

Litigation - Canada

Enforcement of Letters of Credit in Ontario

December 22 2009

[Facts](#)
[Trial Judge's Decision](#)
[Court of Appeal Decision](#)
[Comment](#)

Author

[Michael D Schafler](#)



In *Nareerux Import Co Ltd v Canadian Imperial Bank of Commerce*⁽¹⁾ the Ontario Court of Appeal considered whether an issuer of a letter of credit could refuse payment based on the beneficiary's non-compliance with the letter of credit's terms and conditions. The court ruled in favour of the beneficiary and held that where the issuer has knowingly contributed to, or acquiesced in, the circumstances that undermined the prospect of strict compliance, that issuer is prevented from relying upon the defence of non-compliance. The issuer's conduct was a direct breach of the principle of autonomy underpinning letter of credit transactions and a breach of the issuer's implied duty of good faith.

Facts

Thai Fisheries Co Ltd accepted letters of credit from Canadian Imperial Bank of Commerce in order to ensure payment for shipments of large quantities of Thai shrimp to Douglas R Robertson International Inc in the United States. Ultimately, the shrimp was to be sold by Robertson to Sam's Club.

Thai Fisheries and the bank agreed to include the following provision in the letters of credit:

"Payment of drafts or drafts drawn hereunder will be effected when accompanied by required documents and after receipt from the applicant of a signed purchase order(s) issued by Sam's Club and related delivery receipt(s) showing container number(s), number of cartons and evidencing that goods have been received by Sam's Club Distribution Centre(s)."

This provision gave the bank added protection, as the payment to Thai Fisheries pursuant to the letters of credit would be delayed until a purchase order had been delivered by Sam's Club along with related delivery receipts.

Robertson failed to deliver the receipts from Sam's Club to the bank and as a result Thai Fisheries did not receive payment for substantial amounts of shrimp supplied. However, the proceeds of sale were used by Robertson to reduce his line of credit at the bank. The bank was informed that Robertson may have been withholding the required documents and that there would be no further shipments to Sam's Club. Thai Fisheries was not advised of this information for more than a year thereafter.

Thai Fisheries claimed that the bank and Robertson acted in collusion by arranging for shrimp to be sold without documentation from Sam's Club and for the proceeds of sale to be used to reduce Robertson's overdraft and therefore the bank's exposure.

The bank claimed that the provisions of the letters of credit were not honoured because the requisite documentation was not presented, and that Thai Fisheries knowingly ran the risk of such an eventuality when it accepted the letters of credit in the first place.

Trial Judge's Decision

The trial judge ruled in favour of Thai Fisheries and awarded approximately US\$10.4 million - the unpaid balance under the letters of credit.

The trial judge held that by accepting the moneys in payment of the loan owed by Robertson, the bank acted as a lender seeking satisfaction of what it was owed. However, in doing so, it breached the separate and independent contract that it had entered into with Thai Fisheries and an implied duty of good faith which was part of the

contractual relationship between the bank and Thai Fisheries.

The bank appealed the trial judge's decision.

Court of Appeal Decision

The central issue at the appeal was whether the bank could rely on the defence of non-compliance - that is, the failure to receive receipts from Sam's Club that would have triggered payment to Thai Fisheries.

The court held that the bank was disentitled from relying upon this defence as its own conduct partially generated the documentary non-compliance. The court based its decision on the trial judge's finding that the bank was aware that no receipts were produced for US\$6.9 million of shrimp delivered by Robertson to Sam's Club, and that shrimp was being sold to purchasers, other than Sam's Club, that should have been subject to the requirement of producing receipts. The bank failed to bring this information to Thai Fisheries' attention and continued to accept the proceeds of sale to reduce Robertson's line of credit.

The court upheld the trial judge's decision and held that the bank's conduct was correctly characterized as a direct breach of the principle of autonomy underpinning letter of credit transactions and as a breach of the bank's implied duty of good faith.

Breach of principle of autonomy

The fundamental principle of autonomy requires that the contracts between the following parties be recognized and treated as three separate and distinct agreements:

- the buyer and the seller;
- the buyer and the bank; and
- the bank and the beneficiary seller.

The court agreed with the trial judge's finding that the bank permitted its conflicting concern respecting its financial over-exposure in the creditor/debtor relationship with Robertson to interfere with its payment obligation to Thai Fisheries under the letters of credit. As a result, the bank had put itself in a position where its obligation under the letters of credit to act independently of the underlying relationships between itself and its customer or its customer and the beneficiary had been compromised. In finding that the bank had breached the guiding principle of autonomy, the court held that:

"Letters of Credit by the issuer and its customer as a tap for payment, depending upon when the Bank and its client wanted to effect such payment - in order to better their own positions vis-à-vis each other as debtor and creditor - nullifies the entire autonomy principle and the independent role required of the Bank under the Letters of Credit."

Breach of implied duty of good faith

Canadian law recognizes an implied contractual duty of good faith not to act in a way that defeats the purpose and object of an agreement. The court agreed with the trial judge's finding that the letters of credit were infused with this implied duty of good faith, which the bank breached by acting out of self-interest and undermining the purpose of letters of credit (ie, to provide a degree of financial security).

Failure to provide timely notice

The court identified an additional basis on which to reject the bank's appeal by finding that the contractual language of the letters of credit sufficiently engaged the Uniform Customs and Practice for Documentary Credits (UCP) 500. The letters of credit included the following provision:

"This cable is the operative instrument and subject to the U.C.P. 1993 revision ICC Publication No. 500 and engages us in accordance with the terms thereof."

Pursuant to UCP 500, the bank failed in its obligation to provide timely notice of dishonour to Thai Fisheries when it held back on notifying the seller for more than a year that no receipts would be forthcoming and that the letters of credit would be cancelled. The lack of timely notice prevented Thai Fisheries from taking steps to protect itself by seeking return of the shrimp until it was too late and the shrimp had been sold.

Bank's arguments on assumption of risk and passing of title

The court agreed with the bank that Thai Fisheries assumed the risk of delayed payment and even the risk that Robertson would act dishonestly and fail to provide the required receipts. However, Thai Fisheries' assumption of risk could not be stretched to include the possibility of the bank and Robertson colluding together to frustrate compliance with the terms of the letters of credit and breaching principles of autonomy and the implied duty of good faith. The court held that to interpret otherwise would "render the letters of credit commercially meaningless".

The court also rejected the bank's claim that upon Robertson acquiring title of the shrimp, the bank acquired an interest in the shrimp as a secured lender, in priority to Thai Fisheries' interest as an unsecured creditor of Robertson. The court held that

ownership of the shrimp was irrelevant for disposing of this action as Thai Fisheries was not seeking to assert its rights as an unsecured creditor of Robertson. Rather, it was seeking to enforce its contractual rights against the bank under the letters of credit.

Comment

This case highlights the commitment of Ontario courts to ensure that letters of credit are interpreted in a manner that promotes commercial efficacy and the relative certainty that must surround the use of this financial instrument. It also emphasizes the importance of incorporating principles of contract law, including those invoking notions of fairness and equity, when enforcing letters of credit.

For further information on this topic please contact [Michael D Schafler](#) at *Fraser Milner Casgrain LLP* by telephone (+1 416 863 4511), fax (+1 416 863 4592) or email (michael.schafler@fmc-law.com).

Endnotes

(1) [2009] OJ No 4553, 2009 ONCA 764.

The materials contained on this website are for general information purposes only and are subject to the [disclaimer](#).

ILO is a premium online legal update service for major companies and law firms worldwide. In-house corporate counsel and other users of legal services, as well as law firm partners, qualify for a free subscription. Register at www.iloinfo.com.



Official Online Media Partner to the International Bar Association
An International Online Media Partner to the Association of Corporate Counsel
European Online Media Partner to the European Company Lawyers Association

© Copyright 1997-2010 Globe Business Publishing Ltd