



CHAPTER 7

Bank Collections, Trade Finance, and Letters of Credit

The previous chapters include discussions of contracts for the sale of goods, documentary sales, the risk of loss, and the liability of air and sea carriers. This chapter now turns to the use of the international banking system to move money in an international trade transaction. We will see how sellers collect for their shipments and how buyers remit payments for their purchases. We will also learn how sellers are assured of payment for their goods or services through the use of bank letters of credit and will briefly discuss some issues related to financing the sale. Keep in mind that most of the concepts covered here do not just apply to collecting money for the sale of goods but are equally applicable to many different types of international transactions involving the movement of money internationally and the use of banks to provide an assurance of contractual commitments.

THE BILL OF EXCHANGE

An understanding of how international payments or movements of money are made to fulfill contract obligations requires some basic understanding of the law of negotiable instruments. In general, courses on business law cover the law of negotiable instruments. For our purposes, we assume you have some limited understanding of this field. Our concern here is not with their technical requirements, but with their use in international trade. A **negotiable instrument** is a signed writing, containing an unconditional promise or order to pay a fixed sum of money, to order or to bearer, on demand or at a definite time. Common negotiable instruments include promissory notes, which are two-party instruments containing a promise to pay, and drafts, which are three-party instruments containing orders to pay. In this chapter, our concern is only with drafts. A **draft** is the signed order of the drawer, given to a drawee who is in possession of money to which the drawer is entitled, to pay a sum of money to a third party, the payee, on

demand or at a definite time. A common *check* is a special form of draft, which is drawn on a bank and payable on demand. The three parties to a check include the drawer, who gave the order to pay, the drawee bank to whom the order to pay is given, and the payee. The **bill of exchange** is a specialized type of international draft commonly used to expedite foreign money payments in many types of international transactions. A **documentary draft** is used to expedite payment in a documentary sale. The word *draft* is more frequently in use in U.S. law and banking practice, while the term *bill of exchange* is more frequently in use outside the United States, particularly in England. Generally, we use the term *draft* in this text except when referring specifically to an English bill of exchange. These negotiable instruments can serve two purposes: they act as (1) a substitute for money and (2) a financing or credit device.

Although it is beyond the scope of this text to offer a thorough treatment of the law of negotiable instruments, an understanding of the importance of the draft is essential to anyone engaging in international trade.

The Origin of Bills of Exchange

The origin of the bill of exchange lies in the history of the merchants and traders of fourteenth- and fifteenth-century Europe. Merchants visiting the markets of distant cities to buy and sell their wares sought a safer means of transferring their gold or money than carrying it in their caravans. It might have worked like this: Assume Merchant A delivers goods in a distant city to Merchant B, who becomes indebted to A for the amount of the purchase. Later Merchant A desires to purchase goods from Merchant C. Merchant A can pay Merchant C for the goods with a written piece of paper—an order addressed by A to B to pay that money to C. Assume further that Merchant B is wealthy and respected in the trade—one whose credit is highly regarded. Merchant C can present the written order to B for payment immediately,



or should he wish, he can simply ask B to sign (or “accept”) the order for future payment. Thus, the written order to pay becomes an *acceptance*. With the acceptance in hand, Merchant C can purchase new wares from yet another merchant and use the acceptance in payment. Eventually, merchants turned to wealthy families, Italian banking societies, or medieval bankers spread throughout Europe to transfer money over great distances by issuing payment orders to their correspondents living in distant cities. As merchants recognized that these orders could be bought and sold, the concept of negotiability evolved and negotiable instruments were born. At first, English law did not recognize the validity of negotiable instruments. But merchants accepted them as substitutes for money, and they were enforceable in the merchant’s private courts under the *law merchant*. As their importance and use evolved, so did their validity and treatment under the law. They became formally recognized by statute in England in 1822 in the *English Bills of Exchange Act* and in the United States in 1866 in the *Uniform Negotiable Instruments Law*.

In the United States, the *Uniform Commercial Code* (UCC) governs bills of exchange or drafts, while the *Bills of Exchange Act* governs in England, and the 1930 *Convention Providing for a Uniform Law for Bills of Exchange and Promissory Notes* governs in more than 25 other countries. Despite their common history, these laws differ in their treatment of the creation and transfer of negotiable instruments, as well as in the rights of the parties should an instrument be dishonored or refused.

Brief Requirements of a Bill of Exchange

The English *Bills of Exchange Act* requires that a bill of exchange be (1) an unconditional order in writing, (2) addressed by one person to another, (3) signed by the person giving it, (4) with a requirement that the person to whom it is addressed pay on demand or at a fixed or determinable future time, (5) a sum certain in money, and (6) to or to the order of a specified person, or to bearer. These characteristics are similar to the requirements for a draft set out in the UCC. (The *Convention on Bills of Exchange* requires that the words “bill of exchange” appear on the instrument, but English and U.S. laws do not.)

Basically, a bill of exchange or international draft is similar to a check, in that it is an unconditional order to pay a sum of money. (Drafts can be made payable in any currency.) In the case of a check, the **drawer** orders its bank, the **drawee**, to pay the amount of the check

to the **payee**. However, instead of being drawn against funds held on deposit in a bank (as with a check), an international draft is an order from the seller to the buyer or buyer’s bank to pay the seller upon the delivery of goods or the presentation of shipping documents (e.g., an ocean bill of lading or air waybill). Thus, the seller is both the drawer (the one giving the order to pay) and the payee (the one entitled to payment under the instrument). The drawee is either the buyer or its bank, depending on the arrangements made for payment.

Negotiation and Transfer of Negotiable Instruments. The commercial use of a draft or other negotiable instrument is derived from its negotiability, the quality that allows it to act as a substitute for money. **Negotiation** is the transfer of an instrument from one party to another so that the transferee (called a *holder*) takes legal rights in the instrument. The correct manner of negotiation depends on whether the instrument is a bearer or order instrument. Most drafts used in international trade are order instruments because they are payable to a named payee. To negotiate an order instrument, **indorsement** (by signature) **and delivery** of the instrument to the holder must take place. References to the negotiation of international drafts appear throughout this chapter.

The Documentary Draft and the Bank Collection Process

Drafts come in several different types. A draft that is to be paid upon presentation or demand is known as a **sight draft** because it is payable “on sight.” The seller prepares the sight draft and sends it to the buyer along with the shipping documents (e.g., the bill of lading) through banking channels, moving from the seller’s bank in the country of export to a foreign correspondent bank in the buyer’s country and city. The draft is sent “for collection,” known as a **documentary collection**. The banks act as agents of the seller for collection purposes. A *collection letter* that provides instructions from the seller on such matters as who is responsible for bank collection charges, what to do in the event the buyer dishonors the draft, and how the proceeds are to be remitted to the seller, accompany the draft and documents. Thus, the collection letter may specify that in the event of the buyer’s dishonor of the draft, the seller’s agent in the buyer’s country is to be notified, and that the goods are to be properly warehoused and insured pending resolution of the problem or sale of the goods to another party.



Essentially, documentary collections function like a cash-on-delivery (COD) transaction. When the buyer receives the sight draft at its bank or place of business, the draft is paid, and the payment is remitted to the seller. Only then does the bank turn over the shipping documents with which the buyer can claim its cargo from the carrier. The transaction is somewhat risky, however, because when presented with documents, there is no guarantee that the buyer will actually pay. Assuming the buyer does pay, the average cycle for completing a documentary collection is approximately three weeks (although most banks offer accelerated schedules). If a sales contract between buyer and seller calls for payment upon presentation of a sight draft, the contract terms commonly call for *cash against documents*. (See Chapter 5 for a discussion of sales contracts with documentary payment terms.)

The SWIFT System. The Society for Worldwide Interbank Financial Telecommunication, an industry-owned cooperative commonly known as the SWIFT network, is a high-speed communications network between banks, set up to transfer funds worldwide. It originated through the cooperative efforts of major banks in Europe, the United States, and Canada in the mid-1970s, and it is used by 9,000 institutions throughout the world. It has largely replaced the use of telex and mail-in fund transfers. In fact, the SWIFT network transmits most international letters of credit. It is cost-effective and has greatly expedited the remission of payments in a documentary collection.

In 1998, SWIFT and the TT Club (the international transport and logistics industry's leading provider of insurance and risk management services) created a joint venture to market and support the *Bolero Project*. Bolero seeks to replace the paper-based transfer of trade documents with electronic transmissions on a global scale.

Documentary Drafts Used in Trade Finance

Banks and other financial institutions involved in commercial lending provide a wide range of financing packages for international trade, commonly called **trade finance**. Trade finance not only assists the buyer in financing its purchase but also provides immediate cash to the seller for the sale and is profitable for the lending institution.

The documentary draft can serve as an important financing or credit device, providing the seller and

buyer with a mechanism for financing the international sale. In a competitive marketplace, an exporter must be able to offer its customers credit or other financing for their purchases. Many firms consider their ability to arrange credit a crucial component of their marketing strategies. If an exporter can prearrange financing for the buyer, it has an advantage over a competitor who cannot.

The Use of Time Drafts and Acceptances. The use of the draft in trade finance works like this: Seller agrees to issue a draft that is due, say, 60 days after shipment of the goods. The draft states that it is due in 60 days or on a future date specified on the instrument. A draft due at a future date or after a specified period is known as a **time draft**, as shown in Exhibit 7.1. The time draft is sent to the buyer for its acceptance. Typically, acceptance is done by stamping the date and the word "accepted" across the face of the draft, together with the name and signature of the drawee, because no party is obligated on a draft unless its signature appears on it. Under the UCC, the acceptance "may consist of the drawee's signature alone." The buyer has thus created a *trade acceptance*. The buyer's acceptance indicates the buyer's unconditional obligation to pay the draft on the date due. A draft payable at "60 days after date" is payable by the drawee 60 days after the original date of the instrument. A draft payable at "60 days sight" means that it is due to be paid 60 days after the date of the acceptance.

As with a sight draft, a seller usually sends the time draft together with the shipping documents to the buyer through banking channels with instructions to the banks that the shipping documents should be handed over to the buyer only upon acceptance of the draft. The sales contract would have indicated the parties' agreement to this arrangement by calling for "documents against acceptance," or other clear language of similar meaning. After acceptance, the draft is returned through banking channels to the seller. The seller can then hold the draft to maturity or sell it at a discount to a local bank or commercial lending institution for immediate cash. The commercial lender takes the acceptance by negotiation. The greater the creditworthiness of the buyer, the greater the marketability of the trade acceptance. Where the foreign buyer is unquestionably creditworthy, such as a major multinational corporation, the trade acceptance carries little risk and is easily saleable.

Exhibit 7.1

Time Draft Drawn under Letter of Credit with Banker's Acceptance

AT SIGHT _____ DATE _____ CITY _____
(INDICATE ABOVE WHETHER PAYABLE ON DEMAND OR OTHER TIME LIMIT)

PAY TO THE ORDER OF _____ U.S.A. _____
(NAME OF EXPORTER, EXPORTER'S BANK OR PAYEE)

_____ U.S. DOLLARS

FOR VALUE RECEIVED AND CHARGED TO THE ACCOUNT OF NATIONAL BANK LETTER OF CREDIT NO. _____

THE TRANSACTION WHICH GIVES RISE TO THIS INSTRUMENT IS THE:
☐ IMPORT ☐ DOMESTIC SHIPMENT
☐ WAREHOUSING
OF _____
FROM _____ TO _____

A C C E P T E D

Date _____

National Bank, N.A.

Per Authorized Signature _____

TO: NATIONAL BANK, N.A.,
ANYTOWN, U.S.A.
(IMPORTER, BUYER OR DRAWEE)

_____ DRAWER'S SIGNATURE (EXPORTER)

Banker's Acceptances and Acceptance Financing. A **banker's acceptance** is a negotiable instrument and short-term financing device in wide use to finance international (as well as domestic) sales. The purpose of an acceptance is to substitute a bank's credit for that of the buyer to finance the sale. A banker's acceptance is a time draft drawn on and accepted by a commercial bank. The bank stamps its name, date, and signature on the face of the draft to create the acceptance and thereby becomes obligated to pay the amount stated to the holder of the instrument on the date specified. The holder of the acceptance can convert it to cash immediately at a discounted rate or hold it until it matures.

Banker's acceptances are flexible instruments, with many creative uses. Either a buyer's or a seller's bank can handle the acceptance. Importing buyers can use a banker's acceptance for short-term borrowing until they can resell and liquidate the goods being purchased. Sellers to export markets can use a banker's acceptance for short-term, pre-export financing of raw materials and production costs until the goods are sold to the foreign customer and payment is received. Exporters can also use acceptances to grant credit terms to foreign

customers. For instance, in a sale on open account, an exporter might draw a time draft on its own bank for the amount of its overseas sale. The exporter's bank accepts the draft, the discounted amount is paid to the exporter, and the acceptance is negotiated and discounted in the credit markets. When the importer pays the invoice amount to the exporter, the proceeds are used to satisfy the acceptance at maturity. In another arrangement, the exporter's draft may be accepted by the importer's bank, and then discounted in the credit markets. In any case, the acceptance is satisfied at maturity through the proceeds of the sale.

In essence, the acceptance financing is self-liquidating because repayment is made from the underlying sales transaction, using credit market monies to finance business. The bank charges the borrower a commission and the discount rate for acceptance financing, which is usually deducted from the face amount of the acceptance when paid to the borrower. Depending on market conditions, acceptance financing is often cheaper for companies than regular credit borrowing.

Banker's acceptances are generally short-term instruments because they must be for a period of six months

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or less. An eligible banker's acceptance is one that qualifies for discount at the U.S. Federal Reserve Bank, which will buy it if it is not sold privately. Acceptances thus serve to finance international trade with outside capital. Because commercial banks create them, the use of banker's acceptances is subject to banking laws and Federal Reserve regulations in the United States.

Credit Risk in Trade Finance Programs. Institutions with regular involvement in trade lending commonly prearrange these financing terms by agreeing in advance to purchase the trade acceptances of the foreign buyer. They must first perform an analysis and evaluation of the buyer's financial position. Thorough credit checks are done on the buyer, using trade and banking information, the reports of U.S. or foreign credit reporting agencies, and even site visits to the foreign firm. (Although obtaining and verifying credit information is relatively easy in the United States, Canada, Japan, and Western Europe, it is somewhat more difficult, and the information is less reliable, in other regions of the world.) To reduce the credit risk and lower the cost of trade finance, several government agencies in the United States and other countries provide credit guarantees to back trade finance lending by commercial institutions. In the United States, these agencies include Eximbank, the Commodity Credit Corporation, and the Agency for International Development (discussed later in this chapter).

Credit Risk in Acceptance Financing: Rights of the Holder in Due Course. One of the primary reasons for the popularity of the acceptance as a financing device is the protection it provides to the financial institution or other party who purchases it, provided that party is a holder in due course. The UCC spells out the detailed requirements to become a holder in due course. A **holder in due course** is a holder in possession of a negotiable instrument (such as a draft or acceptance) that has been taken (1) for value, (2) in good faith, (3) without notice that it is overdue or has been dishonored, and (4) without notice that the instrument contains an unauthorized signature or has been altered (UCC 3-302). If all of the requirements for transferring a negotiable instrument are met and the transferee qualifies as a holder in due course, the transferee can take greater rights in the instrument than the transferor had.

According to the *holder in due course rule*, the purchaser of an acceptance, or any negotiable instrument, takes it free from most disputes that might arise

between the drawer and drawee—the original parties to the underlying transaction. The most common type of dispute that might arise is breach of contract. For example, assume that DownPillow sells pillows to a Japanese buyer and forwards documents and a draft for acceptance. DownPillow discounts the trade acceptance to a U.S. bank, which then discounts the instrument in the credit markets. If the pillows turn out to be moldy and worthless, the Japanese buyer must still honor and pay the acceptance upon presentation in Japan. The buyer may then assert its separate claim for breach of contract against the seller. This rule ensures the free transferability of commercial paper in international commerce. A financial institution can discount an international draft without fear that it will be caught up in the middle of a breach of contract action between buyer and seller. If drafts did not come with this protection, banks might not be so willing to finance international sales.

Credit Risks in Factoring Accounts Receivable: The Rights of the Assignee

As firms become more globalized and as credit information becomes more widely available, many firms are offering open account terms to their better, long-term foreign customers. These sellers are giving their customers an open credit period, typically from 30 days to several months, to pay for goods received. However, companies engaged in exporting products are not in business to loan money. Thus, banks are providing open-account trade finance services, including the factoring of foreign accounts receivable.

An account receivable is no more than a representation of a *contract right* belonging to the seller—the right to collect money owed by the buyer under the contract for goods shipped. Contract rights can be assigned to another party. In a typical financing arrangement, the seller (assignor) assigns its right to collect the account to the financial institution (assignee). This is also called *factoring*, and the assignee is sometimes called the *factor*. Under basic contract law, the assignee “steps into the shoes” of the assignor and acquires only those rights under the contract that the assignor had against the other party to the contract (e.g., the buyer of the goods).

Take the following example: Assume that DownPillow ships an ocean container of pillows to Japan and factors the account receivable with a U.S. bank (the assignee). DownPillow now has its money and the bank is awaiting payment directly from Japan. (Of course, it is important for the Japanese buyer to be notified of



the assignment and instructed to pay only the assignee bank.) If a dispute later breaks out over the quality of the pillows, the Japanese buyer may legally assert any claims and defenses against collection by the bank that it otherwise would have had against DownPillow. Thus, for example, the buyer can successfully argue that it does not have to pay the bank because of the breach of warranty by DownPillow. DownPillow must repay the bank for money it receives and resolve the breach of contract suit with the buyer. For this reason, banker's acceptance financing offers some advantages over accounts receivable financing. Unlike a factor, the rule protects a holder in due course of a banker's acceptance. Thus, the fact that the products are defective does not provide a defense against payment to one liable on the negotiable instrument. Some insurance companies today offer commercial *credit insurance* to protect against accounts receivable that become uncollectible bad debts.

THE LETTER OF CREDIT

We will devote considerable attention to letters of credit issued by commercial banks. These flexible banking instruments are in wide use around the world. As much as \$1 trillion in goods is purchased worldwide by letter of credit every year, according to most banking and government sources. In broad terms, we can say that a **letter of credit** is an obligation of a bank, usually irrevocable, issued on behalf of one of its customers and promising to pay a sum of money to a beneficiary upon the happening of a certain event or events. In a sense, it is the substitution of the credit and good name of a bank for that of its customer, permitting the customer to do business with other individuals or firms on terms that otherwise might not be available to them. Letters of credit can be either domestic or international. They can be used in transactions for the sale of goods or services or to guarantee performance of other business obligations. Evidence exists that early forms of letters of credit were in use in Renaissance Europe and in ancient Greece and Egypt. Today, almost all large banks can issue a letter of credit, although in practice a small fraction of the world's largest banks located in major banking centers of the world issue most of them. In this chapter, we discuss two types of letters of credit: the international documentary letter of credit for use in the sale of goods and the standby letter of credit for guaranteeing performance or payment obligations of a bank's customer.

The Documentary Letter of Credit

Suppose that you are an American manufacturer and a buyer in a foreign country approaches you. The buyer makes initial inquiries about your products, engineering and manufacturing capabilities, and installation and service after the sale. You do some informal background checking within the industry and determine that this is a serious customer. You receive its credit statement, containing banking and trade references. You may even obtain a credit report on the buyer. You learn that the buyer has been in business for relatively few years, so you are not willing to enter the sale without some security. After all, you would be manufacturing these goods to conform to their specifications and shipping them halfway around the world on the basis of their promise to take delivery and remit payment. In earlier chapters, we studied some of your options. The risk is too great to ship the goods on 30-day open account terms and hope for your money, and if you demand cash in advance, the customer is not likely to agree. After all, the buyer may not trust you any more than you trust the buyer.

You could use a documentary sale, quoting prices to the customer as "cash against documents," but even then you may never see payment. If you send the documents to the buyer's bank for collection, it is still possible for the buyer to avoid the transaction. The buyer might not be able to pay, may have changed his or her mind, or may even have gone out of business. It is often possible for the buyer to find the same goods for less from another supplier. While probably not an issue in our hypothetical instance, in cases where substitute goods are freely available (and that might include everything from agricultural commodities to computer chips), a buyer might look for a way out of a contract where there has been a sharp decline in market prices. In any event, your customer could simply disappear, leaving the bank with documents to be returned to you and leaving you with specially manufactured goods in a customs warehouse halfway around the world. Unless you can find another foreign customer, which may be unlikely, you must pay the freight costs of returning the goods to your plant. To add a level of security to the documentary sale, you might propose contract terms calling for the buyer to provide an irrevocable, documentary letter of credit issued by a bank and addressed to you. This substitutes the credit and good name of a bank for that of the buyer and is a fairly good assurance (although nothing



is absolute) that if you do your part that will be paid, and paid quickly.

A letter of credit would have another advantage to you in this example. If you ship goods to your customer on open account, you may have to wait several weeks or months to receive your money. By using a letter of credit, you will probably receive payment within a few days. Moreover, because the letter of credit is so secure, it can serve as security, or collateral, for you to obtain a short-term loan to help finance the purchase of materials for manufacturing or other start-up costs.

The Parties to the Transaction. A buyer that has committed in the sales contract to obtain a letter of credit begins by applying to its bank for a letter of credit issued “in favor of” or “for the benefit of” the seller. In this arrangement, the buyer is known as the **account party**, the buyer’s bank is the **issuing bank**, or **issuer**, and the seller is the **beneficiary**. Exhibit 7.2 illustrates a typical documentary sale with a letter of credit.

Documentary Letter of Credit Defined. The **documentary letter of credit** is defined as:

1. the definite undertaking of a bank,
2. issued in accordance with the instructions of their customer,
3. addressed to, or in favor of, the beneficiary,
4. wherein the bank promises to pay a certain sum of money (or to accept or negotiate the beneficiary’s drafts up to that sum) in the stated currency,
5. within the prescribed time limits,
6. upon the complying presentation,
7. of the required and conforming documents.

The requirement that the bank will pay the seller only on the presentation of documents is what gives the documentary credit its name. The documents might differ greatly depending on whether the transaction is a domestic or an international one, the needs of the parties, or the method for shipping the goods. Letters of credit can be used for many different types of shipments, including ocean, air, rail, and road shipments, and with multimodal freight. In reality, they can be used with almost any type of document, from simple invoices to postal receipts. However, we are limiting our discussion to letter of credit transactions involving ocean transport, where the most common documents required by the letter of credit are the ocean bill of lading, the commercial invoice, and the marine insurance policy.

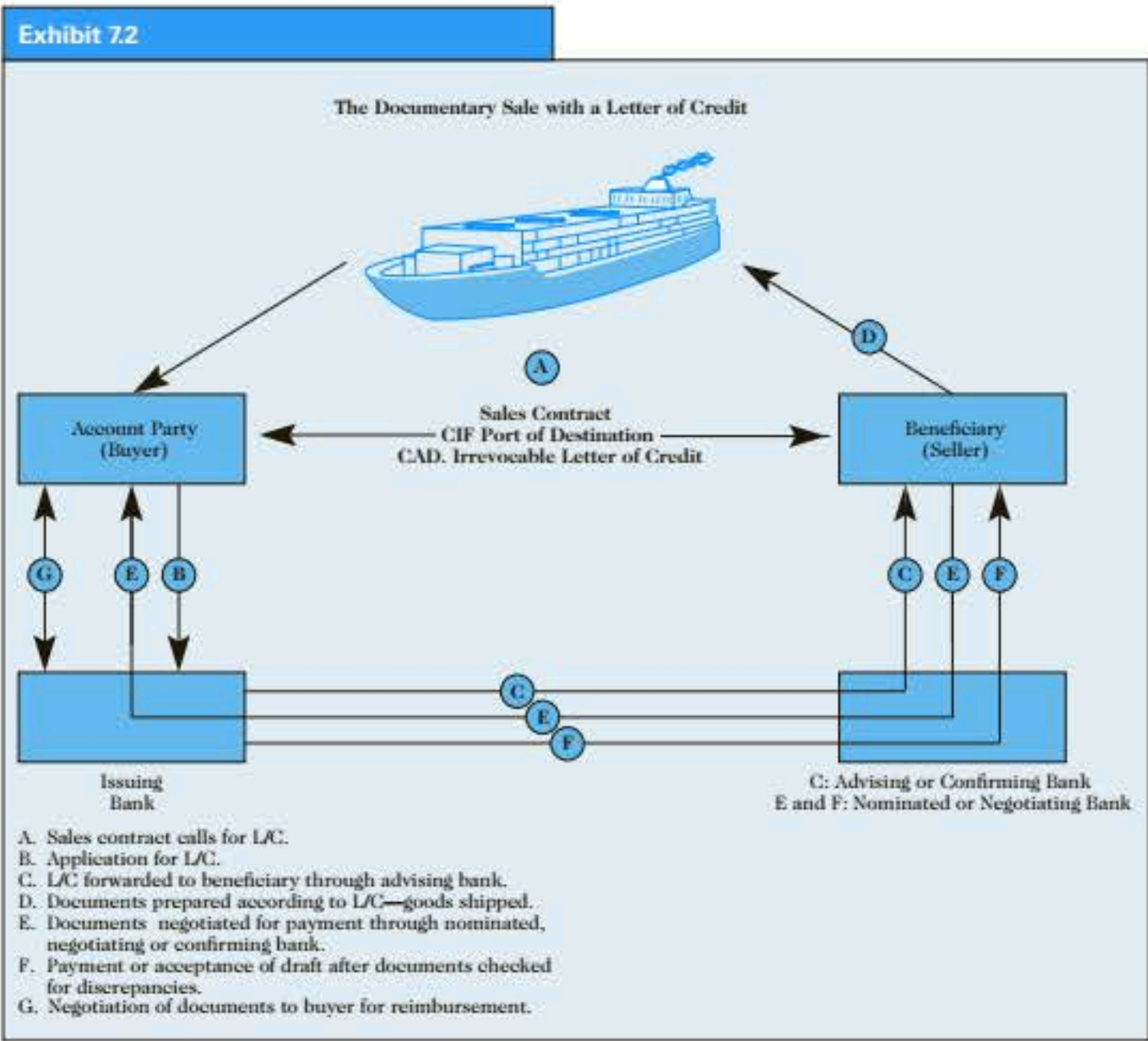
Throughout this chapter, we use the terms “letter of credit,” “credit,” or “documentary credit” interchangeably, although the latter refers only to credits payable on the presentation of documents.

The Legal Status of the Letter of Credit. There has long been an academic argument over whether or not the letter of credit is a contract between the issuing bank and the beneficiary. The letter of credit does act like a promise from an issuing bank to a beneficiary, and it seems to be treated at times like a contract and discussed in terms of the principles of contract law. However, the general consensus is that it is not a contract. If you recall the requirements for a contract, a letter of credit does not come about through offer and acceptance or mutual assent, nor is there any requirement for consideration. The basic requirements of a contract are missing. The bank and the beneficiary do not negotiate about anything; in fact, they usually have no contact whatsoever. The letter of credit is not a negotiable instrument, like a check or a promissory note. Nor is it a third-party beneficiary contract because the beneficiary’s rights do not derive from the contract between the buyer/account party and its bank. The letter of credit is a legal animal all of its own species; it is created by statute. It gives the beneficiary a statutory right to enforce the letter of credit against the bank that issues it, rather a contract right. Moreover, both the UCC and banking customs refer to the letter of credit not as a contract, but as a “definite undertaking.”

Law Applicable to Letters of Credit

All legal systems of the world recognize letters of credit. In the United States, Article 5 (2003 revision) of the *Uniform Commercial Code* codifies the law governing letters of credit. In addition, in some states, notably New York, letters of credit are responsible for a great body of case law. Perhaps the most important rules affecting letters of credit are not laws at all, but a privately developed set of guidelines based on the customs and commonly accepted practices of merchants and bankers, known as the **Uniform Customs and Practice for Documentary Credits**.

The Uniform Customs and Practice for Documentary Credits. The *Uniform Customs and Practice for Documentary Credits* (UCP) is a document that international bankers know well. It is a set of standardized rules for issuing and handling letters of credit that the International Chamber of Commerce (which publishes *Incoterms*, covered in Chapter 5) drafts and publishes



with the assistance of the international banking community. The UCP establishes the format for letters of credit, sets out rules by which banks process letter of credit transactions, and defines the rights and responsibilities of all parties to the credit. Because banks were the main drafters of the UCP, its provisions tend to protect their rights in any transaction. The UCP was first introduced in the early 1930s, with the latest revision (UCP 600) becoming effective in 2007. The UCP is in use in virtually every nation of the world and applies to most letters of credit issued worldwide.

The International Chamber of Commerce is not a government or lawmaking body, and the UCP is not law. The UCP “governs” a letter of credit only to the

extent that it states that the letter of credit is to be “interpreted” according to the UCP (which almost all do). Judges use the UCP in deciding letter of credit cases, and references to the UCP appear in virtually every reported decision on international letters of credit. The UCC, Article 5 (2003 revision), now defers to the UCP and specifically states that the UCC is *not* applicable to any letter of credit to the extent that it is in conflict with the UCP. As a result, the UCP has a far greater impact on the law of international letters of credit than does the UCC.

Irrevocability of Letters of Credit. Letters of credit issued under UCP 600 are presumed irrevocable



unless clear language is used to make them revocable. Nevertheless, most sales contracts recite that the buyer's letter of credit is to be irrevocable. An example of an irrevocable documentary letter of credit is shown in Exhibit 7.3. While revocable credits have some uses, they are not used in documentary sales between unrelated parties.

The Independence Principle and Letters of Credit

The **independence principle** is a general rule of law stating that the letter of credit is independent of the sales contract between buyer and seller. The issuing bank does not concern itself with what the parties had promised to do, or should do, under their contract. The issuing bank's only concern is that the buyer presents to the issuing bank certain "documents" (i.e., invoice, bill of lading, and insurance policy) required by the letter of credit. Think of it as though the bank is purchasing documents for its customer, not goods. The independence principle is found in UCP 600, Article 5, stating, "Banks deal with documents and not with goods . . ."

The banks do not concern themselves with the quality or condition of the goods. They have no obligation to inspect goods or to investigate rumors about them. They do not care if the ship on which they are sailing has gone to the bottom of the sea. Scholars in the United States generally consider the following case, *Maurice O'Meara Co. v. National Park Bank of New York*, to be the classic statement of the legal nature of letters of credit and the independence principle.

Following a Letter of Credit Transaction

In the following sections, we will see how a typical letter of credit transaction works. Some of the topics include the contract between the buyer and the buyer's bank to issue a letter of credit, what the seller should do when the letter of credit arrives, rules for the seller to follow in presenting documents for payment, and the process by which the bank inspects documents and honors or dishonors the seller's request for payment.

The Buyer's Application and Contract with the Issuing Bank. Once the buyer has finalized a sales contract calling for payment to the seller under a letter of credit, it is up to the buyer to apply for that letter of credit at a bank. The application for the credit, usually done on the

bank's form and accompanied by an initial fee, contains the buyer's instructions and conditions upon which the issuing bank may honor the seller's documents. These instructions are based on the details of the original sales contract between buyer and seller. The application requests the bank to issue a letter of credit to the seller promising to purchase the seller's documents covering a certain quantity and description of goods, with a value up to a certain amount of money that are insured and shipped on or before a certain date.

The buyer may impose almost any conditions or requirements on the seller's performance, as long as the conditions or requirements pertain only to the seller's documents. For example, the buyer can prohibit the bank from taking documents showing a partial shipment, or require a document that shows a specific method of shipping, or even name a specific vessel. However, the buyer must remember that this information is based on the buyer's final agreement with the seller.

When the bank accepts it, the buyer's application for the credit becomes a contract between them. It states what the bank must do on the buyer's behalf. If the bank follows the buyer's instructions, then it is entitled to purchase the seller's documents and obtain reimbursement from the buyer. If it does not, or if it violates any terms of its contract, then the buyer need not take the documents or reimburse the bank that took them contrary to instructions. For instance, if the buyer's application requests the bank to issue a letter of credit calling for the seller to submit documents showing that it shipped "1,000 electric toasters," and the bank, without approval, purchases documents showing that the seller shipped "1,000 toaster ovens," then the bank is not entitled to reimbursement. If the buyer instructs the bank to issue a letter of credit showing that the toasters must ship on or before a certain date, and the bill of lading shows the toasters were shipped after that date, the bank is not entitled to reimbursement. Indeed, banking lore is filled with stories of banks getting "stuck" with cargo like this. So (we say only half-jokingly), the next time you are in your bank and you see a sign offering a free toaster oven to anyone opening a new account, you might think of this example and wonder whether it was a marketing decision or a way to unload unwanted cargo. If you choose a career in banking, you might want to remember that banks deal with money and documents. They do not like to deal in goods or to be stuck with them.

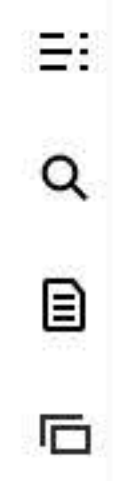
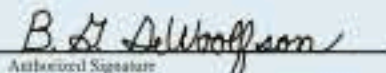


Exhibit 7.3

Irrevocable Documentary Letter of Credit

IMPORTER'S BANK CONFIRMATION OF BRIEF CABLE		Irrevocable Documentary Letter of Credit	
Importer's Bank Charlotte, NC		Date of Issue February 1, 2016	
		Issuing Bank Letter of Credit No. 78346	Advising Bank Letter of Credit No.
Advising Bank German Bank F.R.G.		Applicant Downpillow, Inc. North Carolina	
Beneficiary Federhaus, GIN F.R.G.		Expiry Date (For Negotiation)	
		Day 30	Month April Year 2013
Currency U.S.A.	Amount 35,00000	Thirty-Five Thousand Dollars	
Gentlemen: We hereby issue this documentary Letter of Credit in your favor which is available against your draft at sight drawn on Importer's Bank, Charlotte, North Carolina for 100% of the invoice value bearing the clause "Drawn under documentary letter of Credit Number 78346" Accompanied by the following documents: 1. Commercial invoice in triplicate 2. U.S. special customs form #1111 in triplicate 3. Insurance policy/certificate in duplicate covering all risks 4. Certificate of origin "form A" in duplicate 5. Full set 3/3 clean on-board bills of lading issued to the order of Importer's bank, marked "Freight prepaid," notify applicant. <u>Purporting to cover:</u> 3000 lbs washed white goose down in machine compressed bales, CIF Norfolk, Va.			
Shipment from F.R.G. To Norfolk, Va		Partial Shipments Prohibited	Transshipments Prohibited
Special conditions Documents must be presented to negotiating bank within 10 days of issuance of shipping documents but within the validity of the credit. Latest ship date March 15, 2013.			
Negotiating bank is authorized to forward all documents to us via airmail. All banking charges outside the United States are for account of the beneficiary.			
We hereby engage with the bona fide holders of all drafts under and in compliance with the terms of this letter of credit that such drafts will be duly honored upon presentation to us. The amount of each drawing must be indorsed on the reverse side of this letter of credit by the negotiating bank.		Indications of the Advising Bank	
 Authorized Signature		Place, Date, Name, and Signature of the Advising Bank	
Except so far as otherwise expressly stated this documentary letter of credit is subject to the Uniform Customs and Practices for Documentary Credits (1993 Revision) the International Chamber of Commerce Document No. 500.			

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The buyer may not make any demands on the issuing bank that are not related to the seller's documents. For example, the application may not attempt to require the bank to inspect goods or to make the

letter of credit conditional on an investigative report of the seller, on a criminal background check, on the buyer's receipt of financing, or on a contract to resell the goods.



Maurice O'Meara Co. v. National Park Bank of New York

146 N.E. 636 (1925) (Court of Appeals of New York)

BACKGROUND AND FACTS

National Park Bank issued a letter of credit addressed to Ronconi & Millar, beneficiary, at the request of its account party, Sun Herald, "covering the shipment of 1,322 tons of newsprint paper in 72½-inch and 36½-inch rolls to test 11-12, 32 lbs. at 8½ cents per pound net weight—delivery to be made in December 1920 and January 1921." The letter of credit did not require that a testing certificate from an independent laboratory accompany the documents. When Ronconi & Millar's invoice and draft were presented to the bank, the documents described the paper as was required in the letter of credit. However, the bank refused payment because it had no opportunity to test the tensile strength of the paper. (Interestingly, the market price of newsprint paper had fallen sharply in the time period between the contract of sale and the presentation of documents, amounting to over \$20,000 in this case.) Ronconi & Millar transferred their rights to collect payment to Maurice O'Meara, a financial institution, who brought this action to collect the full amount of the drafts. Maurice O'Meara claims that the issuing bank had no right to test or inspect the paper.

MCLAUGHLIN, JUDGE

[The letter of credit] . . . was in no way involved in or connected with, other than the presentation of the documents, the contract for the purchase and sale of the paper mentioned. That was a contract between buyer and seller, which in no way concerned the bank. The bank's obligation was to pay sight drafts when presented if accompanied by genuine documents specified in the letter of credit. If the paper when delivered did not correspond to what had been purchased, either in weight, kind or quality, then the purchaser had his remedy against the seller for damages. Whether the paper was what the purchaser contracted to purchase did not concern the bank and in no way affected its liability. It was under no obligation to ascertain, either by a personal examination or otherwise, whether the paper conformed to the contract between the buyer and seller. The bank was concerned only in the drafts and the documents accompanying them. This was the extent of its interest. If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for. This view, I think, is the one generally

entertained with reference to a bank's liability under an irrevocable letter of credit of the character of the one here under consideration.

The defendant had no right to insist that a test of the tensile strength of the paper be made before paying the drafts; nor did it even have a right to inspect the paper before payment, to determine whether it in fact corresponded to the description contained in the documents. The letter of credit did not so provide. All that the letter of credit provided was that documents be presented which described the paper shipped as of a certain size, weight, and tensile strength. To hold otherwise is to read into the letter of credit something which is not there, and this the court ought not to do, since it would impose upon a bank a duty which in many cases would defeat the primary purpose of such letters of credit. This primary purpose is an assurance to the seller of merchandise of prompt payment against documents.

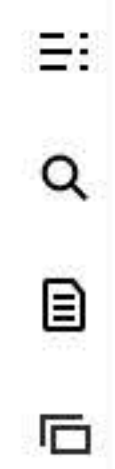
It has never been held, so far as I am able to discover, that a bank has the right or is under an obligation to see that the description of the merchandise contained in the documents presented is correct. A provision giving it such right, or imposing such obligation, might, of course, be provided for in the letter of credit. The letter under consideration contains no such provision. If the bank had the right to determine whether the paper was of the tensile strength stated, then it might be pertinent to inquire how much of the paper must be subjected to testing. If it had to make a test as to tensile strength, then it was equally obligated to measure and weigh the paper. No such thing was intended by the parties and there was no such obligation upon the bank. The documents presented were sufficient. The only reason stated by defendant in its letter of December 18, 1920, for refusing to pay the draft, was that—"There has arisen a reasonable doubt regarding the quality of the newsprint paper . . . Until such time as we can have a test made by an impartial and unprejudiced expert we shall be obliged to defer payment."

This being the sole objection, the only inference to be drawn there from is that otherwise the documents presented conformed to the requirements of the letter of credit. All other objections were thereby waived.

Judgment should be directed in favor of the plaintiff.

Decision. National Park Bank's obligation to pay the beneficiary's drafts submitted under its letter of credit

continues



continued

was separate and distinct from the contract of sale between the buyer and seller. Banks deal in documents only. Therefore the defendant, National Park Bank, could not withhold payment of the drafts even if it believed that the paper was not of the weight, kind, or quality ordered by Sun Herald. Defendant also had no right to demand testing of the paper or to inspect it prior to payment.

Case Questions

1. Had the bank been aware that the newsprint shipment did not conform to the requirements of

the underlying sales contract, would it have still been required to pay under the letter of credit?

2. If the bank pays for documents that conform to the letter of credit, but the goods themselves turn out to be nonconforming, is the buyer legally justified in refusing to reimburse its bank?
3. Do you think, under current law and banking practice, that bankers should physically inspect the goods when they arrive before honoring their customer's letter of credit?

The buyer's international banker and customs broker are two good sources of information and advice on what documents a buyer should require from a seller. Buyers would be well warned to heed their advice or consult an attorney experienced in handling international letters of credit.

The willingness of the bank to issue the letter of credit for the buyer—its customer—depends on the buyer's creditworthiness and the banking relationship between them. More than likely, the buyer and its bank have an established history of banking and commercial lending. The buyer will be responsible to the bank for fees and a percentage of the value of the letter of credit, so the buyer should have already considered these additional costs when agreeing to original sales contract.

Advising the Letter of Credit to the Beneficiary. The issuing bank will send the letter of credit to the seller via a foreign *correspondent bank* (a bank with whom the issuing bank has a reciprocal banking relationship) located in the seller's country. This bank is called the *advising bank*. An advising bank merely informs or "advises" the seller that the letter of credit is available for pick up. It has no responsibility to honor a draft or purchase the seller's documents. It is not liable on the credit. It provides the service of forwarding the letter of credit to the seller, but it has no obligation to advise the credit and may refuse if it wishes. The bank's only responsibility is to satisfy itself that the credit is authentic and accurate as received (e.g., that there were no errors in transmission). For example, it might compare the signature on the credit as advised to them with the authorized signature of the banking officer at the issuing bank. Letters of credit are commonly transmitted between banks using the SWIFT network.

Seller's Compliance with the Letter of Credit. Until the seller receives the letter of credit and reads it carefully, he or she might not want to begin manufacturing, packaging, arranging transportation, or preparing the documents. The letter of credit tells the seller what it must do to be paid. It tells the seller what to ship, how to ship, when to ship, and more. It contains specific terms and conditions drawn from the original sales contract and included in the letter of credit, such as the quantity and description of the goods, shipping dates, the type or amount of insurance, markings on packages, and so on. The letter of credit also tells the seller what documents are needed in addition to the usual ones. For instance, assume a buyer in California wants to import foreign-made beanbag chairs that must meet California's strict flammability standards for upholstered furniture. The letter of credit might call for an inspection certificate showing that the chairs "were tested pursuant to and are compliant with California Technical Bulletin 117." This tells the seller that this test must be performed, probably by an independent laboratory, and the inspection certificate obtained before the shipping date.

The seller will want to decide if the letter of credit is in keeping with his or her agreement with the buyer in the underlying contract of sale. If the letter of credit shows any significant differences from the sales contract, the seller will want to contact the buyer to inquire why. For instance, assume that a sales contract calls for shipment of "4,000 lbs. washed white goose down in machine-compressed bales," and the letter of credit reads "3,000 lbs. washed white goose down in machine-compressed bales." The seller must stop and inquire why a difference appears in the quantities expressed. Did the buyer decide to purchase only 3,000 pounds instead of the 4,000 pounds agreed to? If so,



why didn't the buyer contact the seller to confirm the new order? Perhaps the bank erred in transmitting the letter of credit. Whatever the reason, the seller should do nothing until the problem is resolved or until an amended letter of credit is received. If the seller ships 4,000 pounds, its drafts may be refused and it may only get paid for 3,000 pounds; if it ships 3,000 pounds, it may be losing a sale for the 1,000 pounds difference.

The seller should examine other conditions of the credit to be certain they can be met. Can the seller acquire materials and manufacture on time for the shipment deadline in the letter of credit or before the expiry date of the credit? Does the credit call for a particular shipping method or route or specify a particular carrier or ship that cannot be used? If a license is necessary to export the products from the seller's country, is it possible to process and receive it on time from the government agency?

The seller should also review the credit for accuracy. Is the total amount of the letter of credit sufficient to cover the drafts? Is it in the currency called for in the sales contract? Do the provisions for insurance and the payment of freight charges meet the terms of the contract of sale, and are they agreeable to the seller? Does the letter of credit allow partial shipments?

If the seller is unable to comply with the letter of credit for any reason, the buyer must be contacted immediately, before shipment, so that an amended credit can be issued. In one case, a U.S. furniture manufacturer received a letter of credit from Kuwait calling for the shipment of furniture in "one 40' ocean container." Only after packaging and loading did the manufacturer realize that some of the furniture would not fit into one container. If the manufacturer's documents had shown two containers, or had it shown less furniture than was called for in the letter of credit, the bank would have rejected the documents. An amended credit had to be issued before it was safe to crate and ship the furniture.

Complying Presentation. A *presentation* is the delivery of the seller's documents and draft to the nominated bank or directly to the issuing bank. A **complying presentation** is one in which

1. the seller delivers all of the required documents,
2. within the time allowed for presentation and prior to the expiry date of the credit,
3. containing no discrepancies, and
4. which complies with all other terms of the letter of credit, the provisions of the UCP, and standard banking practices.

The **nominated bank**, usually in the seller's country, has been appointed or "nominated" by the issuing bank to honor the documents. It is often the advising bank that originally transmits the documents to the seller. If no bank is nominated, then the letter of credit is said to be "freely available" and can be negotiated through any bank of the seller's choice.

Article 14(c) of the UCP requires, in most cases, that presentation of the documents be within 21 days of the date of shipment (determined by the date of the bill of lading) and before the expiry date stated in the credit. Documents will be refused for late presentment unless waived by the buyer.

Examination of Documents for Discrepancies. If the seller's presentation complies, the nominating bank will purchase the seller's documents and honor the draft. If the credit calls for payment on sight, the nominated bank will honor and pay the seller's draft on sight. If the credit calls for payment of the draft at some other time, the nominated bank will honor the draft by acceptance. However, if the seller's documents do not comply with the terms of the letter of credit or if they contain irregularities or discrepancies, the documents will be held pending instructions from the buyer or rejected by the banks. If the bank purchases noncomplying documents, it cannot seek reimbursement from the buyer.

Article 14(b) of UCP 600 gives banks up to five banking days to examine the seller's documents to determine if they conform to the requirements of the letter of credit, or if they contain any discrepancies or irregularities. A **discrepancy** is any difference, no matter how minor, between the terms of a required document and the terms required by the letter of credit. The discrepancy may be caused by some wording or data in a document that is not exactly what was required in the credit. The seller's documents and letter of credit are literally put side by side and compared by a bank's professional document checker. Each term in the documents is matched to the requirement of the letter of credit. For instance, a discrepancy exists if the quantity or description of the goods in the invoice does not match that in the credit, if the bill of lading is dated later than required, if any documents are missing, or if they show signs of fraud, forgery, tampering, or missing signatures.

A bank may not try to interpret the wording of a document. The UCP permits banks only to examine the documents "on their face" to see if they comply with the letter of credit or if there is a discrepancy. Banks may

not look to any outside sources or conduct any independent investigation to see if the seller's shipment to the buyer is in good order. It is the documents alone that must be in good order and compliant with the letter of credit. For example, assume a letter of credit calls for the shipment of "1,000 blood pressure monitoring kits." The shipper's invoice shows the sale and shipment of "1,000 sphygmomanometers and cuffs." The document checker may or may not know if items are the same, nor does it matter. The document checker may not consult dictionary definitions, encyclopedias, medical textbooks, or other outside references. The bank is not responsible for interpreting technical or foreign language. The bank may not telephone the seller and ask what was meant in the invoice. In this case there is a discrepancy, and the documents will be rejected, unless the buyer waives the discrepancy. Neither the buyer nor his or her bank is obligated to take the documents.

In the following sections, we will look at the most important documents required under a letter of credit, and some common discrepancies. These derive from the UCP, standard international banking practices, and common requirements on letters of credit. The most common discrepancies found in documents are related to descriptions, time, amounts, missing documents, missing signatures, and contradictions among documents. (See Exhibit 7.4.) Other documents frequently required in a letter of credit include a packing list, certificate of origin, consular invoice, and many others. The seller should not submit documents that the letter of credit does not require; under the UCP, the banks will disregard them and may return them to the seller.

The Commercial Invoice. Buyers, banks, and customs authorities require the commercial invoice in every international sale. It must be made out by the seller and

Exhibit 7.4 Common Discrepancies Found in Documentation	
Bill of Lading/Air Waybill • Incomplete set of bills (originals missing) • Onboard notations not dated and signed or initialed • Time for shipment has expired • Unclean bill of lading shows damage • Indorsement missing • Evidence of forgery or alteration • Does not show freight prepared if required under the letter of credit • Description of goods differs substantially from letter of credit • Name of vessel differs from one required • Shows partial shipment or transshipment where prohibited by the letter of credit • Commercial Invoice • Description of goods does not conform to description in letter of credit • Does not show terms of shipment • Amount differs from that shown on draft • Amount exceeds limits of letter of credit • Weights, measurements, or quantities differ	• Draft does not bear reference to letter of credit • Evidence of forgery or alteration • Draft not signed • Maturity dates differ from letter of credit • Currency differs from letter of credit Insurance Policy • Description of goods differs from invoice • Risks not covered as required by the letter of credit • Policy dated after date of bill of lading • Amount of policy insufficient • Certificate or policy not indorsed • Certificate presented instead of policy, if required in letter of credit General Discrepancies • Letter of credit has expired • Letter of credit is overdrawn • Draft and documents presented after time called for in letter of credit • Incomplete documentation • Changes in documents not initialed • Merchandise description and marks not consistent between documents
Draft • Draft and invoice amounts do not agree	



addressed to the buyer and be in the same currency as the letter of credit. It need not be signed, notarized, or verified, unless the credit requires. Where a commercial invoice is required, a preliminary “pro forma” invoice will not be accepted.

Perhaps the most important requirement is that the description of the goods in a commercial invoice must correspond to that in the credit. Most courts hold that the description must be exactly the same. As we will see in the next section, sellers are encouraged to use the same description in the invoice as the issuing bank used in the letter of credit, misspellings and all. Where bulk items are involved, the invoice should be for the quantity of goods ordered, or within 5 percent of the amount specified in the credit. However, the 5 percent rule does not apply to letters of credit covering a specific number of items or packages. In such a case, the amount of the invoice cannot exceed the amount of the letter of credit. For example, a seller may ship and bill for 5 percent more grain than was ordered, but not for more cases of soft drinks, or tractors.

The Ocean Bill of Lading. For transactions in which the letter of credit calls for presentment of an “on-board” bill of lading, the seller must present to the issuing bank a bill of lading showing the actual name of the ship and containing the notation “on board,” to indicate that the goods have been actually loaded. Where the buyer and seller have agreed, and where it is approved in the letter of credit, it is acceptable for the bill of lading to show that the carrier has received the goods for shipment (but are not yet loaded on board). The dates of receipt or loading must be shown. The seller must present the *original* bill of lading, and if it was issued in a set of more than one original, then all originals must be presented. When all originals are present, this is known as a *full set*. The bill of lading must be dated within the time set in the credit for shipping. It must show the name of the carrier and be signed by the carrier’s agent or ship’s master. It must state either that the goods have been taken in charge for shipment, or that they were shipped “on board.” It must be a “clean” bill—one that has no wording or notations indicating that damage to the goods or packaging was apparent or visible at the time of loading. In transactions where the seller has agreed to arrange and pay for the cost of international freight, the bills of lading must be marked “freight prepaid.” Similar requirements exist for road, rail, inland waterway, or air transportation.

The Insurance Policy. The insurance policy should be of the type and coverage required by the letter of credit, and in the same currency and in the amount specified in the credit or, if none is specified, in the amount of the invoice, plus 10 percent. It should be effective on or before the date of the bill of lading to show that the goods were insured during loading. The policy itself should be used; alternatively, a certificate of insurance may be used unless a certificate is not permitted by the letter of credit. Companies that have open policies that “float” over many shipments use declarations. They must be signed by an agent for the company. Cover letters from agents are not acceptable.

Certificates of Analysis or Inspection. Although certificates of analysis or inspection are not required for letter of credit transactions, they are common and deserve to be mentioned. Frequently, a buyer requires the seller to submit documentary proof of inspection from an independent inspection firm. A seller may require submission of a certificate of inspection for merchandise; a certificate of laboratory analysis; or a certificate of compliance with health, safety, or technical standards from an approved testing lab. Analysis or inspection certificates can be required for almost any product, such as an inspection of the sewing quality of blue jeans, an analysis of the mold content of grain, or a laboratory analysis of the lead content of the paint on children’s toys. Sellers should ensure that certificates they include with their documents meet all the terms the letter of credit requires.

The Rule of Strict Compliance

The prevailing standard established by the courts for examining documents is found in the **rule of strict compliance**. According to this view, the terms of the documents presented to the issuing bank must strictly conform to the requirements of the letter of credit and the UCP. This rule is almost as old as letter of credit law itself. It is stated in the famous words of Lord Sumner in *Equitable Trust Co. of New York v. Dawson Partners Ltd.* [1927] 2 Lloyd’s Rep 49: “There is no room for documents which are almost the same, or which will do just as well.” This does not mean that every “i” must be dotted and every “t” crossed. As one court states, it is not a discrepancy if Smith is spelled “Smithh.” Some typographical errors are excusable, of course. But the thrust of the rule is that every provision of the bill of lading, invoice, insurance policy, and any other required shipping document must match the letter of credit.



Even a small discrepancy can cause the bank to reject the documents. The reason for such a harsh rule is simple: it relieves bankers from the duty of interpreting the meaning of the discrepancy or its possible impact on their customers, and it relieves them of the liability of interpreting it incorrectly.

In the following case, *Courtaulds North America, Inc. v. North Carolina National Bank*, the court considers a discrepancy between the description of the goods on the letter of credit and on the invoice.

Apply the strict compliance rule of the *Courtaulds* case to the following situation: Suppose that a seller



Courtaulds North America, Inc. v. North Carolina National Bank

528 F.2d 802 (1975) (United States Court of Appeals for the Fourth Circuit)

BACKGROUND AND FACTS

The defendant bank issued an irrevocable letter of credit on behalf of its customer, Adastra Knitting Mills. It promised to honor sixty-day time drafts of Courtaulds for up to \$135,000 covering shipments of "100% Acrylic Yarn." Courtaulds presented its draft together with a commercial invoice describing the merchandise as "Imported Acrylic Yarns." The packing lists that were stapled to the invoice contained the following description: "Cartons marked: 100% Acrylic." The bank refused to accept the draft because of the discrepancy between the letter of credit and the commercial invoice. (The buyer had gone into bankruptcy, and the court-appointed trustee would not waive the discrepancy.) The documents were returned and the plaintiff brought this action. The lower court held that the bank was liable to the plaintiff for the amount of the draft because the packing lists attached to each carton stated that the cartons contained "100% Acrylic," and the bank appealed.

BRYAN, SENIOR CIRCUIT JUDGE

The defendant denied liability chiefly on the assertion that the draft did not agree with the letter's conditions, viz., that the draft be accompanied by a "Commercial invoice in triplicate stating (inter alia) that it covers . . . 100% acrylic yarn"; instead, the accompanying invoices stated that the goods were "Imported Acrylic Yarn."

. . . [T]he District Court held defendant Bank liable to Courtaulds for the amount of the draft, interest, and costs. It concluded that the draft complied with the letter of credit when each invoice is read together with the packing lists stapled to it, for the lists stated on their faces: "Cartons marked: 100% Acrylic." After considering the insistent rigidity of the law and usage of bank credits and acceptances, we must differ with the District Judge and uphold Bank's position.

In utilizing the rules of construction embodied in the letter of credit—the *Uniform Customs* and state statute—one must constantly recall that the drawee bank is not to be embroiled in disputes between the buyer and the seller, the beneficiary of the credit. The drawee is involved only with documents, not with merchandise. Its involvement is altogether separate and apart from the transaction between the buyer and seller; its duties

and liability are governed exclusively by the terms of the letter, not the terms of the parties' contract with each other. Moreover, as the predominant authorities unequivocally declare, the beneficiary must meet the terms of the credit—and precisely—if it is to exact performance of the issuer. Failing such compliance there can be no recovery from the drawee. That is the specific failure of Courtaulds here.

. . . [T]he letter of credit dictated that each invoice express on its face that it covered 100% acrylic yarn. Nothing less is shown to be tolerated in the trade. No substitution and no equivalent, through interpretation or logic, will serve. Harfield, *Bank Credits and Acceptances* (5th ed. 1974), commends and quotes aptly from an English case: "There is no room for documents which are almost the same, or which will do just as well." Although no pertinent North Carolina decision has been laid before us, in many cases elsewhere, especially in New York, we find the tenet of Harfield to be unshaken.

At trial Courtaulds prevailed on the contention that the invoices in actuality met the specifications of the letter of credit in that the packing lists attached to the invoices disclosed on their faces that the packages contained "cartons marked: 100% acrylic." . . . But this argument cannot be accepted.

The district judge's pat statement adeptly puts an end to this contention of Courtaulds: "In dealing with letters of credit, it is a custom and practice of the banking trade for a bank to only treat a document as an invoice which clearly is marked on its face as 'invoice.' " This is not a pharisaical or doctrinaire persistence in the principle, but is altogether realistic in the environs of this case; it is plainly the fair and equitable measure. (The defect in description was not superficial but occurred in the statement of the quality of the yarn, not a frivolous concern.) Bank was not expected to scrutinize the collateral papers, such as the packing lists. Nor was it permitted to read into the instrument the contemplation or intention of the seller and buyer . . .

Had the Bank deviated from the stipulation of the letter and honored the draft, then at once it might have been confronted with the not improbable risk of the bankruptcy trustee's charge of liability for

continues



continued

unwarrantably paying the draft monies to the seller, Courtaulds, and refusal to reimburse Bank for the outlay. Contrarily, it might face a Courtaulds claim that since it had depended upon Bank's assurance of credit in shipping yarn to Adastra, Bank was responsible for the loss. In this situation Bank cannot be condemned for sticking to the letter of the letter.

Nor is this conclusion affected by the amended or substituted invoices which Courtaulds sent to Bank after the refusal of the draft. No precedent is cited to justify retroactive amendment of the invoices or extension of the credit beyond the August 15 expiry of the letter.

For these reasons, we must vacate the decision of the trial court, despite the evident close reasoning and research of the district judge . . .

Reversed and remanded for final judgment.

Decision. The judgment is reversed for the defendant bank. The description of the goods in the invoice did not match the description of the goods in the credit, and the defect was not cured by a correct description in the packing list.

Case Questions

1. Why did the bank refuse to accept the draft upon presentation of the documents?
2. Had the bank known that the yarns described in the invoice as "imported acrylic yarns" were actually 100% acrylic, as called for in the letter of credit, would the outcome of the case have been different?
3. What is the liability of a bank for paying or accepting a draft when the documents contain a discrepancy?

receives a letter of credit from a foreign buyer covering "1,000 standard-size bed pillows." Seller's export manager completes an invoice for "1,000 bed pillows, size 20 × 26 in." A discrepancy exists. Bankers are not expected to know that a "standard" bed pillow is 20 × 26 inches, and even if the banker did know, he or she would still have to refuse the document because of the discrepancy. Assume now that the invoice matches the letter of credit, but that the bill of lading shows shipment of "1,000 pillows." On this point the UCP is clear: the description in a document other than an invoice may be "in general terms not conflicting with their description in the credit." Here the documents show no discrepancy.

The Functional Standard of Compliance. While the strict compliance rule remains the prevailing view in most jurisdictions, some courts in the United States and in some European countries have used a more practical "functional standard" of compliance. These courts do not require a bank to reject documents with obviously minor typographical errors. *Voest-Alpine Trading Co. v. Bank of China*, 167 F. Supp. 2d 940 (S.D. Tex. 2000), aff'd 288 F.2d 262 (5th Cir. 2002), involved a shipment of styrene from Voest-Alpine to a customer in China under a \$1.2 million letter of credit issued by the Bank of China. Apparently, the market value of the styrene at the time the documents were presented for payment had fallen well below the contract price. Voest-Alpine refused a price concession requested by the buyer, and the bank started looking for discrepancies. There was

no question that the two documents contained discrepancies. The question was whether they were sufficient to justify the bank's refusal to pay for the documents. The beneficiary's name in the letter of credit, Voest-Alpine Trading USA, was transposed in the documents to "USA Trading." The letter of credit required three "original" bills of lading, but none were stamped "original," one was stamped "duplicate" and another "triplicate." All three, however, contained original hand signatures in blue ink. The survey report for damage was dated a day after the bill of lading, even though the report stated that the goods had been inspected upon loading. Although the reference number of the letter of credit was incorrect on the cover letter prepared by Voest-Alpine, it was correct elsewhere. Finally, the name of the port city, Zhangjiagang, was spelled several different ways in various documents. The Bank of China argued that under a strict compliance standard it was justified in rejecting the documents. Voest-Alpine argued for a "functional standard" of compliance, contending that the bank should have looked at documents as a whole. In agreeing with Voest-Alpine, the court rejected the notion that the documents should be a "mirror image" of those called for in the letter of credit, and adopted a more moderate approach. The district court stated:

A common sense, case-by-case approach would permit minor deviations of a typographical nature because such a letter-for-letter correspondence between the letter of credit and the presentation documents is virtually impossible. While the end result of such an analysis may bear a strong



resemblance to the relaxed strict compliance standard, the actual calculus used by the issuing bank is not the risk it or the applicant faces but rather, whether the documents bear a rational link to one another. In this way, the issuing bank is required to examine a particular document in light of all documents presented and use common sense but is not required to evaluate risks or go beyond the face of the documents. The Court finds that in this case the Bank of China's listed discrepancies should be analyzed under this standard by determining whether the whole of the documents obviously relate to the transaction on their face.

The UCP 600 Rule. The general principles of letter of credit law that we have discussed up to this point have been developed by courts in countries around the world. Often, these decisions are based on the courts' interpretation of the UCP because the UCP contains its own standards for gauging when documents comply with the letter of credit. Article 14(d) of UCP 600 takes a modified strict compliance approach by stating that, while "data in a document" (here "data" means such things as the description of the goods, names of the parties, quantities and weights, addresses, and similar relevant terms) does not have to be "identical" to other data in the same document, or to data in any other required document, or data in the credit itself, it may not conflict with it. The UCP has specific provisions regarding the description of the goods—one of the key terms in any letter of credit. The UCP states that a document (other than an invoice) may describe the goods "in general terms not conflicting with their description in the credit." However, the rule of strict compliance is retained in Article 18(c) with regard to the invoice, which states, "The description of the goods . . . in a commercial invoice must correspond with that appearing in the credit." The UCP also requires that the name, address, and contact details for the consignee or notify party on the transport documents must appear exactly as in the letter of credit. Thus a warning to export managers and to bankers who advise them: Be certain that you describe your goods in your invoice in the exact wording and form that is used in the letter of credit. Be consistent in your data throughout all documents, and conform your data and wording to that used in the credit itself.

Every export manager, freight forwarder, carrier's agent, and international banker should have his or her own reference copy of the UCP readily at hand when drafting documents or dealing in transactions governed by the UCP.

An Ethical Issue in Handling Letters of Credit. In most cases, buyers will waive a minor discrepancy. However, sellers and bankers must beware: If a buyer is looking for a reason to reject the documents (e.g., if the ship has gone down at sea, the market price of similar goods has fallen dramatically, etc.), a discrepancy will give the savvy (or unscrupulous?) buyer a way out. If the buyer is looking for a way to chisel a better price out of the deal, then a discrepancy will give him or her leverage. The buyer can reject the documents, and only later reluctantly agree to waive the discrepancy—but only for a huge discount off the contract price! Issuing banks may on occasion want to find discrepancies. If they discover that their customers—the buyers—are going to back out of the deal, they can use the discrepancy to reject the documents. (An old adage states that any banker who cannot find a discrepancy is not worth his or her salt.) Of course, almost all discrepancies are honest accidents or commercial mistakes and are easily resolved.

Procedures for Dishonor. A bank must follow the UCP guidelines for rejecting or dishonoring a presentation. The first step is to ask the buyer for a waiver. If the buyer decides to refuse the documents, the bank must give notice of its refusal to the presenting bank by telecommunication within five banking days. The notice must inform the presenter whether the documents are being held pending further instructions or are being returned. If the issuing bank fails to do this, it is precluded from claiming that the documents were properly presented.

Enjoining Banks from Purchasing Documents in Cases of Fraud

Earlier in this chapter you read the case of *Maurice O'Meara*, which illustrates the important principle that letters of credit are independent of the underlying sales contract. An issuing bank is responsible only for the seller's documents and is not concerned with the quality of the goods or whether the seller shipped the correct goods. If the goods are defective or nonconforming, the buyer's remedy is against the seller for breach of contract.

What if the buyer's problem is not that the quality or condition of the goods is defective, but that he or she has fallen victim to a fraud or a scam? What good would a breach of contract suit be against the perpetrator of a fraud who disappears with the cash? To address



these situations, a partial exception to the independence principle exists where documents presented by the seller (the beneficiary of the credit) are fraudulent, or forged, or if *fraud in the transaction* exists in the underlying sales contract. For instance, suppose that the buyer in a letter of credit transaction learns, almost too late, that the purported bill of lading is actually a fake, that no ship or carrier by that name exists, and that the goods the buyer was awaiting do not exist. Here the issuing bank would be justified in refusing to pay for fraudulent documents. Similarly, consider the case where an unscrupulous seller places worthless junk into a sealed ocean container and delivers it to an ocean carrier, obtains a bill of lading, and presents it to the issuing bank for payment under a letter of credit. Here too, the issuing bank would be justified in dishonoring the letter of credit because of fraud in the transaction. Of course, banks do not want to refuse documents without cause (especially where they have already been purchased by a nominated bank that is looking for reimbursement). After all, their international reputation is at stake, and no bank wants to be known for refusing to honor its letters of credit. One solution that will preserve the reputation of the bank is for the buyer to obtain a court injunction stopping the bank from honoring its letter of credit.

The UCP is silent on the question of when a court may enjoin a letter of credit for fraud. This is left to the law of individual jurisdictions. In the United States, the authority of a court to enjoin payment under a letter of credit is found in the case law and in Article 5 of the UCC. According to UCC Section 5-109, the standard for enjoining payment under a letter of credit is whether or not “a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant.” Courts may not enjoin payment if the documents are presented by a holder in due course or by a nominating bank that “has given value in good faith and without notice of the forgery or material fraud.” Although the line between what is fraud and what is not fraud is unclear, the fraud must be material and significant to the parties. Such would be the case where worthless rubbish is shipped in lieu of genuine goods. On the other hand, if the seller intentionally ships only 998 pounds of goose feathers but presents a draft and documents for 1,000 pounds, it is probably neither material nor significant. Some of the cases have said that the fraud must be “egregious,” or that the seller’s

demand for payment has “no basis in fact,” or to allow him to collect payment would be “unjust.”

The following pre-UCC case, *Sztejn v. J. Henry Schroder Banking Corp.*, presents a clear distinction between a mere breach of warranty and fraud. Recall that the last case, *O’Meara*, involves a breach of warranty—the seller shipped newsprint paper of inferior quality. *Sztejn* involves **fraud in the transaction**—the presentation of documents covering goods and the shipment of bales of worthless rubbish. The *Sztejn* case is one of the most widely cited cases in U.S. letter of credit law. Today, the UCC provisions largely follow the rule first set out by the *Sztejn* case.

Fraud in the transaction can take many forms. In *Regent Corp., U.S.A. v. Azmat Bangladesh, Ltd.*, 686 N.Y.S.2d 24 (1999), a textile company located in Bangladesh represented to a U.S. buyer that bed sheets and pillowcases were to be manufactured in Bangladesh. In fact, the seller knew that the goods were a product of Pakistan but provided a fake certificate of origin because they were trying to circumvent U.S. import quotas on Bangladeshi linens. The New York court ruled that there was sufficient fraud in the transaction to justify the bank’s refusal to honor the draft under the letter of credit. Another example may be found in the following case of *Semetex Corp. v. UBAF Arab American Bank*.

Confirmed Letters of Credit

In most cases, a letter of credit is adequate assurance for payment. In certain instances, however, a seller may want an additional layer of security. Where a seller is uncertain about the soundness of an issuing bank in a foreign country, or of the integrity of the banking system there generally, or the stability of the government, the seller may want to request that a bank in its own country confirm the letter of credit. A **confirmed letter of credit** is one in which a second bank, usually in the seller’s country, agrees to purchase documents and honor drafts on the same terms as the original issuing bank. Suppose a seller is shipping to a country that has a shortage of foreign currency, large foreign debts, and a poor balance of payments record. It is always possible that foreign government currency restrictions, imposed between the time the contract is agreed to and the time the drafts are tendered for payment, could prevent the issuing bank from honoring its letter of credit in dollars. A letter of credit confirmed by a bank in the seller’s country will ensure prompt payment regardless of



financial or political instability in the country where the issuing bank is located. Additionally, should legal action ever be necessary to collect on a letter of credit, a seller can much more easily sue a U.S. confirming bank in the United States than a foreign bank in foreign courts. Of

course, a confirmed credit is far more expensive than one that is unconfirmed because two banks are exposed to the risk of the transaction. The parties must weigh these costs in determining the level of acceptable risk in the transaction.



Sztejn v. J. Henry Schroder Banking Corp.

31 N.Y.S.2d 631 (1941) (Supreme Court, Special Term, New York County)

BACKGROUND AND FACTS

The plaintiff contracted to purchase hog bristles from Transea Traders in India. The defendant bank issued an irrevocable letter of credit to Transea covering a shipment of hog bristles and payable upon presentation of the proper documents. Transea filled fifty cases with cow hair and other worthless rubbish in order to obtain an ocean bill of lading from the steamship company showing the shipment of fifty cases of hog bristles. The documents and draft were presented to the defendant bank by The Chartered Bank of India, acting as agent for Transea. The plaintiff brought this action against the issuing bank to restrain it from paying on the letter of credit.

SHIENTAG, JUSTICE

One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped . . . Of course, the application of this doctrine presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.

However, I believe that a different situation is presented in the instant action. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. It is true that even though the documents are forged or fraudulent, if the issuing bank has already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment.

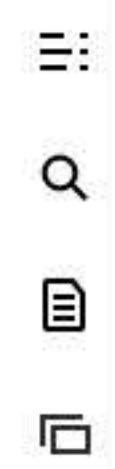
However, in the instant action Schroder has received notice of Transea's active fraud before it accepted or paid the draft . . .

Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving an intentional fraud on the part of the seller which was brought to the bank's notice with the request that it withhold payment of the draft on this account. The distinction between a breach of warranty and active fraud on the part of the seller is supported by authority and reason. As one court has stated: "Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit." *Old Colony Trust Co. v. Lawyers' Title & Trust Co.*, 297 F. 152 at page 158 (2nd Cir. 1924).

No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish, where the draft and the accompanying documents are in the hands of one who stands in the same position as the fraudulent seller, where the bank has been given notice of the fraud before being presented with the drafts and documents for payment, and where the bank itself does not wish to pay pending an adjudication of the rights and obligations of the other parties. While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents. * * * Accordingly, the defendant's motion to dismiss the supplemental complaint is denied.

Decision. The court held in favor of the plaintiff and enjoined the bank's payment. A court can enjoin an

continues



continued

issuing bank from honoring a draft if the bank learns that its customer will suffer irreparable harm as a result of fraud in the transaction.

Case Questions

1. What basic principle of letter of credit law does this decision challenge?
2. How would the result be different if the draft and documents had been sold and negotiated to a holder in due course who took with no

knowledge of the fraud, and who then presented the documents to the issuing bank for payment?

3. Explain the misrepresentation that took place in this case. How was this "fraud in the transaction"? Can you think of other examples of how fraud could occur in a documentary letter of credit transaction between foreign parties?
4. What steps could a buyer and seller take to avoid falling victim to an international fraud? How could they learn more about each other, and what sources could they consult?



Semetex Corp. v. UBAF Arab American Bank

853 F. Supp. 759 (1994) (United States District Court for the Southern District of New York)

BACKGROUND AND FACTS

In 1988, Semetex entered into an agreement with the Al-Mansour Factory in Baghdad, Iraq, an enterprise owned and operated by the government of Iraq, in which Semetex agreed to provide Al-Mansour with an "ion implanter" used to mark circulatory pathways on microchips. Payment to Semetex was to be made through an irrevocable documentary letter of credit in the amount of \$7,462,500. The letter of credit was issued by the Central Bank of Iraq in February 1990 and confirmed by a bank in the United States, specifically, UBAF.

The letter of credit conditioned payment solely on presentation of commercial invoices; a certificate of origin; an air waybill evidencing air shipment, freight prepaid, from the United States to Baghdad via Iraqi Airways or carriers authorized by Iraqi Airways; and a cable to Al-Mansour advising Al-Mansour of the flight number and date of arrival in Baghdad. It did not require evidence that control of the ion implanter had passed to a designated carrier before payment could be made.

Semetex engaged Eaton Corporation to manufacture the ion implanter to Al-Mansour's specifications. Semetex engaged Alison Transport, Inc., a freight-forwarding company, to ship the equipment from Eaton's factory in Austin, Texas, to Baghdad. The shipment was scheduled in several stages by van from Austin to John F. Kennedy International Airport in New York, followed by a Lufthansa flight to Frankfurt and a connecting Iraqi Airways flight to Baghdad. While the truck carrying the ion implanter was in transit to New York, Iraq invaded Kuwait, which caused President George H. W. Bush to issue an executive order blocking Iraqi assets in the United States. The ion implanter was subsequently diverted to a warehouse in Massachusetts in order to comply with the assets freeze.

Semetex made demand for payment upon UBAF, which demand was rejected. UBAF claimed that the documents evidencing transport of the ion implanter as prepared by Alison contained inconsistent information and fraudulent representations regarding the dates of shipment and the identities of carriers. Semetex applied for a license from the U.S. Office of Foreign Assets Control to sue UBAF for payment on the letter of credit, which application was granted.

SAND, JUDGE

UBAF invokes the fraud exception to the letter-of-credit independence principle. UBAF admits that the documents presented to it on August 1, 1990, complied on their face with the requirements of the Letter of Credit. It contends, however, that the documents were in compliance only because Plaintiffs misrepresented the flight information on the air waybill and forged the signature of an Iraqi Airways representative. Alison noted flight dates of July 26 and 29 on the air waybill when it made its second drawing attempt on August 1, UBAF contends, even though Alison and Plaintiffs knew that the ion implanter had only been picked up by truck in Austin on July 31 and that it was not scheduled to reach JFK Airport until August 2. UBAF contends that these discrepancies rise to the level of "outright fraudulent practice" that is required under New York law to supersede the independence principle

Fraud provides a well-established exception to the rule that banks must pay a beneficiary under a letter of credit when documents conforming on their face to the terms of the letter of credit are presented. . . The fraud defense, however, is a narrow one. The defense is available only where intentional fraud is shown, not where the party alleges improper performance or breach of warranty. . . . As the Second Circuit stated in *Rockwell*:

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The “fraud in the transaction” defense marks the limit of the generally accepted principle that a letter of credit is independent of whatever obligation it secures. No bright line separates the rule from the exception, to be sure, but . . . “fraud” embraces more than mere forgery of documents supporting a call. The logic of the fraud exception necessarily entails looking beyond supporting documents . . . We must look to the circumstances surrounding the transaction and the call to determine whether [the] call amounted to an “outright fraudulent practice.” *Rockwell Int’l Systems, Inc. v. Citibank, N.A.*, 719 F.2d 583, 588–89 (2d Cir. 1983).

UBAF argues that . . . Semetex presented a false air waybill to the confirming bank UBAF purporting to evidence shipment and export days earlier than in fact the shipment was scheduled. The air waybill was dated July 24 and signed by Iraqi Airways at Robert Mueller Airport in Austin, Texas, purporting to evidence consignment to that carrier on that date and a flight on July 26. In reality, by August 1, the ion implanter had not been delivered to the designated air carrier, Lufthansa. . . . Although UBAF raises evidence of substantial discrepancies between the actual facts of the ion implanter’s transport and the information on Semetex’s transport documents, we conclude that UBAF has not presented evidence that rises to the level of “outright fraudulent practice.” In particular, evidence of Plaintiffs’ fraudulent intent is lacking.

UBAF has presented no evidence that Plaintiffs “first caused the default and then attempted to reap the benefit of the guarantee.” Semetex and Eaton, defaulted on their obligations on the underlying contract because of an event over which they had absolutely no control—the Iraqi assets freeze.

UBAF likewise has presented no evidence that Plaintiffs either (1) failed to comply with an explicit term of the letter of credit or (2) did so with intent to defraud. . . . UBAF has presented no evidence that Plaintiffs’ alleged “forgery” of dates and a signature on the air waybill was material to the requirements of the Letter of Credit or was committed with intent to defraud. There is no dispute that Eaton in fact manufactured an ion implanter to Al-Mansour’s specifications, and there is likewise no dispute that, had it not been for the invasion of Kuwait and the subsequent Iraqi sanctions orders, the equipment would have reached its destination in Baghdad. . . . UBAF has presented no evidence of . . . fraudulent intent behind the seven-day discrepancy between the July 26 departure date represented on the air waybill and the actual planned flight date of August 2, and have presented no evidence that that discrepancy would have been material in any way in the absence of the unannounced invasion of Kuwait. Similarly, they have presented no evidence of fraudulent intent behind Plaintiffs’ signing the air waybill as agents of Iraqi Airways and designating Robert Mueller Airport as the point of departure.

In this regard, it is significant that the Letter of Credit did not specify that shipment in the United States must begin at Robert Mueller Airport, or otherwise specify how the equipment was to be moved within the United States. . . . [T]he UCP . . . does not assign significance to the date of delivery to a designated air carrier unless the parties expressly incorporate such a term into their letter of credit. . . .

In sum, none of the discrepancies on which UBAF focuses would have been material to Plaintiffs’ ability to draw on the Letter of Credit if the parties’ plans had not been unexpectedly dashed by the invasion of Kuwait and the subsequent freezing of Iraqi assets. [UBAF’s cited authorities] would be analogous to this case only if Semetex had had foreknowledge of the invasion of Kuwait and the resulting freeze of Iraqi assets, and so had conspired with Alison to falsify the dates on the air waybill in order to draw on the letter of credit funds before actually shipping the ion implanter. Of course, no such evidence was presented. . . .

The parties are thus left with the rights and obligations they bargained for: Semetex bargained for the right to be paid from UBAF’s non-Iraqi assets, and UBAF attempted to protect itself against the risk of nonpayment by the Iraqi bank by fully collateralizing its obligation to Semetex. The parties having thus entered into the Letter of Credit arrangement, the material question regarding UBAF’s liability is not whether control of the ion implanter had passed to Al-Mansour at the time that Plaintiffs attempted to draw on the Letter of Credit; rather, the question is whether UBAF has demonstrated either that the documents presented by Semetex failed to satisfy the Letter of Credit’s terms, or that they were forged or fraudulent or there was fraud in the transaction. As set out above, UBAF admits that the documents satisfy the Letter of Credit’s terms on their face, and it has failed to present evidence from which a reasonable factfinder could conclude that the fraud exception applies.

Conclusion. For the reasons set forth above, we conclude that Plaintiffs have demonstrated that they are entitled to judgment as a matter of law.

Case Questions

1. What basic principle of letter of credit law does this decision uphold?
2. Is the court’s decision correct given the many problems with the documentation as prepared by the freight forwarder and the additional complication of the Iraqi government asset freeze? Why or why not?
3. Is the court’s definition of “outright fraudulent practice” too restrictive? What would be the consequences for letter of credit law if the court adopted a more liberal interpretation of fraud?
4. What could UBAF have done in the negotiation and drafting process to prevent the ultimate outcome in this case?



Banks in the United States that confirm foreign letters of credit continuously monitor the economic and political conditions in those foreign countries. If a foreign buyer is unable to have its bank's letter of credit confirmed by a U.S. bank, then that may be a signal that the political and credit risks are too high. After all, if no U.S. bank will confirm a foreign letter of credit, why would the seller want to accept it? In this case, the seller might want to reconsider requesting some amount of cash in advance or other secure arrangement.

Standby Letters of Credit

A **standby letter of credit** (also called a standby credit, or simply a standby) is one in which the issuer is obligated to pay a beneficiary upon the presentation of documents indicating a default by the account party in the payment of a debt or the performance of an obligation. The documents might be as simple as a notice of default by the account party, signed by the beneficiary, and accompanied by a demand for payment. A standby letter of credit is a backup payment mechanism that the parties hope they will never have to use. It can be used to guarantee performance under a service or construction contract, to guarantee repayment of a loan, or as security for almost any other type of contract. The standby works much like the "performance guarantee" used by banks in other countries (or the "performance bond" in the UK) but is legally different. A standby is subject to the *International Standby Practices* (ISP 98), a set of rules and standards published by the International Chamber of Commerce. A standby letter of credit is flexible and can be tailored for almost any use. Most are used in large, complex transactions. Assume that a construction firm enters into a contract with a foreign government to construct a public works project. The government wants assurances that the firm will complete the work as promised by being named as beneficiary of a standby credit. The credit could be payable upon the government's presentation of a written demand for payment and a notice of default to the issuing bank stating that the construction firm has failed to complete the required work in the manner and within the time called for in the contract. Like the documentary requirements we have already studied, the language of default must strictly comply with the language used in the standby letter of credit. Documentary requirements depend on the transaction and the needs of the parties, but could include independent testing reports, architect's reports, court judgments, certified public

accounting statements, or a signed statement by the beneficiary or an authorized corporate officer.

In the sale of goods, a standby can be used in lieu of a conventional letter of credit. Assume that a seller agrees to grant 30-day open account terms to a buyer. In a standby credit, the bank is "standing by" as a backup, ready to purchase the documents if the buyer does not remit payment within 30 days. A standby can also guarantee the *seller's* performance, that is, that the seller will ship conforming goods within the time called for.

Standby letters of credit can ensure the repayment of a loan. Suppose, for example, that a subsidiary of a U.S. company operating in Latin America borrows money from a local bank. The bank can require a standby letter of credit from a U.S. bank that would allow it to draw against the credit should the subsidiary default on its obligation.

A standby can ensure compliance with almost any obligation. In the Exxon Valdez oil spill that occurred in Alaska in 1989, the court required that Exxon provide a \$6 billion standby letter of credit to ensure that Exxon would meet its obligations of environmental cleanup and payment of damages.

Not surprisingly, standby letters of credit have led to a great deal of litigation in the courts. To protect an account party under a standby credit from an "unfair" demand by the beneficiary, many international business lawyers structure the standby credit to require that the beneficiary's request for payment be accompanied by a written, independent confirmation of the account party's default by a third party.

Other Specialized Uses for Letters of Credit

Many specialized types of letters of credit provide a mechanism for financing a sale or other business transaction. We discuss some of these types here.

Transferable Credits. International traders usually use **transferable credits**. Traders buy and sell goods in international trade quickly and with no view to actually using the goods themselves. They bear considerable risk every day. Traders operate on little capital, buying merchandise or commodities in one country, taking title through the documents, and then, through their business contacts built up over years of experience, selling at a profit. Some traders specialize in trade with the developing world, often trading commodities for raw materials or merchandise when dollars or hard currency is not available. For instance, assume a Swiss bank issues a letter of credit for the account of an African country in



favor of the trader, with a part of the credit transferred to the trader's supplier in the Philippines for the cost of the goods it is supplying to the African country. This letter of credit can be split up among many suppliers around the world, each presenting documents for payment, with the trader taking its profit out of the balance of the credit. Shipments of crude oil are often bought and sold in this fashion.

Red Clauses in Credits. A **red clause** is a financing tool for smaller sellers who need capital to produce the products to be shipped under a letter of credit. A red clause in a letter of credit is a promise (usually written or underlined in red ink) by the issuing bank to reimburse the seller's bank for loans made to the seller. The loan, then, is really an advance on the credit. Loans can be used only for purchasing raw materials or for covering the costs of manufacturing or shipping of the goods described in the credit. Ultimately, the liability will fall on the buyer if the seller defaults on shipment or repayment of the amounts taken under the credit. This form of financing is risky for the buyer and its bank.

Revolving Credits and Evergreen Clauses. When a buyer is planning on purchasing from a foreign seller on a regular basis, the buyer may use a **revolving letter of credit**. Instead of having to use several different credits, one may be used with a maximum amount available during a certain period. As the draws against the credit are paid, the full amount becomes available again and continues until the expiration of the credit. An **evergreen clause** provides for automatic renewal of the letter of credit until the bank gives "clear and unequivocal" notice of its intent not to renew.

Back-to-Back Letter of Credit Financing. A **back-to-back letter of credit** is a special type of financing arrangement in which the proceeds of one credit serve as security to obtain a second credit. It might be used where a manufacturer or other exporter has a contract to sell finished goods to a buyer but needs financing to purchase needed component parts or raw materials from a supplier. The exporter, as beneficiary of a letter of credit from its buyer's bank, can assign the proceeds of that credit to its bank as security for a separate letter of credit being issued to the exporter's supplier. Thus, a back-to-back credit is really two credits, one issued in favor of the exporter that serves as security for a second issued in favor of the exporter's supplier. Many banks will issue the second credit only if they had issued

the first one (known as a *countercredit*). Back-to-back credits are also used as a financing arrangement by traders with minimal capital resources.

Electronic Data Interchange and the eUCP

Like funds transfers, letters of credit have been issued and transmitted to advising banks electronically for many years (and from advising bank to beneficiary usually by mail). The use of electronic documentation has increased over time, and beneficiaries are presenting documents electronically to banks for payment.

In 2002, the International Chamber of Commerce published the *eUCP*, a set of rules that extends the UCP to electronic documents. When documents are submitted electronically, *eUCP* rules apply by agreement of the parties. The *eUCP* addresses the format for electronic documents (the rules are flexible and include signed e-mail attachments or secured transfer), authentication and digital signatures, transmission errors, the manner of presentation, and other issues.

Bolero is a technical infrastructure created by the world's banking and logistics firms for exchanging electronic documents in a common format, including bills of lading, letters of credit, and other bank documents. *IdenTrust* is a private company founded by a small consortium of the world's largest banks to provide secure "digital identities" or signatures for confidentiality and authentication of financial and legal documents. Both *IdenTrust* and *Bolero* represent technological innovations necessary to move the centuries-old banking and shipping industries to the paperless age.

Letters of Credit in Trade Finance Programs

Letter of credit financing plays an important role in export financing by government and intergovernmental agencies. U.S. exports are financed by such agencies as the Agency for International Development (AID), the World Bank (which provides financial and technical assistance to developing countries to stimulate economic growth), the Commodity Credit Corporation (which assists with commerce in surplus agricultural products), and the Export-Import Bank of the United States (Eximbank). These agencies often insure payments made to U.S. sellers under letters of credit that are confirmed by U.S. banks using a letter of commitment from the agency to the issuing bank.

AID Financing. A typical AID financing situation might include a letter of credit. A country wishing to



import U.S. products, usually for use in developmental projects such as building roads, power-generating facilities, and the like, applies to AID for financing. AID then issues its commitment to a U.S. bank that issues its letter of credit for the benefit of the U.S. supplier of eligible goods for use in the project. The issuing bank receives reimbursement for payments under its letter of credit from AID.

Eximbank Financing. Eximbank is the largest U.S. export financing agency. It can provide guarantees on loans made by commercial banks and insurance on credit extended by U.S. exporters to their foreign customers. It also makes loans directly from Eximbank funds, including fixed-rate loans to creditworthy foreign buyers of American-made exports. Under another Eximbank loan program, a U.S. bank designated by the foreign buyer opens a letter of credit on behalf of the buyer for the benefit of a U.S. supplier. Eximbank guarantees the issuing bank repayment of sums that it pays out under the credit. Eximbank then receives its payments under the loan agreement worked out in advance between it and the foreign buyer. Eximbank programs cover both the risk of nonpayment and political risk (such as the outbreak of war or government controls that prohibit currency exchange). Despite the importance of the U.S. Eximbank, it only finances a small percentage of U.S. exports. Industries receiving substantial Eximbank support include aircraft manufacturing, oil and gas, mining, construction equipment manufacturing, energy production and agribusiness. In fiscal year 2015, Eximbank authorized 2,600 export sales, which supported \$17 billion in export sales. In the past, Eximbank had been subject to criticism for not assisting small U.S. exporters. In fiscal year 2015, however, more than 2,300 transactions (90 percent of total transactions), representing \$3 billion, went to aid

small businesses. These numbers were reduced from previous years as Eximbank's authority was allowed to lapse by the U.S. Congress as of July 1, 2015 and was not restored until December 4, 2015, the effective date of the *Export-Import Bank Reform and Reauthorization Act*. Eximbank was reauthorized through September 30, 2019 as a result of this legislation. Other countries have export-import banks of their own to assist in financing their exports.

Commodity Credit Corporation. The U.S. Department of Agriculture's Commodity Credit Corporation provides payment assurances to U.S. sellers of surplus agricultural products to approved foreign buyers. Standby letters of credit are often in use, whereby the seller can draw under the credit for invoices that remain unpaid by the overseas buyer.

CONCLUSION

The letter of credit is a flexible banking arrangement that can be structured according to the needs of the parties. It is a security device and a tool for financing. It provides enough security for companies to do business safely over great distances. One indirect result of using the letter of credit is that it gives the parties an opportunity to experiment with doing business with each other. It allows them to build trust, which is essential to generating repeat business. If the buyer and seller are both pleased with each other's performance, they may eventually decide to omit the letter of credit from future transactions. The seller may be satisfied by selling on documentary terms alone, and eventually, on open account terms. Each step becomes easier and less expensive for the buyer, and that in turn may translate into additional business for the seller.

Chapter Summary

1. The *bill of exchange* or *international draft* is a specialized type of *negotiable instrument* commonly used to expedite foreign money payments in many types of international transactions.
2. The commercial and financing use of a draft or other negotiable instrument is derived from its *negotiability*, which is the quality that allows it to act

as a substitute for money. When a draft is negotiated to a *holder in due course*, that party takes it free from most disputes that might arise between the drawer and drawee (the original parties to the underlying transaction). This protection for the holder in due course allows banks and other parties to purchase or accept drafts without fear of becoming embroiled

- in litigation over the original contract for which the draft was drawn.
3. A draft that may be paid upon presentation or demand is known as a *sight draft* because it is payable "on sight." The seller prepares the sight draft and presents it with the shipping documents through banking channels, moving from the seller's bank in the country of export to a foreign correspondent bank in the buyer's country and city. The draft is thereby sent "for collection," a process known as a *documentary collection*.
 4. Banks and other financial institutions involved in commercial lending provide a wide range of financing packages for international trade, commonly called *trade finance*. A draft due at a future date or after a specified period of time is known as a *time draft*. The buyer's acceptance indicates the buyer's unconditional obligation to pay the draft on the date due.
 5. A *banker's acceptance* is a negotiable instrument and short-term financing device widely used to finance international (as well as domestic) sales.
 6. The *documentary letter of credit* is the definite undertaking of a bank, issued in accordance with the instructions of their customer, addressed to, or in favor of, the beneficiary, wherein the bank promises to pay a certain sum of money (or to accept or negotiate the beneficiary's drafts up to that sum), in the stated currency, within the prescribed time limits, upon the complying presentation of the required and conforming documents.
 7. The *Uniform Custom and Practice for Documentary Credits* (UCP No. 600, 2007) is a set of standardized rules for issuing and handling letters of credit, drafted and published by the *International Chamber of Commerce*.
 8. The letter of credit is a separate transaction and independent from the underlying sales contract on which it was based. Bankers deal in documents and not in goods, so they are not concerned with the quality or condition of goods represented in the credit.
 9. The buyer's application for a credit forms a contract between the buyer and the issuing bank.
 10. Credits are transmitted to the beneficiary through an *advising bank* (or through a *confirming bank*, in the case of a confirmed letter of credit).
 11. The seller must make a *complying presentation* to the *nominated bank* within the time limits of the credit and according to the terms of the credit, the provisions of the UCP, and standard banking practices.
 12. Documents containing discrepancies will be rejected and held for the buyer's instructions or returned to the seller. A discrepancy exists if the seller's documents, *on their face*, do not conform to the terms of the letter of credit. The description of the goods in the commercial invoice must correspond exactly to that in the credit. Documents are usually interpreted according to the *strict compliance rule*.
 13. Courts have the power in certain cases to enjoin banks from honoring documents that are fraudulent or where there was fraud in the transaction.
 14. *Confirmed letters of credit* contain the additional obligation of a second bank, usually in the seller's country, to honor a complying presentation. They are the next best alternative to receiving cash in advance for an international sale.
 15. A *standby letter of credit* is one in which the issuer is obligated to pay a beneficiary upon the presentation of documents indicating a default by the account party in the payment of a debt or the performance of an obligation.

Key Terms

negotiable instrument 179	indorsement and delivery 180	account party 185
draft 179	sight draft 180	issuer or issuing bank 185
bill of exchange 179	documentary collection 180	beneficiary 185
documentary draft 179	trade finance 181	documentary letter of credit 185
drawer 180	time draft 181	Uniform Customs and Practice for
drawee 180	banker's acceptance 182	Documentary Credits 185
payee 180	holder in due course 183	independence principle 187
negotiation 180	letter of credit 184	complying presentation 191



nominated bank 191	confirmed letter of credit 197	revolving letter of credit 202
discrepancy 191	standby letter of credit 201	evergreen clause 202
rule of strict compliance 193	transferable credits 201	back-to-back letter of credit 202
fraud in the transaction 197	red clause 202	

Questions and Case Problems

1. Wade entered into a contract to sell irrigation equipment to Ribadalgo, its Ecuadorian distributor. Ribadalgo obtained an irrevocable letter of credit in the amount of \$400,000 from Banco General Runinahui, S.A. (Banco), a bank in Quito, Ecuador. The letter of credit provided that Wade was to ship by July 30, 1992. Wade was to present documents for payment “no later than 15 days after shipment, but within the validity of the credit.” The expiry date of the letter of credit was August 21, 1992. Partial shipments were acceptable. The letter of credit stated that it was governed by the UCP. Citibank confirmed the letter of credit. Wade shipped a portion of the goods on July 7. On July 21, just before the document presentment deadline, Wade presented the requisite documents to Citibank for payment. Two days later, on July 23, Citibank informed Wade that the documents contained discrepancies and that it therefore would not honor Wade’s request for payment. In response, Wade forwarded amended documents to Citibank on July 24 and July 27. Although Citibank conceded the documents as amended contained no discrepancies, it nevertheless rejected them as untimely because they were not received within 15 days of the July 7 shipment date as required by the credit. On July 17, the Ecuadorian government issued an order freezing all Ribadalgo’s assets and precluding payment on any lines of credit made available to Ribadalgo due to alleged drug trafficking. Four days later, Ecuadorian banking authorities entered an order barring Banco from making payment under the letter of credit. In turn, Banco advised Citibank not to honor any request for payment made by Wade thereunder. Is Wade entitled to payment under the letter of credit from Citibank? Wade argues that the documents did not have to be conforming before the presentment deadline, but only before the expiry date of the credit. Is Wade correct? Why do you think Citibank rejected the documents on July 21? *Banco General Runinahui, S.A. v. Citibank*, 97 F.3d 480 (11th Cir. 1996).
2. The rule of strict compliance in New York is best illustrated by *Beyene v. Irving Trust Co.*, 762 F.2d 4 (2d Cir. 1985). The letter of credit specified that payment be made on presentation of a bill of lading naming “Mohammed Sofan” as the party to be notified when the goods arrive. However, the bill of lading submitted to the bank with the demand for payment misspelled the name as “Mohammed
- Soran.” The confirming bank refused payment because of this discrepancy, and the beneficiary sued. Was this a “material” discrepancy, or was it “so insignificant as not to relieve the issuing and confirming bank of its obligation to pay”? The court compared and contrasted the misspelling of “Sofan” as “Soran” to the misspelling of “Smith” as “Smithh.” The court stated that the misspelling of “Smith” is not a discrepancy because the meaning is “unmistakably clear despite what is obviously a typographical error.” How did the court decide? Is there a difference between the misspellings of “Smith” and “Sofan”? For a more recent example, see *Hanil Bank v. Pt. Bank Negara Indonesia (Persero)*, 2000 U.S. Dist. LEXIS 2444 (S.D.N.Y. 2000). The case involves an Indonesian bank that refused payment on a letter of credit it issued, which had been subsequently negotiated to a Korean bank on the basis that the beneficiary was identified as Sung Jin Electronics Company rather than by its correct name Sung Jun Electronics Company.
3. In 2011, Mago International, a New York company, entered into a contract to sell meat products to NTP Genita, a company based in Kosovo. Mago required Genita to obtain a standby letter of credit issued by Bank for Business, a Kosovar bank, and confirmed by LHB AG. Under the terms of the letter, if Genita failed to pay Mago within 45 days after the date of an invoice, Mago could present documents to LHB and obtain payment on the letter. One of the required documents was a “photocopy of [a bill of lading] evidencing shipment of the goods.” Mago shipped 12 containers of products to Genita under invoices, none of which was paid by Genita. Mago tendered documents to LHB on three separate occasions, each of which was rejected by LHB due to the absence of signed bills of lading. LHB rejected a fourth tender of documents that contained signed bills of lading for each of the invoices as untimely. Mago sued LHB and Bank for Business for wrongful dishonor of the letter of credit. Mago claimed that the unsigned bills of lading complied with the terms of the letter of credit as they reflected the name of the ship and purported dates of shipment. The district court concluded that the unsigned copies were insufficient evidence of shipment and that Mago failed to comply with the terms of the letter of credit. Mago appealed the decision. Did the unsigned copies of the bills



of lading comply with the letter of credit's requirement that Mago provide a "photocopy of [a bill of lading] evidencing shipment of the goods." Why or why not? *Mago International v. LHB AG*, 833 F.3d 270 (2d Cir. 2016).

4. Robalen, Inc. was in the business of purchasing and selling yarns, fibers, and plastic resins. In March 1996, Robalen's customer, Resilux, N.V. of Belgium, opened an irrevocable letter of credit with Generale de Banque, S.A., as the issuing bank for the benefit of Robalen to cover three shipments of goods from Charleston, South Carolina to Antwerp, Belgium. The letter of credit required the production of documents evidencing that the goods were loaded on board or shipped on a named vessel. The first two shipments were made to Resilux, and Generale paid Robalen under the terms of the letter of credit. Resilux rejected the third shipment, and Generale did not make payment to Robalen on the basis that there was no printed notation on the tendered documents stating that the goods had been loaded on board or shipped on a named vessel. Generale made payments on the first two shipments despite the fact that they contained the same alleged defect. Robalen sued Generale for wrongful dishonor of the letter of credit. Did Generale's acceptance of the previous bills of lading serve to waive the right to insist on strict compliance with respect to the third shipment? Why or why not? Does Generale's failure to honor the letter of credit strike you as opportunistic given Resilux's rejection of the third shipment? *Robalen, Inc. v. Generale de Banque S.A.*, 1999 WL 688301 (S.D.N.Y. 1999).
5. The seller of goods has a right to proceed judicially against an issuing bank that dishonors its obligation under an irrevocable letter of credit, just as the seller has the right to proceed directly against the buyer. Should the issuing bank also be liable for consequential damages that are reasonably foreseeable? See *Hadley v. Baxendale* [1854] 9 Ex. 341.
6. NAFTA was a New York corporation engaged in the business of importing electronic equipment. In 1994, NAFTA purchased \$1.8 million in goods from Huston Electronics Company, a Taiwanese corporation. Huston was affiliated

with C.M. Hung Company from which it had purchased \$400 million of goods over a seven-year period of time. NAFTA typically made payments to C.M. Hung by means of letters of credit opened with Barclays Bank. These letters of credit required the seller to present certain documents to Barclays in order to receive payment. In 1993, Chiao Tung, a Taiwanese bank, became involved in these transactions. Chiao Tung made payments to Huston, obtained the required documentation, and presented the documentation to Barclays to obtain reimbursement pursuant to the letters of credit. In the 1994 transaction, Chiao Tung paid \$1.8 million to Huston and sought reimbursement from Barclays pursuant to letters of credit, which NAFTA had opened to cover the price of the goods. Barclays denied payment to Chiao Tung on the ground that Chiao Tung had failed to provide inspection certificates that were required by the terms of the letters of credit. Chiao Tung responded that its payment to Huston was made in reliance on the fact that inspection certificates were missing in over 40 prior transactions involving Huston and Chiao Tung, yet Barclays reimbursed Chiao Tung on each of those prior occasions because the inspection certificates were eventually supplied, or because NAFTA waived the requirement. Huston and Chiao Tung subsequently declined to forward the original bills of lading for the disputed goods to NAFTA and instructed Maersk, Inc., one of the carriers, to seize the goods. This action prompted NAFTA to commence litigation against Huston, Chiao Tung and Maersk to prevent removal of the goods from the United States. Chiao Tung filed counterclaims against NAFTA alleging that NAFTA had improperly received the goods without paying for them. Should past waivers of documentary discrepancies serve to waive the right to insist on strict compliance with respect to subsequent transactions? Why or why not? What relevance, if any, should a course of dealing have on the requirement of strict compliance with the terms of letters of credit? *North American Foreign Trading Corp. v. Chiao Tung Bank*, 1997 WL 193197 (S.D.N.Y. 1999).

Managerial Implications

1. Your firm regularly sells to customers in Germany, Poland, Japan, Canada, and Venezuela. How would you evaluate the creditworthiness of firms in each of these countries? How would the credit risk differ in each of these countries? What sources of information would you use? Under what circumstances would you consider selling to firms in these countries without a letter of credit? In which of these countries would you want an American bank to confirm the buyer's letter of credit? Why? What additional protection does confirming the credit provide?
2. An advising bank presents documents to you for payment. How would you respond to each of the following discrepancies? Explain your answers.
 - a. The letter of credit calls for an ocean bill of lading. The seller presents a trucker's bill of lading showing shipment to an ocean port.



- b. The sales contract and the letter of credit call for shipment of "Soda Ash Light." The invoice shows shipment of "Soda Ash Light," but the bill of lading describes the shipment as "Soda Ash."
- c. The letter of credit calls for shipment of 1,000 kilograms. The invoice shows shipment of an equal amount in pounds.
- d. The CIF contract with the letter of credit calls for onboard bill of lading to be dated by December 20. The bill of lading is dated December 20, but the insurance policy is dated December 21.

Ethical Considerations

1. Corby, an experienced tire broker in Wales, offered to sell tires to Chappell, a tire broker in California. Chappell contacted two U.S. tire distributors, Jenkins in Tennessee and Hein in Ohio, and agreed to act as their agent in negotiations with Corby. Corby claimed that he had a large client who had negotiated an arrangement directly with Michelin to handle all of its overstock blemished tires from France and who could offer 50,000 to 70,000 Michelin tires per quarter at 40–60 percent below the U.S. market price on an exclusive and ongoing basis. Corby faxed a list of tires, showing that the tires bore the designation "DA/2C." Chappell faxed the list to Jenkins and Hein. They knew that the "DA" meant "defective appearance." When Chappell asked Corby about the "/2C" he was told that it meant the tires were located at a different warehouse. Chappell told Corby on several occasions that since it was October 1998, the season for selling winter tires was almost over and that he required summer tires as well, to bundle with the winter tires. A second list showed no summer tires and nowhere near the 50,000 tires promised. In November and December, Corby pressured Chappell and Jenkins to open the letter of credit, asserting that if they did not do so the deal would be ended, thus preventing the buyers from being able to procure the requested summer tires. In late December, Jenkins began having reservations regarding the deal because Corby's representations were becoming suspicious. Jenkins requested to speak to Corby's source. Corby put him in touch with Evans, a tire distributor in England. In January, Evans sent the following fax to Jenkins:

There are large stocks of Michelin summer pattern tyres being made available within the next 7/10 days and we will be pleased to offer these to you when an acceptable Letter of Credit is received for the winter pattern tyres. We will be very happy to work with you on Michelin tyres on a long term basis and give you first option on offers. May we once again stress the urgency of letting us have the Letter of Credit for the Michelin winter tyres so that we can commence business on a long term basis?

Evans faxed a *pro forma* invoice requesting a letter of credit in favor of PTZ Trading Company in Guernsey as the beneficiary. Evans said that the letter of credit had to be sent immediately. The buyers felt that they had to comply as a show of good faith. An irrevocable credit was issued by an Ohio bank according to the terms of the *pro forma* invoice and stated:

Covering shipment of: "14,851 Michelin tyres at usd 34.83 per tire in accordance with seller's *pro forma* invoice 927-98 dated 11-19-98. Shipping terms: EXWORKS any European location. The credit is subject to UCP Publication 500. Expiry date April 2, 1999. The credit was advised to the sellers through Barclays Bank.

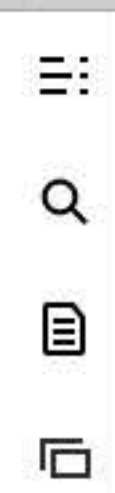
Shortly later, the negotiations broke down over the issue of summer tires, and the parties became hostile. In February, Corby sent a list of summer tires that had fewer units than promised, contained sizes not used in the United States, included various tires not manufactured by Michelin, and specified prices that were often higher than the cost of purchasing the tires one at a time from most dealers in the United States. In March, the buyers discovered that the "DA/2C" designation, attached to many of the tires, actually meant that the U.S. Department of Transportation serial numbers had been buffed off those units, rendering them illegal for import to or sale in the United States. Just before the letter of credit expired, Jenkins was informed by Sievers, a German tire distributor who was shipping the tires for PTZ Trading Co., that the tires were about to ship. Jenkins protested that he had not given permission to ship the tires because there was no agreement on summer tires. He threatened legal action. Sievers responded that he did not need permission and proceeded to ship. Sievers obtained a bill of lading and presented all documents to Barclays Bank for payment. The documents strictly complied with the credit. Jenkins petitioned an Ohio court for a restraining order preventing the issuing bank from honoring the credit. Barclays Bank learned of the order and refused Sievers' presentment. The carrier billed Jenkins for the ocean freight, and the tires remained in a warehouse in Savannah, Georgia. After a hearing in July, the court denied the buyer's petition for the restraining order. The Ohio Court



of Appeals reversed, and the buyer appealed to the Ohio Supreme Court. See *Mid-America Tire, Inc. v. PTZ Trading Ltd.*, 768 N.E.2d 619 (2002).

- a. What are the buyer's legal arguments supporting its petition for a restraining order? How do the facts support that argument? What precedent can it cite?
- b. What are the seller's arguments opposing the petition for a restraining order?
- c. What do you think about the way the buyer handled this from the beginning? What does this say about its level of expertise in international business? Explain.
- d. If you had been in the buyer's position, what would you have done differently?
- e. If the documents had not strictly complied with the credit, would this case have turned out differently?
- f. This court's decision only addressed the petition for a restraining order. How will the parties finally resolve the dispute on the underlying sales contract? What do you think will happen to the tires? Who is responsible for their warehousing fees?

2. Your firm has contracted to purchase silk from overseas suppliers on letter of credit terms. After contracting but before presentment of the seller's documents, China expands its production and floods the market with raw silk. The price of silk plummets on world markets. Comment on whether you should try to find a minor discrepancy in the documents to justify rejecting the documents. Is it ethical for a buyer to reject documents presented under a letter of credit that contains only a minor discrepancy between the documents and the credit? Do the reasons matter? Does it matter that the buyer may know that the shipment actually conforms to the requirements of the contract and of the letter of credit? What does the following statement mean? "Buyers and their banks have on occasion been known to 'invent' discrepancies; to make a 'mountain out of a molehill.' "



PART 3

International and U.S. Trade Law

In Part 3 we examine the legal relationship between countries as they set the "rules of the game" for world trade in goods and services. We will study various international agreements intended to promote world trade, by removing trade barriers and lowering tariffs, for example, and how nations implement those agreements into their national legislation. We will also see how the countries resolve trade disputes and avoid "trade wars."

Chapter 8 discusses the various branches of the U.S. government that share responsibility for regulating foreign commerce and trade, important U.S. trade legislation and U.S. trade agreements, and restrictions on U.S. state involvement in international trade. Chapters 9, 10, and 11 cover the basics of international trade law. Chapter 9 examines important terminology and basic principles of international trade and tariff law, the role of the World Trade Organization, and processes for resolving trade disputes between countries. Chapter 10 examines laws that help keep markets open to foreign firms, and thus to foreign competition. It is about the process called "trade liberalization," through which countries negotiate freer and fairer methods of trade regulation to open markets and further world trade. This chapter focuses on nontariff barriers that have blocked the import of U.S. goods and services in foreign countries. Chapter 11 addresses the issues of free trade versus protectionism and the regulation of import competition. Many of these topics, such as dumping and subsidies, may be familiar to the reader from courses in economics. In this chapter, we will examine the very interesting legal aspects and political ramifications of these issues.

Chapter 12 examines customs and tariff laws that govern the importing of goods into the United States and the relationship between a U.S. importer and the U.S. government. This chapter is important not only to American importers but also to any foreign firm that exports to the United States. We will learn how to determine the dutiable status of foreign goods and how to move them into the United States through the "entry process." We will look closely at the role of U.S. Customs and Border Protection, the U.S. agency charged with administering U.S. customs laws. This chapter focuses on importing as an integral part of the global strategy of the firm, in the context of global sourcing and the location of factories and assembly plants in different regions of the world.

Chapter 13 discusses legal restrictions on the export of goods and technology out of the United States. It addresses the national security and foreign policy implications of exports, such as the use of trade sanctions and other controls to stop the spread of weapons of mass destruction and missile technology, to fight international terrorism, and to further human rights.

Chapter 14 covers the *North American Free Trade Agreement* (NAFTA) and trade issues affecting the Western Hemisphere. This subject is near the end of this part because it builds on the principles of global trade covered in the earlier chapters.

Finally, Chapter 15 covers the European Union, which has a level of economic integration far greater than that of NAFTA. Although NAFTA is a "free trade area," the European Union takes the process of economic integration several steps further and is both a "customs union" with common tariff laws and a "monetary union" with a common currency.



CHAPTER 8

National Lawmaking Powers and the Regulation of U.S. Trade

The U.S. Constitution provides for a separation of powers between the executive and legislative branches of government. In the field of international economic affairs, however, the roles of Congress and the president are not clearly defined. We know that Congress has the authority to impose duties, to regulate commerce with foreign nations, to punish offenses against the law of nations, and to declare war. But what of the president? The Constitution tells us that the president appoints ambassadors, negotiates with foreign nations, and is the commander-in-chief of the armed forces. The president also makes treaties, although only with the advice and consent of the Senate.

Even this cursory reading of the Constitution suggests that most of the authority to regulate U.S. commerce and trade with foreign countries rests with Congress and not with the president. Most scholars would agree. After all, the Constitution tells us that Congress “regulates” commerce with foreign nations, while the president merely “negotiates.” In practice, it is not so simple. The system of checks and balances between the two branches has taken well over 200 years to develop. One established principle of American government is that Congress, within limits set out by decisions of the Supreme Court interpreting the Constitution, has the authority to delegate aspects of its legislative authority to the executive branch. Congress can enact a statute setting forth the goals to be accomplished and the means by which to achieve them and then authorize the president to carry them out. It can authorize the creation of a regulatory agency and provide funding for its work. As long as the president and the executive branch agencies are complying with the will of Congress, they are acting with the full force of law and usually with a large measure of congressional backing. This applies to the regulation of commerce with foreign nations and the establishment of U.S. trade policies.

In this chapter, we begin by exploring the basic concepts of the separation of powers in a modern business

context. We will examine the balance of power over foreign commerce and foreign relations, the “inherent” authority of the president as chief executive and commander-in-chief, and the delegations of power from Congress to the president. We will see the difference between “treaties” and “executive agreements,” both of which are used to implement the trade policies of the nation. We will also see how Congress has enacted statutes giving the president the authority to negotiate foreign trade agreements, including “fast track” trade promotion authority.

The chapter then briefly traces the history of American trade and tariff laws from the protectionist days of the *Smoot-Hawley Tariff Act of 1930* (or *Tariff Act of 1930*), which raised tariffs on imported goods to historic highs just at the start of the Great Depression, to the free trade programs that gave birth to modern free trade areas. Finally, we will look at the issue of federal-state relations and see the limits placed on state power when it comes to international affairs. This material provides an important background for later chapters.

THE SEPARATION OF POWERS

At the time the Constitution was drafted, people were greatly concerned with how to regulate foreign commerce. During this period of U.S. history, each state’s primary interest was in its own economic well being. States imposed regulations on commerce to protect their own local industries, their ports, and their agricultural interests.

To ensure that states would not erect barriers to commerce between them and to guarantee a source of revenue to the federal government in the form of import duties, the drafters of the Constitution placed the power to regulate international commerce in the hands of the federal government. The drafters believed, for example, that economic disintegration could result if

states were free to tax exports or if states located along the seacoast could tax imports passing through to states located inland. Moreover, they wanted the United States to be able to deal with foreign nations from a position of political strength and unity. The framers of the Constitution understood that trade relations with foreign nations could not be handled successfully by each state on its own, but only by a strong federal government that could speak for the economic and political interests of the nation as a whole.

Legislative Power of Congress

Today, the concept that the power over both foreign affairs and foreign trade rests with the federal government arouses little controversy. Considerable debate has arisen, however, over how the Constitution divides that power between Congress and the president. Article I of the Constitution confers “all legislative powers” on Congress, including the power “to regulate commerce with foreign nations, and among the several states” (Section 8, clause 3). In addition, Congress has broad power to pass domestic laws, raise and support armies, provide and maintain a navy, declare war, appropriate monies, and levy and collect taxes and import duties. The Senate has the authority to give advice and consent to the president in making treaties with foreign nations and to approve treaties by a two-thirds vote.

Considering these powers as a whole, the U.S. Supreme Court has consistently held that Congress has wide-ranging constitutional power to establish overall economic and trade policy for the United States and to put it into effect through legislation. Congress has recognized, however, that the day-to-day conduct of trade relations with foreign nations is often best accomplished through a strong executive branch. As a result, Congress has delegated authority to the president to carry out the trade policies set by statute.

President’s Inherent Powers

The president’s powers are generally derived from his inherent power as chief executive and as commander-in-chief, found in Article II of the U.S. Constitution, plus any grants of power delegated to the president by acts of Congress. The president’s **inherent powers** are those that are expressly granted to the president in Article II, which states that, “The executive Power shall be vested in a President.” Although this is a broad grant of power as chief executive, that power is not clearly specified or defined. Other Article II powers are the

power to make treaties (with the advice and consent of the Senate) and thus conduct foreign affairs, to appoint ambassadors, to receive foreign ambassadors, or to act as commander-in-chief of the armed forces, and to appoint judges of the Supreme Court. There have been many court decisions interpreting the president’s inherent power and attempting to balance the role of Congress versus the president. The president may not rely on the inherent powers of office if it contradicts an act of Congress. Article II also imposes on the president the duty to execute the laws in what is known as the “take Care” clause: “he shall take Care that the Laws be faithfully executed.”

Executive Orders, Memoranda, and Proclamations. An **executive order** is an official, legally binding regulation or written directive issued by the president, usually addressed to government officials, departments, or agencies, and used to set policy and direct government operations. Some examples of executive orders are President Roosevelt’s orders implementing the New Deal during the Great Depression and his order internment Japanese-Americans during World War II, President Eisenhower’s order desegregating certain public schools, President Kennedy’s order creating the Peace Corps, President Johnson’s order creating the Warren Commission to investigate the Kennedy assassination, and President G. W. Bush’s order reorganizing 22 government agencies under the Office of Homeland Security.

A **presidential memorandum** is usually less formal than an executive order and often states in its text that it does not create enforceable legal rights. It is often used to give guidance or delegate routine presidential functions to lower government officials. President Trump has used presidential memoranda to continue executive orders set to lapse, to publish a letter to the Speaker of the House, to commission government studies and request recommendations on government regulation, and to impose a hiring freeze on federal civilian employees. Today, there are few differences between executive orders and memoranda except for formalities.

A **presidential proclamation** is a statement or declaration of the president usually addressed to the general public announcing a finding or commemorating an event. The first proclamation was President Washington’s creation of a national Day of Thanksgiving. Although the public perception is that presidential proclamations are ceremonial, often used to recognize special holidays and events, they can



address very significant issues. Proclamations are often used pursuant to statute in implementing the trade and tariff laws. The *Emancipation Proclamation* was issued by President Lincoln, pursuant to his power as commander-in-chief during a civil insurrection.

Executive orders and presidential proclamations are published in the federal register. 44 U.S.C. 1505. A presidential memorandum is not published in the Federal Register unless the president intends it to have legal effect and requests it to be published. The authority of the president to issue orders, memoranda, proclamations, or other directives is not mentioned or defined in the Constitution but is derived from the executive power.

Executive orders and other directives are frequently challenged in the federal courts as exceeding the president's authority, and these court decisions have helped define the limits of presidential power. An executive order cannot be used to "make law." If Congress has passed a statute on a subject, the president's inherent

power does not grant "license" to violate that law. Executive orders based on a statutory grant of power to the president can be subsequently revoked or modified by Congress. Congress may also limit an executive order by denying funding that might be needed to carry it out.

Many controversies arise when Congress fails to address an issue through legislation, and the president acts to "fill the void" by dealing with the issue alone, without the consent of Congress. For example, the president cannot "stretch" his title as commander-in-chief to achieve an objective not normally within the purview of the armed forces. To this day, one of the most frequently cited cases on the president's inherent power is *Youngstown Sheet & Tube v. Sawyer*. In this case, President Truman had relied on his inherent power as chief executive and as commander-in-chief of the armed forces to issue an executive order forcing the continued operation of the nation's steel mills during the Korean War in the face of a threatened labor strike. As you read, pay particular attention to Justice Jackson's concurring opinion.



Youngstown Sheet & Tube v. Sawyer

343 U.S. 579 (1952) United States Supreme Court

BACKGROUND AND FACTS

In the early 1950s, the United States was at war in Korea as part of a United Nations "police action." American steelworkers were threatening to strike over wages and collective bargaining disagreements with steel companies. The president made every attempt to intervene and to help the parties negotiate an agreement. A strike would have disrupted the supply of steel, leading to a possible shortage of steel during the war effort and an increase in prices in all products made of steel. Despite all efforts, the parties were unable to reach agreement. Just before the steelworkers were to go on strike, President Truman ordered Secretary of Commerce Charles Sawyer to seize the steel mills and keep them in operation. The president based his authority for doing so on Article II of the Constitution and on his power as commander-in-chief of the armed forces. A district court granted the request of the steel companies for a temporary injunction against the president's order, the Court of Appeals agreed, and the secretary of commerce appealed to the Supreme Court.

DECISION MR. JUSTICE BLACK DELIVERED THE OPINION OF THE COURT

The President's power, if any, to issue the order must stem either from an act of Congress or from the Constitution itself. There is no statute that expressly authorizes

the President to take possession of property as he did here. Nor is there any act of Congress to which our attention has been directed from which such a power can fairly be implied. Indeed, we do not understand the Government to rely on statutory authorization for this seizure.

Moreover, the use of the seizure technique to solve labor disputes in order to prevent work stoppages was not only unauthorized by any congressional enactment; prior to this controversy, Congress had refused to adopt that method of settling labor disputes. When the *Taft-Hartley Act* was under consideration in 1947, Congress rejected an amendment which would have authorized such governmental seizures in cases of emergency. Apparently it was thought that the technique of seizure, like that of compulsory arbitration, would interfere with the process of collective bargaining. * * *

The order cannot properly be sustained as an exercise of the President's military power as Commander-in-Chief of the Armed Forces. The Government attempts to do so by citing a number of cases upholding broad powers in military commanders engaged in day-to-day fighting in a theater of war. Such cases need not concern us here. Even though "theater of war" be an expanding concept, we cannot with faithfulness to our constitutional system hold that the Commander-in-Chief of the Armed Forces has the

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ultimate power as such to take possession of private property in order to keep labor disputes from stopping production. This is a job for the Nation's lawmakers, not for its military authorities.

Nor can the seizure order be sustained because of the several constitutional provisions that grant executive power to the President. In the framework of our Constitution, the President's power to see that the laws are faithfully executed refutes the idea that he is to be a lawmaker. The Constitution limits his functions in the lawmaking process to the recommending of laws he thinks wise and the vetoing of laws he thinks bad. And the Constitution is neither silent nor equivocal about who shall make laws which the President is to execute. The first section of the first article says that "All legislative Powers herein granted shall be vested in a Congress of the United States." * * * The power of Congress to adopt such public policies as those proclaimed by the order is beyond question. It can authorize the taking of private property for public use. It can make laws regulating the relationships between employers and employees, prescribing rules designed to settle labor disputes, and fixing wages and working conditions in certain fields of our economy. The Constitution did not subject this lawmaking power of Congress to presidential or military supervision or control. * * *

The Founders of this Nation entrusted the lawmaking power to the Congress alone in both good and bad times. It would do no good to recall the historical events, the fears of power and the hopes for freedom that lay behind their choice. Such a review would but confirm our holding that this seizure order cannot stand.

The judgment of the District Court is affirmed.

**MR. JUSTICE JACKSON, CONCURRING
IN THE JUDGMENT AND OPINION
OF THE COURT**
* * *

When the President acts pursuant to an express or implied authorization of Congress, his authority is at its maximum, for it includes all that he possesses in his own right plus all that Congress can delegate. In these circumstances, and in these only, may he be said (for what it may be worth), to personify the federal sovereignty. If his act is held unconstitutional under these circumstances, it usually means that the Federal Government as an undivided whole lacks power. A seizure executed by the President pursuant to an Act of Congress would be supported by the strongest of presumptions and the widest latitude of judicial interpretation, and the burden of persuasion would rest heavily upon any who might attack it.

When the President acts in absence of either a congressional grant or denial of authority, he can only rely upon his own independent powers, but there is a zone of twilight in which he and Congress may have

concurrent authority, or in which its distribution is uncertain. Therefore, congressional inertia, indifference or quiescence may sometimes, at least as a practical matter, enable, if not invite, measures on independent presidential responsibility. In this area, any actual test of power is likely to depend on the imperatives of events and contemporary imponderables rather than on abstract theories of law.

When the President takes measures incompatible with the expressed or implied will of Congress, his power is at its lowest ebb, for then he can rely only upon his own constitutional powers minus any constitutional powers of Congress over the matter. Courts can sustain exclusive Presidential control in such a case only by disabling the Congress from acting upon the subject. Presidential claim to a power at once so conclusive and preclusive must be scrutinized with caution, for what is at stake is the equilibrium established by our constitutional system. * * *

Into which of these classifications does this executive seizure of the steel industry fit? It is eliminated from the first by admission, for it is conceded that no congressional authorization exists for this seizure. That takes away also the support of the many precedents and declarations which were made in relation, and must be confined, to this category. * * *

The clause on which the Government next relies is that "The President shall be Commander in Chief of the Army and Navy of the United States." * * * These cryptic words have given rise to some of the most persistent controversies in our constitutional history. Of course, they imply something more than an empty title. But just what authority goes with the name has plagued Presidential advisers who would not waive or narrow it by nonassertion yet cannot say where it begins or ends. It undoubtedly puts the Nation's armed forces under Presidential command. Hence, this loose appellation is sometimes advanced as support for any Presidential action, internal or external, involving use of force, the idea being that it vests power to do anything, anywhere, that can be done with an army or navy.

There are indications that the Constitution did not contemplate that the title Commander-in-Chief of the Army and Navy will constitute him also Commander-in-Chief of the country, its industries and its inhabitants. He has no monopoly of "war powers," whatever they are. While Congress cannot deprive the President of the command of the army and navy, only Congress can provide him an army or navy to command. It is also empowered to make rules for the "Government and Regulation of land and naval forces," by which it may to some unknown extent impinge upon even command functions.

That military powers of the Commander-in-Chief were not to supersede representative government of internal affairs seems obvious from the Constitution and from elementary American history. * * *

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In view of the ease, expedition and safely with which Congress can grant and has granted large emergency powers, certainly ample to embrace this crisis, I am quite unimpressed with the argument that we should affirm possession of them without statute. Such power either has no beginning or it has no end. If it exists, it need submit to no legal restraint. I am not alarmed that it would plunge us straightway into dictatorship, but it is at least a step in that wrong direction.

Decision. The lower court's injunction against the President's action was upheld. The President was not acting pursuant to an act of Congress, nor could the seizure of private property during wartime be justified on the basis of his inherent power as President or as Commander-in-Chief.

Comment. The concurring opinion by Justice Jackson is one of the most frequently cited opinions in American constitutional history regarding presidential powers. Justice Robert Jackson was America's chief prosecutor of

Nazi war criminals at the Nuremberg Trials. Where, as in this case, the President's action is in contradiction to acts of Congress, the President's power is at its "lowest ebb."

Case Questions

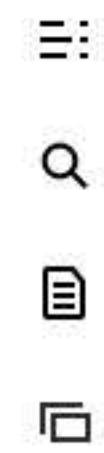
1. On what grounds did Justice Black reject President Truman's seizure order?
2. Explain Justice Jackson's tripartite classification of presidential power. When is the president's authority considered to be at its "lowest ebb?" How did he classify President Truman's action in seizing the steel mills, and why?
3. Considering that the United States was engaged in a brutal war in Korea, and that steel was needed for the war effort, do you agree with this decision (three justices dissented)? If the Court had permitted the seizure of a private business in this case, could that have led to a "slippery slope" and ultimately future seizures on somewhat lesser grounds?

Presidential Power in International Affairs. It is generally accepted by both courts and legal scholars that the president has greater and wider-reaching power over foreign affairs than over domestic policy. An important argument in favor of a strong executive branch is that the nation must "speak with one voice" in international affairs. If each senator or representative, perhaps motivated by the local interests of his or her own constituents, attempts to negotiate agreements with foreign nations on matters such as tariff reductions, free trade areas, provisions for military assistance, or even nuclear disarmament, the process would be encumbered by local interests and would be ineffective and potentially disastrous. One of the most famous statements about the power of the president over foreign affairs is found in *United States v. Curtiss-Wright Export Co.*, 299 U.S. 304 (1936).

Not only, as we have shown, is the federal power over external affairs in origin and essential character different from that over internal affairs, but participation in the exercise of the power is significantly limited. In this vast external realm, with its important, complicated, delicate and manifold problems, the President alone has the power to speak or listen as a representative of the nation. He makes treaties with the advice and consent of the Senate; but he alone negotiates. Into the field of negotiation the Senate cannot intrude; and Congress itself is powerless to invade it. As Marshall said in his great argument of March 7, 1800, in the House of Representatives, "The President is the sole organ of the nation in its external relations, and its sole representative with foreign nations." . . . It is quite apparent that if, in the maintenance of our international relations, embarrassment—perhaps

serious embarrassment—is to be avoided and success for our aims achieved, congressional legislation which is to be made effective through negotiation and inquiry within the international field must often accord to the President a degree of discretion and freedom from statutory restriction which would not be admissible were domestic affairs alone involved. Moreover, he, not Congress, has the better opportunity of knowing the conditions which prevail in foreign countries, and especially is this true in time of war. He has his confidential sources of information. He has his agents in the form of diplomatic, consular and other officials. Secrecy in respect of information gathered by them may be highly necessary, and the premature disclosure of it productive of harmful results.

Sole Executive International Agreements. In addition to the executive actions previously discussed, the president has the authority to make executive international agreements. A **sole executive international agreement** is one negotiated and put into legal effect without congressional approval. The president's authority to enter a sole executive agreement is based either on presidential powers inherent in being the chief executive and commander-in-chief or it arises pursuant to existing legislation. Sole executive agreements are not treaties or substitutes for treaties and are not used to set national policy. Examples are a legally binding contract with a foreign country to lease property for the site of an American embassy, or an agreement for scientific cooperation or the exchange of technical information. Most sole executive agreements, such as the one in the following case, *Dole v. Carter*, relate to specific matters.



Dole v. Carter

444 F. Supp. 1065 (1977) United States District Court (D. Kan.)

BACKGROUND AND FACTS

This action was brought by a U.S. senator against the president to enjoin him from returning the Hungarian coronation regalia to the People's Republic of Hungary. The Holy Crown of St. Stephen had been held by the Hungarian people as a treasured symbol of their statehood and nationality for nearly 1,000 years. At the close of World War II, it was entrusted to the United States for safekeeping by Hungarian soldiers. In 1977, the governments of the United States and Hungary entered into an agreement returning the crown to Hungary. Many Hungarians living in the United States were opposed to the return of the crown. The plaintiff filed this action seeking an injunction against delivery of the crown to Hungary on the ground that such action was tantamount to a treaty undertaken by the president without the prior advice and consent of the Senate.

DISTRICT JUDGE O'CONNOR

We turn now to the plaintiff's argument that the agreement to return the coronation regalia to Hungary in and of itself constitutes a treaty which must be ratified by the Senate. It is well established, and even plaintiff admits, that the United States frequently enters into international agreements other than treaties. Indeed, as of January 1, 1972, the United States was a party to 5,306 international agreements, only 947 of which were treaties and 4,359 of which were international agreements other than treaties. These "other agreements" appear to fall into three categories: (1) so-called congressional-executive agreements, executed by the President upon specific authorizing legislation from the Congress; (2) executive agreements pursuant to treaty, executed by the President in accord with specific instructions found in a prior, formal treaty; and (3) executive agreements executed pursuant to the President's own constitutional authority (hereinafter referred to as "executive agreements"). Defendant contends that his agreement to return the coronation regalia to Hungary falls into the latter category, and the court agrees. * * *

The United States enters into approximately 200 executive agreements each year, and it has been observed that the constitutional system "could not last a month" if the President sought Senate or congressional consent for every one of them. L. Henkin, *Foreign Affairs and the Constitution* . . . Congress itself recognized this fact in passing P.L. 92-403, 1 U.S.C. §112b, requiring the secretary of state to transmit for

merely informational purposes the text of all international agreements other than treaties to which the United States becomes a party. The House Committee on Foreign Affairs stated in recommending passage of that statute that while it wished to be apprised of "all agreements of any significance," "[c]learly the Congress does not want to be inundated with trivia." 1972 U.S. Code Cong. and Admin. News, p. 3069. While the President's understanding to return the Hungarian coronation regalia is hardly a "trivial" matter to either the United States or the people of Hungary, the court is yet convinced that the President's agreement in this regard lacks the magnitude of agreements customarily concluded in treaty form. The President's agreement here involves no substantial ongoing commitment on the part of the United States, exposes the United States to no appreciable discernible risks, and contemplates American action of an extremely limited duration in time. The plaintiff presented no evidence that agreements of the kind in question here are traditionally concluded only by treaty, either as a matter of American custom or as a matter of international law. Indeed, while the court has not exhaustively examined all possibly pertinent treaties, the court can hardly imagine that any such examination would lend support to the plaintiff's position. Finally, the agreement here encompasses no substantial reciprocal commitments by the Hungarian government. As a matter of law, the court is therefore persuaded that the President's agreement to return the Hungarian coronation regalia is not a commitment requiring the advice and consent of the Senate under Article II, Section 2, of the Constitution.

Decision. The plaintiff's motion for a preliminary injunction was denied. The agreement to return the coronation regalia was found to be not a treaty requiring ratification by the Senate, but a valid executive agreement based on the president's inherent power.

Case Questions

1. Why did the president use a sole executive agreement resolving this issue with Hungary instead of relying on the treaty power?
2. Was the president's action required to be authorized by the Congress?
3. What kinds of agreements are usually reserved for treaties, and what kinds are handled through executive agreements?



The Treaty Power

In Chapter 2 we discuss the legal status of self-executing and nonself-executing treaties under international and national law. The term **treaty power** refers to the authority of the United States to enter treaties pursuant to Article II of the Constitution. U.S. treaties are negotiated by the executive branch with the “advice and consent” of the Senate and approved by a two-thirds vote of the Senate. The House does not vote on treaties. Treaties are binding on both the federal and state governments with the same force as an act of Congress. This is known as the **equal dignity rule**; both statutes and treaties are of equal importance. In the event of a conflict between a treaty and statute, the last in time prevails. A treaty will override an inconsistent prior act of Congress. Similarly, an act of Congress can override an inconsistent prior treaty, provided that Congress had expressed its intention to do so. Treaties of the United States can be found in the U.S. State Department document, *Treaties in Force*. For a discussion of treaties under international law, and an explanation of the different types of treaties, see Chapter 2.

Congressional-Executive Agreements. Treaties are not the only type of international agreement. **Congressional-executive agreements** are international agreements between the president, representing the United States, and a foreign country, negotiated and concluded by the president and voted into law by a simple majority vote of both the Senate and the House of Representatives. Congressional-executive agreements serve much the same purpose as treaties, but they are entered into without resort to the treaty process. Their legal nature, however, is different. Unlike treaties, congressional-executive agreements are not described in the Constitution. They are a creature of compromise between the president and Congress. Congressional-executive agreements date to the Roosevelt era of the 1930s and 1940s, when the president was seeking new and more flexible ways of dealing with the nation’s economic problems during the Great Depression and World War II. By the close of World War II, the House and Senate had informally agreed with the president to provide a substitute process for approving international agreements—one that would not require a two-thirds vote of approval of the Senate, as do treaties. Instead, they agreed on a substitute process permitting international agreements to be approved either by statute or by joint resolutions of both houses of Congress. Statutes and joint resolutions can pass on a *simple majority vote* of both houses. Presidents usually

prefer the congressional-executive agreement process to the treaty process because it is often easier for them to obtain congressional approval by simple majority vote of both the House and Senate than it is to obtain a two-thirds vote of the Senate. Since World War II, most international agreements of the United States have been executive agreements, not treaties. Congressional-executive agreements, as a delegated power, clearly meet the standard for presidential power set out in Justice Jackson’s concurring opinion in *Youngstown Steel*.

Presidential Power and U.S. Trade Relations

From the time of America’s first tariff act in 1790 through the early 1900s, the concern of Congress was more with setting tariffs than setting trade policy. Tariff setting was a unilateral process—rates were not set by negotiations with foreign governments so much as by negotiation in the halls of Congress, no doubt under some political influence. U.S. law gave little authority to the president other than to collect the tariffs on imported goods according to the rates set by Congress. Congress saw tariffs as a way to collect revenue and protect American industry and workers. Shortly after World War I, partially as a result of isolationist sentiments at home, the United States began to increase tariffs on imported goods. Under the *Smoot-Hawley Tariff Act of 1930*, signed into law by President Herbert Hoover, the U.S. Congress imposed the highest tariff levels in the nation’s history. The levels were so high that other nations raised their tariffs in retaliation. Some tariff rates reached nearly 100 percent of the cost of the goods. It was disastrous. Economic activity declined precipitously. When the United States slowed imports of foreign goods, buyers in those countries no longer had the U.S. dollars to purchase U.S. goods. Foreign nations retaliated and imposed burdensome tariffs on their imports. It became a worldwide problem, and it is generally accepted today that it exacerbated the Great Depression of the 1930s. The *Tariff Act of 1930* has been amended many times over the years and is still the basic tariff law of the United States. We will study its impact on imports and its relevance to U.S. importers in Chapter 12.

While President Franklin Roosevelt recognized the immediate need to reduce tariffs, he simply did not have the legal authority to take any significant action without congressional approval, and the treaty process was too cumbersome. Roosevelt therefore worked with Congress to pass the *Reciprocal Trade Agreements Act of 1934*, which provided the president with the authority needed to lower tariffs.



The Reciprocal Trade Agreements Act of 1934

The *Reciprocal Trade Agreements Act of 1934* created a partnership between the executive and congressional branches of government in setting tariff and trade policy. It not only provided the president with a mechanism for lowering “the *Smoot-Hawley* tariff rates” but for encouraging other countries to lower their rates on our products in return. This act granted the president far more flexible powers to adjust tariffs than under any prior legislation. The president was granted the authority to negotiate tariff reductions on a product-by-product basis with other countries on the basis of **reciprocal trade**. The United States would reduce a tariff on a foreign product if the foreign country would reciprocate by lowering its tariffs. An agreement to reduce a tariff to a specified level is known as a **tariff concession**. If the United States lowers an existing tariff on an imported product from France, for example, then France must make similar concessions on the same or other products coming from the United States.

Unconditional Most-Favored-Nation Trade. The 1934 *Reciprocal Trade Agreements Act* also introduced the concept of “unconditional” most-favored-nation or *MFN trade*. MFN trade can be conditional or unconditional. **Conditional MFN trade** means that any trading advantage (such as a reduced tariff rate) applied to an item imported into a country will also be applied to the same or like items coming from any other country that has MFN status with the importing country, *provided that country reciprocates and lowers its tariff rates in an equivalent amount in return*. As far back as 1778, the

United States relied on conditional MFN trade. The concept of unconditional MFN trade, however, came into U.S. law in 1934. In **unconditional MFN trade**, any new lower tariff that applies to an item imported from one MFN trading partner *automatically applies to the same or like items imported from all other nations that are in MFN status with the importing country, without any concession being required from those nations in return*. Thus, if the United States negotiates a lower tariff rate on raw shrimp coming from one MFN trading nation, then that rate *automatically applies* to raw shrimp coming from all other MFN trading nations without them having to do anything in return. Unconditional MFN trade is one of the foundations of the modern trading system today.

One country grants MFN legal status to another by international treaty or congressional-executive agreement, and the executive branch negotiates MFN tariff rates. While the logic of unconditional MFN trade may not be clear, it makes economic and political sense. It helps to lower global tariff rates much faster than would otherwise occur, and it is fairer. It allows for equal treatment, without discrimination, of all countries designated as MFN partners. In the United States, unconditional MFN trade has been renamed by Congress as **normal trade relations**. Countries with whom the United States has normal trade relations receive a favorable, negotiated rate well below the original 1930 *Smoot-Hawley* rate.

In the following case, *Star-Kist Foods, Inc. v. United States*, the constitutionality of the tariff-setting process of the *Reciprocal Trade Agreements* was upheld against a charge that it was an unconstitutional delegation of power by Congress to the president. In doing so, the court upheld the foundations of U.S. customs and tariff laws in use today.



Star-Kist Foods, Inc. v. United States

275 F.2d 472 (1959) United States Court of Customs and Patent Appeals

BACKGROUND AND FACTS

Star-Kist Foods, a U.S. producer of canned tuna, instituted a lawsuit to protest the assessment of duties made by the collector of customs on imported canned tuna. Duty was assessed on the canned tuna at the rate of 12.5 percent pursuant to a trade agreement with Iceland. Prior to the agreement, the tariff rate had been set by Congress in the *Tariff Act of 1930* at 25 percent *ad valorem*. The trade agreement with Iceland, which resulted in lowering the rate of duty, was executed pursuant to the *Reciprocal Trade Agreements Act of 1934*.

That act authorized the president to enter into foreign trade agreements for the purpose of expanding foreign markets for the products of the United States by affording corresponding market opportunities for foreign products in the United States. To implement an agreement, the president was then authorized to raise or lower any duty previously set by Congress, but not by more than 50 percent. Star-Kist brought this action, contending that the delegation of authority under the 1934 act and the agreement with Iceland were unconstitutional.

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JUDGE MARTIN

A constitutional delegation of powers requires that Congress enunciate a policy or objective or give reasons for seeking the aid of the President. In addition the act must specify when the powers conferred may be utilized by establishing a standard or "intelligible principle" which is sufficient to make it clear when action is proper. And because Congress cannot abdicate its legislative function and confer carte blanche authority on the President, it must circumscribe that power in some manner. This means that Congress must tell the President what he can do by prescribing a standard which confines his discretion and which will guarantee that any authorized action he takes will tend to promote rather than flout the legislative purpose. It is not necessary that the guides be precise or mathematical formulae to be satisfactory in a constitutional sense.

In the act before us the congressional policy is pronounced very clearly. The stated objectives are to expand foreign markets for the products of the United States "by regulating the admission of foreign goods into the United States in accordance with the characteristics and needs of various branches of American production so that foreign markets will be made available to those branches of American production which require and are capable of developing such outlets by affording corresponding market opportunities for foreign products in the United States. . . ."

Pursuant to the 1934 act the presidential power can be invoked "whenever he [the President] finds as a fact that any existing duties or other import restrictions of the United States or any foreign country are unduly burdening or restricting the foreign trade of the United States and that the [purpose of the act] will be promoted." . . .

Under the provisions of the 1934 act the President by proclamation can modify existing duties and other import restrictions but not by more than 50 percent of the specified duties nor can he place articles upon or take them off the free list. Furthermore, he must accomplish the purposes of the act through the medium of foreign trade agreements with other countries. However, he can suspend the operation of such agreements if he discovers discriminatory treatment of American commerce, and he can terminate, in whole or in part, any proclamation at any time . . .

In view of the Supreme Court's recognition of the necessity of flexibility in the laws affecting foreign relations . . . we are of the opinion that the 1934 act does not grant an unconstitutional delegation of authority to the President.

Decision. The court held for the United States. The congressional delegation of authority under the 1934 statute was constitutional because Congress had provided the president with a sufficiently discernible standard to guide any decisions in carrying out the purposes of the act.

Case Questions

1. What was the constitutional authority for the agreement with Iceland?
2. What was the policy objective of Congress in enacting the *Reciprocal Trade Agreements Act* noted by the court? How was the president to implement this policy?
3. Why was the congressional delegation of authority constitutional?

Survey of Changes in U.S. Trade Policy since 1962

The year 1962 marked a change in the development of U.S. trade legislation and policy. In that year, Congress moved the responsibility for trade negotiations from the State Department to the newly created Office of the Special Trade Representative. In the *Trade Expansion Act of 1962*, Congress authorized the negotiation of across-the-board tariff reductions through multilateral trade negotiations instead of using the tedious product-by-product system set up in 1934. This allowed for an even faster reduction of tariffs worldwide. By the mid-1970s, tariff rates had been reduced significantly, and it was the nontariff barriers that were seen as interfering with the worldwide free flow of goods and

services. Recall that a **nontariff barrier** is any barrier to trade, other than a tariff, that has the effect of prohibiting or discouraging imports. Examples are quotas on imported products, special licenses for importing, and hidden or bureaucratic "red tape" in the customs or import process. Also during the 1970s, Congress elevated the Special Trade Representative's position to a cabinet-level rank in the President's administration, renaming it the *United States Trade Representative* (USTR), and giving it enhanced authority for developing U.S. trade policy. Congress also gave additional authority to the U.S. Trade Representative and to the president that went beyond negotiating tariff reductions. For example, it permitted them to impose trade sanctions, such as temporary punitive tariffs against foreign governments that erect unfair or discriminatory nontariff



barriers to the entry of U.S. goods and services, and to retaliate against foreign governments that have failed to protect U.S. intellectual property rights.

Also in the 1970s, the trade concerns of developing countries were taken more seriously—concerns that are of importance today in all global trade negotiations. For example, during this period, the United States initiated a program giving trade preferences to goods imported from developing countries. A **trade preference** is a law that grants favorable trade and tariff treatment to products coming from developing countries, and is intended to aid in their economic development. Various U.S. programs dating to the mid-1970s grant trade preferences and lowered rates of duty on goods from Africa, the Caribbean, and developing countries throughout the world. Most developed countries have similar programs. Trade preference rates of duty are generally lower than even the MFN rate.

By the 1980s and 1990s, the focus of U.S. trade objectives changed, geographically and in scope. There were several new areas of concern: (1) removing barriers to trade in high technology industries, (2) removing barriers to trade in services, (3) incorporating the protection of intellectual property and investment concerns into trade laws, (4) negotiating free trade areas, and perhaps most importantly, (5) a commitment to formalize multilateral trade negotiations and dispute settlement procedures in one permanent international organization. The *Omnibus Trade and Competitiveness Act of 1988* extended the president's authority to negotiate trade agreements, which led to the *North American Free Trade Agreement* (1994), the *Central American Free Trade Agreement* (2004), and the *Agreement Establishing World Trade Organization* (1994). In addition, the president and Congress have also passed a number of trade agreements dealing with specific issues, or affecting U.S. trade with specific world regions. This led to the eventual passage of the *Caribbean Basin Economic Recovery Act of 1983*, the *Andean Trade Program and Drug Eradication Act of 2002*, and the *African Growth and Opportunity Act of 2000*, as well as other important trade laws.

Trade Agreements and Trade Promotion Authority

A **trade agreement** is an international agreement between nations on matters related to trade and tariffs. In addition to reducing tariffs or other barriers to trade in goods or services, trade agreements can achieve far broader

objectives. For example, some agreements manage or control trade in endangered wildlife, forestry products, or antiquities, while others might also address “side-issues,” such as the protection of intellectual property, the rights of workers in developing countries, the rights of investors, or cross-border transportation. Some trade agreements have a mechanism for resolving disputes between countries over trade issues. Trade agreements can be either bilateral or multilateral. Many trade agreements are completed between neighboring countries or those with regional concerns. America's first trade agreement was a bilateral agreement with France in 1778.

Free Trade Agreements. A **free trade agreement** or **FTA** usually refers to a trade agreement with broader coverage that establishes a “free trade area” in which special tariff and customs provisions govern the flow of trade between the participating countries. Goods moving between these countries usually have few or no tariffs and few restrictions. These special trade arrangements provide even “more favorable” tariff and customs treatment for imports and exports than does “most favored” nation status alone. Special treatment of trade in services is often included.

Although trade agreements can be concluded by treaty, the United States usually uses the congressional-executive process instead, as discussed earlier. Of course, there is always the risk that a politicized Congress might later reject any agreement that the executive branch and a foreign country reach. Imagine the executive branch taking years to negotiate trade agreements with dozens of countries, covering thousands of products affecting hundreds of industries, only to have a senator or representative vote against it because it would reduce import duties on foreign products that compete with those made by his or her special interests back home. A potential rejection by Congress or delay of many years might also make a foreign nation less willing to enter trade negotiations.

Trade Promotion Authority. To avoid this, the *Trade Reform Act of 1974* set up a “fast-track” process for approving trade agreements, today known as the president's **trade promotion authority**. The statute gives the president (through the U.S. Trade Representative) limited and temporary authority to negotiate trade agreements pursuant to the objectives set out by Congress. During trade negotiations, the president must consult with Congress and notify it of proposed changes to U.S. trade laws that might be needed to implement the



agreement. Congress can then comment on the negotiations before there is a final agreement and while there is still time for the president to modify it. At the conclusion of negotiations, both houses of Congress must vote on a bill submitted by the president. The agreement must pass a simple majority vote in its entirety without amendment—an “up or down” vote only. This process helps shepherd negotiations and ensure the passage of trade agreements into U.S. law because it eliminates the possibility of Congress trying to rewrite agreements under pressure from special interests. Trade promotion authority has been used successfully to negotiate many trade agreements since the end of World War II. Most notably, trade promotion authority was used to when the United States entered the World Trade Organization and the *North American Free Trade Agreement*.

Current U.S. Free Trade Commitments. As a result of the process started decades earlier, as of 2017 the United States had bilateral or regional free trade agreements with Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Korea, Mexico, Morocco, Nicaragua, Oman, Panama, Peru, and Singapore. Many of these free trade areas, and their relevance to U.S. companies, will be discussed later in this book.

Trade promotion authority was renewed by Congress in the *Trade Preferences Extension Act of 2015* and was used by President Obama in negotiating the *Trans-Pacific Partnership Agreement* (known as “the TPP”), a free trade agreement between the United States and 12 Asian and Pacific countries, excluding China. However, during the 2016 election, the TPP lost popular support, and within a few weeks of his inauguration, President Trump withdrew the United States from the agreement. In departing from the multilateral trading system that the United States has supported since the 1940s, he issued a presidential memorandum ordering the USTR to “permanently withdraw the United States from TPP negotiations, and to begin pursuing, wherever possible, bilateral trade negotiations.” The TPP remains in effect, but without the United States. The debate over the TPP is addressed in a later chapter.

Enhanced and Emergency Powers of the President

Today, the president is authorized not just to reduce duties on products but also to take a wide range of executive actions to deal with the complexities of the

modern business world. This authority is in keeping with the modern notion that the president needs increased flexibility in handling matters related to international trade and foreign affairs. For example, the president has authority to negotiate special trade relations with developing countries; negotiate rules for dealing with agricultural trade problems; coordinate international monetary policies; negotiate better mechanisms for protecting copyrights, patents, and trademarks in foreign countries; negotiate a reduction of barriers to trade in high technology; and ensure equal access to foreign high technology by U.S. firms.

When a country enters into a free trade agreement, there are often both “winners and losers.” While a U.S. trade agreement may benefit America’s exporting firms, and may benefit America’s importers and consumers through lower prices, there may very well be some U.S. industries that are adversely affected—the U.S. companies and workers who produce goods in competition with the now cheaper imports. To deal with this complicated and politically charged problem, Congress has by statute granted the president additional powers to protect U.S. firms from increases in imports of foreign-made goods that harm U.S. companies and workers. These “trade remedies” usually take the form of temporary tariffs or emergency measures to help disaffected U.S. industries and workers adjust to the increased imports resulting from freer trade. This is covered in depth in Chapter 11.

Congress also grants the president **emergency powers** for responding to international emergencies. International emergencies are generally unexpected international events that threaten American national security. The *International Emergency Economic Powers Act* enables the president to block financial transactions or restrict the flow of trade with foreign countries, or seize the assets of governments, individuals, or organizations responsible. These issues are discussed in Chapter 13.

FEDERAL-STATE RELATIONS

Thus far our discussion focuses on the relation between the executive and legislative branches of the federal government. But the notion of “federalism” also implies that the United States has two levels of government—state and federal. The Constitution has several provisions that touch on the relations between the state and federal governments and that determine a state’s authority to regulate international (as well as interstate) trade.



The Supremacy Clause

When a law or regulation of the federal government directly conflicts with those of the state (or local) government, the federal law will generally prevail when Congress expresses the intention that the federal law shall prevail or when that intention may be inferred from the legislation or from the circumstances. This is known as **federal preemption**. Where Congress enacts a comprehensive scheme of legislation, such as statutes and federal regulations governing commercial aviation, the federal rule will prevail over an inconsistent state rule. The inconsistent state law is void to the extent it conflicts with the federal scheme.

In the following case, *Arizona v. United States*, the U.S. Supreme Court considered an attempt by the State of Arizona to deal with illegal immigration there. Arizona, like other border states, does indeed have many problems stemming from illegal immigration. The Court was aware of the “epidemic of crime, safety risks, serious property damage and environmental problems associated with the influx of illegal migration” from Mexico. It also noted that hundreds of thousands of deportable aliens are apprehended in Arizona each year. However, the issue confronting the Court was not what Arizona should do about the immigration problem, but about what the Constitution permitted it to do considering the limits of federal preemption.



Arizona v. United States

132 S. Ct. 2492 (2012) United States Supreme Court

BACKGROUND AND FACTS

During a time of political controversy in the United States over immigration policy and enforcement, the State of Arizona enacted a statute to deal with the large number of unlawful aliens in the state. Section 3 made it a misdemeanor under Arizona law for any person to violate federal alien-registration laws. Section 5(c) made it a misdemeanor for an unauthorized alien to seek or engage in work in the state. Section 6 authorized state and local officers to arrest without a warrant any person they believed could lawfully be removed from the United States. Section 2(B) required state and local officials to contact federal officials for the purpose of verifying the immigration status of any person who had been lawfully stopped or detained. The United States brought this action against Arizona challenging the constitutionality of the statute. A federal district court enjoined enforcement of the statute, and Arizona appealed. The Supreme Court granted certiorari.

JUSTICE KENNEDY DELIVERED THE OPINION OF THE COURT

The Government of the United States has broad, undoubted power over the subject of immigration and the status of aliens. See *Toll v. Moreno*, 458 U.S. 1, 10, 102 S. Ct. 2977 (1982) [citations omitted]. This authority rests, in part, on the National Government’s constitutional power to “establish an uniform Rule of Naturalization,” *U.S. Const.*, Art. I, §8, cl. 4, and its inherent power as sovereign to control and conduct relations with foreign nations.

The federal power to determine immigration policy is well settled. Immigration policy can affect trade, investment, tourism, and diplomatic relations for the

entire Nation, as well as the perceptions and expectations of aliens in this country who seek the full protection of its laws. Perceived mistreatment of aliens in the United States may lead to harmful reciprocal treatment of American citizens abroad.

It is fundamental that foreign countries concerned about the status, safety, and security of their nationals in the United States must be able to confer and communicate on this subject with one national sovereign, not the 50 separate States. This Court has reaffirmed that “[o]ne of the most important and delicate of all international relationships . . . has to do with the protection of the just rights of a country’s own nationals when those nationals are in another country.” *Hines v. Davidowitz*, 312 U.S. 52, 64, 61 S.Ct. 399 (1941).

Federal governance of immigration and alien status is extensive and complex. Congress has specified categories of aliens who may not be admitted to the United States. Unlawful entry and unlawful reentry into the country are federal offenses. Once here, aliens are required to register with the Federal Government and to carry proof of status on their person. Failure to do so is a federal misdemeanor. Federal law also authorizes States to deny noncitizens a range of public benefits, and it imposes sanctions on employers who hire unauthorized workers.

Congress has specified which aliens may be removed from the United States and the procedures for doing so. Aliens may be removed if they were inadmissible at the time of entry, have been convicted of certain crimes, or meet other criteria set by federal law. Removal is a civil, not criminal, matter. A principal feature of the removal system is the broad discretion exercised by immigration officials. Federal officials, as

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an initial matter, must decide whether it makes sense to pursue removal at all. If removal proceedings commence, aliens may seek asylum and other discretionary relief allowing them to remain in the country or at least to leave without formal removal.

Discretion in the enforcement of immigration law embraces immediate human concerns. * * * Some discretionary decisions involve policy choices that bear on this Nation's international relations. Returning an alien to his own country may be deemed inappropriate even where he has committed a removable offense or fails to meet the criteria for admission. The foreign state may be mired in civil war, complicit in political persecution, or enduring conditions that create a real risk that the alien or his family will be harmed upon return. The dynamic nature of relations with other countries requires the Executive Branch to ensure that enforcement policies are consistent with this Nation's foreign policy with respect to these and other realities. * * *

Federalism, central to the constitutional design, adopts the principle that both the National and State Governments have elements of sovereignty the other is bound to respect. From the existence of two sovereigns follows the possibility that laws can be in conflict or at cross-purposes. The Supremacy Clause provides a clear rule that federal law "shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." Art. VI, cl. 2. Under this principle, Congress has the power to preempt state law. See *Crosby v. National Foreign Trade Council*, 530 U.S. 363, 372, 120 S.Ct. 2288 (2000); *Gibbons v. Ogden*, 9 Wheat. 1, 210–211 (1824).

State law must also give way to federal law in at least two other circumstances. First, the States are precluded from regulating conduct in a field that Congress, acting within its proper authority, has determined must be regulated by its exclusive governance. * * * Second, state laws are preempted when they conflict with federal law. * * *

The four challenged provisions of the state law each must be examined under these preemption principles.

Section 3 of the Arizona Statute Section 3 creates a new state misdemeanor. It forbids the "willful failure to complete or carry an alien registration document . . . in violation of [federal law]." * * *

Federal law makes a single sovereign responsible for maintaining a comprehensive and unified system to keep track of aliens within the Nation's borders. If §3 of the Arizona statute were valid, every State could give itself independent authority to prosecute federal registration violations, "diminish[ing] the [Federal Government]'s control over enforcement" and "detract[ing] from the 'integrated scheme of regulation' created by Congress." *Wisconsin Dept. of Industry v. Gould Inc.*,

475 U.S. 282, 288–289, 106 S.Ct. 1057 (1986). Even if a State may make violation of federal law a crime in some instances, it cannot do so in a field (like the field of alien registration) that has been occupied by federal law. * * *

Section 5(C) Unlike §3, which replicates federal statutory requirements, §5(c) enacts a state criminal prohibition where no federal counterpart exists. The provision makes it a state misdemeanor for "an unauthorized alien to knowingly apply for work, solicit work in a public place or perform work as an employee or independent contractor" in Arizona. The United States contends that the provision upsets the balance struck by the *Immigration Reform and Control Act of 1986* (IRCA) and must be preempted as an obstacle to the federal plan of regulation and control. * * * Congress enacted IRCA as a comprehensive framework for "combating the employment of illegal aliens." *Hoffman Plastic Compounds, Inc. v. NLRB*, 535 U.S. 137, 147, 122 S.Ct. 1275 (2002). The law makes it illegal for employers to knowingly hire, recruit, refer, or continue to employ unauthorized workers. It also requires every employer to verify the employment authorization status of prospective employees. These requirements are enforced through criminal penalties and an escalating series of civil penalties tied to the number of times an employer has violated the provisions. * * *

The legislative background of IRCA underscores the fact that Congress made a deliberate choice not to impose criminal penalties on aliens who seek, or engage in, unauthorized employment. * * * In the end, IRCA's framework reflects a considered judgment that making criminals out of aliens engaged in unauthorized work—aliens who already face the possibility of employer exploitation because of their removable status—would be inconsistent with federal policy and objectives. * * *

Although §5(c) attempts to achieve one of the same goals as federal law—the deterrence of unlawful employment—it involves a conflict in the method of enforcement. * * *

Section 6 [Section 6 allows a state officer to arrest without a warrant anyone that they believe is removable from the United States for a violation of the law.] The United States argues that arrests authorized by this statute would be an obstacle to the removal system Congress created.

As a general rule, it is not a crime for a removable alien to remain present in the United States. See *INS v. Lopez-Mendoza*, 468 U.S. 1032, 1038, 104 S.Ct. 3479 (1984). If the police stop someone based on nothing more than possible removability, the usual predicate for an arrest is absent. When an alien is suspected of being removable, a federal official issues an administrative document called a Notice to Appear. The form does not authorize an arrest. Instead, it gives the alien

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information about the proceedings, including the time and date of the removal hearing. If an alien fails to appear, an *in absentia* order may direct removal. * * *

Section 6 attempts to provide state officers even greater authority to arrest aliens on the basis of possible removability than Congress has given to trained federal immigration officers. * * * This would allow the State to achieve its own immigration policy. The result could be unnecessary harassment of some aliens (for instance, a veteran, college student, or someone assisting with a criminal investigation) whom federal officials determine should not be removed. * * *

By authorizing state officers to decide whether an alien should be detained for being removable, §6 violates the principle that the removal process is entrusted to the discretion of the Federal Government. * * *

Section 2(B) [Section 2(B) requires state officers contact the federal government to determine the immigration status of any person they detain or arrest on some other legitimate grounds if they have a "reasonable suspicion that the person is an alien unlawfully present in the United States."] Congress has done nothing to suggest it is inappropriate to communicate with [federal officials] in these situations, however. Indeed, it has encouraged the sharing of information about possible immigration violations. See 8 U.S.C. §1357(g)(10)(A). A federal statute regulating the public benefits provided to qualified aliens in fact instructs that "no State or local government entity may be prohibited, or in any way restricted, from sending to or receiving from [federal officials] information regarding the immigration status, lawful or unlawful, of an alien in the United

States." §1644. The federal scheme thus leaves room for a policy requiring state officials to contact [federal officials] as a routine matter.

The National Government has significant power to regulate immigration. With power comes responsibility, and the sound exercise of national power over immigration depends on the Nation's meeting its responsibility to base its laws on a political will informed by searching, thoughtful, rational civic discourse. Arizona may have understandable frustrations with the problems caused by illegal immigration while that process continues, but the State may not pursue policies that undermine federal law. * * *

Decision. Affirmed in part and reversed in part. Those sections of the Arizona statute [Sections 3, 5(c), and 6] are preempted by federal law and invalid. Section 2(B) which encourages consultation between state and federal officials does not conflict with federal immigration law and is valid.

Case Questions

1. Where does the federal government derive its authority to regulate immigration?
2. What policy arguments does the court give for the federal government's regulation of immigration?
3. On what grounds did the Court strike down three parts of the Arizona statute?
4. Why did the court uphold the fourth part of the Arizona statute (2B)?

Federal Preemption of Trade Policy. The doctrine of federal preemption has also been applied to attempts by state governments to regulate imports of foreign goods into the state or to conduct their own trade relations with foreign countries. In 1996, the Commonwealth of Massachusetts passed a law prohibiting all commonwealth and municipal government agencies from buying goods or services from any person or firm that did business in Burma. Congress took a different strategy with a federal statute to ban all economic aid to the Burmese government except for humanitarian assistance, deny U.S. entry visas to Burmese citizens, and authorize the president to prohibit "new investment" in Burma if the Burmese government continued its violent suppression of democracy. The powers delegated to the president were specific and directed him to work with other Asian countries to promote democracy in Burma through diplomatic means.

In *Crosby v. National Foreign Trade Council*, 530 U.S. 363 (2000), the U.S. Supreme Court struck down the Massachusetts law on the basis of federal preemption. The Court noted the difference between the federal and state sanctions. The Massachusetts sanctions were immediate and direct in prohibiting business in Burma. The federal sanctions were more flexible, gradually allowing the president to increase pressure on Burma as needed and to do so through both specific legal and diplomatic means. The court reasoned, "If the Massachusetts law is enforceable the president has less to offer and less economic and diplomatic leverage as a consequence." Thus, the state law undermined the intended purpose and "natural effect" of the federal act. In deciding that federal law preempted the state statute, the Court repeated that the federal government must "speak with one voice" in foreign policy matters and that Congress had left little or no role for states or municipalities.

Taxing Imports and Exports in the United States

Although the authority to tax *imports* rests solely with the federal government ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises . . . but all Duties, Imposts and Excises shall be uniform throughout the United States." Art. I §8 Cl.1), Congress may not tax the *export* of goods or services ("No Tax or Duty shall be laid on Articles exported from any State. . . ." Article I §9 Clause 5). However, the federal courts have made a distinction between a tax on exports and "user fees" charged to exporters. They have upheld user fees if the fee is not based on the value of the goods exported, but on the cost of government services rendered, such as fees tied to the actual use of a port or harbor facility.

The Constitution also prohibits the states from taxing *both* imports or exports. ("No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws. . . ." Article I §10 Clause 2). This is often called the **Import-Export Clause**. Historically, there were several reasons for this: First, the founding fathers understood that a nation's "trade policy" is often used as a tool of "foreign policy," and that both had to be controlled by the federal government. Second, federal control over imports had to be uniformly applied throughout the country. Third, import duties provided an important source of revenue for the federal government, as there was no income tax in the United States at the time. And fourth, interstate disputes were avoided by prohibiting seaboard states from taxing goods that were merely "in transit" to inland states.

Court-Imposed Limitations on State Taxation of Imports. A state's authority to tax imports has been limited by the courts to collecting fees for inspecting imports necessary to protect public health and safety. In *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), the U.S. Supreme Court addressed the issue of the state's power to tax imports. Michelin Tire Corporation imported tires manufactured in France and Nova Scotia, Canada, by Michelin Tires, Ltd. The company maintained a distribution warehouse in Georgia. The state assessed an *ad valorem* property tax against the tires that were held in inventory. The tax was nondiscriminatory in nature in that the same tax was imposed on all property similarly being held for resale in Georgia—that of

both domestic and foreign origin. The petitioner filed suit to have the collection of the tax enjoined as unconstitutional under the Constitution. The Supreme Court ruled that the tax was permitted because the tax was imposed on all products for the purpose of supporting the cost of public services, the tax was nondiscriminatory, and it did not interfere with the federal government's regulation of international commerce.

In 1978, the Supreme Court considered the constitutionality of a Washington state tax on stevedoring (the process of loading and unloading cargo on ships). Relying on the *Michelin* decision, the Court in *Department of Revenue of the State of Washington v. Association of Washington Stevedoring Cos.*, 435 U.S. 734 (1978) held that,

the tax does not restrain the ability of the federal government to conduct foreign policy. As a general business tax that applies to virtually all businesses in the state, it has not created any special tariff. The assessments in this case are only upon that business conducted entirely within Washington. No foreign business or vessel is taxed . . . The tax merely compensates the state for services and protection extended by Washington to the stevedoring business.

In refusing to strike down the tax, the Court concluded that to do otherwise would burden the state of Washington and its citizens with the cost of public services needed to safely operate the port system as goods were moved inland. The tax had the effect of transferring the cost of services to inland consumers and others who actually benefited from the port.

The Commerce Clause

As discussed earlier in the chapter, the broadest power of the federal government to regulate business activity is derived from Article I, Section 8 of the Constitution.

The **Commerce Clause** vests the federal government with exclusive control over foreign commerce. Conversely, in the negative implication doctrine, state governments may not enact laws that impose a substantial burden on foreign commerce. Where there is an existing federal law governing some aspect of foreign commerce, a conflicting state statute may be invalid (preempted) under the **Supremacy Clause**.

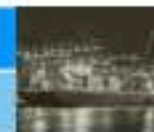
The Commerce Clause and Multiple Taxation. A state's authority to tax a business engaged in foreign commerce is also determined by whether or not the tax imposed results in **multiple taxation**. Multiple taxation occurs when the same service or property is subjected

to the same or a similar tax by the governmental authorities of more than one nation. The following case, *Japan Line, Ltd. v. County of Los Angeles*, discusses the problems of multiple taxation. The purpose of restricting multiple taxation is to strengthen the government's ability to foster domestic participation in the international marketplace. By not prejudicing foreign companies operating in the United States, this country does not risk retaliation by foreign governments against U.S. firms operating abroad.

The issue of multiple taxation was considered in *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994). The Court upheld the constitutionality of California's "unitary" method of assessing income tax on companies in California that are subsidiaries of foreign multinational corporations.

Barclays Bank of California (Barcal), a California banking institution, was a subsidiary of the Barclays Group, a multinational banking enterprise based in the United Kingdom. The Barclays Group included more than 220 corporations doing business in 60 nations. In 1977, Barcal reported taxable income only from its own operations within California. California claimed that Barcal was a part of a multinational **unitary business**

(an affiliated or related group of companies under common control) and that the entire worldwide income of the unitary business (the income of all of the subsidiaries within the Barclays Group operating anywhere in the world) was taxable in California. Under the unitary method, taxes were assessed on the percentage of worldwide income equal to the average of the proportions of worldwide payroll, property, and sales located in California. Thus, if a multinational corporation had 8 percent of its payroll, 3 percent of its inventory and other property, and 4 percent of its sales in California, the state imposed its tax on 5 percent of the multinational's total income. (The weight given to each category can vary under different formulas.) California used the unitary method because it believed that under traditional methods of tax accounting, conglomerates had the ability to manipulate transactions between affiliated companies so as to shift income to low-tax jurisdictions (although to guard against such manipulation, transactions between affiliated corporations are generally scrutinized to ensure that they are reported on an "arm's length" basis). Barclays claimed that California's tax resulted in multiple taxation, in violation of the Commerce Clause.



Japan Line, Ltd. v. County of Los Angeles

441 U.S. 434 (1979) United States Supreme Court

BACKGROUND AND FACTS

The state of California imposed an *ad valorem* property tax on cargo containers owned by Japanese companies and temporarily located in California ports. The containers were used exclusively for transporting goods in international commerce. They were based, registered, and subjected to property taxes in Japan. The containers spent, on average, only three weeks a year in California. Japan Lines contended that the tax was invalid because it subjected the containers to multiple taxation in Japan and the United States. The California Supreme Court upheld the statute and the ship owners appealed.

JUSTICE BLACKMUN

This case presents the question whether a state, consistently with the Commerce Clause of the Constitution, may impose a nondiscriminatory *ad valorem* property tax on foreign-owned instrumentalities (cargo containers) of international commerce . . .

In order to prevent multiple taxation of commerce, this Court has required that taxes be apportioned among taxing jurisdictions, so that no instrumentality

of commerce is subjected to more than one tax on its full value. The corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full. "The rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile . . . Otherwise there would be multiple taxation of interstate operations." The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies.

Yet neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a state should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that "multiple burdens" logically cannot occur, the same conclusion, as to foreign commerce, logically

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cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the state, may subject foreign commerce "to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids."

Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees v. United States*, 289 U.S. 48 (1933). Although the Constitution, Art. I, §8, cl. 3, grants Congress power to regulate commerce "with foreign Nations" and "among the several States" in parallel phrases, there is evidence that the Founders intended the scope of the foreign commerce power to be the greater. Cases of this Court, stressing the need for uniformity in treating with other nations, echo this distinction. * * *

A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate

against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing state, so that the Nation as a whole would suffer . . .

It is stipulated that American-owned containers are not taxed in Japan. California's tax thus creates an asymmetry in international maritime taxation operating to Japan's disadvantage. The risk of retaliation by Japan, under these circumstances, is acute, and such retaliation of necessity would be felt by the Nation as a whole . . .

We hold the tax, as applied, unconstitutional under the Commerce Clause.

Decision. The Supreme Court reversed, holding that the tax was unconstitutional. The Court ruled that an ad valorem property tax applied to cargo containers used exclusively in foreign commerce violates the Commerce Clause because it resulted in multiple taxation of instrumentalities of foreign commerce.

Case Questions

1. What rule does the Court espouse for the state taxation of cargo containers and other instrumentalities of foreign commerce?
2. How does this case affect taxation by foreign countries?
3. What effect would multiple taxation have on international commerce?

Citing its previous decisions, the U.S. Supreme Court upheld the California tax because seven requirements were met:

1. The tax applied to an activity with a substantial connection to California.
2. The tax was "fairly apportioned."
3. The tax did not discriminate against interstate commerce.
4. The tax was fairly related to the services provided by the state.
5. The tax did not result in multiple taxation.
6. The tax did not impair the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments."
7. Compliance with the formula was not so impossible as to deprive the corporation of due process of law.

Even before this case went to court, foreign corporations doing business in California had objected strongly to the unitary tax. Foreign governments also objected, claiming it violated international law.

In response to this outcry, the state of California in 1986 instituted a **water's edge election** allowing "multinational" corporate taxpayers the option of excluding the income of related entities that are incorporated in a foreign country or that earn a majority of their income in a foreign country. The result is that today, in California and several other states, the taxpayer has the option of being taxed as a unitary business according to the Supreme Court's decision in *Barclays*, or only on its California (or taxing state) income—up to the "water's edge." Most states, however, require reporting on the "water's edge" basis. Income tax regulations are complicated for any firm engaged in a multistate business, and even more so for related multinational parent-subsidiary corporations. Professional tax advice is crucial.

State Restrictions on Exports. The Commerce Clause prohibits state governments from restricting, taxing, or otherwise imposing undue burdens on exports. In *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984), the Supreme Court considered a



challenge to an Alaska regulation that required that all timber taken from state lands be processed within the state prior to being exported. South-Central was an Alaskan company engaged in purchasing timber and shipping logs overseas. It filed suit claiming that the regulation violated the negative implications of the Commerce Clause. Alaska argued that the Commerce Clause did not apply because the state was acting as a “market-participant” (a vendor of lumber), not as a regulator. The Court agreed with South-Central:

The limit of the market-participant doctrine must be that it allows a State to impose burdens on commerce within the market in which it is a participant, but allows it to go no further. The State may not impose conditions, whether by statute, regulation, or contract, that have a substantial regulatory effect outside of that particular market . . . [A]lthough the state may be a participant in the timber market, it is using its leverage in that market to exert a regulatory effect in the processing market, in which it is not a participant. . . . In light of the substantial attention given by Congress to the subject of export restrictions on unprocessed timber, it would be peculiarly inappropriate to permit state regulation of the subject.

State Restrictions on Imports. State government restrictions on imports are severely limited. User fees for the use of port facilities are generally permitted. Also, states may impose restrictions directly related to the protection of the public health and safety. For example, Florida could limit, restrict, or ban the import of fruits or vegetables suspected of carrying a disease that could contaminate the local crop. In one case, however, a labeling and licensing statute was invalidated by the courts even though its alleged purpose was the protection of the public health and safety. Tennessee had enacted a statute calling for the licensing of all persons who deal in foreign meat products in the state and the labeling of all foreign meats sold in the state as being of foreign origin. The court, in *Tupman Thurlow Co. v. Moss*, 252 F. Supp. 641 (M.D. Tenn. 1961), concluded that “The regulation here involved cannot fairly be construed as a consumer protection measure, and if it should be, it would be interdicted by the Commerce Clause because it unreasonably discriminates against foreign products in favor of products of domestic origin.”

FEDERAL AGENCIES AFFECTING TRADE

Many U.S. government agencies provide technical and financial assistance for international firms. These include the Small Business Administration, the

Export-Import Bank, the Overseas Private Investment Corporation, the Commodity Credit Corporation, the Agency for International Development, the Trade and Development Program, the U.S. Department of Agriculture, and any others. We mention a few here and will discuss those that are highlighted in bold in more detail in later chapters.

U. S. Department of Commerce

The U.S. Department of Commerce has broad authority over many international trade issues. The department’s functions are fostering trade and promoting exports of U.S. goods and services (trade promotion), investigating and resolving complaints by U.S. firms that foreign governments are unfairly blocking access to foreign markets (market access), administering U.S. unfair import laws (import administration), issuing export licenses for certain products, developing U.S. international trade statistical information, and many other functions. The International Trade Administration (ITA), housed within the department, performs many of the trade promotion, market access, and import administration functions. Within the ITA, the U.S. Commercial Service maintains a network of offices at home and abroad to assist U.S. firms in developing export opportunities. The U.S. Bureau of Industry and Security regulates the export of sensitive goods and technologies for national security and foreign policy and administers U.S. export control laws.

U. S. Department of Homeland Security

The Department of Homeland Security was created as an executive department of the federal government in 2003. Its creation was part of the largest reorganization of the American government in over a half-century. The new department brought together many existing government agencies with a common responsibility for protecting the American “homeland.” Although its primary mission is to prevent terrorist attacks on the United States, its impact on American business and on the cross-border flow of people, money, and goods is undeniable.

The nine key operative agencies of Homeland Security are Customs and Border Protection (CBP), U.S. Immigration and Customs Enforcement (ICE), U.S. Citizenship and Immigration Services (with responsibility for legal immigration), Transportation Security Administration (TSA), Federal Law Enforcement Training Center, the Domestic Nuclear Detection Office, U.S.



Secret Service, the Federal Emergency Management Agency (FEMA), and the U.S. Coast Guard.

Customs and Border Protection. The agency with the greatest impact on our reading is the U.S. Bureau of Customs and Border Protection. Its functions are preventing suspected terrorists from entering the United States; apprehending individuals attempting to enter the United States illegally; stemming the flow of illegal drugs and other contraband; protecting American agricultural and economic interests from imported pests and diseases; preventing the illegal import of goods in violation of U.S. copyright, patent, and trademark laws; enforcing U.S. import and export laws; and collecting import duties. The U.S. Border Patrol is a uniformed arm of CBP that is responsible for securing U.S. borders at between U.S. ports of entry. This includes remote regions of the U.S. southwest, along the border with Canada, the coastline of Florida, and Puerto Rico.

United States Trade Representative

The United States Trade Representative (USTR) is a cabinet-level post reporting directly to the president. The USTR carries on all bilateral and multilateral trade negotiations on behalf of the United States, is the principal adviser on trade matters to the president, represents the United States at all WTO meetings, coordinates the trade agreements program, and coordinates all U.S. trade policies, including those related to commodity trade and unfair trade practices. Each year the USTR prepares the president's report to Congress on U.S. trade activities. These reports are in the president's annual *Trade Policy Agenda*, the *Annual Report of the United States on the Trade Agreements Program*, and the annual *National Trade Estimate Report on Foreign Trade Barriers*.

U. S. Department of the Treasury

The Treasury Department has a tremendous impact on all international business transactions because of its near total control of U.S. currency moving in and out of the United States and control over U.S. banks worldwide. Since 2001, the role of Treasury has grown considerably as it took on a major role in fighting the financial war on terror by disrupting the United States and worldwide flow of money to terrorist groups. The Bureau of Financial Crimes Enforcement Network (known as "FinCEN") fosters domestic

and international cooperation among law enforcement agencies in dealing with financial crimes. The Office of Foreign Assets Control (OFAC) administers U.S. trade and financial sanctions enacted by Congress on the basis of U.S. foreign policy and national security objectives. Sanctions are often targeted against named individuals or groups of foreign cyber-criminals, international drug traffickers, terrorists, or those that illegally proliferate weapons of mass destruction.

International Trade Commission

The International Trade Commission (ITC), formerly the U.S. Tariff Commission, is an independent agency of government created by Congress in 1916. The ITC maintains a highly trained cadre of professional economists and researchers who conduct investigations and prepare extensive reports on matters related to international economics and trade for Congress and the president. Because of the highly political nature of many of the investigations related to the impact of imported goods on U.S. domestic industry, the ITC is a bipartisan agency. The members of the commission are appointed by the president from both political parties and are subject to Senate confirmation. We will thoroughly discuss the role of the ITC (along with that of the International Trade Administration) in investigating unfair trade practices in Chapter 11.

The U.S. Court of International Trade

The Court of International Trade (CIT) consists of nine judges who hear cases arising from the trade or tariff laws of the United States. Appeals from U.S. Customs and Border Protection regarding duties assessed on imported goods and appeals from decisions of the ITC in unfair import cases are heard by the CIT. Appeals from the CIT go to the Court of Appeals for the Federal Circuit and to the U.S. Supreme Court.

The court has exclusive jurisdiction over all civil actions commenced against the United States involving (1) revenue from imports or tonnage; (2) tariffs, duties, fees, or other taxes on importation of merchandise for reasons other than the raising of revenue; (3) embargoes or other quantitative restriction of the importation of merchandise for reasons other than the protection of the public health or safety; and (4) administration or enforcement of the customs laws. The court is located in New York City.



CONCLUSION

The constitutional system of checks and balances between the branches of government has developed throughout U.S. history. There is no question that Congress has the authority to make law, and they want to see a strong legislative branch. Naturally, presidents want to see a strong executive branch and want to use executive power to implement their ideas and their thoughts on policy. So every president has tested the limits of presidential power to a certain extent. But as Justice Jackson said in his famous concurring opinion in the *Youngstown* case, "When the president takes measures incompatible with the expressed or implied will of Congress, his power is at its lowest ebb, for then he can rely only upon his own constitutional powers minus any constitutional powers of Congress over the matter."

The United States has had a long history of negotiating and implementing its trade agreements with foreign countries, dating to the country's founding. After the Great Depression of the 1930s, trade agreements that were authorized and approved by Congress served to reduce tariffs and barriers to trade significantly.

In international trades, there will always be temporary "winners" and "losers." Some industries, and some workers, will do well and others will not. But the trend of history has been on the side of those who trade, and to borrow another adage, "a rising tide floats all boats." And it's long been said that nations who trade are not quick to sacrifice those benefits by going to war. The United States continued that course of advancing free trade until a worldwide populist movement ushered in a new wave of protectionism and nationalistic sentiments and the election of President Trump. One can only speculate on the course that trade relations will take for America and the world.

To understand more about U.S. trade commitments, consider looking at an annual publication of the United States International Trade Commission, *The Year in Trade: Operation of the Trade Agreements Program*. It is an annual survey of U.S. trade statistics, trade laws and regulations, trade agreements, and recent developments between the United States and its major trading partners. This publication also provides an excellent way to stay current on this material in the years ahead.

Chapter Summary

1. U.S. trade law is that body of public law that governs America's trade relations with foreign countries, including the import and export of goods and services. Trade law is used to implement American trade policies as well as American foreign policy and thus can be used to encourage trade with a political ally or to discourage trade with a potential foe. Using trade policy as a tool of foreign policy can lead to many conflicts.
2. Article I of the Constitution confers "all legislative powers" on Congress, including the power "to regulate commerce with foreign nations, and among the several states." In addition, Congress has broad power to pass domestic laws, raise and support armies, provide and maintain a navy, declare war, appropriate monies, and levy and collect taxes. The Senate has the authority to give advice and consent to the president in making treaties with foreign nations and to approve treaties by a two-thirds vote.
3. Treaties are binding on both the federal and state governments and have the same force as an act of Congress.
4. The president's powers are derived from two sources: those powers delegated to the president by Congress and those "inherent" powers set out in Article II of the Constitution. Inherent powers are the treaty power, the power to appoint ambassadors, the power to receive foreign ambassadors, and the power inherent in being commander-in-chief of the armed forces.
5. Three common types of presidential statements or directives are the executive order, the presidential memorandum, and the presidential proclamation. Executive orders are required to be published in the Federal Register and carry the force and effect of law. Presidential memoranda are less formal statements and often do not have legal effect. However, today, the line between an order and memoranda has become less clear. Many presidential directives have been challenged in the courts and these case decisions have helped define the limits of presidential power.
6. The primary instrument for implementing foreign political and economic affairs is the *international agreement*. International agreements are treaties and executive agreements.

7. An *executive agreement* is an international agreement between the president and a foreign country, entered into without resort to the treaty process. The two types of executive agreements are *sole international executive agreements* (based on the president's inherent powers) and *congressional-executive agreements* (based on authority delegated by Congress). Sole executive agreements are usually reserved for agreements with foreign countries that do not affect the broad interests of the nation as a whole. Congressional-executive agreements, based on the majority vote of both houses of Congress, are recognized as having the same binding legal effect as treaties.

8. A *trade agreement* is an agreement between nations on matters involving trade, tariffs, and related issues. A *free trade agreement* seeks to eliminate or substantially reduce tariffs and nontariff barriers and often sets up a mechanism for resolving trade disputes between the countries. Trade agreements can be bilateral, multilateral, or regional.

9. *Trade promotion authority* allows the president to negotiate trade congressional-executive trade agreements. The *North American Free Trade Agreement*
- and many other trade pacts were successfully negotiated under trade promotion authority.

10. The *Smoot-Hawley Tariff Act of 1930* placed the highest tariffs on goods in the U.S. history. It is generally believed to have had disastrous economic effects, to have had a role in precipitating the stock market collapse, and to have greatly exacerbated the Great Depression.

11. Beginning with the *Reciprocal Tariff Act of 1934* and continuing to this day, tariff reductions have been negotiated on a reciprocal basis. As a result, tariffs today are not a major barrier to trade for most goods and services.

12. In the United States, the role of state or local governments in regulating or interfering with trade relations with foreign countries is very limited. States have no authority to regulate imports or exports of foreign goods or services. In case after case, legislation enacted by state or local governments that restricts trade with foreign countries has been ruled unconstitutional under either the Supremacy Clause or the Commerce Clause of the Constitution.

Key Terms

inherent powers 211	reciprocal trade 217	free trade agreement (FTA) 219
executive order 211	tariff concession 217	trade promotion authority 219
presidential memorandum 211	conditional most-favored-nation (MFN) trade 217	emergency powers 220
presidential proclamation 211	unconditional most-favored-nation (MFN) trade 217	federal preemption 221
sole executive international agreement 214	normal trade relations 217	Import-Export Clause 224
treaty power 216	nontariff barrier 218	Commerce Clause 224
equal dignity rule 216	trade preference 219	Supremacy Clause 224
congressional-executive agreement 216	trade agreement 219	multiple taxation 224
		unitary business 225
		water's edge election 226

Questions and Case Problems

1. What are the most common written mechanisms for issuing presidential statements or directives, and how are they generally used?

2. What are the limits on the president's use of executive orders?

3. What recent executive orders, memoranda, or proclamations have been issued by the president affecting U.S. international trade?
4. What is meant by the president's "trade promotion authority?" In what way does it enhance the president's trade negotiating authority with other nations?

5. Explain the benefits of a multilateral trading system based on reciprocal tariff reductions. During the early days of the Trump Administration, the president called for an emphasis on "bilateral trade." Explain how this departs from America's position on trade since the Great Depression of the 1930s.



6. Due to threats by the president to set import quotas, the U.S. State Department negotiated directly with European and Japanese steel producers to limit their companies' exports to the United States. No foreign government was party to the agreement. Although the president has express authority to limit imports by an act of Congress, this act required that he either hold public hearings through the Tariff Commission about setting import quotas or deal directly with foreign governments about limiting imports. The Consumers Union of U.S., Inc., felt that when Congress gave the president this express power, it preempted any other action by the president. They brought an action against the secretary of state to have the president's agreement with private steel producers in Europe and Japan declared illegal. What should be the result of such an action? See *Consumers Union of U.S., Inc. v. Kissinger*, 506 F.2d 136 (D.C. Cir. 1974).
7. During the 1940s, the U.S. government sought to protect the domestic potato market from imported Canadian potatoes. The U.S. secretary of state entered into an executive agreement with the Canadian ambassador in which they agreed that Canada would permit the export of potatoes to the United States for use only for seed and not for food. The agreement was not submitted to or approved by Congress. The *Agricultural Act of 1948* permitted the president to restrict potato imports by requesting an investigation by the Tariff Commission and considering its recommendations. While a shipment of potatoes were in transit, Guy Capps sold them to the A&P grocery store chain for resale. The United States brought suit against Guy Capps for damages. The court entered judgment for Guy Capps and the government appealed. Was the U.S.-Canadian agreement valid under the U.S. Constitution? Was the president acting under his inherent constitutional authority, under power delegated from Congress, or neither? What did Congress say the president could do to restrict agricultural imports? See *United States v. Guy W. Capps, Inc.*, 204 F.2d 655 (4th Cir. 1953).
8. Xerox manufactured parts for copy machines in the United States that were shipped to Mexico for assembly. The copiers were designed for sale exclusively in Latin America. All printing on the machines was in Spanish or Portuguese. The copiers operated on a 50-cycle electric current unavailable in the United States. The copiers had been transported by a customs bonded warehouse in Houston, Texas, where they were stored pending their sale to Xerox affiliates in Latin America. The copiers had previously been stored in Panama. Under federal law, goods stored in a customs bonded warehouse are under the supervision of the U.S. Customs Service. Goods may be brought into a warehouse without the payment of import duties and stored for up to five years. At any time they may be re-exported duty-free or withdrawn for domestic sale upon the payment of the duty. Harris County and the city of Houston assessed a nondiscriminatory *ad valorem* personal property tax on the copiers. Xerox claimed that the local tax is preempted by the federal legislation. What did the Court decide? Would it have made any difference whether the goods were needed for domestic use or intended for re-export? See *Xerox Corporation v. County of Harris, Texas*, 459 U.S. 145 (1982).
9. The state of Tennessee passed legislation requiring that any person selling or offering for sale in the state of Tennessee any meats that are the products of any foreign country must so identify any such product by labeling it "This meat is of foreign origin." The state law did not require a higher standard of purity and sanitation than that required by the U.S. Department of Agriculture. A New York corporation selling imported meats to customers in Tennessee challenged this state statute in U.S. District Court. The corporation's sales of imported meat to customers in Tennessee were one-half of its volume prior to enactment of the statute. What do you think was the legal basis for this challenge to the Tennessee law? What do you think was Tennessee's argument for passing the law? What do you think the court decided? See *Tupman Thurlow Co. v. Moss*, 252 F. Supp. 641 (M.D. Tenn. 1966).

Managerial Implications

Your firm, Day-O Shoes, Inc., manufactures deck shoes in the Caribbean island country of Haiti, the poorest nation in the Western Hemisphere. Your plant there employs more than 400 workers and has always considered itself a good citizen of both Haiti and the United States. Most of the shoes are imported for sale into the United States, where you maintain a 30 percent share of a competitive market. In 1991, the freely elected President of Haiti is removed from office by military officers who install a dictator of their choice. In response, the President of the United States exercises authority under the *International Economic Emergency Powers Act* and issues

an executive order imposing a complete embargo on trade with Haiti. The Treasury Department's Office of Foreign Assets Control is charged with enforcing the embargo. Facing the impending embargo, your firm shut down its production operations there one week prior to the date set for the embargo. Feeling some obligation to the unemployed workers, your company's chief executive ships over ten tons of food and clothing to the people who have lost their jobs.

Believing that the United States is serious about the embargo and that it will remain in effect until the rightful president is returned to Haiti, your firm ships its U.S.-made



raw materials, such as rubber soles and leather uppers, from Haiti to your other factory in Costa Rica. However, you soon discover, much to your surprise, that your competitors are continuing to produce and stockpile their shoes in Haiti in the belief that the embargo will soon be lifted. Three months after you cease operations, the U.S. government decides to lift the embargo because it has resulted in the loss of 50,000 Haitian jobs. With no inventory of finished shoes and your raw materials en route to Costa Rica, your firm is unable to fill existing orders. Your competitors are ready to ship their shoes from Haiti immediately.

1. Evaluate the course of action taken by Day-O Shoes. How did Day-O Shoes balance its responsibility under U.S. law to comply with the embargo with its need to remain competitive in the industry? What could it have done differently? Evaluate the ethics of Day-O's actions.

2. Was Day-O Shoes required to stop producing in Haiti? Were its competitors violating U.S. law by continuing to produce and stockpile their inventories? Were they violating any moral code or even the "spirit of the law" by continuing to produce there? Evaluate the risks taken by the competitors in continuing their operations in Haiti during the embargo.
3. The embargo was intended to put economic pressure on Haiti to encourage political reform. Is the U.S. government saying that the embargo worked too well? Do you think that the embargo was lifted because of its impact on the Haitian workers or on U.S. firms doing business there? Critics argue that the U.S. government's attempts to use trade policy as a means of conducting foreign policy lead to confusion and uncertainty and are counterproductive. Evaluate this argument.

Ethical Considerations

It is clear that Congress has the authority to require that any trade agreement negotiated by the president take into account environmental and labor issues. At least since 1974, U.S. trade laws have instructed the president to consider foreign worker rights and workplace conditions in negotiating trade agreements. One U.S. statute, which fosters U.S. trade with developing countries, contains provisions for labor standards. The 1994 *North American Free Trade Agreement* contained specific provisions for protecting worker rights and the environment. More recently, the *Trade Act of 2002* called for countries entering trade agreements with the United States to abide by the "core labor standards" of the International Labour Organization, including the freedom of association, the right to form unions and to bargain collectively, minimum age requirements and limitations on child labor, maintenance of safe working conditions, and a ban on forced labor.

Some U.S. trade agreements also reflect environmental concerns. They do not set environmental standards, but they call for each nation to enforce its own standards and to ensure that environmental protections are not weakened in order to promote foreign trade.

Do you think that the United States should require foreign countries to address worker rights, worker safety, and environmental harm in return for trade privileges with the United States? Find out how U.S. trade agreements incorporate concerns over the environment and worker's rights. What has been the policy of presidential administrations in this regard? What are the competing economic and political issues in domestic politics? Should trade be used to accomplish these political and social objectives? How much focus should be placed on human rights? Why or why not?