

International Business Transactions

Letters of Credit

September 14, 2009

Some Basic L/C Terms

- Applicant (or “account party” or “customer”)
- Beneficiary
- Issuer (or “issuing bank”)
- L/C application contract
- Confirming bank
- Advising bank
- Collecting bank
- Nominated bank
- Negotiating bank
- Commercial L/C
- Standby L/C
- Undertaking
- Uniform Customs and Practices for Documentary Credits (UCP)

Definition lists are given in:

- UCC §5-102
- UCP Article 2

UCC vs. UCP

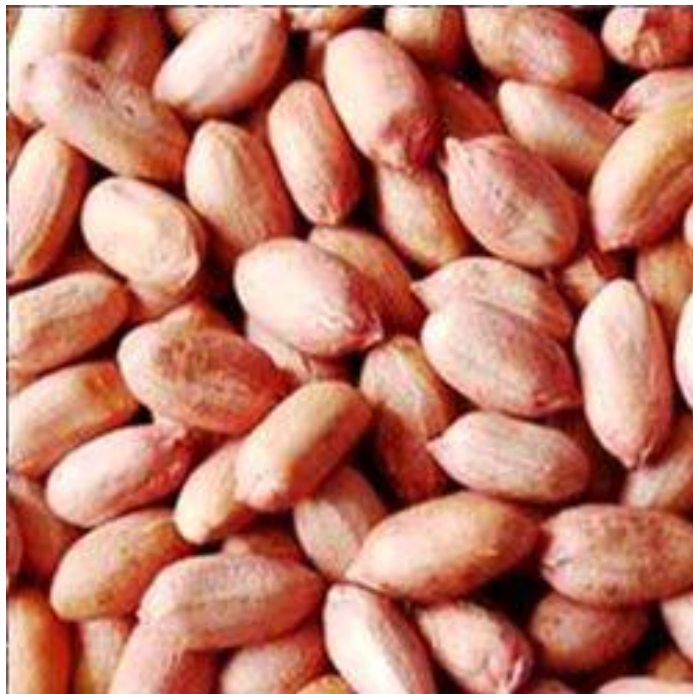
UCC

- Not particularly extensive.
- Intended to establish a theoretical framework for further development of L/C custom
- Except for certain mandatory provision (of which there are only a handful), UCC provision may be modified by mutual agreement or by a provision in an undertaking
- Contains rules related to fraud.

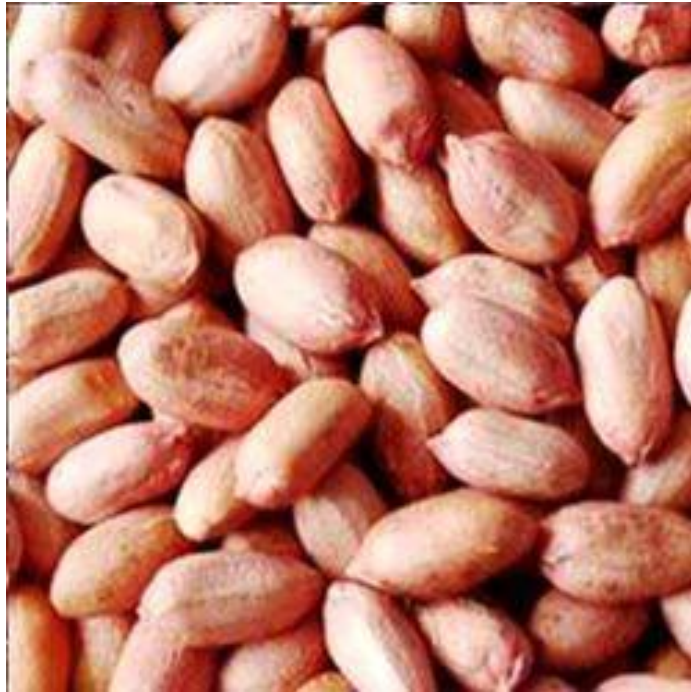
UCC vs. UCP

UCP

- An ICC restatement/compilation of internationally accepted banking customs and practices regarding commercial L/Cs.
- Not law; not statutory law or international treaty. Therefore not binding on courts.
- However, in the absence of statutory provisions, the UCP is the centerpiece of L/C rules.
- Quite extensive, especially with regard to the mechanics of an L/C transaction.
- Private parties can expressly incorporate the UCP into their agreements or undertakings (modified as agreed or declared) to govern their contractual obligations. Except as such provisions would conflict with mandatory UCC provisions, US courts recognize and enforce such UCP provisions.
- ICC has an commission to which questions about UCP interpretation can be posed and it will issue advisory opinions (also not binding on courts).
- Virtually every L/C in the world incorporates the UCP. Therefore, courts have had to interpret it.
- Has greatly influenced the development and revisions of the UCC.
- Contains no rules related to fraud.
- Contains no rules related to the L/C application contract.



Coromandel Groundnuts

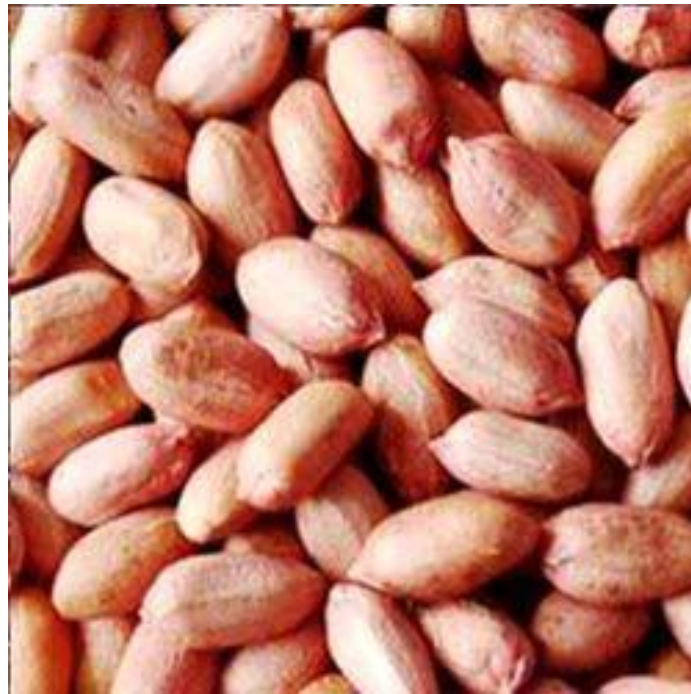


Coromandel Groundnuts



(a.k.a. shelled groundnut kernels)

Coromandel Groundnuts



(a.k.a. shelled groundnut kernels)
(a.k.a. peanuts)

Mid-America Tire Case

Issue #1

Need there be an absence of an adequate legal remedy for injunctive relief to be available?

Ans.: Yes.

Here there is such an absence since obtaining an adequate legal remedy would require:

- many law suits,
- in many jurisdictions, and
- against many dependents,
- and damages would be difficult to estimate.

Mid-America Tire Case

Issue #2

With regard to a fraud exception, is the LC governed by the UCP or the UCC?

Remember, the issuing bank declared that the UCP would govern the LC, but the UCP is silent on fraud.

In these circumstances, the UCP governs, except for:

- Mandatory UCC provisions (See section 5-103(c)), and
- Non-conflicting UCC provisions (serve as gap fillers)
e.g., the fraud provisions and provisions on injunctive relief!

Mid-America Tire Case

Issue #3

Is the fraud exception available when the fraud is in (the inducement of) the underlying sales transaction?

Court looked at Section 5-109 of the UCC and declared the answer to be:

YES

However, the fraud must be “material.” What does this mean?

In accordance to the court:

“Fraud which has *so vitiated the entire transaction* that the legitimate purpose of the independence of the issuer’s obligation can no longer be served.”

Mid-America Tire Case

Issue #4

Should payment be enjoined in this case under the fraud exception; was the fraud material enough/vitiating enough/egregious enough?

Lots of false representations:

- That PTZ was the sole distributorship for surplus Michelin and had a direct relationship with Michelin
- That there would be 50-70,000 summer tires available soon, and for cheap
- That buyers had to buy the winter tires iot get to buy the summer ones
- That the tires to be initially sold could be imported into the US

Court quotes:

- “There were all intentionally false, inaccurate reps that the buyers relied on. These were all material statements which induced the buyers to enter into the sales K.”
- “The L/C in the case was being used by PTZ as a vehicle for fraud”
- “It would be pointless and unjust to let PTZ draw the \$\$”
- “A L/C should not be a fraudulent sellers Holy Grail, which once obtained would provide cover for fraudulent business practices in the name of commercial expedience.”

Fraud vs. Breach

Fraud is not merely breach; it is more than mere breach.

In a case where there is merely breach, the Independence Principle holds.

Standby LCs

Governing law/rules

- One international treaty
 - UN Convention on Independent Guarantees and Standby Letters of Credit
 - only eight states have ratified this convention.
 - Not the US.
- US law
 - UCC Article 5
- Three ICC publications:
 - UCP (to the extent that these rules are applicable to standbys)
 - Uniform Rules for Demand Guarantees (URDG)
 - The International Standby Practices (ISP98)

Ways an Account Party can Limit its Vulnerability to Standby LC Fraud

- Try to avoid “suicide” LCs (i.e., LCs payable upon a mere demand).
- Insist on very detailed documentary requirements and conditions. (This increases the possibility of non-conformity and lays the groundwork for a lawsuit afterwards.)
- Possible documents:
 - Certificate from a responsible officer of the beneficiary specifying with detailed facts how the account party had defaulted.
 - Independent certification from a third party of the account party’s default (e.g., an auditor’s report, court judgment, arbitrator’s ruling).
 - A certificate from the account party acknowledging that the funds are owed.
- Increase the possibility of non-conformity by requiring such documentary formalities as notarization, apostilles and other certificates of incumbency.
- Include a provision that the amount of the LC reduces as account party performs.
- Include in the LC itself express language that it should terminate upon termination of the underlying contract.
- Have the beneficiary’s bank be a collecting or advising bank so as to reduce the holder in due course problem.
- Avoid using an LC at all and, if applicable, use a Performance Bond instead (which would be issued by someone knowledgeable in the business and often entails their investigation before any payment is made).

One’s ability to include such requirements in the LC depends on one’s negotiating power relative to the beneficiary’s, and banks may resist changing their standard forms and practices.

If you think you are encountering fraud in an LC transaction...

If you are representing the applicant:

- Getting an injunction is very difficult, since the independence principle, which has been established in order to ensure market confidence in LCs, is quite strict.
- The evidence of fraud you present will have to be very strong.
- A mere breach of the contract by the beneficiary may not amount to fraud.
- To date, few if any courts recognize the fraud exception when the allegedly fraudulent party is anyone but the beneficiary under the LC.
- Banks honoring presentation must usually pay within a certain time period, so any evidence you might have must be gathered and presented to the bank or a court quickly.
- You must ensure you meet any other requirements for an injunction in your jurisdiction.
- Contact the bank and see if you can get the bank to delay payment (with the time limit) so you can gather more evidence of fraud.
- Try to prevent the draft from getting in the hands of a holder in due course (e.g., a confirming bank) since the fraud exception is not available after a innocent holder in due course acquires the right to be paid under the credit.
- Absent a court injunction, a bank will almost always prefer to pay (and be reimbursed by the applicant), despite strong allegations of fraud, since it will wish to be perceived as a reliable payer in the market and will be unwilling to play the role of judge, to look beyond the documents presented and to engage in litigation.
- In light of all of this, be prepared to litigate directly against the beneficiary over the sales contract after having reimbursed the issuing bank.

Takeaways I

- LCs are game changers; they make transactions happen that would not otherwise happen. They are a big deal because they give comfort to the beneficiary that they have the right to money as long as they meet the documentary requirements listed in the LC, a list for which they can bargain.
- People prefer not to have to apply for an LC since they are expensive, and, in the case of standby LCs, risky.
- Commercial LCs are governed by custom and, in the US, the UCC.
- Standby LCs are governed by custom and, in certain cases, international treaty, and, in the US, the UCC.
- These rules are designed to promote efficiency and efficacy of international trade.
- The ICC's UCP is the most accepted restatement of commercial LC custom, and its rules are typically incorporated into commercial LCs.
- The ICC's ISP is designed to be the UCP counterpart for standby LCs and its rules may also be incorporated into an LC.
- LCs are independent of the underlying transaction; issuing banks are obligated under the LC regardless of breach or performance under the sales contract. This is known as the Independence Principle or the Autonomy Principle.
- The only exception to the independence principle is the fraud exception. The fraud exception is narrow and rarely applied in commercial LCs. This exception does not refer to mere breach of the underlying sales contract, but fraud in the transaction.

Takeaways (cont.)

- In order to be paid under an LC, the documents presented must strictly conform with the requirements listed in the LC. This strict conformance principle, however, when examined closely is subject to interpretation. A minority of document tenders are, in fact, perfect tenders. Just how strict conformance must be is a function of international banking custom.
- Under the UCC and the UCP, banks, when determining whether or not documents are compliant, are under no legal obligation to seek waivers from the applicant nor to do any investigation beyond the face of the documents (at least not yet).
- Standby LCs function as performance guarantees, and unlike commercial LCs, if a transaction goes as intended, should not be drawn on.
- Typically, very few documents are required to be presented for a draw under a standby LC. As a result, the potential for fraud is greater than with commercial LCs and the fraud exception is more readily applied to standby LCs.
- In order to reduce vulnerability to fraud in the context of a standby LC, the LC should contain appropriate documentary hurdles for the beneficiary to overcome which will be difficult to fraudulently produce.