PRINCIPLE OF STRICT COMPLIANCE IN LETTER OF CREDIT (LC): TOWARDS A PROPER STANDARD OF COMPLIANCE

by

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ABSTRACT

Principle of strict compliance is significant to sustain the smooth flow of LC procedure. LC expedites payment to a seller as well as guarantees delivery of goods that fulfill contract description to a buyer. However, the issue of standard of compliance causes delays in payment and vitiates the credibility of LC as a method of payment in international trade. Once discrepancies exist in seller’s documents, the documents will be considered as non-compliance and all undertakings are suspended. Consequently, a seller will not receive payment and a buyer will not be able to claim the goods at port of delivery. This paper addresses issues relating to the required standard of compliance from perspective of the UCP 600 and ISBP.

INTRODUCTION

Letter of credit (LC) is a payment mechanism, used to facilitate trade in international sales. One of the fundamental principles governing the LC operation is the principle of strict compliance. The principle requires the seller to present the necessary documents in accordance with LC requirements; in order to claim payment for the goods sold. The principle
of strict compliance is defined as the legal principle that entitles the bank to reject documents which did not strictly comply with the terms of LC.\textsuperscript{[1]}

The issue of strict compliance comes into the picture during the process of checking documents in LC transactions. The bank is the party responsible in determining whether or not the presentation complies with LC requirements based on the Uniform Custom and Practice for Documentary Credit (UCP 600) and ISBP. The former is the primary rules which govern LC transactions whereas the latter serves as guidelines for the standard interpretation within which the bank must exercise its reasonable judgment in ascertaining the documentary compliance.

The principle of strict compliance aims to protect the buyer who has neither the opportunity to examine the physical goods nor to supervise the process of loading the goods in the seller’s country due to geographical distance. Therefore, the documents are the only security for the buyer. The documents prove that the goods have been properly delivered in accordance with the description in the sale contract.

At the same time, the principle of strict compliance also benefits the seller by providing fast payment. The seller does not have to wait until the goods shipped safely reach the buyer before claiming payment. The seller can claim payment for the goods sold by presenting to the bank the documents required by the buyer once the goods have been shipped to the buyer. Thus, it is essential that the seller’s documents contain a true description of the goods; otherwise the buyer has a right to instruct the bank to reject the documents, which are deemed to be non-compliant.
Apart from the buyer and seller, the bank also benefits from the application of the principle of strict compliance in LC. The bank will be protected against any legal repercussion as long as the payment to the seller was made upon strict compliance of seller’s documents. This is irrespective of the condition of the goods received by the buyer. Since banks usually have limited expertise in goods or industries, they are not expected to know every aspect of commercial terminology in trade, for instance, “coromandel groundnuts” is another trade name for “machine-shelled groundnuts kernel.” [2] In most cases, the bank does not even know what kinds of goods are transacted between the seller and the buyer. [3] Hence, even if there is any problem with the goods delivered, the bank will not be held responsible for releasing the payment to the seller as long as the documents are in order. Bank will not be required to ensure that the goods delivered to the buyer meet the specifications in the sale contract.

STANDARD OF COMPLIANCE: A CONFLICT

The well-noted problem regarding the application of the principle of strict compliance in LC is the problem of determining the standard of compliance. Surprisingly, despite being the fundamental principle underlying LC transactions, the requirement for strict compliance is not mentioned in any versions of the UCP. [4] In other words, UCP, being general in nature, does not provide guidelines as to what are the degrees or parameters of discrepancies which would justify the bank to withhold payment on the ground of documentary non-compliance. Until the introduction of the UCP 600, none of the previous revisions of the UCP
Since there were no standard parameters set by the previous revisions of the UCP, the task of determining the standard of compliance required in documents was left to the courts to decide. Evidently, this loophole has contributed towards conflicts of judgment in case laws as well as uncertainty in banking practices. Over the years, judges and LC experts struggled to come up with a formula to determine the standard of compliance in LC, resulting in diverse opinions and views being formulated. In general, the standard of compliance is divided into literal and substantial compliance standards. The literal compliant standard demands a high standard of compliance. The documents must be in strict compliance with the LC requirements. In other words, it must be the ‘mirror image’ of the LC. This standard suggests that minor mistakes such as typographical errors can be considered as a discrepancy which allows the bank to reject the documents. It is essential in order to protect the banks’ scope of undertaking which is confined to the face of documents only. It also protects the banks from customers’ complaints. Last but not least, it serves the objectives of certainty and reliability of the banker’s credit and guarantees sureness of payment to the beneficiary.

The substantial compliance standard suggests that the presentation of documents which are substantially in compliance with the credit can be accepted as a good presentation. Accordingly, any trivial or non-significant discrepancies can be waived. The rationale behind the substantial compliance standard is to promote equity to the beneficiary. It
also protects the relationship between bankers and their high valued-
customer from being affected by minor discrepancies; which results in
documentary non-compliance. However, despite its slightly relaxed
nature of compliance parameters compared to the literal compliant
standard; the substantial compliance standard is not easily practiced. The
latter requires skills and in-depth knowledge in order to determine
whether to accept or reject the documents tendered. Thus, to certain
extent, substantial compliance standard demands the involvement of the
bank’s senior or experienced officers to make decisions.[7] Moreover,
there are opinions; which claim that substantial standard is inappropriate,
controversial and triggers disputes.[8]

However, there are however some LC experts who do not favor the
literal and substantial compliance standard classification. They opined
that there is no principle of “strict” compliance mentioned in the UCP.
The phrase is merely a fiction invented by lawyers drawn from contract
law. Moreover, they also alleged that “strict” compliance is not a
principle of sound banking.[9] The idea signifies that compliance should
be determined based on the documents as a whole with reference to their
roles in LC transactions. Regardless of the standard applied, the
examination of documents which involves humans checking should not be
carried out based on scientific method but it must be realistic. In addition,
the question of standard of compliance is subjective and it depends on
each individual approach. Some bankers may view the non-compliance on
one document as discrepancy while others may look at the content of the
requirement and construe it as complying with the LC requirement.
STANDARD OF COMPLIANCE AND THE UCP 600

The current UCP 600 is the result of the ICC Committee’s effort to solve problems relating to strict compliance and documentary discrepancies which arise from the application of the UCP 500. Among the points being painstakingly dissected during the UCP Drafting Group meeting are related to the doctrine of strict compliance and the mechanism to reduce the percentage of rejected documents due to discrepancies. Having realized the high rate of discrepancies found in the seller’s documents, the ICC working groups came up with the new UCP 600. The new version aims to reduce the strict requirements imposed by the UCP 500 on documents. Various views and comments on the current rules in the UCP 600 portray it as more customer-friendly and an easier reference compared to the earlier UCP version.

The UCP 600 still maintains its general nature. It does not highlight objectively the criterion that constitutes compliance or otherwise. The current UCP through the provision of Article 16(b) seems to be the mechanism to pass over the bulk of documents to the trading parties ie, the seller and the buyer to finally determine whether or not to accept the discrepant documents. Yet, the word “may” of Article 16 (b) implies that the bank retains a discretionary authority whether to refer the notified discrepancies to the applicant or not.

Despite the generality of the rules, UCP 600 contains provisos which clarify the previous provisions of documentary compliance. It also introduces new articles including those which provide definitions of
presentation and complying presentation. As an example, complying presentation is defined as:

a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of the UCP rules and international standard.\textsuperscript{[13]}

The above clarification removes the existing perceptions of compliant documents.\textsuperscript{[14]} It states that the compliance of documents is not only determined by LC requirements and the rules of the UCP rules; it must also be guided by the International Standard Banking Practice (ISBP).

The doctrine of strict compliance has been relaxed by the provisions introduced by the UCP 600.\textsuperscript{[15]} It is stated in Article 14(d), UCP 600:

Data in document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated documents or credit.”

The above provision eliminates the narrow provision of Article 13(a) of the UCP 500, which stated that documents which are “inconsistent with one another,” will be treated as non-compliant. The introduction of the new provision by the UCP 600 reduces the complexity presented by the strict compliance principle. It signifies that as long as the contents of the documents are not contrary to the LC, the bank will accept documents as in compliance. The requirement that the content of
the seller’s documents “need not be identical to, but must not conflict” eliminates conflicts between different documents, which is the most frequent ground for the dishonor of documents presented under commercial LCs. Likewise, the application of this current rule has lessened the seller’s burden relating to documentary compliance. In other words, leeway accorded by the UCP 600 will be able to minimize the volume of discrepancies in documents presented by the seller as the requirement for compliance becomes simpler and easier to perform. It gives the bankers a greater degree of flexibility that should result in fewer discrepancies and rejections.\(^{[16]}\) This provision however does not objectively state the criteria of compliance. While it undoubtedly implies a wider compliance approach, it however opens up room for potential new disputes; for example, to what extent the data is not in conflict with each other.

Another provision in the UCP 600 that comforts the seller is Article 14(e) which allows the goods in all documents (other than the commercial invoice) to be described in general and not be in conflict with LC requirements.\(^{[17]}\) Furthermore, Article 14(j) provides that addresses of the beneficiary and applicant need not be the same as those in the credit, provided that they are in the same respective country. Thus, in the present position under the UCP 600, such non-compliance is no longer considered as discrepancy.

However, notwithstanding the tolerance offered by the UCP 600, it does not promise absolute leniency for the seller. The requirement of
strict compliance still remains in Article 18(c) relating to the description of the goods in a commercial invoice. It states:

The description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit.”

The above provision expressly maintains the requirement of strict compliance in commercial invoice. Generally, the leniency offered by the UCP 600 to other LC documents and addresses are not extended to commercial invoice since the phrase “must correspond” with the requirement of LC in Article 37(c) of the previous UCP 500 is still maintained. However, by virtue of Article 14(d) above, the phrase “must correspond” should be construed within the meaning of this provision, which offers less rigidity in documentary compliance.

Furthermore, the UCP 600 offers some leniencies and protections for bankers. The emergence of Article 16 of the UCP 600 has eased the tension suffered by banks in dealing with discrepant documents. The rule allows the bank to practice ‘conditional refusal.’ This procedure makes the bank’s duty to justify acceptance or refusal of the documents much easier. The bank may refuse to honor the draft under an LC if the presentation of the documents is not compliant. In doing so, the bank must notify the presenter by giving a notice of refusal. The notice must be given by telecommunication or by any expeditious means no later than the close of the fifth banking day following the day of presentation. The notice must state that:
(i) the bank has refused to honour

(ii) list down each discrepancy

(iii) (a) the bank is holding the documents pending further instruction from the presenter;

or,

(b) the issuing bank has requested a waiver of the discrepancies from the applicant and is holding the documents until it receives such a waiver and accepts it, or receives further instructions from the presenter prior to agreeing to accept a waiver,

or

(c) the bank is returning the documents; or

(d) the bank is acting in accordance with instructions previously received from the presenter.\[24\]

Failure by the bank to state clearly in the notice its refusal and rejection of the presentation of documents may preclude the bank from exercising its right of rejection. Merely sending a notice from the bank to acknowledge the discrepancies is not sufficient to constitute rejection.\[25\]

In addition, the UCP 600 provides disclaimers for the banks to protect them from any difficulties arising out of the documents and performance of LC transactions.\[26\]
Furthermore, this Article bestows mercy on the seller since he would have known whether or not the documents are discrepant and allows him to provide prior instructions to the issuing bank, and the buyer would have also been contacted before the documents arrived.\textsuperscript{[27]}

**STANDARD OF COMPLIANCE AND THE ISBP**

Apart from the UCP, another important reference that guides the banks in determining the international standard to be used in checking documents is the ISBP.\textsuperscript{[28]} The latest version is the ISBP 2013, ICC Publication No. 745. Thus far, the ISBP, which aims to reduce the number of documents rejected by banks, has already played a significant role in reducing international discrepancies. It contains a list of general principles relating to the standard practices for determining documentary compliance. The ISBP is referred to in cases whereby the rules of the UCP need clarification.\textsuperscript{[29]} The ISBP allows the transaction to continue in a normal way without hindering it. This has definitely contributed a lot in reducing discrepancies since the ISBP requires substantial compliance instead of strict literal compliance. It is basically done by examining the documents and neglecting minor non-compliance to be regarded as discrepancies.

However, it should be noted that the requirement that a presentation must be in accordance to the ISBP is not mandatory. Banks may only adopt the ISBP for clarification. They cannot rely only on the ISBP in deciding whether to reject or accept the presentation as it must be solely based on the UCP alone.
CONCLUSION

The application of the principle of strict compliance may put the buyer in difficulty if the seller’s documents are rejected for non-compliance. The buyer in such a case needs to wait for the seller to rectify the rejected documents since the buyer has to possess the documents to take delivery of the goods. This delay may affect the buyer’s business schedule and causes him to lose his business profit. Even though the buyer has the right to waive the discrepancies, in practice, the final say in most cases is still with the bank.

Obviously, the hindrance caused by the discrepancies of documents produces negative impact on the LC as a means of payment. This phenomenon should not be ignored as it affects the LC’s integrity as a recognized means of settlement in international trade. Once a document is found to contain discrepancies, the whole process is likely to be deferred. Such discrepancies trigger unnecessary hiccups, which may be temporary or permanent in the flow of LC procedures. In most cases, non-compliance disputes will open a leeway to court proceedings. The delays may definitely be prolonged as the litigation continues. In worse situations, delay of payment may end up causing possible loss of future trade.

The existence of the latest UCP 600 is claimed to provide leniency and a higher degree of compromise to the strict compliance principle. Wider strict compliance as suggested by the UCP 600 does not mean that the data content in any documents could go ‘unmatched’. Generally, it
only widens the scope of compliance where data in any document may differ expressly with one another but should not contradict each other. This is in line with the different purposes and functions of each document where the express wording contained in any one document may slightly differ with the expressed wording in other documents. This new approach of compliance is seen to ensure smoother payment under the LC rather than looking for discrepancies and rejecting such discrepant documents during the process of document examination.

In short, the current UCP 600 limits the depth of examination of documents by banks and provides leniency in resolving issues on discrepant documents where the trading parties, namely the buyer and the seller, equally have some binding say on how the discrepant documents should be dealt with. Generally, as far as ‘compliance’ is concerned, the UCP 600 can be said to encourage fair and equitable trade. Nevertheless, it is alleged that the adoption does not totally eradicate issues of compliance of documents in LC since the examination process of documents involves human intervention.\[30\] Therefore, discrepancies cannot be avoided completely no matter how well the UCP is written.*\[31\]

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Endnotes:


[9] Byrne, James E, School of Law, University of George Mason, USA ( Interviewed by author, Kuala Lumpur, 21 July 2009).


[18] Article 14(e), UCP 600.


[20] The new Article 16 of the UCP 600 has modified the terms of Article 14 of the UCP 500 in dealing with discrepant documents.

[21] See, Article 16(a), UCP 600.

[23] Article 16(d), UCP 600.

[24] Article 16(c), UCP 600.


[26] See, Articles 34, 35, 36 and 37, UCP 600.

[27] See, Langerich, n 23.


[29] For instance, the issues of what constitute discrepancy or non-compliance can be guided by the provisions of Rule 23, definition of invoice by Rules C1-C2 and description of goods by Rules C3-C14, ISBP.
