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## A Study on Buyer's Obligation in Relation to the Letter of Credit in a Sales Contract

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### Abstract

**Purpose:** This study aimed to deal with disputes between the seller and the buyer in connection with the Letter of Credit (LC) in a sales contract. The Contracts for the International Sale of Goods (CISG) provides the rules on the fundamental breaches which can lead to termination of the sales contract but the CISG is not enough to govern issues arising from the LC disputes when the sales contract is not clear about the payment terms. This paper tried to find some solutions to the disputes by considering international rules, such as the Principles of European Contract Law (PECL). **Research design, data and methodology:** The methodology applied in this study was an analysis of some court decisions and extended literature review. **Results:** The study revealed that in contracts for the sale of international goods, the buyer was obliged to open an LC as manner of payment. If the buyer failed to open an LC or amend the terms of the LC, the seller could avoid the contract because this could deprive the seller's expected interest. **Conclusions:** Few studies in Korea have been comprehensively analyzed in terms of the obligations of regarding the LC with respect to the CISG in court cases. This study suggests safeguarding the buyer and seller when the LC is considered absolute or conditional.

**Keywords:** Buyer's Obligation, Fundamental Breach, LC and Sales Contract, Avoidance of Sales Contract, Seller's Discrepant Document

**JEL Classification Code:** K15, K22, K33, O33

### 1. Introduction

The international sale of goods, usually, represents a huge amount of money and large shipments of goods. International commercial transactions are often vulnerable to non-performance by the seller or non-payment by the buyer. Parties may not know a lot about each other, in particular, about trustworthiness of their trading partner and

the financial capability. The problem is further deepened by the uncertainty of the applicable national law, where parties cannot make explicit choices of the applicable laws in their contract. Even if national laws are chosen by the contracting parties, at least one of the parties will have to deal with legal systems that are not known to the parties involved.

The United Nations Convention on Contracts for the International Sale of Goods 1980 (hereinafter referred to as "CISG") regulates the international sale of goods defining

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the contract by which the seller usually agrees to deliver the goods and transfer the property rights to the buyer, and the buyer agrees to pay the price for the goods and also take possession of the products. These approaches are consistent with the understanding that the buyer and the seller have reciprocal obligations toward concluding the sales contract. The CISG represents a unified approach to the obligations of the seller in respect to the goods delivered to the buyer.

In a contract for the sale of international goods, the buyer is obliged to open a Letter of Credit (hereinafter referred to as "LC") under the terms agreed upon in the contract. If the buyer refuses or fails to open an LC, the seller may void the sales contract along with appropriate claims, because this deprives the seller of what he may gain from the contract. On the other hand, there is a chance for the seller not to deliver documents matching up to the terms of the LC leading to a rejection of payment by the issuing bank. The documents must therefore conform strictly with the terms of the credit. As such, the principle of strict compliance has evolved from international banking practices (Xiang and Buckley, 2003).

There have been several studies in Korea concerning the obligations of the buyer and seller under an LC, such as, CISG: Heo (2009), Shim (2013), Lee (2014), Park and Song (2018) which articulated that the buyer should open an LC if it was stipulated in the sales contract and the LC should be regarded as part of the payment method. On the other hand, Huh (2010) studied the buyer's right of non-payment against discrepant documents under an LC. With regard to overseas studies, Muñoz (2017) stressed that the buyer's failure to open an LC or a non-compliant LC could entitle the seller to claim certain remedies but did not discuss the seller's obligation when complying with the presentation of documents. Moreover, Alsvi (2016) analyzed the issuing bank's role in the process of the operation and what liabilities the issuing bank had toward the beneficiary. Husam (2016) evaluated the conditional and absolute payment issues in an LC in an attempt to identify which position provided maximum flexibility, fairness, party autonomy, certainty, and good faith. Yasutoshi (2020) attempted to solve the CISG fundamental provisions by the good faith duty of parties and Ilyas (2023) asserted that the concept of "fundamental breach" has fundamental issues in itself due to lack of a universally accepted and reliable definition and redrafting the article 25 might be a radical yet efficient solution. Kim (2021) studied that late delivery or late payment does not itself constitute fundamental breach. Where the goods delivered is defective or does not conform to the contract, the buyer can avoid the contract if the defect or non-conformity constitutes fundamental breach. Lee and Kim (2021) which articulated that the study reviewed regulations and theories regarding the buyer's right to suspend performance where the seller fails to fulfill the

obligations under CISG and specifically consider the functions, requirements, methods and effects of the suspension of performance. Furthermore, the study provided practical and legal considerations and implication of the LC.

This study analyzed disputes arising from obligations of the seller and buyer under an LC operation in relation to the CISG and further suggested practical safeguards for the trade parties by researching various court cases and literature differentiating precedent studies.

## 2. Obligations and Remedies in a Sales Contract

### 2.1. Obligations of the Buyer

The main obligation of a buyer under a sales contract is to pay the price or the goods delivered. According to Article 6, CISG, a buyer is liable to pay the purchase price at the due date agreed upon by both parties and to take possession of the goods delivered. The place of delivery will be the seller's business place if the contract is silent on the place. The buyer must examine the goods. Further, in cases of nonconformity, the seller is to be notified within a reasonable time pursuant to Article 39, CISG.

Article 64 of the CISG stipulates that one party may terminate the contract in the event of a "fundamental" breach of contract by the other party. The fundamental breach of contract means that one party gives the other party a substantial loss depriving the other party of what is expected in the contract. Nevertheless, that is not the case provided that the party in violation, and the same kind of rational person, has not foreseen such an outcome under the same circumstances.

Whereas, Korean civil law stipulates delay and inability to perform the contract gives a reason for terminating the contract, and the precedent (the Supreme Court's 93Da45480 and 45497) recognizes that an incomplete performance is a reason for termination of the contract, so a fundamental breach of the contract under CISG is a bit unfamiliar to Korea. Therefore, the interpretation of fundamental has a significant meaning (see Table 1).

**Table 1:** Buyer's and Seller's Obligations under the CISG

Article	Rules
Article 33	The seller must deliver the goods: (a) if a date is fixed by or determinable from the contract, on that date; (b) if a period of time is fixed by or determinable from the contract, at any time within that period unless circumstances indicate that the buyer is to choose a date.
Article 34	If the seller is bound to hand over documents relating to the goods, he must hand them over at the time and place and in the form required by the contract. The buyer's obligation to pay the price includes taking such

Article	Rules
	steps and complying with such formalities as may be required under the contract or any laws and regulations to enable payment to be made.
Article 54	The buyer's obligation to pay the price includes taking such steps and complying with such formalities as may be required under the contract or any laws and regulations to enable payment to be made.
Article 60	The buyer's obligation to take delivery consists of: (a) in doing all the acts which could reasonably be expected of him in order to enable the seller to make delivery; and (b) in taking over the goods.

Note: CISG (Vienna Convention) 1980

## 2.2. Seller's Remedies Against the Buyer's Breach of Contract

Right of termination of contract is granted to the seller only in the case of a fundamental breach but in certain cases, it is expanded to non-fundamental breaches by granting an additional period of time according to the CISG 64(1)(b) and the Principles of European Contract Law (hereinafter referred to as "PECL") 8:106(3). Furthermore, the PECL 9:303(2) states that all notices of termination must be given at a reasonable time. During that period the aggrieved seller may resort to other remedies in terms of damages that occur or if the buyer cannot avoid the contract unless the buyer declares that they have no cure for what happened. The additional period of time is to allow for eventual termination of the contract; the period of time allowed shall be reasonable so that the buyer in breach may cure its non-performance. If the buyer fails to perform its obligation throughout the additional period, the seller is empowered to void the contract together with an automatic expiry of the contract.

In general, the CISG provides the seller with some remedies to choose from in case of a breach by the buyer (See Table 2).

**Table 2:** CISG Seller's Remedies

Article	Rules
Article 62	The seller may require the buyer to pay the price, take delivery or perform his other obligations.
Article 63	(1) The seller may fix an additional period of time of reasonable length for performance by the buyer of his obligations.
Article 64	(1) The seller may declare the contract avoided: (a) if the failure by the buyer to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract; or (b) if the buyer does not within the additional period of time fixed by the seller per paragraph (1) of article 63, perform his obligation to pay the price or take delivery of the goods, or if he declares that he will not do so within the period so fixed.

Note: CISG (Vienna Convention) 1980

## 3. Breaches in a Letter of Credit under a Sales Contract

### 3.1. Fundamental Breach and Strict Compliance Using the Template

The concept of fundamental non-performance in Article 8:103 PECL and 7.3.1 UNIDROIT Principles commonly coincides with the concept of fundamental breach mentioned in Article 25 stressing that the conformity of the goods with the terms of the contracts is the main rule for estimating lack of conformity. If the parties have not agreed otherwise, the secondary rule in Article 35(2) will apply. Lastly, Article 35(3) contains exceptions to the seller's liability for lack of conformity of goods, where buyers knew or would not have been perceive the lack of conformity.

Unlike the PECL, the CISG and the UNIDROIT Principles cover not only sales contract but also other types of contract, such as contracts of services. To facilitate future development and to provide maximum flexibility of two sets of principles, the basic rule concerning the conformity of performance has been explained in more general terms. In Article 7.1.1. of the UNIDROIT, non-performance is determined as a failure by parties to perform some of its obligations under the contract, including late performance or defective performance. This is similar to PECL Article 8:101(1). The UNIDROIT Principles and the PECL have several articles which may be used to supplement or interpret Article 35 of the CISG. Article 7.3.1(2) in the UNIDROIT Principles lists several circumstances which may bring about the conclusion that particular breaches of contract are fundamentally contrary, unlike Article 35 of the CISG.

Both Article 8:103(a) PECL and 7.1.3(2) UNIDROIT Principles state that the parties have implicitly or expressly accepted that strict compliance with contractual terms is indispensable and any deviations from the obligations by the parties under the contracts are to be considered fundamental breaches. This is on the ground of the core principles of the party autonomy, which permits the parties to decide the circumstances under which breaches of contract will be fundamental.

### 3.2. Buyer's Obligations in Terms of the Letter of Credit

Payment of the contract price is the buyer's main obligation. Many payment modes involve the necessary preparatory step, such as, procuring an LC or a bank guarantee. Such acts are normally considered essential obligations of the buyer to pay the goods.

With regard to the LC under a sales contract, requiring the buyer to open an LC obliges the buyer to have a bank

assume the payment of the contract price against stipulated documents in the LC. Even though the buyer's obligation to open a credit in favor of the seller may not be a condition precedent for all responsibilities of the seller, it is still a conditional precedent, especially, for delivery of goods.

According to Article 2 Uniform Customs and Practice for Documentary Credit (hereinafter referred to as "UCP") 600, an LC is an arrangement, however, described or named, whereby the issuing banks act at the request and on the directions of customers, being the buyer or applicant, to pay the third party, being the seller or beneficiary against a stipulated document.

### **3.3. Seller's Remedies against Buyer's Failure**

The failure of the buyer to open a complying LC is a reason for nonperformance of the contract and this enables the seller to withhold goods until the complying LC as per terms of the underlying contract has been furnished. Further, the seller may use the LC as a tool to finance an export trade, meaning that the LC involved in the practice of international trade is regarded as more than just a means of payment for the price stipulated in the sales contract.

In the event that the buyer eventually fails to open an LC, the seller may have the right to terminate the contract; but it will be safer for the sellers to terminate the contracts after serving the buyers with due notice of intention to terminate. The seller should notify the buyer with the exact deadline when opening a complying LC in the notice. If the buyers fail to open an LC on time, the sellers will be entitled to void the contract and also claim for damages from the buyers.

With reference to the autonomy principle, payment using an LC is an absolute undertaking of the bank which is accepted by the seller. Therefore, the seller may have no remedies in case of being left unpaid by the bank despite the presentation of a complying document. The above presumption might be effective when the seller expressly admits the absolute nature of payment by the credit which can happen for example through their requirement to open an LC. This refers to Article 9(2), CISG which stipulates that parties are, generally, bound by prevalent usages, such as a UCP because international sales contracts are concluded against a background of trade usage and practice. Implied or expressed requirements of the seller in the sales contract that the LC is to be issued by a particular bank - to the exclusion of the buyer - would make the LC an absolute payment.

## **4. Court Cases**

### **4.1. Cases of Buyer's Obligation in Opening an LC**

It is often the buyer's obligation to deliver the goods

backed by some court cases such as *Siporex Trade S.A. v. Banque Indosuez* [1986] 2 Lloyd's Rep. 146, *Gliddens v. Anglo-African Produce Company, Ltd.* (1923) 14 Ll.L. Rep. 230 and *Danubian Trading Co. Ltd., v. Trans Trust S. P. R. L.* [1952] 1 Lloyd's Rep. 348. Also, the seller's right to repudiation may be justified when the buyer is not able to open an LC within a specified time.

In the leading case of *Newman Industries Ltd., v. Indo-British Industries*, the Queen's Bench held that the defendant's procurement of an LC was merely a conditional payment. In *W. J. Alan & Co. Ltd., v. El Nasr Export and Import Co.*, it states that when a non-conforming LC is opened, the seller may directly claim payment from the buyer.

In the case of *Nigerian Sweets & Confectionery Co., Ltd. v. E. D. & F. Man Ltd.*, the issuing bank resorted to a liquidation after being reimbursed by the buyer but payment to the seller under ninety-day drafts drawn from it was left unpaid. The seller sued the buyer, instead. The seller exercised its remedy on grounds that the buyer breached its contractual promise to pay through an LC.

### **4.2. Korean Court Cases**

#### **4.2.1. Korean Supreme Court 2013.11.28 (2011Da103977)**

(1) Facts: A Korean buyer opened an LC that was not consistent with the sales contract and further amended the LC by adding requirements that were difficult to perform. The buyer did not even respond to the seller's amendment request for an additional period of 10 days.

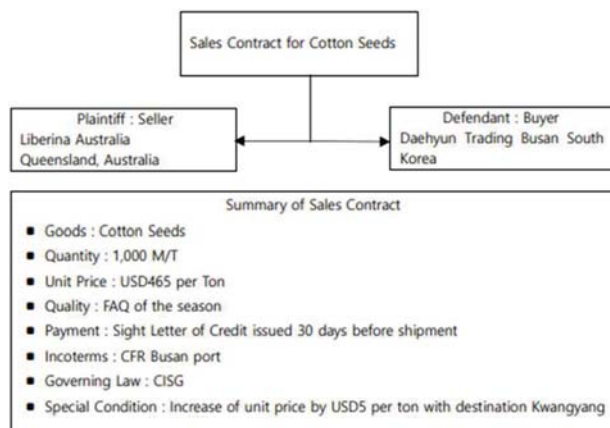
(2) Issues: The LC issued was inconsistent with the parties' sales contract and it was further amended to include the conditions: from 20-feet to 40-feet container packaging, non-transshipment, 3rd party inspection certificate designated by the buyer, and non-Genetically Modified Organism certificates. These amendments were disadvantageous to the seller because larger containers meant increase in shipping charges, and there might not be a direct sailing route. Specifically, if the inspection certificate issued by the person designated by the buyer was conditional, the inspection certificate may not be issued according to the will of the buyer. Meaning, there was a high possibility that the buyer may default on its payment obligations. As long as the seller requested a reasonable additional period for the above serious breach of contract, it could be said that the buyer had no intention of fulfilling the obligation when the buyer refused to do so.

(3) Court Decision: According to the CISG, the buyer was obliged to pay for goods (Article 53), and the buyer's obligation to pay for such payments included taking the measures prescribed by the contract or law and procedures (Article 54). Seller could avoid the contract if the contract or convention resulted in a fundamental breach of contract



due to non-fulfillment of the buyer's obligation (Article 64.1.1). Therefore, if the buyer refused to open an LC, it effectively deprived the seller of the terms they expected from the contract, and thus the seller could declare the contract null and void.

(4) Evaluation: The court's finding was in accordance with other English courts but the Korean court did not provide specific criteria for a fundamental breach of contract. The court further admitted that some delays in opening an LC may not be a fundamental breach of contract. Moreover, it was considered that some delays in a bank's payment would not be a fundamental breach of contract but the delay in the opening of the LC may be different. This was because the seller would not manufacture goods or prepare shipping until the LC came to their hands. In this regard, the delay in the opening of the LC was considered a fundamental breach of contract unless there were special circumstances (see Figure 1).



Source: author

**Figure 1:** Fact Summary of Liberina vs. Daehyun

**4.2.2 Korean High Court 2013.7.19(2012Na59871)**

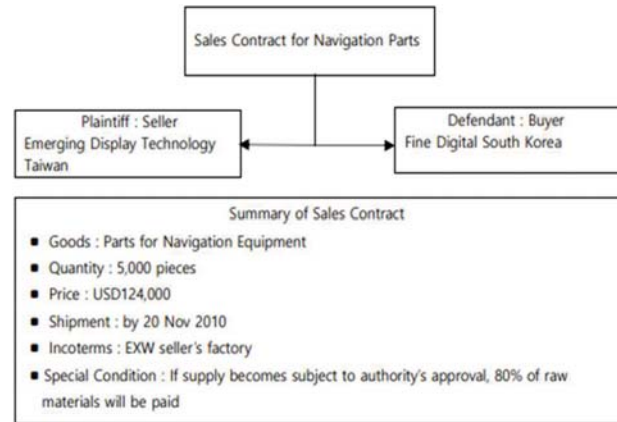
(1) Facts: The buyer opened an LC with the shipment date as of 20 November 2010. After the LC issuance, the buyer continued to request product modification but finally approved the product specifications on 4 November 2010, making the seller unable to meet the shipment date in the LC.

(2) Issues: The buyer, defendant, argued that the seller was well aware of the delivery date but the seller failed to supply.

(3) Court Decision: The court held that buyer's opening an LC is part of a mutual agreement and constitute seller's protest for simultaneous execution.

(4) Evaluation: The CISG did not have any special provisions for simultaneous executions, like the Korean Civil Law but, in this case, the Korean court quoted

simultaneous executions in addition to several CISG clauses. The simultaneous executions in this court were interpreted that the buyer's opening an LC as per sales contract was a precedent obligation to the seller (see Figure 2).



Source: author

**Figure 2:** Fact Summary of Emerging Display vs. Fine Digital

**5. Conclusions**

Although the sales contract imposes duties on the buyer to open the documentary LC in the seller's favor, the LC contract is entirely a matter between the issuing bank and the seller. When an LC is opened it becomes independent from the underlying sales contract and forms a separate legal relationship between the seller and the issuing bank. This means that the delivery of non-conforming documents might be regarded as the delivery of non-conforming goods to the buyer. Therefore, documents play a crucial role in an LC transaction.

Termination of a contract is possible only in the event of a fundamental breach. However, both the CISG and PECL seem to deviate from the LC operations in that they allow the issuing bank to reject documents that fail to strictly conform with the conditions of the LC even though that discrepancy is of little practical significance.

The UCP 600 itself is a reflection to the current international banking practices and therefore even if parties do not incorporate the UCP 600 into their contract, the principles of strict compliance are considered to be implicitly agreed upon when an LC is used as payment. This is supported by the UNIDROIT Principles and PECL in place of the lack of the CISG rule.

Whereas the LC is independent, the underlying contract may affect the implementation of an LC for arbitrators and courts on how to resolve possible disputes between parties.

A conflict between the credit and sales contract may be found in different areas from the nature of parties' obligations and terms including absolute or conditional nature of the credit based on the framework of the underlying contract.

Parties to the fundamental sales contract are free to agree implicitly or explicitly on whether payment by an LC is conditional or absolute. If the contract is silent on this, most legal cases deem this as conditional rather than absolute. This means that when the LC is given to the seller it operates as conditional payment of the price, not absolute payment, especially in the case wherein the seller delivers conforming goods to the buyer. This suggests that opening of an LC does not remove the buyer's obligation to pay.

However, in relation to the question of flexibility on whether payment by LC is absolute or conditional, if the sales contract stipulates that the LC shall be regarded as absolute, this will bring some difficulties to bona fide sellers. As a safeguard, the seller should prepare a checklist to protect oneself and the buyer should not include in the LC those matters which affect the seller's rights. It is also important for the seller to have enough shipment time for adequate production and safe shipment of the goods in order that an extension will not be needed. Also, the seller should not wish to impose the LC to be opened by any specific bank, but it should be an international top-tier bank.

The buyer, for his part may arrange an LC payable against an inspection certificate which is to be carried out by independent inspectors. Furthermore, the buyer may ask the seller for a standby LC so as to be secured against the seller's non-payment.

In conclusion, it is emphasized that one of the vital roles of the CISG is the conservation of the sales contract. In LC transactions, the avoidance of the sales contract is a remedy of last resort. Only after all other options have failed should the aggrieved party void the contract. Both parties shall preserve their end of the bargain and also not hamper the performance of the other party.

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