

INNOVATIONS

The Principle of Autonomy of Letter of Credits: Its Justifications and Application under the Commercial Code of Ethiopia

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Abstract

Letter of Credit is an indispensable document in the international sale of goods. International sale of goods probably may be very cumbersome without this vital document. This article tries to critically analyze the principle of autonomy of letter of credits focusing on its justifications and applications under the commercial code of Ethiopia by employing doctrinal legal research methodology and analytical approach. The commercial code of Ethiopia is a domestic law that tries to address the issues of letter of credits in general and principle of autonomy of letter of credits in particular. However, the code is not congruent with and detail like international instruments dealing with letter of credits and its principle of autonomy—the Uniform Customs and Practice to Documentary Credits and Uniform Commercial Code. This has an impact on international sale of goods to which Ethiopia is a party and hence this call for revision of the pertinent provisions of the commercial code of Ethiopia.

Key Words: 1. Letter of Credits 2. Principle of Autonomy 3. Ethiopia 4. Commercial Code

Introduction

It is obvious that international trade is a sort of business transaction that is often conducted across trans-boundaries. International trade may be defined in multifold perspectives. It is the sale and purchase of goods and services crossing international borders. ^[1] As per dictionary of international trade, it is defined as a different type of activities from domestic trade, and more complicated one, given that buyer and seller are in different countries. ^[2]

The parties to international trade don't have full information of each other and they are distant far from each other, even due to differing laws in each country but they need to transact business with each other, hence, the letter of credits the way they can do away with such barriers. The fact that it is difficult to discharge payment through traditional method of payment is also another factor that necessitates the letter of credit in international trade.

1. The Concept of Letter of Credits

In international trade, phrases documentary credit or letter of credit are usually used interchangeably. ^[3] The writer also uses these phrases interchangeably throughout the paper. Documentary credits are a payment method that ensures that the exporter will receive payment immediately after the goods have been sent to importer. According to Kozolchyk, it is described as a type of mercantile currency consisting an abstract promise of payment which

possesses high immunity from attack on the ground of breach of duty of the seller to the buyer. [4]Another academician articulates it as “a money promise which is independent of a transaction that it gives birth and which is considered binding when received by the beneficiary without acceptance, consideration, reliance or execution in the solemn form.” [5]

It is also a financing method and a kind of guarantee as bank issuing the documentary credit guarantees that the exporter will receive payment once the terms of the documentary credit have been met and after the goods are delivered in due time. [6] Thus, documentary credits are often used when the parties to an international trade don't know each other and the exporter doesn't want to send goods to the importer without being sure that payment will be made. Letters of credit is also arrangements whereby a bank at the request of the purchaser permitted another bank if during a certain period to the seller, the buyer order goods transport document in accordance with conditions stipulated in credit give to the bank, maximum amount of credit to pay or promise to pay and then mentioned letters send to transfer to the buyer for ordering bank. [7]

Literally, letter of credit means a letter written by the buyer's bank to the seller's bank promising that they guarantee to pay the seller in case of the buyer's default. Therefore, documentary credits deal in documents, not goods, and hence, the bank scrutinizes 'documents' and 'not goods' for making payment.

It is also defined as “credit means any arrangement, however, named or described, that is irrevocable and thereby constitutes a definite undertaking of issuing bank to honor a complying presentation.” [8]Documentary credits is a means of making national or international payments by substituting a bank for the buyer as a party who guarantees and makes the payments. [9]As a result of its high importance in the international trade, documentary credit is described as the “life blood of international trade.” [10]

2. The Notion of the Principle of Autonomy of Letter of Credits

Letter of credit is separate transaction from contract of sale of goods in international trade or other contracts on which it may be based as it could be understandable from International Chamber of Commerce for Uniform Customs and Practice which reads:

“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 to it is included in the credit.” [11]

Thus, the documentary letter of credit is autonomous of other transactions in international trade. In other words, banks deal with the documentary letter of credit and not with the goods, service or performance to which the document may relate [12] or any other transaction except in case of exceptions such as fraud, nullity. Mentioning differently, the principle of autonomy of letter of credit states that financial transaction is essentially separate and independent from the underlying sale contract. As a result, any dispute in the framework of contract between the parties should be seen separately from issues related to the letter of credit *per se*.

Therefore, the principle of autonomy of letter of credit indicates that any failure of beneficiary to comply with his/her obligation in underlying contract and delivery of goods with promised quantity or quality will neither affect bank's obligation to pay him/her after receiving complying presentation nor buyer's obligation to reimburse the issuing bank which has honored a complying presentation.

That is also why this principle is considered as “an engine behind letter of credit”^[13] or “a corner stone of the validity of letter of credit.”^[14]

Shortly, as the name speaks for itself, the principle of autonomy of letter of credit unequivocally provides that credit transaction is essentially independent of the underlying sale agreement in international business transactions.

3. Conceptual Frameworks About Letter of Credits

In the preceding discussion we have seen about definition of letter of credit and a pillar principle behind the application of this document in international trade. At this juncture, it is important to raise some conceptual frameworks about the letter of credit as explained hereunder.

3.1 Historical Development of Letter of Credits

In the history of international trade, merchants usually carry out huge amount of cash to buy goods from the sellers, which is traditional mode of payment and this exposed them for a lot of problems.^[15] In eighteenth century, banks started to issue a formal letter of introduction, which became known as Traveler’s Letter of Credit, addressed to the issuing bank’s correspondents and agents abroad as way out to the problem.^[16]

This helps the merchants to avoid carrying cash to buy goods as the sellers would get the payment from the banks abroad. This usage of Traveler’s Letter of Credit continued for a couple of years.^[17] However, as international trade became more and more complex, this document was no longer sufficient to serve as significant method of payment in international trade. Due to inconveniences it creates and for the fact that it is expensive as well as it raises conflict between the parties, a method of payment in which neither the buyer nor the seller has influence, a bank as third party and letter of credit as mode of payment in international trade was introduced.^[18]

3.2 Parties to Letter of Credits

In the foregoing explanation, it is clearly addressed that letter of credit is a document that is serving as a convenient method of payment in international trade. Parties to letter of credits are:

3.2.1 Issuing Bank

This party to letter of credit is the banker of the importer who issues letter of credit and makes payment to the exporter and is a bank in the country of buyer.^[19] Its liability to pay payment to exporter and to be reimbursed from its buyer becomes absolute upon the completion of the terms and conditions of the letter of credit.^[20]

3.2.2 Advising Bank

An advising bank, usually a foreign correspondent bank of the issuing bank that will advise the beneficiary.^[21] Generally, the beneficiary would want to use a local bank to ensure that the letter of credit is valid. Besides this, the advising bank would be responsible for sending the documents to the issuing bank.^[22] The advising bank has no other obligation under the letter of credit. If the issuing bank doesn’t pay the beneficiary, the advising bank is not obligated to pay.^[23]

3.2.3 Confirming Bank

The correspondent bank may confirm the letter of credit for the beneficiary at the request or authorization of issuing bank. ^[24] At the request of the issuing bank, the correspondent obliges itself to ensure payment under the letter of credit. This is how confirming bank is different from the advising bank. The confirming bank would not confirm the credit until it evaluates the country and bank where the letter of credit originates. The confirming bank is usually the advising bank but not necessarily. Therefore, advising and confirming bank may be the same or different.

3.2.4 Beneficiary

A person in whose favor the letter of credit is issued is another party to letter of credit. ^[25] Beneficiary is seller of goods who enter into contract of sale of goods with the buyer in international business transaction.

3.2.5 Applicant

Applicant is a buyer at the request of whom the letter of credit is issued. ^[26] Issuing Bank issue letter of credit and make payment to the exporter on behalf of the applicant.

5. The Justification and Application of Autonomy Principle of Letter of Credits under the Commercial Code of Ethiopia

We have seen hereinabove that letter of credit is separate transaction from contract of sale of goods in international trade or other contracts on which it may be based. This clearly indicates that letter of credit is independent from the underlying transaction. ^[27] Thus, the payment obligation of issuing bank doesn't depend on the underlying contract between applicant and the bank. In other words, the emitting bank cannot reject performance of its obligation by referring to non-performance of obligations by other parties to the transaction. This is known as principle of autonomy of letters of credit.

5.1 Justification of Autonomy Principle of Letters of Credits under Commercial Code of Ethiopia

One of the pillar principles on which letters of credit is built up on is the principle of autonomy of letters credit. And as aforementioned, this principle of autonomy of letters of credit is recognized under article 959 (2) of the commercial code of Ethiopia:

A documentary credit is independent of any contract of sale on which it may be based and to which a bank is not a party. ^[28]

This provision of commercial code unequivocally tells us that, due to inherent cardinal principle of autonomy of letters of credit, obligation of the parties to it never depends on the contract of sale of goods or service which is concluded most probably only between the importer and the exporter. Thus, the obligation of issuing bank, paying the worth of goods which are subject matter of the underlying contract to the beneficiary doesn't depend on the performance or otherwise of underlying contract by beneficiary. ^[29]

One of the justifications behind such autonomous nature of letters of credit is that the issuing bank assumes the liability of paying to the beneficiary, and exclusively deal with the documents and not

with the goods or service to which document may relate. ^[30]That is, the code enshrined that payment is made against presentation of specified documents, not against the shipment of goods or up on performance of the underlying contract in general. Thus, because of the fact that the obligation of issuing bank is limited to ensuring that the documents are compliant, as we can understand from article 959 (1), not whether exporter has actually performed his/her duties of shipping goods and, therefore, whether documents are goods at all, the letters of credit is autonomous.

The principle of autonomy of letters of credit can also be justified by the fact that viability of letters of credit as a mechanism of payment in international trade finance is very questionable unless letter of credit is separate from other transactions to which it may relate. The very spirit of commercial code section 4 which governs documentary credits seems weigh a place for this justification as a domestic law governing documentary credits and thereby tie the jurisdiction to international trade. Thus, for letters of credit to serve as payment mechanism in international trade of sale of goods or service, it needs to have continued viability.

The obligation of the issuer of letters credit to pay the exporter is independent of whether the latter has performed or otherwise the main contract because of the fact that letter of credit is a separate transaction both from contract of sale of goods concluded between applicant and beneficiary as well as from credit application agreement which usually demands the issuing bank to honor conforming documents which exclusively governs the relationship between the issuing bank and applicant. ^[31]

Thus, by virtue of article 959(2) of commercial code, the principle of autonomy of documentary credit is justified by the fact that the credit is separate from the underlying contract though issuance of documentary credit may not be applied for where there is no contract of sale which we may call as main obligation. Indeed, due to specific nature of letter of credit, the principle of original obligation and subsidiary obligation relationship that apply in the case of law of contracts doesn't holds true here. This is what rules of documentary credits clearly so provides including uniform customs and practice for documentary credits and Ethiopia commercial code article 959 (2).

The other justification behind the autonomy principle of letter of credit is that because it ensures or guarantees the payment to the beneficiary on implicit understanding that the latter will comply with agreed terms of underlying transaction that gave rise to the credit. ^[32] This plays pivotal role in the smooth functioning of international trade, on one hand, and secures the beneficiary, on the other hand. Thus, the seller should not be deprived of payment for the facts that happened out of the documentary credits which is separate from the contract which stipulates about terms and conditions of contract of sale of goods under question. For instance, though the applicant declared bankrupt after letter of credit is issued, the issuing bank cannot reject payment for the beneficiary. This guarantees payment for exporter.

Not only for continued viability of letter of credit but also for continued utility of letters of credit as convenient mechanism of payment in international trade, strictest observance of the principle of autonomy is a must. Thus, it is tenable to argue that the spirit of commercial code provisions dealing with documentary credit, articles 959-967, incorporates the principle of autonomy of letter of credit under article 959(2) because of the need to continue the utility of the letter of credit as method of payment in international trade as the country could hardly engage in international trade without this internationally convened mechanism of payment of international contract of sale of goods.

5.2 Application of Autonomy Principle of Letter of credits under the Commercial Code of Ethiopia

As far as the application of the principle of autonomy letters of credit under commercial code is concerned, a lot of issues in relation its application may be raised. It doesn't, to begin with, apply to matters which are under the subject matter of the underlying contract. Thus, it has no linkage with terms and conditions under the main obligation nor with goods. Mentioning differently, its application is limited to the stipulations of letter of credit. That is why article 959 (2) plainly envisages that documentary credit is separate from the contract of sale on which may it relate.

The other scenario in relation to application of the principle of autonomy of letter of credit under the commercial code of Ethiopia is the case where bank fails to verify whether the presented documents comply with the credit—the strict compliance of documents—in which case the principle is still applicable.^[33]Therefore, by contrario reading of article 965 of commercial code, where the bank failing to discharge its obligation of strictest conformity of documents refuses payment, the principle of autonomy of letter of credit is still applicable and, hence, the bank cannot reject discharging its obligation.

Dealing with obligation of the issuing bank is another application area of the principle of autonomy of documentary credit under commercial code of Ethiopia. Under section 4 which regulates documentary credit, the commercial code recognizes revocable, irrevocable as well as transferable documentary credits.^[34]The principle of autonomy of documentary credit also has an application on such types of documentary credit recognized under the commercial code of Ethiopia. That is, where irrevocable letter of credit is issued, for instance, the principle of autonomy of letter of credit will be up held.

In other jurisdictions either by virtue of the case law or the law that governs letter of credit, there are areas where the principle of autonomy of letter of credit is not applicable. These are, for instance, in the case where false statements are intentionally included in the document to be used against the deceived party or where the document is forgery or nullity as well as others which are considered as exception to the principle of autonomy of letter of credit in literature.

Such areas which limit the application of the principle of autonomy of letter of credit is not explicitly or implicitly stated under the commercial code of Ethiopia. And therefore, it is the position of the writer to argue that the principle of autonomy of letter of credit is applicable to such scenarios under commercial code of Ethiopia unless we place exceptions such as fraud under articles 959 and 965 by strict interpretation.

5.3 Merits and Demerits the Autonomy Principle of Letter of Credits

Letter of credits is a convenient mechanism of payment in international trade. It eases and facilitates the smooth functioning of international business transactions. Thus, it has advantages in international trade on one side. It may also have demerits on the other edge. The merits and demerits of the principle of autonomy of letter of credit inherently stems from the nature of letter of credit itself.

5.3.1 Merits of Autonomy Principle of Letter of Credits

Letter of credit is appropriate method of payment in international trade because of distance, lack of familiarity with the other parties, lack of currency, differences in applicable law, problems arising

possible disputes. It is also a means to obtain credit, as the buyer to purchase goods require obtaining credit and the sellers also require credit to provide their goods which is solely possible through this documentary credit. Thus, the advantages of the principle are inherent the document itself. It has merits both for the applicant and beneficiary.

5.3.1.1 Advantages for the Beneficiary

As letter of credit is separate transaction by virtue of the principle of autonomy of letter of credit, it guarantees payment for the beneficiary regardless of discrepancies between buyer and seller on goods or on other transactions.^[35] It also enables the seller to get the financing opportunity in the period between shipment of goods and receipt of payment particularly in the case of deferred payment delayed or postponed payment.^[36]

The other advantage of this principle for the exporter is that the importer cannot refuse payment due to compliant about the goods or services under question as the principle of autonomy of letter of credit unequivocally provides that the credit is independent of the goods.^[37]

In other words, it is the obligation of the issuing bank to pay for the beneficiary in spite of discrepancies on the goods due to the fact that the former assumes the obligation to pay beneficiary and deals with the documents, not with goods.

It is also logical to argue that the principle of autonomy of letter of credit reduces the production risk if the buyer, for instance, cancels or changes his/her order as the principle guarantees payment once order is made. On the other hand, the fact that exporter's claim against importer becomes a claim against the issuing bank is also another merit of the principle of autonomy of letter of credit for the beneficiary. And thus, the exporter would not be worry whether the buyer is solvent or otherwise because s/he will get payment from the issuing bank. Therefore, any failure of performance in the underlying contract doesn't affect beneficiary's right to payment or the issuing or confirming bank's obligation to pay. This is big advantage of the autonomy principle of letter of credit to the beneficiary. The beneficiary of the credit, thus, is not required to establish as a precondition to payment that there is breach of the underlying contract by applicant.

The other advantage of the principle of autonomy of letter of credit for exporter, which is also of course for importer as well, is that any issue in relation to validity of the underlying contract or agreement between bank and applicant doesn't affect the validity of the letter of credit.^[38] Thus, the mere fact that the underlying transaction is void, voidable, terminated for breach or unenforceable doesn't affect the payment undertaking due to this principle of autonomy of letter of credit.^[39] This indicates that the obligation of payment of the issuing bank to the beneficiary yet persist though the credit application agreement or the contract of sale is void, voidable or unenforceable.

5.3.1.2 Advantages for Importer

As aforementioned, the principle of autonomy of letter of credit saves the credit from falling under the question of validity where the underlying transaction is void, voidable or unenforceable which is also advantageous to the buyer as well. Thus, where the beneficiary, for instance, invokes that the contract of sale is void and thereby refuses performance, the importer could invoke the autonomy principle of letter of credit. The fact that it facilitates the smooth functioning of international trade also has its own advantage for the buyer like the seller.

The issuing bank cannot refuse payment to the seller due to the principle of autonomy of letter of credit and hence, the former cannot invoke the contractual relationship between it and the applicant to refuse payment. This has an advantage for the buyer as the claim of the seller against the buyer becomes claim of seller against the issuing bank. In other words, the buyer can still receive the ordered goods though there is dispute between the importer and the issuing bank as a result of this principle of letter of credit. Another advantage is that the importer may be granted a discount because of the provision of security and promptness of payment.^[40]

In nutshell, the main advantage of principle of autonomy of letter of credit in international trade is that it can give security to both the seller and the buyer by balancing the possibility of risk.

5.3.2 Demerits of the Principle of Autonomy

The fact that the principle of autonomy of letter of credit has advantage in international trade doesn't mean that it has no pitfalls. To mention some, though letter of credit cannot be issued where there is no underlying contract of sale of goods, independence principle makes payment mandatory whatever happen to the goods or to the underlying contract of sale of goods. This is a shortcoming of this principle from one perspective.

The principle also seems doesn't consider the interest of the issuing bank where the buyer becomes insolvent after application for issuance of letter of credit as the former has an obligation to pay the beneficiary once the letter of credit is issued according to the principle of autonomy of letter of credit. It also seems that it imposes burden on buyer particularly where the goods shipped to latter's destination doesn't conform to the terms and conditions of the contract of sale. In other words, it doesn't give any warranty for the buyer who is obliged to pay the seller through his/her issuing bank.

6. Conclusion and Recommendations

This paper critically analyzed the principle of autonomy of letter of credit focusing on the justification and application of same under the commercial code of Ethiopia. In doing so, the paper tried to explore the conceptual frameworks in relation to the letter of credit before analyzing the principle of autonomy of letter of credit under Ethiopia commercial code focusing on its justification and application.

The principle of autonomy of letter of credit is recognized under the commercial code of Ethiopia article 959(1). In fact, the justification of the principle of autonomy of letter credit under Ethiopia commercial is not as such different from its justification under internationally applicable instrument governing letter of credit—Uniform Customs and Practice to Documentary Credits, and Uniform Commercial code of US. Thus, the principle of autonomy of letter of credit is justified due to the fact the letter of credit is autonomous from other transactions such as the underlying contract sale of goods. The other thing that can be concluded from this paper analysis is that the principle of autonomy of letter of credit under Ethiopia commercial code is not beyond its incorporation or simple recognition. And hence, a wide coverage is not given. Coming to its application under Ethiopia commercial code, again it is not well addressed. More detail is necessary. For instance, the scenario where it is inapplicable such as fraud exception, nullity, etc., which are recognized under international instruments applicable in international sale of goods is not provided. This opens a way for judicial encroachment and interpretation in application of letter of credit in general and the principle of autonomy of letter of credit in particular. Based on foregoing analysis and conclusion, the paper thus suggests that:

- The provisions of commercial code of Ethiopia dealing with letter of credit in general and the principle of autonomy in particular should be detail enough like that of Uniform Customs and Practices to Documentary Credits and Uniform Commercial Code.
- Exceptional issues such as fraud, nullity where the principle of autonomy of letter of credit is inapplicable should be succinctly incorporated.
- The provisions of the commercial code of Ethiopia dealing with documentary credits should be congruent with Uniform Customs and Practice to Documentary Credits as these provisions have applicability at international level as issue of letter of credit would be raised in the case of international trade.

¹Introduction to Law of Kurdistan, Iran Working Paper Series, International Trade, The American University of Iraq, Stanford Law School, P.3

² Olegario Llamazares (ed), Dictionary of International Trade, Global Marketing Business Publication, P.5

³ See also Dictionary of International Trade, P.61. Traders and Bankers in US, Asia countries tend to use the terminology Letter of Credits where as bankers in Europe use the term Documentary Credits.

⁴See Kozolchyk, 'Letters of credit', (1973) in IX International Encyclopedia of Comparative Law (ed K Zweigelt and Ulrich Drobniq, 1973) Chapter 5 at pp138-143;See also the definition offered by Professor Ellinger, where he argued that documentary credits should be treated as a *sui generis* instrument embodying a promise which by mercantile usage is enforceable without consideration. E P Ellinger, Documentary Credit (1970) Chapter IV cited in Ewan McKendrick Goode on Commercial Law (Penguin 2009), 1078.

⁵See Roy Goode 'Abstract Payment Undertakings' in Peter Cane and Jane Stapleton (eds), *Essays for Patrick Atiyah* (OUP 1991) P.225

⁶www.google.com.at (Retrieved on March 27, 2021)

⁷ Maryam Solhi Lord, *et al*, The Role of Letter of Credit in International Trade, *Universal Journal of Management and Social Science*, Vol.3, No.11, 2013

⁸ International Chamber of Commerce Uniform Customs and Practice for Documentary credits, art. 2 version 600

⁹ Felicity Monteiro, Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand, *Auckland University Law Review*, P.144

¹⁰Carole Murray and David Holloway, Export Trade: The Law and Practice of International Trade, p.5

¹¹Supra Note 8, art. 4

¹² Id, article 5

¹³Alavi, H. (2016). Mitigating the Risk of Fraud in Documentary Letters of Credit, *Baltic Journal of European Studies*, 6(1), pp.139-142

¹⁴ Arkins, J. (2000). Snow White v. Frost White: The New Cold War in Banking Law? *Journal of International Banking Law*, 15(2). See also Alavi Hamed, Autonomy Principle and Fraud Exception in Documentary Letters of Credit, A Comparative Study between United States and England, *International and Comparative Law Review*, 2015, Vol. 15, No. 2, p.48

¹⁵ Mariam Babiker Mohieldeen, Letter of Credit and Independence Principle, LL.M Thesis (University of Khartoum, unpublished)

¹⁶ Ibid

¹⁷ Ibid

¹⁸ Goode on Commercial Law, pp.878-879

¹⁹ Supra Note 8, article 2

²⁰ Id, article 7

²¹ Id, article 2

²² Id, article 9

²³ Ibid

²⁴ Id, article 2

²⁵ Ibid

²⁶ Ibid

²⁷The Commercial Code of the Empire of Ethiopia, *Negarit Gazette*, Extraordinary Issue No. 3, 1960, article 959 (2). See also articles 3 and 4 of Uniform Customs and Practice as well as section 5-103 (d) of Uniform Commercial Code.

²⁸See Commercial Code, article 959(1)

²⁹See this principle of autonomy is envisaged under articles 959 (2)&960of commercial code

³⁰See article 959 (1) cum article 959 (2) of the commercial code of Ethiopia

³¹John Dolan (2007), *The Law of Letters of Credit: Commercial or Standby Credits*, 4thed, Vol.1, pp.1-17

³² Supra Note 27. The readings (*contrario*, cumulative) of article 959, 965 and 966 of commercial code may enable us to argue that the principle of autonomy of letters of credit is embodied thereunder to guarantee the payment or discharging of obligation of issuing bank regardless of what happened to the main contract.

³³ Supra Note 27, article 965

³⁴ Id, articles 961, 967

³⁵ www.danskebank.com (Retrieved on March 29, 2021).

³⁶ Ibid

³⁷Ibid

³⁸ Supra Note 8, article 4 as well as supra Note 27 article 959 (2).

³⁹ Christopher Hare, National University of Singapore Center for Maritime Law Working Paper 18/03, NUS Law Working Paper 2018/012

⁴⁰ Supra Note 35

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