

## **Uniform Rules versus Freedom of Contract: Japanese Practice in Letters of Credit Transactions**

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This article examines the difference between the Japanese practice of the Uniform Customs and Practice for Documentary Credits and those of other jurisdictions. The author demonstrates why Japanese practice tends to favour banks over beneficiaries, and why in certain circumstances, this is attractive.

### I. INTRODUCTION

IT is well known that the basic rules concerning documentary letters of credit are generally uniform throughout the world, since the Uniform Customs and Practice for Documentary Credits (UCP), published by the International Chamber of Commerce (ICC), was adopted in most jurisdictions. Japan is no exception. However, practice among Japanese parties in this field is somewhat different from the practice in other countries. How is it possible for a unique local practice to prevail in a country where the uniform rules have been adopted? Does the local practice in Japan conflict with the UCP and cause difficulties among the parties concerned? The aim of this article is to discuss the uniqueness of the Japanese practice and examine whether it is really compatible with the UCP.

Standard textbooks describe a documentary letter of credit as involving three agreements. The first one is the underlying transaction between the buyer (applicant) and the seller (beneficiary). The second one is between the issuer and the applicant whereby the issuer agrees to issue a letter of credit and the applicant agrees to reimburse the issuer when payment is properly made. The third one is the letter of credit itself, whereby the issuer promises to the beneficiary to make payment

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when the required conditions are met. The practice in Japan does not differ in so far as these agreements go.<sup>1</sup>

The uniqueness of the practice in Japan becomes evident when we take a closer look at the transaction. When the letter of credit provides for negotiation, the beneficiary draws a draft and asks a bank – the nominated bank or any available bank as the case may be – for negotiating it in order to get paid. A Japanese bank, when asked for negotiation, looks to the credit of the beneficiary rather than that of the issuer of the letter of credit. If the beneficiary is not a familiar customer, the bank usually refuses negotiation, no matter who the issuer is. Even when the beneficiary is a familiar customer, the negotiating bank will, without exception, require an agreement in which the bank reserves the right of recourse to a large extent, before negotiation.

The practice which prevails in Japan as described above (hereinafter referred to as ‘Japanese practice’) may appear strange, since the very aim of opening a letter of credit is to make use of the issuer’s credit in order to facilitate the underlying transaction. Some commentators in Japan therefore assert that this practice runs counter to the essence of letter of credit. Before jumping to conclusions, it is necessary to carefully review its function and impact on the parties concerned. This paper examines what happens if a bank refuses negotiation with an unfamiliar beneficiary (Part II), analyses the agreement between the beneficiary and the negotiating bank (Part III), and then explores the rationale and drawbacks, if any, of the Japanese practice (Part IV).

## PART II. REFUSAL TO NEGOTIATE WITH UNFAMILIAR CUSTOMERS

Under Japanese practice, a bank will not negotiate a draft with a beneficiary that the bank does not know. It reflects the view held by Japanese bankers that negotiation of a draft is equivalent to giving credit to the beneficiary rather than to the issuer of the letter of credit. This view is not so particularly unusual. An American court ruled as far back as 1926 that:

<sup>1</sup> As to relevant statutory provisions, see Kohei Izawa, Kazuaki Sono & Warren L. Shattuck, *Letters of Credit in Japanese-United States Trade*, (1963) 38 *Wash L Rev* 169. Although the practice has changed since this paper was published (the bank practice it reports differs in several points from the description of this essay), statutory provisions are almost unchanged.

When a bank buys a draft relating to a letter of credit, it acts solely for itself and at its own risk; its transaction is with the drawer, not with the drawee, except so far as it seeks to benefit from the drawee's commitment in its letter of credit[.] ... It is buying commercial paper, relying upon the credit of the drawer and any other security the drawer at the time may offer.<sup>2</sup>

The Japanese practice, however, is different in that a bank never relies on 'the drawee's commitment in the letter of credit,' regardless of whether it is nominated as a negotiating bank or non does the bank concern itself with who the issuer of the letter of credit is. As a result, the beneficiary cannot directly benefit from a letter of credit if a bank which the beneficiary has had no transactions with, is nominated as the negotiating bank. In this case the beneficiary may have two alternatives. One is to require a bank which the beneficiary knows well to negotiate the draft it draws. If it finds the beneficiary financially credible, the bank will negotiate the draft and require the nominated bank to 're-negotiate' it as if the former bank were a beneficiary. The other alternative available to the beneficiary is to ask someone that has had previous transactions with the nominated bank to act on its behalf.

Sometimes both measures are employed simultaneously. For example, in *Tsukamoto Shoji KK v Tokyo Ginko KK*,<sup>3</sup> the beneficiary asked the defendant, a trading company, to arrange negotiation of a draft it was drawing. The defendant required the plaintiff bank, which was not a nominated bank, to negotiate the draft probably because it was a bank the defendant usually had transactions with. Having negotiated the draft, the plaintiff bank in turn required the nominated bank (confirming bank) to re-negotiate it. The Tokyo High Court rejected the argument of the defendant that it acted merely as an agent of the beneficiary. The court reasoned that it was the defendant who concluded the Agreement on Negotiation of Bills with the plaintiff bank (discussed further in Section III below) and who received the proceeds for the draft. Further the court held that the plaintiff bank was not an agent of the beneficiary but that the former had transacted with the confirming bank in its own name and capacity.

<sup>2</sup> *Courteen Seed Co v Hong Kong & Shanghai Banking Corp*, (1926) 216 App Div 495, 215 NYS 525.

<sup>3</sup> 888 Kin'yu Shoji Hanrei 16 (Tokyo Koto Saibansho (Tokyo High Court), 26 Aug 1991).

## PART III. THE DUTY TO RECOURSE (DUTY TO 'PURCHASE BACK')

*Agreement Between Negotiating Bank and Customer*

When the beneficiary or someone acting on its behalf is a customer familiar to a Japanese bank, the bank is usually prepared to negotiate the draft but only on conclusion of an agreement governing the relationship with the customer. Although the bank and customer must have already entered into a basic agreement on general banking transactions, the main purpose of which is to protect the bank's interest as a lender, the bank requires an additional agreement before commencing transactions involving foreign exchange. The Zenkoku Ginko Kyokai (Japanese Bankers Association)<sup>4</sup> prepares model forms for these agreements. The Agreement on Bank Transactions (Form) is a model for basic agreements employed by almost all the banks in Japan while the Agreement on Purchase or Negotiation of Bills (Form) is for special agreements governing international transactions and is used by all Japanese banks.

The model form for the Agreement on Purchase or Negotiation of Bills provides in article 15 that in some cases the customer owes a duty of recourse, which is called the 'duty to purchase back the draft.' When the customer or the obligee of the negotiated draft becomes insolvent, the duty of the customer to purchase back all the drafts concerned arises automatically. Similarly, when payment or acceptance of a draft is rejected, the duty to purchase back the draft in question arises automatically. Besides, the bank reserves the right to require the purchase back of the draft in question when (a) collection or re-negotiation of the draft is rejected, (b) the bank is required to make recourse, (c) the bank is not reimbursed; or (d) when any other similar justification exists. The bank requires the customer to provide security or a guarantor or both in case the customer becomes insolvent and is unable to purchase back the drafts.

These provisions are enforced literally by the courts. One example is the above mentioned case of *Tsukamoto Shoji*,<sup>5</sup> where the negotiating bank (plaintiff), having had recourse to the confirming bank, relied on the provision that entitles the bank to require the customer

<sup>4</sup> Zenkoku Ginko Kyokai (Japanese Bankers Association), formerly called Zenkoku Ginko Kyokai Rengokai and was a federation of regional Bankers Associations, has transformed itself into an association of banks throughout Japan as of April 1999.

<sup>5</sup> 888 Kin'yu Shoji Hanrei 16 (Tokyo Koto Saibansho (Tokyo High Court), 26 Aug 1991).

(defendant) to purchase back the draft 'when the Bank is required to refund an amount equivalent to the proceeds of the Bills.'<sup>6</sup> In this case the confirming bank claimed recourse against the plaintiff bank five days after negotiating the draft because the issuing bank, having found a discrepancy between one of the documents presented and a condition in the letter of credit, refused to reimburse the confirming bank. It may be arguable whether a confirming bank that had once negotiated a draft is entitled to recourse. However, the Tokyo High Court upheld the decision of the Tokyo District Court<sup>7</sup> in favor of the plaintiff bank. The Tokyo High Court held that:

... the negotiating bank, when 'required to refund an amount equivalent to the proceeds of the Bills' by the re-negotiating bank, is entitled to claim purchase back of the draft against the customer who had asked for its negotiation, regardless of whether the requirement of refund is lawful or whether it is justified.<sup>8</sup>

The interpretation of another provision of the Agreement on Purchase or Negotiation of Bills,<sup>9</sup> which entitles the bank to require purchase back of the draft when the collection or re-negotiation of the draft is rejected, was disputed in *Takatoku Shoji YK v Mitsubishi Ginko KK*.<sup>10</sup> The plaintiff in that case was asked by the beneficiary to arrange for the negotiation of the draft drawn against a letter of credit and required the defendant bank, with which the plaintiff had transactions for several years, to negotiate it. The defendant bank negotiated it and required the nominated bank for its re-negotiation, but the nominated bank rejected the request for the reason that it had no corresponding arrangement with the issuing bank. Though the issuing bank offered to negotiate the draft and asked the defendant bank to send the draft with the necessary documents, the latter bank ignored this offer and chose to require the plaintiff to purchase it back relying on the above-cited provision of the Agreement. A year later it turned out that the beneficiary had committed a fraud on the plaintiff. The plaintiff initiated a suit against the negotiating bank and denied its obligation to purchase back the draft, arguing that the provision at issue should not be relied

<sup>6</sup> Art 15 para 2 (2) of the Agreement on Purchase or Negotiation of Bills.

<sup>7</sup> 862 Kin'yu Shoji Hanrei 17 (Tokyo Chiho Saibansho (Tokyo District Court), 19 Nov 1990).

<sup>8</sup> 888 Kin'yu Shoji Hanrei 16, 20 (Tokyo Koto Saibansho (Tokyo High Court), 26 Aug 1991).

<sup>9</sup> Art 15 para 2 (1) of the Agreement on Purchase or Negotiation of Bills.

<sup>10</sup> 932 Kin'yu Shoji Hanrei 9 (Tokyo Chiho Saibansho (Tokyo District Court), 22 Feb 1993).

on other than in a case where discrepancies exist between documents presented and the conditions of the letter of credit. The Court rejected this argument and decided in favour of the defendant bank. Whatever the reason for rejection of re-negotiation or collection, stated the Court, the bank would be faced with a threat of not being reimbursed so that there should emerge a need to secure its interest by requiring the customer to purchase back the draft.

Although provisions of the Agreement on Purchase or Negotiation of Bills are in most cases enforced just as they are written, they can not always be relied on. Recently in *Daiichi Kangyo Ginko KK v Rakuto Boeki KK*,<sup>11</sup> the Tokyo District Court estopped a bank from requiring the beneficiary to purchase the draft back. The plaintiff bank had earnestly proposed to the beneficiary (defendant) to negotiate the draft drawn against a letter of credit though another bank was nominated as a negotiating bank. The beneficiary, who had once turned down the offer, accepted it when the plaintiff bank offered to undertake examination of the documents. The bank, however, not only failed to discover several existing discrepancies but even misled the defendant into producing a new discrepancy through an incorrect instruction. After the issuing bank rejected the request for reimbursement because of these discrepancies, the plaintiff bank required the defendant to purchase back the draft and raised a suit against the latter. The Court rendered judgment in favour of the defendant stating that the plaintiff bank was estopped from requiring purchase back under the circumstances.

#### *Inter-bank Transactions – Implied Duty to Recourse ('Purchase Back')*

In a case where the nominated bank re-negotiates a draft drawn against the letter of credit from a bank that had negotiated it and the issuing bank refuses to reimburse the nominated bank, the re-negotiating bank (nominated bank) will require the negotiating bank to purchase back the draft if both are Japanese banks. The relationship between them is considered to be parallel to the relationship between the negotiating bank and the customer. Therefore, even though no written agreement exists between banks, the re-negotiating bank is entitled to require purchase back of the draft when one of the events equivalent to those enumerated in article 15 of the model Agreement on Purchase or Negotiation of Bills arises. It can be seen from the

<sup>11</sup> 1056 Kin'yu Shoji Hanrei 35 (Tokyo Chiho Saibansho (Tokyo District Court), 25 March 1998).

facts of *Tsukamoto Shoji*<sup>12</sup> and *Daiichi Kangyo Ginko*<sup>13</sup> that the negotiating bank usually does not dispute this implied duty of purchase back.

The exceptional case where this implied duty was disputed was *The State Bank of India v Korea Exchange Bank*<sup>14</sup> decided by the Osaka District Court in 1990. The defendant bank, which was nominated as a negotiating bank, agreed to re-negotiate the draft that the plaintiff had negotiated from the beneficiary. The defendant did not pay for the re-negotiated draft because the issuing bank refused reimbursement and the plaintiff brought suit. The Osaka District Court approved the defence the defendant bank raised and affirmed the implied duty of the plaintiff bank to purchase back the draft that the issuing bank refused to pay, without examining the reason for refusal. The Court dismissed of the plaintiff bank's argument that this kind of implied duty, even if existed among Japanese banks, could not be imposed on non-Japanese banks, The court further added that is implied duty amounted to a customary rule binding transactions between branches of non-Japanese banks situated in Japan.

#### PART IV. RATIONALE AND DRAWBACKS OF JAPANESE PRACTICE

##### *Compatibility with UCP*

Japanese practice elaborated by agreements, case law and the customary rules outlined above, may be unique compared with the practice in other countries. It needs to be pointed out, however, that it does not contradict any of the uniform rules contained in the UCP. First, as is clearly indicated by article 10 paragraph (c) of the UCP, the nominated bank is under no obligation to negotiate unless it has confirmed the letter of credit. Therefore no problem arises if a bank other than a confirming bank, decides never to negotiate a draft from an unfamiliar customer. Second, there exists no rule prohibiting banks from making an agreement of recourse (purchase back) independently from obligations under the letter of credit. The Osaka District Court in *The State Bank of India*<sup>15</sup> emphasized this when it affirmed the

<sup>12</sup> 888 Kin'yu Shoji Hanrei 16, at 20 (Tokyo Koto Saibansho (Tokyo High Court), 26 Aug 1991).

<sup>13</sup> 1056 Kin'yu Shoji Hanrei 35 (Tokyo Chiho Saibansho (Tokyo District Court), 25 March 1998).

<sup>14</sup> 1351 Hanrei Jiho 144 (Osaka Chiho Saibansho (Osaka District Court), 8 Feb 1990).

<sup>15</sup> 1351 Hanrei Jiho 144 (Osaka Chiho Saibansho (Osaka District Court), 8 Feb 1990).

existence of a valid customary rule that agreements between the customer and the bank or between banks is independent of the letter of credit itself.

### *Prevention of Fraud*

There are some distinct advantages in the Japanese practice. As a number of cases in various jurisdictions indicate, letters of credit are often abused by beneficiaries with fraudulent intent. Too often, shipping documents, including bills of lading, invoices and certificates, are falsified or forged. In the end payment is made pursuant to the letter of credit even though the beneficiary did not actually perform its obligations under the underlying transaction. Japanese practice can have the effect of preventing this kind of fraud to some extent. A bank will not negotiate a draft from an unknown beneficiary, who is more likely to have a fraudulent intent than a customer familiar to the bank. Even when a familiar customer tries to defraud the bank the attempt will fail if it is required by the bank to repurchase the rejected draft. The security and/or guarantor provided at the request of the negotiating bank upon conclusion of an Agreement on Purchase or Negotiation of Bills makes it harder for the customer to run away and keep the unlawful gains of its fraudulent scheme.

This does not mean that frauds using letters of credit never succeed in Japan. In *Tsukamoto Shoji*<sup>16</sup> and *Takatoku Shoji*,<sup>17</sup> the beneficiary was successful in receiving payment against false shipping documents. However, in either case the beneficiary did not directly transact with the negotiating bank but instead asked some other company to act on its behalf. It was not the negotiating bank (or re-negotiating bank) but rather the company acting on behalf of the beneficiary that incurred losses as a result of the deception. Since these companies must have had opportunities to investigate the beneficiary there is a good reason to have them bear the resulting loss.

The negotiating bank in Japan is in this way relieved from the risk of being harmed by fraud of the beneficiary. We should also remember that honest beneficiaries benefit from this system as well in that they receive payment smoothly and rapidly. If the negotiating bank were

<sup>16</sup> 862 Kin'yu Shoji Hanrei 17 (Tokyo Chiho Saibansho (Tokyo District Court), 19 Nov 1990), *aff'd*, 888 Kin'yu Shoji Hanrei 16 (Tokyo Koto Saibansho (Tokyo High Court), 26 Aug 1991).

<sup>17</sup> 932 Kin'yu Shoji Hanrei 9 (Tokyo Chiho Saibansho (Tokyo District Court), 22 Feb 1993).

to share the loss incurred as a result of a fraudulent transaction, it would have to spend a tremendous amount of time and effort to examine presented documents in order to find tiny discrepancies, which may indicate fraud. Or it might offer to collect the draft as an agent of the beneficiary instead of negotiating it. With the last resort of the right to require purchase back of the draft, Japanese banks are willing to negotiate the draft after briefly examining the documents. As the Osaka District Court in *The State Bank of India* put it, the practice of purchase back 'enables examination of presented documents to be carried out flexibly and payment to be made rapidly in Japan.'<sup>18</sup>

#### *Drawbacks to the Beneficiary?*

A concern may be raised against the Japanese practice in that it appears to allow the negotiating bank or the re-negotiating bank to require purchase back of the draft even when rejection of payment by the issuing bank cannot be justified. A case of 'market claim' can easily be imagined – the applicant (buyer) might become uninterested in the underlying transaction, perhaps as a consequence of a change in the relevant market, and ask the issuer to reject payment. If in this case there exists the Agreement on Purchase or Negotiation of Bills between the negotiating bank and the beneficiary, the latter will be required by the former to purchase back the draft, though it has a right to claim payment under the letter of credit.

This situation is not as unjust as it appears at first sight because the beneficiary is not deprived of the opportunity to raise suit against the issuer. Besides, the negotiating bank in Japan, in most of the cases, makes efforts to defend the interest of the beneficiary when the latter is a familiar customer. Indeed a Japanese banker wrote, in an article,<sup>19</sup> that the negotiating bank does everything but raise suit against the issuer in order to have the issuer make payment. An example is found in *Palsmo KK v Tokyo-Mitsubishi Ginko KK*,<sup>20</sup> where the issuing bank refused to pay, relying on a non-documentary condition contained in

<sup>18</sup> 1351 Hanrei Jiho 144, at 148 (Osaka Chiho Saibansho (Osaka District Court), 8 Feb 1990).

<sup>19</sup> Katsuto Iida, *Shin'yojo Hakko Ginko ni taisuru Kaitori Ginko no Hoshoseikyū no Fukakujitsusei to Kaitori ni kansuru Yakujo no Igi* (The Unpredictability of the Request for Reimbursement by the Negotiating Bank against the Issuer of a Letter of Credit and the Meaning of an Agreement on Negotiation) (pt 2), 1278 KIN'YU HOMU IJJO 28, 29 (1991). (in Japanese)

<sup>20</sup> 1512 Kin'yu Homu Jijo 34 (Tokyo Chiho Saibansho (Tokyo District Court), 30 June 1997).

the letter of credit.<sup>21</sup> In this case the letter of credit required the shipment of the merchandise to be made subject to the instructions of the applicant. The date when the shipment was actually made differed from the date dictated in an instruction note from the applicant, and the issuing bank rejected payment. The negotiating bank, at the request of the beneficiary, who had reason to believe that the applicant wished the payment to be made, tried to have the issuing bank receive the documents. It made still another attempt, asserting strongly that the rejection was not justified, even after it required recourse against beneficiary.<sup>22</sup> It is expected that this type of effort by the negotiating bank works as a disincentive against the issuer making an unjustified rejection.

## V. CONCLUSION

Some Japanese commentators are critical of the Japanese practice, saying that it unduly favors banks at the expense of the beneficiaries. However, as we have seen above, it does present some advantages to honest beneficiaries. In addition, it must be noted that the beneficiary, if it finds itself disadvantaged, can seek confirmation by the nominated bank. The drafters of the model Agreement on Purchase or Negotiation of Bills clearly state<sup>23</sup> that the provision on purchase back (article 15 of the Agreement) does not override the definite undertaking of the confirming bank to pay, accept or negotiate.<sup>24</sup> Therefore the beneficiary (seller) can make it a condition of the underlying transaction to open a letter of credit that is confirmed by a bank familiar to the beneficiary. If it does not choose to do so, it cannot complain about an alleged disadvantage under Japanese practice that is easily foreseeable at the time of underlying transaction.

<sup>21</sup> This was a case under the UCP 1983 revision (publication no 400), which, as opposed to art 13 para c of the UCP 1993 revision (publication no 500), contained no clear provision as to non-documentary conditions.

<sup>22</sup> In this case recourse was required in reliance of the warranty clause contained in the Agreement on Purchase or Negotiation of Bills instead of the above-mentioned clause regarding purchase back. According to the clause the customer warrants that the draft and documents presented are accurate, genuine, valid and in compliance with the conditions of the letter of credit. Art 5 of the Agreement.

<sup>23</sup> The commentary on the model Agreement on Purchase or Negotiation of Bills by the drafters is found at 1024 *Kin'yu Homu Jijo 12 et seq* (in Japanese).

<sup>24</sup> See art 9, para b of the UCP.

The answer can now be given to the query raised at the beginning of this article: How is it possible for a unique local practice to prevail in a country where the uniform rules have been adopted? The practice is formed by agreements and the customary rules based on them as well as court decisions authorising them. To the extent it is not in conflict with the uniform rules contained in the UCP, it is supported by the sacred principle of freedom of contract.

Still, there remains some doubt as to whether the philosophy behind the Japanese practice of placing reliance on the credibility of the customer, contradicts that of the uniform rules where reliance is on the issuer. Where any bank refuses to negotiate a draft from an unfamiliar customer even when the draft is drawn against a letter of credit while a draft drawn by a familiar beneficiary is easily negotiated, there is little meaning in the issuance of a letter of credit. One could achieve just the same result without the letter of credit. It may be a business matter, however, to be arranged by the relevant parties. If one is aware of the Japanese practice and still wishes the issuance of a letter of credit, why not let him or her have one?

In closing, one caveat may be required when talking about of *the* Japanese practice. Practice may change from time to time. In April 1999, one of the major commercial banks in Japan decided to depart from the model Agreement on Bank Transactions prepared by the Japanese Bankers Association, which used to be employed by every bank in Japan, and began using its own original agreement. There is a good chance that this movement will spread to letter of credit transactions. In this rapidly changing world, nothing remains forever.