

THE LEGAL RELATIONS IN DOCUMENTARY LETTER OF CREDIT TRANSACTION¹

Kristina Savić²

² Faculty of Law, University of Priština

Received: 21.2.2025; Accepted: 9.3.2025.

Review Article

Correspondence: kristina.savic@pr.ac.rs

Abstract: In this paper we will analyze the legal relations inherent in the letter of credit transaction, a crucial financial instrument in international trade. Letter of credit, regulated primarily by the Uniform Customs and Practice for Documentary Credits (UCP) provide security for both buyers and sellers by ensuring payment upon the presentation of stipulated documents. This research contributes to a deeper understanding of the complex legal relations and the roles of main parties involved, uncluding the buyer, seller, issuing bank and confirming bank, and analyzes their rights and obligations under the UCP.

Keywords: letter of credit, international trade, legal relations, UCP, banking law

¹ The paper is the result of research financed by the Ministry of Science, Technological Development and Innovation (Contract number 451 – 03 – 65/2024 – 03/200254 of the fifth of February, 2024).

Introduction

Although letter of credit, as we know them today, began to take shape after the First World War, the concept itself existed in a more rudimentary form long before that, even in ancient Rome. (Carić, et. al, 1990, p. 162) Different authors reference historical development of letter of credit on different ways. Some of them, such as Ellinger notes that English kings used it as a financial instrument as early as the 13th century, while merchants adopted its use much later, around the 17th century. (Ellinger, 1970, p. 24) Throughout history, the development of regulations concerning letter of credit was very difficult process. However, in modern times, the International Chamber of Commerce has taken a leading role in codifying relevant customs and practices through the Uniform Customs and Practice for Documentary Credit – UCP. (Alavi, 2016, p. 110) Under the UCP, letter of credit is defined as: “any arrangement, however named or described, whereby a bank (the “Issuing Bank”) acting at the request and on the instructions of a customer (the “Applicant”) or on its own behalf,

- i. is to make a payment to or to the order of a third party (the “Beneficiary”) or is to accept

and pay bills of exchange (Draft(s)) drawn by Beneficiary, or

- ii. authorises another bank to effect such payment or to accept and pay such bills of exchange (Draft(s)), or
- iii. authorises another bank to negotiate, against stipulated document(s), provided that the terms and conditions of the Credit are complied with”. (Article 2, UCP)

Documentary letter of credit is essential for financing international trade. They facilitate the exchange of goods and services in the international market, even before the actual transaction occurs. The effectiveness of letter of credit relies heavily on their inherent autonomy from the underlaying transaction. (Monteiro, p. 144) On the other hand, recognizing that the letter of credit plays a central role in numerous transactions, both internationally and domestically, we must focus on the bank’s involvement in handling the relevant documents. The bank’s role is to ensure payment upon the delivery of certain documents, and the parties specify which documents must be provided to trigger the payment. This system effectively positions the

bank as a neutral subject. (Grassi, 1995, p. 3) Letter of credit is also very useful for seller. Although the seller who requires acceptance or payment against documents has some level of security, he is not fully protected. By this stage, he has already incurred the expense of manufacturing or acquiring the goods and shipping them to the buyer's country. If the bill is dishonored, the seller will be left with the goods and will bear the trouble and cost of disposing of them elsewhere. What the seller needs is an assurance that he will be paid after shipment, and this need that letter of credit transaction is designed to meet. (Goode, 2004, p. 962)

The legal relations in documentary letter of credit transaction

Observing the structure of the letter of credit transaction, we can notice the existence of internal and external legal relations. However, all these legal relations, in their entirety, can be divided into four parts, where each one is a prerequisite for the existence of the other legal relations. The first and so – called “external” relation is, in fact, not a legal relation within the mechanism of the letter of

credit transaction itself. (Rosenberg, 1975, p. 31)

The previously mentioned legal relations can be classified as follows:

- the legal relation between the seller and the buyer, based on the contract of sale, or between contractual parties based on some other contract or transaction (i.e. the legal relationship between the issuer and the beneficiary of the letter of credit);
- the legal relation between the issuer (buyer) and the bank that opens the letter of credit;
- the legal relation between the bank that opens the letter of credit and the bank participating in the realization of the letter of credit transaction (i.e. the advising or confirming bank);
- the legal relations between the bank that opens the letter of credit (or the advising or confirming bank) and the beneficiary of the letter of credit. (Antonijević, 1960, p. 69)

The legal relation between the issuer and the beneficiary of the letter of credit

The legal relation between the issuer and the beneficiary of the letter of credit can also be referred to as the preliminary (previous) credit rela-

tion. The entire system of the letter of credit transaction cannot be envisioned without the existence of a legal relation that represents the primary legal relation or the primary legal transaction, considering that the letter of credit serves as a means of realization of the primary transaction. (Đorđević, 2013, p. 83)

The letter of credit is most commonly associated with a contract of sale and the buyer's intention to fulfill their payment obligation to the seller by approaching their bank to conclude a contract for opening a letter of credit. (Marjanski, et. al., 2021, p. 106). However, there are neither economic or legal reasons to limit its use to this domain (this contract). The letter of credit, as a payment instrument, can also be used in contracts of sale of investment equipments, construction contracts, etc. For example, in U.S. case law, the largest percentage of disputes concerning the usage of the letter of credit (other than the contract of sale) are related to construction contracts. (Murray, 1974, p. 1113)

As an integral part of all the aforementioned contracts, we observe the existence of a financial clause. The financial clause is that part of the primary transaction (primary contract) in which all issues related to the financial obligations of the con-

tracting parties should be precisely resolved. The financial clause should include the financial structure of the entire primary contract and its detailed elaboration. A component clause of the financial clause is the letter of credit clause. The letter of credit clause represents a contractual provision that confirms that the buyer's obligation to pay will be fulfilled through the letter of credit. This clause should generally be short and concise, but it is advisable for it to include all necessary elements, such as:

- the deadline for opening the letter of credit;
- the documents that will be required for payment under the letter of credit;
- the name of the bank that will open the letter of credit, etc. (Vasiljević, Z., 2022, p. 28)

There are different theoretical views on whether the letter of credit clause can be equated with the financial clause, or if there are differences between them. In this context, we encounter the opinion of prof. Vasiljević, who uses the formulation "letter of credit of financial clause", (Vasiljević, 2022, p. 30) while, on the other hand, prof. Rosenberg emphasizes that "the financial clause is much broader than the so – called letter of credit clause, which repre-

sents only a part of the financial clause being discussed". (Rosenberg, 1975, p. 29).

The primary obligation of the issuer, arising from the letter of credit clause, is considering to be the opening of the letter of credit in favor of the beneficiary. The essence of this obligation also includes the deadline for its fulfillment, that is, the time within which the letter of credit must be opened. In most cases, the contracting parties from the primary contract, through the provision of the letter of credit clause, specify the exact date for the opening of the letter of credit. (Đorđević, 2013, p. 88) In business practice we can find situations where the date for the opening of the letter of credit is tied to certain actions and procedures of the seller (for example, sending a proforma invoice or notifying that the goods are ready for shipment), or the deadline (date) is simply defined by the term "immediately". However, the use of such common trade terms or the omission of specifying the time for the opening of the letter of credit can lead to problems in determining the intent of contracting parties. Prof. Vukadinović believes that "when the contract does not specify the time for the opening of the letter of credit, but the period for the delivery of goods is determined, the

buyers is obligated to open the letter of credit and make it available to the seller no later than the first day of the delivery period". (Vukadinović, 2021, p. 732)

The proper fulfillment of the issuer's obligations from the letter of credit clause also relates to opening a specific type of letter of credit and the bank where the letter of credit should be opened, where such specifications are usually made in the clause itself. However, it can happen that the contracting parties fail to include such details in the letter of credit clause, and in business practice, the prevailing view is that irrevocable and confirmed letters of credit are most commonly agreed upon. We can conclude that the issuer's obligation represents a condition precedent for the performance of the beneficiary's obligations, given that the letter of credit clause and the choice of a documentary letter of credit as the method of payment are the results of the autonomy of the contracting parties. Therefore, the beneficiary of the letter of credit has obligation to:

- receive payment through the opened letter of credit;
- provide "compliant" documents that will correspond with the fulfillment of their obligation under the primary contract. (Đorđević, 2013, p. 89)

The legal relation between the issuer and the bank

The buyer will fulfill their obligation from the letter of credit clause by instructing the bank to open a letter of credit, assuming that such an instruction contains all the elements and meets all the conditions outlined in the letter of credit clause. Upon acceptance of the instruction by the issuing bank, a new legal relation is formed, which by its nature, is entirely different from the relations in the primary contract. A sui generis relation is created. (Rosenberg, 1975, p. 32)

The buyer from the primary contract, who was in the direct legal relation with the seller, loses that status once the letter of credit is opened. On the other hand, their contractual counterpart is no longer the seller from the primary contract, but rather the bank that has expressed its readiness to accept and execute the instruction. (Rosenberg, 1975, p. 32)

The legal relation thus created is entirely independent and separate from the both the underlying contract and the relation between the bank and the other participants in the letter of credit transaction. The bank must be viewed as a new entity because it was not a party to the rights or obligations in the primary contract. As a result, the bank has no connection with the underlying contract. It is a subject of

the newly formed letter of credit relation and it is only concerned with the letter of credit documents, not the goods from the primary contract, which is a crucial distinction. (Vilus, et. al., 2012, p. 429)

The instruction to open a letter of credit has the character of an offer to conclude a contract, but neither the instruction itself nor the contract for opening the letter of credit is required to be in written form under the provision of UCP, unlike some national laws, including our own. The UCP also does not prescribe mandatory content for the instruction, although the instruction to open a letter of credit regularly includes the following informations:

- the name and the address of the issuer;
- the name and the address of the beneficiary;
- the type of letter of credit;
- description of the type, quantity and quality of the good for which the letter of credit is being opened;
- the validity period;
- transportation details and delivery modalities;
- the method of opening and notifying the beneficiary of the letter of credit;
- the method of securing letter of credit coverage and necessary costs;

- the issuer's signature. (Vukadinović, 2021, p. 755)

The execution of the instruction to open the letter of credit is carried out in such a way that the bank pays a certain amount of money to the beneficiary of the letter of credit. This amount of money often comes from a loan granted to the issuer by the bank, but it may also come from the issuer's own funds. If the amount of money comes from the issuer's own funds, the bank acts merely as the issuer's agent. If the amount of money comes from a loan, the bank retains all the rights it is entitled to under the prior loan agreement. (Antonijević, 1960, p. 70).

The legal relations between the banks participating in documentary letter of credit transaction

The legal relations between the banks participating in the letter of credit transaction are independent and completely separate from the underlying contract. In this *sui generis* relation, different forms of cooperation can be established, considering the numerous financing options available in the letter of credits field. Prof. Vasiljević identifies three situations in this regard:

- first, for the buyer in the underlying transaction, it is the sim-

plest to approach a bank located in their headquarters. Since this bank cannot physically deal with the seller in the underlying transaction, the bank, at the request of its client may engage another bank, usually in the country of the beneficiary. This second bank is called correspondent bank and performs honoring of documents, acceptance of bill of exchange, or negotiation;

- second, the issuing bank may instruct another bank to add its confirmation to the issued letter of credit. If the issuing bank's instruction is accepted by the second bank, the letter of credit becomes a confirmed letter of credit. The bank providing the confirmation is called the confirming bank. The role of the confirming bank, as the fourth party in the letter of credit transaction is to honor the documents upon request. The confirming bank assumes this obligation as its own, meaning the beneficiary has two joint debtors – the issuing bank and the confirming bank. This provides the beneficiary with the highest level of protection, as they can demand payment from either issuing bank or the confirming bank, or from the both together. A legal relation is established between these two banks, where the

confirming bank acts as a commission agent in relation to the issuing bank. As with commission contract, the issuing bank, as the principal, is obligated to pay, in this case to the confirming banks, the letter of credit amount and to reimburse any costs incurred.

- third, besides the option of engaging another bank to honor the documents, the issuing bank may instruct the other bank to inform the beneficiary that a letter of credit has been opened in their favor and to convey the terms of opened letter of credit (e.g., the deadline for submitting the documents, the moment of payment of the letter of credit amount...). In this case, this second bank is called advising bank. The issuing bank may authorize this bank to perform other actions, such as receiving and examining documents, accepting or purchasing a bill of exchange, etc. In such cases, this bank takes on the role of the paying bank. However, it is important to conclude that this bank, whether acting as the paying or advising bank, does not act independently in relation to the beneficiary. (Vasiljević, M., 2019, p. 403 – 404)

The legal relation between the bank and the beneficiary

The legal relation between the bank and the beneficiary of the letter of credit is established at the moment when the written notification of the opened letter of credit reaches the beneficiary. (Vukadinović, 2021, p. 727) Although the UCP does not contain a provision regarding the moment when the obligation of the issuing bank arises, it states that the issuing bank is obliged to honor documents from the moment it issues the letter of credit. (Article 76, UCP) The moment of issuing the letter of credit is understood as the moment when the written notification of the opened letter of credit is received by the beneficiary or delivered to their business premises. (Vukadinović, 2021, p. 727) In practice, other solutions have developed regarding this matter, linking the moment of opening the letter of credit to:

- the moment when beneficiary became aware that the issuing bank accepted the order from the applicant to open the letter of credit;
- the moment when beneficiary took actions in response to the opened letter of credit. (Vukadinović, 1989, p. 103)

If the beneficiary wishes to realize their claim under the opened letter of credit, they must fulfill certain con-

ditions, which can be specified as follows:

- submission of documents on time;
- submission of documents in the place specified by the issuing bank;
- the documents must comply with the conditions of the opened letter of credit. (Vukadinović, 2021, p. 728)

On the other side, the bank also assumes certain obligations, namely:

- the obligation to examine the documents;
- the obligation to settle the debt based on the letter of credit. (Đorđević, 2013, p. 155)

Conclusion

Documentary letter of credit plays a crucial role in international trade, providing security and trust between buyers and sellers in international transactions. The legal relations established through the letter of credit transaction involve multiple parties, including the buyer, seller, issuing bank, and advising of confirming bank. These relations are governed by a complex framework of International rules, most notably the Uniform Customs and Practice for Documentary Credits (UCP), as well as national laws. The UCP, established by the International Chamber of Commerce, serves as a back-

bone for harmonizing practices across jurisdictions, ensuring consistency and reliability.

In examining the legal relations within letter of credit transaction, it becomes evident that the bank play a critical role as intermediaries, ensuring payment to the seller upon fulfillment of documentary conditions, while simultaneously safeguarding the buyer's interests. The independence principle, which separates the credit transaction from the underlying contract, reinforces the autonomy of the letter of credit, making it a self – contained mechanism of payment.

Ultimately, letter of credit remains a cornerstone of international commerce, offering a reliable payment mechanism that balances the interests of all parties involved. Nevertheless, continuous harmonization of laws and practices across jurisdictions is necessary to mitigate potential legal conflicts and ensure the smooth functioning of international trade.

References

- Alavi, H., (2016), Documentary Letters of Credit, Legal Nature and Sources of Law, *Journal of Legal Studies*, Vasile Godis, Western University of Arad.

- Antonijević, Z., (1960), Privredno pravo, Bankarski poslovi i hartije od vrednosti, Zavod za izdavanje udžbenika Narodne Republike Srbije, Beograd.
- Vasiljević, Z., (2022), Obaveze i prava banaka iz poslovanja sa dokumentarnim akreditivima, Pravni fakultet u Banjoj Luci, Banja Luka.
- Vasiljević, M., (2018), Trgovinsko pravo, Beograd.
- Vukadinović, R., (1989), Pravni odnosi iz međunarodnog dokumentarnog akreditiva, Naučna knjiga, Beograd.
- Vukadinović, R., (2021), Međunarodno poslovno pravo – opšti i poseban deo, Službeni glasnik.
- Vilus, J., Carić, S., Đurđev, D., Divljak, D., (2012), Međunarodno privredno pravo, drugo izmenjeno i dopunjeno izdanje, Novi Sad.
- Goode, R., (2004), Commercial Law.
- Grassi, P., (1995), Letter of Credit Transactions: The Banks' Position in Determining Documentary Compliance – A Comparative Evaluation under U.S., Swiss and German Law, Pace International Law review, Vol. 7., 83-127.
- Đorđević, D., (2013), Pravni odnosi iz međunarodnog dokumentarnog akreditiva, doktorska disertacija, Univerzitet u Novom Sadu, Pravni fakultet u Novom Sadu.
- Ellinger, E., P., (1970), Documentary Letters of Credit, Singapore.
- Marjanski, V., Fišer – Šobot, S., (2021), Ugovori bankarskog prava, Novi Sad.
- Monteiro, F., (2002), Documentary Credits: The autonomy Principle and the Fraud Exception: A comparative Analysis of Common Law Approaches and Suggestion for New Zealand, Auckland University Law Review, 144-164.
- Murray, E., D., (1974), Letters of Credit in Nonsale of Goods Transaction, Business Lawyer, Vol. 30., 1113-1130.
- Rosenberg, (1975), Pravo međunarodnih plaćanja u poslovnim transakcijama, drugi svezak. Međunarodni dokumentarni akreditiv, Inkaso vrijednosni papiri, Bankovne garancije, Informator, Zagreb.
- Carić, S., Hribovišek, F., (1990), Spoljnotrgovinsko plaćanje, Beograd.
- Uniform Customs and Practice for Documentary Credits (UCP), www.2go.iccwbo.org.com

PRAVNI ODNOSI U DOKUMENTARNOM AKREDITIVNOM POSLU

Rezime: U ovom radu analiziraćemo pravne odnose inherentne akreditivnoj transakciji, ključnom finansijskom instrumentu u međunarodnoj trgovini. Akreditiv, regulisan prvenstveno Jedinstvenim običajima i praksom za dokumentarne akreditive (UCP), obezbeđuje sigurnost i za kupce i za prodavce obezbeđujući plaćanje po podnošenju propisanih dokumenata. Ovo istraživanje doprinosi dubljem razumevanju složenih pravnih odnosa i uloga glavnih uključenih strana, bez kupca, prodavca, banke izdavaoca i banke koja potvrđuje, i analizira njihova prava i obaveze prema UCP.

Ključne reči: akreditiv, međunarodna trgovina, pravni odnosi, UCP, bankarsko pravo