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The strict-compliance rule: documentary compliance in a recession

by John F. Dolan

The global recession may prompt issuers and their applicants to question the compliance of a seller's presentation, and documentary compliance, which has not been a problem in recent years, may become more of a problem now. Falling markets sometimes prompt buyers and their banks to look carefully for documentary excuses to dishonor the seller's draft or demand for payment. Thus, a few thoughts on the documentary compliance rules, especially as they apply in common law countries, may be in order. Some recent cases are not encouraging to those who see the letter of credit as a payment mechanism.

Prior to UCP 500, common law courts generally applied a strict rule to documentary compliance issues. The UK courts, followed by US and Commonwealth courts held, in line with the much-quoted UK judgment by Viscount Sumner in 1926, that "[t]here is no room for documents which are almost the same, or which will do just as well." A former US Supreme Court Justice writing for a circuit court of appeals observed that documentary compliance "is not like pitching horseshoes. No points are awarded for being close." Any notion of "reasonableness" in the document examination setting, these courts held, would corrode the predictability and certainty that the letter of credit - a quick, low-cost, bank product - demands.

Effect of falling markets

The strict rule survives in common law countries and perhaps in civil law countries, but bankers have been rightly concerned that in a falling market, buyers or their bankers might be tempted to invoke the strict rule in bad faith in order to avoid market loss. For years, moreover, we have seen studies reporting that the percentage of compliant presentations was low, but that applicants waived the defects and bank issuers paid the sellers anyway.

In 2000, Professor Ronald Mann reported the results of his study into documentary compliance and to the response of bank issuers and applicants to non-complying presentations. His investigation involved the record of documentary compliance at only five selected US and foreign banks located in the US. The study is impressive, nonetheless. It indicated that documentary compliance was woefully low (as low as 27 per cent), but that applicants were waiving discrepancies at a high rate (well over 90 per cent). Professor Mann conducted that study, however, in healthy economic times, and he was careful not to claim, as some who did not read his article carefully have claimed, that banks as a rule do not insist on documentary compliance. Importantly, Professor Mann did not conclude that applicants would waive defects in recessionary markets.

There are three ways to read the study: (1) that sellers are feckless when they prepare their documents; (2) that applicants don't care much if documents are non-compliant; and (3) that when business is booming, sellers and bank issuers know that buyers, who want the goods or services, will waive discrepancies. Only the third reading makes much sense, and when markets fall and buyers are disinclined to take goods or services they have ordered, the happy practice of waiving discrepancies may not obtain.

In short, sellers should now spend the time they chose not to spend in the past making sure that their documents are compliant.

The UCP's role

The UCP's primary purpose is to indicate to the world's banks and sellers what documents banks will and will not accept as compliant. The ICC addresses the issue in UCP 500 and UCP 600 by mandating that a presentation that satisfies the terms of the credit, the UCP and "international standard banking practice" is a complying presentation. The UCP rule provides guidance for documentary compliance officers, for the ICC Banking Commission when it resolves disputes, for DOCDEX and similar bodies composed of experienced international bankers and for sellers. The barebones of the UCP standard find considerable fleshing out in the International Standard Banking Practice (ISBP) handbooks ICC has published to accompany UCP 500 and UCP 600.

But the UCP standard, even with the handbooks, is unhelpful in many common law jurisdictions, where judges with little experience with trade issues decide whether a presentation is complying. Significantly, the drafters of Article 5 of the Uniform Commercial Code guarded against the risk that jurors who know nothing about international trade or banking would be deciding documentary compliance issues. Article 5 stipulates that such questions are for the court and not the jury to decide. Yet problems remain, for many common law judges are not drawn from commercial practice and remain woefully inexperienced in matters of international trade.

Disappointing record

Regrettably, both in the US and in other common law jurisdictions more than a few courts have failed to apply international standard banking practice or have failed to apply any standards other then their own "feelings".

Recently, a court sitting in Toronto decided a dispute on the basis of such feelings without regard for the UCP standard. A Thai seller agreed to supply a Canadian importer with significant amounts of shrimp against letters of credit that called for documents completely beyond the control of the seller to obtain. The documents were purchase orders to be issued by the importer's customer and, in the event, the customer did not issue the purchase orders, and the seller could not satisfy that documentary requirement of the credit. The cables establishing the credits indicated that they were "subject to

U.C.P. 1993 revision ICC Publication No. 500" and that they "engage us [the bank issuer] in accordance with the terms thereof". Nonetheless, ignoring documentary compliance rules and ignoring the preclusion rule of UCP 500, article 16, the court held "[o]n my view, the words used do not justify the utilization of these provisions this would mandate", i.e., that the UCP did not apply. One's shock at the egregious nature of the court's mistakes is amplified in light of the fact that counsel for the beneficiary and the bank had argued that the UCP *did* apply.

In a second illustrative case, this one from New York, the court declined to follow the view of a banking expert that a bill of lading was defective. Instead, the court substituted its own judgement on the validity of the bill. Beneficiary's counsel did not marshal expert testimony, but even in the absence of any contrary opinion, the court rejected the expert's testimony, deciding that the court was more knowledgeable on international standard banking practice than the bank's expert.

In a third case, a US court sitting in Kentucky held compliant an undated certificate submitted under a letter of credit that called for a dated certificate. The court ruled that under ISP98 the certificate was compliant because there were dates on the bills of lading that accompanied it. Significantly, the drafters and sponsors of ISP98 adopted a rule similar to the UCP international standard banking practice that documents must comply with the specific rules of ISP98 and otherwise comply with "standard standby practice". Yet the US court in Kentucky adopted its own view of what standard standby practice is and rejected the ISP98 rule that documents must be dated if the credit so provides. The court also ruled that a description of the goods in bills of lading that bore little resemblance to that in the credit was cured by the description of the goods in accompanying invoices.

In another Canadian case, a court sitting in Toronto held that an invoice description of the goods that varied the letter of credit description by omitting a heading was, in the court's "view", compliant. The court did not refer to international standard banking practice and, by all indications, had no evidence of what the application of that practice would yield on the compliance issue.

These cases are illustrative. The body of case law in common law jurisdictions is huge, and many courts respect the UCP, but the number of cases ignoring the UCP command that courts look to international standard banking practice is a major problem that might become more of a problem if issuers and their buyer/customers start combing through the documents carefully in these days of falling prices.

Suggested responses

There are three courses that sellers and their lenders might choose to avoid this unsettling tendency of common law courts to substitute their judgement for international standard banking practice.

First, sellers might insist that their buyers agree that letter of credit disputes will be resolved by binding arbitration before a panel of arbitrators consisting of bankers experienced in international trade.

Second, lawyers litigating documentary compliance issues before a common law court should be prepared to offer expert testimony on the questions of documentary compliance and international standard banking practice, and they should insist that any such testimony is by bankers, not lawyers or law professors. Lawyers may know much about letter of credit law, but they are not expert on documentary compliance questions, and courts should not allow documentary compliance testimony from persons who have not earned their living in international banking.

Third, and least attractive, sellers and their banks might insist that the letter of credit be subject to the UCP except for any reference to "international standard banking practice". By virtue of that exception, the documentary compliance questions would be decided first by the terms of the credit, second by the express terms of the UCP and third by the strict compliance rule that most common law courts have followed.

Conclusion

Disputes between beneficiaries and letter of credit issuers do not surface until many months, if not years, pass after the day on which the beneficiary presents its documents and the issuer rejects them. The litigation that will surface in court reports over the next couple of years may prove more faithful to international standard banking practice if bankers, not lawyers and judges, apply this practice to documentary compliance disputes.

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