Principle of Autonomy in Letter of Credit: Malaysian Practice

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Abstract

The term letter of credit (LC) is not uncommon in international trade as it is the most frequent method of payment used by seller and buyer in their sales contract. LC serves its significant role by facilitating payment between buyer and seller from different countries, who are always prejudiced towards each other on the issue of payment, especially when the deal involves a huge amount of money. By using LC, the seller and buyer will be represented by their own bankers whose function is to issue an LC for the buyer and pay on presentation of seller's documents which are strictly compliant to LC requirement. It is well-known that LC is governed by the principle of autonomy or also referred to as the principle of independence[4] which indicates LC, being a contract of payment is totally separated from the underlying sales contract. The bank concerns with documents only and does not concern with the goods. LC transaction is governed by the Uniform Custom and Practice for Documentary Credit, known as the UCP which provides the rules relating to LC matters and is adopted in almost all LC transactions. This paper discusses the nature and background and significance of principle of autonomy in LC transaction. Furthermore, it elaborates the provisions of principle of autonomy in the UCP 600. To certain extent, comparisons between relevant articles in the UCP 500 and 600 are highlighted. Next, discussion focuses on relevant case-law where the principle of autonomy was upheld in LC transaction. Furthermore, it discusses the principle of autonomy as practiced by Malaysian bankers, in comparison between the applications of this principle in conventional and Islamic LC in Malaysia. The finding found that Malaysian bankers are fully subscribed to the principle of autonomy as outlined by the UCP 600.

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[4] The phrase "independence principle" instead of "autonomy principle" has been used by these following articles: D'Ascenzo, R, "The Supreme Court of Ohio's Decision in *Mid-America Tire, INC.* v *PTZ Trading Ltd.*, and The Weakening of the Independence Principle," (2004) Cap. U.L. Rev. 1097, LexisNexis, retrieved 30 July, 2007; Mann, R. J, *The Role of Letters of Credit in Payment Transactions*, (2000) University of Michigan, US <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214633> viewed on 29 April, 2001), 401-438; Dolan, J. F. "Tethering the Fraud Inquiry in Letters of Credit Law," (2006) 21 B.F.L.R. 479-503, Westlaw database, retrieved 2 July, 2007; the terms autonomy, separability and independence will be used interchangeably in this thesis.

INTRODUCTION

Letter of credit (LC) refers to "a letter that is written by a bank, at the request of a buyer of merchandise, directed to the seller, as a means of assuring the seller that he will be paid."[5] According to the latest Uniform Custom and Practice for Documentary Credit, known as UCP 600, LC has been defined as,

> "Any arrangement however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation."[6]

It is one of the payment mechanisms in international trade. It is widely used, particularly in trade transactions where the seller and the buyer do not reside in the same country.[7] A great distance in location between both parties always invites worry as it is very difficult to trust each other. Dealing with someone who is not known, or not seen in person is very dangerous, especially when the sales involve a huge amount of money and expensive goods. Both parties in this situation will be reluctant to give any commitment unless they are assured that their positions will be protected. A seller will not be willing to part with his goods unless he has been guaranteed payment. Likewise, the buyer will also not be so generous as to advance payment on the goods unless he feels secured that he will receive the goods according to his orders. In this case, LC serves as an important tool to overcome the problems of trustworthiness between buyer and seller. The role and function of LC is to provide efficient payment by using the bank as a reliable paymaster to advance payment. The seller will be automatically paid once he has presented to the bank documents which strictly comply with the credit requirements. Such payment by the bank is governed by the principle of autonomy. Thus, this paper looks into the nature, background and significance of principle of autonomy. Furthermore, it focuses on the discussion of the relevant provisions of UCP and decided cases on such principle of autonomy. Finally, it discusses the application of principle of autonomy as practised in Malaysia amongst the bankers.

PRINCIPLE OF AUTONOMY – NATURE AND BACKGROUND

Autonomy means self-governing that is originated from a Greek word, *autonomia* which means 'independent.'[8] In the LC context, it denotes that LC is separate or independent from the underlying sale contract.[9] The essence of LC contract discharges the bank from implicating itself

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[5] Harfield, Henry, "Secondary Uses of Commercial Credits," Columbia Law Review, vol. 44, No. 6 (November, 1944), 899-913, at 899.

[6] Article 2, UCP 600.

[7] See, Appendix 1, Breakdown by Percentage: International Trade Product, at *i*; Appendix 2: LC Usage By Region, at *ii*.

[8] John Collier, *What is Autonomy,* (1999) via Google <http://cogprints.org/2289/0/autonomy.pdf> viewed on 2 January, 2006; via Google http://en.wikipedia.org/wiki/Autonomy

[9] Lord Diplock in the case of *United City Merchants (Investments) Ltd.* v *Royal Bank of Canada (The American Accord,)* [1983] 1 AC 168; It is established that there are four autonomous contracts in LC. The first contract is an underlying contract of sale between seller and buyer. Secondly, it is a contract between the issuing bank and the

of the underlying contracts exists between the buyer and the seller. In simple words, LC is only a contract of payment which is solely concerned with compliance presentation of the documents expressly called for under the LC or normally termed as matching payment against documents.

In the previous years, the distinctive concept of so called autonomous were not a disputable issues since traders and bankers customarily considered that goods were to be the "factor" in making a payment by banks.[10] Similarly, the goods are the only determining factor to ensure the trade transaction is free from fraud whereby the bank would conduct a brief inspection to confirm the existence of the goods. But, as trade and commercial gradually developed into sophistication, a trend of 'specialisation' exploded and took over the world where banks are also not spared from refurbishment. Consequently, banks are confined to handling financial and papers only.

To date, this outlook remains to be the main characteristic within which the banks worldwide operate their business. Taking cue from this change, the UCP incorporates guidelines in handling LC where the concept of autonomous becomes a distinctive identity to LC.[11] Disputes between trading parties concerning the underlying contracts are to be addressed using a different cause of action which should not compromise the LC operations and undertaking of the bank to honour payment. Deviating from this practice means disaster for the system of financing.[12]

The principle of autonomy is derived from the main objective of LC itself that assures the seller will get "a prompt payment" for the goods sold.[13] It is observed that this practice has long been recognised by various English cases.[14] Hence, banks ultimately deal with documents and not with the underlying goods, services or performance to which the documents may relate, and any dispute between the buyer and the seller must be settled between them. The bank must pay the seller upon compliance of his documents regardless whether the buyer is unable to pay or bankrupt. Likewise, the bank must honour the payment irrespective of whether the goods are of sub-standard quality and not as per contract description.[15] Therefore, the bank must pay the seller on compliance of his documents even the seller does not ship the goods; goods shipped are of poor quality,[16] or totally different from contract description.[17]

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applicant. Thirdly, it is a contract between the issuing bank and the corresponding bank. Fourthly, it is a contract between correspondent bank and beneficiary; However, it was commented that actually there are five separate contracts in LC as the Lord had overlooked the contract between the beneficiary and the issuing bank, Jack, Raymond, Malek Ali, Quest, David, *Documentary Credit*, Third Edition, Butterworths London, Dublin, Edinbrugh, (2001), at 21.

[10] See, Harfield, Henry "The Increasing Domestic Use of the Letter of Credit," (1972) 4 U.C.C.L.J 251.

[11] See, article 4 and 5, UCP 600.

[12] See, Chuah, Jason, *Law of International Trade*, Third Edition, Sweet & Maxwell, London, 2005, at 488.

[13] Miller, I .Norman, "Legal Problems of International Trade," (1959) U.III.L.F. 162, at 166, HeonOnline Database, retrieved 30 February, 2010.

[14] See, *Hamzeh Malas and Sons* v *British Imex Industries Ltd* (1958) 2 QB 127; *Urquhart Lindsay & Co* v *Eastern Bank Ltd* (1922) 1 KB 318 *Discount Records Ltd* v *Barclays Bank Ltd* [1975] 1 WLR 315 *Power Cuber International Ltd* v *National Bank of Kuwait SAK* [1981] 3 ALL ER 607; See also, David McShane, "The Letters of Credit – The Autonomy Principle", F&CL 10(1), at 4, LexisNexis database, retrieved 25 June, 2008.

[15] Daihuisen, Jan, *International Commercial, Financial and Trade Law*, Hart Publishing Oxford and Portland, Oregon, 2000, at 338.

[16] *Hamzeh Malas & Sons* v *British Imex Industries* [1958] 2 Q.B.127.

Thus far, a lot of literatures have supported the application of this principle which has been referred to as central,[18] sacrosanct,[19] backbone,[20] cornerstone,[21] foundation[22] and crucial[23] of the LC. Thus, it is the autonomous nature coupled with the doctrine of strict compliance which gives LC its 'life' and stands among others as the most valuable payment instrument in international trade.[24] Moreover, it has been exemplified as equivalent as "cash in hand."[25]

SIFNIFICANCE OF PRINCIPLE OF AUTONOMY IN LC

The role of a bank as an additional party in LC transaction brings about the movement of the goods from seller to buyer from different countries. Being a third party in trade transaction, the bank is acting as a middleman or moderator in making a payment on behalf of the buyer to the seller. This exclusive position of the bank renders high requirement of independency from any influence arises from the dispute of trading parties concerning goods or performance.

Thus, the principle of autonomy in LC transaction protects banks from being trapped in any disputes or possible litigations in the underlying contract.[26] It would defeat the purpose of the bank and its primary function in the economic cycle should the goods are to be encapsulated as one of the consideration factors in making a payment. This would mean that the bank and the financial institutions as a whole have to employ individuals of undisputable knowledge in various tradable goods besides banking knowledge so to speak. On the other hand, it is always perceived by general public that banks are also to avail themselves to the underlying contracts or specifically the goods. This perception arises due to the inter relation between the goods shipped by the seller, payment by the bank and the taking delivery of the goods by the buyer is only separated by a thin illegible line that is the definition of LC itself.

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[17] *Discount Records Ltd* v *Barclays Bank Ltd* [1975] 1 WLR 315.

[18] Mann, R. J. *The Role of Letters of Credit in Payment Transaction,* (2000) US, University of Michigan, 401-438, at 406, via Google <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214633> viewed on 2 July, 2006.

[19] Coutsoudis, B, *Letters of Credit, the Independence Principle and the Fraud Exception,* at para 4, via Google <http://www.law-online.co.za/IntTradeLaw/ucm%20case.htm>, viewed on 29 April, 2001,.

[20] Davidson, A, *Fraud Exception, The Prime Exception to the Autonomy Principle in Letters of Credit,* International Trade & Business Law ANNUAL VII, Cavendish Publishing (Australia) Ltd, 2003. 23-55, at 24, via Google <http://books.google.com/books?id=CDIkgKFPX4AC&pg=PA23&lpg=PA23&dq=%22Fraud+Exception,+The+Prime+Exception+to+the+Autonomy+Principle+in+Letters+of+Credit.%22&source=bl&ots=CwfqqBeU8m&sig=S2mWNYZvE8MX7ej3QffRib8CU&hl=en&ei=93J1SDKHYa3rAeJmeC8Cg&sa=X&oi=book_result&ct=result&resnum=1&ved=0CAkQ6AEwAA#v=onepage&q=&f=false> viewed on 2 July, 2006.

[21] Gao Xiang & Ross P. Buckley, "The Unique Jurisprudence of LCs: Its Origin and Sources," (2003) 4 San Diego Int'l Law J. 91, 119-124, at 119, LexisNexis database, retrieved 30 July, 2007.

[22] D'Ascenzo, (2004), at 1097.

[23] Dolan, (2006), at 480.

[24] See, Davidson, (2003), at 24, See also Dixon, William M *As good as cash? The Diminution of Autonomy Principle,* (2004) Australian Business Law Review 32(6): 391-406, at para 2.1, via Google <eprints.qut.edu.au/archive/00006547> viewed on 2 July, 2006.

[25] See, Dixon, ibid; see also a statement by Lord Denning in *Power Cuber International Ltd.* v *National Bank of Kuwait* [1981] 1 WLR 1233, at 1241.

[26] See, Bodget, Mark S, Wislon, Jerry W, *The Impact of Transaction Fraud: Strategies for the International Letter of Credit,* (1993) Review of Business, Spring, Issue, via Google http://findarticles.com/p/articles/mi_hb6451/is_199303 viewed on 12 May, 2004.

Other point to support the application of principle of autonomy in LC is the banks should not be involved to resolve dispute between seller and buyer. The dispute would cause delays in payment and would render the LC unattractive as a payment mechanism.[27] The effect is to restrict the role of banks involved in LC, in essence, to the ministerial functions of document checking and the transmission of funds.[28] Furthermore, the banks are not required to concern themselves in the realities of the underlying contractual position, with the sole exception of fraud.[29] This limits the type of risk to which the banks are exposed and enables them to complete the transaction quickly and economically.[30]

Moreover, it is established that the autonomy principle reduces the risk of non-payment due to applicant's asserting defences such as breach of warranty.[31] Banks cannot be held liable to ensure the type of goods purchased, the quality, content, substance, taste, smell or physical appearance of various goods referred by the documents. Banks are only employed individuals who are competent in checking the documents as required by the standard banking practice.

As a paying agent, the banks concern only with what the documents say. If the banks are to be held responsible to certify compliance of certain contents of the goods, this would result in unnecessary delay. Besides, conclusion from such examination would not be credible and may open rooms for disputes as employees of the banks are not experts in various types of goods.[32] The responsibility of a bank is only restricted in establishing the consistency of the data in presented documents. Furthermore, the bank is obliged to make sure that information transcribed in each of the document presented by the seller is consistent or does not contradict with the description of the goods expressly indicated in the credit.[33] Therefore, the important criteria or a determining factor in making payment lies in each and every document that strictly complies with the requirement stated in the credit.

Moreover, the autonomous nature of LC guaranteed payment to the seller where on compliance of his documents, he will get a quick payment prior to the physical delivery of the goods to the buyer.[34] Likewise, the buyer can ensure correctness of the goods based on the content of seller's documents. Hence, the documents represent as proof that the actual and correct goods are shipped. Any non-compliance in documents may give the right for buyer's bank, to postpone payment. With this peculiar characteristic, LC is seen to be the best form of payment in international trade which provides security at both ends. The idea of independence or self-governance of LC has evolved as a result form the development and modernization of trade practice worldwide.

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[27] See, Ramberg, Jan, *International Commercial Transactions,* ICC Kluwer Law International, Stockholm, 2000, at 142.

[28] See, Gerard McCormack, A. W, "Subrogation and Bankers' Autonomous Undertakings," (2000) L.Q.R., 116 (JAN), 121-146, at 134, Westlaw database, retrieved 13 July, 2007; See also, Sarna, Lazar, *Letters of Credit: The Law and Current Practice*, Second Edition, Toronto, 1986, at 127-129.

[29] Ibid.

[30] Ibid.

[31] Gao Xiang & Ross P. Buckley (2003), at 122.

[32] See, Mc Kinnon LJ in *JH Rayner & Co. Ltd.* v *Hambro's Bank Ltd* [1943] 1 K.B. 37, at 41.

[33] See, article 14, UCP 600.

[34] See, *O'Meara Co* v *National Park Bank*, 239 N.Y. 386, 397,146 N.E. 635, 639 (1925).

PRINCIPLE OF AUTONOMY AND THE UCP

Even though, the principle of autonomy in LC is very important, it is found that the phrase "principle of autonomy" is not expressly stated by the UCP but the autonomous nature of LC is reflected by certain provisions.[35] In the latest version for the UCP, the relevant provisions with regards to autonomy principles are laid down by the following articles; first, article 4(a), UCP 600 states:

> "A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary."

The second limb of article 4(a) states:

> "A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank."

Article 4(b) has elaborated further by providing:

> "An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, pro-forma invoice and the like."

From article 4(a) quoted above, first, it is clear that LC emerged from the sales contract agreed upon by buyer and seller as a method of trade settlement. Secondly, even though the LC emerged from the contract of sales, it is indeed a separate and independent from the underlying contract of sale. The presence of a bank as one of the parties is specifically to execute the payment without the slightest responsibility on the goods described in the contract of sale.[36] Thirdly, the buyer and the seller at this juncture are co-existence in two separate and independent contracts that is contract of sale being the first contract and LC being the second contract.

Simultaneously, the subject matter contained in the contract of sale remains the concerned of both the buyer and the seller. It would not have any influence on the second contract that is LC contract where a bank is one of the parties involved. Failure by the seller or the buyer to perform his duties in the contract of sale would not invalidate the other contract, which is LC, a contract of payment.

[35] Article 4, 5, UCP 600.
[36] See, article 34, UCP 600.

The new version of the UCP does not alter autonomy provisions laid down by its predecessor that is the UCP 500.[37] In relation to this, it is commented that the current wording of article 4, UCP 600 is enhanced to discourage the incorporation of copies of contracts, pro-forma invoices and the like as an integral part of LC.[38] Therefore, it places an absolute prohibition to any inclusion of extraneous material and extremely detailed requirements which could give a leeway to unnecessary documentary burden.[39] Similarly, any part of the contract of sale or copies, even the simplest form of sales contract that is pro-forma invoice, should not be included to form an essential part of the credit simply because it does not have any impact at all. This is evidenced by the inclusion of an additional article 4(b) where an issuing bank is specifically mentioned and being placed in a position to ensure such practice is not to be exercised in the issuance of LC.

In contrast, this was not the case in the previous UCP 500. Nevertheless, article 5(a)(i) of UCP 500 states generally:

> "In order to guard against confusion and misunderstanding, banks should discourage any attempt:
> (i) to include excessive detail in the Credit or in any amendment thereto."

The general language of article 5(a)(i) of the UCP 500 allows some LCs issued to bear the description of goods in the following manner, for example, "industrial metal fan as per pro-forma invoice number 123" and copy of the same is forwarded to the issuing bank for reference. In some cases, it is attached as an integral part of the LC. When this happens, the doctrine of autonomous in LC operations is compromised. By doing so, payment of LC is conditioned by another contract which is clearly impairing the function of LC from the autonomous point of view.

Prior to the UCP 600, it is noted that it was generally practiced by some banks in Malaysia and worldwide to issue an LC bearing intentionally lengthy and detailed description of the goods to ensure delivery of the correct goods.[40] The facts that in most cases, sales transaction take place between strangers of different countries and the goods traded are the most important consideration to the buyer, LC is perceived to serve as the 'guarantee' instrument for goods by many customers. This misconception has long been established within the trader community until now especially to those new traders or first time LC users. To mitigate this potential complexity and misconception, the UCP 600, article 4 is amended to signify a stronger prohibition of such practice. The issuing bank, in this case, is the main party to eliminate this misconception from circulating. This is to further maintain the 'nature' of the LC as a contract of payment which is independent from any other contracts existing between buyer and seller. Thus, it is obligatory on the part of the issuing bank to deter such attempt and to make known to the

[37] See, articles 3 and 4, UCP 500; The essence of article 3 of the UCP 500 has been retained in article 4 of the UCP 600; see, International Chamber of Commerce, *ICC Commentary on the UCP 600, Article-by-Article Analysis by the UCP 600 Drafting Group*, ICC Services, Publications Department, 2007, at 28.

[38] See, International Chamber of Commerce *ICC Commentary on the UCP 600*, 2007, at 28.

[39] See, Bergami, R, "What Can UCP 600 Do For You?" (2007) 11 VJ 1, at 3, Westlaw database, retrieved 12 May, 2008.

[40] R1 (Interviewed by 30 July, 2008); R2 (Interviewed by writer, 9 April, 2008)

buyer that LC is by nature does not concern with goods. Therefore, it should not be implicated by incorporation or attachment of another contract.
Furthermore, the application of principle of autonomy is strengthened by the provision of the article 5 of the UCP 600 which provides:

> "Banks deal with documents and not with goods, services of performance to which the documents may relate."

With reference to the above article, the word 'all parties' in article 4 of the UCP 500 has been changed to the word 'banks'. This is due to the fact that not all parties deal with documents in LC since the beneficiary deals with goods.[41] Thus, the drafting group found that it is not appropriate to state 'all parties' and changed the word to 'banks' as it is the banks who actually deal with documents only and not all parties.

In addition, Article 5 of the UCP 600 confirms that all banks in LC operations chain do not consider goods as a basis for payment but strictly based on documents alone. The buyer and seller are parties responsible to ensure correctness of the goods. To a certain extent, they may engage a third party to conduct inspection prior to shipment, if necessary.

Based on the above discussion on autonomy principles, the question that may arise in this case, whether the bank is totally excluded from the underlying transaction since the documents is the only matter the bank is dealing with. To answer this question, the real practice of LC should be scrutinised in order to clarify the point. It should be noted that in practice, there is a close connection between autonomy and strict compliance[42] in LC operations. This is reflected by the SWIFT format MT 700/701,[43] which forms a complete transcription of what is to be taking place within the given time frame. The issuing bank is fully aware of the criteria such as who is the buyer and of his whereabouts, who is the seller, type of goods, originating country, the price, method and manner of delivery, place of shipment and destination. At this point, LC provides a 'mirror' to the bank of the future events that should take place. Thus, it provides some guides for the issuing bank to conduct a preliminary check, which is customary, to ensure compliance to local regulations on dangerous and prohibited goods, foreign exchange, tax requirements, import regulations and financing regulations. At this point, the bank must exercise principle of strict compliance so as to make sure smooth transaction in delivery of the goods as well as transmitting the payment upon receipt of compliance documents. Without the knowledge of the above mentioned criteria, the trade transaction might be on halt and payment would be prohibited as a result of violation to certain local regulations.

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[41] International Chamber of Commerce ICC, *Commentary on the UCP 600*, 2007, at 31.
[42] See, Chapter 6.
[43] SWIFT is the acronym for the Society for Worldwide Interbank Financial Telecommunications. "It operates a network of communications which can be used by banks and other financial institutions for money transfers, for the opening of LC and generally for the transmission of messages from institution to institution," Ellinger, E.P, Lomnika. E, Hooley, R.J.A, *Modern banking Law*, Oxford University Press, New York, Third Edition, 2002, at 489; See also, Mei Pheng, Lee, Samen, Detta, *Banking Law*, Third Edition, LexisNexis Malaysia, 2006; See also, T.W Trader, T. Wolf, *What is SWIFT?*, via Google < http://www.bradynet.com/bbs/newdeals/106044-0.html> viewed on 2 January, 2008.

Upon receipt of the LC, the seller should also exercise strict compliance in tendering the documents expressly listed down in the LC. At this point, the seller will initiate the events, from handing over the goods to the carrier up to tendering the documents to the bank. All these events must be transcribed into documents such as invoice, packing list, weight list, bill of lading, certificate of insurance and certificate of origin in strict compliance as required by the LC. The purpose is to serve as a mirror to the bank that such events which have been required in the LC have actually taken place.

Based on these documents tendered by the seller, the bank is obliged to exercise the standard of strict compliance in checking the contents of document to ensure that they are complied with LC's requirements. It is at this point that the duty of the bank is only limited to contents of documents. On the other hand, whether such content of the documents in fact correct or otherwise does not fall within the jurisdiction of the bank.[44] This is again, due to the fact that the bank does not deal with the goods, services or performance to which the documents may relate.[45] This autonomous doctrine will allow the bank to fully focus on strict compliance of the documents alone as a basis of payment consideration. The documents are the final line or border to which the bank would deal with the goods, services or performance. They serve as written evidences or lawful and binding records that the events had actually taken place and in fact completed.

Thus, the strict compliance rules within the autonomous framework form what is called the autonomy characteristic of the LC. Disputes on goods, services or performance between the buyer and the seller will not compromise the undertaking obligation of the bank.

In addition, article 7(a) of the UCP 600 states:

> "Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, the issuing bank must honour..."

This article sets a standard condition to banks for consideration before making a payment. In other words, documents are the only 'consideration' for banks making a decision whether or not payment should be honoured. Hence, requesting for excessive documents or inclusion of detailed and lengthy description would give possibility that the seller would fail to comply with the terms and conditions of the credit. In such a case, the worst effect is that the seller may face the risk of rejection.[46]

Apart from all the provisions mentioned above, the UCP 600 has given autonomous to all types of LC by virtue of article 3 which ascertains that all credits to be irrevocable. Prior to this provision, article 6 of the UCP 500 gives a leeway for the parties to revoke the issued LC. In

[44] See, article 33, UCP 600.
[45] Article 5, UCP 600.
[46] However there was a remarkable case in 1991, *Banker's Trust* v *State Bank of India.* [1991] Vol. 2 Lloyds Rep, where 967 documents were presented by the seller as required by the credit as reported in.

other words, revocable LC does not attribute the autonomous nature as it can be cancelled without recourse.

However, it is interesting to note that despite article 3 of the UCP 600, revocable LC can still be issued or allowed to be circularised by virtue of article 1. Revocable LC is embedded and stealth under the meaning of article 1 which states:

> "...they are binding on all parties thereto unless expressly modified or excluded by the credit."

This article provides some rooms for traders who wish to opt for revocable LC by modifying or excluding parts of the articles. Frequent fluctuation of prices in the open market especially commodities and other limited supplied goods may trigger the use of a revocable LC.[47] It would be useful for the buyer to request for issuance of revocable LC to avoid from sudden increase of price in the country of the seller before shipment is affected.[48]

Simultaneously, the principle of autonomy in LC transaction is clearly mentioned by article 5-103(d) of the UCC which states:

> "Rights and obligations of an issuer to a beneficiary or a nominated person under a LC are independent of the existence, performance, or non-performance of a contract or arrangement out which the letter of credit arises or which underlines it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary."

In the official comment to the Uniform Commercial Code, it is mentioned that LC is independent from the underlying sale contract whereby the issuer's duty to honour payment is based on the compliance if the terms of the credit without reference to compliance with the terms of the underlying contract.[49]

PRINCIPLE OF AUTONOMY AND CASE LAW

Evidently, prior to the recognition of the principle of autonomy in LC and the birth of the UCP, history proves that during ancient time, common law courts have reluctant to recognise mercantile law (where LC is originated), which disregard common law concept of consideration.[50] Accordingly, it is established that it is not easy for common law to validate the

[47] R3 (Interviewed by writer, Kuala Lumpur, 2 October, 2007).
[48] Ibid.
[49] UCC S 5-114, Official Comment 1; See Paul H. Vishny, *Guide to International Commercial Law*, Mc-Graw-Hill Book Company, Colorado, 1983, at 2-31.
[50] See, Trimble, R.J, "The Law Merchant and the Letter of Credit", Harvard Law Review, Vol. 16, No 6 (Jun, 1948) at 981-1008, at 987, JSTOR database <http://www.jstor.org.stable/1336141> , retrieved 29 December, 2009; "Historically, the merchants rather than the lawyers have developed the rules concerning LC through their usage."

LC arrangement which is irrevocable and independent on its issuance and have no element of consideration between the seller and buyer, since consideration comes from the issuer that is the bank as required for a valid contract.[51] It is only during the seventeenth century mercantile principles were accepted by the common law courts irrespective of their disregard of the common law rules of contract and consideration.[52] The recognition of common law courts on mercantile law is based on the theory of custom of merchant incorporated into the contract of the parties, where custom has contributed large part of common law.[53] Accordingly, LC and its unique nature of autonomy or independence which was borne from mercantile law have been accepted by common law courts since then.

Based on this platform, the importance of the principle of autonomy in LC transaction has been enhanced through case-law.[54] Most of the relevant cases decided by various jurisdictions have shown the uncompromising courts' approach to uphold the application of this principle in LC transaction.[55] The early dictum describes the application of this principle in LC as:

> "The large and important part which LC plays in modern commerce restrains me from expressing my opinion on many of the point argued. The system should be kept as free as possible from technicalities and from unnecessary judicial dicta which may embarrass business dealings in future."[56]

The above dictum clearly supports the principle of autonomy and any acts which compromise this principle should be avoided. However, notwithstanding the above points, it is claimed that

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Davidson, Alan, "Commercial Laws in Conflict - An Application of the Autonomy Principle in Letters of Credit," 6 Int'l. Trade & Bus. L. Ann. 65 (2001), at 67, HeinOnline database, retrieved 1 January, 2008.

[51] Ibid, at 986; see also, William E. McCurdy, "Commercial Letters of Credit" Harvard Law Review, Vol. 35, No. 5 (Mar., 1922), pp. 539-592, at at 563, retrieved 29 December, 2009; see also, Dolan J.F, *The Law of Letters of Credit: Commercial and Standby Credits*, Fourth Edition 1996, Warren, Gorham & Lamont, Incorporated, USA, at 3-7.

[52] See, *Pillans & Rose* v *Van Mierop and Hopkins*, 3 Burr. 1663, 1669, 97 Eng Rep. 1035, 1038(K.B. 1765); see also, Omer F. Hershey, "Letters of Credit", Harvard Law Review, Vol. 32, No. 1 (Nov., 1918), pp. 1-39, at 4, JSTOR database <http://www.jstor.org/stable/1327675> retrieved 29/12/2009.

[53] See, Triamble (1948) at, at 988.

[54] See, Dolan, (1996), at 2-46.

[55] It can be proved by series of case law, for English cases, see, *Urquhart Lindsay & Co.* v *Eastern Bank Ltd* (1922) 1 KB 318, *Hamzeh Malas and Sons* lwn *British Imex Industries Ltd* (1958) 2 QB 127; *Power Cuber International Ltd* v *National Bank of Kuwait SAK* [1981] WLR 1233; *Discount Records Ltd* v *Barclays Bank Ltd* [1975] 1 WLR 315; *Montrod* v *Grundkotter Fleischvertreibs GmbH* [2002] 1 All ER (Comm) 257; US cases, see, *Frey & Son* v *E.R Sherbourne* Co.,184 N.Y.S. 661, 664 (App.Div. 1920), *Imbrie* v *D.Nagase &Co.*, 187. Supp. 692, 695 (N.Y. App.Div. 1921, *S.L Jones & princiCo.* v *Bond*, 191 Cal 551, 555 (1923), *Sztejn* v *J.Henry Schroder Banking Corp.*, N.Y.S. 2d 631, 633 (n.Y. Spec. Term 1941; Canadian case, see, *Angelica-Whitewear Ltd* v *Bank of Nova Scotia* [1987] 1 S.C.R. 59, 1987, 36, D.L.R. (4th) 161 at [10] (S.C.C); *Wespact Banking Corp* v *Duke Group Ltd* (1994) 27 C.B.R. (3d) 291, 20 O.R. (3d) 515 (Ont Gen. Div.); *Royal Bank* v *Gentra Canada Investments Inc.* [2000] O.J. No 315, Hong Kong cases, see, *Ever Eagle Co Ltd.* v *Kincheng Banking Corp.* [1993] 2 HKC 157; *Xin Yuan Trading Co. Ltd & Anor* v *Bank of China* [1999] 4 HKC 686; *Prime Deal (HK) Enterprises Ltd.* v *Hong Kong & Shanghai Banking Corp. Ltd & Anor* [2006] 3 HK 74;

[56] *Donald H. Scott & Co* v. *Barclays Bank Ltd* [1923] 2 K.B. 1, per Bankes L.J, at 10; quoted by E.P Ellinger, "Does a Documentary Credit Constitute Absolute Payment? The Modern Law Review, Vol. 24, No. 4 (July, 1961), at 530-533, at 530-531, JSTOR database <http://www.jstor.org/stable/1093285> retrieved 28 December, 2009.

the legal nature of autonomy of LC had failed to be observed and was not given sufficient weight by lawyers, including judges.[57] This comment proves that there is no standardisation in the application of this principle and its privilege varies from one case to another as well as from one jurisdiction to another jurisdiction.[58]

The famous English case on this point is *Hamzeh Malas & Sons* v *British Imex Industries Ltd*,[59] where Lord Justice Jenkins remarks:

> "It seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of goods, which imposed upon the banker as absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not."[60]

Similarly, Jacob J in *Sirius International Insurance Co (Publ)* v *FAI General Insurance Ltd*[61] had stated that principle of autonomy which applied to LC is of vital importance and it was not undermined in the very special case where a party expressly agreed not to draw down unless certain conditions were met.

At the same time, the court had been reluctant to interfere with the LC transaction when all the tasks had been carried out properly. It was upheld by Lord Denning MR in *Power Cuber International Ltd* v *National Bank of Kuwait SAK*:[62]

> "It is vital that every bank which issues a letter of credit should honour its obligations. The bank is in no way concerned with any dispute that the buyer may have with the seller. The buyer may say that the goods are not up to contract. Nevertheless, the bank must honour its obligations. The buyer may say that he has a cross-claim in a large amount. Still the bank must honour its obligations. A letter of credit is like a bill of exchange given for the price of goods. It ranks as cash and must be honoured"

Parallel to the above judgment, the same notion was also indicated by Stephen J in the leading Australian case of *Wood Hall Ltd* v *Pipeline Authority*.[63] The judge held that the autonomy principle is necessary to ensure that LC remains as good as cash.

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[57] See, Gao Xiang & Ross P. Buckley (2003), at 92.
[58] See, Dolan, (2006).
[59] [1958] 2 QB 127.
[60] Ibid, at 129.
[61] [2003] 1 W.L.R 2214.
[62] [1981] WLR 1233, at 1241.
[63] (1979) 141 CLR 443, at 457.

A similar remark is highlighted in the leading case of Canada, *Angelica-Whitewear Ltd* v *Bank of Nova Scotia,*[64] where Le Dain J. stated:

> "The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour a draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued. Disputes between the parties to the underlying contract concerning its performance cannot as a general rule justify a refusal by an issuing bank to honour a draft which is accompanied by apparently conforming documents. This principle is referred to as the autonomy of documentary credits."[65]

Furthermore, it was held in *Bolivinter Oil SA* v *Chase Manhattan Bank NA and Others,*[66] that the court may not entertain the application for an injunction to restrain the bank from making payment on the basis of disputes on the underlying transaction. In his judgement, Sir Johnson MR stated:

> "Judges who asked, often at short notice and ex parte, to issue an injunction restraining payment by a bank under an irrevocable letter of credit of performance bond or guarantee should ask whether there is any challenges to the validity of the letter, bond or guarantee itself. If there is not or if the challenge is not substantial, prima facie no injunction should be granted and the bank should be left free to honour its contractual obligation..."[67]

On the other hand, the principle of autonomy is instantly eliminated in the case of fraud where a strong proof of its existence could be established. Therefore, eventhough there is an allegation of fraud in LC transaction or the existence of fraud is published for public knowledge, it is not recognised as far as principle of autonomy is concerned. The presumption is that all parties are innocent and the LC transactions are fraud-free until and unless strong evidence has been successfully established by the alleged party. Hence, the undertaking to pay remains in force. It is stated by Selvam J in *Agritrade International Pte Ltd* v *Industrial Commercial Bank of China*[68] that:

> "The principle of autonomy of credit, excepting fraud, is sacrosanct in the law of LC. Any inroad into the principle will undermine and annihilate the trust and confidence in the use of documentary credits in international trade. The court must therefore do its utmost to preserve its integrity."[69]

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[64] [1987] 1 S.C.R. 59 (S.C.C).
[65] Ibid, at 70.
[66] [1984] 1 WLR 392.
[67] Ibid, at 393.
[68] [1998] 3 SLR 211.
[69] [1998] 3 SLR 211, para 23, 219.

In relation to this issue, Dolan through his analysis of several case-laws suggests that the practice of a broad fraud inquiry by court will rust autonomous nature of LCs and thereby destroy them as unique commercial devices.[70] The author concludes:

> "...well-advised, disciplined courts will refuse to elevate the underlying contract disputes into LC fraud disputes, especially if they realised the importance of the rules in protecting the commercial integrity of independent obligations. Undisciplined and ill-advised courts will undoubtedly fail to restrain themselves from litigating in the LC context disputes that should be litigated in the underlying context. In short, the rules matter not if the court has no desire to tether the fraud exception. To the extent that desire absent, all commerce bears the cost."[71]

Thus, it is not easy for an injunction to override the absolute autonomous of LC. It is unanimously agreed that only in the rarest situation that a bank will set aside the application of the principle of autonomy in LCs transaction. [72] Hence, it is advisable that the bank should not play safe by relying too heavily on protective measures built into the LCs as the courts are very slow to avoid payment to the seller who has presented the documents which complied with the terms of the credit.

As far as Malaysian case is concerned, the autonomous nature of LC is highlighted in the case of the *Ka Wah Bank Limited* v *Hong Leong Bank Bhd & Ors.*[73] In this case, the judge referred to the statement of Lord Diplock in the case of *United City Merchants*[74] that identifying four categories of relationships in LC transaction states.[75] Furthermore, the judge referred to *Halsbury's Laws of England* and states that the beneficiary in LC transaction must not involve with the contractual relationships between the buyer or applicant for the credit and the issuing bank.[76]

Apart from this case, it is very hard to find any Malaysian case-law which exactly discusses on the autonomy of LC. This fact predicts two possible situations, either principle of autonomy in LC transaction has been observed harmoniously and no dispute arises between banks and the customers on this issue, or; there are such disputes but these matters had not been exposed to the public or not ended by legal proceeding.

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[70] Dolan, (2006), at 481, the author has analysed the issue of autonomy and fraud based on three cases from Australia, Canada and United States.

[71] Ibid, at 503.

[72] Chuah, J.C.T, "Is There a Nullity Defence in Documentary Credit?" (2002) F&CL 4.13, LexisNexis database, retrieved July 30, 2007; Pamela, S, *Law of International Trade*, Second Edition, Old Bailey Press, 2004, at 22.

[73] High Court (Kuala Lumpur) Originating Summons No C3–31–369 of 1986.

[74] [1982] 2 Lloyd's Rep 1, at 6.

[75] Ibid, Syed Ahmad Idid J, at 8; See, fn 3, at 1.

[76] *Halsbury's Laws of England*, Fourth Edition Volume 3(1), at para 255; The is actually the provision of Article 4, UCP 400 which is applicable to LC transaction in this case; This article is similar to Article 3(b), UCP 500 and Article 4(a), UCP 600; see explanation for this provision at 7.

The real fact discovered that it is not accurate to claim that there are no disputes at all on matters pertaining to the autonomous nature of LC. Somehow, there are conflicts arose between bankers and customers but the matters are not brought before the court.[77] In most cases, the disputes were dealt as internal affairs.[78] Normally, the facts of the disputes have been recorded by the particular banks as their personal references and could not be disclosed to public. Factors such as reputation, length of times and a lot of expenses incurred in legal proceeding are among the main reasons for the choice of alternative dispute resolutions.[79] As a result, the settlement outside the court has denied the opportunity to establish Malaysian standard or approach in applying this principle. This is due to fact that alternatives methods of dispute settlements such as arbitration, mediation or conciliation are not qualified as a decision and could not be recognized as a binding legal principle.

Nevertheless, although it is unlikely to find direct authorities from Malaysian case-law which encountered the issues of autonomy of LC, the following cases which focus on the issue of granting injunction in performance bond or guarantee can be relied on since "the performance guarantee stands on a similar footing to a letter of credit,"[80] and similar legal principles applied by courts.[81] In line with the Malaysian bankers' strict practice of autonomy in LC, local case law proves that the same is practiced by the local court.

For instance, in *Kirames Sdn Bhd* v *Federal Land Development Authority*,[82] Zakaria Yatim J had cited with approval the English cases[83] in setting aside the injunction granted on the defendant restraining him from make a demand to payment under the terms of the security guarantee.[84] The learned judge states:

> "Following the authorities I have just cited, I am of the view that the defendant in present case is entitled to demand payment under the terms of the security

[77] This fact is agreed by all respondents during the interview.
[78] Ibid.
[79] Ibid.
[80] See, *Ellian & Anor* v *Matsas & Ors* [1966] 2 Lloyd's Rep. 495, per Lord Denning MR, "...a bank guarantee is very much like LC," at 497; See also, *Edward Owen Engineering Ltd* v *Barclays Bank International Ltd* [1978] 1 QB 159, per Lord Denning MR at 169, " A performance bond is a new creature...It has many similarities with letter of credit...", at 171, See also, RM Goode, "The New ICC Uniform Rules for Demand Guarantees" LMCLQ [1992] 190, at 192; "Demand guarantees share with documentary credits the characteristic of being abstract payment undertakings, that is, they are promises of payment which are considered binding upon communication to the beneficiary without the need for acceptance, consideration, reliance, or solemnity of form;" See, cf *Teknik Cekap Sdn. Bhd.* v *Public Bank Bhd* [1995] 3 A.M.R. 2697, per Shaikh Daud J.C.A, at 2972; See also, *Potton Homes Ltd* v *Coleman Contractors Ltd* (1984) 28 BLR 19, per Eveleigh LJ, at 29; see also, C Debattista, "Performance Bonds and Letters of Credit: A Cracked Mirror Image" [1997] JBL 289.
[81] *Turkiye Is Bankasi AS* v *Bank of China* [1998] 1 Llyod's Rep 250.
[82] [1991] 2 MLJ 198.
[83] *Bolivinter Oil SA* v *Chase Manhattan Bank* [1984] 1 WLR 392; *RD Harbottle (Merchantile) Ltd* v *National Westminster Bank Ltd & Ors* [1977] 2 ALL ER 862; *Edward Owen Engineering Ltd* v *Barcalys Bank International Ltd* [1978] 1 ALL ER 976; *United Trading Corp SA* v *Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554; *Hamzeh Malas & Sons* v *British Imex Industries Ltd* [1958] 2 QB 127; *Howe Richardson Scale Co Ltd* v *Polimex-Cekop* [1978] 1 Lloyd's Rep 161; *Intraco Ltd* v *Notis Shipping Corp of Liberia ('The Bhoja Trader')* [1981] 2 Lloyd's rep 256
[84] Ibid, at 202.

guarantee. There is no evidence of fraud in this case. The injunction granted on 6 May 1986 is therefore set aside."[85]

In this case, the defendant promised to supply to the plaintiff reinforced concrete spun pipes. A dispute arose on the underlying contract. The plaintiff commenced proceeding and obtained an ex parte injunction restraining defendant from any act of whatsoever nature in relation to the security deposit. The defendant then applied to set aside the injunction. Allowing the defendant's application, the court held that except when there is a clear case of fraud, the defendant is entitled to demand payment under the terms of the security guarantee. Therefore, the principle of autonomy was given priority over the dispute in the underlying sale contract.

Similarly, in *Patel Holdings Sdn Bhd* v *Estet Pekebun Kecil & Anor,*[86] the court held that guarantees, being performance guarantees, the second defendant was obliged to honour them unless it has notice of clear fraud committed by the first defendant. In *Lee Contractors (M) Sdn Bhd (Formerly known as Lotterworld Enginering & Construction Sdn Bhd* v *Castle Inn Sdn Bhd & Anor,*[87] it was held that the disputes between parties must be settled between the contracting parties and would not affect the performance bond.[88] In order to justify any injunction to stop payment, there must be clear evidence of fraud on the part of the beneficiary.[89]

Thus, based on the above cases, it is proved that the Malaysian courts have strictly preserved the integrity of the LC and separate it from the disputes in the underlying sales contract. It is clear from those cases, the courts have reserve their interference on the payment undertaking by narrowing the scope of exception to the principles of autonomy. For instance, fraud is recognised as an exception to principle of autonomy but its existence is not easy to prove. Simultaneously, injunction is not simply granted to restraint payment undertaking unless a clear fraud can be established by the claiming party.

APPLICATION OF PRINCIPLE OF AUTONOMY – MALAYSIAN PRACTICE

Case-law in Malaysia shows that the principle of autonomy in LC transaction applied in line with the UCP provisions. To enhance the result for the application of principle of autonomy in LC transaction in Malaysia, interviews are conducted with the Malaysian commercial banks' key person to LC and LC experts in order to examine the real banking practice pertaining to the principle of autonomy applied in Malaysia.[90] The following discussion presents the response of

[85] Ibid.
[86] [1989] 1 MLJ 190; See also, *Malaysia Overseas Investment Corp Sdn Bhd* v *Sri Segambut Supermaket Sdn Bhd* [1986] 2 MLJ 382; *Sri Palmar Development & Construction Sdn Bhd* v *Transmetric Sdn Bhd* [1994] 1 CLJ 224; *Esso Petroleum Malaysia Inc* v *Kargo Petroleum Sdn Bhd* [1995] 1 MLJ 149.
[87] [2000] 3 MLJ 339.
[88] Ibid, at 340.
[89] Ibid.
[90] Data collection was conducted by an in-depth face to face interview with respondents. This approach is claimed to be "especially helpful to obtain information that might be otherwise difficult to come by." Salkind, Neil, J, *Exploring Research*, Seven Edition, Pearson Prentice Hall, USA, 2009, at 195; The respondents consist of eighteen (18) Head of Trade Finance of Malaysian Commercial Banks, three (3) LC trainers and one (2) prominent professor in LC. Structured questions were drafted which focus on issues of the application of principle of autonomy in LC.

the respondents during the interview on bank's action in dealing with disputes arising between buyer and seller on the goods. These situations are selected in order to establish the parameter that practiced by the banks in the application of principle of autonomy in LC transactions. For a clear interpretation on how and to what extent this principle is practiced, the responses are converted into tables or figures below.

Table 4.1 - Dispute between Seller and Buyer on Goods – Bank's Action

Bank's action	Conventional	Islamic
1 : follow B's instruction	1	0
2: follow UCP	9	4

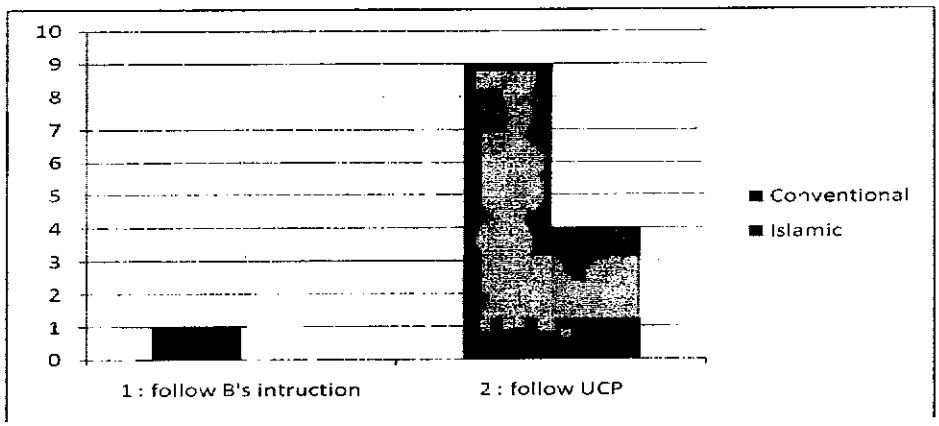

Figure 4.1 - Dispute between Seller and Buyer on Goods – Bank's Action

If the dispute arises between seller and buyer with regards to the condition of the goods in sale contract, most of the banks do not involve with such conflict. Based on the table 4.1 and figure 4.1 above, as shown by column 2, majority of the bankers, nine (9) from Conventional banks and four (4) from Islamic banks who responded to this question, explained that they have followed the UCP rules in dealing with such disputes. One (1) Conventional banker explained:

The interviewed data was analysed by using the Nvivo software version 8, "a qualitative data analysis (QDA) computer software package produced by QSR International. It has been designed for qualitative researchers working with very rich text-based and/or multimedia information, where deep levels of analysis on small or large volumes of data are required." QSR International, "What is qualitative research?" <http://www.qsrinternational.com/what-is-qualitative-research.aspx> viewed on 27 November, 2008; For the sake of reputation and on request of the respondents, their names are not disclosed. Accordingly, the respected respondents were addressed by using the capital letter "R" which is short form for "Respondent" and followed by the number, such as R1,R2 and R3.

> "If this happens, we will advise our customer (buyer) to settle his case with his seller or supplier. We do not concern ourselves with the conditions of the goods. As long as our duty is concerned, we only deal with documents. Any disputes, let the customers settled among them."[91]

Therefore, the banks in such a case will honour payment to the seller and advise the buyer to settle the dispute with the seller based on their sale contract. The bank pays on compliance of documents regardless of condition of the goods. It is emphasised by one (1) LC expert:

> "Since the dispute is concerning the goods, the problem should be resolved between the buyer and the seller, as the bank is not a party to the sales and purchase contract between the buyer and the seller."[92]

However, it happened that, one (1) Conventional banker in column 1, out of fourteen (14) bankers interviewed, has entertained the buyer's instruction to stop payment against defective goods shipped by the seller. It is admitted by the said banker that they will entertain buyer's instruction if the goods delivered are sub-standard and totally of different quality as agreed in sale contract. Besides, they will follow buyer's instruction to postpone payment with a sole objective to preserve their good relationship with customers. This practice seems irregular and it could be due to ignorance of the true meaning of the principle of autonomy in LC transaction, lack of knowledge and absent of proper training. With regards to this practice, one (1) LC expert comments:

> "If the bank listens to him (buyer), that stupid bank also, that's something wrong with the banker, sometimes they do also (follow buyer's instruction to stop payment), that's the funny thing, sometime they also do mistake, because of ignorance, no proper training."[93]

In such situation, the principle of autonomy is compromised and bankers are at risks. This irregularity should not happen if the bankers are very well verse with LC's autonomous nature and abide by the UCP provision.

[91] R4 (Interviewed by writer, Kuala Lumpur, 10 April, 2008).
[92] R5 (Interviewed by thesis writer, Selangor, 25 April, 2009).
[93] R6 (Interviewed by thesis writer, Selangor, 23 April, 2009).

Table 4.2 - Dispute between Seller and Buyer on Goods – Bank's advice

Dispute between Seller and Buyer on Goods – Bank's advice	Conventional	Islamic
1 : ask buyer to insure the goods	5	2
2 : ask buyer to take action against seller	8	1
3 : ask inspection by third party	5	2

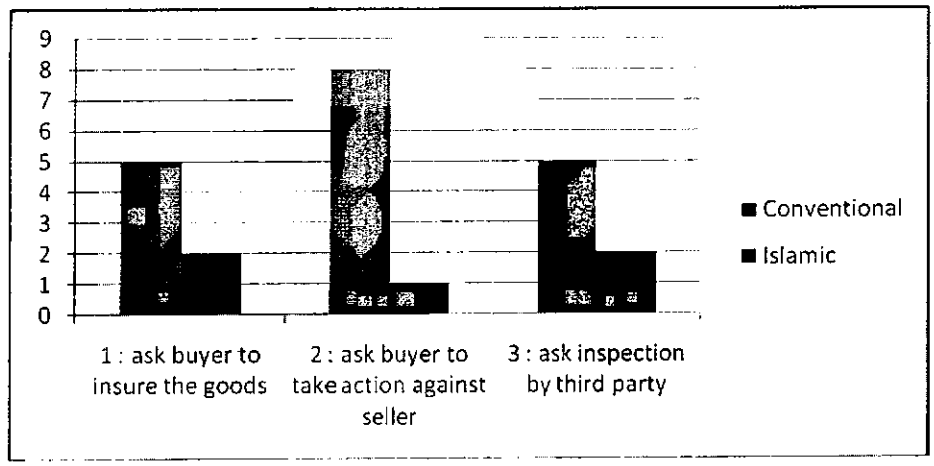

Figure 4.2 - Dispute between Seller and Buyer on Goods – Bank's advice

In dealing with the dispute between the buyer and the seller which is brought to the banks' attention, the first step taking by the banks is to reserve their interference. Majority of the banks as demonstrated by the table 4.2 and figure 4.2, column 2 above, will ask the buyer to look at their purchase contract and take action against the seller for legal remedies. It is commented by one (1) expert:

> "Eventually, it will depend on the forms of disputes and in any cases; the bank will try to abide by the UCP provision. Thus, if the goods delivered are wrong or sub-standard, the buyer may make a claim to the supplier or the seller or inspection company if one was appointed. If the goods are lost or damaged, the buyer can forward his claim on the Transport Company or insurance company but he must be mindful of non-insurable risks."[94]

However, due to generosity and humanity, the banks may provide an advisory and networking services, such as checking with their branches or correspondent banks to introduce alternative

[94] R7 (Interviewed by writer, 24 July, 2008).

suppliers or sellers for the applicant to cater his future transactions. Alternatively, prior to the execution of the LC contract, the banks will give some advices such as ask the buyer to procure insurance to protect the goods prior to the shipment, as shown in column 1. Besides, the banks as shown in column 3 may also suggest the buyer to get a certificate of inspection issued by a third party to be included in their future LC. With regards to this, one (1) Conventional banker points out:

> "Banks will not interfere. However we recommend that an inspection certificate issued by a third party be included in their future LC. It will not provide a hundred percent guarantee though as inspections are carried out by random sampling. We also ask buyers to look at their purchase contract for legal remedies."[95]

Table 4.3 - Banks Do Not Establish Correctness of the Goods with the Buyer

Banks Do Not Establish Correctness of the Goods	Conventional	Islamic
1 : Bank deals with documents-pay on compliance	9	4
2 : bank has no investigative role	1	1
3 : sale contract is between Buyer and Seller only	2	1

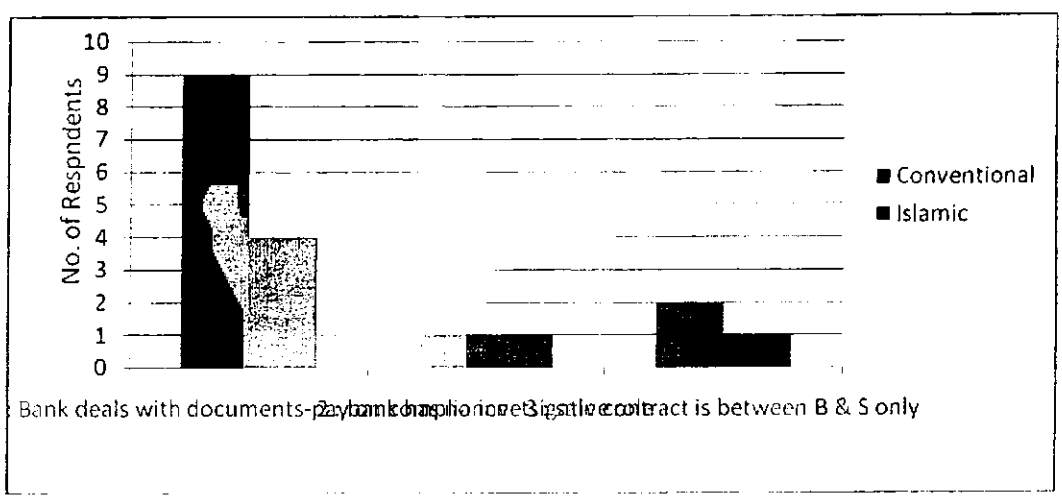

Figure 4.3 - Banks Do Not Establish Compliance of the Goods with the Buyer

In response to the issue of whether the banks check the compliance of the goods with the buyer before making payment to the seller, most of the banks denied such action. All eighteen (18)

[95] R8 (Interviewed by writer, Kuala Lumpur, 21 March, 2008)

banks interviewed as shown by table 4.3 and figure 4.3 above, regardless of their types, do not check the compliance of the physical goods with sale contract.

The main frequent reason highlighted by the banks that is nine (9) from Conventional and four (4) from Islamic banks as shown in column 1 is, they have to act in accordance with the UCP 600 provision that the banks deal with documents only, whereas the goods in a sale contract is a matter between seller and buyer. Accordingly, the banks check on the face of documents' content only as required by the UCP[96] and as guided by the ISBP standard. It is explained by one (1) Islamic banker that:

> "We do not refer to buyer to establish correctness of the goods but we just refer to inform about discrepancy in documents."[97]

Similarly, the same approach highlighted by one (1) banker from Conventional bank:

> "Actually we don't ask the buyer whether the goods are correct or not, we don't refer to the buyer to establish correctness of the goods, we try not to ask, since the bank deals only with documents."[98]

Besides, it is added by another Conventional banker that banks only examine documents presented by the seller to ensure that the documents comply with the terms and conditions of the LC and pay the seller on compliance. Accordingly, it is claimed by conventional and Islamic bankers in column 2 that the banks have no investigation role to check the physical goods. Furthermore, it is added by the two (2) conventional bankers and one (1) Islamic banker in column 3 that the sale contract is carried a matter between seller and buyer.

Therefore, the issuing bank must accept or reject the documents based on the documents alone. Reference to the buyer is not on the matters relating to the goods but on documentary issues such as discrepancies or non-compliance of documents presented by the seller.

[96] Article 4, 5, UCP 600.
[97] R9 (Interviewed by writer, Kuala Lumpur, 19 March, 2009).
[98] R10 (Interviewed by writer, 9 April, 2008).

Table 4.4 - Buyer Asks Bank to Stop Payment – reasons for no experience by bank

Reasons for no experience	Conventional	Islamic
1 : Buyer cannot see the goods	1	1
2 : Buyer do not have Bill of lading to clear the goods	2	1
3 : bank deals with documents	6	1
4 : only court's injunction can stop	6	0

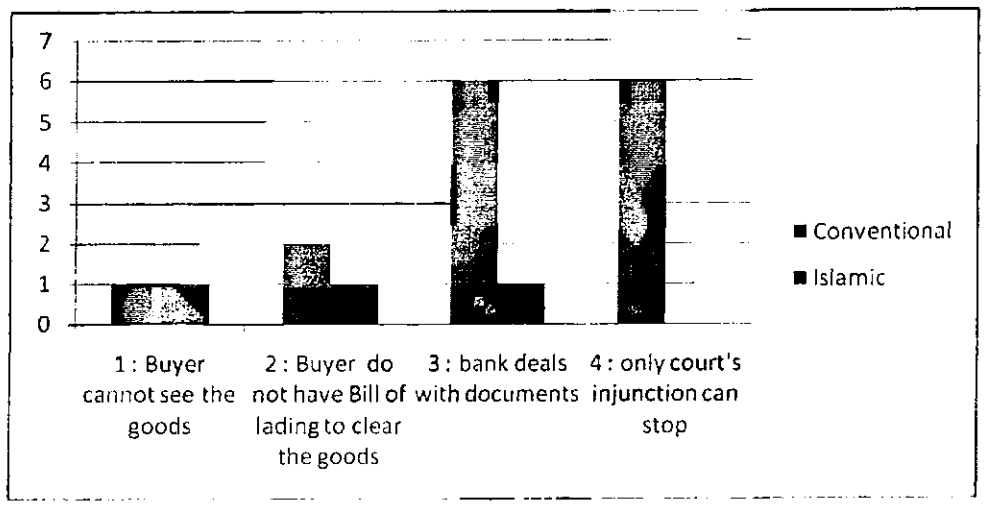

Figure 4.4 - Buyer Asks Bank to Stop Payment – reasons for no experience by bank

In response to the situation whether banks have experienced a request from the buyers to stop payment due to conditions of the goods are not as per contract descriptions, one (1) Conventional banker points out:

> "Number of cases is minimal...it happens in one or two only out of 1000 transactions. Normally it happens in international trade"[99]

Hence, majority of the bankers unanimously agreed that it is very rare for the bank to receive a request or instruction to stop payment from the buyer. As shown by table 4.4 and figure 4.4, column 1 above, one (1) banker from Conventional and one (1) banker from Islamic bank stated that such experience is rarely happened in LC transaction since the buyer has no opportunity to check the goods as the arrival of the goods is later than the documents. Thus, it is impossible for the buyer to find out that the goods are sub-standard since he does not have opportunity to

[99] R11 (Interviewed by writer, 2 January, 2010).

inspect the condition of the goods prior to arrival of the shipment. Therefore, the buyer has no basis to instruct the banks to stop payment.

Furthermore, it is explained by two (2) Conventional banks and one (1) Islamic bank as shown by column 2 above, in order to clear the goods, the buyer must first obtain a Bill of lading which entitled him to take delivery of the goods. Thus, without the Bill of lading the buyer will not be able to clear or see the goods at port of delivery. Accordingly, there is no possible situation for the buyer to ask the bank to stop or postpone payment since he has no reason to do so.

On the other hand, it is clarified by one (1) Islamic banker[100] that there are occasions where the goods may arrive earlier than the shipping documents.[101] In this case, the buyer can actually check the goods by way of getting the shipping guarantee issued by his banker. The bank will issue a letter of indemnity[102] in the form of shipping guarantee which entitled the buyer to take delivery of the goods at port of delivery. Normally, in such a case, the buyer may have a chance to see the goods and there will be a possibility that he may reject the goods which is not complying with his contract description.

In addition, it is further explained that the bank may receive a request from the buyer to stop payment in the case of usance LC where the seller beneficiary has agreed to give a certain period to the buyer to pay.[103] In this case, it is possible for the buyer to request the bank to stop payment when they realize that the goods delivered are not as per requirement.

Obviously, in dealing with buyer's request to stop payment, majority of the banks, six (6) from Conventional banks and one (1) from Islamic bank as shown in column 3, held that bankers follow the UCP strictly which requires them to deal with documents only and not with goods. As long as the dispute is concerning the goods, the problem should be resolved between the buyer and the seller based on the sales and purchase contract whereby the bank is not a party.

Simultaneously, as shown by column 4, the most common situation agreed by six (6) Conventional bankers to stop payment is, if there is court's injunction presented against the bank. It is only upon receiving a valid court injunction, the issuing bank is bound by the court's order to stop payment. It is explained by one (1) LC expert:

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[100] R12 (Interviewed by writer, 29 December, 2009).

[101] The late arrival of the documents could be due to the complicated LC requirements such as certificate by a third party or certificate origin which is difficult to obtain.

[102] "The bank's indemnity issued in as standard format normally known as shipping guarantee issued by a bank in a standard format indemnifies the shipping company against all consequences and liabilities of any kind whatsoever should there be any claim on it by the rightful owner. It is signed by the buyer and countersigned by the bank." Ismail Mahayudin, *International Trade Operation – A Guide*, BIMB Institute of Research and Training Sdn Bhd, 1997, at 75.

[103] See, Abdul Latif Abdul Rahim (1990) Documentary Credits in International Trade, Pelanduk Publications, Malaysia, at 28.

"...because law becomes more paramount than the UCP. If the buyer take injunction against the bank from making payment then the bank will not pay even the documents are in order."[104]

In this case, the issuing bank's undertaking to the beneficiary remains intact and once the court injunction is uplifted, the issuing bank is required to honour its irrevocable undertaking to the beneficiary.

Table 4.5 - Injunction to stop payment – Bank's action

Bank's cause of action	Conventional	Islamic
1 : consult legal before stop payment	0	3
2 : injunction comes after payment, ignore	1	0
3 : must show clear & cogent evidence	2	0
4 : stop payment -court order overruled UCP	9	3

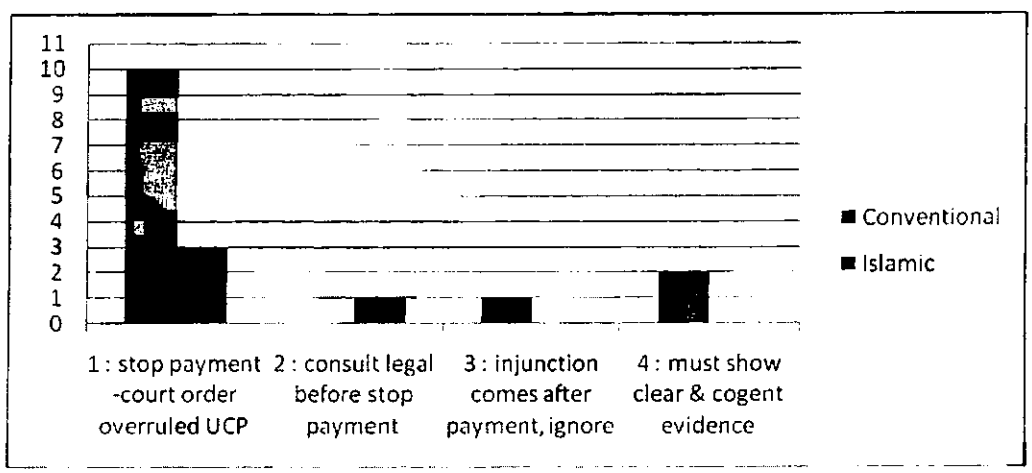

Figure 4.5 - Injunction to stop payment – Bank's action

In a case where injunction is granted by the court and be presented to the banks instructing to stop payment, various actions are taken by them. Table 4.5 and figure 4.5 demonstrated that majority of the banks, that is ten (10) from Conventional banks and three (3) from Islamic banks in column 1, will abide by the injunction believing that only court's order can discharge the bank's duty to honour payment. It is explained by one (1) Islamic banker:

[104] R13 (Interviewed by writer Selangor, 23 April, 2009); However, it should be noted that the bank can apply to set aside the injunction as long as the content of documents are strictly comply with LC terms and conditions and contain no fraudulent element.

> "If documents presented by the beneficiary comply with the LC terms and conditions, the issuing bank will have no choice but to honor its obligation to the beneficiary. In this instance, the applicant can apply for a court injunction in order to initiate a stop payment."[105]

However, the practice of the banks seems varies in dealing with such court's order. Some bank may hold the payment by the time the injunction is served against them. On the other hand, certain banks as shown in column 2 above, may forward the injunction to legal department before stopping the payment. The legal department's advice will be sought for the purpose of interpretation of the legal language relating to the injunction. Thus, reference to the legal department is just a matter of procedure which will not affect the effectiveness of the injunction.

Another point highlighted as shown by column 3 is, it must be determined either the injunction is granted before or after the bank makes payment to the beneficiary. It is stated by one (1) banker from Conventional bank that:

> "Under LC, there is no compromise. If documents complied we have to pay. The question is injunction comes before or after the bank made payment. The UCP has stated that if documents complied we have to pay. The dispute is between buyer and supplier, nothing to do with bank."[106]

Therefore, if the injunction is served after the bank had made payment, the bank's action is prevailed. In this situation, a proper procedure for the bank is to apply a court's order to set aside the injunction on the basis that the bank has acted in good faith in making payment as explained by one (1) Conventional banker:

> "Bank will withhold payment obligation and will advise the negotiating bank accordingly. The negotiating bank may request the Issuing Bank to apply to the court to set aside the injunction." [107]

In addition, as far as injunction is concerned, like in a normal case involving court's injunction, two (2) Conventional bankers as shown in column 4, emphasised that it must show a clear and cogent evidence before such order may be granted by the court.

Based on the feedback presented above, it is observed that the Malaysian bankers have strictly applied the principle of autonomy in LC transaction. In most cases, they are abide by the UCP and are fully aware of their obligation to pay only on compliance of seller's documents. Accordingly, the provisions of the UCP and the ISBP are followed in dealing with documents[108]

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[105] R14 (Interviewed by thesis writer, Kuala Lumpur, 27 September, 2007).
[106] R14 (Interviewed by writer, Kuala Lumpur, 24 October, 2008)
[107] R16(Interviewed by thesis writer, Kuala Lumpur, 21 March, 2008).
[108] The latest version is ISBP (2007) ICC Publication No. 645 E. With respect to "standard practice", stated generally, all banks follow the standard guideline outlined by the ISBP.

and in most cases; documents are prevailed over the goods. Except in the case of a clear fraud and injunction, the principle of autonomy prevails against any disputes arising out of the underlying sales contract such as goods ordered are of different quality or not as per contract terms. In such a situation, the banks will not involve in any commercial disputes in the underlying contract of sale. The dispute would have to be resolved between the contracting parties that is buyer and seller. It is unanimously agreed by the respondents that LC is an irrevocable conditional undertaking by the issuing bank to honour a compliant presentation. Otherwise, the LC would lose its credibility as an instrument of payment for trade settlements. Should the issuing bank refuse to honour its undertaking under the LC on compliance of seller's documents, (which is not in accordance with the UCP 600), it will affect the reputation of the issuing bank and its country.[109] Furthermore, should the bank fail to observe the principle of autonomy, this will expose the bank to tendency to be involved in court litigation.

CONCLUSION

The irrevocable undertaking of the LC cannot be affected by the battle between the seller and the buyer relating to the conditions of the goods neither can it be tampered with arising from breach of the sale contract by any contracting parties. The principle of autonomy in LC transaction should be applied justifiably since over rigidity or leniency would deny confidence of the LCs mechanism. Therefore, it is suggested that "principle of autonomy should not be extended to protect an unscrupulous seller"[110] and "placing blind faith in the autonomy principle will no longer suffice."[111] As commented by one (1) expert:

> "I would never place blind faith to autonomy principle, ~~but I've~~ realized that some people believed that it should be absolute. I think that's incorrect. I think it is just a dangerous if LC becomes known as a tool to commit fraud, or to facilitate fraud as I think that LC can be easily be enjoined so there is a need for balance, my opinion, is a balance of a fall on the side of making it difficult but it is not impossible to obtain an injunction."[112]

[109] R17 (Interviewed by writer, Kuala Lumpur, 24 March, 2008).
[110] *Sztejn* v *Henry Schroder Banking Corporation* (1941) 31 NYS 2nd 631, per Shientag J, at 634; see detail discussion at Chapter 5, at ?.
[111] Dixon, 2006, at 1.
[112] Professor James Bryne, School of Law, University of George Mason, USA (Interviewed by writer, Kuala Lumpur, 23 April, 2009).