I. Introduction

Letter of credit bankers at large money center banks and their in-house counsel have a distinct advantage when it comes to knowing the rules, customs and practices that govern or define letter of credit transactions. Letter of credit activity in this country is concentrated in a handful of large banks, allowing them to capitalize on their expertise. Those banks issue, advise, confirm, negotiate and examine documents presented on hundreds of letters of credit every day. They have well-trained employees, some with 20 years or more of experience in letter of credit banking. Letter of credit bankers regularly attend internal staff meetings to discuss letter of credit developments and occurrences, control risk and refine practices. Their attorneys are well-versed in letter of credit rules and law, have carefully prepared and reviewed the bank’s letter of credit forms, agreements and procedures and are available to advise their bank clients on letter of credit problems and issues as they arise. Letter of credit bankers attend and participate in letter of credit conferences presented by experts and specialists from other major banks, the IIBLP, the IFSA, the ICC, the USCIB and private trade specialists. They take

1 Although there are over 7,000 banks in the United States, 10 banks account for well over half the dollar amount of all outstanding letters of credit issued by U.S. banks. JPMorgan Chase Bank alone accounts for almost $100 billion face amount of standbys issued and outstanding as of the end of the third quarter of 2006. See Doc. Credit World (Feb. 2007).

2 Institute for International Banking Law and Practice. The IIBLP was instrumental in the drafting of the International Standby Practices or ISP, publishes salient works on letters of credit, and holds major seminars on letter of credit practice and law throughout the world. Their website is www.iiblp.org.

3 International Financial Services Association. The IFSA membership is composed primarily of banks, including the largest U.S. banks and most of the major banks of the world with branches or banking subsidiaries in the United States. IFSA members handle over 98% of the letters of credit issued in the United States and over 98% of the U.S. funds transfer volume. The IFSA represents the international operations of financial services providers with particular emphasis on trade payments involving documentary credits, funds transfer, treasury operations, compliance and regulatory reporting. The IFSA regularly sponsors and conducts educational programs and conferences on payments, collections and letters of credit at the regional and national levels.

4 International Chamber of Commerce. The ICC, through its Committee on Banking Technique, has promulgated the Uniform Customs and Practice for Documentary Credits (the “UCP”) which gets revised about every ten years. The latest version of the UCP is the UCP 600. The ICC publishes commentary and supplement guides for the UCP. Their website is www.iccwbo.org.
letter of credit training courses, tutorials and exams to become certified documentary credit specialists ("CDCS"). They subscribe to and review letter of credit publications such as the IIBLP’s *Documentary Credit World* or the ICC’s *DC Insight*. Finally, standard letter of credit practices used to supplement applicable letter of credit regimes are based on what letter of credit banks themselves do on a regular basis.

The purpose of this presentation is to provide attorneys that do not practice frequently with letters of credit with practical legal advice on how to use letters of credit. This presentation explores rules, practices or practice pointers dealing primarily with standby letters of credit as opposed to commercial letters of credit. Most lawyers that only occasionally have contact with letters of credit in their practice, have situations that involve standby letters of credit. Standby letters of credit frequently involve negotiated, agreements and larger dollar amounts where lawyers tend to be more involved. Except perhaps to enjoin a fraudulent draw, most attorneys do not normally have much contact with commercial letters of credit used to pay for goods shipped in international trade. Unless there is a dispute over a commercial letter of credit leading to litigation, applicants and beneficiaries usually seek assistance, not from lawyers, but from experienced letter of credit bankers, international factors, freight forwarders, document preparation services, trained export-import staff, or other trade specialists.

II. **What is a letter of credit and how is it used**

A. **Types.** There are two major types of letters of credit: standby letters of credit used to secure payment or performance of an obligation, and commercial letters of credit used to pay for goods in international trade. Commercial letters of credit were frequently used in the late 1800s and their use became widespread after World War I with the growth of international trade. Standby letters of credit acquired use in the 1960s for certain types of financings, such as real estate developments, shipbuilding and Middle East infrastructure projects and gained widespread use and recognition in the 1970s. See Paul R. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 Stan. L.Rev. 716 (May 1973); John R. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* (A.S. Pratt 2002) ¶¶ 3.05 & 3.06.

---

5 The United States Council for International Business. The Banking Committee of the USCIB educates its members and promotes their interests on international trade finance issues, including the UCP 600, documentary collections, and dispute resolution.

6 Becoming a CDCS requires some 4-6 months of independent study and passing a 3 hour examination consisting of 120 multiple choice questions as well as 3 “in basket” exercises with questions which demonstrate skill in real-world applications of the UCP. The IFSA has a training course and exam for letter of credit personnel to become a Certified Documentary Credit Specialist. The ICC sponsors an on-line training program and discussion groups called DC Pro. Private trade firms such as Mantissa and Sitpro also offer letter of credit training.

7 UCC §5-108(e) provides that an issuer shall observe standard practices of financial institutions that regularly issue letters of credit. The ISP rules are to be interpreted as mercantile usage with regard for practice and terminology of banks and businesses in day-to-day transactions and consistency within the worldwide system of banking operations and commerce. ISP Rule 1.03(b) & (c). Compliance of documents presented with the credit terms are determined by international standard banking practices as reflected in the UCP. UCP 500, Art. 13(a). A complying presentation under UCP 600 is one that is in accordance with the terms and conditions of the credit, the applicable UCP articles and international standard banking practice. UCP 600, Art. 2.
1. **Commercial Letters of Credit.** Commercial letters of credit are always drawn upon to effect payment against live documents such as bills of lading, insurance certificates, invoices, inspection certificates and customs invoices. Upon presentation of conforming documents, the seller receives through the network of letter of credit banks involved, payment and the buyer receives control of the goods ordered. The issuing or negotiating bank receives a security interest or title to the goods until it is reimbursed, unless it chooses to release those documents to the applicant or issuer before it is reimbursed.

   a. Almost all commercial letters of credit are governed by the Uniform Customs and Practice for Documentary Credits or UCP promulgated by the International Chamber of Commerce (the “ICC”). The current version is UCP 600 named after the ICC publication number in which the UCP is found. The UCP 600 was adopted in October of 2006 by the ICC Banking Commission and became effective on July 1, 2007. Although the UCP 600 still has some shortcomings, most bankers, applicants and beneficiaries find it more user-friendly than the UCP 500 and have accepted its use in commercial letters of credit.

   b. Commercial letters of credit are usually of short duration – ninety days or less. Their duration is only long enough for the seller to procure or manufacture and ship goods ordered. If the goods are not shipped within a time certain, as shown by the documents called for by the letter of credit such as a bill of lading, then the letter of credit cannot be drawn upon.  

   c. Commercial letters of credit are characterized by high discrepancy rates due to a combination of (i) the complex nature and variety of the documentation involved in cross-border shipping, (ii) the lower level personnel involved in preparing them (frequently with language and translation issues), (iii) the technical nature and detail of the rules under the UCP for determining the compliance of the documents with the documents described or specified in the letter of credit, and (iv) the strictness with which the UCP’s rules for determining compliance of the documents with the credit are applied (the “strict compliance standard”).

---

8 The default rule under the UCP is that the shipping documents show that the seller has delivered the described goods to a carrier at a designated shipping point for its intended destination within 21 days from the date of issuance of the letter of credit. UCP 500, Art. 43; UCP 600, Art. 14(c). If the seller does not want this rule to apply, it should negotiate for a longer period or request that the letter of credit permit presentation of stale documents.
2. **Standby Letters of Credit.** Standby letters of credit are used primarily to assure payment of financial obligations. Thirty of the various types of obligations which standbys are used to secure are listed below in Section II.C. Standby letters of credit are usually but need not be longer term than commercial letters of credit. The amounts involved can be quite large. Standbys are divided into two major subtypes: true or traditional standbys and direct pay letters of credit.

a. A true or traditional standby letter of credit is worded to call for a default certificate or statement certifying or stating that a default has occurred in the payment of the underlying obligation that the standby is issued to secure.

b. A direct pay letter of credit is priced and risk-assessed like a standby, but is meant to be drawn upon to satisfy the obligation which it secures. Direct pay letters of credit are used instead of a traditional standby to provide the beneficiary with better protection against preferences under Section 547 of the Bankruptcy Code. (See below.) If the beneficiary receives payment from the issuing bank, the payment is not normally subject to avoidance as a preference even if the applicant files for bankruptcy within 90 days after the payment is made through the letter of credit. That is because the courts have determined that the beneficiary receives funds of the issuer and not the bankrupt applicant so that there is no “transfer” of property of the debtor when the letter of credit is drawn upon within the meaning of Section 547 of the Bankruptcy Code. Direct pay letters of credit are frequently used to secure municipal bond issues and commercial paper issuances.

c. Once drawn upon, some direct pay standby letters of credit provide that they automatically reload by the amount drawn unless the issuer gives written notice within a designated time after the draw to the beneficiary that it will not reload the letter of credit. These types of standbys are used to

---

9 A famous case illustrating this point is *In re Powerine Oil Co.*, 59 F.3d 969 (9th Cir. 1995). Justice Kozinski in his opening remarks in the case stated: “Can an unsecured creditor be better off when the debtor defaults rather than paying off the debt? Yes, truth can be stranger than fiction in the Preference Zone.” The case involved a traditional letter of credit posted to secure oil shipment payments. When payment was late, instead of drawing on the letter of credit, the seller accepted late payment during the preference period. Those payments were attacked and partially set aside as preferential. The creditor would have been better off drawing on the letter of credit to effect payment, avoiding a preference. Better yet, the use of a direct pay letter of credit would have avoided the preference issue altogether since even payments made on time would be paid through draws on the letter of credit and there would be no need to prove that the payment was made in the ordinary course of business (an exception or defense against a preference challenge) as opposed to having been made under circumstances involving financial distress of the debtor.
secure rated or structured debt issues so that again, the beneficiary will not be subject to preferences.

B. **Definition.** A letter of credit is an independent undertaking by an issuer, issued at the request of or for the account of an applicant to honor, usually by payment, a beneficiary’s timely presentation of documents which conform to the terms of the credit. UCC 5-102(a)(10).

1. **Two-party letters of credit.** A financial institution can issue a two-party letter of credit, i.e., one for its own account such as a bank acting both as trustee for industrial revenue bondholders and as an issuer of a letter of credit securing the IRD bonds issued. Id.

2. **Issuers are usually banks.** Although not required by Article 5 of the Uniform Commercial Code, an issuer is usually a financial institution, usually a bank, as opposed to a corporation or business. Individuals are not permitted to issue letters of credit for personal, family or household purposes. UCC 5-102(a)(9).

   a. Sometimes major merchants such as Target or Walmart will issue their own two-party letters of credit to suppliers, especially Chinese Suppliers or their middlemen. These documents look like letters of credit, and are frequently advised through legitimate major banks. The suppliers usually accept these “letters of credit” by manufacturing and shipping the goods. However, they frequently contain conditions controlled by the applicant-issuer such as a certificate of approval from the applicant that the goods conform to the order. This means the applicant has the final right of approval of whether a drawing will be allowed under its “letter of credit.” Merchant letters of credit also include a lot of additional fees and charges.

   b. A major retailer bankruptcy or major litigation challenging these “letters of credit” could undermine their use. However, they seem to be working for the large retail chains because of their command of the marketplace.

3. **Formalities.** Letters of credit, their amendment, advice and confirmation must be in writing or evidenced by a record and authenticated by a signature or by an authentication method authorized by the parties or standard letter of credit practice. UCC 5-104.

   a. As noted below under SWIFT, letters of credit issued internationally are frequently issued and authenticated through SWIFT based on codes, conventions and data filled
in designated fields by the issuing bank. The advising bank then will produce from this coded message, a document that will look like a standard letter of credit.

b. In 2002, the International Chamber of Commerce promulgated an addendum to the Uniform Customs and Practice for Documentary Credits called the eUCP. This addendum contemplates electronic presentation (not just fax presentation) of documents to effect a draw. It is not used much in practice, as the international trade industry, including shipping lines, insurers, bankers, and major industries, struggle with how to electronify bills of lading in a safe and internationally acceptable manner. The problem is that almost 200 nations of the world have their own laws, many of them paper based, and in almost all cases, they have no laws at all governing electronic documents.

C. **Uses** -- Commercial letters of credit are used to pay for goods sold and delivered in international trade. Standby letters of credit can be used to support or pay almost any type of underlying obligation. Standby letters of credit have been used to secure obligations in connection with the following types of transactions:

1. Workmen’s compensation insurance fronting arrangements
2. Surety bonds
3. Commercial paper
4. Municipal or IRD bonds
5. Power plant construction
6. Other construction contracts
7. Open account indebtedness
8. Government permits
9. Government contracts
10. Cable installation obligations
11. Purchase price holdbacks
12. Advance payment guarantees
13. Bank guarantees
14. Environmental clean-up
15. Executive compensation
16. Reinsurance obligations of nonadmitted reinsurers
17. Financial contracts such as SWAPs
18. Forward Contracts (e.g., power purchase agreements)
19. Clearing obligations (e.g. Chicago Mercantile Exchange)
20. Road and subdivision improvements
21. Obligations to consumers or the public
22. Supersedeas in lieu of appeal bond
23. Pre-judgment attachment security
24. Injunction security
25. Preliminary arbitration awards
26. Office lease security
27. Equipment lease security
28. Securitizations
29. Oil for food and medicine (Iraq)
30. Exchange of prisoners (Cuba)

D. **Largest Dollar Amount Use** -- Although there are dozens of different uses for letters of credit, besides their use for payment of the export purchase of goods sold in international trade, the largest dollar amount uses for letters of credit are standby’s posted as security for the following types of obligations:

1. Municipal bond issues;
2. Foreign bank guaranties;
3. Obligations of foreign reinsurers to U.S. insurance companies and sureties;
4. Indemnities by private business to insurance companies fronting workmens compensation and other types of state mandated insurance.

E. **Standby Letter of Credit Volume** -- According to the FDIC, U.S. banks and thrifts and U.S. branches of foreign banks had issued and outstanding approximately $550,000,000,000 in standby letters of credit at the end of the second and third quarters of 2005.\(^\text{10}\)

F. **Commercial Letter of Credit Volume** -- Over $1,000,000,000,000 of goods sold and shipped in international trade is paid for each year by use of letters of credit.\(^\text{11}\)

G. **Largest Letters of Credit Issued** -- The largest letters of credit issued include the severally issued letter of credit posted by AT&T to act as supersedeas for the $1.9 billion judgment obtained against it by MCI in an anti-trust case filed and tried in the Northern District of Illinois, and a letter of credit in excess of $5 billion posted by Exxon to secure payment of the judgment against it arising out of the Exxon-Valdez oil spill case. Each of these letters of credit were severally issued by a consortium of banks.

---

\(^{10}\) $345,775,191,000 issued by U.S. banks outstanding as of end of the third quarter 2005; $194,204,347,000 issued by U.S. branches of foreign banks at the end of the second quarter 2005; and $5,382,097,000 issued by thrifts as of the end of the third quarter 2005.

\(^{11}\) This figure is an extrapolation of the estimated amount of annual world trade ($10,000,000,000,000) times the amount of world trade paid through commercial letters of credit (11%). The amount of commercial letters of credit issued and outstanding in the United States at any one time is only about one-tenth of the amount of standbys issued and outstanding. The figure for the total amount of commercial letters of credit issued in a year is larger than the standby figure because (i) commercial LC’s have a relatively short duration (90 days or less), so that annually many more are issued (and expire) during a year than are outstanding at any given time, and (ii) the figures for commercial LC’s include those issued by banks all over the world and not just from the U.S.
III. What Distinguishes Letters of Credit from Other Types of Credit Enhancements

A. Primary Alternatives to Letters of Credit:

1. Surety or performance bond -- Bonds are issued by insurance companies. Most do not have expiration dates, although their coverage period for claims can be specified in the bond. Their payment of a claim goes through a claims review process, and unlike letters of credit, the surety can raise the defenses of the primary obligor against payment on the bond. This can lead to litigation which must be completed or settled before payment is effected. The pricing of a bond is usually lower than that for a letter of credit, but frequently the bonding company will require that a letter of credit be issued to it by a major rated bank that can easily be drawn on and will be extended indefinitely until the insurer chooses to draw on it or release it. Thus the primary obligor ends up paying two fees – a premium for the issuance of the bond, and the annual and other fees for issuance of the letter of credit.

2. Financial guaranty insurance. Financial guarantee insurance is issued by a handful of what are known as monoline insurance companies that until recently had AAA ratings. The cost of financial guaranty insurance was generally very low, but these monoline insurers usually would only insure obligations of government agencies that had taxing power to repay the insured debt, or they insured debt of companies that already had a credit rating of A or would have such a rating if rated. The purpose of the use of this type of insurance is to move the rating of the insured debt from say “A” to “AAA” to enable it, with the higher rating, to command a lower interest rate in the financial marketplace for rated bonded debt. This mean that only very large debt issues are insured, because the debt has to be rated, underwriting analysis performed, and then the say 50 basis pints savings involved has to justify the cost of the insurance, obtaining and maintaining a debt rating and other costs of the underwriting. Monoline insurers would thus insure specific debt issues only of governmental agencies, large corporations with good credit ratings or with debt that could structured with the use of a special purpose vehicle as having a separate good rating. Monolines thus insured debt securities of subprime mortgage pools which were underwritten with assumptions that did not contemplate the default rates.

---

foreclosures and decline in real estate values of the subprime mortgage crisis. The result of their insuring mortgage backed securities is that almost all monolines have suffered a decline in their AAA ratings or their ratings are under review by the rating agencies with negative implications. Unless they raise sufficient capital to shore up their ratings, financial guarantee insurers will be unable to compete in the markets from which they generate the bulk of their business – raising a rating of a debt issue from A to AAA. One result of the decline of the ratings of the monolines has been a reported uptick in letter of credit backed bonds that previously were insured.

3. **Export insurance.** Export insurance is a strong competitor with commercial letters of credit for international trade payment assurance. Export insurance guarantees, with a number of exceptions, against a credit default by the buyer in an international sale of goods or services. To qualify for the insurance, both the exporter and the foreign buyer must be on approved lists of the export insurers, the trade credit extended must be within limits specified by the insurer for the particular buyer, and the terms of the sale otherwise must conform to the terms of export insurance policy. The export insurer insures against nonpayment due to insolvency and political or country risks, but does not insure or pay if nonpayment is due to disputes over the quality of the goods shipped, their conformity to contract terms, or the timeliness of their delivery. Export insurance is usually less expensive than the cost of letters of credit, but obtaining export insurance involves pre-approval and documentation processes that are burdensome. State and federal government export insurance programs are also available to encourage U.S. exporters to sell on credit into specified international markets subject to the conditions and criteria specified in the respective government export insurance program.13

4. **Documentary Collections.** Documentary collections are simply the payment for goods shipped in international trade against specified shipping documents, again through the banking system. If the buyer does not pay, the bill of lading and control of the goods remains with the seller and the seller’s bank. While cheaper than letters of credit, documentary collection does not assure the seller that it will receive payment when it ships the goods. The seller therefore may be stuck with unsold goods overseas in a declining market or without ready means to dispose of the goods.

---

13 The U.S. government’s program is through the Export-Import Bank or Ex-Im Bank. See their website for more details of their export insurance program at http://www.exim.gov/products/insurance/index.cfm.
without incurring substantial losses, in either case, if the buyer chooses not to or is unable to pay for them.

5. **Private guaranty.** A corporate or other guaranty can provide comfort to a party entitled to payment or performance from a company which is an affiliate of the guarantor. Problems with guaranties include the availability and willingness of a guarantor to furnish a guaranty and the creditworthiness of the guarantor. Guaranties do not provide either instant liquidity or avoid the need to prove in a lawsuit or otherwise, that the beneficiary of the guaranty fully performed and the primary obligor breached the underlying obligation guaranteed. Unless waived in the guaranty, the beneficiary is subject to a variety of suretyship defenses that the guarantor can raise.\(^{14}\)

6. **Independent bank guarantee.** Bank guarantees are sometimes called demand guarantees, independent bank guarantees, unconditional guarantees, simple demand guarantees or first demand guarantees. A bank guarantee is in some respects the European equivalent of a standby letter of credit. Although the UNCITRAL Convention on Independent Guarantees and Stand-By Letters of Credit has not been ratified by any major country, it sets forth a number of principles applicable to bank guarantees parallel to those applicable to letters of credit. Like letters of credit, the payment undertaking under a bank guarantee is regarded as independent of determination of performance of the underlying obligation the guarantee supports. The guarantee is usually issued by a bank and payment after the beneficiary makes demand on the guarantee. It is not normally subject to injunction in the absence of a showing of fraud. Bank guarantees and the law governing them are not as clear as U.S. law and the ISP governing standby letters of credit, although the ICC in 1992 promulgated a regime to govern bank guarantees called the Uniform Rules for Demand Guarantees, ICC Publication No. 458 (the “URDG”). Bank guarantees differ from standby letters of credit in that bank guarantees may not have an expiration date, may be subject to termination upon the occurrence of an event, and payment is normally triggered by a simple demand. The wording of demand guarantees can vary and in some cases the issuer of a demand guarantee may not regard it as totally independent of the underlying obligation that it supports. Like a bond, to induce a foreign bank to issue a bank guarantee in favor of a foreign beneficiary to secure performance of a contract or shipment of goods, the foreign bank guarantor will usually require the U.S.

\(^{14}\) See e.g., UCC 3-605 which covers discharge of endorsers and accommodation parties on a note.
applicant to obtain and furnish a letter of credit to secure the issuer of the bank guarantee in case it is called upon. Significant problems and difficulties can be encountered to obtain release of that letter of credit when the U.S. seller or contractor believes it has performed and the foreign buyer argues otherwise, asking instead for a payment or discount on the price.\textsuperscript{15}

7. **Cash or other collateral.** Documenting a security interest in collateral is one way of assuring payment or performance of an obligation. Sometimes, however, the cash or other collateral is not available. If the collateral is not cash, than the secured party is faced with the problem of converting it to cash by a foreclosure process that can be uncertain, technical, contested and interrupted by a bankruptcy or counterclaim.

8. **Escrow.** Escrows can be established to hold funds or documents to secure or await performance of an obligation. If the escrow is a joint order escrow, the escrow agent will not act unless both parties agree to direct it to act, or a court of competent jurisdiction orders it to act. Sometimes an escrow agent will agree to act at the unilateral direction of a secured party. Not all escrow agents will agree to do so. Escrow agreements require careful drafting and can entail substantial expense if the escrow agent is a major institution and/or the amount held in escrow amount is large. Sometimes escrows will be the subject of litigation, in which event the escrow agent will usually not release funds or other escrowed property until the litigation is resolved. Finally, escrow agents will not usually exercise independent judgment to determine whether to release property held in escrow.

9. **Netting.** Netting is the offset of obligations either on a bilateral or multilateral basis based on multiple financial transactions, to reduce the net amount owed on those transactions occurring over the same period of time. It is commonly used in SWAP agreements of various types between the same parties or corporate groups. In the Enron bankruptcy, there were dozens of cases where corporate groups asserted netting and the bankruptcy estate resisted on the grounds that the debts were not mutual. While the Bankruptcy Act and the FDIC regulations have been amended to more liberally allow netting, it still cannot be used to reduce exposure for single transaction obligations. Nor does it in and of itself provide security for the net amount owed. The Collateral Annex to the standard ISDA SWAP Agreement provides a form of

\textsuperscript{15} See Carter H. Klein, “Standby Letter of Credit Rules and Practices Misunderstood or Little Understood by Applicants and Beneficiaries,” 40 *U.C.C.L.J.* 2 (Fall 2007).
letter of credit to be posted under certain circumstances to secure the net amount owed from time to time.

B. **Advantages of Letters of Credit:**

1. **Instant liquidity** -- The terms of a letter of credit can specify that fax presentments are allowed and that the draw must be honored (or notice of dishonor given) within a few days or less. In some cases for special large customers, such as trustees for bondholders, to secure commercial paper or to secure clearing obligations owed to commodities or security exchanges, the letter of credit will be payable on the same day as presentation is made. The payment is by cash usually via wire transfer by the issuer to the beneficiary’s account.

2. **Solvency of issuer** – By use of a letter of credit, the beneficiary is assured that the payment obligation is backed by credit of a bank which is substituted for or added to credit of a corporate or individual applicant. The creditworthiness of the bank can be determined or specified in the selection process and/or set forth in the letter of credit or the underlying agreement that provides for use of a letter of credit. If the credit of the issuing bank deteriorates below designated levels, the beneficiary of the letter of credit should be able to draw on the letter of credit if the applicant does not replace the letter of credit with one issued by a bank with an acceptable credit rating within a time certain – say 30 days after the downgrade of the issuing bank.

3. **Independence of issuer** – Except for material fraud, the issuer’s obligation to honor is independent of the obligations of the parties (applicant and beneficiary) to and their disputes over the underlying contract which the letter of credit supports. The issuer only looks to see if the documents presented are timely and conform to the documentary conditions specified in the letter of credit. The issuer looks to standard banking practice for that determination, as supplemented by the UCP and ISBP if the UCP is applicable to the credit, or the ISP, if the ISP is applicable. See UCC 5-108(a), (e); UCP 500, Art. 13(a); UCP 600, Art. 2 (definition of “Complying Presentation’’); ISP Rules 1.03(b) and 4.01(b). The issuer does not and should not involve itself in whether the undying contract has been properly performed.

4. **Bankruptcy avoidance**

   a. **Automatic stay** -- Unlike attempting to realize on collateral, because a draw on a letter of credit is treated as a
draw on the funds of the issuing bank and not the funds of the bankrupt debtor, courts should not enjoin otherwise proper draws or treat the automatic bankruptcy stay under Sec. 365 of the Bankruptcy Code as applicable.

b. **Ipso facto clause** -- Sec. 365(e)(1) of the Bankruptcy Code prevents a counterparty from declaring a default and terminating a contract with a debtor simply because the debtor is insolvent or bankrupt. However, that provision does not stop a beneficiary from drawing on a letter of credit to repay itself for indebtedness owed to it secured by the letter of credit, if the conditions of the letter of credit to effect a draw are met. See *In re Prime Motor Inns*, 130 B.R. 610 (S.D. Fla. 1991). Some caution should be exercised here.

c. **Preferences** – As noted above, a draw on a letter of credit to pay for an obligation of a bankrupt applicant is not normally regarded as transfer of the bankrupt’s estate; rather the money transferred are regarded as funds of the issuing bank. Id. As a result, courts will not normally set aside as preferential a paydown of a debt effected by a draw on a letter of credit. The exception is if the letter of credit was posted to secure the debt within 90 days of the applicants bankruptcy, the debt was antecedent, and the letter of credit reimbursement obligation was secured. See *In re Compton*, 831 F.2d 586 (5th Cir. 1987); *In re Air Conditioning*, 845 F.2d 293 (11th Cir. 1988).

5. **Pay now, litigate later** -- Courts have taken the view that if there is a problem with the underlying contract or its performance while a draw is being made or about to be made on a letter of credit, the beneficiary should be entitled to draw and hold or use the proceeds until the dispute or litigation is resolved. In the absence of egregious fraud, courts will treat the rights of a beneficiary under a letter of credit, similar to those of a party already holding the cash, usually without restriction. Courts have used the phrase -- pay now, litigate later to describe the beneficiary’s rights against the obligation of the issuer and applicant to allow the beneficiary to draw on the letter of credit. See *Eakin v. Continental Illinois Nat. Bank & Trust Co.*, 875 F.2d 114 (7th Cir. 1989); *In re Sabratek, Corp.*, 257 B.R. 732 (Bankr. Del. 2000).

6. **Difficult to enjoin draws** -- The standard to enjoin a draw on a letter of credit is material fraud. UCC 5-109. Official Comment 1 to that section states that “material fraud by the beneficiary occurs
only when the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor. The comment goes on to endorse cases such as *Intraworld Indus. v. Girard Trust Bank*, 336 A.2d 316 (Pa. 1975) and *Ground Air Transfer, Inc. v. Westates Airlines, Inc.*, 899 F. 2d 1269 (1st Cir. 1990) where the standard for injunction is very high -- the fraud must be “so serious as to make it obviously pointless and unjust to permit the beneficiary to obtain the money.” In addition, UCC 5-109 puts the burden on the applicant to show all the other requirements for equitable relief have been met, including irreparable harm, no adequate remedy at law, the public interest and posting a bond.

7. **Adaptability.** As is shown from the variety of uses for letters of credit enumerated below, a letter of credit can be tailored to secure almost any type of obligation. The draw conditions can require elaborate or simple certifications identifying the obligation secured and the events justifying the draw.

8. **Expiration date can be extended.** Although issuing banks insert an expiration date on a letter of credit, which is usually one year or less from the date of issue, through the use of an automatic extension clause, the letter of credit can be extended over a multi-year period or even indefinitely. These clauses work automatically, so that unless the issuer sends out notice in advance of expiration alerting the beneficiary that it will not extend the letter of credit, the letter of credit will be extended. If the notice is sent and the letter of credit and/or underlying agreement is properly worded, the beneficiary can then draw on the letter of credit to hold the cash proceeds as cash collateral unless the applicant procures a suitable replacement letter of credit two weeks or more before the current letter of credit expires.

9. **Documentary safeguards.** An applicant that is concerned about uncontrolled draws by a beneficiary can draft documentary conditions to guard or protect against untoward or unjustified draws. These safeguards could include such documents as third party inspection certificates, copies of judgments or arbitration awards, copies or originals of bills of lading and other shipping documents, or even opinions of counsel as well as detailed statements, which if false, could give rise to a cause of action against the beneficiary.

10. **Payment against right to receive goods.** Documentary credits used in international trade provide that the beneficiary must present to the issuer shipping documents, including bills of lading,
to receive payment. These documents are passed along to the applicant to enable it to receive the goods shipped which are being paid from a draw on the letter of credit.

11. **Cost is relatively modest.** The cost of a letter of credit can vary with the creditworthiness of the applicant or if cash or liquid collateral is posted to secure it. One rule of thumb that larger banks sometimes use is to charge for letters of credit based on the spread between the prime rate and the borrowing on the loan facility offered to the applicant. This pricing in theory reflects extra cost for extra risk. If the borrowing rate is prime + 1.5%, a letter of credit fee will be 150 basis points. That method does not work for borrowers that borrow at prime, so there is a minimum percentage charge that bank issuers will impose to reflect their cost of capital, expenses, and profit. On letters of credit issued by a bank secured by a brokerage account of an affiliate containing liquid securities, the fee could be as low as 80 basis points. So the normal range for the annual fee, usually paid quarterly, is between 75 and 150 basis points. There are other fees as well, such as issuance and payment fees, amendment fees, document preparation fees, fees for advising or confirming a credit, and others. While bond premiums are usually less than letter of credit fees, as noted above, a letter of credit usually has to be posted to the bonding company to induce it to issue the bond – resulting in two fees being paid.

IV. **Sources of Letter of Credit Law -- Statutes and Conventions**

A. **UCC Revised Article 5**

1. Revised Article 5 of the UCC is effective in all states and the District of Columbia.

2. It has been uniformly adopted with the following exceptions:

   a. A few states have deleted or varied provisions on the mandatory award of attorneys fees (UCC § 5-111(e)),

   b. A few states allow a jury rather than the court to determine standard banking practice where that is an issue in the case (UCC § 5-108(e)), and

   c. One state has altered the Article 5 definition of good faith to include the observance of reasonable commercial standards of fair dealing. (UCC § 5-102(a)(7))
3. Revised Article 5 clarifies fraud standard by adopting the material fraud test and requiring other requirements for injunctive relief to be met. (UCC § 5-109).

4. Article 5 clarifies warranties of presenter (UCC § 5-110). Now a beneficiary presenting documents warrants to the issuer, any confirmer and the applicant that there is no fraud in the transaction and that the presentation of documents to effect a draw does not violate the terms of any underlying agreement the obligations of which the letter of credit supports.

5. Article 5 provides for subrogation rights to the applicant and issuer after a draw is honored resolving a split in the caselaw. (UCC § 5-117)

6. Endorses and largely defers to regimes such as the UCP and ISP (UCC § 5-116(e))

7. Revised Article 5 allows the parties to choose the law and forum governing the letter of credit. In the absence of a choice to the contrary in the letter of credit, the law of the issuer’s location governs the letter of credit. (UCC § 5-116)

8. Article 5 adopts standard banking practice as the proper interpretative rule for determining compliance of documents with the terms of the letter of credit. (UCC § 5-108(e))

9. Except in a few states, attorneys fees are now to be awarded to the prevailing party in letter of credit litigation (UCC § 5-111(e)).

10. UCC Article 5 revisions are summarized in the ABA’s August 1995 Business Lawyer and ABA’s 1998 “The ABC’s of the UCC Article 5.”

B. **UCC Article 9 Revisions Affecting Letters of Credit**

1. Letter of credit drawing rights are governed by UCC Article 5, not Article 9.

2. A transfer of drawing rights is a novation producing a new or parallel letter of credit; it is not a creation of a security interest.

3. Assignments of letter of credit proceeds are governed by both UCC Article 5 (see § 5-114) and UCC Article 9. See §§ 9-107, 9-203(f), 9-308(d); 9-312(b)(2); 9-314(a); 9-329.
4. The right to letter of credit proceeds (called "letter of credit right" in UCC Rev. Revised Article 9) is assignable before drawing. UCC § 5-114.

5. A perfected security interest in the beneficiary’s underlying right secured or to be paid by an letter of credit, such as an account, automatically perfects security interest in beneficiary’s right to letter of credit proceeds under Rev. 9 as a supporting obligation UCC § 9-308(d).

6. A bank’s consent to assignment of letter of credit proceeds (“control”) is required under UCC Articles 5 and 9 to perfect both an outright assignment of proceeds and a security interest in proceeds. § 5-114; § 9-107.

7. Assignments of letter of credit rights as additional security seldom used in practice by secured lenders.

8. Issuer’s discourage blanket assignments of letter of credit proceeds are discouraged unless the issuer is also the secured lender.

C. Uniform Customs and Practices for Commercial Credits (UCP 600)

1. The UCP is almost universally used for commercial letters of credit and for a large number of standby letters of credit (perhaps 20-40%).

2. The UCP governs standby letters of credit to the extent its articles are applicable. The UCP does not explain when and how its articles should be applied to standby letters of credit. Most lawyers and their clients do not have a working knowledge of the articles of the UCP or the written and unwritten standard customs and practice of banks that regularly issue, confirm or advise letters of credit and examine and negotiate or accept documents presented under letters of credit. Even preparing a draft to be presented under a standby letter of credit can present challenges for those that do not have a working knowledge of how banks expect drafts to be worded and presented. Yet every regime that governs letters of credit provides that standard banking practices or international standard banking practices are to be used

---

16 UCP 500, Art. 1; UCP 600, Art. 1.
17 The UCP 500 is supplemented by the International Standard Banking Practices ("ISBP") approved by the ICC Banking Commission in October 2002. The ISBP is a distillation into 200 sections of interpretations of the UCP, written by a specially-appointed committee of the ICC Banking Commission after receiving and reviewing national committee comments and dozens of ICC interpretative letters on the UCP. The ISBP has been revised for the UCP 600. Although the ISBP has a statement of general principles, most of its sections deal with commercial letter of credit practice and documents.
to determine whether documentary presentations and other aspects of letter of credit transactions are proper and compliant.\textsuperscript{18}

3. The UCP contains a number of provisions inappropriate for standbys. These include those dealing with inconsistencies, force majeure, installment drawings, stale documents and limits on transfer. See discussion below on ISP.

4. ICC Publication 600 can be purchased from the ICC at iccbooksusa.com.

5. The eUCP (effective April 2002) is a supplement covering electronic presentations, which as noted above, is not used much in practice.

6. The International Standard Banking Practice (ICC Publication 645) - provides 200 interpretations and “mini-rules” for UCP. It was recently revised to accommodate the UCP 600.

D. \textbf{International Standby Practices (ISP 98)}

1. The ISP was drafted and sponsored by the Institute for International Banking Law & Practice (IIBLP) and adopted by the ICC as ICC Pub. 590, which is available at iccpub@interport.net and www.iiblp.org. It has been in effect for about ten years now and has received widespread usage and acceptance for standbys by U.S. banks and their customers. Major banks report that the ISP is used in about 70-80\% of their standbys. It is easy to read, understand, and apply and is drafted expressly for standbys. The ISP, like the UCC and the UCP, adopts international banking standards for interpretation and application of its rules.

2. Much of the lack of familiarity with or transparency of standby letter of credit practices has been overcome by the International Standby Practices or ISP. The ISP’s rules specifically address standby letter of credit practice separate and apart from commercial letter of credit practice. The ISP’s rules are well written and for the most part are clear, even-handed and straightforward. They avoid significant pitfalls of using the UCP in standby letters of credit, such as presentation of stale documents,\textsuperscript{19} installment drawings,\textsuperscript{20} force majeure\textsuperscript{21} and the requirement that

\textsuperscript{18} Under the UCP, the ISP and Article 5 of the Uniform Commercial Code, the conformance of documents to the terms of the credit are determined under standard banking practice. UCP 500, Art. 13(a); UCP 600, Art. 2 (definition of “Complying Presentation”); ISP, Rules 1.03(b) and 4.01(b); UCC §5-108(a), (e).

\textsuperscript{19} UCP 500, Art. 43; UCP 600, Art. 14(c).

\textsuperscript{20} UCP 500, Art. 41; UCP 600, Art. 32.
documents and data in documents be consistent.  Unfortunately, the UCP is still used many standby letters of credit issued in this country, and probably in most standbys issued by foreign banks in other countries. Additionally, even the ISP’s rules are not all-encompassing. Resort to standard banking practices outside the ISP, caselaw and the UCC is necessary to fill in the gaps. Finally, there are several rules or provisions of the ISP, the UCP or the UCC that govern standby letters of credit that lawyers and their letter of credit applicant or beneficiary clients may not be familiar with, overlook, or miscomprehend their import. Many letter of credit customs, practices and rules are counterintuitive and cannot be predicted by resort to simple contract law principles or even other articles of the UCC.

3. The ISP provides for many situations in which the UCP and the UCC are silent, such as conditions on transfer and assignment, lost originals, when consent of the applicant is not necessary for waiver of certain conditions, what constitutes acceptable nondocumentary conditions, etc.

4. Secondary sources on the ISP include Official Commentary on ISP and The ISP98 and UCP500 Compared, both published by Professor James Byrne and the IIBLP.


F. UNCITRAL Convention on Independent Bank Guarantees and Standby Letters of Credit

1. Most countries do not have laws governing letters of credit
2. This convention could fill this void if adopted
3. It is not widely adopted; only 7 countries
4. U.S. has not yet ratified it.
5. Progress is being made in Canada to do so which may spur the U.S. adoption of it.

G. SWIFT

21 UCP 500, Art. 17; UCP 600, Art. 36.
22 UCP 500, Art. 13(a); UCP 600, Art. 14(d).
23 For example, Article 5 of the UCC is the only article of the UCC that defines good faith as “honesty in fact in the conduct or transaction in question” without reference to the observance of reasonable commercial standards of fair dealing. See UCC §5-102(a)(7). Assignments of proceeds of letters of credit can be used to perfect a security interest in letter of credit rights, but a transfer of drawing rights to the secured party is outside the scope of Article 9 of the UCC. See UCC §5-114(e) & (f) and Official Comment 4 to UCC §9-107. A failure to identify a discrepancy on dozens of prior drawings of the same or similar letters of credit does not preclude the issuer from raising that discrepancy, without prior notice, on any subsequent drawing on that or another letter of credit issued to the same beneficiary. See Official Comment 7 to UCC §5-108. Many other examples could be cited.
1. Most commercial LC’s are issued via S.W.I.F.T. interbank message.
2. S.W.I.F.T. message types influence LC texts and systems

H. Secondary Resources
1. Annual Survey of Letter of Credit Law (IIBLP)
2. IIBLP Compendium of Letter of Credit Laws (4th ed.)
4. ABA Business Lawyer Annual Survey of Letter of Credit Law
5. James Barnes, ABC’s of the UCC -- Article 5 (ABA)
6. Documentary Credit World (IIBLP)
7. ICC Documentary Insight.

V. Letter of Credit Terms
A. Participants
1. Issuer – need not be a bank
2. Applicant – party for whose account L/C is issued
3. Beneficiary – party to whom letter of credit is issued and who has drawing rights
4. Nominated bank – a bank authorized by the issuer in the credit to honor or negotiate a drawing under the letter of credit
5. Advising bank – a bank that authenticates the letter of credit but is not liable on it
6. Transferee beneficiary of letter of credit – a party to whom the right has been transferred to make drawings under the letter of credit, consent to amendments and cancel the letter of credit. Transfers have to be authorized by the letter of credit or all parties to it.
7. Assignee of proceeds of letter of credit – a party to whom the beneficiary has assigned and the issuer has recognized the right to receive the proceeds of draw otherwise payable to the beneficiary. Assignees of proceeds do not have drawing, amendment or cancellation rights.
8. Negotiating bank – a bank nominated in the letter of credit to accept and pay or commit to pay the draft and documents presented under a letter of credit and receive payment from the issuer in place of the beneficiary.
9. Confirmer – a party nominated or authorized by the letter of credit, that commits to honor a conforming draw on the letter of credit and is entitled to reimbursement from the issuer as if it were the beneficiary when it forwards the documents it received and honored.

B. Other Terms
1. Expiration date or expiry
2. Draft or demand for payment
3. Documents
4. Nondocumentary conditions
5. Negotiation
6. Place of presentation
7. Advice
8. Confirmation
9. Presentation
10. Honor
11. Notice of dishonor
12. Strict compliance
13. Originals
14. Expiration drawing
15. Automatic extensions or evergreen clauses
16. Clean or suicide letters of credit
17. Negotiable letters of credit
18. Straight letters of credit
19. Presentation credits

VI. Drawing on a Letter of Credit – Pointers and Problems

A. Structure of a Letter of Credit (see attachment)
   1. L/C No.
   2. Amount
   3. Date
   4. Place of presentation
   5. Identification of beneficiary
   6. Expiration date
   7. Issuer (name and address)
   8. Identification of applicant
   9. Commitment to honor
   10. Draw triggers or documentary conditions for drawing
   11. Governing regime
   12. Choice of law
   13. Other terms

B. Common Problems
   1. Impossibility
   2. Ambiguity
   3. Mistake
   4. Nondocumentary conditions
   5. Inconsistency
   6. Use of UCP in standby credits
   7. Right to draw for failure to extend
   8. Presentation credits
   9. Specification of applicant signed draw documents
10. Failure to deal with letter of credit issues in underlying agreement
11. Not using an experienced reputable issuing letter of credit bank
12. Not using a letter of credit banker or experienced freight forwarder for advice on documentary letters of credit

C. Special Drafting Issues
   1. Automatic extension provisions
   2. Choice of law and forum
   3. Payment to a designated account
   4. Transferability
   5. Fax presentations
   6. Omission of draft requirement
   7. Foreign issuers
   8. Confirmations
   9. Time to honor

D. Common Draw Problems and Tips
   1. Waiting too long to effect a draw; not allowing enough time to cure
   2. Not strictly complying with the draw conditions; substantial compliance is not enough
   3. Where draw conditions are ambiguous, consider submitting alternative draw documents
   4. Expecting the issuer to honor when beneficiary walks the documents into the bank
   5. Not realizing that the issuer has a reasonable time up to five to seven business days to honor or give notice of dishonor
   6. Not having the necessary third party documents available
   7. Not having the proper signers of the documents available
   8. Losing the original of a presentation letter of credit and expecting the issuer to waive the requirement or issue another

E. Ethical Issues for Lawyers in Counseling Letter of Credit Participants
   1. Drawing when no colorable basis exists for a draw
   2. Drawing for excess amounts
   3. Counseling the issuer on its independence

VII. Common Types of Letter of Credit Disputes
   A. Wrongful Dishonor
   B. Wrongful Honor
   C. Fraud/Forgery Defenses and Enjoining Honor of a Letter of Credit
      1. §5-109 requirements
      2. Probable success - showing egregious or material fraud
      3. No adequate remedy at law
4. Public interest
5. Bond
6. Close cases:
   a. Fraud not serious enough
   b. No forged or fraudulent documents
   c. Draw documents literally true
   d. Lack of scienter
7. Attorneys fees under §5-111(e)

D. Sovereign Compulsion/Illegality as a Defense

E. Letters of Credit in Bankruptcy
   1. Indirect preferences (In re Air Conditioning, 845 F.2d 293 (11th Cir. 1988); In re Compton, 831 F.2d 586 (5th Cir. 1987))
   2. Powerine preference trap (In re Powerine Oil Co., 59 F.3d 969 (9th Cir. 1995))
   3. Draw conditions which require violation of automatic stay
   4. Bankruptcy caps on certain claims (landlords, executives, securities options)

*****

CARTER H. KLEIN is a partner at Jenner & Block LLP where he has practiced for the past 34 years in the areas of financial services, Uniform Commercial Code, credit enhancements and commercial law. He is co-author of West’s Uniform Laws Annotated – Uniform Commercial Code Forms and Materials; West’s Illinois Practice – Uniform Commercial Code Forms Annotated; and West/Thompson Illinois Code Comments. He was 2004-2007 Chair of the ABA’s Business Law Section Letter of Credit Subcommittee of the Uniform Commercial Code Committee; was 2003-2004 Co-Chair of the Chicago Bar Association’s Commercial and Financial Transactions Committee; is an editorial advisor for Documentary Credit World; is a member of the American College of Commercial Finance Lawyers; is the liaison for the Business Law Section of the American Bar Association to the Permanent Editorial Board of the Uniform Commercial Code; and is a member of the Banking Committee for the U.S. Council on International Business. He participated in the drafting of the International Standby Practices (1998) and Revised Article 5 of the Uniform Commercial Code and has authored numerous articles and lectured frequently on Uniform Commercial Code topics. He can be reached at 312-923-2950 or cklein@jenner.com.