

Letters of Credit An Overview
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§ 1.01 INTRODUCTION

The Letter of Credit is the principal means by which a seller of goods in international commerce assures itself of the realization of its major expectation: payment. Furthermore, “it is perhaps the only area of international trade in which a practice has been standardized by a universally accepted set of rules - the Uniform Customs and Practice for Documentary Credit . . . issued by the International Chamber of Commerce.”

The methods of payment used in international commerce are similar to those in domestic commerce. The parties may agree on payment in advance, on open account, or C.O.D. The latter method is generally accomplished by payment against collection documents. This means that the seller forwards all of the customary shipping documents through its bank to the buyer’s domestic bank, including a draft drawn on the buyer for collection. When the draft is honored and paid (or, if appropriate, accepted) the buyer obtains delivery of the documents, entitling it to delivery of the goods. These methods of payment involve some risks which are lessened by the use of letters of credit.

Where cash is paid in advance, the buyer bears the risk of non-performance or defective performance. In a C.O.D. or collection transaction, the goods have generally been shipped and often have arrived when the documents are presented. If the draft is not honored, the fabrication and delivery may go unrewarded. In a sale on open account, the seller bears the maximum risk of non-payment.

In a documentary letter of credit transaction, most (but not all) of these risks are accommodated. The risk of non-payment by the buyer is handled by substituting the credit of a bank. The seller is not paid until the documents presented evidence shipment of the goods, although documents do not guarantee quality, or adequate performance of the underlying contract. The buyer is assured that documents evidencing shipment are in hand. The buyer remains at some risk, however, although a certificate of inspection can be among the documents that must be presented before payment.

Notwithstanding the elements of risk remaining, buyers and sellers tend to view letters of credit as the most effective means by which risks are fairly distributed.

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1 This paper was revised by Charles Routh, April 2008.
3 Less used, and less well known, are the International Chamber of Commerce Uniform Rules for Collection, 1995 rev. I.C.C. Pub. No. 522. First published in 1956, the Rules are not further discussed in this paper.
§ 1.02 DEFINITION

Letters of credit are dealt with in Article 5 of the Uniform Commercial Code (U.C.C. or “the Code”) as a matter of statutory law. They are also defined and tend to be governed by the Uniform Customs and Practice (U.C.P)\(^4\) as a matter of custom and contract. Since the Code and the U.C.P. (which conforms more closely to commercial practice) are not always consistent, a revised Code was drafted by a committee appointed by the National Conference of Commissioners on Uniform State Laws and approved by the American Law Institute in May, 1995.\(^5\) On January 1, 1999, rules on International Standby Practices (ISP 98) came into effect. The new rules were created by the Institute of Banking Law and Practice, and adopted by the International Chamber of Commerce. The new rules have been published as ICC Publication Number 590.

The Code provides that it is applicable to a credit issued by a bank or by a person other than a bank. If issued by a bank, the credit must require a documentary draft or a documentary demand for payment. If issued by a person other than a bank, the credit must require that the draft or demand be accompanied by a document of title. If there is no draft or demand, or no document of title when a person other than a bank is concerned, the credit must state conspicuously or be entitled conspicuously indicating that it is a letter of credit.\(^6\)

Unlike the U.C.C., however, the U.C.P. applies by definition only to an undertaking by a bank. Thus it would appear that credits which do not come within the requirements of the U.C.C. or the U.C.P do not benefit from the provisions of that statute or publication. However, it should be noted that the U.C.P. in any event requires that it be incorporated into each, documentary credit by appropriate wording.\(^7\) The U.C.P. is applicable as a matter of contract rather than statutory law. This being the case, parties should be free to incorporate its terms whether or not a bank credit is involved, although more explicit incorporation by reference would be advisable in such cases.

As we have seen, the Uniform Commercial Code contemplates the presentation of a document in letter of credit transactions. This is true as well of the U.C.P.\(^8\)

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\(^5\) For a brief review, see Barnes and Byrne, Revision of U.C.C. Article 5, 50 Bus. L.W. 1449 (1995). For an example of state law revision based on the revised Code, see Illinois amendments to its Banking Act, effective January 1, 1997. Illinois Public Act 89-534 (1996). The revised Code, where effective, expressly refers to “standard practice” (§ 5-108(a)) as well as the U.C.P. (§ 5116(c)). All references to the revised Code in this paper are revisions as they appear in the Illinois legislation mentioned above. This paper does not refer to all such revisions and any reference to the U.C.C. without a citation to the Illinois legislation is a reference to Article 5 prior to the revised Code.

\(^6\) U.C.C. § 5-102(l). The revised Code excludes an engagement by an individual for personal, family, or household purposes. Formal requirements are the same for a bank and other persons. See, e.g., Ill. U.C.C. §§ 5-102(a)(10) and 5-104.

\(^7\) Id., art. 1. It may be that the U.C.P. will also be recognized as a binding trade custom or usage.

\(^8\) Id., art. 2. For the purposes of U.C.P., the 2007 revision contains a provision in article 3 to the effect that bank branches in different countries are considered different banks.
§ 1.03 COMMERCIAL AND STANDBY LETTERS OF CREDIT

Both commercial and standby letters of credit are documentary. In other words, collection is accomplished by the presentation of one or more documents, including generally a draft or other demand.

The commercial letter of credit\(^9\) is generally utilized in sale of goods transactions. Its purpose is to assure the seller that, upon presentation of the appropriate documents, the obligation of the buyer to pay will be performed. The standby letter of credit\(^10\) is sometimes used in sale of goods transactions, but it is applied in an unlimited variety of other situations. It is intended to assure a party to a contract that the other party will perform its obligations.

That obligation may be the manufacture or delivery of goods or services, payment of the price, compliance with quality or performance standards, or the fulfillment of other contractual obligations. A standby letter of credit, in this sense, is similar in function to a performance guarantee.

The use of standby letters of credit has been made substantially easier and more clear by the publication of the Rules on International Standby Practices (1998). The new rules apply to any undertaking issued subject to the rules, and the rules suggest that they be so made applicable by including language such as (but not limited to):

- This undertaking is issued subject to the International Standby Practices 1998;
- Subject to ISP 98. (ICC Publication No. 590, Preface at page 8)

The new rules are not generally inconsistent with U.C.P., but clarify the standard practice for standby letters of credit in many respects. For example the new rules:

A. Contain explicit language defining and describing the doctrine of independence (¶1.06).

B. Advise concerning language in a credit which is undesirable (such as the word “unconditional”), terms which are to be disregarded (such as “divisible”) and words which should be disregarded unless meaning is given to them by the context (such as “revolving” or “evergreen”). (¶1.10).

C. Contain specific language with respect to automatic amendment (¶2.06).

D. Are explicit in their references to electronic presentations and communications (¶3.06).

E. Provide specifically for the procedures to be followed when the place for presentation is closed on the last business day provided for in the credit (¶3.14).

\(^9\) A sample commercial letter of credit follows this paper.

\(^10\) A sample standby letter of credit follows this paper. The Illinois legislation, it should be noted, defines a standby credit as one where drafts are payable on the condition of the customer’s default “in the performance of a duty, liability, or obligation.” Public Act 89-534, Section 5.
§ 1.04 THE TRANSACTION CYCLE

The typical letter of credit transaction in a sale of goods is made up of three contracts. The transaction usually is constructed as follows:

1. The buyer and seller enter into a contract providing for the purchase and sale of the goods. This is the first of the three contracts. This contract will require payment through a documentary credit.

2. The buyer makes an application at its bank for a letter of credit, instructing the bank to open the credit for the benefit of the seller on the terms specified in the application. The second contract is between the buyer and its bank. The bank customer is also referred to as the “account party.” The bank is the issuer.

3. The issuing bank issues the letter of credit. Generally the letter of credit is forwarded to an advising bank in the country of the seller. The latter advises the seller of the opening of the credit in its favor. The letter of credit is the third contract.

When requested, a second bank (frequently the advising bank) may also add its confirmation to the letter of credit. In this case, the confirmation constitutes an engagement on the part of the confirming bank that the credit will be paid if its provisions are complied with. When a letter of credit is confirmed, a contractual relationship, with corresponding duties, exists between the issuing and confirming banks. The issuer is the customer of the confirming bank. 11

The “three contract” cycle is present in standby credits as well in other words, there is a contract between the parties, between the issuer and its customer, and between the issuer and the beneficiary. Only two contracts are present, however, when a bank issues a credit for its own account.

Where a standby letter of credit is issued, the documents required to be presented are usually minimal. A demand or draft is customarily required, with a certification to the effect that the amount drawn is due. Depending on the situation, the certification can take a variety of forms. It may be a certification of default, maturity of an obligation, absence of performance or, in fact, virtually any occurrence. As with other credits, it is the documents which are operative. The standby credit, consequently, is a powerful instrument of payment which often places in the hands of the beneficiary a virtually unlimited or uncontrolled power to demand and receive payment. When the other party to the transaction has concern about the exercise of this power the parties may want to consider alternate payment provisions, such as the creation of an escrow to receive payment. 12

11 On the relationship of the parties in advised and confirmed credit transactions, see VISHNY, supra note 2, at § 2.13.
12 See, e.g., Appendix B for a simple escrow provision in a standby letter of credit.