I. **Letter of Credit Basics**

A. **Letters of Credit: What They Are and How They Work**

1. **Description.** A letter of credit is a definite undertaking, pursuant to an authenticated record, usually by a commercial bank (referred to as the "issuer"), for the benefit of another person (referred to as the "beneficiary") at the request and for the account of a third person (referred to as the "applicant") to honor a documentary presentation by payment or delivery of an item of value. *(See UCC § 5102 (a)(10))*

2. **History.** Letters of credit have evolved over hundreds of years of commerce. Traditionally they have been used in connection with the sale of goods between distant parties. The buyer would be reluctant to part with its money until it knew the goods were safely en route; the seller was unwilling to ship the goods until it knew the money was ready at hand. This impasse was resolved by a bank issuing a letter of credit pursuant to which the bank undertook to pay the seller upon presentation by the seller of bills of lading evidencing the shipment of the goods and evidencing the satisfaction of other conditions. The seller felt comfortable having the credit of the bank on the letter of credit, as opposed to the credit of an unknown buyer. The buyer felt comfortable that the bank would not disburse the funds until it had the shipping and other documents in hand.

The use of letters of credit has evolved significantly from this early scenario. Letters of credit are now used not only in transactions involving the sale of goods but also in numerous other types of transactions where credit enhancement is desired.

3. **Structure.** The following is a quick summary of letter of credit law and practice. By its nature, many of the details have been simplified. Before using a letter of credit, the parties should consult with a person knowledgeable in letter of credit practice.

A diagram showing the structure of letter of credit relationships is set forth on Part I of Exhibit A.

We start with an underlying transaction between two parties. This can be a sale of goods, a loan, an equipment lease, or whatever. One of the parties (the beneficiary) is uncomfortable extending credit to the other party solely on the basis of the creditworthiness of the other party (the applicant).
The applicant is the person or entity that applies to the issuer for a letter of credit. The applicant is also referred to as the “customer” or the “account party.” The issuer is normally a commercial bank but can also be any type of person or entity. The issuer issues the letter of credit to the beneficiary and thus adds its own credit to the applicant’s. A sample form of a letter of credit is attached as Exhibit B.

4. Confirmations. In some situations a second bank will “confirm” the letter of credit. This means that the confirmer will take on all the responsibilities of the issuer vis-à-vis the beneficiary. After a confirmer pays a complying draw, it in turn has reimbursement rights against the issuer. This arrangement is diagrammed on Part II of Exhibit A. If the beneficiary wishes the backing of a large bank but the applicant’s contacts are only with its local bank, confirmation of the letter of credit by the local bank’s correspondent bank solves the impasse. Confirmers are also frequently encountered in international transactions where the issuer is in the applicant’s home jurisdiction and the confirmer is in the beneficiary’s home jurisdiction.

5. Documentary Nature. A letter of credit basically provides that, if the beneficiary presents the documents required by the letter of credit to the issuer, the issuer will promptly pay the beneficiary. The key to this arrangement is that the letter of credit is documentary. This means that the issuer pays only against the presentation of documents. If the documents comply with the requirements of the letter of credit, the beneficiary gets paid. If the documents do not comply, the beneficiary does not get paid, at least not through the letter of credit. The beneficiary may still have a claim against the applicant on the underlying contract. We will get into more detail on the standard for compliance of the documents shortly, but for now, suffice it to say that the general standard is one of strict compliance.

6. Commercial and Standby Letters of Credit. Letters of credit can be divided into two broad categories. First, the traditional letter of credit involving the sale of goods is often called a commercial letter of credit. The parties anticipate that, if the transaction goes well, the beneficiary will be paid through the letter of credit mechanism. The second type of letter of credit is the standby letter of credit. These are normally used in situations where the parties anticipate that the letter of credit will not be drawn upon unless something goes wrong in the underlying transaction. An example would be a letter of credit issued to an equipment lessor which permitted the equipment lessor to draw under the letter of credit by presentation of a certificate that there was a default in the underlying transaction. Note here that, because the letter of credit is documentary, the condition for payment is not that there is a default in the underlying transaction, but that the beneficiary submit a certificate stating that there is a default in the underlying transaction. An issuer is not in a position, particularly given the small margins it makes on letters of credit, to investigate whether a default has in fact occurred. Its job is merely to compare the certificate against the letter of credit to determine whether the certificate complies with the requirements of the letter of credit. This is a very ministerial process and is key to the functioning of a letter of credit.

7. Drafts. One of the documents normally required under a letter of credit is a sight draft or a time draft. A draft is similar to a check in which the beneficiary instructs the issuer to pay a fixed amount to the beneficiary. A sight draft is one which is payable upon receipt by the issuer. A time draft is one that is payable at a specified number of days after receipt by the issuer.
8. **Expiration Date.** Letters of credit invariably have an expiration date. If a complying presentation of documents is not made before the expiration date, the letter of credit essentially evaporates. Hence it is critical for the beneficiary to calendar the expiration date of a letter of credit.

Some letters of credit have evergreen clauses. Under such clauses, a letter of credit can be extended for additional time periods (usually one year) unless the issuer sends notice to the beneficiary within a prescribed time period before the current expiration that the expiration date will not be extended. To put teeth in the evergreen clause, the evergreen clause normally provides that, if a notice of non-extension is sent, the beneficiary can draw under the letter of credit with only a draft without the other documents which would normally be required. Evergreen (or auto-renewal) clauses are in a state of constant evolution as litigation over their mechanics motivates more detailed clauses.

9. **Reimbursement Agreement.** The issuer does not issue the letter of credit for free. The issuer will require the applicant to pay certain issuance fees and to sign a reimbursement agreement. The reimbursement agreement contains the applicant’s promise to reimburse the issuer if the issuer has to pay on the letter of credit. It also contains a number of credit provisions similar to what one might find in a loan or credit agreement, including representations, warranties, covenants and the like. The reimbursement agreement can be secured just like any other credit agreement so that, if the issuer has to pay on the letter of credit, the issuer will have recourse against the security posted by the applicant. A very common form of security in letters of credit is the posting of cash collateral. The reimbursement agreement usually also contains provisions establishing the issuer’s standard of care in paying or not paying under the letter of credit. For instance, even though the issuer is obligated to pay the beneficiary only if the documents submitted by the beneficiary **strictly** comply with the letter of credit, most reimbursement agreements obligate the applicant to reimburse the issuer even if the issuer pays against documents which **substantially**, but not **strictly**, comply.

10. **Minimal Defenses.** The appeal of the letter of credit to the beneficiary is at least twofold. First, the issuer’s credit is on the line in addition to that of the applicant. Second, if properly handled, the letter of credit is often deemed to be “as good as cash.” There are very few defenses to payment on a letter of credit. These include:

   (1) The documents presented by the beneficiary do not comply with the letter of credit;
   
   (2) The letter of credit has expired;
   
   (3) There is fraud in the transaction; and
   
   (4) The bank is insolvent (this may not be a legal defense but it nevertheless results in nonpayment).

The prudent beneficiary normally has control over the first three possible defenses. As to the fourth, the insolvency of the issuer, the beneficiary should insist that the letter of credit be issued by a highly creditworthy bank.
If there is fraud in the transaction, current law provides that the issuer may nevertheless honor the presentation under the letter of credit but that the applicant upon a proper showing can enjoin payment under the letter of credit. Most courts have set a fairly high standard of fraud, requiring that the fraud be so egregious that it vitiates the underlying transaction or that the beneficiary have no “colorable basis” for drawing on the letter of credit. A simple dispute in the underlying transaction is not sufficient. The practical result is that a letter of credit permits the beneficiary to hold the money while any dispute in the underlying transaction is being sorted out.

It is important to note that the fraud that is required to enjoin payment under a letter of credit is fraud by the beneficiary. For example, fraud by the counterparty to the underlying contract with the applicant is insufficient to allow an injunction against payment. Two recent cases from Florida illustrate this requirement.

In 2002 Irrevocable Trust v. Huntington National Bank, 2008 WL 5110778 (M.D. Fla. 2008) and in Jaffe v. Bank of America, 2009 U.S. Dist. Lexis 72881 (S.D. Fla. 2009), the letter of credit beneficiary was a lender to the company that was the counterparty to the underlying transaction with the applicant. Both transactions involved a letter of credit applicant in Florida who contracted with a ship builder in China to purchase luxury yachts. In each case, the applicant was required to provide a letter of credit for the payment of the purchase price for his yacht. In each case, the ship builder had a construction lender in China who required that the buyer’s letter of credit be issued for the benefit of the construction lender, as collateral security for the loans made by the construction lender to the ship builder/seller. In each case, the yachts were never constructed and delivered to the applicant/purchaser. In each case the applicant/purchaser sought to enjoin payment of the letter of credit. Although in each case the applicant alleged fraudulent conduct by its seller, each court held that fraud by the seller was insufficient to enjoin payment to the beneficiary. Instead, the applicant must demonstrate that the beneficiary acted fraudulently, which the applicant in each case was unable to do.

11. Independence Principle. A key principle under letter of credit law is that the letter of credit is independent of the underlying transaction. This is called the “independence principle.” Thus, absent fraud, a dispute in the underlying transaction is irrelevant to whether the issuer has to pay on the letter of credit, so long as the beneficiary submits complying documents. Another consequence of the independence principle is that, even if there is no dispute in the underlying transaction as to the right of the beneficiary to be paid, the beneficiary will not be paid under the letter of credit unless he submits complying documents.

12. Strict Compliance. What are complying documents? The courts have debated for years as to whether strict compliance or merely substantial compliance was required. The view of most commentators and the trend of the courts is to require strict compliance. There are extremely detailed rules concerning commercial letters of credit involving the sale of goods as to the form of invoices, bills of lading and the like.

An example will give a feel for the strict compliance standard. In Beyene v. Irving Trust Co., 596 F.Supp. 438 (SDNY 1984), aff’d, 762 F.2d 4 (2d Cir. 1985), the letter of credit required that a bill of lading, a required document, specify the “notify” party as Mr. Sofan. The bill of lading instead specified a Mr. Soran. Was this a mere typo or was this another
person? The court stated that something which was clearly a typo would not be grounds for finding noncompliance. However, in this case the issuer was not in a position to determine how important the name of the “notify” party was and whether the discrepancy was merely a typo or whether a different person was actually intended. Accordingly, the documents failed the strict compliance test.

“No substitution and no equivalent, through interpretation or logic, will serve. Harfield, Bank Credits and Acceptances (5th Ed. 1974), at p. 73, commends and quotes aptly from an English case: ‘There is no room for documents which are almost the same, or which will do just as well.’ Equitable Trust Co. of N. Y. v. Dawson Partners, Ltd., 27 Lloyd’s List Law Rtps. 49, 52 (1926).” Courtaulds North Am. v. North Carolina Natl. Bank, 528 F2d 802, 806; United Commodities-Greece v. Fidelity Intl. Bank, 64 NY2d 449, 455 (1985).

Other examples under the strict compliance test are set forth in the list of authorities on Exhibit C.

13. Assignment of Proceeds. As described in more detail below, Article 5 of the Uniform Commercial Code (the “UCC”) normally governs letters of credit issued in the United States. Under old UCC Section 5-116(1) and under new Section 5-112, the right to draw under a letter of credit is transferable only if the letter of credit specifically permits transfer of the letter of credit. Most issuers have detailed procedures for such transfers.

A transfer of the letter of credit is to be distinguished from an assignment of proceeds or a security interest in the proceeds. Unlike a transfer, an assignment of proceeds does not give the assignee the right to draw under the letter of credit but only the right to receive the proceeds when and if the beneficiary makes a complying draw. Under UCC Sections 9-314 and 9-107, a security interest in letter of credit rights (which includes a security interest in proceeds under a letter of credit) can be perfected only by the secured party getting the consent of the issuer or the confirmer under Section 5-114(c). The one exception is where the secured party has a perfected security interest in the underlying obligation and the letter of credit is a supporting obligation within the meaning of UCC Article 9. The topic of security interest in letter of credit rights and the priority of rights to obtain payment under a letter of credit is a complex topic. See G. Hisert, “Letters of Credit and Article 9: Mixing Oil and Water,” 73 Amer. Bankr. L. Jour. 183 (1999).

If a secured party wishes to control the actual drawing under the letter of credit, it should either arrange for a transfer of the letter of credit to itself or the original issuance of the letter of credit to itself. If neither of these approaches is possible, the secured party should consider getting undated draw certificates and drafts pre-signed by the beneficiary, with a power of attorney authorizing the secured party to submit the documentation on the beneficiary’s behalf. Given the nature of some of the documents required under letters of credit, this may not always be feasible.

B. Difference from Guarantees

Letters of credit differ from guarantees in several important respects. Guarantees are often referred to as “secondary” obligations, meaning that the liability of the guarantor is