Letters of Credit

Outline

1. Structure of LOC: parties involved
2. Structure of LOC: Laws and types
3. Structure of LOC: Walk-through
4. Structure of LOC: Principle of independence
5. Legal Concerns: Doctrine of Strict Compliance
6. Legal Concerns: Fraud
7. Variations on a theme
8. Questions
Structure of LOC: parties involved

- **Applicant** - the party that requests the letter of credit is opened, usually the buyer.
- **Beneficiary** - the party for whom the letter of credit is opened, usually the seller.
- **Issuer** - the original bank that opens the letter of credit, often a local bank that has a finance relationship with the buyer.
- **Carrier** - a shipper of goods.

Structure of LOC: parties involved

- **Nominated person** - a party the issuer selects to pay, negotiate, or accept documents under the letter of credit and agrees to do so.
- **Advisor** - a party who, at the request of the issuer, informs the beneficiary that the letter of credit has been issued.
- **Confirmmer** - a nominated person who honors the presentation of the documents for the letter of credit.
Structure of LOC: Laws and types

- UCC Article 5: Letters of Credit, narrow rule set.
- UCP-Uniform Customs and Practice for Documentary Credits, nonbinding international law that deals with letters of credit, it has been used as a default rule in US courts, broad rule set.
- Commercial LOC- a payment mechanism.
- Standby LOC- serves as a guarantee.

Structure of LOC: walk-through
Structure of LOC: Principle of independence

Basic LOC involves 3 transactions:
1. Buyer and Seller enter a contract for the sale of something.
2. Buyer and issuing bank enter an agreement for Buyer to pay bank for issuing the LOC.
3. Issuer has agreement to pay Seller.
The principle of independence is that these 3 transactions must be viewed by the courts as separate contracts.

Structure of LOC: Principle of independence

- Banks are in the business of money and documents, not goods.
- Commercial LOC are not surety bonds.
- The purpose of the LOC is to make sellers more comfortable when they ship away their goods.
- The benefit of the LOC is the credit risk shifts, the bank is at risk for default by the buyer and the seller is at risk for default by the bank.
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**Legal Concerns: Doctrine of strict compliance**

- Bank must honor LOC and pay beneficiary upon presentation of the documents.
- Documents must be in strict compliance with the terms of the LOC.
- Strict compliance- court rule: would a reasonable banker take on expense to investigate the mistake?
- Banker safe harbor in party names and insurance numbers.
- May ask for waiver.
- May dishonor.
Legal Concerns: Fraud: Bank created remedies

- UCC §5-109: If “a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or the applicant… the issuer, acting in good faith, may honor or dishonor the presentation” unless any of the following conditions are met, in which case the issuer must honor.

The issuer shall honor presentation if:
1. Honor is demanded by a nominated person who has given value in good faith; or
2. A confirmer who has honored its confirmation in good faith; or
3. A holder in due course of a draft drawn on the LOC after the LOC was issued; or
4. An assignee for value of a deferred obligation without notice of fraud.
Legal Concerns: Fraud: Court remedies

A court may enjoin payment on an LOC if:
1. Relief is not prohibited under law,
2. The party at risk of loss is adequately protected with a bond,
3. All conditions that entitle a party to relief under State law have been met,
4. The party demanding honor is not a protected party under the bank relief section, and
5. The applicant is more likely than not to succeed in proving material fraud.

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Variations on a theme: revolving

- Sometimes called “turn key”
- Small amount
- No, or few documents
- Controlled by applicant

Variations on a theme: Standby

- Applicant is the seller
- Guarantee that goods are sold
- Active upon breach
- Unilateral power to call debt are called suicide LOC
- Good idea to require an audit
- Banks cannot guarantee
- Similar to indemnity clause
- Counts against capital requirements