

THE LETTER OF CREDIT TRANSACTION:
BASIC CONCEPTS AND
RECENT DEVELOPMENTS

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Working Paper No. 79

Working Paper Series
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I. THE BASIC TRANSACTION

A. Introduction

The letter of credit, as we know the term today, existed in England by the time of the 17th Century when the bill of exchange had matured into an instrument similar to the drafts used today. While the letter of credit was developed to facilitate international commercial transactions involving the sale of goods, there is nothing about letters of credit which limit their application to international trade. They are used in domestic sales transactions, and as a means to secure performance of contracts and obligations other than the sale of goods.

Letters of credit not only serve as a means of payment, but also can provide a financing function, as well as performing some of the functions of a guaranty. Though the functions may differ, the basic elements and parties in each letter of credit transaction are largely the same.

B. The Parties

In a common transaction involving a letter of credit, a buyer of goods (the ACCOUNT PARTY, or in the case of a credit issued by a bank, the bank's CUSTOMER) will cause a bank (the ISSUER) to issue a letter of credit payable to the seller of the goods (the BENEFICIARY). The letter of credit will state that upon presentation to the issuing bank of the letter of credit and accompanying documents specified in the letter, the issuing bank will pay the beneficiary the sum of money set forth in the letter

of credit. The documents which must accompany the letter of credit are often invoices, bills of lading and insurance policies.

The issuing bank is usually located in the place where the buyer does business. The seller often will want a local bank available to which it can present the documents for payment. An ADVISING BANK is one that gives notification to the beneficiary-seller of the issuance of a letter of credit by another bank. The advising bank agrees that the beneficiary will present the letter of credit to it for payment, but it does not assume any obligation to pay the letter of credit. A CONFIRMING BANK is a bank which promises that it will honor a letter of credit issued by another bank, and becomes directly obligated to the beneficiary, as though it had issued the letter of credit itself. The issuing bank remains obligated as well.

C. The Benefits

In the transaction discussed above, the letter of credit provides benefits for both the buyer and seller of goods. The buyer is assured that the seller will not be paid until the proper documents evidencing shipment (and possibly inspection, insurance, etc.) have been presented to the bank. The risk of payment in advance for goods that might never be shipped is thus avoided.

The seller's "credit" risk is minimized. The risk of delivery of goods without payment is minimized. Payment is obtainable shortly after delivery of goods to the carrier. The seller also avoids the prospects of litigation in a foreign court, with the accompanying uncertainties and expense.

D. Three Independent Relationships

All letters of credit involve three relationships:

1. the underlying contract between the account party (buyer of the goods) and the beneficiary of the letter of credit (seller of the goods);
2. the arrangement between the account party and the issuing bank; and
3. the obligation of the issuing bank to pay the beneficiary upon presentation of the documents specified in the letter of credit.

These three relationships in a letter of credit transaction are separate and distinct. The most notable feature of the letter of credit is the independence of the obligation of the issuer from the underlying contract between the bank's customer (buyer of the goods) and the beneficiary (seller of the goods). The obligation of the bank is not conditioned upon performance or nonperformance (perhaps shipment of nonconforming goods) of the underlying contract. The obligation of the bank is limited to the determination of whether the drafts or demands for payment made by the beneficiary comply with the conditions specified in the letter of credit.

E. A Letter of Credit is a Letter of Credit

One of the prime purposes of the drafters of Article Five of the Uniform Commercial Code was to set up an independent theoretical framework for letters of credit, independent of contract, of guaranty, of third party beneficiary law, of the law of assignments, and of negotiable instruments. WHITE and SUMMERS, UNIFORM COMMERCIAL CODE §18-2 (2d ed. 1980).

A letter of credit is not exactly a contract, third party beneficiary contract, an assignment, agency relationship nor a negotiable instrument. While many courts refer to the three relationships in a letter of credit as "three contracts," there is usually no direct contractual relationship between the issuer and the beneficiary. Offer, acceptance and consideration are lacking in the relationship between the issuing bank and the beneficiary, who may be totally unknown to each other prior to the issuance of the credit. Furthermore, letters of credit are independent of contracts directly related to them, are transferable in limited circumstances, and generally do not lend themselves to contract rules regarding performance.

The several leading treatises dealing with letters of credit do not use the contract label, at least in describing the relationship between the issuer and the beneficiary, but recognize that contract law supplements the law of credits to the extent that contract principles do not interfere with the unique nature of credits. [For a discussion of a letter of credit as an executory contract in the case of a debtor-beneficiary in bankruptcy, see part VII, below.]

Although a draft presented with a letter of credit may be a negotiable instrument, the letter of credit itself does not comply with the requisites of a negotiable instrument under §3-204(1) of the Code. It is not payable to order or bearer, and it is typically not unconditional.

II. TYPES OF LETTERS OF CREDIT--COMMERCIAL vs. STANDBY

A. Commercial Letter of Credit

In a commercial letter of credit for the sale of goods, the buyer's bank issues a letter of credit in favor of the seller-beneficiary (as discussed above). The seller draws upon the letter of credit by delivering to the issuing bank an invoice, bill of lading, or similar documents specified by the credit.

B. Standby Letter of Credit

The standby credit performs some of the functions of guaranty. The standby credit secures an account party's legal obligation to the beneficiary. Under the standby credit, the beneficiary may draw upon the credit by submitting the default notice, demand for payment or draft required by the credit. In a case where a unilateral demand or simple draft will suffice, the expression "suicide credit" has been applied.

1. Contrasting Commercial and Standby Credits

The expectations of the parties are exactly the opposite in the two types of credits. The commercial letter of credit (sale of goods) is used as a payment service and is expected to be drawn upon. The standby credit provides a means of securing payment of performance if the bank's customer defaults on the underlying obligation.

With a commercial letter of credit, if the underlying transaction is completed (for example, the shipment of goods), payment is made on the credit. However, with the standby letter of credit, payment will be made if the underlying transaction does NOT go through. The standby credit closely resembles a guaranty, but there are several

important distinctions between the two [discussed in II.B.3, below].

2. Frequent Uses of Standby Credits

Standby credits became an increasingly important commercial device in the years following World War II. A review of the cases and financial literature suggests the principal growth in the use of letters of credit in the past 20 years has occurred in the use of standby letters of credit.

The standby credit can be used in domestic or international transactions to guarantee the obligations of a particular party. Some of the many ways in which standby credits are used are:

- a. To insure payment or performance in construction financing;
- b. To ensure payment in real estate transactions;
- c. To guarantee performance under leases or real and personal property; and
- d. To facilitate stock transfers, stock purchases and corporate consolidations.

Standby credits are also used in the sale of goods (bringing the standby credit close to the function of a commercial credit), where the seller bills the buyer directly and draws upon the credit only if the buyer fails to honor the invoice.

3. Standby Credit Compared to Guaranty

National banks lack the authority to act as guarantors for the performance of contracts made by others.

However, it is well established that a letter of credit is not a guaranty. The three federal government agencies that regulate banks have recognized that banks have the authority to issue standby letters of credit. Careful drafting of a standby letter is necessary to avoid it being characterized as a guaranty.

- a. An instrument is a standby letter of credit if "the issuer has a primary obligation that is dependent solely upon presentation of conforming documents [or demands for payment] and not upon the factual performance or nonperformance by the parties to the underlying transaction." Republic Nat'l Bank v. Northwest Nat'l Bank, 578 S.W.2d 109, 115 (Tex. 1979). In this circumstance there is no need to determine liability on the underlying contract since the letter of credit is purely documentary.
- b. If the conditions of compliance are phrased in factual, rather than documentary terms, the honoring of the instrument becomes contingent upon some occurrence or nonoccurrence which can only be determined by inquiring into the status of the underlying obligation. Such a transaction would take on the characteristics of a guaranty, rather than a letter of credit.

III. THE SOURCES OF LAW

Other than state and federal banking statutes, two bodies of law govern most of the issues which arise in a letter of credit transaction: Article 5 of the Uniform Commercial Code (the UCC) and the International Chamber of Commerce's Uniform Customs and Practice for Documentary Credits (the UCP). The UCC and the UCP are generally, but not completely consistent. Each covers areas not covered by the other. Both stress the first principle of letter of credit law, which is that the credit engagement is independent of the underlying contract.

A. The UCC--Article 5

UCC Article 5 was adopted in Alabama as §7-5-101 through 7-5-117. UCC Article 5 expressly states that it does not purport to provide a complete statutory regulation of letters of credit (§7-5-102(3)). More importantly, in Alabama, New York and Missouri, §5-102(4) was added which states:

Unless otherwise agreed, this article 5 does not apply to a letter of credit or credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the thirteenth or by any subsequent congress of the International Chamber of Commerce.

Thus, in Alabama, Article 5 does not apply to a letter of credit if by its terms or by agreements, course of dealing or usage of trade it is subject in whole or in part to the UCP. However, the wording of the amendment does not preclude the parties to a letter of credit from stipulating that Article 5 governs.

B. The Uniform Customs and Practice for Documentary Credits

Since the early 1930's, the International Chamber of Commerce has promulgated a set of rules, applicable to both domestic and international letters of credit, for the purpose of creating uniformity in the treatment of documentary credits and facilitating trade. American banks played a major part in promoting these international rules for commercial credits.

These rules, set forth in the Uniform Customs and Practice for Documentary Credits (UCP) were first published in 1933, with revisions being issued in 1951, 1962, 1974 and 1983. The 1962 revision was the first to achieve global acceptance.

Issuers of credit, primarily banks, commonly specify in the credit that such credit is subject to the UCP. This may occur in purely domestic, as well as international letter of credit transactions. Even though the UCP is not expressly incorporated by reference into the credit, the UCP may still apply either because it evidences a specific custom, or because of §5-102(4).

The 1983 revision of the UCP (adopted fifty years from the first edition) became effective on October 1, 1984. The revision is contained in ICC Pub. No. 400. The revision does not contain any radical changes in credit transactions. The changes incorporated in the 1983 revision relate primarily to transport documentation, banking obligations and certain procedures regarding payment, acceptance and negotiation. No new anti-fraud provisions were added.

While a brief presentation of the principal changes made by the 1983 UCP will be made below, a detailed study of the differences between the 1974 and the 1983 UCP may be found in Cannon, "The

Uniform Customs and Practice for Documentary Credits: The 1983 Revision," 17 U.C.C.L.J. 42 (1984), and Wheble, "Documentary Credits: UCP 1974/1983 Revisions, Compared and Explained," ICC PUB. NO. 411.

IV. THE 1983 UCP REVISIONS (EFFECTIVE OCTOBER 1, 1984)

A. The Revocability Presumption

1983 UCP art. 7 maintains the presumption that any letter of credit not labeled revocable or irrevocable is deemed revocable. A revocable credit may be amended or cancelled by the issuing bank at any moment without prior notice to the beneficiary.

Most letters of credit issued by banks are irrevocable. Revocable letters of credit in either domestic or international transactions are not common.

B. Standby Credits

The revision explicitly applies the UCP to standby letters of credit. 1983 UCP art. 1. This addition is important because the applicability of the UCP to standby credits had been questioned by a number of courts and commentators.

C. Amendments to Credits

Several changes serve to make clear that rules applicable to original credits also apply to amendments. 1983 UCP art. 5.

D. Transport Documents

Under the prior rules, it was frequently unclear whether a bill of lading would be acceptable if it was issued by someone other than the shipping company. In Article 25 of the 1983 revision, this problem is solved by providing that transport documents are to be issued by an institution that assumes the responsibility for shipment of the goods. The party responsible for shipment is thus identified, but it is also recognized that the responsible party may contract with various individual carriers. However, a substitute document cannot suffice in a transaction where the letter of credit requires the original document prepared by a particular carrier.

E. The Nature of Documents Presented

The 1983 UCP art. 22 provides that documents that are produced as carbon copies or by such processes as photocopying may be accepted as originals by banks.

F. Rights and Obligations of the Issuing Bank

Article 21 of the 1983 UCP provides a number of new provisions regarding the rights and obligations of the issuing bank in relation to paying, accepting and negotiating banks.

G. Fraud

One of the most pressing issues before the committee that drafted the 1983 revision of the UCP was a movement to more

clearly define the rights and duties of all parties in letter of credit transactions involving fraud, particularly in cases of the deliberate shipment of nonconforming goods in the contract underlying the letter of credit. However, the committee did not choose to alter the relevant provisions of the UCP. Under Article 15 of the 1983 revision, the obligation of the bank is limited to an examination of all documents, exercising reasonable care to ascertain that the documents appear on their face to be in accordance with the terms and conditions of the credit. The lack of any real device or procedure to halt fraud in the underlying transaction, without impairing the independence of the letter of credit obligation, accounted for the decision to avoid revisions in the UCP on this issue. As noted in the Foreward to the 1983 revisions, "... fraud originates when a commercial party first contracts with a rogue, and that the documentary credit merely pays for the commercial transaction and cannot 'police' it." [A more thorough discussion of "fraud in the transaction" is discussed in part VI, below.]

V. FORM OF THE LETTER OF CREDIT

A. Signed Writing

A letter of credit should be in writing and signed by the issuer. UCC §5-104(1). Under the UCC, a "telegram" may be a sufficient signed writing if it identifies its sender by an authorized authentication (which may be in code). Under the UCP,

a "teletransmission" or a "cable, telegram or telex" will be the operative credit unless it states "details to follow" or states that mail confirmation is to be the operative credit. See 1983 UCP art. 126.

B. Payment Against Documents

A letter of credit should provide for payment only against presentment of carefully defined documents. The credit should be drafted to be self contained, insulating the issuer from involvement in any disputes between the account party and the beneficiary. UCC §5-103(1)(a), 5-109(2) and 5-114(1). 1983 UCP arts. 4, 15 and 16.

C. Revocable or Irrevocable

The letter of credit should indicate whether it is revocable or irrevocable. While the UCC does not specify whether an unlabeled credit is revocable or irrevocable, the UCP specifies that all credits should be labeled, and in the absence of such indication, the credit shall be deemed revocable. 1983 UCP arts. 7(b) and (c).

D. Payment

All credits must clearly indicate whether they are available by sight payment, by deferred payment, by acceptance or by negotiation. 1983 UCP art. 11.

E. Expiration

All credits must specify an expiry date for presentation of documents. 1983 UCP art. 46.

F. Transferable?

The letter of credit should indicate whether it is transferable. It will not be transferable unless so designated. 1983 UCP art. 54(b).

G. Partial Drawings or Shipments

The letter of credit should specify whether partial drawings and/or shipments are to be allowed. They will be allowed unless the credit stipulates otherwise. 1983 UCP art. 44.

H. UCP or UCC

The letter of credit should specify whether the credit will be governed by the UCP or the UCC.

VI. FRAUD OR FORGERY

A. Independence

The letter of credit is an independent contract, to be construed in accordance with its own terms, without reference to any other contract. UCC §5-109 and 5-114(1). 1983 UCP arts. 3, 4, 16 and 17.

B. Issuer's Duty to Honor

The issuer who refuses payment is generally liable for wrongful dishonor unless it can show either:

1. that the documents do not appear on their face to comply with the terms of the relevant credit, or
2. that the case falls within one of the recognized exceptions excusing honor in UCC §5-114(2).

C. UCC §5-114(2)

Under UCC §5-114(2), the issuer may lawfully refuse honor, if:

1. the documents are in fact forged or fraudulent, or
2. there is in fact "fraud in the transaction."

The most frequently litigated section in Article 5 is §5-114. Most of the litigation under §5-114(2) has resulted from the attempts by customers to enjoin payment. To enjoin payment, the customer must fit the case within one of the exceptions listed in §5-114(2) and show that the remedy at law is inadequate.

Although the UCP is silent on the availability of remedies to a plaintiff alleging that fraud is involved in a beneficiary's demand on a letter of credit, courts in the United States have consistently held that the applicability of the UCP rather than the Code "does not bar the relief provided for in 5-114 of the

Code." See Comment, "Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases," 21 HARV. INT'L L. J. 189, 202 (1980).

D. Forged or Fraudulent Documents

Presumably, a forged document is one that includes forged signatures, and a fraudulent document is one that has been materially altered. This provision in §5-114(2) codified pre-Code law.

E. "Fraud in the Transaction"

Neither the Code nor the UCP provides a definition of "fraud in the transaction." It is widely assumed that the "fraud in the transaction" language in §5-114(2)(b) codified the case of Sztejn v. Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (1941), where the documents called for bristles, but the goods shipped consisted of cases of cowhair and other rubbish. The issuer became aware of the nature of the shipment before honor, and the court enjoined honor at the request of the issuer's customer. The analysis in Sztejn eroded the long standing independence principle of letter of credit law. To launch into an inquiry of compliance or noncompliance with the underlying contract threatens the essential nature and utility of a letter of credit.

F. Breach and Failure of Consideration

Mere breach of warranty by the beneficiary, or failure

of consideration, should not justify dishonor under §5-114(2), even then the issuer knows of the breach in advance and the fact is not disputed.

G. For the most part, courts have refused to enjoin payment absent "a clear showing of intentional fraud," or "evil intent," as opposed to a dispute over performance of a contract. See KMW International v. Chase Manhattan Bank, 606 F.2d 10, 16 [27 UCC Rep 203] (2d Cir 1979); United Technologies Corp. v. Citibank, N.A., 469 F. Supp. 473, 478-79 [27 UCC Rep 212] (S.D.N.Y. 1979).

H. Letter of Credit Problems--Iran

Prior to the overthrow of the Shah, many U.S. companies had contracted with the Iranian government to supply goods and services. Most of the contracts were backed by standby letters of credit issued by U.S. banks for the government of Iran. After the seizure of the American embassy and near total disruption of commercial relations between the two countries, the Iranian government began submitting certifications that U.S. companies had breached their contracts and demanded payment under the letters of credit. Many U.S. companies sought injunctions against honor, claiming that the certifications were fraudulent, and that if the credits were honored, they had no legal remedy. Although some U.S. courts granted injunctive relief, many did not.

I. The Eleventh Circuit affirmed an injunction of payment in Harris Corp. v. National Iranian Radio and Television, 691 F.2d

1344 (11th Cir. 1982). The court read "fraud in the transaction" broadly to "encompass any type of fraudulent conduct in the letter of credit transaction," and stated that §5-114(2) encompasses "fraud external to the complying documents." The court inferred fraud in Iran's demand and assertion of default, which were at odds with the revolutionary conditions that halted performance, as well as contractual terms allowing termination for force majeure.

J. In KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10 (2d Cir. 1979), the Second Circuit expressed an unsympathetic view toward the issuance of injunctions, by stating that "when [the plaintiff] entered into its contract with the [Iranian government agency] it assumed the business risks of international transactions [The plaintiff] has previously subjected itself to the risks and hazards of foreign political turmoil." The Second Circuit vacated a preliminary injunction against payment but directed the bank to furnish three days written notice of any demand for payment.

K. For an excellent discussion of the litigation resulting from the Iranian conflict, along with a discussion of precautions to be considered in the structuring of standby credits, see Kimball and Sanders, "Preventing Wrongful Payment of Guaranty Letters of Credit - Lessons From Iran," 39 BUSINESS LAWYER 417 (1984).

VII. LETTERS OF CREDIT AND BANKRUPTCY

A. Introduction

The increase in recent years both in business bankruptcy filings and the use of standby credits has brought together bankruptcy and letter of credit law in a number of cases. Most of the cases result from efforts to enjoin issuers from paying, and beneficiaries from drawing under letters of credit. The cases involve both debtor-account parties and debtor-beneficiaries.

B. The Problem Case

In the case of In re Twist Cap, Inc., 1 Bankr. 284 (Bankr. D. Fla. 1979), a chapter XI debtor sought and obtained a preliminary injunction against its bank from honoring letters of credit issued for the account of the debtor, which were secured by property of the debtor. The court held that to permit the beneficiaries under letters of credit to receive a payment on a prepetition debt would amount to preferential treatment. The holding was not appealed because the debtor subsequently consented to the honoring of the letters of credit. Courts in subsequent cases have NOT followed Twist Cap, and the decision has been uniformly criticized by commentators.

C. In In re MJ Sales & Distributing Co., 25 Bankr. 608 (S.D.N.Y. 1982), the court held that no preference occurs when

the payment depletes the assets of the issuer and not those of the debtor-customer.

D. "Property of the Estate"

A letter of credit and its proceeds are not "property of the estate" within the meaning of 11 U.S.C. 541, and therefore the payment of a letter of credit is not a transfer of assets in violation of the automatic stay provision of 11 U.S.C. 362. The letter of credit and its proceeds constitute property of the bank. See In re Page, 18 B.R. 713 (D.D.C. 1982); In re Elegant Merchandising, Inc., 41 B.R. 398 (S.D.N.Y. 1984).

E. The debtor could not avoid properly perfected liens granted to secure a contingent liability created by a prepetition letter of credit, since the transfer of the debtor's property took place at the time the letter of credit was issued and liens were granted, and not when the issuer of the letter of credit paid the draft after the debtor filed. The act of paying merely converted the issuer's claim from contingent to fixed. In re Briggs Transportation, 37 B.R. 76 (D. Minn. 1984).

F. Bankrupt Beneficiary

In In re Swift Aire Lines, Inc., 30 B.R. 490 (9th Cir. B.A.P. 1983), the Bankruptcy Appeals Panel for the Ninth Circuit viewed the letter of credit as an executory contract to make a financial accommodation which the trustee could not assume

under Section 365(2)(2). The Panel also held that the trustee could not draw under the credit because the letter of credit required submission of a statement signed by the corporate secretary. The office ceased to exist upon bankruptcy. Swift Aire is on appeal to the Ninth Circuit.

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