

## **CRITICAL ANALYSIS OF THE PRINCIPLE OF STRICT COMPLIANCE IN LETTER OF CREDIT OPERATION WITH RELATION TO THE UCP 600**

**Ridoan Karim,\*<sup>1</sup> Md. Zahidul Islam<sup>2</sup>**

<sup>1</sup> *Adjunct Faculty Member of Business Law, School of Business Administration, East Delta University(EDU), 1267/A, Goshaildanga, Agrabad, Chittagong, Bangladesh.*

<sup>2</sup> *PhD Researcher, Ahmad Ibrahim Kulliyah (Faculty) of Laws (AIKOL), International Islamic Malaysia (IIUM); Lecturer, Kulliyah (Faculty) of Shari'ah and Law, Islamic University of Maldives (IUM).*

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### **ABSTRACT**

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#### **Keywords:**

*Critical Analysis; Strict Compliance; Letter of Credit; UCP 600;*

One of the fundamental principles governing the Letter of Credit operation is the principle of strict compliance. The paper is based on the understanding of the “Doctrine of Strict Compliance” within the context of UCP 600 in international trade. The objectives of this study are to (i) analyze the current status of principle of strict compliance in letter of credit system; (ii) identify the implementation of the doctrine in International Trade; (iii) make an outline to develop a relation between the principle of strict compliance and UCP 600; (iv) and conclude the research by answering how the usage of UCP 600 softens the principle of strict compliance. The whole study of the paper focuses on how the implementation of UCP 600 softens the doctrine of strict compliance. The paper shall address the very basic characteristics of principle of strict compliance and shall find out how the application of the provisions of UCP 600 changes the characteristics of the doctrine. The outcome of the paper will bring a proper understanding on how the doctrine of strict compliance has changed and reformed over the year in international trade practices and how UCP 600 re-shaped the basic structure of that doctrine.

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## **INTRODUCTION**

To understand what the ‘principle of strict compliance’ is, we need to understand what does ‘Letter of Credit’ means. The terms ‘Principle of strict compliance’ and ‘Letter of Credit’ are inter-dependent. Letter of credit (LC) is a payment mechanism, used to facilitate trade in international sales (Hashim, 2013). It is commonly applied in cases where the parties involved are from different jurisdictions. Letter of Credit helps to ensure the performance of both the parties within the scope of the contract. Generally, there are four different stages to be observed where the payment is arranged by the LC (Bal, 2010). The stages are:

- “First, the seller and the buyer agree in their main contract that the payment shall be made under a letter of credit.
- Secondly, the buyer (the applicant), usually at his place of business, applies to a bank (issuing bank) to open a credit in favors of the seller.
- Thirdly, the issuing bank arranges with a bank (advising bank) at the business place of seller, to advise the buyer, of the opening of the credit.
- The fourth step is that the seller (the beneficiary) will be informed of the opening of the credit by the advising/confirming bank” (Bal, 2010).

The seller will ship the goods after being informed by the advising bank if the letter of credit complies with the terms of the underlying contract. Therefore, the bank will affect the payment only if the documents strictly comply with the terms of the credit.

## **PRINCIPLE OF STRICT COMPLIANCE: AN OVERVIEW**

One of the fundamental principles governing the LC operation is the doctrine of strict compliance. The principle requires the seller to present the necessary documents in accordance with LC requirements; in order to claim payment for the goods sold. The principle of strict compliance is defined as the legal principle that entitles the bank to reject documents which did not strictly comply with the terms of LC (Alan, 2001). The bank is the responsible in determining whether the presentation complies with

LC requirements based on the Uniform Custom and Practice for Documentary Credit (UCP 600) and ISBP (Hashim, 2013). The principle of strict compliance aims to protect the buyer who has neither the opportunity to examine the physical goods nor to supervise the process of loading the goods in the seller's country due to geographical distance (Hashim, 2013). It also provides the seller a confirmation of fast payment if the seller complies with the contract of sale. The Principle also states that the bank is entitled to reject payment which does not strictly conform to the terms of the LC. Thus, the principle itself establish a general rule/obligation which ensures that the bank will only pay if the documents received complies strictly with the terms and conditions of the LC as stipulated by the buyer, and the seller also knows that the payment will only be received where the transactions are accordingly performed by both parties (Krazovska, 2008), thus, there are no scope of fraudulent performance in against with any parties.

## **RIGHTS AND DUTIES OF BANKS IN RELATION TO THE PRINCIPLE OF STRICT COMPLIANCE**

### **Document examination**

#### ***Meaning of complying presentation***

UCP 600 provides general rules relating to the document examination in case of LC. It introduces new articles including those which provide definitions of presentation and complying presentation. As an example, complying presentation is defined as a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of the UCP rules and international standard (Article 2, UCP 600). The above clarification removes the existing perceptions of compliant documents (Bergami, 2007). It states that the compliance of documents is not only determined by LC requirements and the rules of the UCP rules; it must also be guided by the International Standard Banking Practice (ISBP) (Hashim, 2013). Thus, UCP 600 provides a clear idea about document examination as it describes that in a Letter of Credit the documents must comply with terms and conditions of the credit and with the rules of UCP 600 and as well as ISBP.

#### ***Standard for examination of documents (Art.14, UCP 600)***

In UCP 600, art.14 establishes the responsibility of the banks to comply with the standard for examination of documents. It has introduced three new features: examination of the documents on their face (Article 14(a), UCP 600), the time given to the banks for examination (Article 14(b), UCP 600) and consistency between documents tendered (Article 14 (d, e), UCP 600).

The standards for the examination of the documents according to the Article 14 of the UCP 600 states that the bank is under an obligation to examine all the documents stipulated in the credit, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation (Bal, 2010). The examination of the documents on their face indicates the review of a document in line with the ISBP (International Standard Banking Practice) and features of the document itself. Also the phrase “with reasonable care”, which was used in art.13 of UCP 500 has been excluded in order to impose stricter liability on the banks in examining documents (quoted in “UCP 500 to 600: a forward movement” by Rodrigo, T). In addition to this, “article 14 of UCP 600 provides that the documents need not be identical between each other but must not conflict with any other document. Article is considered as a step to reduce the number of rejections as it allows non-identical documents by clarifying how similar the documents must be”( Bal, 2010).

### **Options of Banks in Respect of Strict Documentary Compliance**

#### ***Complying presentation: bank must honour***

If the credit instructions are clear enough and the beneficiary has tendered a complying presentation, the bank must honour (or negotiate). However, if the tendered documents do not comply strictly with the terms of the letter of credit, the bank needs to decide what to do (Art. 16(a) of the UCP 600). Thus, the article 15 of the UCP 600 provides the following rules regarding the complying presentation:

- a. When an issuing bank determines that a presentation is complying, it must honour.
- b. When a confirming bank determines that a presentation is complying, it must honour or negotiate and forward the documents to the issuing bank.
- c. When a nominated bank determines that a presentation is complying and honours or negotiates, it must forward the documents to the confirming bank or issuing bank” (Art 15 of the UCP 600).

#### ***Discrepant presentation***

If a nominated bank acting on its nomination, a confirming bank or the issuing bank determines that a presentation does not comply with the credit, it may refuse to honour or negotiate. Again, when an issuing bank determines that a presentation does not comply, it may in its sole judgment approach the applicant for a waiver of the discrepancies. This option gives the purchaser an opportunity to waive discrepancies, thus promoting efficiency in a field where as many as half of the demands for payment under letters of credit are discrepant (Dole, 2006).

The second option for the bank in case of a discrepant presentation is to refuse to honour or negotiate. This would also be the course of action in case the applicant would communicate a refusal to waive the discrepancies, or if the issuer would decide not to waive even if the applicant would. Article 16(c) of the UCP 600 sets out the requirements regarding the contents of the rejection notice. Firstly, the notice must state that the bank is refusing to honour or negotiate. Secondly, it must specify each of the discrepancies in respect of which the bank has made the decision to reject. The bank must list literally “all” discrepancies, failing which it will not have a second chance to supplement or amend the relevant notice. The bank which does not state all the discrepancies upon which it subsequently seeks to rely, has failed to act in accordance with the Article 16(c) (ii) of the UCP 600 and is therefore precluded from later raising those extra discrepancies as grounds for rejection. Courts over the year in International Trade Practice have treated the rejection procedure prescribed by the UCP rules with the same degree of rigidity as the strict documentary compliance doctrine (Ellinger, 2006). Notices which do not manifest a clear intention to reject have been treated as faulty.

### **DIFFERENT INTERPRETATIONS OF THE PRINCIPLE OF STRICT COMPLIANCE**

The court’s ability to interpret the principle of strict compliance is fundamentally important to international trade practice. Again how a court determines which discrepancies between the documents produced and the letter of credit constitute grounds for a bank to reject the documents and refuse payment is important regarding the letter of credit law.

#### **Typing errors and misspellings**

The UCP rules, by themselves, do not regulate misspellings or typing errors in the presented documents. For the first time this issue was addressed in 2003 only when the ICC Banking Commission published the ISBP for the examination of documents under documentary credits. The respective paragraph 25 of the 2007 revision of the ISBP provides that: “a misspelling or typing error that does not affect the meaning of a word or the sentence in which it occurs does not make a document discrepant. For example, a description of the merchandise as “mashine” instead of “machine”, “fountan pen” instead of “fountain pen” or “modle” instead of “model” would not make the document discrepant. However, a description as “model 123” instead of “model 321” would not be regarded as a typing error and would constitute a discrepancy”. Till the publication of the ISBP it was left completely in the discretion of courts to decide which misspelling or typing error constituted a discrepancy and which did not. Over time, courts have developed their own standards how to decide which discrepancy renders the presented documents non-compliant and

which does not. Unfortunately, these have been different standards which have often brought different court rulings, if applied to similar typing mistakes. However, these have also been different standards which have brought similar case outcomes. Therefore, it is necessary to find out whether it could be only one optimal standard to avoid these inconsistencies, and what would it be (Kraáovska, 2008).

### **Deviations in the description of goods in commercial invoices**

The description of goods in commercial invoices is regulated by Article 18(c) of the UCP 600 which states that “the description of goods, services or performance in a commercial invoice must correspond with that appearing in the credit”. The ISBP adds that in a commercial invoice “there is no need for a mirror image. For example, details of the goods may be stated in a number of areas within the invoice which, when collated together, represent a description of the goods corresponding to that in the credit”.

### **Discrepant dates**

Incorrect data in presented documents is one of the most frequent discrepancies leading to rejection of letters of credit (SITPRO, Report on the Use of Export Letters of Credit 2001/2002). Besides the misspellings already analyzed previously in this paper, it can be any information on the set of documents which is not in conformity with the letter of credit, i.e., discrepant dates. Article 14(d) of the UCP 600 in this matter says that “data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit”.

## **UCP 600 AND THE PRINCIPLE OF STRICT COMPLIANCE**

### **Different standards of compliance with the credit**

#### ***Strict compliance***

The doctrine of strict compliance was first established in 1927 by English courts with the well-known words of Lord Sumner in *Equitable Trust Company of New York v Dawson Partners Ltd* as; “*There is no room for documents which are almost the same, or which will do just as well... if the bank does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk*”. Lord Sumner's argument was based on the fact that “the banks know nothing regarding the underlying transaction they financed thus they cannot

distinguish between which document will do well enough and which will not. He also emphasized that if banks were to be concerned with the underlying transaction as well, it would be unlikely for business practice to proceed” (Bal, 2010). Again, in a case named *Moralice (London) Ltd v E D & F Man [1954] 2 Lloyd’s Rep 526* it is found that “the contract was for the sale of 5000 bags but the bill of lading tendered to the bank indicated that only 4997 bags had been shipped. The bank was held to be entitled to reject the documents. The *de minimus* rule is not applicable to documentary credits”. In that case it was also established by the Justice Mc Nair that the documents must be such which will strictly comply with the terms of the letter of credit. According to the above cases the reasons for establishing the doctrine of strict compliance in order to fulfill a payment by Letter of Credit are:

First, the rule of strict compliance itself establishes the law of agency between the banker and the buyer. The Advising Bank is a special agent of the Issuing Bank and the latter is the special agent of the buyer. Thus, “if an agent with limited authority acts outside that authority (i.e. his mandate) the principal is entitled to disown the act of the agent, who cannot recover from him and has to bear commercial risk of the transaction.”

“The second reason for the rule of strict compliance lies in the bank’s position in relation to the sale contract. The bank is not a dealer in goods; it cannot be expected to know why the buyer has stipulated for a particular item and what importance he might attach to that item” (Hamid, 2015).

#### ***Common-sense approach***

Again, In *Voest-Alpine International Corporation v. Chase Manhattan Bank, N.A. (New York, USA, 1982)* the beneficiary brought an action to recover amounts allegedly due under two letters of credit issued by Bank of Baroda and confirmed by the defendant Chase Manhattan Bank, N.A. (“Chase”). The letters of credit as issued and amended required that the drafts submitted by the beneficiary be accompanied by (i) on-board bills of lading evidencing current shipment dated no later than January 31, 1981; (ii) certificates of inspection indicating the date of the shipment; and (iii) weight certificates issued by an independent inspector. The presented bills of lading were dated January 31, 1981 and stated that the goods were on board the ship on that date. However, the weight certificates and certificates of inspection stated that the goods had been loaded aboard the vessel between February 2 and February 6, 1981, which was why the bank denied payment. The court resolved the case based on Article 7 of the UCP 290 (1974 Revision), the predecessor of Article 14(d) of the UCP 600, which provided in part that documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit.

Accordingly, the court held that regardless of when the goods were in fact loaded aboard the motor vessel, there can be no doubt that the documents required for presentation were inconsistent on their face and, therefore, Chase was entitled to conclude that the presented documents did not conform to the letters of credit and to deny payment. In the light of the rephrased Article 14(d) of the UCP 600 which now requires data in the document “not conflict” (instead of “to be consistent”) with other presented documents and the credit, the case would probably be decided the same way in nowadays.

Doctrine of ‘strict compliance’ under the general contexts of UCP 600  
It is important to understand how UCP 600 rules made simpler and clearer wording in order to reduce the ambiguity and differences in interpretation of LC. “UCP was first introduced to remove the different applications by individual countries and to avoid endorsing national rules on letter of credit practice. The first set of rules was published in 1933 which has been updated throughout the years, UCP 600 being the most up to date version. It should be noted that the previous version, which is UCP 500 is still often encountered in practice as it is the parties' choice to choose which set of rules governs the credit transaction” (Bal, 2010). The very basis of the doctrine clearly states that the banks deal in finance and not in goods (UCP 600, article 5). “According to this doctrine, every single party under a letter of credit transaction is required to tender strictly complying documents in order to be entitled to receive payment. The underlying ground for this doctrine is that the letter of credit is established on an agent collaborated transaction, thus the principal should be entitled to disown the act of its agent” (Bal, 2010). In order to sustain the credit transaction, banks are only required to check the compliance of the documents with the credit terms.

Thus it remains as a tentative ground for a bank when it comes to the question that which document should be accepted and which one should be disregarded. Even UCP 600 did not provide any clear idea on that ground which leads those different courts from different jurisdiction may interpret the doctrine accordingly in relation to facts of the cases. A crucial question arises to all the parties involved with regard to the term ‘strict compliance’ that how strictly the documents must conform to the LC terms. According to UCP 600 “a complying presentation means a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and the international standard banking practice”(article 2, UCP600).

### **UCP 600: softening the principle of strict compliance**

It is important for us to examine how the term ‘strict compliance’ has implemented in case of LC. Surprisingly, the word “strict” is not UCP expression; however, it is the result of judicial interpretation of the UCP

rule of compliance. Again, analyzing the Italian court decisions one scholar concludes that the courts in Italy follow the principle of “substantial compliance” in place of “strict compliance” (Hamid, 2015). The scholar also thinks that the trend established by the Italian courts is in compliance with the current banking practice as reflected in the UCP.

The expressions in Article 14 imply the substantial compliance as the main principle and supplemented the application of ‘strict compliance’ in the case of commercial invoice. Thus, when we interpret article 14 which says “Data in a document need not be identical but must not conflict with”, we can find out that UCP has certainly softens the doctrine of ‘strict compliance’. Again, article 18(c) UCP says “the description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit”, but talking of the invoice amount it says in article 18 (b) that ‘bank may accept a commercial invoice issued for an amount in excess of the amount permitted by the credit, and its decision will be binding upon all the parties, provided the bank in question has not honored or negotiated for an amount in excess of that permitted by the credit’.

“The article 18(c) speaks of strict compliance in matters of goods description and substantial compliance with the documentary amount description but strict compliance with the amount to be honored or negotiated. This means the rule of strict compliance is now restricted to the specified documents and not extended to all the required documents as used to be. The restriction implies that the strict compliance doctrine stands softened by the new UCP” (Mehta, 2007).

## CONCLUSION

UCP 600 encourages fair, equitable and transparent trade so far ‘compliance’ is concerned. However, ‘UCP 600 limits the depth of examination of documents by banks and provides leniency in resolving issues on discrepant documents where the trading parties, namely the buyer and the seller, equally have some binding say on how the discrepant documents should be dealt with’ (Hashim, 2013). UCP 600 widens the scope of compliance where data in any document may differ expressly with one another but should not contradict each other. Thus, UCP 600 softens or restrains the doctrine of strict compliance and at the same time it also encourages an equitable and transparent international trade.

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