Key contacts

Sesan Sulaiman
Partner,
Dispute Resolution & Tax
sesan.sulaiman@templars-law.com

Orji Agwu Uka, MCIArb
Managing Counsel,
Dispute Resolution & Tax
orji.uka@templars-law.com

Precious Emeka-Egonu
Associate,
Tax and Finance
precious.emeka-egonu@templars-law.com

TEMPLARS ThoughtLab

Revisiting the Autonomy Principle in Financial Instruments: *Application in Domestic and Cross-Border Contracts*

Introduction

Financial instruments, such as letters of credit or on-demand performance bonds, are commonly used in commercial transactions to mitigate the risk of a contracting party's failure or inability to fulfil its obligations under a contract.

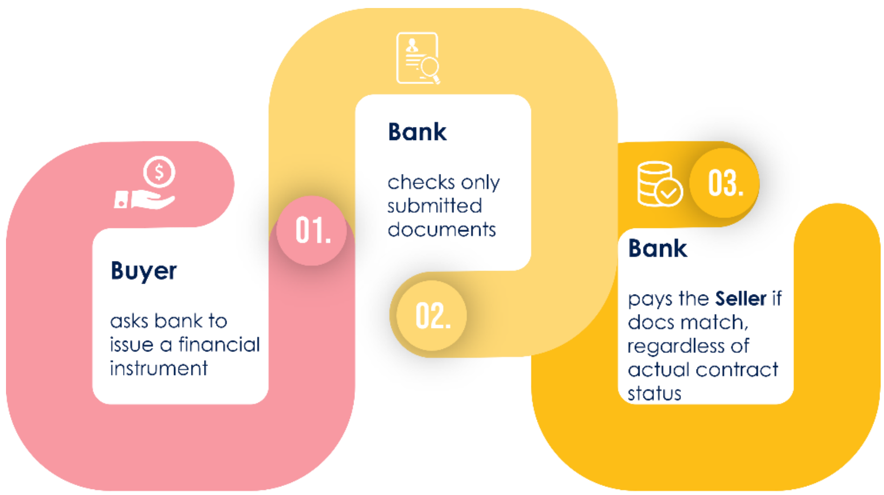
One key characteristic of this class of instruments is their inherent autonomy from the underlying contract. This ensures that the financial institutions who issue them are obligated to honour payments strictly based on compliance with the terms of the instrument. While this principle of autonomy remains fundamental to international trade finance, it has often been the subject of dispute.

This publication examines the principle of autonomy of financial instruments, evaluates its significance in cross-border trade, and considers its implications for international commercial transactions. The paper will also highlight how the courts have applied the autonomy principle and in the final analysis provide practical options for contracting parties when faced with a dispute relating to the autonomy principle of financial instruments.

The Utility of Financial Instruments in Domestic and Cross Border Trade Contracts

In an increasingly globalised world, international trade and commerce have become integral, and transactions between parties across different jurisdictions are now commonplace, facilitated by cross border contracts[1] executed and implemented without the need for physical interaction, often between parties who may have no prior relationship.

The geographical separation between contracting parties, however, presents peculiar challenges, particularly in relation to trade financing. Often, the parties lack comprehensive knowledge of each other's financial credibility, business reputation, or legal environment, making it difficult to assess the reliability of the other contracting party. In the context of global commerce, this uncertainty complicates transactions: sellers may be reluctant to release their goods across borders without a secure and prompt payment mechanism, while buyers may hesitate to make payments for goods without assurances of delivery.



UCP 600 Article 4:
"A credit is a separate transaction... Banks are not bound by the underlying contract."

To mitigate these payment risks while preserving contractual obligations, the law has developed the mechanism of financial instruments issued by banks on behalf of applicants (typically buyers) to facilitate the receipt of payment for goods and services by the beneficiaries (usually sellers) provided that they meet the specified terms and conditions. Compliance is usually demonstrated by submitting designated documents to a specified bank within a stipulated timeframe. While there are many variants of financial instruments used to facilitate domestic and cross-border contracts, this publication is only concerned with documentary credits such as letters of credit (LCs) and on-demand performance bonds (together referenced as **Financial Instruments)**.

As Lord Denning M.R. explained in **Pavia & Co. S.P.A. v. *Thurmann-Neilsen***,[2] an LC can be described as follows:

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[1] Cross-border contracts are legally binding agreements made by two or more parties in different countries or legal jurisdictions. By their nature, cross-border contracts involve parties operating under distinct legal systems, currencies, trade regulations, etc.
[2] (1951) 2 Lloyd's Rep 328.

> *"The sale of goods across the world is now usually arranged by means of confirmed credits. The buyer requests his banker to open a credit in favour of the seller and in pursuance of that request the banker or his foreign agent, issues a confirmed credit in favour of the seller. The credit is a promise by the banker to pay money to the seller in return for the shipping documents. Then the seller when he presents the documents gets paid in the contract price. The conditions of the credit must be strictly fulfilled; otherwise, the seller would not be entitled to draw on it".*

For domestic contracts, particularly those involving capital-intensive projects, financial instruments are used to guarantee or secure compliance with the obligations of the underlying contract by providing financial security to enable a party to claim compensation if the counterparty fails - or is alleged to have failed – to fulfil its contractual obligations.[3] In addition to LCs, performance bonds are commonly used financial instruments. These instruments may take the form of either conditional performance bonds - which require proof of a breach of the underlying contract before the guarantor becomes liable - or unconditional or "on-demand" performance bonds, which impose liability on the guarantor upon a simple demand, without the need to establish default. This publication focuses exclusively on the latter.

The Legal Framework for Financial Instruments in Nigeria

In Nigeria, the legal framework governing Financial Instruments is a combination of case law, banking regulations, and international standards especially the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits (UCP 600).[4] While the UCP 600 rules are generally not legally binding and have to be specifically outlined in trade finance contracts to apply, the Central Bank of Nigeria (CBN) via a Circular dated 25 June 2007, has mandated that all LCs will be subject to the provisions of the UCP 600.[5] Performance bonds, on their part, are contractual instruments and are therefore mainly governed by the Nigerian law of contract, which is largely based on the English common law principles.

The Autonomy Principle

The principle of autonomy of Financial Instruments dictates that banks are solely concerned with the documents presented and not with the goods, service or performance to which the document relates. The autonomy principle is deeply entrenched in international commercial trade law and banking practices, as illustrated by its codification in article 4 of the UCP 600 to the effect that "*A credit, by its nature, is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contracts, even if a reference to them is included in the credit.*"

[3] Contractors often require some upfront payment to mobilize resources to cover material costs, labor, and other initial expenses. This creates a risk that the contractor may fail to deliver or complete the project as agreed. To mitigate this, project owners typically require an advance payment guarantee from a bank or other financial institution, ensuring that they can recover their funds if the contractor defaults. Similarly, contractors sometimes require bank guarantees from project owners that if the contractors execute the contract, the project owners will fulfil their payment obligations.

[4] UCP600 is an official publication of the International Chamber of Commerce (ICC), comprising 39 articles that regulate the issuance, obligations of parties and operation of LC. The UCP 600 has been adapted in over 175 countries including Nigeria.

[5] This has received judicial imprimatur of the highest order in Nigeria in the case of ***Owigs and Obigs (Nig) Limited v. Zenith Bank PLC*** (2025) 2 NWLR (Pt. 1977) 451 at page 496 [A-D].

A bank's main obligation is to examine the presented documents and determine, based solely on their content, whether they comply with the terms of the Financial Instruments .[6] Thus, Financial Instruments operate independently of the underlying transaction, and a beneficiary is entitled to payment as long as the submitted documents strictly comply with the terms of the Financial Instruments , irrespective of any disputes in the underlying agreement. Accordingly, courts have traditionally been reluctant to deviate from the strict autonomy principle, except in cases of fraud. Lord Denning M.R. articulated the foregoing in ***Edward Owen Engineering Ltd v. Barclays Bank International Ltd***,[7] by stating thus:

> *"A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions".*

This is also the general position under Nigerian law. In ***Owigs and Obigs (Nig) Limited v. Zenith Bank PLC,***[8] the Supreme Court per Tijjani Abubakar, JSC restated the position on the autonomy principle as follows:

> *"No defence to a claim on the letter of credit can be argued that the beneficiary has breached an underlying contract, the agreement has been declared unenforceable by a court, or that the purchaser has failed to deposit cash with the issuing bank. What this means is that the bank is not concerned with issues regarding a probable breach of the underlying contract between the seller and the buyer. Since the parties cannot agree on how to proceed in the event of a disagreement over how the underlying contract should be performed, they are forced to pay the beneficiary upon submission of compliant documents and seek redress through legal action.* ***This independence of the letter of credit is described as the autonomy principle****. [Emphasis Ours]*

The principle of autonomy also exempts a bank from liability for the authenticity of a document. In ***Gian Singh & Co Ltd v. Banque de L'Indochine***,[9] the issuing bank debited the buyer's account after honouring an LC based on a certificate signed by Balwant Singh, confirming the vessel met the required specifications. It was later discovered that the signature on the certificate was forged, prompting the buyer to sue the bank for wrongful debiting. The Privy Council ruled that although the signature was forged, the certificate complied with the terms of the LC, and therefore, the buyer was obligated to reimburse the bank. Lord Diplock emphasized that banks must act swiftly in documentary credit transactions and *are only required to conduct a visual inspection of the presented documents, without any duty to verify the authenticity of signatures unless explicitly required by the LC*.[10]

[6] Article 14 (a) of the UCP 600.
[7] (1978) 1 QB 159.
[8] (2025) 2 NWLR (Pt. 1977) 451 at pages 502 - 503 [G-F].
[9] (1974) 2 Lloyd's Rep 1.
[10] This has been codified by ICC in article 34 of the UCP 600 which states that "A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document.

While this autonomy is fundamental for the efficiency and certainty of Financial Instruments [11] by ensuring a predictable and independent payment mechanism in international trade, it has not been without controversy. For instance, the principle has been criticized for exempting banks from their professional duty of diligence and due care. As a result, certain exceptions to the autonomy principle have been developed.

Exceptions to the Autonomy Principle

Fraud is the one generally accepted exception to the autonomy principle and provides banks with a justifiably basis to refuse payment under Financial Instruments. Fraud can occur where a Financial Instrument is attempted to be drawn for a purpose other than the purpose for which it was issued.[12] In such case, a bank can refuse payment, and where it pays, knowing full well that the credit is being considered for a fraudulent purpose, it will be liable. Articles 15 and 16 of the UCP 600 state that where an issuing bank determines that a document presented complies with the condition, it must honour but where the documents do not comply with the agreed conditions, it may refuse to honour and give a notice to that effect to the presenter of the document (e.g. the seller).

Secondly, the autonomy principle will not exclude a bank from liability where it fails to exercise due care in complying with the instruction under the Financial Instrument or verifying compliance with it. In **Nasaralai Enterprises Ltd. v. Arab Batik Nigeria Ltd**,[13] the respondent (bank) issued an irrevocable letter of credit (LC) to the Bank of Tokyo, Thailand, on behalf of the appellants (buyers) to facilitate the purchase of 100,000 bags of rice. The LC required the Bank of Tokyo to release payment upon receiving from the seller, documents which complied with the specifications in the LC. The appellants later sued for breach of contract and negligence, arguing that the respondent bank failed to comply with their instruction to endorse the Merchant Shipping (Amendment) Decree 1978 on the LC. The court ruled that banks must strictly follow customer instructions when issuing an LC. Failure to endorse the required legal provision was a breach of the bank's obligation. The court further held that banks must examine documents with reasonable care to ensure compliance with LC terms. As the Bank of Tokyo had failed to identify inconsistencies in the submitted documents, leading to an improper payment, both the Bank of Tokyo and the respondent bank were held liable for breaching their respective duties.

Similarly, in ***Zenith Bank v. ATO Properties Limited,***[14] the bank paid the entire sum guaranteed under an advance payment guarantees (APG) by the respondent to the 1st defendant, when the 1st defendant had not discharged its contractual obligations to the respondent and contrary to the terms of the APG. The Court of Appeal held that a bank owes a duty of care to its customers which includes the duty to exercise banking care and skill. In the specific context of an APG, the Court stated that a bank should not consider that its role in relation to an APG is simply to receive and transmit the sum guaranteed without due regard to the terms and conditions thereof and that the very essence of the guarantee is for the bank to exercise banking care and skill in the administration

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[11] Indeed, the efficacy of documentary credits has been described as "the lifeblood of international commerce." See ***Intraco Ltd v. Notis Shipping Corp of Liberia: The Bhoja Trader*** [1981] 2 Lloyd's Rep 256,257.

[12] See ***Bank of Newport v. First National Bank& Trust Co of Bismarck*** 687 F.2d 1257, 34 UCC Rep.Serv. 650, 8th Cir. (N.D.), where the purpose of the LC was to assure delivery of blood pressure machines, and it was used to repay loans to Bank Newport. This was considered to constitute fraud.

[13] (1986) 4 NWLR (Pt. 35) 409.

[14] (2019) LPELR-47783(CA).

or disbursement of the funds and not to merely act as conduit pipe for the transfer of the sum. On this basis, the Court held that (i) the bank was bound by the terms and conditions set out in the APG and had the contractual duty of care which it refused to exercise in the disbursement of the funds and (ii) the bank could not escape responsibility and liability for the breach of the legal and contractual duty of care owed under the APG. Consequently, the Court held that the respondent was entitled to special damages for the sum lost under the APG.

In ***Owigs and Obigs (Nig) Limited v. Zenith Bank PLC,***[15] the Supreme Court outlined the exceptions to the autonomy principle to include fraud, unconscionability, illegality, recklessness of the beneficiary, etc. On the unconscionability exception for example, the Court stated that the courts should not uphold the autonomy principle where the beneficiary's conduct is tainted with bad faith.

On the strength of the above judicial authorities, it becomes clear that under Nigerian law an applicant would have a right of action against its bank both under contract and the tort of negligence if the bank makes payment to a beneficiary merely by reason of a demand, without first satisfying itself that the trigger events in the relevant Financial Instrument have occurred or where any of the recognised exceptions exist.

Concluding Remarks

The principle of autonomy is crucial for Financial Instruments in cross-border trade, ensuring that banks can process transactions efficiently without being entangled in disputes arising from the underlying contract. This independence allows these instruments to function as a reliable payment mechanism, fostering trust between trading partners and guaranteeing obligations. While autonomy facilitates speed and certainty in international trade, parties must exercise due diligence to ensure that the relevant Financial Instrument aligns with their contractual terms, verify documents properly, and be mindful of the limitation to independence particularly in cases of fraud. A balanced approach to leveraging Financial Instruments will enhance security, mitigate risks, and promote seamless international trade financing.

One practical thing to note about the autonomy principle is that drafting matters and Nigerian courts interpret the provisions of Financial Instruments strictly. Thus, where the text of a Financial Instrument gives room for conditions then the banks are bound to ensure that the conditions are fulfilled before they can pay out the sums guaranteed thereof.

It is also clear that Nigerian courts impose on the banks a duty to exercise banking care and skill. Accordingly, Nigerian banks should not consider themselves as merely acting as conduit pipe for the transfer of the sum guaranteed under a documentary credit. Where there is a breach of such duty, Nigerian courts will not hesitate to grant injunctive reliefs to prevent the release of the funds or in deserving cases to grant monetary compensation for wrongful disbursement.

If you require any further clarification, do not hesitate to contact us.

[15] (Supra) at page 503 [F-G].