Perspectives — Selected Articles

A Question from 2007, Found in a Footnote

The risk I identified under UCP 600 Article 12(b)—and the safeguard I put into practice.

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While examining the online visibility of my earlier professional writing, I came across an unexpected reference to an article I had written nearly twenty years ago.

It appeared in footnote 288 of a 2008 legal study by Professor Richard F. Dole, Jr., published in *The Wayne Law Review*. The study examined the relationship between UCP 600 and Article 5 of the American Uniform Commercial Code, particularly the protection of banks against letter-of-credit fraud.

The publication has an established academic setting. Founded in 1954, *The Wayne Law Review* is the principal scholarly law journal of Wayne State University Law School, part of a public research university in Detroit, Michigan. Professor Dole was a commercial-law scholar at the University of Houston Law Center.

The footnote referred to my article, *A Reaction from the Middle East*, published in *DC Insight* in early 2007, before UCP 600 came into effect.

What interested me was not simply finding the reference. It was the particular concern for which the article had been cited—and the way that concern had shaped my own approach to documentary credit operations.

The question behind Article 12(b)

Article 12(b) addressed an important difficulty arising from earlier litigation, notably *Banco Santander v. Bayfern*.

Under UCP 600, an issuing bank that nominates another bank to accept a draft or incur a deferred payment undertaking authorizes that nominated bank to prepay or purchase the acceptance or undertaking it has itself incurred.

The provision serves a legitimate financing purpose. A bank that has undertaken to pay at maturity may provide the beneficiary with funds earlier, with an express authorization under the rules for doing so.

But that clarification raised another question for me.

Suppose the nominated bank has already paid the beneficiary, acting in good faith and without notice of fraud. Before maturity, the applicant discovers that the beneficiary has acted fraudulently.

The nominated bank may be entitled to reimbursement from the issuing bank under the applicable rules and law. But what does that leave the issuing bank entitled to recover from its applicant—and how effectively can that entitlement be enforced?

The issuing bank's undertaking to reimburse a nominated bank and the applicant's obligation to reimburse the issuing bank are not the same legal relationship.

Article 7(c) establishes the issuing bank's reimbursement undertaking, subject to its conditions. Under acceptance or deferred payment credits, reimbursement is due at maturity even where the nominated bank has prepaid or purchased earlier. Article 8(c) contains the corresponding undertaking of a confirming bank to another nominated bank.

These provisions clarify the interbank position. They do not, by themselves, resolve every commercial, contractual or recovery risk arising in the issuing bank's relationship with its applicant.

That distinction was central to the concern I addressed in 2007.

From a written concern to an operational safeguard

I did not regard the issue as a reason to oppose early financing. Nor did I believe that an issuing bank could protect its position merely by adopting an internal policy restricting what UCP 600 otherwise authorized.

Article 12(b) confers the relevant authority through the nomination itself. Where UCP 600 governs the credit, that authority cannot be restricted merely by an issuing bank's undisclosed internal procedures.

Any intended qualification must therefore be properly expressed in the credit, consistently with the rules governing its incorporation, modification and exclusion.

In banks where I was responsible for documentary credit operations, I adopted an approach built around that distinction.

We inserted an express condition in the documentary credits we issued requiring the nominated bank to obtain the issuing bank's prior authorization before prepaying or purchasing its accepted draft or deferred payment undertaking, notwithstanding the authority otherwise arising under Article 12(b).

The restriction was therefore stated in the credit itself, rather than left as an internal instruction that the nominated bank could not be expected to observe.

When the nominated bank requested authorization, we first referred the proposed early financing to the applicant.

We obtained the applicant's specific authorization before deciding whether to permit the nominated bank to proceed.

Depending on the circumstances, the applicant confirmed its acceptance of the goods where such acceptance had actually occurred, or expressly acknowledged the commercial risks associated with the proposed early payment and agreed not to raise subsequent claims against the issuing bank and its correspondent banks arising from agreed categories of problems with the goods, their specifications or subsequently discovered beneficiary fraud.

An acknowledgment of actual acceptance and an agreement to assume specified risks were not treated as interchangeable statements.

The distinction mattered because the issuing bank was being asked to permit a financing step that brought forward the beneficiary's receipt of funds, while the bank's reimbursement exposure and the applicant's underlying commercial concerns might continue beyond that date.

The reasoning behind the arrangement was straightforward.

It was the applicant that had selected the beneficiary and established the underlying commercial relationship. It was also the applicant that had requested the issuance of the credit and was in a position to undertake the necessary commercial due diligence regarding the beneficiary and the transaction.

If the applicant wished to permit the beneficiary to receive funds before the originally contemplated payment date, I considered it appropriate that the applicant expressly authorize that decision and acknowledge the corresponding risks before the issuing bank gave its permission.

The objective was not to transfer every conceivable consequence of fraud to the applicant, or to relieve banks of their independent legal obligations.

An applicant's undertaking cannot automatically override mandatory law, eliminate rights arising from a bank's own improper conduct or determine the treatment of every form of fraud.

Its effectiveness depends on its wording, the relevant facts and the governing law.

But the arrangement did something important: it required the issuing bank and its applicant to address the consequences of early financing before the nominated bank acted on the authorization.

The decision was no longer made without an express consideration of the applicant's position and the protections on which the issuing bank intended to rely.

What I proposed in 2007

In *A Reaction from the Middle East*, I examined the issuing bank's exposure arising from early payment or purchase.

The possible approaches discussed included expressly excluding Articles 7(c), 8(c) and 12(b), together with requiring prior authorization for discounting, or addressing the applicant's reimbursement obligation directly in the agreement between the applicant and the issuing bank.

These approaches addressed the same underlying question: how should the issuing bank manage the consequences of a financing decision that may protect the nominated bank against a risk subsequently arising from beneficiary fraud?

The procedure I implemented was a practical expression of that concern.

It did not require treating early financing as undesirable. It required deciding whether to authorize it after the issuing bank had considered its position and obtained the applicant's informed instruction.

Nor did it necessarily require the exclusion of every provision mentioned in the original discussion.

The exact drafting and allocation of risk had to be appropriate to the transaction, the nominated bank's rights, the applicant's undertaking and the applicable law.

The principle, however, remained consistent: the authority to finance and the allocation of its consequences should be examined before the funds are advanced.

Where the American legal study enters

Professor Dole's 2008 study approached the subject through the American legal framework.

He examined how UCP 600 interacts with Article 5 of the Uniform Commercial Code, particularly the conditions under which banks that have given value may be protected against remedies arising from material letter-of-credit fraud.

In considering Article 12(b), he discussed the protection potentially available to a nominated bank that had prepaid or purchased its own acceptance or deferred payment undertaking in good faith and without notice of material fraud.

He also addressed the issuing bank's position and the importance of clearly drafted applicant reimbursement agreements.

Footnote 288 cites my 2007 article specifically in connection with the issuing bank's identified risks and the possible responses involving prior authorization, exclusions and the applicant's reimbursement agreement.

The reference does not mean that every proposal in my article became the conclusion of his study.

Its significance is more precise.

A concern I had identified from banking practice before UCP 600 took effect became relevant to a scholarly legal analysis of the consequences of the revised rules the following year.

And it was a concern that I had also sought to address through the documentary credit arrangements for which I was professionally responsible.

The study provides a further reminder that the position cannot be resolved by one formula under every legal system.

For example, Article 5 of the American Uniform Commercial Code recognizes an issuing bank's statutory entitlement to reimbursement from the applicant when it has honoured as permitted or required by the applicable provisions. Section 5-109 separately addresses material fraud and the protection of specified parties acting in good faith.

Those statutory rights must be recognized where the relevant enacted law applies.

But an enforceable entitlement to reimbursement, the contractual terms governing the applicant's responsibility and the practical ability to recover the amount remain distinct matters.

The judgment that remains

Article 12(b) serves a valuable financing function. The arrangements I adopted were not intended to diminish that function, but to permit its use with a clearer understanding of the issuing bank's position.

I have never regarded a rule's authorization as sufficient, by itself, to resolve every question arising when that authorization is exercised.

Before permitting early payment or purchase, I wanted the issuing bank to understand what its applicant had authorized, what the applicant had accepted or agreed to bear, and which legal and contractual protections would support the bank if the underlying transaction subsequently became disputed.

There was also an essential distinction between a bank's internal risk policy and the terms governing the nominated bank's authority.

Where Article 12(b) applies without modification or exclusion, the issuing bank cannot rely on an undisclosed internal policy to impose a prior-authorization requirement on the nominated bank.

That was precisely why the requirement was expressly incorporated into the credits we issued.

The issuing bank's decision whether to authorize the proposed early financing was then informed by a separate, specific authorization from the applicant.

These were two different permissions serving different purposes: one governing the nominated bank's ability to proceed under the credit as modified, and the other establishing the applicant's informed instruction to the issuing bank.

The credit terms, the issuing bank's authorization and the applicant's undertaking had to operate as a coherent arrangement.

Nearly twenty years after writing the original article, I continue to regard that distinction as fundamental.

A rule may establish what a bank is authorized to do. Professional judgment must also determine what follows when that authority is exercised, whose obligations are engaged and where the remaining exposure lies.

A footnote may preserve a question raised in practice. The more consequential record is often found in the terms through which that question was addressed before the money moved.

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