

# E-Commerce and Letter of Credit Law and Practice

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## I. Introduction

Much in the current movement to realign commercial law in light of the e-commerce revolution can be traced to the processes of simplification and harmonization of the procedures surrounding international trade. They involved decade-long efforts to identify and articulate practices, and to develop formulae and forms that reflected these practices.<sup>1</sup> This convergence of rulemaking and trade simplification occurred at an early stage in the field of letters of credit (LC) because of its central role in international trade and commerce.

Indeed, in many respects the LC lends itself to a paperless transaction. The undertaking that it embodies is dematerialized. Unlike negotiable instruments in which the obligation is merged with the paper, the obligation of an issuer of an LC is not reified and honor is not necessarily, or even typically, conditioned on presentation of the original LC. Nonetheless, the LC is an undertaking conditioned on the presentation of documents. As a result, it has one foot in the world of electronic commerce and one foot in the world of paper documentation. The question for today is what efforts are being made to put both feet squarely in the world of e-commerce? The question for tomorrow is whether this product of nineteenth-century mercantilism has any long-term future in the twenty-first century.

## II. The Current LC Regime

In terms of issuance and payments, electronic letters of credit (eLC) were in place decades ago. The presentation of paperless documents under LCs is still developing.

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1. The extraordinary impact of international LC practice on domestic LC law is set forth in James J. White, *The Influence of International Practice on the Revision of Article 5 of the UCC*, 16 Nw. J. INT'L L. & BUS. 189 (1995) and James G. Barnes, *Internationalization of Revised UCC Article 5 (Letters of Credit)*, 16 Nw. J. INT'L L. & BUS. 215 (1995).

## A. ISSUANCE

By the end of the nineteenth century, LCs were regularly issued by telegraph, and major issuers developed code books containing shorthand expressions in order to reduce the cost of telegrams. In the early 1950s, the prior version of U.C.C. Article 5 provided for telegraphic issuance and signature of LCs.<sup>2</sup> After World War II, telegraph came to be displaced by telex and, with the development of SWIFT,<sup>3</sup> the inter-bank communication network, by a secure, closed system. In addition, in the past fifteen years, many major banks began developing computerized links to their major customers enabling them to initiate issuance of LCs on their own terminals and processing them through the issuing bank with interface to the bank's SWIFT terminal. Originally, these links were based on special proprietary systems with attendant start-up costs. Recently, banks have been using the Internet for bank-customer links. As a result, virtually all LCs have an electronic component in their issuance, and the vast majority are entirely electronic up to the point of transmission to the beneficiary.

The remaining barrier to electronic issuance is the linkage with the beneficiary. Historically, a local advising bank has fulfilled the role of communicating the LC to the beneficiary. The adviser provides practical assurance that the LC is authentic. While similar assurance is theoretically possible in a direct issuer-beneficiary communication, there is currently no practical or cost-effective means in place to deliver it. Until such time, or until the risks inherent in direct communication are known and acceptable, the last step in electronic issuance is unlikely to be taken. When it is taken, the role of advising banks as advisers is likely to disappear, although there may well continue to be a place for a local bank to receive presentation or make payment.<sup>4</sup> Questions of choice of law are thought to be settled with respect to disputes between either the issuer or confirmer on the one hand and the beneficiary on the other hand on the basis of the place of issuance or confirmation.<sup>5</sup> The global network of banking, however, may raise questions about where is the place of issuance of an e-credit, at least where the credit does not recite the place of issuance or confirmation, or that recital is not given effect on its face.<sup>6</sup>

## B. PAYMENTS

As with electronic issuance, electronic payment is not new to the LC field. Fund transfers have been possible and conducted since the early twentieth century. Transfers are facilitated

2. Prior U.C.C. § 5-104(2) (1992) provides that "[a] telegram may be a sufficient signed writing if it identifies its sender by an authorized authentication. The authentication may be in code and the authorized naming of the issuer in an advice of credit is a sufficient signing." Arguably, this provision is one of the first express statutory recognitions of electronic writings and signatures.

3. The Society for World-Wide Inter-bank Financial Telecommunications (SWIFT) is a private international cooperative society of over 2,500 banks and is headquartered in Belgium. It transmits financial messages. See Swift, <http://www.swift.com> (last visited Feb. 3, 2001).

4. The relevance of such banks is also impacted by the global consolidation of international banks through mergers and acquisitions. It is increasingly unlikely that an issuer will not have a presence in a local market.

5. Prior U.C.C. §§ 5-116(a)-(b); *U.N. Convention on Independent Guarantees and Stand-by Letters of Credit*, G.A. Res. 50/48, U.N. GAOR, 50th Sess., arts. 21-22, U.N. Doc. A/RES/50/48 (1995).

6. To date, however, there has been little concern or will to address this issue through rulemaking, a situation that will probably continue until the LC community is faced with a particularly unfortunate and expensive judicial decision that runs contrary to its expectations.

by the global payments system linking all the major banks in the world through New York and other international money centers, and have become the norm by which LC payments are made.

### C. EXAMINATION OF DOCUMENTS

The modern business environment of 24/7/365 is a real possibility in the examination of documents presented under an LC. Driven by market leaders such as Citibank, documents are examined on a continuous basis throughout the world. This step is made possible by establishing processing centers in different time zones and scanning documents that are then forwarded as one center closes and another opens. What is then examined is an image. While only a few banks are in a position to create similar systems, it is likely that, except for certain regional markets, the processing of LC documents will gravitate to the banks able to forge strategic alliances or to build and maintain such facilities. The operational risk for such a system is the need to “eyeball” the originals for information that would not be apparent on the scanned version such as superimposition of data.

### D. PRESENTATION OF DOCUMENTS

What is missing in current eLC practice is a provision for the electronic presentation of documents. On the whole, it is paper documents that are presented under LCs. There are important reasons and plausible explanations for the failure to electrify LC presentations. Many of them can be attributed to the transactions that give rise to LCs. For commercial LCs that support international trade, many of the documents to be presented must be in paper or original form to enable the applicant to obtain possession of the goods from carriers or warehousemen or to pass governmental tests necessary to import them. The absence of secure links between the issuer of the LC and the beneficiary or issuer of the documents also poses obstacles. Some issuers of commercial documents have not developed formats that are designed to be issued in an electronic format. Inertia is also a factor.

That is not to say that there are no current electronic presentations; merely that they are the exception. There is no inherent reason in the nature of an LC why a presentation cannot be electronic. But LC practice is grounded in a paper mentality. UCP500,<sup>7</sup> the international set of rules for commercial LCs, does not even expressly refer to paper, since it takes a paper presentation for granted. It is implied, but not stated, that presentation by an electronic medium would not comply unless expressly permitted by the terms and conditions of the credit.

There are two common situations where non-paper presentation is contemplated under current LC practice. Some LCs permit presentation by telefax, especially where only a demand is required or where time is a critical factor, such as for LCs backing payment of margin calls for commodity exchanges. In addition, where the beneficiary is another bank and the only required document is a demand, LCs routinely permit drawings by electronic means, such as a SWIFT message.

Notably, the LCs involved in these situations are standby LCs. Unlike commercial LCs, standbys rarely require presentation of documents that have inherent value. As a result,

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7. See ICC UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, ICC PUBLICATION No. 500 (rev. 1993) [hereinafter UCP500].

they are particularly well suited for electronic presentations. The rules of practice created for standby LCs, the International Standby Practices (ISP98),<sup>8</sup> provide that the normative medium for presentation under ISP standbys will be paper with the exception of a situation where only a demand is required and it is presented “via S.W.I.F.T., tested telex, or other similar authenticated means by a beneficiary that is a S.W.I.F.T. participant or a bank. . . .”<sup>9</sup> As explained in *The Official Commentary*, this rule “reflects the common practice of permitting beneficiaries linked to the issuer by methods or systems which permit authentication to make drawings by such means. . . . In such situations, the rule reverses the general norm, permitting electronic presentation unless the standby prohibits it.”<sup>10</sup> In addition, the ISP accords the issuer discretion to accept an electronic presentation from a beneficiary who is not linked to it by authenticated means although the issuer bears the risk that the presenter is the true beneficiary.<sup>11</sup>

The ISP also encourages electronic presentation by providing an optional glossary of terms that can be incorporated into standby LCs intended to permit electronic presentations. In ISP98 Rule 1.09(c), definitions are given for “electronic record,” “authenticate,” “electronic signature,” and “receipt.”

While these provisions represent an important step forward, they do not provide a clear distinction between telefaxes and the electronic transmission of data, and they leave many other important issues to the actual drafting of the text of the standby itself.

### III. Developments: eUCP

The recent e-commerce revolution will likely accelerate electronic presentations under letters of credit and the dematerialization of the documents used in trade. The principal challenges for electronic documents are government-generated documents, documents mandated by governments for export, import, or approval, and documents that embody rights with respect to property. Recent years have witnessed an acceleration of efforts on behalf of many governments to remove paper obstacles to trade and commerce in their regulations, and this process is accelerating. On the document-of-title front, SWIFT has joined with transport groups in the Bolero project to create a system by which title can be transferred by non-paper means pursuant to private rulemaking.<sup>12</sup>

In light of these developments, the LC community through the Commission on Banking Technique and Commerce of the International Chamber of Commerce has begun to develop rules for the electronic presentation of documents. To be known as the eUCP, these rules are intended to supplement UCP500 where a credit is issued subject to them. While the project is still underway at the time that this article is being written, it has yielded

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8. See INTERNATIONAL STANDBY PRACTICES, ISP98, ICC PUBLICATION No. 590 (1998) [hereinafter ISP98]; see also Institute of International Banking Law and Practice, *2001 Annual Survey of Letter of Credit Law and Practice*, at <http://www.iiblp.org> (last visited Feb. 3, 2001). ISP98 is available for purchase through the Institute of International Banking Law and Practice.

9. *Id.* R. 3.06(b).

10. JAMES E. BYRNE, *THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES* 110 (James Barnes ed., 1998).

11. ISP98, *supra* note 8, R. 3.06(b)(ii), 3.11(c).

12. See *Bolero: The Bolero Project*, in 1998 ANNUAL SURVEY OF LETTER OF CREDIT LAW & PRACTICE 389 (James E. Byrne ed., 1998); *The Bolero System: Paving the Way for a Paperless Future*, DOCUMENTARY CREDIT WORLD, Apr. 1997, at 16–22; see also Bolero.net, <http://www.bolero.net> (last visited Jan. 15, 2001).

important insights into the electrification of presentation of documents that have overarching significance for rulemaking in the brave new world of e-commerce.<sup>13</sup>

The eUCP project emphasizes the considerable significance of rules of practice for commerce. While legislation and regulation have their place, it is the formalized practices of the commercial community that will have the most significance for day-to-day commerce and will provide the needed flexibility to cope with the rapid pace of technological change. Contrary to the musings of certain doctrinaire theorists what is needed is not less lawmaking, but wise lawmaking with a realistic allocation of roles, with law deferring to the practical management of business affairs with sound rulemaking efforts and encouraging such efforts.

In any such effort, it is usually necessary to consider whether to develop rules exclusively for electronic activity or to address situations where both paper and electronic activity will occur. Wisely, the eUCP project has recognized that the current state of technology renders a dual approach essential if the project is to have any practical value, since there are irreducible paper documents in some situations. The rules address situations where both electronic and paper presentations are permitted under the same credit. Of course, such an approach adds considerable complexity to the exercise.

In considering the scope of the rules, it also becomes necessary to consider whether they should encompass only the electronic transmission of electronic data or also other technological approaches such as imaging or telefaxing. In the opinion of the Working Group, the latter technology presumed the existence of a document that was being scanned and transmitted, whereas the former involved situations where the document existed only in an electronic modality. Because of concerns in an LC context with the originality of documents, it was thought preferable to confine the eUCP to circumstances where there was only an e-document and no paper precursor.

A considerable portion of any effort at rulemaking for e-commerce must necessarily be devoted to linguistic concerns. One of the issues that must be addressed is whether to harmonize the definitions of inevitable terms such as "writing," "signed," and "document" with other international efforts at law or rulemaking. Wisely, the Drafting Group decided wherever possible to align its usage with important international efforts, particularly those of UNCITRAL. Other terms that have peculiar meaning or significance for letter of credit practice, such as "original," "on its face," "apparent," or "superimposed," also have required consideration. Several of these terms relate to fundamental principles of letter of credit law and practice, and in particular the independence of the credit transaction from the transaction that gave rise to it. In this respect, the increased possibility of authentication of sender, transmission, and of the contents of the data transmitted pose important questions and challenges to the role and obligations of banks in the LC transaction. While they offer important tools to combat commercial fraud (for example, the ability to check Lloyd's Directory automatically with respect to the registry of a named vessel and its location on a certain date), they also call into question the meaning of the independent nature of the LC transaction in the eLC.

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13. The project is under the co-chairmanship of Dan Taylor, President of the International Financial Services Association, and René Müller, Vice President, Crédit Suisse First Boston. The members of the Drafting Group are: James E. Byrne, Bill Cameron, Neil Chantry, Carlo Di Ninni, Winfried Holzwarth, Ron Katz, Laurence Kooy, Liu Yun Fei, Fredrik Lundberg, Salvatore Maccarone, Vincent Maulella, Paul Miserez, Vincent O'Brien, and Art Thomas. Although drafts have not yet been made public, information will be available through the International Chamber of Commerce at <http://www.iccwbo.org> (last visited Feb. 3, 2001). Completion of the eUCP is expected during the year 2001.

The eUCP rules must address certain aspects of normative conduct of the parties affected by e-presentation. In a paper regime, all documents are expected to be presented at the same time unless the credit permits otherwise. In an e-presentation, it is not possible to present all documents at the same time because the senders may be different entities and they may be sent by the same sender in different files. Where the presentation combines paper and electronic documents, these problems are compounded. As a result, it will be necessary for banks permitting e-presentations to archive presentations. It is also necessary to determine when a presentation occurs in the sense that the bank is required to examine it and the time to do so begins to run. This point in time has enormous significance for LC practice because, under mercantile practice, a bank is precluded from raising objections based on discrepancies that it has not timely raised. Under paper practice, that time starts when the documents are received. The burden is on the bank to inform the beneficiary that the presentation is incomplete. In an e-presentation, it will be necessary that the beneficiary or its document-traffic manager inform the bank when the presentation is complete.

It is also necessary to consider whether the electronic presentation of documents mandates shortening of the time in which documents may be examined by banks, with the draconian consequences of preclusion attendant on a failure to act in a timely manner made even more pressing.

Since LCs have been important components in trade finance, historically through the negotiation of time drafts and through the creation of bankers' acceptances, it remains to be seen whether LC practice can accommodate a draft-free world of trade. The concerns, of course, are the protection of nominated banks that act pursuant to their nomination in financing an apparently complying presentation under another bank's LC. In the deferred payment undertaking, the LC community has an ideal vehicle to offer the commercial world. These undertakings are the functional equivalent of bankers' acceptances without the paper component. Although this reality is embraced in rules such as the ISP,<sup>14</sup> it may take time (and perhaps legislation) before paper-minded courts can adapt themselves to the new world of e-trade.<sup>15</sup>

#### IV. Parallel Developments

In addition to such supplements to classical LC practice,<sup>16</sup> the e-revolution has spawned a wide variety of new products currently in various stages of roll-out. Some of these products, such as LCconnect, seek to provide a market in which applicants, beneficiaries, and banks can bid for LC issuances and confirmations, while others, such as QualityLC, attempt to improve the process of document issuance and presentation.<sup>17</sup> Other initiatives such as

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14. ISP98, *supra* note 8, R. 5.03. Rule 5.03 recognizes that the obligation of the issuer or confirmer arises on the failure to give timely notice of dishonor or acknowledgment of a presentation under a deferred-payment undertaking.

15. See Revised U.C.C. § 5-109(a)(1), which protects assignees of deferred payment obligations like holders of accepted drafts. Lacking statutory guidance, the English courts do not protect assignees of deferred obligations incurred under LCs. *Banco Santander SA v. Banque Paribas*, [1999] 2 All E.R. 18 (Comm) (*aff'd* *Banco Santander SA v. Bayern Ltd*, C.A. Feb. 25, 2000).

16. ICC Publishing has joined in a venture to make its rules and products more readily available to the international community in DC-PRO at <http://www.dcpprofessional.com> (last visited Jan. 15, 2001).

17. See LCconnect, <http://www.lcconnect.com> (last visited Jan. 15, 2001); Quality Letters of Credit, Inc., <http://www.qualitylc.com> (last visited Jan. 15, 2001).

bolero.net, originalsonline, and SWIFT,<sup>18</sup> to name a few, seek to replace the mails and courier services with secure and reliable Internet transmission of electronic records. Taking the eUCP's coverage of electronic presentation of documents under LCs one step further, @globaltrade offers other payment obligors in addition to banks. Other products would compete with the LC or attempt to reach markets not currently serviced by LCs, typically for reasons of price. Some of these cater to business-to-business (B2B) exchanges, while others are directed to the marketplace at large, and include Ariba,<sup>19</sup> Commerce One,<sup>20</sup> escrow.com,<sup>21</sup> Tradenable.com,<sup>22</sup> and TradeCard.<sup>23</sup> It remains to be seen whether those products that would compete can offer the assurance that has been provided by LCs and whether they will attract similar regulatory attention.

## V. Reflections

The LC and the system of correspondent banking on which it is founded face critical challenges in the age of e-commerce. Increased mechanical creation of documents will inevitably reduce (but probably not eliminate) discrepancies in documents. The consolidation of banks will reduce the need for confirming and negotiating banks. The inability of courts to align the rule of strict compliance with typographical, irrelevant, and extraneous errors, and differences between documents themselves and the terms of the LC, calls into question the very efficacy of the commercial LC practice and has driven many users to commercial standbys instead because of their relative simplicity.

All of these considerations and many more suggest that the LC of the twenty-first century will differ in important ways from its predecessor, the classical commercial LC. Nonetheless, basic fundamentals in trade suggest that LCs will be around in some form for the foreseeable future. As long as parties are not prepared to exchange goods for payment without the use of a third-party carrier and a trusted intermediary, either to effect payment or to back up the promise to pay based on something less or other than inspection and acceptance of the goods by the buyer, there is a need for an LC-like device. As long as parties need trade finance, there is a possibility for financing intermediaries to assess one party's creditworthiness, provide funds, and examine various indicators of apparent performance by the other party. LCs can admirably and efficiently serve these functions. If, through the inflexibility or inattention of the LC community, the LC in its present form should fall into disuse or disrepute, it will remain for a future generation to reinvent it.

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18. Bolero.net, *supra* note 12; Originals Online, <http://www.originalsonline.com> (last visited Jan. 15, 2001); SWIFT, *supra* note 3.

19. See Ariba, <http://www.ariba.com> (last visited Jan. 15, 2001).

20. See Commerce One, <http://www.commerceone.com> (last visited Jan. 15, 2001).

21. See escrow.com, <http://www.escrow.com> (last visited Jan. 15, 2001).

22. See Tradenable, <http://www.Tradenable.com> (last visited Jan. 15, 2001).

23. See TradeCard, <http://www.tradecard.com> (last visited Jan. 15, 2001).

