

## Answer Guidance for Chapter 24 Practice Questions

1. Explain the following terms:

- Negotiability
- An instrument
- A bill of exchange
- A letter of credit.
- Issuing Bank, Advising Bank, Confirming Bank, Nominated Bank

- Negotiability is used in two senses. It can be used as it is in the Bills of Exchange Act 1882 to mean 'transferable', so that someone other than the named payee can claim under it. Negotiable can also mean not only that the thing is transferable but also that a transferee can obtain better title to it than the transferor.
- An instrument is a document which embodies a payment obligation, of which bills of exchange are good examples. The advantage is that title to instruments passes as with any other chattel, but with title to the document goes also the underlying right to make a legal claim so that the right to claim on the embodied payment obligation passes as well as the paper document. Indeed, where the instrument is 'negotiable' in the full sense of the word, transfer of the document and the right to sue may give the transferee title where the transferor had none.
- A bill of exchange is an instrument in a particular form. It is an unconditional order from one person to another to pay a certain sum of money at a fixed or determinable time and must be signed in writing by the person giving the order.
- A letter of credit is an undertaking by a bank to make a payment typically by accepting or purchasing (negotiating) a bill of exchange. In the case of a documentary credit, this obligation is conditional on the fulfilment of certain conditions, including the tender to it of documents conforming to the description set out in the credit.
- In the case of a documentary credit, the bank which issues the credit and undertakes to accept or negotiate the bill(s) of exchange is called the Issuing Bank in the standard form documentation, the UCP 600. Issuing Bank may ask another bank, Advising Bank, to inform the beneficiary of the credit that it has been opened. Advising Bank (or any other bank) may itself give a separate payment undertaking to the beneficiary, and thus also become

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Confirming Bank. A bank which is to effect payment, for example by purchasing a bill of exchange drawn on Issuing Bank, is called Nominated Bank.

2. Discuss and illustrate with examples the proposition that, notwithstanding the fact that the juridical basis for the issuing bank's obligation to the beneficiary and the fraud and illegality defences are entirely unclear, letters of credit provide a secure payment mechanism for both buyer and seller of goods in international sales.

### Introduction

- As with all essays, you should begin with an introduction that sets out what the question is about, why the topic is an important one, and how your essay will go about answering the question set. By providing an outline structure of the discussion to follow, your essay will be clearer and more structured.
- This essay asks you to do three things. First you need discuss two legal issues, one where, although the legal position is clear, there is no systematic explanation for the law being as it undoubtedly is, and the other where the law is decidedly uncertain. Second, you need to explain the duties of the principal parties to a letter of credit. Finally, you need to show how, notwithstanding the technical legal problems, letters of credit provide security for buyers and sellers. However, you will need to provide a brief outline of how letters of credit operate in order to provide a foundation for the remainder of the essay.

### Outline of the operation of letters of credit

- The key issues to mention are that a letter of credit is an undertaking by a bank to make a payment on being tendered documents, conforming to a specification set out in the credit as stipulated by the procurer of the credit – in this instance the buyer. It would then be sensible to explain briefly the role letters of credit can perform in cif and other documentary sales by way of illustration, including providing credit support or security to lenders to both buyer and seller. In the process, you need to show you are familiar with the names used in the UCP to describe the parties.

### The basis of the Issuing Bank's obligations

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- Although there are a number of contractual relationships involved in letters of credit—principally buyer and Issuing Bank and Issuing Bank with Advising/Confirming/Nominated Banks - there is probably no contract between any bank and the seller/beneficiary. Although Issuing and Confirming Bank (if any) give undertakings to the seller to pay against conforming documents, it is difficult to argue that the seller has given any consideration to the provider of such undertaking. *Commercial Law* page 661 briefly canvasses the main arguments on this issue, but you should read the article by Roy Goode mentioned in the footnote to obtain a fuller picture.
- Having pointed out the problems in trying to explain the Issuing Bank's obligations in a way that fits systematically into legal theory, it is essential to point out that the fact that there is such an obligation is without question and indeed the existence of that duty is the *raison d'être* for letters of credit. You might illustrate this by reference to such cases as *Hamzeh Malas* and other cases focussed on the autonomy of the credit principle, and this might well be used to link in to the next section of your essay.

### The fraud, illegality and other exceptions to the autonomy of the credit

- If you have not already done so, you will need to explain the idea of the autonomy of the credit and that there is some tension between the commercial importance of the principle and the need for exceptions in order to do justice to the parties.
- Of the exceptions, that for fraud is the most well-established and so there needs to be a detailed analysis of *The American Accord*. The emphasis in this case is on the marketability of the documents since, as you will have explained in the earlier part of the essay, letters of credit along with conforming documents are regularly bought and sold, and this is a key feature of their commercial utility. The tension is between the requirement that a bank must always to pay against apparently conforming documents on the one hand and permitting a bank to reject such documents where it knows or strongly suspects they are not accurate. The compromise reached in *The American Accord* focuses on the state of knowledge of the person seeking payment apparently at presentation and not acquisition so that a purchaser of the documents is vulnerable since, if he subsequently obtains knowledge of their falsity before presentation, he will not be entitled to payment. That said, there are suggestions that a bank must pay on an innocent tender, even on forged, though apparently conforming documents, although this is hotly contested and does not accord with a rational analysis of the effect of a nullity.
- You should also point out that the exception may and indeed probably does extend to cases where the underlying contract is voidable, for example for misrepresentation. It is perhaps surprising that there is a personal defence like this, since it is no defence to a claim for

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payment on a bill of exchange by a holder in due course, although it is only effective when there is a defect in title.

- You will then need to discuss the question whether illegality in the underlying contract can affect the autonomy of the credit.

### How much security do letters of credit provide the buyer and seller? / Conclusion

- As noted above, you also need to consider the position of lenders to the parties, since providing security to the banks is a key to the commercial success of letters of credit. This section in effect involves an evaluation of the autonomy principle which will entail not only drawing on material you included in the previous section, but also a discussion of other possible exceptions, particularly the 'unconscionability' exception. The issue is clear: to what extent ought characteristics of the underlying contract or even of the beneficiary affect the bank's payment obligation? Ultimately, you need to formulate some criteria against which to measure the 'ought'. These might include looking for a conclusion which accords with existing principles of law – ie 'are the exceptions systematic'? Perhaps a suitable criterion might involve looking at the extent to which banks are entitled to treat letters of credit almost as if they were currency, since, as it is important to remember, if Issuing Bank pays it will debit its customer – the autonomy of the credit is primarily an advantage to banks – though, of course, erosion of the principle will increase risk to banks and so increase the cost to customers of using letters of credit.
- In this essay the material in this section is in effect a conclusion, but do not forget that, having proposed some criteria, you need to evaluate them and suggest your view based on the material you have included.

3. Xavier wishes to buy some goods from Gordon but Gordon will only sell to him if Alexander will accept a bill of exchange, payable to Gordon in 120 days. Xavier draws the bill in Gordon's favour

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which he gives to Gordon with A's signature on it as acceptor. Gordon sells the goods to Xavier. Gordon later gives the bill to Henry.

As a result of his investigations into Xavier's finances, Gordon becomes concerned because he has sold goods in the past to Xavier on credit and he owes Gordon a lot of money as a result. Gordon indicates to Xavier that he is concerned about this and Xavier gives him a second bill of exchange with Alexander's signature as acceptor, again payable to Gordon in 120 days. To procure this bill Xavier promised Alexander that he will repay him with interest.

A little later, in identical circumstances to the first bill, Gordon receives a third bill with A's signature on it as acceptor.

Henry presents the three bills to Alexander for payment but Alexander refuses. H claims summary judgement against him and Alexander raises the following defences:

Defence 1 - In relation to bill number 1, Alexander received no consideration for his accepting the bill.

Defence 2 - In relation to bills 1 and 2, A accepted the bill only because Xavier had threatened to ruin him financially if he did not.

Defence 3 - In relation to bill 3, Alexander's signature was forged by Xavier.

Defence 4 – In relation to bills 1 and 2, the date on the bill has been altered.

Are these defences valid against Henry? Would they have been valid against Gordon if he had not given the bill to Henry?

### Introduction

- Many students think that only essay questions require an introduction, but this is not so. Answers to problem questions should also begin with a lucid and well-structured introduction that clearly highlights the area (or areas) of law to which the question relates. By doing this, you demonstrate immediately that you have understood the question and have clearly identified the relevant legal topics.
- This question focuses primarily on the availability of defences in respect of a claim for payment on a bill of exchange. The validity of such defences depend on:

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1. Is the defendant prima facie liable on the bill?
2. If he is, the status of the claimant, and;
3. The nature of the defence.

By way of explanation, the Bills of Exchange Act provides for liability for three types of person: the acceptors, endorsers, and the drawer. You should briefly describe the characteristics of each before going on to explain that there are three possible statuses for a holder of a bill of exchange. These are: mere holders, holders for value, and holders in due course and the effectiveness of the possible defences to a claim based on a bill of exchange depends on the status of the holder with all defences available against a mere holder and very few effective against a holder in due course, the equivalent so to speak of the bona fide purchaser for value of a bill.

In relation to each bill, A is prima facie liable on the bill since it appears that he is the acceptor so the remainder of the answer deals solely with the other two issues. There are two possible structures to the answer. You could take each bill in turn and determine H's status in relation to bill 1, turn to the nature of the defence, reach a conclusion and then pass on to bill 2, and likewise with bill 3. Alternatively, you could deal with H's status in respect of each bill and then move on to consider the nature of each defence. This answer takes the latter course.

### H's status.

- H has not himself given consideration so that prima facie he can only be a mere holder. However, because a holder can derive status from a previous holder we need to consider G's position too.
- Has G provided consideration so as to qualify as at least a holder for value?

Dealing with bills 1 and 3, S27(1)(a) Bills of Exchange Act 1888 provides that '[a]ny consideration sufficient to support a simple contract is sufficient to give value' and although the question is not entirely explicit on this point it seems highly likely that in effect X wished to buy goods from G on credit – why else would G be concerned to obtain credit support from A? Literally therefore G has in these cases given consideration by lending money to X. However the consideration was not given to the acceptor A, but *Diamond v Graham* demonstrates that this is not necessary – see *Commercial Law* pages 642-643. Consequently, by virtue of s27(2), H is deemed to be a holder for value as against previous parties to the bill, and this of course includes A the acceptor.

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In relation to bill 2, G had already sold the goods and was getting 'edgy' because of the credit risk. This is not a case where G gives consideration in the S27(1)(a) sense, the giving of credit is past consideration, which is no consideration. However, s27(1)(b) provides that '[a]n antecedent debt or liability... is deemed [to be] valuable consideration' and, literally understood, this section appears to benefit G. However, in *Oliver v Davies* it was held that the section only applies where a debtor makes provisional payment for a pre-existing debt by tender of a bill of exchange and not where the bill is provided by a stranger like A. That said, if G were threatening to sue X and only decided not to because A has accepted a bill in his favour, then G in forbearing to sue does provide consideration under S27(1)(a).

This position, in relation to bill 2, is subject to an argument to the contrary. Dankwerts LJ in *Diamond v Graham* held that value for the purposes of S27(2) can be provided by a third party. In our problem, X has promised to repay A and pay interest in return for A accepting to pay G. G has given no consideration to A for A's bill, but X has, and Dankwerts LJ suggests that this is sufficient. If it is, then value has been given for the bill and consequently H has the benefit of S27(2) and so is a holder for value. It is generally agreed that Dankwerts LJ is incorrect on the basis that it is difficult to reconcile with the decision in *Oliver v Davies* that the holder must provide consideration.

In summary, therefore, H is deemed to be a holder for value in respect of bills 1 and 3 by operation of s27(1) and (2) in relation to bills 1 and 3, but probably not in relation to bill 2.

- Was G a holder in due course?

In the cases of bills 1 and 3, G is the payee and *Re Jones Ltd v Waring and Gillow Ltd* held that a payee cannot be a holder in due course, though G, since he has given value, may have all the rights of a holder in due course, as in *Talbot v Von Boris*, where a payee/holder was held not to be affected by duress which induced signature of the bill since he had no notice of it and duress would have been a defence against all except a holder in due course.

In the case of bill 2, assuming Dankwerts LJ is wrong, we have noted that even G is not a holder for value not having given value and consequently H cannot be either.

- If H is a holder for value and, assuming he otherwise fulfils the honesty and notice criteria of S29, is he necessarily also a holder in due course?

S29 defines a holder for value and s 29(1)(b) requires the holder to take the bill 'in good faith and for value' which seems to suggest that the good faith and the giving of value must coincide. This has caused commentators to conclude that a holder in due course must himself actually give consideration rather than being deemed to do so by virtue of S27(2). *Commercial Law* page 645 points out that this view may be incorrect. However, if a holder must himself have provided consideration to take advantage of s29(1) then H will have to

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rely on S29(3) and construed literally he cannot do so since G was not a holder in due course being the payee. Whilst G seems to have all of the benefits of a holder for value, it seems he cannot shelter a subsequent party, at least not by virtue of S29(3) though see *Commercial Law* pages 645-646 for a contrary view.

### The nature of the defences:

- Defence 1 is a personal defence. If H is a mere holder (as he probably is in Case 2), then the defence is good. If H is a holder for value, however, the defence - lack of consideration - may not be good against him (See page 649 of *Commercial Law*).
- Defence 2 is a defence based on a defect in title. Duress does not avoid the bill *ab initio*, it makes it voidable. Such defences are not good against a holder in due course (not involved in the duress), but of course are valid as against a mere holder and a holder for value.
- Defence 3 is a defence based on nullity. If A's signature was forged, it is of no effect and so will be a good defence even against a holder in due course.
- Defence 4 is also a defence based on nullity in the sense that S64 Bills of Exchange Act 1882 renders a bill of exchange void if it has been materially altered (and this would include altering the date), unless everyone who is potentially liable on it agree. However, this is subject to an exception in favour of a holder for value if the alteration is not apparent.

### Conclusion

- Only a brief conclusion is needed. If A is correct and the signature on bill 3 was forged, then regardless of H's status he cannot sue on the bill. However, it is conceivable that he is a holder in due course in respect of bill 1 (and 3, assuming A cannot prove the forgery allegation) and will succeed in his claim. However, it may be that because G was not himself, literally a holder, in due course being the payee. H may only ever be a holder for value and so would be vulnerable to all defences except possibly the lack of consideration received by A.