMBIA JOURNAL OF WORLD BUSINESS*, 36 (1981); RAMBERG, 43. 2011.

¹⁵ BRIDGE, 292. 2013.

¹⁶ Goode, *THE INTERNATIONAL AND COMPARATIVE LAW QUARTERLY*, 550 (2005); Gao, *THE INTERNATIONAL LAWYER*, 1069, 1070 (2007); Thanuja Rodrigo, *UCP 500 TO 600: A FORWARD MOVEMENT*, 18 *eLAW: MURDOCH UNIVERSITY ELECTRONIC JOURNAL OF LAW*, 5 (2011).

obligations of the buyer under that contract.¹⁷

THE CISG

The 1980 United Nations Convention on Contracts for the International Sale of Goods (the “CISG”)¹⁸ does not require the buyer to open a letter of credit in order to pay the purchase price.¹⁹ However, this state of affairs does not preclude the parties from agreeing on this mode of payment. Article 6 CISG expresses the principle of party autonomy to tailor their contract.²⁰ The provisions of the CISG governing the buyer's obligations apply only insofar as the contract contains no other specific provisions.²¹ As a result, the parties may agree upon the buyer's obligation to have a bank opening a letter of credit for the seller's benefit.²² In such a case, the contract of sale may determine the terms and characteristics of the letter of credit that the buyer is expected to open.²³ Where the contract as a whole falls within the scope of application of the CISG,²⁴ the obligation to open a letter of credit, but not the terms of the credit itself, will also be subject to the CISG provisions since that would be an

¹⁷ Rodrigo, *eLaw: Murdoch University Electronic Journal of Law*, 4, 5 (2011); Nevin Meral, *THE FRAUD EXCEPTION IN DOCUMENTARY CREDITS: A GLOBAL ANALYSIS*, 5 ANKARA BAR REVIEW, 48 (2012).

¹⁸ The CISG is the law for contracts on the international sale of goods in force in 84 countries, including the US and its main trading partners. *See* text and status at www.uncitral.org/ (last accessed November 24, 2016).

¹⁹ Pursuant to Articles 53 and 54 CISG, the buyer's obligations include taking delivery of the goods, paying the price which also includes taking such steps and complying with such formalities as may be required under the contract or the law to enable payment.

²⁰ INGEBOG SCHWENZER, et al., *GLOBAL SALES AND CONTRACT LAW* 65 (OUP, 2011); Ingeborg Schwenger, *Article 6*, in SCHLECHTRIEM & SCHWENZER: COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS 115, (Ingeborg Schwenger ed. 2016); FRANCO FERRARI, *CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS—APPLICABILITY AND APPLICATIONS OF THE 1980 UNITED NATIONS SALES CONVENTION* 155 (Martinus Nijhoff Publishers. 2012).

²¹ Florian Mohs, *Article 53*, in SCHLECHTRIEM & SCHWENZER: COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS 822, (Ingeborg Schwenger ed. 2016).

²² JOSEPH LOOKOFKY, *UNDERSTANDING THE CISG* 88, 89 (Wolters Kluwer Fourth Worldwide Edition ed. 2012).

²³ RAMBERG, 47. 2011; BRIDGE, 292. 2013.

²⁴ The CISG applies to contracts for the international sale of goods when the parties to the contract have their place of business in different Contracting States (Article 1(1)(a)) or when the rules of private international law lead to the application of the law of a contracting state (Article 1(1)(b)).

obligation arising from a CISG contract.²⁵

The parties to a CISG contract may agree for example that a letter of credit be opened by the buyer and that the credit itself, *i.e.* the relationship between the seller and the bank, be governed by the UCP 600.²⁶ The UCP 600 will thus apply to the Letter of Credit by an indication in the credit itself.²⁷ As the UCP 600 apply in this case by virtue of the parties' agreement, it follows that the application of their provisions may be amended or excluded by the express terms of the credit.²⁸ Absence of express choice by the parties, Article 8 and 9 CISG may enable a court or arbitration tribunal to find that the UCP 600 (or part of the provisions therein) apply to a letter of credit as part of the parties' practice or relevant trade usages.²⁹ The law of the credit which may supplement the UCP 600 is different to the law governing the underlying sales contract.³⁰ Accordingly, the law of the letter of credit will be determined by resort to the conflicts rules applicable by the State court or arbitral tribunal under consideration.³¹

²⁵ Mohs, 826, 829. 2016.

²⁶ Joshua Karton, *Contract Law in International Commercial Arbitration: The Case of Suspension of Performance*, 58 THE INTERNATIONAL AND COMPARATIVE LAW QUARTERLY, 891, 895 (2009): referring to the ICC Case no 11849 of 2003 where the Arbitral Tribunal upheld the application of the UCP by virtue of the parties' choice of law in the CISG contract.

²⁷ Art. 1 UCP 600.

²⁸ BRIDGE, 293. 2013.

²⁹ *But see* Goode, THE INTERNATIONAL AND COMPARATIVE LAW QUARTERLY, 550 (2005): "the widely adopted Uniform Customs and Practice for Documentary Credits. These may be evidence of pre-existing usage but this will not be true of all the terms, since there will inevitably be some departures in order to improve current practice; indeed, some of the 'rules' are merely precatory indications of desirable practice, such as the avoidance of excessive detail in a credit"; Cronican, McGEORGE LAW REVIEW, 389 (2013): the UCP "became a popular regulatory scheme to adopt because of its reflection of market practices and its more modern and practical approach to the transaction in general." In Mexico, Article 71 of the Credit Institutions Act endorses the application of usages and practices applicable to the parties in each letter of credit, *see* Santacruz & Oria, INTERNATIONAL FINANCIAL LAW REVIEW, 64 (2008).

³⁰ Cronican, McGEORGE LAW REVIEW, 389 (2013).

³¹ If one considers the question of the proper law of the credit in the context of proceedings pending or likely to be pending before a State court, then the applicable law will be determined by the conflicts rules applicable before such court. If, on the other hand, one considers the question of the proper law of the credit in the context of proceedings pending or likely to be pending before an arbitrator, then the applicable law will be determined by the conflicts rules of the *lex arbitri*. In this regard, the law applicable to the letter of credit will be the law chosen by the Parties and in the absence of such choice the law where the issuing bank or the confirming bank is located, since the issuing bank or the confirming bank is the party whose performance characterizes the letter of credit under, for example, the EC Rome Regulation on the applicable

THE UNDERLYING CONTRACT

If the parties have thus agreed that payment be effected by letter of credit, the buyer will have to instruct his bank (the issuing bank, generally in his own country) to open a documentary credit in favour of the seller.³² In principle, the parties should make provision in the underlying sales contract about what the terms of the credit should be.³³ If the letter of credit issued by the bank is not in accordance with the terms of the underlying CISG contract of sale, the buyer may incur in breach of part of its obligation to pay the price (see below). When the underlying sales contract is null and void or voidable for duress, undue influence, mistake, or any other legal grounds admissible under its applicable law,³⁴ that contract's payment clause will most likely follow the same fate. However, the invalidity of the underlying sales contract will not entail the nullity of the letter of credit because, under the principle of independence, the letter of credit constitutes a separate agreement from the contract of sale (see above). Therefore, the bank must honor a complying presentation of documents unless the seller's request to pay is fraudulent (see discussion below).

The principle of freedom of contract also operates at the level of the letter of credit (and not only at the level of the underlying contract), the parties are able to freely structure the type of letter of credit. In principle, letters of credit are irrevocable under the UCP 600,³⁵ and the word "irrevocable" need not be set out in the terms of the credit.³⁶ As the provisions in the UCP 600 may be modified,³⁷ the parties may agree that a credit is "revocable."³⁸ Whether a credit is revocable will depend by the terms of the underlying CISG contract and the letter of credit itself.³⁹ In case of a revocable letter of credit, the issuing bank

law to contracts, see Jonathan Hill, *Choice of Law in Contract under the Rome Convention: The Approach of the UK Courts*, 53 THE INTERNATIONAL AND COMPARATIVE LAW QUARTERLY, 334 (2004); Cronican, McGEORGE LAW REVIEW, 389 (2013).

³² RAMBERG, 142. 2011.

³³ LOOKOFESKY, 89, 90. 2012.

³⁴ The CISG will not apply to these issues as they fall outside its scope of application in accordance with article 4(a) CISG.

³⁵ Rodrigo, eLAW: MURDOCH UNIVERSITY ELECTRONIC JOURNAL OF LAW, 4 (2011); Goode, THE INTERNATIONAL AND COMPARATIVE LAW QUARTERLY, 550 (2005).

³⁶ Art. 3 UCP 600.

³⁷ Art. 1 UCP 600.

³⁸ Rodrigo, eLAW: MURDOCH UNIVERSITY ELECTRONIC JOURNAL OF LAW, 4 (2011).

³⁹ *Id.* at; RAMBERG, 145. 2011.

may cancel the credit without notice to the seller.⁴⁰

The underlying contract may also require the buyer to apply for a confirmed letter of credit.⁴¹ In such a case the letter of credit will be issued by the issuing bank, and then be confirmed by a further bank (“the confirming bank”) upon the request or authorisation of the issuing bank.⁴² By adding its confirmation to the credit issued by the issuing bank, the confirming bank assumes a definite undertaking to honour or negotiate a complying presentation of documents.⁴³ Such undertaking by the confirming bank is in addition to that of the issuing bank.⁴⁴ In addition, the buyer may have an obligation to make payment available to the seller by sight payment,⁴⁵ deferred payment,⁴⁶ or negotiation,⁴⁷ and this characteristic will also depend on the payment terms of the underlying CISG contract.

QUESTIONS

Against this background, various questions arise as to the enforcement and effects of the buyer’s obligation to open a letter of credit under the CISG. In particular, whether failing to apply, or the opening of a letter of credit that deviates from the terms of the underlying contract, may entitle the seller to claim certain remedies but exclude others. This article discusses the remedies that may follow from a buyer’s breach of a contractual obligation to open a letter of credit pursuant to the CISG. This first part of the article introduces the topic. The final part of the article, which will appear in an upcoming issue of *The Banking Law Journal*, will analyze the remedies that may follow from a buyer’s breach of a contractual obligation to open a letter of credit pursuant to

⁴⁰ Rodrigo, eLAW: MURDOCH UNIVERSITY ELECTRONIC JOURNAL OF LAW, 4 (2011).

⁴¹ LOOKOFSKY, 89, 90. 2012.

⁴² Rodrigo, eLAW: MURDOCH UNIVERSITY ELECTRONIC JOURNAL OF LAW, 5, 6 (2011).

⁴³ See Art. 2 UCP 600, Definitions of “Confirmation” and “Confirming bank” and Art. 8a UCP 600.

⁴⁴ Art. 2 UCP 600.

⁴⁵ Arts. 2 and 6(b) UCP 600. A sight credit means that the letter of credit provides for payment against presentation of the documents. Payment is usually made by the advising bank. See BRIDGE, 287, 288. 2013.

⁴⁶ Arts. 2 and 6(b) UCP 600. A deferred payment credit means that payment takes place after the expiry of the designated period from shipment, from the bill of lading date or from presentation. The seller provides the documents to the buyer, before receiving payment. If the nominated bank prepaid before maturity, the issuing bank must reimburse the nominated bank. See Rodrigo, eLAW: MURDOCH UNIVERSITY ELECTRONIC JOURNAL OF LAW, 12–13 (2011).

⁴⁷ Arts. 2 and 6(b) UCP 600.

the CISG, discuss a buyer's right to suspend performance of a contractual obligation to open a letter of credit and other interdependent obligations, as well as a buyer's right to stop payment after opening of a letter of credit, and provide a reminder of the legal effect of the avoidance of the underlying contract over a letter of credit.

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The final part of this article will appear in an upcoming issue of *The Banking Law Journal*.