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## **CHINA'S NEW STATUTORY REGULATIONS ON LETTERS OF CREDIT**

Letters of credit are the most frequently used payment methods in complex international trade transactions. Despite the enormous literature dealing with the functioning and the characterizing features of this financial instrument, there are only some countries, which managed to create a definite law on letters of credit, or to define its real legal nature.

At the first time in 1954 the United States formed rules on letters of credit in the 5<sup>th</sup> Chapter of Uniform Commercial Code, which was revised in 1996, and in 2006. The latest version has adopted some of new approaches of international banking practices, especially the changes in UCP.<sup>1</sup> The next countries to follow the example of USA, were Canada and Australia, working out their rules based on the conception of USA Commercial Code. According to jurisdictions of these countries letters of credit are considered as contracts between an issuer and a beneficiary, and not only warranties, but the hierarchy of involved legal issues are regulated.

Certain provisions regulating letters of credit can be found in commercial laws of some Arabic countries<sup>2</sup>, fundamentally focusing on the undertaking of an issuer, on the presentation of a beneficiary. Formally these rules are very similar to UCP, but above all they fit to the general concept of Sharia, therefore the solutions may be quite different from the standard practice formulated by the international financial community.

There is no statutory law relating to letters of credit in most European countries and according to the general legal opinion, they are to be observed as a special accessory annex to the contract of a commercial transaction concluded by parties. The same point of view is taken by Hungarian courts as well.

Except the regulations of USA the Case Law defines how to judge the rightfulness or wrongfulness of an honor and defines the content of a "material fraud" and as a consequence the "fraud exception rule".

In 2006 China took a big step to development of the law on letters of credit enacting fundamental regulations about its working mechanism and on fraudulent

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<sup>1</sup> Uniform Customs and Practice for Documentary Credits, issued by International Chamber of Commerce (ICC).

<sup>2</sup> Oman, Arab Emirates, Yemen, Kuwait etc.

demand when issued the *“Provisions of the Supreme People’s Court of the People’s Republic of China on some Issues concerning the Trial of Cases of Disputes over Letter of Credit.”*

This new law is not only a milestone in jurisdiction of China, which was formed by thousands of verdicts of courts during the last 25 years, but it also means an outstanding achievement in the world of letters of credit.

This paper aims to present – and to some extent to criticize – the most important provisions of the Chinese “Rules”, pointing to the modern solutions (suggested to be followed) but to problems and inconsistencies as well.

The new “Rules” have adopted some provisions of USA Uniform Commercial Code and of UCP and took into consideration several judgments of English and European courts. They created a linkage to international banking practice saying in 2<sup>nd</sup> Article the following: “...if any stipulation is made by the parties concerned that the relevant international practices or other provisions should be applicable... such stipulation shall prevail; if no stipulation is made by the parties concerned, The Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce and other relevant international practices<sup>1</sup> shall be applicable to the case.”

To better understand the legal surroundings of letters of credit in China it is necessary to have some words about the connecting laws, especially about the Civil Code and the Contract Law, which declare the obligation of acting in good faith, of collaboration of parties, and of peaceful settlements of debates relating to problems of business dealings.

The Chinese Civil Code which has large similarity to civil laws of Roman-Germanic type unfortunately has failed to classify the legal context of a letter of credit and has not decided whether or not it is a contract.

It seems worthy mentioning the Law of Negotiable Instruments which plays a significant role in particular in letters of credit where bill of exchanges and bill of lading are involved. For all litigation processes concerning disputes over letters of credit, the Chinese Civil Procedure Law is to be applied, but if any foreign element is involved the regulations of a Memorandum from 1989 are also to be considered.

The 1<sup>st</sup> Article of the new “Rules” determines the situations to which the provisions refer, namely the disputes over “issuance, notification, revision, revocation, confirmation, negotiation and acceptance of letter of credit.” The phrases used suit basically to the wording of UCP, except the word of revocation, of which real content is not clearly defined. The word “revision” is likely to refer to the procedure of amendments.

According to the 3<sup>rd</sup> Article the term of “disputes” comprises problems in relationship between the applicant and the issuer with regard to the issuance of a letter of credit, and debates arising from the co-operation between the issuer and its entrusted parties related to the “entrustments” for the issuance. It is quite right that all aspects of an issuance belong to the competence of the “Rules”, but preliminary actions, such as the conduct of a contract of agency and of reimbursement between the applicant and the issuer, independently of the fact, that they are necessary for the issuance, are to be handled as separate transactions outside of the scope of the “Rule”.

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<sup>1</sup> ISBP International Standards Banking Practice issued by ICC.

It is remarkable that the 3<sup>rd</sup> Article introduces the term of “guarantor” stating that “disputes over the guarantor’s provisions of a guaranty for the application for the issuance of a letter of credit” must be subject to the “Rules”. It is not clear what the definition of “guarantor” and “guaranty contract” cover with special regard to the 16<sup>th</sup> Article: “In case he guarantor makes the request of exempting it from the guarantee obligations on the grounds that the issuing bank or the applicant accepts discrepancies without getting the consent of the guarantor, it shall not be supported by the people’s court, unless it is otherwise stipulated in the guaranty contract.”

In addition the 17<sup>th</sup> Article sets: “In case the applicant and the issuing bank revises the letter of credit without getting the consent of the guarantor, the guarantor shall only assume the guarantee obligation on the basis of the time limit and scope as stipulated in the original guaranty contract...”

Analyzing the meaning of the above mentioned paragraphs the following conclusions may be drawn. The person of confirmer seems to fit the person of a “guarantor”, who takes its payment obligation in its own discretion and in its own name therefore any action of an issuer will never have any impact on its activity. The term of “guaranty contract” is even more confusing and misleading. Firstly, the guaranty means an independent personal security according to civil codes of Roman-Germanic type, but the terms of the “Rules” is more likely to refer to the result of the confirmation procedure which is a new letter of credit. Secondly, the legal relationship between an issuer and a confirmer often takes the form of a contract of agency, or sometimes of a counter-letter of credit, but it should be always handled from the original transaction.

The 5<sup>th</sup> Article ensures the effect of the principle of independence and exactly clarifies the nature of a letter of credit, stating that the payment obligation of the issuer may not be affected by any moments of the underlying contract and therefore, “if a party concerned initiates a protest for the reason of the basic transaction between the applicant and beneficiary, the people’s court shall not support it, except the frauds, described in the 8<sup>th</sup> Article.” It is also stated that banks are dealing with documents which must be examined and checked exclusively on their face and within the given time specified in the letter of credit. In harmony with the general rules of documentary credits of UCP, the “Rules” provide that the unconditional and irrevocable payment obligation of an issuer can be enforced only when and if the presented “documents conform to each other on the surface”.

According to the 6<sup>th</sup> Article: “If the documents under a letter of credit do not completely conform to the clauses of the letter of credit, and the documents do not completely conform to each other on the surface, but there is no discrepancy between them, the people’s court shall not deem that any discrepancy has constituted.”

It means that an issuer is not entitled to reject the demand of the beneficiary, referring to pure formal mistakes. This clause is consonant with the 14<sup>th</sup> (b) paragraph of UCP 600<sup>1</sup> and which seems to give up the traditional examination practice of “strict compliance”, stating the following: “data in a document whom read in context with the credit, the document itself and the international standard banking practice, need not be identical, but must not conflict with, date in that document, any other

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<sup>1</sup> Entered into force in 1<sup>st</sup> of July 2007 and which may reflect the strong influence of negotiating groups of China and of other Asian countries.

stipulated document or credit". At present it is not foreseeable whether or not that amendment would result a positive effect on efficiency of functioning of letters of credit or on the contrary it would lead to more uncertainties.

On the other hand it became obvious that the radical fall of issuances of letters of credit during the last 5-8 years all over the world, is likely to be due to the incredible variety of potential defects, failures or mistakes arising from the rigid application of the principle of strict compliance.<sup>1</sup>

In case of *Industrial Bank of Korea (Seoul Head Office) v. Lianyuangang Kuchifuku Foods Ltd.*<sup>2</sup> of 2002, in which the Bank of China operated as a nominated person advising a letter of credit, the issuer dishonored the presentation of the beneficiary referring to the following alleged discrepancies:

Firstly it was stated that there was a difference in the name of goods written in commercial invoices and the packing list. In reality it was only one letter mistake, because instead of Lianyungang**g**, Lianyungand**d** (instead of "g", a "d") was written.

Secondly it was stated that the date of "receipt on board" was allegedly falsified. In fact the loading process failed to be finished on the day when it began, and it was ready only at 4. A.m. early morning, therefore the bill of lading was "backdated" to the previous day, precisely to 1<sup>st</sup> of June.

The beneficiary sued the issuer for wrongful dishonor and prevailed. The judge analyzing all the details and circumstances of the case stated that one letter difference might not have caused any real disturbances or any serious concern relating to the origin of goods or to identification of the beneficiary. Furthermore the given "backdated" bill of lading did not embody the intention of any abusive demand, since the beneficiary had fulfilled its performance, had shipped the required goods in full conformity with the contract, at the agreed manner and time. Thirdly the issuer was not able to provide any clear evidence to prove that "the 4-hours delay in loading" could have caused any irreparable harm to the applicant.

In case *Korea XIN HU Co. v. Sichuan Province Ouya Jingmao* the buyer stated that the seller XIN HU had falsified the bill of lading to be submitted to the draw of letter of credit and filed an appeal to the court with success and got a preliminary injunction, which stopped the payment of the issuer. The Court of Appeal explaining the final decision stated that the applicant (the buyer) was entitled to claim for a stop-payment order under circumstances, if it could provide clear evidence to the existence of fraud. The judge continued his arguments declaring that the two contracts may be connected to each other if an abusive demand or fraudulency was present in the transaction.

In case of *Tianjian Tiandatiancai Co. Shin-Etsu Chemical Co*<sup>3</sup>, the buyer and the seller concluded a long-term agreement of sales of fiber products. After issuance of letter of credit the price of fiber products fell down dramatically and the buyer wanted to change the contract claiming for price-reduction. Because the buyer failed to get rid of the contract in a peaceful way, alleged that there was a material fraud in the price and applied for a stop-payment injunction. At the end of the litigation process the appellate court stated that "two separate claims existed in this case: that the purchase agreement should be void, and the price fraud in the

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<sup>1</sup> The ICC experts have already identified 450-500 typical mistakes.

<sup>2</sup> DC Word 2006 June.

<sup>3</sup> Byrne (2006) pp. 452-454.

purchase agreement constitutes LC fraud exception.” However, no debate over changes of prices will meet the legal requirements of “fraud exception”, because it creates the elemental part of the commercial contract.

Firstly, these cases illustrate the acceptable method of examination of documents but at the same time lead to the “Fraud Rules” incorporated in 8<sup>th</sup> Article, which acknowledge the exception from the general and protected rule of autonomy, if

- 1) “The beneficiary forges documents or provides documents containing false information;
- 2) The beneficiary maliciously refuses to deliver the goods or delivers goods of no value;
- 3) The beneficiary provides false documents by colluding with the applicant or third party and there is not any true basic transaction; or
- 4) Other circumstances under which letter of credit fraud is conducted.”

The 2. point seems to be ambiguous because it does not clearly define whether or not the application of “Fraud Rules” needs beneficiary action in bad faith with a definitive intention to cause damages to its contracting party.

The use of phrase “delivers goods of no value” should be also disagreed since the decision whether or not the shipped goods have the agreed value or have any value at all, leads to the underlying contract and creates a link to the commercial transaction therefore it is likely to hurt the principle of independence.

The fundamental concept of “fraud exception rule” regulated by USA Uniform Commercial Code is reflecting in the 8<sup>th</sup> and 9<sup>th</sup> Article of the Chinese “Rules”, when they require the presumable advent of “irremediable losses”<sup>1</sup> as a precondition for a successful claim of a stop-payment order.

Nevertheless, it is not enough to state that the beneficiary is likely to draw the letter of credit in a fraudulent manner, it must be proved. Therefore it needs to examine the obligation of the proof and the acceptable measures of the proof to get an injunction with success for terminating of the issuer’s payment obligation.

It seems to be very hard to an issuer to provide clear evidence about abuse or fraud, because it is only entitled to check the presented documents on their face, and is not allowed to intervene into the underlying contract to get information or facts which are able to base its refusal. The allegations of an issuer are not allowed to be based on hearings or testimony of the applicant or of the “entrusted parties”. The applicant on the other side is obliged to “present evidential materials” to prove the existence of fraud, and to provide a “reliable and full guaranty” for potential losses and damages.

According to the judgment in case of *Heilongjiang v. Hualong*, which became one of the most frequently cited verdict in China, the judge stated the following:

“If the examination of presented documents on their face does not show any obvious sign of discrepancy and if there is no evidence for the existence of any fraudulent action, the law does not allow the applicant to prevent the issuer in paying the amount of the letter of credit.” The judge has also affirmed that the letter of credit and the contract of sales of goods are two separate dealings, and stated that any defect in the contracted goods does not create a cause, which may have any influence on the payment obligation under the letter of credit. Not even a serious defect of the delivered goods meets the minimum requirements of the use “fraud exception” rule.

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<sup>1</sup> In USA law: irreparable harm.

The “Rules” determine special situations when the issuer’s obligation to honor may not be deleted even if forged documents have been submitted or other abusive behavior of any party is present.

According to 10<sup>th</sup> Article no judgment may be made to terminate “the payment under the letter of credit” if:

- The nominee or entrusting party of the issuing bank in bona fide has made the payment according to the instructions of the issuing bank;
- The confirming bank, in bona fide, has performed the payment obligation;
- The negotiating bank, in bona fide, has negotiated the payment;

In addition, the applicant’s claim for “suspending the payment” should be deemed as delayed, if the issuer has already paid.

In case of *Rabobank v. Bank of China*, which was negotiated before the Court of Hong Kong, the Rabobank sued the issuer for wrongful dishonor and based its legal opinion on the following facts:

Rabobank, as “entrusting party” of the issuer Bank of China, negotiated the documents, having given adequate value for them. Since it acted in good faith, without notice of any fraudulency, got the right to claim reimbursement from the issuer, despite the actual situation, in which the beneficiary had made an abusive demand. Rabobank argued that it was free from any defects on the side of the beneficiary, because it had negotiated in bona fide. Actually the Rabobank had not given “real value”, that means had not provided any loan, but issued a new standby letter of credit in return of getting the right of the demand of the original standby letter of credit.<sup>1</sup>

The court rejected the arguments of Rabobank, declaring that an issuance of a letter of credit would never meet the requirements of the bearings of the “giving value”, because a payment obligation under a letter of credit creates only a contingent liability of an issuer.

The regulations of the new Chinese “Rules” ensure the same privileged position and protected legal status for any confirmer or any nominated persons, which they also enjoy according to the UCC<sup>2</sup> 5-109§ as follows:

“If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, the issuer shall honor the presentation, if honor is demanded by:

- 1) a nominated person who has given value in good faith and without notice of forgery or material fraud;
- 2) a confirmer who has honored its confirmation in good faith;
- 3) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance of the issuer or nominated person;
- 4) an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person;

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<sup>1</sup> This situation is called as a back-to-back letter of credit construction.

<sup>2</sup> USA Uniform Commercial Code.

According to UCC an issuer may not dishonor if a holder in due course of its draft<sup>1</sup> claims for it.

In case of *Finanz AG v. Guangdong Development Bank (Beijing Branch)*, the court took a more rigid point of view. In this case the issuer dishonored the demand of Finanz AG, which was “the holder in good faith”<sup>2</sup> of a bill of exchange issued by the beneficiary, made out to the issuer, Guangdong Development Bank. Despite the fact that the issuer had not even accepted the bill, and there was no signature of the issuer on it, the court decided to protect any bona fide holders and commanded the issuer to pay.

According to 7<sup>th</sup> Article “an issuer shall have the right and obligation to check the documents independently. It shall have the right to decide, on its own initiative, whether or not the documents conform to the clauses of the letter of credit...if the issuing bank finds that there is a discrepancy under the letter of credit, it may, on its own initiative, decide whether or not to contact the applicant to accept the discrepancy...the applicant decision...will not have any influence on the issuing bank’s final decision...”

Unfortunately, the new Chinese “Rules” have adopted the same provision of UCP<sup>3</sup>, of which necessity and existence have been questioned and discussed for a long time, and which is able to breach the quasi abstract character of the instrument.

A few of legal difficulties may arise from this provision.

Firstly, it is not quite clear and understandable why an issuer needs the applicant’s permission, if it is not compulsory for it, even if the applicant on the ground of the contract of agency has a ruling position against the issuer. This ambiguous provision is likely to make impossible that independent nature of a letter of credit will remain injured.

Secondly, if an issuer rejects the payment against the applicant’s will with special regard to autonomy of letters of credit and its action might cause damages and losses, the issuer must take the responsibility for it and must compensate all concerned parties including the immaterial losses (injury of goodwill) as well.

The author personally takes the points of those experts, who are against this paragraph, which must have been deleted from the new UCP 600.

On the other side the “Rules” correctly state that in case of any discrepancy a beneficiary will never get the right to enforce the payment even if the applicant would give its permission to an issuer, or would accept the beneficiary’s performance and will be ready to pay for it. The contracting parties have the opportunity to settle this problem outside of the framework of letters of credit.

If an appeal for preventing the issuer from the payment has been submitted to a court, it has only 48 hours to decide to issue a “stop-payment” injunction or not. This very short time of decisional procedure is based on the requirement of “evidential material” presented by the appellant. In contrary to some European countries an injunction is obligatory to all involved parties and must be executed immediately. Against the preliminary injunction an appeal may be filed, but the

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<sup>1</sup> A bill of exchange accepted by the issuer.

<sup>2</sup> The Chinese regulation for bill of exchange take more similarity to Geneva Convention than to English bill of exchange laws.

<sup>3</sup> 16§(b).

final decision is to be made within 10 days “from the date of receipt of reconsideration application.”

The new Chinese “Rules” on letters of credit mean an effective barrier to fraudulent transactions which have proliferated during the last ten years in China. To estimation of certain experts, 1500 different claims for injunction on wrongful dishonor have been submitted each year, but till 2006 courts had unlimited discretion to judge them. The percentage of frauds under letters of credit on average is not higher than it is in other countries, but the huge numbers of issuance because of rapid economic development of China may cause losses of million dollars to innocent parties and to the whole banking sector. Although the “Rules” have a solid legal basis for solution of disputes, they need a revision in order to make more precise some confusing provisions.

### **ABSTRACT**

This paper is purporting to give a critical analysis about the new Chinese provisions on letters of credit disputes, which came into force from 1<sup>st</sup> of January 2006. These new “Rules” direct the other countries how to develop the national jurisdiction in this field, adopting the best legal solution of the USA. Unfortunately, there are some ambiguous provisions, some of which are originating from the usage of International Chamber of Commerce (ICC), but there are others, which do not define to the required accuracy the tasks and the liabilities of involved parties. Nevertheless, it seems to be very useful to get to know these “Rules” and to illustrate their application on case studies.

### **LITERATURE**

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