

## Commercial Law Update: Lending

Nov 18 2013

Posted By: David I. Cisar

Practice Area: Banking and Commercial Finance

*Letters of Credit ("L/Cs") have evolved over nearly three centuries of commerce into an essential tool for banks and their customers in international business transactions, financings and government contracting. This Update provides an overview of some of the key legal and practical concepts that are necessary to use this tool effectively.*

The FDIC's examiner's handbook defines a letter of credit as "a document issued by a bank on behalf of its customer authorizing a third party to draw drafts on the bank up to a stipulated amount and with specified terms and conditions," and states that an L/C is a bank's "conditional commitment...to provide payment on drafts drawn in accordance with the document terms."

### Governing Law

The sources of "law" governing L/Cs are:

- **Statute:** UCC Article 5 applies to "letters of credit and to certain rights and obligations arising out of transactions involving letters of credit." UCC Section 5-108(e) provides that an issuing bank "shall observe standard practice of financial institutions that regularly issue letters of credit."
- **Practice codes:** Derived from two sources: the UCP600 (*Uniform Customs and Practice for Documentary Credits 2007 Revision*, International Chamber of Commerce Publication No. 600) and the ISP98 (*Institute for International Banking Law and Practice Publication 590; International Standby Practices* (1998)).
- **Contract law:** With some limited exceptions, any provision of Article 5 may be modified by contract. Thus, if the UCP600 or ISP98 is incorporated into an L/C, it supersedes any contrary provision of Article 5. The exceptions include the "Independence Principle" (discussed below) and certain other rights and obligations of the issuing bank.

### Terminology

Certain terms are important to an understanding of the parties' respective rights and obligations, with some of the most basic being:

- **Issuer** – the bank that issues the L/C and is required to Honor a Draw by the Beneficiary;
- **Applicant** – the customer for whose account the L/C is issued;
- **Beneficiary** – the person in whose favor the L/C is issued and who is entitled to Present/Draw and receive payment from the Issuer;
- **Honor** – performance of the Issuer's undertaking (in the L/C) to make payment; and
- **Presentation** (also called a Draw) – delivery of document(s) to an Issuer for (or to induce) Honor of the L/C.

## **The Independence Principle**

Central to an understanding of L/C law and practice is that an L/C is a self-contained whole. This is known as the "Independence Principle" based upon language in UCC §5-103, which states that the rights and obligations of an Issuer to a Beneficiary under an L/C are "*independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.*"

The Independence Principle protects all parties. The Issuer is protected because, as long as the Presentation requirements in the L/C are strictly complied with, the Issuer must Honor it without looking into the relationship between the Applicant-customer and the Beneficiary making the Draw. The Applicant and Beneficiary are also both protected because the Issuer's obligations under the L/C are not affected by the relationship between the Applicant-customer and the Issuer itself. Thus, the Applicant may be in default of its obligations to the Issuer, but the Issuer must nevertheless Honor a proper Presentation.

## **Types of L/Cs**

L/Cs fall into two general categories: "commercial/documentary L/Cs" (which are the primary focus of the UCP600) and "everything else," consisting mainly of what are known as "*Standby L/Cs*" which, themselves, come in several varieties and are covered by the ISP98.

"Commercial/Documentary L/Cs" are typically issued to facilitate specific transactions and to assure payment in trade or commerce (usually international). Generally, Presentation is made when the underlying transaction is consummated. These are referred to as "documentary L/Cs" because a Draw requires documentary proof that the underlying transaction has occurred.

For example, an exporter and importer might agree that goods will be paid for at the time of shipment. The exporter won't ship without assurance of getting paid, and the importer won't pay without assurance that the goods have been shipped. Thus, the importer (Applicant) arranges with its Bank (Issuer) for an L/C that gives the exporter (Beneficiary) the right to Draw when the exporter provides the Issuer with an original Bill of Lading proving shipment. Anecdotally, this is partly why documentary L/Cs were conceived – to avoid having the Issuer bank independently verify shipment, which might have involved the banker making a trip to the dock and watching the goods being loaded and the ship sailing off beyond the horizon.

"Consummation" of the underlying transaction – *i.e.*, the goods being placed on the ship – is defined by the terms of the L/C, as are the documentation requirements, which are either spelled out in the L/C or incorporated from the UCP600.

"Standby L/Cs". The ISP98 defines eight types of Standby L/Cs, of which the most common are "Financial Standbys."

A Financial Standby is an irrevocable guarantee by an Issuer of Applicant's payment or performance in an underlying transaction. The Beneficiary may Draw, and the Issuer must Honor, if its customer (Applicant) does not pay, deliver or perform. Some event, usually a default by Applicant under its contract with Beneficiary, "triggers" the Beneficiary's right to Draw. Although independent proof of the Beneficiary's right to Draw is not required, a Financial Standby is still "documentary" in the sense that the Beneficiary must make the Draw in writing and (typically) represent to the Issuer that Applicant has defaulted. Due to the Independence Principle, the Issuer (without verifying the default) must Honor if the Draw complies with the Presentation requirements spelled out or incorporated into the L/C.

Financial Standbys present an Issuer with both a credit benefit and a credit risk. Because Applicant's default under its contract with the Beneficiary is a condition to the Issuer having to Honor the Beneficiary's Draw, the Issuer may never have to "fund" (Honor) as long as Applicant doesn't default; BUT, if the Issuer does have to fund, it will be on account of a customer who has already defaulted on a (probably material) business obligation.

A "Direct Pay L/C" is a type of Financial Standby. While it is also an Issuer's guarantee of Applicant's payment of a debt or other obligation, the difference is that Applicant's default is not a condition to Draw – all payments are made by Draws on the L/C. Direct Pay L/Cs are useful in cases where the "Beneficiary" is a group of unaffiliated debt holders (*i.e.*, holders of publicly-traded bonds) because this payment method provides liquidity and avoids bankruptcy preference claims against debt service payments. Because of the Independence Principle, the Issuer is the primary obligor for payment of debt service; thus, Applicant's default is of no concern to bondholders and bonds backed by an irrevocable Direct Pay L/C are marketed on the strength of the Issuer's credit, not the Applicant's.

Of special note are Standby L/Cs required by governmental entities. Various Wisconsin Statutes and Administrative Rules require or permit a person transacting business with a state agency (obtaining a license or permit, for example) to provide a Standby L/C primarily to demonstrate proof of financial responsibility in cases where the license or permit, for example, creates a potential monetary obligation to the State. Many Wisconsin state agencies' regulations make reference to such L/Cs, but only the Department of Natural Resources and the Department of Transportation have prescribed forms.

### **Issuer's Risks**

An Issuer's most obvious risk is its customer's default: failure to reimburse the Issuer after a Draw has been Honored. The reimbursement obligation can be a requirement to deposit funds with the Issuer immediately upon a Draw, but can also be part of an ongoing credit relationship where Draws are simply treated as "advances" on a term or revolving credit agreement.

Issuer banks also face other risks, such as fraud (a legitimate Beneficiary makes a fraudulent Draw), forgery (impostor Beneficiary makes a Draw) and sovereign, regulatory and legal risks. Regulatory issues created by L/Cs involving lending limits, contingent liabilities, off-balance sheet treatment and regulatory capital requirements also come into play but are beyond the scope of this overview.

### **Common Problems**

Among the more common L/C problems we have seen with our Issuer bank clients are:

- Standby L/Cs that incorrectly incorporate provisions of the UCP600 or, less frequently, Commercial/Documentary L/Cs that incorrectly incorporate from the ISP98;
- not being aware of automatic renewal and reinstatement provisions, and potential post-expiry obligations;
- failing to insist on strict adherence to the Presentation requirements, especially if they are incorporated from the UCP600 or the ISP98;
- failing to Honor a proper Draw as an "accommodation" to its customer/Applicant who has informed the bank of a dispute with the Beneficiary; and
- poorly-drafted L/Cs that make inappropriate reference to non-documentary issues.

\* \* \*

Banks issuing L/Cs to assist customers in export-import transactions, or providing proof of financial responsibility or liquidity/credit support, should be aware that their obligations and rights are often not obvious from simply reading the L/C without being familiar with the underlying laws and practice codes that are summarized in this *Update*. As noted above, a carefully-considered and well-drafted L/C protects all parties, including the Issuer.

---

von Briesen & Roper Legal Update is a periodic publication of von Briesen & Roper, s.c. It is intended for general information purposes for the community and highlights recent changes and developments in the legal area. This publication does not constitute legal advice, and the reader should consult legal counsel to determine how this information applies to any specific situation.