

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 frequently used method of payment 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, among others is to issue an LC for the buyer and pay on presentation of seller's documents which strictly comply to LC requirements. It is well-known that LC is governed by the principle of autonomy or also referred to as the principle of independence¹ which indicates LC, being a contract

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¹ The phrase "independence principle" instead of "autonomy principle" has been used in the following articles: D'Ascenzo, R, "The Supreme

of payment is totally separate from the underlying sales contract. Banks are concerned with documents only and not with the goods. LC transaction can be governed by the Uniform Custom and Practice for Documentary Credit, known as the UCP through express incorporation which provides the rules relating to LC matters and is adopted in almost all LC transactions. This paper discusses the nature, background and significance of principle of autonomy in LC transaction. In elaborating the provisions on the principle of autonomy in the UCP 600, comparisons between relevant articles in the UCP 500 are highlighted. The discussion also focuses on relevant case law and on the application of the autonomy principle in conventional and Islamic LC. The paper concludes with the finding that Malaysian bankers fully subscribe to the principle of autonomy as outlined by the UCP 600.

Keywords: letter of credit (LC), international trade, LC transactions, principle of autonomy, UCP 600, Islamic principles, banking practice.

PRINSIP AUTONOMI DALAM SURAT KREDIT: AMALAN MALAYSIA

ABSTRAK

Terma surat kredit (SK) lazim dalam perdagangan antarabangsa kerana ia adalah cara bayaran paling

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.

kerap oleh penjual dan pembeli dalam kontrak jualan mereka. SK berguna dengan memudahkan bayaran antara pembeli dan penjual dari negara berbeza, yang selalunya berpasangan terhadap satu sama lain dalam isu bayaran, terutamanya apabila urusan niaga itu membabitkan jumlah wang yang sangat besar. Dengan menggunakan SK, penjual dan pembeli akan diwakili oleh pengurus banknya sendiri yang berperanan, antara lain, untuk mengeluarkan sepucuk SK untuk pembeli dan membayar berdasarkan penyampaian dokumen penjual yang benar-benar mematuhi syarat SK. Sudah dimaklumi bahawa SK ditentukan oleh prinsip autonomi atau yang turut dirujuk sebagai prinsip kebebasan yang merupakan ciri SK, sebagai satu kontrak bayaran yang terpisah sepenuhnya daripada kontrak jualan asasi. Bank mementingkan dokumen sahaja dan tidak barang-barang. Urusan niaga SK boleh ditentukan oleh Adat dan Amalan Seragam untuk Kredit Berdokumen, dikenali sebagai UCP, melalui penggabungan jelas, yang menyediakan peraturan berkaitan dengan hal ehwal SK dan digunakan dalam hampir semua urusan niaga SK. Makalah ini membincangkan sifat, latar belakang dan kepentingan prinsip autonomi dalam urusan niaga SK. Dalam memperincikan peruntukan-peruntukan prinsip autonomi dalam UCP 600, perbandingan dengan artikel-artikel berkaitan dalam UCP 500 diserlahkan. Perbincangan turut memfokuskan kepada undang-undang kes yang berkaitan dan kepada pemakaian prinsip autonomi dalam SK konvensional dan Islami. Makalah ini diakhiri dengan dapatan bahawa pengurus bank Malaysia menerima sepenuhnya prinsip autonomi seperti yang digariskan oleh UCP 600.

Kata kunci: surat kredit (SK), perdagangan antarabangsa, urusan niaga SK, prinsip autonomi, UCP 600, prinsip Islami, amalan perbankan.

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.”² 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.”³

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.⁴ A great distance in location between both parties always invites worry due to lack of mutual trust. 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

² Harfield, Henry, “Secondary Uses of Commercial Credits,” *Columbia Law Review*, vol. 44, No. 6 (November, 1944), 899-913, at 899.

³ Article 2, UCP 600.

⁴ See, Appendix 1, Breakdown by Percentage: International Trade Product; Appendix 2: LC Usage By Region.

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

Literally, autonomy is defined as self-governing. It originates from a Greek word, *autonomia* which means ‘independent.’⁵ In the LC context, it denotes that LC is separate or independent from the underlying sale contract.⁶ The essence of LC contract discharges the bank from implicating itself of the underlying contracts between the buyer and the seller. In simple words, LC is only a contract of payment which is solely concerned with compliance of 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 ‘autonomy’ was not a disputable issue since traders and bankers customarily considered that goods were to be the “factor” in making a payment by banks.⁷

⁵ 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>.

⁶ Lord Diplock in the case of *United City Merchants (Investments) Ltd. v Royal Bank of Canada (The American Accord)*, [1983] 1 AC 168; It was 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 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 Lord Diplock 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.

⁷ See, Harfield, Henry “The Increasing Domestic Use of the Letter of Credit,” (1972) 4 U.C.C.L.J 251.

Similarly, the goods were the only determining factor to ensure that the transaction was free from fraud whereby banks would conduct a brief inspection to confirm the existence of the goods. But, as trade and commerce gradually developed in term of sophistication and complexity, a trend of ‘specialisation’ exploded and took over the world where banks were also not spared from refurbishment. Consequently, banks are confined to handling financial and papers only.

To date, this position remains 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 principle of autonomy becomes a distinctive identity of LC.⁸ 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 the bank’s undertaking to honour payment. Deviating from this practice means disaster for the system of financing.⁹

The principle of autonomy is derived from the main objective of LC itself that assures the seller will get “prompt payment” for the goods sold.¹⁰ It is observed that this practice has long been recognised in various English cases.¹¹ Hence, banks ultimately deal with the documents only 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 tender of documents that strictly comply with the contractual requirements regardless of whether the buyer is unable to pay or is bankrupt. Likewise, the bank must honour the payment irrespective of whether the goods are of sub-standard quality and not as per contract description.¹² Therefore,

⁸ See, article 4 and 5, UCP 600.

⁹ See, Chuah, Jason, *Law of International Trade*, Third Edition, Sweet & Maxwell, London, 2005, at 488.

¹⁰ Miller, I .Norman, “Legal Problems of International Trade,” (1959) U.III.L.F. 162, at 166, He in Online Database, retrieved 30 February, 2010.

¹¹ 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.

¹² Daihuisen, Jan, *International Commercial, Financial and Trade Law*, Hart Publishing Oxford and Portland, Oregon, 2000, at 338.

the bank must pay the seller on presentation of the required documents which strictly complies with the terms in the mandate even if the seller does not ship the goods; goods shipped are of poor quality,¹³ or totally different from contract description.¹⁴

Thus far, the literature abounds supporting the application of this principle which has been referred to as the central,¹⁵ sacrosanct,¹⁶ backbone,¹⁷ cornerstone,¹⁸ foundation¹⁹ and crucial²⁰ 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.²¹ Moreover, it has been exemplified as equivalent as "cash in hand."²²

¹³ *Hamzeh Malas & Sons v British Imex Industries* [1958] 2 Q.B.127.

¹⁴ *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 WLR 315.

¹⁵ 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.

¹⁶ 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.

¹⁷ 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&lpq=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.

¹⁸ 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.

¹⁹ D'Ascenzo, (2004), at 1097.

²⁰ Dolan, (2006), at 480.

²¹ 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.

²² 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.

SIGNIFICANCE OF PRINCIPLE OF AUTONOMY IN LC

In LC transaction, the bank is acting as a third party or middleman in making a payment on behalf of the buyer to the seller. This exclusive position of the bank necessitates high requirement of independence from influences arising from any dispute between the trading parties concerning goods or performance.

Thus, the principle of autonomy in LC transactions protects banks from being trapped in any disputes or possible litigations in the underlying contract.²³ It would defeat the purpose of the bank and its primary function in the economic cycle should the condition of the goods be made as one of the considerations in settling payment. To do this would mean that the banks and financial institutions have to employ individuals of undisputable knowledge in various tradable goods besides having only banking knowledge so to speak. On the other hand, it has always been perceived by the general public that banks are also to avail themselves to the underlying contracts or specifically the goods. This perception arises due to the interrelation between the goods shipped by the seller, payment by the bank and the taking delivery of the goods by the buyer which is only separated by a thin illegible line that is the definition of LC itself.

The other point in support of the application of principle of autonomy in LC is that banks should not be dragged into resolving disputes between seller and buyer. These disputes would cause delays in payment and would render the LC unattractive as a payment mechanism.²⁴ The effect is to restrict the role of banks involved in LC, in essence, to the ministerial functions of documents checking and the transmission of funds only.²⁵ Furthermore, the banks are not required to concern themselves to the realities of the underlying contractual position, with the sole exception

²³ 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.

²⁴ See, Ramberg, Jan, *International Commercial Transactions*, ICC Kluwer Law International, Stockholm, 2000, at 142.

²⁵ 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.

of fraud.²⁶ This limits the type of risk to which the banks are exposed and enables them to complete the transaction quickly and economically.²⁷

Moreover, it is established that the autonomy principle reduces the risk of non-payment when an applicant resorts to asserting defences such as breach of warranty.²⁸ 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 to in the documents. Banks only employ individuals who are competent in checking the documents as required by the standard banking practice.

As the paying agent, banks are concerned only with what the documents state. 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 room for disputes as employees of the banks are not experts in various types of goods.²⁹ The responsibility of a bank is only restricted in establishing the consistency of the data in the 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.³⁰ 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.

In addition, the autonomous nature of LC guarantees payment to the seller where on presentation of the named documents in compliance with the contract, he will get quick payment prior to the physical delivery of the goods to the buyer.³¹ Likewise, the buyer also can ensure correctness of the goods based on the content of seller's documents. Hence, the documents stand as proof that the actual and correct goods are shipped. Any non-compliance in the documents may give the right to the buyer's bank, to postpone payment. With this peculiar characteristic,

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ Gao Xiang & Ross P. Buckley (2003), at 122.

²⁹ See, Mc Kinnon LJ in *JH Rayner & Co. Ltd. v Hambro's Bank Ltd* [1943] 1 K.B. 37, at 41.

³⁰ See, article 14, UCP 600.

³¹ See, *O'Meara Co v National Park Bank*, 239 N.Y. 386, 397, 146 N.E. 635, 639 (1925).

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 of the development and modernization of trade practice worldwide.

PRINCIPLE OF AUTONOMY AND THE UCP

Even though, the principle of autonomy in LC is fundamental, the phrase “principle of autonomy” is not expressly stated by the UCP. Nevertheless, the autonomous nature of LC is reflected by certain provisions.³² In the latest version of the UCP, the relevant provisions with regards to autonomy principles are laid down in 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,

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Article 4, 5, UCP 600.

copies of the underlying contract, pro-forma invoice and the like.”

From article 4(a) quoted above, it is clear that LC emerges as a method of trade settlement from the sales contract agreed upon by buyer and seller. Despite emerging from the contract of sales, it is separate and independent from the said contract. The presence of a bank as one of the parties is specifically to execute payment without the slightest responsibility on the goods described in the contract of sale.³³ Moreover, the buyer and the seller at this juncture are in co-existence in two separate and independent contracts that is contract of sale³⁴ being the first contract and LC being the second contract.³⁵

The subject matter contained in the contract of sale remains solely the concern 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.

The new version of the UCP does not alter the autonomy provisions laid down by its predecessor that is the UCP 500.³⁶ It is even 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.³⁷ Therefore, it places an absolute prohibition to any inclusion of extraneous material and extremely detailed requirements which could give any leeway to unnecessary documentary burden.³⁸ Similarly, any part of the contract of sale or copies, even the

³³ See, article 34, UCP 600.

³⁴ This is an underlying sale contract entered into by seller and buyer.

³⁵ This is an LC payment contract entered into by both seller and buyer and the bank.

³⁶ 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.

³⁷ See, International Chamber of Commerce *ICC Commentary on the UCP 600*, 2007, at 28.

³⁸ See, Bergami, R, “What Can UCP 600 Do For You?” (2007) 11 VJ 1, at 3, Westlaw database, retrieved 12 May, 2008.

simplest form of sales contract that is pro-forma invoice, should not be included to form the 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 which in article 5(a)(i) 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 autonomy 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 autonomy point of view.

Prior to the UCP 600, it was generally the practice of some banks to issue LC bearing lengthy and detailed description of the goods to ensure delivery of the correct goods. 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, the LC is perceived to serve as the ‘guarantee’ instrument for goods by many customers. This misconception has long been established within the trading community and still persists, especially among those new traders or first time LC users. To mitigate this potential complexity and misconception, article 4 of the UCP 600 is amended to signify a stricter 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 buyer that LC by its nature is not concerned with the goods traded. 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.³⁹ 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 that 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 which is 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 principle, the question that may arise is whether the bank is totally excluded from the underlying transaction since banks are exclusively concerned with documents. 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 compliance⁴⁰ in LC operations. This is reflected by the SWIFT format MT 700/701,⁴¹

³⁹ International Chamber of Commerce ICC, *Commentary on the UCP 600*, 2007, at 31.

⁴⁰ Principle of strict compliance is another fundamental legal principle in LC. It is a legal principle which entitles the bank to reject documents which do not strictly comply with the terms of LC. See, Alan Davidson, “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.

⁴¹ 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, Lomnka. E,

which forms a complete transcription of what should take place within the given time frame. The issuing bank is fully aware of the criteria such as who is the buyer and 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 an insight 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 with 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.

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 comply 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.⁴² This is again, due to the fact that the bank does not deal with the

Hooley, R.J.A, *Modern banking Law*, Oxford University Press, New York, Third Edition, 2002, at 489; See also, Mei Pheng, Lee, Samen, Delta, *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.

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See, article 33, UCP 600.

goods, services or performance to which the documents may relate.⁴³ 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 rule within the autonomous framework form what is called the autonomous 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 for consideration by banks before making a payment. In other words, documents are the only ‘consideration’ for banks before making any decision whether or not payment should be honoured. Hence, requesting for excessive documents or inclusion of detailed and lengthy description would possibility lead to the seller’s failure 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.⁴⁴

Apart from all the provisions mentioned above, the UCP 600 has given autonomy to all types of LC by virtue of article 3 which ensures that all credits to be irrevocable. Prior to this provision, article 6 of the UCP 500 provided the parties a choice to revoke the issued LC. 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

⁴³ Article 5, UCP 600.

⁴⁴ 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.

by virtue of article 1. Revocable LC is embedded 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.⁴⁵ 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.⁴⁶

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 of the terms of the credit without reference to compliance with the terms of the underlying contract.⁴⁷

⁴⁵ R3 (Interviewed in Kuala Lumpur, 2 October, 2007), see, *infra* note 101.

⁴⁶ *Ibid.*

⁴⁷ 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.

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 indicates that during ancient time, common law courts were reluctant to recognise mercantile law (the precursor of LC), which disregards the common law concept of consideration.⁴⁸ Accordingly, it is established that it is not easy for common law to validate the 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.⁴⁹ It was only during the seventeenth century that mercantile principles were accepted by the common law courts irrespective of their disregard for the common law rules of contract and consideration.⁵⁰ The recognition of mercantile law by common law courts was based on the theory that custom of merchants were incorporated into the contract of the parties, custom having made significant contribution to the common law.⁵¹ Accordingly, LC and its unique nature of autonomy or independence which originated from mercantile law have since been accepted by common law.

⁴⁸ 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." 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.

⁴⁹ *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.

⁵⁰ 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.

⁵¹ See, Triamble (1948), supra n 48, at 988.

As a result of this acceptance, the importance of the principle of autonomy in LC transactions has been enhanced through case law.⁵² 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.⁵³ An earlier 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 points argued. The system should be kept as free as possible from technicalities and from unnecessary judicial dicta which may embarrass business dealings in future.”⁵⁴

The above dictum clearly supports the principle of autonomy and any acts which compromise this principle must be avoided. However,

⁵² See, Dolan, (1996), supra n 49 at 2-46.

⁵³ Reference can be made to English cases, such as, *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 Curber 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 Fleischvertreibe GmbH* [2002] 1 All ER (Comm) 257; For 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; For Canadian cases, 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; For 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.

⁵⁴ *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.

notwithstanding the above, it is often claimed that the lawyers and judges have failed to observe and give sufficient weight to the legal nature of autonomy of LC.⁵⁵ This comment indicates that there is no uniformity in the application of this principle and its privilege varies from case to case as well as from one jurisdiction to another jurisdiction.⁵⁶

The famous English case on this point is *Hamzeh Malas & Sons v British Imex Industries Ltd*,⁵⁷ where Lord Justice Jenkins remarked:

“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 an 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.”⁵⁸

Similarly, Jacob J in *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd*⁵⁹ stated that the principle of autonomy applicable in 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 courts have been reluctant to interfere with the LC transaction when all the tasks had been carried out properly. It was held by Lord Denning MR in *Power Curber International Ltd v National Bank of Kuwait SAK*:⁶⁰

“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-

⁵⁵ See, Gao Xiang & Ross P. Buckley (2003), at 92.

⁵⁶ See, Dolan, (2006), supra note 49.

⁵⁷ [1958] 2 QB 127.

⁵⁸ *Ibid*, at 129.

⁵⁹ [2003] 1 W.L.R 2214.

⁶⁰ [1981] WLR 1233, at 1241.

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”

The same conclusion was also reached by Stephen J in the leading Australian case of *Wood Hall Ltd v Pipeline Authority*⁶¹ in which he judge held that the autonomy principle is necessary to ensure that LC remains as good as cash.

A similar remark was highlighted in the leading Canadian case, *Angelica-Whitewear Ltd v Bank of Nova Scotia*,⁶² 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.”⁶³

Furthermore, it was decided in *Bolivinter Oil SA v Chase Manhattan Bank NA and Others*,⁶⁴ 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 judgment, Sir Johnson MR stated:

⁶¹ (1979) 141 CLR 443, at 457.

⁶² [1987] 1 S.C.R. 59 (S.C.C).

⁶³ *Ibid*, at 70.

⁶⁴ [1984] 1 WLR 392.

“Judges who are 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...”⁶⁵

On the other hand, the principle of autonomy is instantly eliminated in the case of fraud where strong proof of its existence could be established. Therefore, although 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 party alleging fraud. Hence, the undertaking to pay remains in force. Selvam J in *Agritrade International Pte Ltd v Industrial Commercial Bank of China*⁶⁶ stated 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.”⁶⁷

In relation to this issue, Dolan through his analysis of several cases suggests that the practice of a broad fraud inquiry by the court will corrode the autonomous nature of LCs and thereby destroy them as unique commercial devices.⁶⁸ The author concludes:

⁶⁵ *Ibid*, at 393.

⁶⁶ [1998] 3 SLR 211.

⁶⁷ [1998] 3 SLR 211, para 23, 219.

⁶⁸ Dolan, (2006), at 481, the author has analysed the issue of autonomy and fraud based on three cases from Australia, Canada and United States.

“...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.”⁶⁹

Thus, it is not easy for an injunction to override the absolute autonomy of LC. It is unanimously agreed that only in the very rare situation that a bank will set aside the application of the principle of autonomy in LCs transaction.⁷⁰ 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 in compliance with the terms of the credit.

In Malaysia, the autonomous nature of LC is highlighted in *Ka Wah Bank Limited v Hong Leong Bank Bhd & Ors*.⁷¹ In this case, the judge referred to the statement of Lord Diplock in *United City Merchants*⁷² in identifying the four categories of relationships in LC transactions.⁷³ Furthermore, the judge in referring to *Halsbury's Laws of England* stated that the beneficiary in LC transactions must not be concerned with the contractual relationships between the buyer or applicant for the credit and the issuing bank.⁷⁴

⁶⁹ *Ibid*, at 503.

⁷⁰ 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.

⁷¹ High Court (Kuala Lumpur) Originating Summons No C3-31-369 of 1986.

⁷² *Supra*, note 6 at 6.

⁷³ Syed Ahmad Idid J, *supra* note 71 at 8.

⁷⁴ *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.

This is the only Malaysian case which deals with the autonomy of LC as a focal point. This fact predicts two possible situations, either the principle of autonomy in LC transactions has been observed harmoniously and no dispute arises between banks and the customers on this issue, or such disputes do exist but these matters have either not been reported or they are settled without resorting to legal proceedings.

Research shows that conflicts between bankers and customers do exist but such matters are not normally brought before the court.⁷⁵ In most cases, the disputes are dealt as internal affairs.⁷⁶ Normally, the facts of the disputes have been recorded by the particular banks for their personal references and could not be disclosed to public. Factors such as reputation, length of times and enormous expenses incurred in legal proceeding are among the main reasons for the choice of alternative dispute resolutions.⁷⁷ 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 alternative methods of dispute settlements such as arbitration, mediation or conciliation outcomes do not result in binding legal principles.

Although Malaysian case law pertinent to issues of autonomy of LC is acutely lacking, cases which focus on the granting of injunctions in performance bond or guarantee cases can be relied on since “the performance guarantee stands on a similar footing to a letter of credit,”⁷⁸

⁷⁵ This fact is agreed by all respondents during the interview.

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

⁷⁸ 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 Cepak 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.

and similar legal principles are applied by courts.⁷⁹ In line with the Malaysian bankers' strict practice of autonomy in LC, local case law proves that the same line is taken by the local court.

For instance, in *Kirames Sdn Bhd v Federal Land Development Authority*,⁸⁰ Zakaria Yatim J cited with approval the English cases⁸¹ in setting aside the injunction restraining a demand for payment under the terms of the security guarantee.⁸² The learned judge held:

“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 guarantee. There is no evidence of fraud in this case. The injunction granted on 6 May 1986 is therefore set aside.”⁸³

The defendant had contracted to supply to the plaintiff reinforced concrete spun pipes. A dispute arose on the underlying contract. The plaintiff commenced proceedings and obtained an ex parte injunction restraining defendant's right to the security deposit. Allowing the defendant's application to set aside the injunction, 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.

⁷⁹ *Turkiye Is Bankasi AS v Bank of China* [1998] 1 Lloyd's Rep 250.

⁸⁰ [1991] 2 MLJ 198.

⁸¹ *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.

⁸² [1991] 2 MLJ 198 at 202.

⁸³ *Ibid.*

Similarly, in *Patel Holdings Sdn Bhd v Estet Pekebun Kecil & Anor*,⁸⁴ the court held that in the absence of notice of clear fraud the defendant must honour performance guarantees. In *Lee Contractors (M) Sdn Bhd (Formerly known as Lotterworld Engineering & Construction Sdn Bhd v Castle Inn Sdn Bhd & Anor)*,⁸⁵ it was held that underlying disputes must be settled between the contracting parties and such disputes would not affect the performance bond.⁸⁶ In order to justify any injunction to stop payment, there must be clear evidence of fraud on the part of the beneficiary.⁸⁷

Thus above cases are proof that the Malaysian courts have strictly preserved the integrity of the LC and treat it separately from disputes in the underlying sales contract. It is clear from those cases that the courts have reserved 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 restrain payment undertaking unless clear fraud can be established by the claimant.

APPLICATION OF PRINCIPLE OF AUTONOMY – MALAYSIAN PRACTICE

In Malaysia, LC mechanism either conventional or Islamic is used as a method of payment in international trade. Though the utilisation of Islamic LC is still new, its application is very encouraging. Currently, like other Islamic banking products, Islamic LC is offered not only by Islamic banks but also by conventional ones. The operational aspects of Islamic LC are very similar to conventional LC,⁸⁸ except it should exclude any

⁸⁴ [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.

⁸⁵ [2000] 3 MLJ 339.

⁸⁶ *Ibid*, at 340.

⁸⁷ *Ibid*.

⁸⁸ See, Lee Mei Pheng & Ivan Jeron Detta, *Islamic Banking and Finance Law*, Pearson Malaysia Sdn. Bhd, 2007, at 105.

element of *ribâ* (interest) and *gharâr* (uncertainty). It is governed by the same UCP which has standardised the operational aspects of various international financial instruments. An Islamic LC can be issued using either the principles of *wakâlah* (agency), *murâbahah* (mark-up sale) or *mushâarakah* (partnership).

In *wakâlah*⁸⁹ LC, there is an agency relationship between bank and customer, whereby the bank acts as agent of the customer (the buyer). Delegation of agency is where the customer or the applicant will hand over the instruction in writing to the bank by completing a standard form indicating details of the trade. The bank or the agent will act on the written instruction or request by the customer to issue the said LC. This written instruction acts as *‘aqad* (contract) which binds both parties to the agreement. From this point onwards, the bank as the agent will ensure that the LC reaches the exporter. The bank then undertakes to examine the documents as required by the UCP and to effect payment accordingly once the documents are found to be in compliance.⁹⁰

Acting as an agent, the issuing bank is only relaying the guarantee of payment to the seller. The bank is not a purchaser, but only an agent to make a payment on behalf of the buyer. The goods are in actual fact, fully paid for by the applicant from the deposit placed with the bank. Being an agent, the bank is entitled to receive commissions apart from the service charge obtained on issuance of the LC. It is customarily and expressly stated that the LC issuance fee in Malaysia is charged at 0.1% per month or part thereof based on the Malaysian amount equivalent until expiry.⁹¹ Currently, LC *wakâlah* is practiced by all full-fledged Islamic banks in Malaysia.

⁸⁹ The word *wakalah* literally means “preservation.” It is also means agency or delegating of a duty to another party for specific conditions, see, Dr. Wahbah Al-Zuhayli (2003) *Financial Transactions in Islamic Jurisprudence*, vol.1, Dar al-Fikr, Damascus – Syria, at 631. From banking’s perspective, *wakalah* is an agreement between customer and bank whereby the customer appoints the bank as his agent by authorizing the bank to act on his behalf. Under this concept, the bank acts as an agent in completing a particular financial transaction. As an agent, the bank will be paid a certain amount of fee for the service provided.

⁹⁰ Mei Pheng & Detta, at 108.

⁹¹ Association of Bank in Malaysia (ABM) Rules, H5 Commercial Letters of Credit or Authority and/or Guarantee. However, the rules have existed

Under *murabâḥah*⁹² LC, the bank will provide a financing facility to the customer or applicant where the customer is given a certain period of time to make a full settlement of the purchase, for example 30 days, 90 days or 120 days. The bank issues the LC and pays the purchase price to the exporter. Then the bank, through the documents of title of the goods, buys the said goods and resells them at a different price agreeable to the customer. The new selling price constitutes a mark-up of a certain profit above the original cost price. In this case, the customer is further assisted by a certain grace period in order to enable him to sell the goods to the final buyer. It also permits him to collect the sales proceeds before he is required to make full settlement to the bank. For instance, a customer engaging either in trading or manufacturing, may need to purchase merchandise or raw materials in the course of his business. The customer therefore requires the LC together with financing over a certain period of time. The Islamic bank can then offer him an LC *murabâḥah* facility.⁹³

since 1984 and have not been revised since then. It has no enforcement on the banks and most of the banks have applied their own specified charges.

⁹² “In its original Islamic connotation is simply a sale.” Muhammad Taqi Usmani (2002) Introduction to Islamic Finance, Kluwer Law International, The Hague, at 342. It is usually referred to as a mark-up sale or also known as trust sale which discloses the cost price and margin of profit in term of percentage or fixed amount.

⁹³ Example illustrated by Mei Pheng, & Detta, at 109; See also, Kamal Khir, at 126. To date, *murabâḥah* re presents more than 70 percent of all financial structures used by Islamic Financial Institutions (IFIs); see, Walid, S. Hegazy, “Islamic Business and Commercial Law: Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism,” (2007) 7 Chi. J. Int’L. 581, at 21-22, Westlaw database, retrieved 27 September, 2007. Some estimates suggest that *murâbahah* reached 80 to 90 percent of the total financing offered by IFIs (Islamic Financial Institution), the author had referred to Mohamed Elgari, “Credit Risk in Islamic Banking and Finance,” 10 Islamic Econ Stud 1, 21 (March, 2003). In Malaysia, it is said that 70 percent to 80 percent of *Sharfah* banking activities is under the concept of *murabâḥah*, see, Hamid Sultan Abu Backer, “Is there A Need for Legislative Intervention to Strengthen Syariah Banking and Financial Instrument?” [2002] 3 MLJA, LexisNexis Database, clxx, retrieved 18 February, 2008; the author also mentioned the same percentage on the concept of *bay' bithamin âjil*.

Under *mushâraakah*⁹⁴ LC, the bank issues the LC and both the bank and the customer contribute to the purchase price under LC. They later share the profits of the business venture based on the pre-agreed profit-sharing ratio. Losses are borne proportionate to capital contribution (in paying the purchase price). For instance, where a customer of the Islamic bank has been awarded a contract for supply of certain merchandise to a particular organisation, he may propose a joint-venture scheme whereby the bank grants him a credit facility in order for him to import and supply the merchandise. This joint venture proposal is known as *mushâraakah* which will be operated on the basis of profit-sharing.⁹⁵

As far as the principle of autonomy is concerned, it is applied with the same rigour in Islamic LC. Documents will be examined by the bank and compliance of documents constitutes the autonomous nature of LC which later prompts the buyer to settle the payment.

The previous discussion on case law in Malaysia shows that the principle of autonomy in LC transaction has been applied in line with the UCP provisions.⁹⁶ To investigate the practical application of principle of autonomy in LC transaction in Malaysia, interviews were conducted with Malaysian banks' key personnel and LC experts.⁹⁷

⁹⁴ *Mushâraakah* can be described as “an agreement, whereby the customer and the bank agree to combine financial resources to undertake any type of business venture and agree to manage the same according to the terms of the agreement.” Kamal Khir Gupta, L, Shanmugam, B, *Islamic Banking, A Practical Perspective*, 1st Edition, Longman, Malaysia, 2008, at 157.

⁹⁵ See, Kamal Khir et al, at 224-225; Mei Pheng & Detta, at 118; See also Central Bank of Malaysia website, <http://www.bnm.gov.my/index.php>.

⁹⁶ For a detailed discussion of Malaysian case law on autonomy of LC, refer to para 5 above, note 71 et seq.

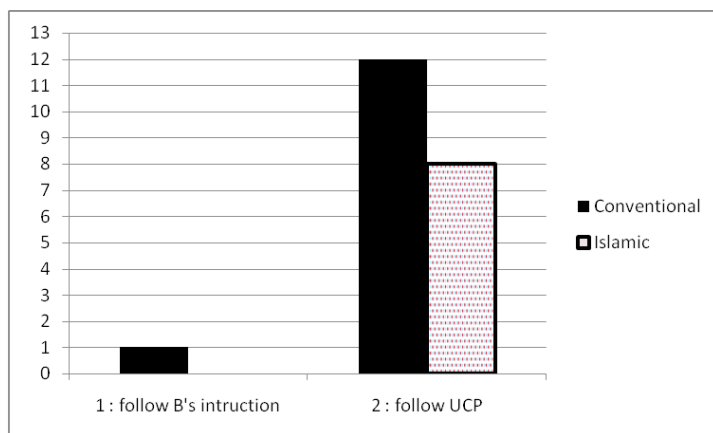
⁹⁷ Data collection was conducted by an in-depth face to face interview with respondents. This approach is claimed to be “especially helpful to obtain information that might be otherwise difficult to come by.” Salkind, Neil, J, *Exploring Research*, Seven Edition, Pearson Prentice Hall, USA, 2009, at 195; The respondents consist of eighteen (18) Head of Trade Finance of Malaysian Commercial Banks, three (3) LC trainers and one (1) prominent professor in LC. Structured questions were drafted which focus on issues of the application of principle of autonomy in LC. The interviewed data was analysed by using the Nvivo software version 8, “a qualitative data analysis (QDA) computer

For a clear interpretation on how and to what extent the principle of autonomy is practiced by Malaysian bankers, the responses are converted into tables or figures below.

Table 6.1 - 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	12	8

Figure 6.1 - Dispute between Seller and Buyer on Goods – Bank’s Action



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 reason of confidentiality and on the request of the respondents, their names are not disclosed. Accordingly, the respondents are addressed by using the capital letter “R” which is short form for “Respondent” and enumerated as R1,R2, R3.

If a dispute arises between seller and buyer regarding the condition of the goods in the sale contract, most banks do not get involved with such conflict. Based on table 6.1 and figure 6.1 above, as shown in column 2, majority of the bankers, twelve from conventional banks and eight from Islamic banks explained that they have followed the UCP rules in dealing with such disputes. One conventional banker explained:

“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 settle among themselves.”⁹⁸

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 was emphasized by one LC expert:

“Since the dispute concerns 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.”⁹⁹

However, only one conventional banker in column 1, out of twenty interviewed, entertained the buyer’s instruction to stop payment against defective goods shipped by the seller. This banker admitted that they will entertain buyer’s instruction if the goods delivered are sub-standard and totally of different quality as agreed in the sale contract. Besides, they will follow buyer’s instruction to postpone payment with the sole objective of preserving 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 absence of proper training. With regards to this practice, one LC expert commented:

⁹⁸ R4 (Interviewed in Kuala Lumpur, 10 April, 2008).

⁹⁹ R5 (Interviewed in Selangor, 25 April, 2009).

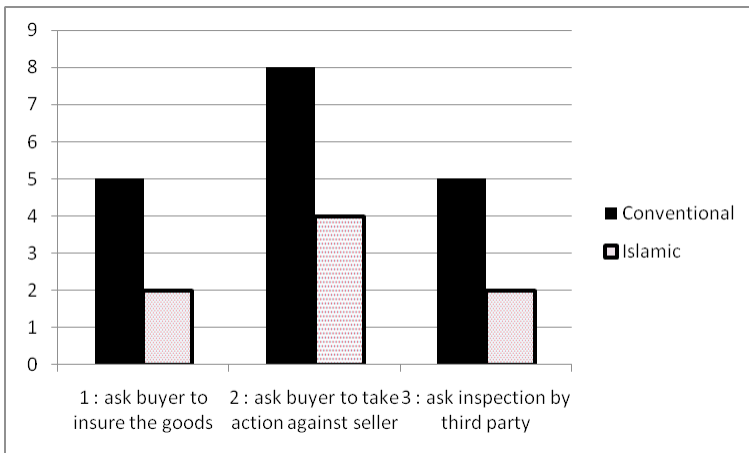
“If the bank listens to him (buyer), that’s something wrong with the banker, sometimes they do also (follow buyer’s instruction to stop payment), that’s the funny thing, sometimes they also make mistakes, because of ignorance, no proper training.”¹⁰⁰

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

Table 6.2 - 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	4
3 : Advise inspection by third party	5	2

Figure 6.2 - Dispute between Seller and Buyer on Goods – Bank’s advice



¹⁰⁰

R6 (Interviewed in Selangor, 23 April, 2009).

In dealing with the dispute between the buyer and the seller which is brought to the banks' attention, the first step taken by the banks is to reserve their interference. Majority of the banks as demonstrated by the table 6.2 and figure 6.2, column 2 above, will ask the buyer to look at their sale contract and take action against the seller for legal remedies. It was commented by one expert:

“Eventually, it will depend on the forms of disputes and in any case 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 against 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 to the Transport Company or insurance company but he must be mindful of non-insurable risks.”¹⁰¹

However, to enhance good relationship the banks may provide an advisory and networking services, such as checking with their branches or correspondent banks to introduce alternative 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 advice such as asking 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 conventional banker pointed 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.”¹⁰²

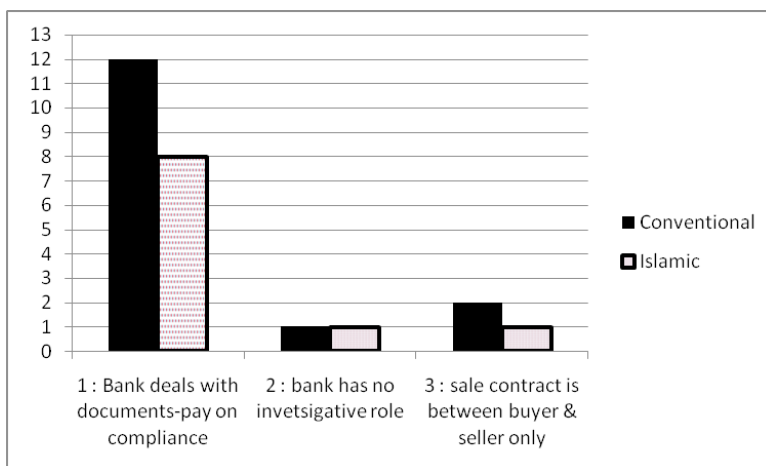
¹⁰¹ R7 (Interviewed in Kuala Lumpur, 24 July, 2008).

¹⁰² R8 (Interviewed in Kuala Lumpur, 21 March, 2008).

Table 6.3 - Banks Do Not Establish Contractual Goods Shipped by the Buyer

Banks Do Not Establish Goods comply with the Sale Contract	Conventional	Islamic
1 : Bank deals with documents & pay on compliance	12	8
2 : Bank has no investigative role	1	1
3 : Sale contract is between buyer & seller only	2	1

Figure 6.3 - Banks Do Not Establish Compliance of the Goods with Sale Contract



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 twenty bankers interviewed as shown by table 6.3 and figure 6.3 above, regardless of their types, do not check the compliance of the physical goods with sale contract.

The main reason highlighted by the banks, twelve from conventional and eight from Islamic banks as shown in column 1 is that they have to act in accordance with the UCP 600 provisions 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

documents only as required by the UCP¹⁰³ and as guided by the ISBP standard. An Islamic banker explained:

“We do not refer to buyer to establish correctness of the goods but we just refer to inform about discrepancy in documents.”¹⁰⁴

Similarly, the same approach was highlighted by one banker from a 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.”¹⁰⁵

Another conventional banker added 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, column 2 shows that the banks have no investigation role to check the physical goods. Furthermore, it can be seen in column 3 that two conventional bankers and one Islamic banker asserting that the sale contract is 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 matters relating to the goods but on documentary issues such as discrepancies or non-compliance of documents presented by the seller.

Table 6.4 - Buyer Asks Bank to Stop Payment

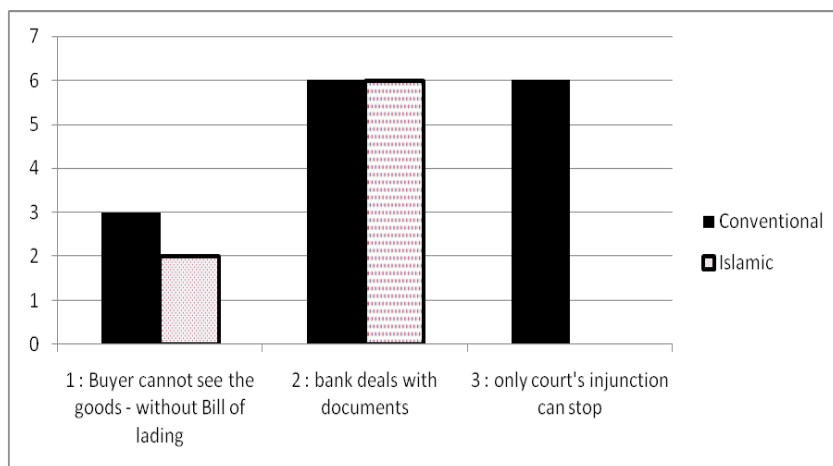
	Conventional	Islamic
1 : Buyer cannot see the goods – without bill of lading	3	2
2 : Remind the buyer - bank deals with documents only	6	6
3 : Only court's injunction can stop payment	6	0

¹⁰³ Article 4, 5, UCP 600.

¹⁰⁴ R9 (Interviewed in Kuala Lumpur, 19 March, 2009).

¹⁰⁵ R10 (Interviewed 9 April, 2008).

Figure 6.4 - Buyer Asks Bank to Stop Payment



In response to the situation whether banks have experienced a request from the buyers to stop payment due to conditions of the goods not complying with contractual descriptions, one conventional banker pointed out:

“Number of cases is minimal...it happens in one or two only out of 1000 transactions. Normally it happens in international trade”¹⁰⁶

Hence, majority of the bankers unanimously agree that it is very rare for the bank to receive a request or instruction to stop payment from the buyer. As shown in table 6.4 and figure 6.4, column 1 above, three bankers from conventional and two bankers from Islamic bank stated that such experience is rare in LC transaction since the buyer has no opportunity to check the goods which normally arrive after processing of 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 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.

¹⁰⁶

R11 (Interviewed 2 January, 2010).

Furthermore, it is explained that in order to clear the goods, the buyer must first obtain a Bill of lading which entitles 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, the buyer has no reason to ask the bank to stop or postpone payment.

On the other hand, it was clarified by one Islamic banker¹⁰⁷ that there are occasions where the goods may arrive earlier than the shipping documents.¹⁰⁸ 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 indemnity¹⁰⁹ in the form of shipping guarantee which entitles 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 for non compliance with the contractual description.

In addition, the bank may receive a request from the buyer to stop payment in the case of usance LC (deferred payment LC) where the seller beneficiary has agreed to give a certain period to the buyer to pay.¹¹⁰ In this case, it is possible for the buyer to request the bank to stop payment when he realizes that the goods delivered do not comply with the sale contract.

Obviously, in dealing with buyer's request to stop payment, majority of the banks, six from conventional banks and six from Islamic bank as shown in column 2, held that bankers follow the UCP strictly which requires them to deal with documents only and not with goods. As long as the disputes relate the goods, the problem should be resolved between the buyer and the seller based on the sales and purchase contract to which the bank is not a party. Thus, they will always remind the buyers that they are dealing with documents only and do not provide them an

¹⁰⁷ R12 (Interviewed 29 December, 2009).

¹⁰⁸ 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.

¹⁰⁹ "The bank usually demands a letter of indemnity from the person presenting the documents as a safeguard against any loss which may arise from the departure from its customer's mandate." Miller, at 188; for purpose and importance of letter of indemnity, see, Williams, Richard, *Letters of Indemnity*, (2009), 15 J.I.M.L., 394-410.

¹¹⁰ See, Abdul Latif Abdul Rahim, *Documentary Credits in International Trade*, Pelanduk Publications, Malaysia, 1990, at 28.

opportunity to submit any comments pertaining to the conditions of the goods or to ask the banks to stop payment due to dissatisfaction with the quality of the goods delivered by the seller.

Simultaneously column 3 shows that the most common situation according to six conventional bankers to stop payment is an injunction against the bank restraining payment. It is only upon receiving a valid court injunction, the issuing bank is bound by the court's order to stop payment. It was explained by one LC expert:

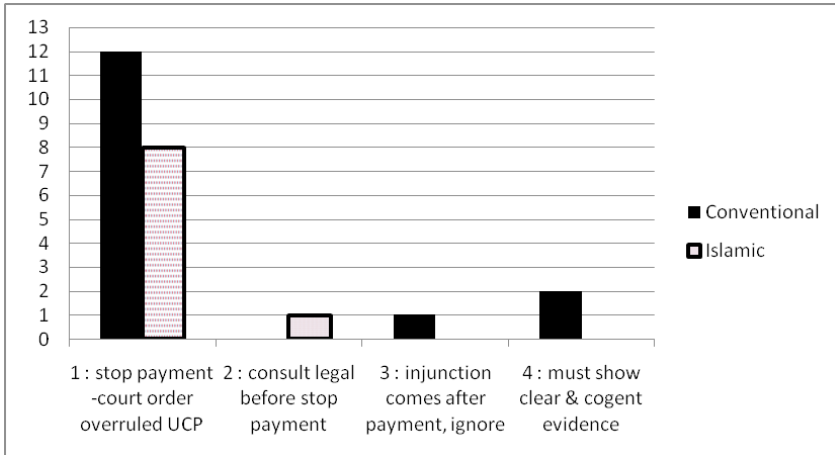
“...because law becomes more paramount than the UCP. If the buyer obtains injunction against the bank from making payment then the bank will not pay even the documents are in order.”¹¹¹

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 6.5 - Injunction to stop payment – Bank's action

Injunction to stop payment – Bank's action	Conventional	Islamic
1 : Stop payment - court order overruled UCP	12	8
2 : Consult legal counsel before stopping Payment	0	1
3 : Injunction comes after payment, ignore	1	0
4 : Must show clear & cogent evidence	2	0

¹¹¹ R13 (Interviewed in 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.

Figure 6.5 - Injunction to stop payment – Bank’s action

In a case where injunction is granted by the court and presented to the banks instructing them to stop payment, various actions are taken by them. Table 6.5 and figure 6.5 demonstrate that all the banks, that is twelve from conventional banks and eight 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:

“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.”¹¹²

However, the practice of the banks varies in dealing with such court order. Some banks may withhold payment by the time the injunction is served against them. On the other hand, certain banks as shown in column 2 may forward the injunction to legal department before stopping the payment. The legal department’s advice will be sought for the purpose

¹¹² R14 (Interviewed in Kuala Lumpur, 27 September, 2007).

of interpretation of the legal language relating to the injunction. In practice, reference to the legal department is just a matter of procedure which will not affect the effectiveness of the injunction.

Another point highlighted in column 3 is the bank's position when it receives the injunction after having made payment to the beneficiary. One banker from conventional bank stated that:

“Under LC, there is no compromise. If documents comply we have to pay. The question is whether injunction comes before or after the bank has made payment. The UCP has stated that if documents comply we have to pay. The dispute is between buyer and supplier, nothing to do with bank.”¹¹³

Therefore, if the injunction is served after the bank has made payment, the bank's action prevails. In this situation, the proper procedure for the bank is to apply for 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 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.”¹¹⁴

In addition, as far as injunction is concerned, like in a normal case involving court's injunction, two conventional bankers as shown in column 4, emphasised that clear and cogent evidence must be adduced 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 have complied with 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 documents¹¹⁵ and in most cases documents prevail

¹¹³ R15 (Interviewed in Kuala Lumpur, 24 October, 2008).

¹¹⁴ R16 (Interviewed in Kuala Lumpur, 21 March, 2008).

¹¹⁵ The latest version is ISBP (2007) ICC Publication No. 645 E. With respect

over the goods. Except in the case of clear fraud and injunction, the principle of autonomy prevails against any disputes arising out of the underlying sales contract. In such a situation, the banks will not get involved 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.¹¹⁶ Furthermore, should the bank fail to observe the principle of autonomy, this will expose the bank to court litigation.

CONCLUSION

As far as Malaysian position is concerned, this study shows that the principle of autonomy evident in case law is harmoniously applied in banking practice. So far, there is no argument on the application of the principle of autonomy in Malaysian case law where courts have always been in complete accord with the same and have yet to depart from it.¹¹⁷

Likewise, the practice of Malaysian banks has always respected the independent arrangement of LC where their undertaking is absolutely restricted to matters pertaining to documents only.¹¹⁸

Eventually, the irrevocable undertaking of the LC cannot be affected by the disagreement between the seller and the buyer relating to the conditions of the goods nor can it be tampered with breach of the sale contract by any of the 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. However, it is suggested that "principle of autonomy should not be extended to protect

to "standard practice," stated generally, all banks follow the standard guideline outlined by the ISBP.

¹¹⁶ R17 (Interviewed in Kuala Lumpur, 24 March, 2008).

¹¹⁷ Supra note 71.

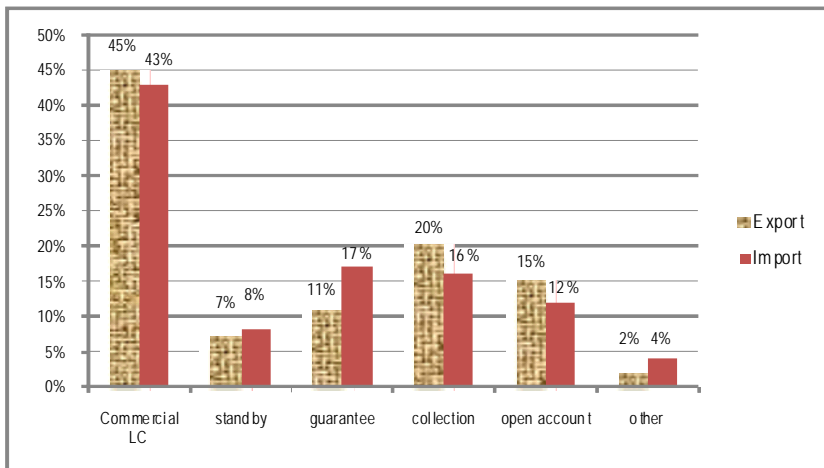
¹¹⁸ Supra note 99 et seq.

an unscrupulous seller”¹¹⁹ and “placing blind faith in the autonomy principle will no longer suffice.”¹²⁰ As commented by one academic expert:

“I would never place blind faith in the autonomy principle, but I’ve realized that some people believe that it should be absolute. I think that it is incorrect. I think it is just dangerous if LC becomes known as a tool to commit fraud, or to facilitate fraud. LC can be easily enjoined so there is a need for balance that is a balance of a fall on the side of making it difficult but not impossible to obtain an injunction.”¹²¹

APPENDIX 1

Figure 1 - Breakdown, by percentage, mode of financing international trade



¹¹⁹ *Sztejn v Henry Schroder Banking Corporation* (1941) 31 NYS 2nd 631, per Shientag J, at 634.

¹²⁰ Dixon, 2006, at 1.

¹²¹ Professor James Bryne, School of Law, University of George Mason, USA (Interviewed in Kuala Lumpur, 23 April, 2009).

“When respondents were asked to indicate the percentage breakdown, by volume, of the type of trade finance products handled by their trade finance departments for 2009, they responded that the majority of transactions, for both export and import transactions, by volume, were commercial letters of credit.”

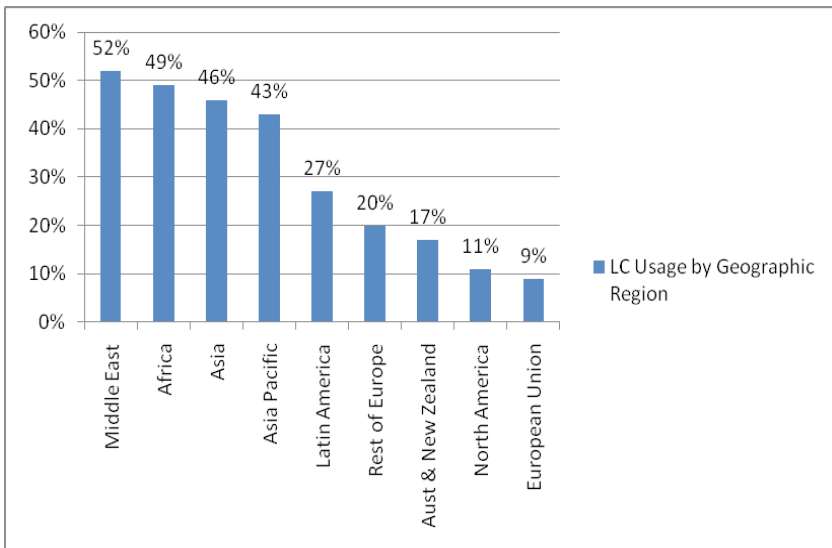
It is however noted by this survey that “historically, open account has been understood to be in the region of 80-85% of world trade. It is widely expected that this figure fell between 2007 and 2009 as exporters sought a more secure method of settlement.”

Source: An ICC Banking Commission Market Intelligence Report Rethinking Trade Finance 2010: Global Survey, 2010, at 33.

APPENDIX 2

Figure 2 - Volume of LC used by Geographic Region

Source: SITPRO’s LC Report, 11 April, 2003.



Source: SITPRO’s LC Report, 11 April, 2003.