



Intricacies of Documentary Credits – A situational Analysis

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Abstract: This paper is an attempt to explore intricacies in Documentary Credit operations through situational analysis. The paper presents a situation of plausible non settlement under Documentary Credit Method and further analyses the situation with an aim to explore viable solution to the conflicting stands taken by parties to the Letter of Credit. The paper concludes with specific recommendations towards an amicable solution to the research problem.

Key words: Documentary Credit, U.C.P.D.C. 600, Cross Border Trade Transactions, Discrepant Documents, Contract v/s Credits, Letter of Credit.

Background of the study:

With the advent of globalization the world trade has witnessed phenomenal growth, particularly in the first decade of 21st century. The increase in the volume of world trade is certainly not without trade settlement related issues that are somewhat complex in nature as compared to Domestic trade, resulting into delay in the process of trade settlement. The complexities are attributed to various factors that really differentiate cross border trade from domestic trade. These factors are of financial and Non-financial in nature, such as Economic Environment, Socio Political and Legal Environment, Currency of invoicing and Distance etc.[3]

In order to know the complexities involved which possibly lead to disputes and further delay in settlement the researcher undertook a survey of cross border traders. The survey results brought to light various issues faced by the parties involved in cross border trade.

The research paper focuses upon analyzing one of such issues involved where reference to the original contract signed by the party is made in commercial documents. The dispute relates to whether such reference to original sale contract becomes a part of the LC and therefore banker is bound by same or original contract is independent of the LC contract.

In order to analyze and effectively deal with such problems the researcher has presented a case describing a typical situation (issue under consideration) commonly encountered by the

parties leading to conflicting situation in the stand taken by the Importer and opening bank.

The organization of the research paper is as under:

- I. Documentary Credit as Trade Settlement Method
- II. Description of the Case/situation
- III. Identification of the of Problem
- IV. Analysis of the Case/Situational Analysis
- V. Inferences
- VI. Conclusions
- VII. Limitations

I. Documentary Credit as Trade Settlement Method:

When the exporter and importer enters in to the cross border trade contract, the nature of contract is about the flow of goods from exporter to importer and corresponding flow of foreign currency (money) from the importer to the exporter .It is only when these two flows are complete ,we say that there is a settlement of the cross border trade transaction .Towards settlement the methods available are, Open Account ,Advanced payment, Documentary Credit Documentary collection, Consignment and International Trade Guarantees.

In Open account Method the exporter allows the buyer to effect the payment at any later date but delivers goods immediately, here exporter faces the uncertainty about the payment.

On the other hand in advance payment method the exporter insists upon full payment in advance and only then delivers goods, here the importer faces the uncertainty about the performance.

In between above two methods of Open Account and Advance Payment lies most popular method known as Letter of Credit where it is the Banker who plays the role of intermediary and assures Payment and Performance to Exporter and Importer respectively.

The contents of the definition as per clause 2, of U.C.P.D.C. highlights on following aspects about meaning of Documentary Credit:

- Documentary Credit is an arrangement



- Opening Banker ensures compliance to the original terms and conditions of credit
- If compliance is observed opening banker is committed to pay for or negotiate to the beneficiary
- Authorizes another bank to effect the payment or negotiation.

All above in simple terms means “**Banks conditional undertaking to make payment**”

Unlike documentary credits, in case of Documentary collection there is no commitment whatsoever and banker plays the role of agent. In case of consignment trading the goods are handed over to the agent on the basis of trust receipt and this method more like trading on open account only.

It needs to be pointed out that irrespective of the trade method chosen are opted ultimately “trust relation tells the trade method” and even though compliance to the credit terms is seen the breach of the trust costs heavily to the parties.

The situation described below points out precisely above aspect of trust relation.

II. Description of the Case/situation:

The case presented below are of cross border trade deal in which Letter of Credit Method is used as a mutually agreed settlement method. The period considered is post globalization era. The background information is as under:

Type of Credit: Irrevocable Credit

Application: U.C.P.D.C. 600

Issuing Bank: Bank of Bharat

Availability: At sight with Issuing Bank

Applicant: Sudarshan Engineers Ltd. Pune-India

Beneficiary: Mac Milan Co. New York-USA

Situation: An applicant Sudarshan Engineers Ltd. approached his banker in India, and requested to open letter of credit in favour of Mac Milan Co. NY for import of spares with following description:- “**SPARE FOR ENGINES AS PER CONTRACT NO. 111**”

The documents were presented finally to the issuing bank for payment. The issuing bank honored the draft and paid by debiting applicant’s account and subsequently released documents. The applicant objected to the debit of his account stating that documents released do not include certificate from inspecting agency NY about having inspected quality of goods.

The applicant further argued that production of such certificate was as per one of the terms of contract number 111 and description of goods clearly states “**SPARE FOR ENGINES AS PER CONTRACT NO. 111**”

The Bank of Bharat should checked fulfillment of various condition of the contract on which basis letter of credit was opened. This is a clear case of negligence on the part of Bank of Bharat while extending credit to the beneficiary. The Sudarshan Engineers demanded immediate re-credit to the account.

Bank of Bharat flatly refused to exceed to the request of the crediting account stating that terms and condition of the credit are strictly complied with.

III. Identification of the of Problem

The above situation clearly identifies the problem of research as stated below:

The problem pertains to following aspects:

1. The delay and probable non settlement of the cross border trade transaction
2. The breach of “contract” or “credit” or “both” resulting into delay/non settlement.
3. The Conflicting issues pertaining to the stand taken by the Importer and the Opening Banker in determination of the compliance of credit terms.

IV. Analysis of the Case/Situational Analysis

The analysis of the case is against the backdrop of Article 4, UCP- 600, and 2007 Revision. The analysis of the clause clearly gives protection to the Opening Banker under such situations and depicts dichotomy between “contracts” and “Credits”.

The claim of the importer objecting to the debit of account on the grounds that documents are discrepant in nature due to non-inclusion of Inspection Certificate as demanded in the original contract and also clearly mentioned in the Description of goods as “Spares by Engine as per Contract 111” is untenable against the meaning and interpretation of UCP Clause 4: Credit v/s Contract.

The analysis further reveals important fact that when the original contract was entered, the opening bank was not a party to that contract the banker came into the picture only when importer as an opener approaches the banker to open Letter of Credit thus both contracts are separate as follows.

1. Original Trade Contract between Sudarshan Engineers and MacMilan



2. Letter of Credit Contract between Bank of Bharat and Sudarshan Engineers

The action of Issuing Bank viz., Bank of Bharat is fully justified in spite of the breach of contract as stated by the applicant. It is because, the wording of Clause No.4 of U.C.P.D.C.-600-2007 revision edition are very clear in this respect.

The clause contents connotes “credits by their nature are separate transactions from the cells or other contracts on which they may be based or bound by such contracts, even if any reference what so ever to such contract is included in the credit.

Bank of Bharat has nothing to do with one of the conditions of contract about the certificate of inspection so long as it is not demanded as one of the documents under the letter of credit.

Had the letter of credit condition been such that document should include the certificate from “XYZ Co. of NY” of having inspected the quality of goods, then, Sudarshan Industries claim to re-credit their account on the basis of non-compliance of LC Terms would have been entertained.

It is pointed out that the credit terms are separate from original contract terms as clearly stipulated in the Clause 4, itself. Hence issuing Bank is in no way concerned to verify fulfillment of contract terms. Therefore, in spite of breach of contract, Bank of Bharat action is fully justified.

V. Inference:

- a) The conflicting situation emerged due to the reference made to the contractual terms in the description of goods in the document
- b) The Banker’s action is justified in spite of the breach of the contract
- c) There is violation of “contract terms” but not that of “credit terms”. The violation of credit terms would also have been there had credit specifically asked for inspection/quality certificate.

VI. Conclusions:

The following conclusions are drawn on the basis of situational analysis carried out earlier with an aim to expedite the trade settlement process.

- a) The importer should incorporate clause to the effect that “Inspection/Quality Certificate is required” in the original terms at the time of Opening Letter of Credit as incorporation of such clause would help and avoid importer into landing in such conflicting situations and thus expedite the trade settlement.
- b) The course of action suggested is that the Importer viz., Sudarshan Engineers may initiate

legal action against beneficiary directly for the breach of contract without involving issuing bank anywhere as ultimately it is the trust relation that tells the trade method.

VII. Limitations:

- The case presented and analyzed is, though based on factual information gathered through survey however in order to maintain confidentiality parties names are substituted by hypothetical identities.
- The reproduction of the relevant clauses of U.C.P.D.C. requires permission and therefore interpretation of the clauses is done without reproduction.

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