



Can Soft Clauses in Letter of Credit Transactions Be Considered Letter of Credit Fraud in China?

by

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1 Introduction

1.1 Letter of Credit: A Payment System

Documentary credit (also letter of credit, or more formally documentary letter of credit), which was created in trade and business several hundred years ago, is a well known financial method for international trade parties nowadays. Letter of credit has a long history and has been stated as “the life blood of international commerce” by English judges¹. It is considered as an instrument that reconciles the interests of the seller and the buyer, thus providing security both to the buyer and seller.² The terms and conditions governing letter of credit transactions are almost always to be found in Uniform Customs and practice for Documentary Credits (UCP) issued by the International Chamber of Commerce (ICC)³.

In commercial practice, letter of credit⁴ is a letter issued from a bank promising payment where the recipient of the letter (known as the beneficiary of letter of credit) presents to the bank the stipulated documents during a specific time period.⁵ The buyer (known as the applicant) is the person who applies for a letter of credit for the beneficiary from a bank. These documents presented by the beneficiary of the letter of credit (also the seller of the sales contract) will then be passed on by the bank to the buyer. Thus, a letter of credit also signifies an agreement in which a bank acts for its customer and assures payment against presentation of the specified documents by the beneficiary.

¹ D’Arcy, Leo (2000), *Schmitthoff’s Export Trade - The law and Practice of International Trade*, London: Sweet & Maxwell, 10th ed., p. 166.

² Further analysis, see Llewellyn, K. N. (1929), ‘Some Advantages of Letters of Credits’, *Journal of Business of the University of Chicago*, Vol. 2, No. 1, Jan., pp. 1-16.

³ UCP have six versions since they were first promulgated in 1933; UCP 400 came into effect on 1 Oct., 1984, and UCP 500 on 1 Jan., 1994, and the latest version is UCP 600, which came into effect on 1 July, 2007. The ICC is a private body made up of the union of national chambers of commerce, the World Business Organisation based in Paris and established in 1919, the global leader in the development of standards, rules and reference guides for international trade. The lawmaking process is argued to be a bottom-up approach. For further discussion see Levit, Janet Koven (2005), ‘A Bottom-up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments’, *Yale Journal of International Law*, Vol. 30, p. 125.

⁴ Further discussion about the theory about the legal feature of letter of credit: contract theory or debt theory, see e.g. Deng, Xu (2006), pp. 193-196.

⁵ Dalhuisen, J. H. (2004), *Dalhuisen on International Commercial, Financial and Trade Law*, Oxford: Hart Publishing, 2nd ed., p. 463.

In the letter of credit system, two fundamental principles are the autonomy of the credit (also the independence principle) and the doctrine of strict compliance.⁶ The independence principle of the letter of credit is clear and is accepted worldwide.⁷ According to the autonomy principle, a letter of credit is separate from and independent of the underlying contract of sale or other transactions involved.⁸ The strict compliance doctrine, which accords with the first autonomy principle of the letter of credit, means that the beneficiary must strictly comply with the documentary requirements laid down in the letter of credit. In brief, the letter of credit has its documentation character, and the two fundamental principles of it allow letter of credit payment in international trade to operate in an efficient manner.

In an international letter of credit transaction, a letter of credit usually involves four different and independent contracts between different parties. Some scholars⁹ have accepted the idea of the letter of credit as a contract between the bank and the beneficiary, although several theories have been advanced to explain the judicial basis of the letter of credit itself¹⁰. In this paper, contract theory is employed to explain different legal relationships in letter of credit transactions.

1.2 Introduction to Letter of Credit Fraud

The character of the letter of credit facilitates international transactions, but makes it easy to be abused by fraudsters. The phenomenon of fraud is timeless and universal, and is found both in the East and West. According to the UNCTAD report, four kinds of letter of credit fraud have been popular: 1) where the cargo is non-existent, the documents are falsified by the beneficiary in order to obtain payment from the bank; 2) where the goods are of inferior quality or quantity; 3) where the same goods are sold to two or more parties; 4) where bills of lading are

⁶ D'Arcy, Leo (2000), p. 170; see also Gao, Xiang & Buckley, Ross P. (2003), 'The Unique Jurisprudence of Letters of Credit: Its Origin and Sources', 4 *San Diego International Law Journal* 91, pp. 119-124; Regal, Dorothea W. (2003), 'Basic Principles of Letters of Credit', 847 *Practising Law Institute* 13 (Commercial Law and Practice Course Handbook Series), February.

⁷ See e.g. Ortego, Joseph J. & Krinick, Evan H. (1998), 'Letters of Credit: Benefits and Drawbacks of the Independence Principle', 115 *Banking L.J.* 487 (May); see also Chatterjee, Charles & Lefcovitch, Anna (2003), 'The Principle of Autonomy of Letters of Credit is Sacrosanct in Nature', *Journal of International Banking Regulation*, Sep., Vol. 5, No. 1, p. 72; Wang, Saisai (2007), 'Discussion on letter of credit Independence Principle', *Times Finance*, Vol. 7, pp. 31-33.

⁸ For analysis from the legal perspective and contractual engagement, see Goode, Roy, chapter 9 'Abstract Payment Undertakings', in Cane, Peter & Stapleton, Jane (Eds.) (1991), *Essays for Patrick Atiyah*, Oxford: Clarendon Press, pp. 217-220.

⁹ For example, Raymond, Jack (1993), *Documentary Credits - The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees*, London & Carlsbad & Calif: Butterworths, 2nd ed., chapter 5, pp. 78-79.

¹⁰ Penn, G. A. (1987), *The Law and Practice of International Banking - Banking Law*, Vol. 2, London: Sweet & Maxwell, pp. 295-303.

issued twice for the same goods.¹¹ It can be seen that in the most common letter of credit fraud scheme, the victims are the buyers. Besides letter of credit against applicants, banks sometimes can also be the target.¹² The UNCTAD report mentioned that fraudsters could invest large sums of money for many years in creating a pattern of international activity though nothing exists; and they attempt to defraud paper-obsessed bankers.¹³

Letter of credit fraud happens quite often in China (China refers to the People's Republic of China (PRC)) during its international trade. Before the 1990s most letter of credit fraud was involved in the importing sector.¹⁴ Businessmen in foreign countries, being the seller, often forged required documents, received the payment for goods and then disappeared. Either there were no goods at all, or sometimes the delivered goods were merely rubbish. After the 1990s, with the development of the economy in China and a sharp increase in foreign trade, letter of credit fraud began to happen not only in the importing trades but also in the exporting trades, with variant types of letter of credit fraud taking place. Several typical types of letter of credit fraud in China will be discussed.¹⁵

Firstly, the most common type of letter of credit fraud in China is when the beneficiary presents the fraudulent documents to the bank to demand payment.¹⁶ Fraudulent documents could be a forged bill of lading, where there are no delivered goods, or the delivered goods are rubbish, or in a very small quantity. Sometimes, the beneficiary and the carrier conspire to defraud letter of credit payment.

¹¹ The UNCTAD report (2003), prepared by the UNCTAD secretariat, 'A Primer on New Techniques Used by the Sophisticated Financial Fraudsters with Special Reference to Commodity Market Instruments' (UNCTAD/DITC/COM/39), 7 Mar., 2003, p. 7, available at http://www.unctad.org/en/docs/ditccom39_en.pdf, accessed 29 July, 2009.

¹² Letter of credit fraud can also be connected with the crime of money laundering, see Ellen, Eric (1998), 'Complex letter of credit Frauds Put Banks at Risk', *DCI (ICC)*, Winter, Vol. 4, No. 1, p. 1.

¹³ The UNCTAD Report (2003), p. 7.

¹⁴ Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), *Research on Internationalization of Punitive Regulations on Financial Crimes*, Peking: Law Press China, 1st ed., p. 225.

¹⁵ There have also been several new types of letter of credit fraud deriving from old types in recent years, such as forging the amendment of letter of credit, forging confirming letter of credit, using revocable letter of credit, see Cao, Yuanfang (2006), 'New Trend and Corresponding Solutions to letter of credit Fraud', *Practice in Foreign Economic Relations and Trade*, No. 11, 51, pp. 51-52.

¹⁶ This point is discussed in various literature, see e.g., Jin, Saibo (2002), *PRC Letter of Credit Law and Comments on Typical Cases*, Peking: University of International Business and Economics Press, pp. 94-95; Wu, Guoping (2005), 'Letter of Credit Documentary Fraud and Relief of Bank's Responsibility of Payment and Questions', *Business Consultation, Practice in Foreign Economic Relations and Trade*, No. 5, 25, p. 26; Wang, Jingen (2009), 'Seller's letter of credit Fraud against Buyer and Prevention', *Practice in Foreign Economic Relations and Trade*, No. 12, 64, pp. 64-65.

Secondly, the buyer and the seller conspire to defraud the issuing bank by presenting forged documents.¹⁷ This is a common phenomenon in letter of credit transactions in China; and was especially so during the 1990s.¹⁸ The applicant and beneficiary collude to sign a sales contract first, and then apply for a letter of credit from a bank. After presenting the forged documents, they obtain payment through the issuing bank. Once the fraud succeeds, the applicant and beneficiary will then quickly disappear.¹⁹ Quite often the applicant has a small percentage of deposit or no deposit in the issuing bank, and thus the bank cannot attach any properties of the applicant.²⁰

The third type is to use a false or a blank-out letter of credit, or to obtain letter of credit through deceitful means.²¹ This type of letter of credit fraud used to be rampant in China.²² However, nowadays it is much easier to identify whether a letter of credit itself is authentic through the banking internal system.

Fourthly, the issues on back-dated BL, ante-dated BL and re-issued BL²³ deserve attention. Both antedating and re-issuing BL are serious maritime frauds²⁴, but whether they are letter of credit

¹⁷ Jin, Saibo (2002), p. 96; see also Li, Xiaoyong (1998), p. 161; Cheng, Zhengyun (1997), p. 150; Wang, Linxia (2006), 'Brief Analysis of Letter of Credit Fraud and Prevention', *HLJ Foreign Economic Relations & Trade*, No. 8 (Serial No. 146), 59, pp. 59-60; Li, Jian (2005), 'Study on the Legal Problem of letter of credit Fraud in International Trade', *Market Modernisation*, Dec. (1st Issue) (Sum. No. 451), 46.

¹⁸ See e.g. Zhao, Limei (2000), *Guide to Letter of Credit Operations*, Vol. 2, Peking: China Economy Press, pp. 1201-1202.

¹⁹ See e.g. Guo, Xiaojie (2005), 'Risk and Countermeasures of letter of credit Fraud', *Market Modernisation*, Dec. (1st Issue) (Sum. No. 451), 39, p. 40.

²⁰ Jin, Saibo (2002), p. 97; see also Yang, Ming (2001), 'Certain Risks and Prevention in Usance letter of credit Transaction', *South China Finance*, No. 2, 45.

²¹ Sui, Qingjun (2006), *Theory and Practice of dealing with Financial Fraud Cases*, Peking: China Agriculture University Press, 1st, 2006, pp. 125-126; see also, Tan, Xinghua (2005), 'Discussion on Letter of Credit Fraud Types, Forms, and Preventive Measures', *Journal of Dalian University*, Vol. 26, No. 5, Oct., 74, p. 76.

²² For features and cases of such type of letter of credit fraud, see Chen, Yulong & Lin, Hong (1995), *International Financial Fraud Identification and Countermeasures*, Peking: Peking Economic College Press, 1st ed., pp.142-143; Sun, Dingjie (1995), *Combating Non-criminal Financial Fraud and Criminal Financial Fraud*, Peking: Chinese Prosecutor Press, 1st ed., pp. 644-650.

²³ For further explanation and case examination on these issues which are considered as letter of credit fraud, see Gu, Xiaorong & Ding, Muying (2000), pp. 184-189, for cases in this type of letter of credit fraud, see Gu, Min (1993), *International Trade Fraud and Prevention*, Peking: University of International Economics and Business Press, pp. 59-62; particularly about anti-dated BL fraud, see Liu, Yuliang (2006), 'Beware of Cheat Trap in Global Trade', *China Economy and Trade*, View & Commercial Observation, (June), 78, pp. 79-80.

fraud is debatable. Most PRC court cases confirmed that they are letter of credit fraud; whereas some court cases demonstrated that antedating or backdating bill of lading does not always constitute letter of credit fraud. Furthermore, some academics argue that the bill of lading is itself real and authentic, from the theoretical and practical point of view;²⁵ and these behaviours do not necessarily result in criminal liabilities and transactions may still continue²⁶.

The fifth category is called letter of credit soft clauses fraud, in which the buyer takes advantage of some clauses in the letter of credit to defraud the seller.²⁷ This is commonly considered as one type of letter of credit fraud by the banking and commercial community in China.²⁸ However, it is complicated and controversial issue, which will be discussed further.

1.3 Letter of Credit Soft Clauses Issue in China

There is no internationally acceptable definition for the term “soft clauses”; neither is such a term mentioned in UCP 600. Some practitioners in Hong Kong, China, considered such an

²⁴ For further discussion about the concept of maritime fraud and its legal problems and judicial remedy in China, see Zhang, Xianwei (2002), ‘Several Legal Issues and Maritime Judicial Remedy of Maritime Frauds’, published on 28 May, available at www.ccmt.org.cn/hs/explore/exploreDetail.php?slid=133, accessed 15 July, 2008; Yin, Xiyang (2007), ‘Current Situation Analysis and Countermeasures of International Maritime Fraud’, *Law and Society*, Vol. 8, 173; Zhang, Xianglan (2000), ‘Study on Legal Problem of International Maritime Fraud’, *Law Review (bimonthly)*, Vol. 1, 107; about the jurisdiction and applicable law, Li, Feng (2000), ‘The Jurisdiction and Applicable Law of International Maritime Fraud’, *Tianjin Sailing*, Vol. 1, 39; about prevention, Zhang, Meisheng & Du, Ming (2005), ‘Prevention and Control and International Maritime Fraud’, *Crime Study*, No. 1, 15; also Zhang, Xianglan & Wang, Huaiyu (2000), ‘Studies on the Legal Mechanism of Prevention and Control of International Maritime Fraud’, *Modern Law Science*, Vol. 22, No. 4, August, 112.

²⁵ Sui, Qingjun (2006), p. 102.

²⁶ Chen, Li (2006), *Theory and Practice of Economic Crime*, Xiamen: Xiamen University Press, 2nd ed., p. 98.

²⁷ It is also possible that the buyer will conspire with the issuing bank to defraud the seller, see Li, Xiaoyong (1998), pp. 164-165; Chen, Zhengyun (Ed.) (1999), *Distinguish and Deal with Economic Fraud Crime*, Peking: China Fangzheng Press, p. 406; for concrete letter of credit soft clause cases and analysis, see e.g. Jiang, Xianling (Chief Ed.) (2005), *International Trade Settlement Practice and Cases*, Peking: University of International Economy and Business Press, pp. 273-278.

²⁸ This opinion is so widely accepted in China, see Li, Ziping & Hu, Xiangfu (2005), *New Comments on Financial Crimes*, People Press, 2005, p. 303; Zhou, Ying (2003a), ‘Dilemma in Preventing Documentary Credit Fraud’, *Economy Professional*, Vol. 5, pp. 46-47; Bai, Jianjun (1994), *Financial Fraud and Prevention*, Peking: Chinese Legal Press, pp. 33-34; there are quite a number of letter of credit fraud cases concerning soft clauses, see e.g. Chen, Yu (2002), ‘Guarding Against letter of credit Soft Clauses Pitfall: Comment on Jiaying letter of credit Fraud Case’, *International Business Study*, No. 2, 64; Tu, Yonghong (2006), ‘Case Analysis on letter of credit Soft Clauses Fraud’, *New Finance and Economics*, No. 3, 116.

issue as 'built-in discrepancy'.²⁹ According to the statistics from the Bank of China, the fraud of letter of credit soft clauses has led to a loss of millions of dollars since 1992.³⁰

The term soft clauses can be discussed by comparing them with normal clauses in the letter of credit. According to the independence principle of the letter of credit, the only condition for a paying bank to decide on whether to honour a letter of credit payment is that the documents presented by the beneficiary conform to the letter of credit itself. In an ordinary letter of credit, the beneficiary who honestly performs the sales contract is able to obtain the required documents. Such clauses that can be satisfied through the beneficiary's performance are normal clauses.³¹

However, sometimes there are other letter of credit clauses, in which some special documents are required to be presented by the beneficiary, such as the buyer's receipt of goods, inspection of goods issued by the buyer, or the letter of credit will take effect under some conditions.³² With such clauses, whether the beneficiary can get specified documents or whether the stipulated conditions can be satisfied, partially or entirely depends on the buyer or other parties, rather than the beneficiary's performance of contract; such clauses can be regarded as soft clauses in the letter of credit.³³

Soft clauses are commonly abused by dishonest businessman as a tool for committing fraud, breach of contract or dishonour; thus letter of credit soft clauses can make a beneficiary's obtainment of the letter of credit payment risky and uncertain.³⁴ Very often letter of credit soft clauses are connected with the applicant's intention to deceive a prepaid performance deposit, a letter of credit issuance deposit and so forth from the beneficiary.³⁵ Once the applicant has received such a prepaid deposit, the applicant would find faults with the quality of goods, refuse to issue an inspection certification, and finally achieve the fraudulent purpose. The risk of such

²⁹ Fung, King Tak (2005), extract of some cases discussed in *Leading Court Cases on Letters of Credit*, published by DC-PRO, 18 Jan., 2005; in this extract, Fung argues that although the bank may refuse letter of credit payment because of a discrepancy under the letter of credit, it does not discharge the payment obligation of the buyer to the seller under the sales contract.

³⁰ Cai, Lei & Liu, Bo (1997), *International Trade Fraud and Prevention*, Peking: Law Press China, p. 278; this type of letter of credit fraud still happens nowadays, see e.g. Chen, Qian (2007), 'International Fraud Trial Hangs on Credit Letters', *Shanghai Daily*, 04 August.

³¹ Xu, Donggen (2005), p. 299.

³² Zhang, Zongliang (2005), p. 215.

³³ Yu, Jingsong (Chief Ed.) (2003), *Current Issues of International Economic Law*, Wuhan: Wuhan University Press, 1st ed., pp. 231-232; see also Dong, Guoshu & Li, Dejun (2006), 'Discussion on letter of credit Risk and Prevention', *Market Modernisation*, Jan. (2nd Issue), (Sum. No. 456), 14.

³⁴ Zhao, Limei (2000), *Guide to Letter of Credit Operations*, Vol. 2, Peking: China Economy Press, p. 1199.

³⁵ Cai Lei & Liu, Bo (1997), *International Trade Fraud and Prevention*, Peking: Law Press China, p. 278; see also Shi, Zheng (2006), 'Value Evaluation of letter of credit in International Trade', *Enterprise Economy*, No. 4 (Sum. No. 308), 174, p. 176.

a clause is that the applicant can take advantage of it by refusing to appoint someone to inspect goods or they can simply reject the goods in times when the market falls or the importer finds cheaper goods.³⁶ Thus the financial payment of the letter of credit guaranteed by the credit of the bank in a way becomes a commercial payment depending on the credit of one trading party.³⁷

However, soft clauses of a letter of credit do not always mean fraud, as sometimes soft clauses in a letter of credit can be accepted due to different business customs in different countries or agreements between trading parties.³⁸ Identifying which clauses are letter of credit soft clauses and which clauses are reasonable requirements from the buyer can be difficult. The forms of letter of credit soft clauses are various and changeable; sometimes they can be formulated in a very obscure way.³⁹ Therefore, it is sometimes difficult for the beneficiary to notice and understand them.

The problem of soft clauses seriously affects the beneficiary's legal rights and further deteriorates the value and function of the letter of credit as a payment method in international trade.⁴⁰ Are letter of credit soft clauses a kind of letter of credit fraud? To answer this question, we will start by discussing the main types of letter of credit soft clauses.

2 Various Categories of Letter of Credit Soft Clauses in China

Soft clauses in a letter of credit take on various forms, as the forms and expressions of a letter of credit issued by different banks are different.⁴¹ But it is still helpful to explain the problem by classifying different types of soft clauses so as to find out the common features of this problem.

³⁶ See Xu, Junke (2007), pp. 97-98.

³⁷ See e.g. Ma, Guobing & Weng, Di (2005), 'Discussion on Risk of Fraud and Prevention under letter of credit', *HLJ Foreign Economic Relations & Trade*, No. 5 (Serial No. 131), 61, pp. 61-62.

³⁸ Liu, Debiao & Yu, Youyan (2003), *International Business Cases Selection*, Peking: International Economy and Business University Press, p. 95; Leng, Hanbing & Jiang, Xiaochun (2000), 'Soft Clauses and Forgery - Two Means of letter of credit Fraud', *China Foreign Exchange Management*, 5, p. 33; see also Xu, Junke (2007), p. 99.

³⁹ See e.g. Qi, Hongwei (2003), 'Analysis and Countermeasure on letter of credit Fraudulent Soft Clauses', *Jiangsu Business View*, No. 10, 39.

⁴⁰ Xu, Xin & Mao, Xuegang & Guo, Yu (2009), 'Discussion on letter of credit Soft Clauses: from a letter of credit Dispute Case', *Theory Research*, No. 5 (General No. 179), 127, p. 128.

⁴¹ The categories are different under different opinions, see e.g. Hu, Yuexiu (2007), 'letter of credit Soft Clauses and Risk Prevention', *Market Modernisation*, August (2nd Issue), 295, pp. 295-296; Zhang, Zongliang (2005), 'Letter of credit Soft Clauses Analysis and Prevention', *Market Modernisation*, December (2nd Issue), 215, pp. 215-216.

2.1 Soft Clauses that Create Conditions for a Valid Letter of Credit

The first type of soft clauses in a letter of credit in essence makes an irrevocable letter of credit become a conditional letter of credit.⁴² A normal letter of credit is effective and valid when the beneficiary receives it. However, some letters of credit are valid with some conditions⁴³ and the specified conditions can be controlled by the buyer, or controlled by a third party in the buyer's country such as an authorised certificate from the importer's government, or certification of approval from the Foreign Exchange Office in the importer's country.⁴⁴

In particular, such a type of soft clauses can be written for example as, "This credit will be effective only after receiving further instruction", or "This credit will become an effective instrument with confirmation from the applicant"⁴⁵. Some other soft clauses can become more complicated where the condition of a valid letter of credit is reflected in the letter of credit amendment.⁴⁶ If the buyer does not give any further notice or instructions on shipping date or vessel, then it can result in great loss to the seller where part of the performance of the sales contract has been done. Thus, with such clauses, the buyer decides whether or not a letter of credit will be effective. But how one defines the legal nature of such a clause is a debatable issue in theory. Should such an amendment clause belong to the preconditions of an effective letter of credit or should it be considered as an amendment agreement clause later?⁴⁷

Two concrete case examples are provided in order to illustrate such a problem. The first case can demonstrate the problem of this type of letter of credit soft clauses, in which some conditions are controlled by the buyer. One seller in China concluded a contract with KAM WA Enterprises Inc. USA; then it received an irrevocable letter of credit with the letter of

⁴² See Qu, Xinjiu (2003), *Finance and Financial Crime*, Peking: CITIC Publishing House, 1st ed., pp. 340-341; see also Li, Jinze (2004), *Letter of credit and Legal Problems in Financing of International Trade*, Peking: China Finance Press, pp. 19-20.

⁴³ See e.g. Wu, Cuihua (2005), 'Risk and Prevention of letter of credit Soft Clauses', *Economic Forum*, No. 12, 32; Yuan, Hui (2005), pp. 91-92.

⁴⁴ Wang, Xitong (2007), p. 77.

⁴⁵ Xu, Donggen (2005), *Study on letter of credit Law and Practice*, Peking: Peking University Press, p. 301.

⁴⁶ For example, such clauses may read that the "carrying vessel of shipment, date of shipment and destination port shall be informed by the issuing bank in the form of letter of credit amendment upon receipt of the notification from applicant", "The goods will be shipped upon receipt of shipping advice issued by opener of letter of credit appointing the name of vessel, which will be issued by way of an amendment to this credit by the issuing bank" (see Tang, Jinlong (2005), p. 177), or "The goods will be shipped upon the appointing of the vessel by the Applicant of letter of credit and adding a Cable/Telex Amendment of letter of credit by Issuing Bank to Advising Bank, which should be negotiated accompanied with the original documents" (see Chen, Yan & Liu, Ling (2007), *UCP 600 and letter of credit Essentials*, Peking: University of International Business and Economics Press, p. 203); see also Jia, Qinghong (2003), 'Letter of Credit Fraud, Prevention and Treatment', *International Economy Cooperation*, No. 5, 48, pp. 48-49.

⁴⁷ Further discussion, see Fang, Shuangfu (2003), 'The Legal Character and Judicial Remedy of letter of credit Soft Clauses', *People's Justice*, No. 5, 28.

credit amount of 1, 9 million dollars.⁴⁸ One term of the letter of credit was that, “Shipment can only be effected upon receipt of applicants’ shipping instructions through letter of credit issuing bank nominating the name of carrying vessel by means of subsequent credit amendment”.⁴⁹ The Chinese seller shipped all the goods to Dalian Port in China before the valid period of shipping, waiting for further specific notice from the buyer. The buyer nominated a deputy to inspect the goods before shipping, but the deputy refused to give notice of shipping date and the name of the vessel. Subsequently, the transaction could not continue and the Chinese seller could not draw on the letter of credit. But the Chinese exporter also paid 2, 6 million RMB (Chinese currency) as the quality guarantee to the deputy of the buyer, after receiving the letter of credit. Thus, the deputy of the USA buyer drew out the Chinese seller’s prepaid deposit, and disappeared.⁵⁰

The second case illustrated the problem of such a type of letter of credit soft clauses, in which some condition is controlled by a third party in the buyer’s country. Company A in China concluded a contract with Company B in Canada, paid by an irrevocable letter of credit.⁵¹ Company B applied for bank C in Canada to issue 5 letter of credits from July to October 1991. However, the letter of credit payment is effective only after the issuing bank receives the notice of approval of importing such goods by the Canadian government. After the goods arrived at the destination port, Company B did not present the Inspection Certification issued by the Agriculture Department of Canada to the bank. Then bank C notified the Bank of China that all the issued letters of credit were invalid and they would not honour the payment.⁵² In this case, according to the contract, the letter of credit was irrevocable, but in fact it was conditional. The purpose of inserting such clauses most probably was to obtain the goods first and then to avoid payment. Generally, such clauses are not valid unless some conditions are satisfied; thus, they provide no guarantee to the beneficiary.

2.2 Soft Clauses that Place Obstacles to Obtaining Documents

The second type of letter of credit soft clause in essence creates obstacles for the beneficiary to obtain the required documents under the letter of credit. Under such a soft clause, the letter of

⁴⁸ Gao, Jie (2006), *International Settlements Cases Analysis*, Peking: University of International Business and Economics Press, 1st ed., pp. 59-61.

⁴⁹ Ibid.

⁵⁰ He, Xie & Zhang, Xikui (2002), *Financial Crime Cases – Experience and Techniques of Preventing Financial Crime*, Peking: Economy Daily Press, pp. 247-248.

⁵¹ Gu, Xiaorong & Ding, Muying (2000), pp. 203-204.

⁵² Later Company A applied for arbitration to the International Commercial Arbitration Centre in Canada, claiming the payment for goods. However, Company B was in debt long ago, and had already signed agreements with all its creditors to discharge 1/4 of its debts by reason of bankruptcy. Finally, this arbitration case ended up with Company A obtaining only 1/4 of the payment.

credit documents presented by the beneficiary need to include an inspection certificate or cargo receipt signed by the letter of credit applicant or the person appointed by the applicant (the agent).⁵³ The issuance of an inspection certificate by the applicant violates the commercial customary rule, as inspection of goods usually is conducted by a third independent institution (authoritative, qualified, professional institution) excluding trading parties.⁵⁴

Sometimes such an inspection certificate or other documents are required to be certified by the issuing bank or advising bank.⁵⁵ It is argued that such clauses obviously violate customary practice of international trade, as banks shall not engage in trade according to UCP, but such clauses involve banks in a trading business.⁵⁶

In addition, an applicant can leave one person's specimen in the issuing bank, but appoint another person to sign.⁵⁷ When the market rises, the applicant may issue the inspection certification; however, once the market falls at the time of honouring payment, the applicant may collude with the bank to refuse to pay on the grounds of the incompliant documents.⁵⁸ The problem is that the beneficiary knows nothing about the seal or specimen left by the applicant in the issuing bank.⁵⁹ Thus, the beneficiary cannot ensure their presented documents conform to the letter of credit, and thus there is no guarantee for the seller to obtain the payment under the letter of credit.

⁵³ See Chen, Li (2006), p. 101; see also Li, Qiujuan (2003), 'Typical letter of credit Soft Clauses Forms and Harm', *Economist*, No. 10, 48; see also Liu, Aie (2009), 'Main Forms and Preventive Measures of letter of credit Soft Clauses', *Commercial Accounting*, Vol. 11, No. 21, 33, pp. 33-34.

⁵⁴ Song, Jie (2010), 'Features and Risk Prevention of letter of credit Soft Clauses in Foreign Trade', *Commercial Times*, No. 10, 38.

⁵⁵ Hu, Meilun (2006), 'Letter of credit Fraud and Risk Legal Study', *Exploration*, No. 12, 117; Several examples of such type of soft clauses are provided below: a) "cargo receipt and signed by XXX and the signature must be in strict compliance with that of our file" b) "The certificate of Inspection would be issued and signed by the authorized Agent of the Applicant of letter of credit before Shipment of cargo and the Signature will be inspected by the Issuing Bank" c) "Commercial Invoice in Triplicate, all duly signed and counter-signed by Mr. xx and whose signatures must be in conformity with the specimen signatures(s) held in xx Bank" d) "Quality confirmation issued and signed by authorized person(s) of Applicant (whose signature must be conformed with that hold in your file), certifying that goods are in good condition, and stating date, value, quantity of goods and dated", see Chen, Yan & Liu, Ling (2007), p. 203.

⁵⁶ Jin, Saibo (2002), p. 99.

⁵⁷ Xu, Junke (2007), *Study on International Trade Law Special Topics: New Development under WTO Framework*, Peking: China Legal Publishing House, p. 99.

⁵⁸ Ibid.

⁵⁹ Li, Qiujuan (2003), p. 48.

2.3 Other types of Soft Clauses in Letters of Credit

There are some other different types of soft clauses in the letter of credit;⁶⁰ and conflicting clauses are sometimes stipulated in the sales contract and the letter of credit.⁶¹ Sometimes, different types of soft clauses may be combined together in one letter of credit.

For example, the Xiamen Branch of the Bank of China received one letter of credit issued by one bank in Singapore, for the amount of 1 million dollars in 1993.⁶² In this letter of credit, one clause was that “Shipment can only be effected after the letter of credit applicant has nominated the carrying vessel by way of subsequent tested telex amendment to this credit via opening bank to advising bank, the tested telex amendment must accompany original documents presented for negotiation”, which seems to fall in the first type of letter of credit soft clauses as discussed earlier. The other clause was that “Inspection Certificate to be issued prior to shipment and signed by authorized signatories of applicant whose signatures must be verified by letter of credit issuing bank”, which falls into the second type of letter of credit soft clauses. With these two letter of credit clauses, the buyer controlled the transaction by nominating a ship, and controlled the letter of credit payment by issuing an inspection certificate. In this case, the beneficiary seller was required to pay the deposit of performance of contract in advance, with the amount of 5 -10 percent of the whole contracting amount, in order to get a letter of credit issued. After 10 million RMB remitting to the bank account instructed by the buyer, the deputy of the buyer immediately withdrew it from the bank. Thus the buyer intended to deceive the performance deposit from the seller by taking advantage of inserting such letter of credit soft clauses.

The discussed letter of credit soft clauses can either make the letter of credit ineffective, or the applicant can in fact control the letter of credit payment. It is also possible that the applicant colludes with the issuing bank, or advising bank to delay or avoid payment. In fact, with such letter of credit soft clauses, the letter of credit payment, which is guaranteed by a bank, has already been changed to a kind of conditional commercial payment, which is controlled by one party. Thus, the beneficiary's rights and interests can be seriously harmed. It is strongly recommended that the sellers pay careful attention to such a kind of clauses in letter of credit transactions.⁶³

⁶⁰ Gu, Xiaorong & Ding, Muying (2000), *Letter of credit, Credit Card and Foreign Bills – Cognizance and Sanctions*, Peking: Taihai Press, 1st ed., p. 203.

⁶¹ Yuan, Hui (2005), ‘How Foreign Trading Company will Identify and Prevent letter of credit Soft Clauses’, *International Business – Periodical of University of International Business and Economics*, No. 1, p. 91; see also Bai, Jianjun (1994), p. 28; Yang, Yishi (2007), ‘Identification and Types of letter of credit Frauds’, *Business Weekly*, May 5, 84, p. 86.

⁶² Sun, Dingjie (1995), pp. 653-654.

⁶³ Wang, Xitong (2007), ‘Reflection on letter of credit Soft Clauses and Countermeasures’, *Decision Exploration*, No. 3 (1st Issue), 78, p. 79.

3 Soft Clauses in Letters of Credit in Practice

3.1 How Soft Clauses in Letters of Credit are Viewed in England?

Soft clauses in letters of credit seem to be a serious problem in China. However, whether such problem is frequent in other countries is unclear. Literature and academic discussions in western countries concerning such issue are rarely seen. Judith Autié, a consultant from France, raised the discussion of such problem on letter of credit requiring documents to be issued by buyers (applicants) in an international conference organized by the ICC Austria on 28 May 2008. However, no exact term concerning such letter of credit clauses has been discussed in England. Thus, it seems that such letter of credit clauses have not been clearly recognised as 'letter of credit soft clauses' by the courts in England. The principles of contract were applied when letter of credit cases were dealt with by courts in England⁶⁴. The English case law concerning letter of credit has shown rigid attitudes of the courts towards the autonomy principle and the strict compliance doctrine of letter of credit.

It would be interesting to explore the English courts' attitude towards them, according to current theory and practice of letter of credit in England. Whatever soft clauses are called, they are part of clauses in letter of credit. According to the party autonomy principle widely accepted either by Courts or scholars in England, the courts would regard the arrangement of opening letter of credit as offer and acceptance between applicant and issuing bank, and the letter of credit clauses as the result of mutual agreement between issuing bank and beneficiary.

Upon the requirement of applicant the issuing bank opens a letter of credit containing soft clauses, which may be merely considered as an offer. The beneficiary has the right to put forward objection, either asking for amendment or reissuing a new letter of credit. If the beneficiary does not articulate any points against the letter of credit after the issuance of letter of credit, then it is a silent acceptance. Thereafter the beneficiary should present conforming documents required by letter of credit. If the beneficiary cannot make themselves submit compliant documents with letter of credit, then definitely the issuing bank is entitled to dishonour the payment according the doctrine of strict compliance.

Occasionally, the English courts may issue an order to enforce the buyer to complete the document so that the beneficiary could present the document to the bank for payment or it could order a third party, who most probably is the officer of the court, to perform the document on behalf of the buyer.⁶⁵ However, such a document may be refused by the paying bank on the grounds of incompliant documents under the letter of credit.

⁶⁴ Here are some examples: *Donald H.Scott & Co., Ltd v. Barclays Bank, Ltd.* [1923] 2 K.B. 1 p. 14; *Midland Bank Ltd. v. Seymour* [1955] 2 Lloyd's Rep. 147 p. 166; *Malas (Hamzeh) & Sons v. British Imex Industries Ltd.* [1958] 2 Q.B. 127, p. 129.

⁶⁵ Raymond, Jack (1993), para 9.42, p. 231.

The *Astro Exito Navegacion SA v. Southland Enterprise Co. Ltd (No. 2) (Chase Manhattan Bank NA intervening)* case illustrated the problem of such clauses.⁶⁶ In this case, the sales transaction was financed through a letter of credit by a London bank. There was a clause requiring the notice of readiness to be signed and accepted by the buyer's agent for an amendment of the letter of credit, but the buyer refused to sign it. The judge ordered that the buyer or the buyer's agents should sign the notice by noon of 28 October, since the letter of credit would expire on 30 October; and if the buyer failed to do this, a master of the Supreme Court was to sign the notice on the basis of the Supreme Court Act 1981, section 39. Eventually, the seller tendered the documents including the required notice signed by a master of the Supreme Court. However, the bank refused to pay because the documents were not compliant with the credit of their face value.

Such clauses inserted in letter of credits require some cooperation and performance from the buyer. As for the situation where such clauses are inserted and documents such as an inspection certification from the buyer are required, but the buyer refuses to sign or issue such documents, the beneficiary is not able to present compliant documents to obtain the letter of credit payment. Certainly the beneficiary will face huge losses resulting from such letter of credit clauses, and this is a common phenomenon in China. In China, letter of credit soft clauses sometimes can be misused as a way for conducting fraud. The banking and commercial community mostly consider letter of credit soft clauses as a crime (letter of credit fraud). However, what is the attitude by the courts in China towards this issue?

3.2 The Approach of the Courts in China towards Letter of Credit Soft Clauses

Some cases concerning letter of credit soft clauses have been decided by the courts in China. In the case of *Tsaolian v. China Agriculture Bank Hunan Branch*⁶⁷, the buyer Hulong Company applied for a letter of credit through China Agriculture Bank Hunan Branch. The branch issued a 90 days usance letter of credit with the Tsaolian Material Corporation Limited as the beneficiary, and Hong Kong South Pacific Commercial Bank as the advising bank. Article 48A.3 of this letter of credit stated that "the signature of the applicant on the receipt of goods shall be in compliance with the signature specimen held by the issuing bank". This is a typical letter of credit soft clause falling in the second type. The beneficiary had the receipt from the applicant, but the signature on the receipt was different from the specimen held in the issuing bank. Thus the issuing bank did not honour the payment. Then the beneficiary sued the issuing bank in the Hunan High Court with the cause of action that the issuing bank broke its credit obligation.

⁶⁶ [1983] 2 AC 787.

⁶⁷ The SPC, Civil Court, the 4th Tribunal (2006), *Selected Court Cases of Letter of credit Disputes*, Peking: China Democracy and Legal Press, pp. 40-42.

The First Instance Court decided that the beneficiary should perform according to the terms and conditions of the credit since the beneficiary had accepted the letter of credit.⁶⁸ The issuing bank has the right to refuse the payment in accordance with the strict compliance doctrine, because Tsaolian presented one incompliant document. Tsaolian appealed to the SPC. The SPC held that the beneficiary should understand the specific condition in the letter of credit before he accepted it.⁶⁹ The acceptance of the credit showed that the beneficiary and applicant mutually agreed on this contract about the letter of credit. Based on the contract autonomy, the court should respect the agreement. The documents presented by the beneficiary were not compliant with the letter of credit, thus the issuing bank has the right to dishonour payment. As a result, the SPC approved the judgment of the First Instance Court.⁷⁰

The case *Sanhe Bank Shenzhen Branch v. China Communication Bank Changsha Branch*⁷¹, decided by the SPC, also shows the same attitude as in the case discussed above towards soft clauses in a letter of credit. One of the documents in the letter of credit was the receipt of goods to be signed by the applicant, and the signature of the receipt should conform to the specimen in the issuing bank. The SPC decided that the “soft clause” in the letter of credit should bind on the relevant parties to the credit as a result of the willingness of all parties.⁷² Furthermore, due to the incompliance of the signature on receipt with the requirements of the letter of credit, the issuing bank is entitled not to reimburse the negotiating bank.⁷³

Three points can be identified concerning the SPC’s attitude towards letter of credit soft clauses. Firstly, the cases involving the letter of credit soft clauses were dealt with under the principle of contract law. Secondly, the validity of the letter of credit soft clauses was confirmed by regarding it as an agreement between parties. Thirdly, the courts in civil cases did not show any tendency of considering soft clauses in the letter of credit as a way of letter of credit fraud.

However, letter of credit soft clauses issue is considered differently under criminal law. In 1997 China had its new version of Criminal Law⁷⁴ and the crime of letter of credit fraud is listed separately under the subtitle of financial crime in the new Criminal Law. In article 195 on the crime of letter of credit fraud, it provides that the following acts are criminalised: (1) using a forged or altered letter of credit or any of its attached bills or documents; (2) using an

⁶⁸ Ibid.

⁶⁹ Ibid.

⁷⁰ For further comment on this case, see Tang, Jinlong (2005), *New Version of Case Study: Financial Law*, Peking: China Renmin University Press, 1st ed., pp. 172-177.

⁷¹ *Sanhe Bank Shenzhen Branch v. China Communication Bank Changsha Branch*, Judgment of December 31, 2000, (1999) Series No. 86, The SPC.

⁷² Ibid.

⁷³ Ibid.

⁷⁴ The Criminal Law of PRC was revised at the 5th Meeting of the Standing Committee of the 8th National People’s Congress of PRC on 14 March, 1997, and came into force on the same date.

invalidated letter of credit; (3) obtaining letter of credit fraudulently; (4) other types of letter of credit fraud. The Article 195 (4) – other types of letter of credit fraud is explained as the fraud of soft clauses in the letter of credit by legislature.⁷⁵

In both criminal law theory and judicial practice in China, it is very common that a crime is approached by analysing four elements - subject, subjective element, object, and objective element.⁷⁶ According to Criminal Law 1997, the subjects who may commit letter of credit fraud include natural persons and legal persons⁷⁷. Natural persons include not only natural persons with Chinese nationality, but also foreigners and those without nationality.⁷⁸ The subjective element for this crime is the intention of illegally possessing the properties of others under the letter of credit; intention only refers to direct intention, rather than indirect intention or negligence.⁷⁹ The object of letter of credit fraud is widely accepted as the harm to the national administering system of the letter of credit and public and private property rights.⁸⁰ The objective element of letter of credit fraud crime is the behaviours of committing letter of credit fraud, and it seems to include both presenting forged documents and acting fraudulently in underlying sales transactions.⁸¹ It can be seen that there is a conflicting judicial view between civil law and criminal law. Some argue that soft clauses in a letter of credit are not a kind of

⁷⁵ Other types of letter of credit fraud usually refer to 'letter of credit soft clauses' fraud; for further explanation and concrete circumstances for each type of letter of credit fraud, see Zhao, Bingzhi (Ed.) (2000), *Judicial Countermeasure to Distinguish Financial Crime*, Jilin: Jilin People Press, 1st ed., pp. 359-362; see also Wei, Dong & Tang, Lei (2001), pp. 276-279.

⁷⁶ See e.g. Zhao, Bingzhi (2007), *Introduction to Criminal Law*, Peking: Renmin University of China Press, 1st ed., pp. 140-144; see also Wang, Zuofu (2007), *Criminal Law*, Peking: Renmin University of China Press, 3rd ed., pp. 60-61; Zhang, Mingkai (2007), *Criminal Law*, Peking: Law Press China, 3rd ed., pp. 96-98; Liu, Xianquan & Yang, Xingpei (2007), *Topics of Criminology*, Peking: Peking University Press, 1st ed., pp. 92-93.

⁷⁷ PRC Criminal Law, article 200, provides the sanctions of letter of credit fraud conducted by legal persons.

⁷⁸ PRC Criminal Law, article 8.

⁷⁹ This is considered as a fundamental feature of the subjective element of letter of credit fraud, see Sui, Qingjun (2006), *Theory and Practice of Dealing with Financial Crime Cases*, Peking: China Agriculture University Press, 1st ed., pp. 130-133, see also Chen, Li (2006), pp. 102-104; Zhao, Bingzhi & Zhou, Jiahai (2001), 'Discussion on 'Illegal Possession Intention' the Essential Condition of letter of credit Fraud', *People's Procuratorial Monthly*, Vol. 3, 5; but it is an arguable issue, as some academics and judges consider that such an intention is not necessary in order for it to constitute letter of credit fraud, see Yan, Rempeng & Chen, Guangxiu (2003), 'Comments on letter of credit Fraud Subjective Element - 'Illegal Possession'', *Contemporary Law*, (10), p. 44.

⁸⁰ See Wei, Dong & Tang, Lei (2001), *Financial Crime Identification and Investigation*, Peking: People Publishing House, p. 275.

⁸¹ For further discussion on the features of the objective element; see Hou, Fang (2005), *Research on Crimes Concerning Letters of Credit and Credit Card*, Peking: Law Press China, 1st ed., pp. 27-65.

letter of credit fraud;⁸² and it is wrong for criminal law to regulate such a type of letter of credit fraud and it should be amended.⁸³

In judicial practice, there are criminal cases which constituted fraud by the way of stipulating soft clauses in the letter of credit. However, it should be pointed out that in some cases the criminal could be accused as having committed fraud, instead of letter of credit fraud.⁸⁴ As some examples have shown earlier, with letter of credit soft clauses, either the sellers' performance deposit was deceived, or the seller's goods were taken but without letter of credit payment. In such cases the buyers have intended to deceive deposit or goods from the sellers by misusing the instrument of letter of credit, which can be analyzed from the criminal law perspective. Nevertheless, if the subjective element is the intention of deceiving some amount of deposit rather than the full amount of letter of credit payment, the kind of act can be considered as a kind of fraud but not letter of credit fraud.

Therefore, whether letter of credit soft clauses is a civil law case handled under contract law, or is a letter of credit fraud dealt with under criminal law is not a clear-cut issue. It depends on not only the facts of cases, but also on which legal perspective one approaches such issue. Due to the difficulty the letter of credit soft clauses has raised to the legal field, it is necessary and helpful for sellers to consider some measures to avoid such kind of problem in commercial practice.

4 Preventive and Proactive Measures to Solve Soft Clauses Problems in Commercial Practice

4.1 Choose a Credible Partner

Choosing a credible trading partner is the best way of avoiding fraud or falling into a harmful situation. A well-known letter of credit expert pointed out that the buyer who employs letter of credit to pay should be very careful and must clearly know who the trading party is.⁸⁵ This suggestion is also relevant to the seller. A common channel by which to investigate the credibility of new customers is through the bank and those professional institutions that

⁸² Yang, Jianhong (2002), 'Clarifying Soft clauses in letter of credit', *Journal of Southwest University for Nationalities, Philosophy and Social Sciences*, Vol. 23, No. 12, Dec., pp. 190-192.

⁸³ Jin, Saibo & Li, Jian (2004), *The Law of Letters of Credit*, Peking: Law Press China, 1st ed., p. 766.

⁸⁴ See one case example - Li, Hua (South African), *Fraud*, 2005, cited from Tu, Yonghong (2006), pp. 166-167.

⁸⁵ Zhou, Xianshun & Liang, Lan (2006), 'Risk Prevention Measures of Exporters Under Letter of Credit', *Science Information*, Vol. 4, 176.

provide credibility investigation.⁸⁶ If the trading partner is a middleman, then it is much more important to find out its credibility including its economic strength and its past record of implementing contracts.⁸⁷

4.2 Draft International Sales Contract Carefully

Usually letter of credit clauses in a letter of credit agreement are essentially based on an underlying international sales contract. Therefore, the whole sales contract, especially contracting clauses on the various documents should be drafted as clearly as possible.⁸⁸ It would be preferable if the various required documents including bill of lading, insurance policy, commercial invoice, inspection certification, certificate of origin and other possible documents are stipulated clearly in the sales contract. If contingent conditions in the future are possible to predict and are stipulated in the sales contracts, then the possibility of inserting soft clauses into letter of credit agreements would be reduced.

4.3 Check letter of credit after it is Received

The seller needs to carefully and promptly check the letter of credit after it is received, so as to leave sufficient time if any amendment is necessary and to avoid the failure of not having the conforming documents.⁸⁹ There are two main aspects requiring attention when the letter of credit is checked. Firstly, the seller needs to check the validity of the letter of credit itself, including the credibility of the issuing bank, the terms of honouring payment, and the

⁸⁶ Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), p. 237; see also Zhou, Qinghua (2001), 'Discussion on Preventive Measures and Judicial Remedy to letter of credit Fraud', *Contemporary Law Review*, No. 12. 68, pp. 68-69; Cheng, Songliang & Xiao, Xiao (2008), 'Discussion on letter of credit Fraud', *Pioneering with Science & Technology Monthly*, No. 8, 131, p. 132.

⁸⁷ Sun, Dingjie (1999), *Financial Fraud and Legal Countermeasures*, Peking: People's Court Publishing House, p. 176; see also Yang, Zhengming (Ed.) (1999), *Financial Crime and Legal Control*, Peking: Linxin Accounting Press, 1st ed., p. 215.

⁸⁸ Gu, Xiaorong & Ding, Muying (2000), p. 213-214; see also Cai, Lei & Liu, Bo (1997), pp. 323-325; Shi, Donglian (2005), 'letter of credit Fraud and Risk Prevention of Exporters', *Market Modernisation*, Sep. (2), No. 444, 90, p. 91. Zhu, Min (2006), 'The Causes and Risk Prevention of letter of credit Soft Clauses', *Finance and Accounting Journal (Integrated)*, No. 3, 35, p. 36; Hong, Tao (2009), 'letter of credit Fraud and Preventive Measures in International Trade', *Modern Business*, No. 11, 89, p. 91.

⁸⁹ Li, Xiaoyong (1998), *Financial Crime and Prevention*, Hangzhou: Hangzhou University Press, 1st ed., p. 17; see also Bai, Jianjun (1994), p. 31; this is only one small part in managing documentary credits on the side of exporters; for a detailed discussion see 'Vincent O'Brien with Some Personal Tips for Exporters who Receive a Letter of Credit', *DCI (ICC)*, Autumn 1997, Vol. 3, No. 4, pp. 21-22.

appropriateness of period of validity.⁹⁰ Secondly, the seller needs to check whether the letter of credit terms comply with the clauses of the sales contract.⁹¹

Once the seller identifies soft clauses in the letter of credit, the seller must immediately require the applicant to amend; at the same time, the seller sets forth the time limit for the buyer to amend or provide other guarantees, and clearly points out that the buyer should extend the validity of the letter of credit due to the delay of amendment.⁹² If the buyer refuses to amend the letter of credit afterwards, the seller may claim that the contract is terminated and can require the buyer to provide a valid guarantee, and further preserves the right to claim for compensation as the buyer breaks the sales contract due to the failure of opening the letter of credit.

4.4 Establish a Set of Effective Criterion of Soft Clauses

The key of preventing soft clause problems in letter of credit transactions is to establish a set of effective criterion that could help to identify various letter of credit soft clauses.⁹³ Through such criterion, when one soft clause is in a letter of credit, it is possible to identify which type of soft clause it is, what effect it can bring to the seller, and what protective measures can be taken. Unfortunately, there is no standard criterion for it as letter of credit soft clauses are different and variable. Preventing soft clause becomes feasible, if the seller is aware of possible soft clauses in each stage of a letter of credit transaction.⁹⁴ Before solving the problem of letter of credit soft clauses in a letter of credit, the seller must not impatiently ship the goods in order to avoid more loss. Concerning problematic soft clauses in a letter of credit, on the one hand, we emphasise preventing including such clauses; on the other hand, we recommend the sellers make use of contractual provisions to protect themselves.

⁹⁰ Wang, Haizhi & Ma, Youxin (2000), p. 213; this point is also closely related to the prevention of Letter of Credit soft clauses, see Li, Xiaoyong (1998), p. 176.

⁹¹ Hu, Yuexiu (2007), 'Soft Clause of letter of credit and Risk Prevention', *Market Modernisation*, No. 512, August (Second), p. 296; concrete contractual terms that need to be checked, see also Li, Xiaoyong (1998), p. 176.

⁹² See e.g. Lu, Jingsheng (2003), *Legal Security Study and Measures in Business Operations*, Peking: China Economy Press, p. 299; see also Chen, Zhenhang (2007), 'The Risk and Its Prevention In International Letter of Credit Transactions by Exporters', *Science and Educational Innovation*, March, No. 6, 220, p. 221.

⁹³ Xu, Donggen (2005), p. 310; see also Wang, Xiaodong (Ed.) (2006), *Research on Prevention of Modern Financial Crime*, Jinan: Shandong People Press, p. 79; Jin, Xiaohua & Zheng, Shuhua (2005), 'Analysis of letter of credit Soft Clauses', *Market Modernisation (Academic)*, No. 7, 70.

⁹⁴ There are several stages such as the stage of letter of credit taking effect, inspecting goods, shipping goods and accepting goods, Liu, Zhiyong (2006), 'Analysis of Letter of Credit Fraud', *Academic Journal of Shanxi Provincial Committee Party School of C.P.C.*, Vol. 29, No. 3, June, 107, pp. 108-109; see also Wu, Renbo (2009), 'Identification and Prevention of letter of credit Soft Clauses', *Practice in Foreign Relations and Trade*, No. 8, 56, p. 57.

4.5 Cooperate with Internal Units and Banks

It is important for the seller to make efforts to cooperate between different units inside the company and cooperate with banks.⁹⁵ It is clear that sellers need to have sufficient knowledge not only of their business but also of letter of credit transactions. Letter of credit is in itself complicated and risky, thus once a letter of credit transaction is involved, it is essential not only for each unit of a company to do its own work well, but also to cooperate with each other through effective communication. In addition, the seller must cooperate with the advising bank in its home country⁹⁶ by seriously taking on board the bank's advice on some terms in the letter of credit.

To sum up, the sellers in international sales transactions certainly have to be able to choose a credible commercial partner, to identify soft clauses when manipulating the payment method of the letter of credit and inform the buyers to amend it without delay, and to cooperate with internal departments and banks, so as to solve such soft clauses problem at an early stage. Nevertheless, it is up to the sellers to decide whether to accept such soft clauses or not, depending on the particular customer and trading business.

5 Conclusion

From the above discussion, we can see that the issue of soft clauses in the letter of credit is indeed complex and debatable. On the one hand, in some particular circumstances, designing and inserting soft clauses in the letter of credit is a kind of protective measure taken by the buyer against letter of credit fraud committed by the seller. Letter of credit soft clauses could be influenced by several elements, such as trading practice, features of the goods and the buyer's market; not all soft clauses in the letter of credit are unreasonable and tricky. Thus, considering the balance of rights and interests of both parties, it is impossible to entirely prohibit letter of credit soft clauses. On the other hand, soft clauses in the letter of credit can be abused by the buyer to conduct deceitful behaviours or even to commit fraud with intention, such as defrauding goods without payment or deceiving deposit of performance of contract or guarantee of the letter of credit issuance.

⁹⁵ See Wang, Xiaodong (Ed.) (2006), p. 81; see also Li, Xiaoyong (1998), p. 176; Bai, Jianjun (1994), p. 32; cooperation with banks may prevent the false letter of credit, ensure the creditability of the issuing bank, avoid letter of credit soft clause fraud, transferring letter of credit fraud, and so forth, see Yang, Zhengming (Ed.) (1999), pp. 216-217; Xie, Ying & Zhu, Zhiyong (2003), 'Discussion on letter of credit Fraud and Prevention', *International Economics and Trade Research*, Vol. 19, No. 5, Oct., 41, p. 44.

⁹⁶ Wu, Cuihua (2005), 'Risk and Avoidance of Soft Clauses in Letter of Credit', *Economy Forum*, No. 12, p. 33; similarly, establishing a platform for exchanging information for business enterprises and banks is also recommended, see Zhang, Xianglan (1999), 'Discussion on Letter of Credit Fraud and Countermeasures', *Law Review (Bimonthly)*, No. 2 (Sum. No. 94), 78, p. 82.

In England, where some documents issued by the buyer are required, and if the buyer refuses to issue or sign such documents, the court may order the buyer or third party on behalf of the buyer to do so. However, a problem arose where a third party on behalf of the buyer is ordered to sign or issue such documents. The paying bank may consider such documents as not being compliant documents and refuse to honour the letter of credit payment. Thus, the solution of the English court still would not be able to protect the seller against the problem of obtaining the letter of credit payment.

In summary, letter of credit soft clauses issue can be considered either from contract law perspective or from criminal law perspective. The letter of credit soft clauses can take various forms; and the most important thing for the sellers is to take preventive and proactive measures to reduce the risk resulting from soft clauses to the lowest degree.