

# Issues with letters of credit and how to deal with them

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# Overview

- Part 1: Back to basics
  - › Key features and uses of documentary letters of credit (LCs) and standby letters of credit (SBLCs)
  - › Roles of the parties
  - › Key terms and governing rules
  - › Process for issuance and claim
  - › Different types of LCs and jargon
  
- Part 2: Key issues and how to deal with them
  - › Different uses and structures – structured LCs, silent confirmations
  - › Problematic provisions – governing law, jurisdiction for disputes, sanctions, using UCP 600 for SBLCs
  - › Relationship with the applicant – terms of reimbursement agreement, cash cover, taking security
  - › Presentations – discrepancies, non-documentary conditions, force majeure, fraud
  - › Future of LCs in a digital world

# PART 1: BACK TO BASICS

# Key features and uses

- Documentary LCs
  - › Instruments of payment in respect of the sale and purchase of goods
  - › Irrevocable promise made by a bank to pay upon presentation of compliant documents – from the seller’s perspective, this substitutes the credit risk of the buyer for that of the bank
  - › Principle of autonomy – LC is independent from the underlying transaction
  - › Matrix of contractual relationships
  - › Can be used to extend credit to the buyer
- SBLCs
  - › Credit support or allocation of risk of non-performance – linked to underlying transaction
  - › Irrevocable promise made by a bank to pay upon presentation of a complying demand
  - › Independent from the underlying transaction
  - › Matrix of contractual relationships
  - › Share many features with demand guarantees and other types of risk distribution agreements

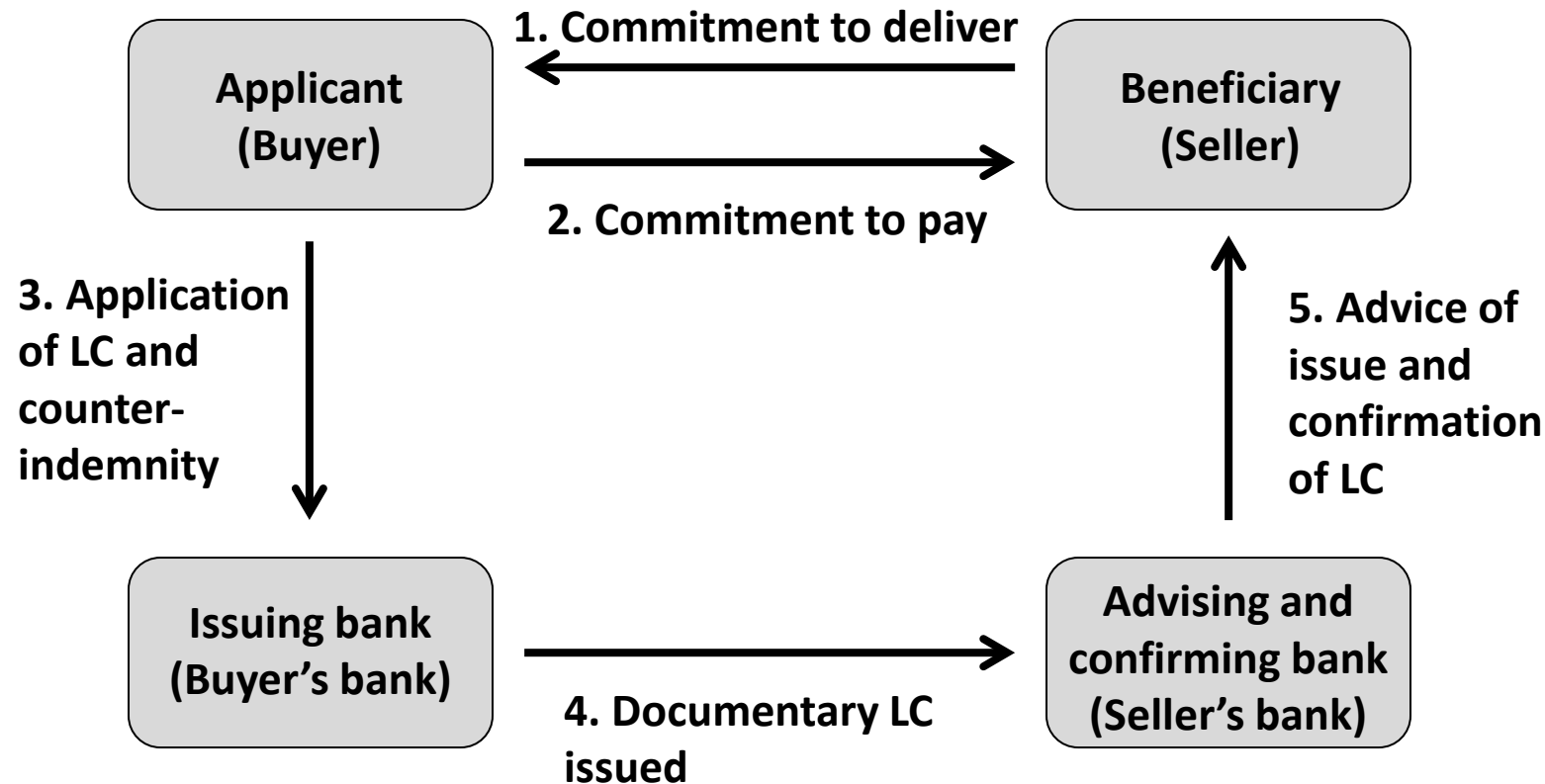
# Roles of the parties – documentary LCs

- Commercial parties:
  - › Applicant: buyer of goods, owes money to seller of goods, applies for issuance of LC
  - › Beneficiary: seller of goods, requires payment under commercial contract by LC
- Bank parties
  - › Issuing bank: applicant's bank, issues LC and has obligation to make payment under it
  - › Advising bank: usually beneficiary's bank, acts as messenger
  - › Nominated bank: can be any bank (except the issuing bank), can accept role under LC
  - › Confirming bank: usually beneficiary's bank, undertakes to make payment under the LC
  - › Transferring bank: relevant to transferable LCs, advises credit to the final beneficiary
  - › Negotiating bank: usually beneficiary's bank, may purchase drafts presented under LC at a discount

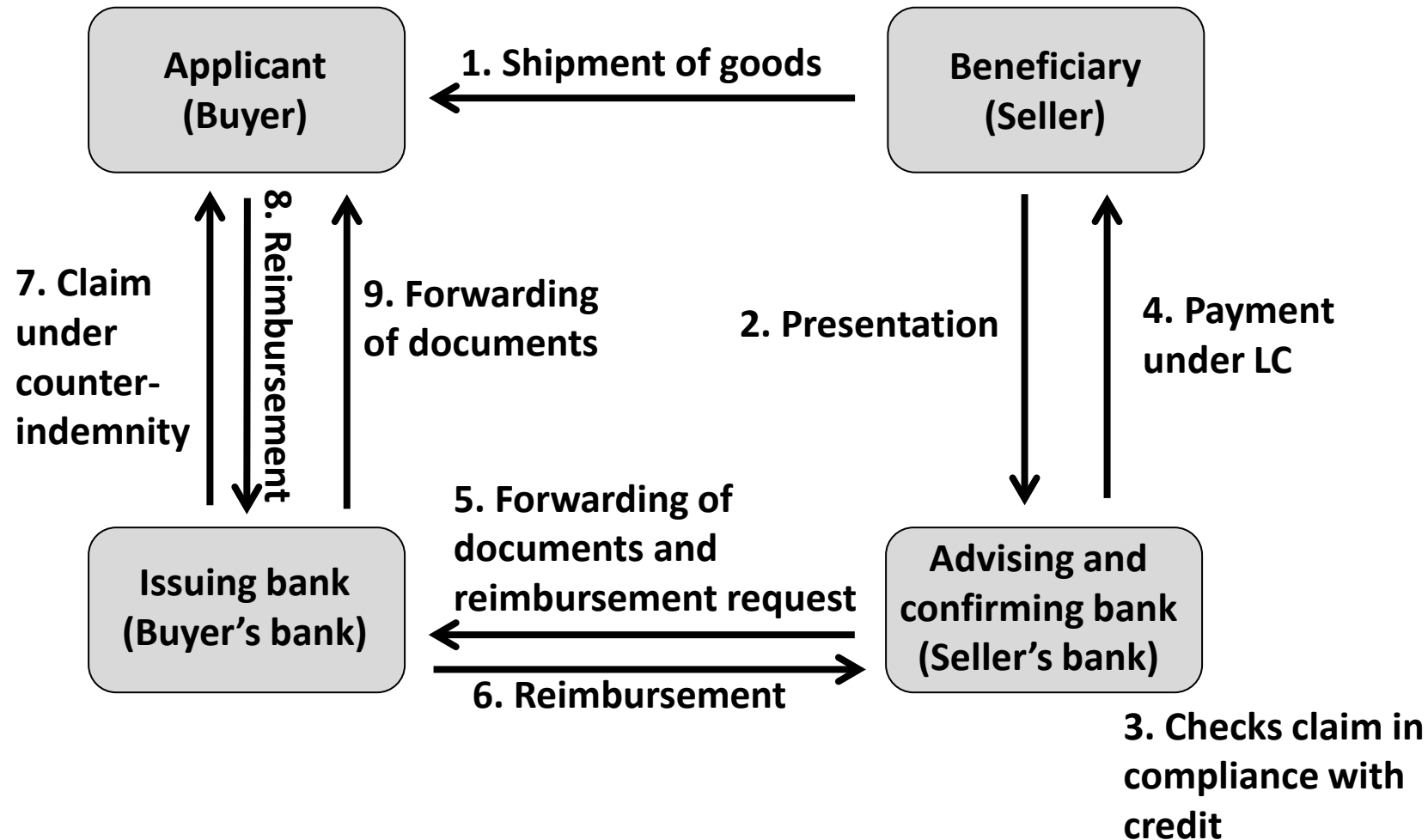
# Key terms – documentary LCs

- Contractual terms of LC
  - › Parties, amount, availability, expiry date, etc
  - › Documents required
  - › Other terms?
- ICC Uniform Customs and Practice for Documentary Credits (UCP 600)
  - › Internationally-recognised governing rules for LCs
  - › Aims to harmonise practice in the issuance and treatment of LCs internationally
  - › Does not have force of law – must be interpreted in accordance with the governing law of the LC
  - › Must be explicitly incorporated into the LC
  - › Can be amended
- International Standard Banking Practice for the Examination of Documents under UCP 600 (ISBP)
  - › Read in conjunction with UCP 600
  - › Highlights how UCP 600 to be interpreted and applied and gives meanings to certain words used in LCs

# Process for issuance – documentary LCs



# Process for claim – documentary LCs





# Process for issuance and claim – documentary LCs

- Buyer and seller enter a contract for the sale and purchase of goods
- Buyer (applicant) requests its bank (issuing bank) to issue an LC in favour of the seller (beneficiary)
- Applicant enters into a counter-indemnity with the issuing bank and pays issuance fee
- Issuing bank issues LC and asks seller's bank (the advising bank) to advise the seller that LC has been issued and of its terms
- Advising bank adds its “confirmation” to the LC, and becomes confirming bank
- Seller ships goods and presents shipping documents and any other documents required under the LC to confirming bank
- Confirming bank checks documents against the LC and, if they comply, pays beneficiary
- Confirming bank forwards documents that were presented by seller to issuing bank and claims reimbursement
- Issuing bank reimburses confirming bank
- Issuing bank claims reimbursement from applicant under its counter-indemnity
- Applicant reimburses issuing bank, and issuing bank forwards the presented documents so that the buyer can take possession of the goods

# Process for claim and issuance – key points

- Checking a presentation
  - › Autonomy from underlying contract
  - › Banks deal with documents only
  - › Expiry and place for presentation
  - › Standard for examination, dealing with certain types of documents and issues
  - › Importance of compliance with timelines
- Discrepancies / non-complying presentation
  - › Notice to presenter
  - › Waiver from applicant
- Complying presentation
  - › Requirement to “honour” (pay at sight, incur deferred payment undertaking or accept a draft)
  - › Forward documents to issuing bank

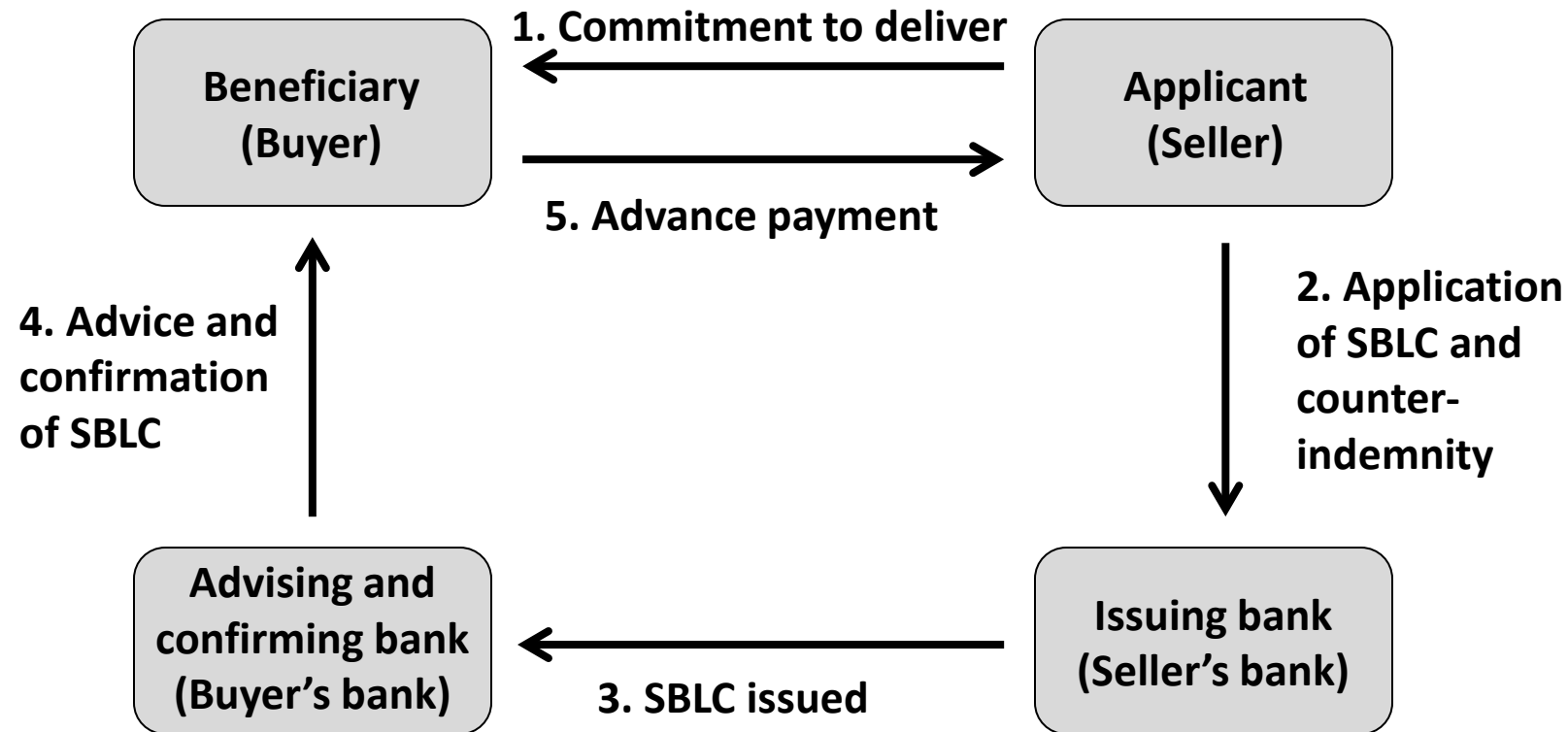
# Different types of LC and jargon

- Availability of LCs
  - › Sight, deferred payment, acceptance, negotiation
  - › Transferable LCs
- Discounting of LCs
- Import and export LCs
- Evergreen
- Revolving, escalating, de-escalating
- Back-to-back
- Red clause, green clause

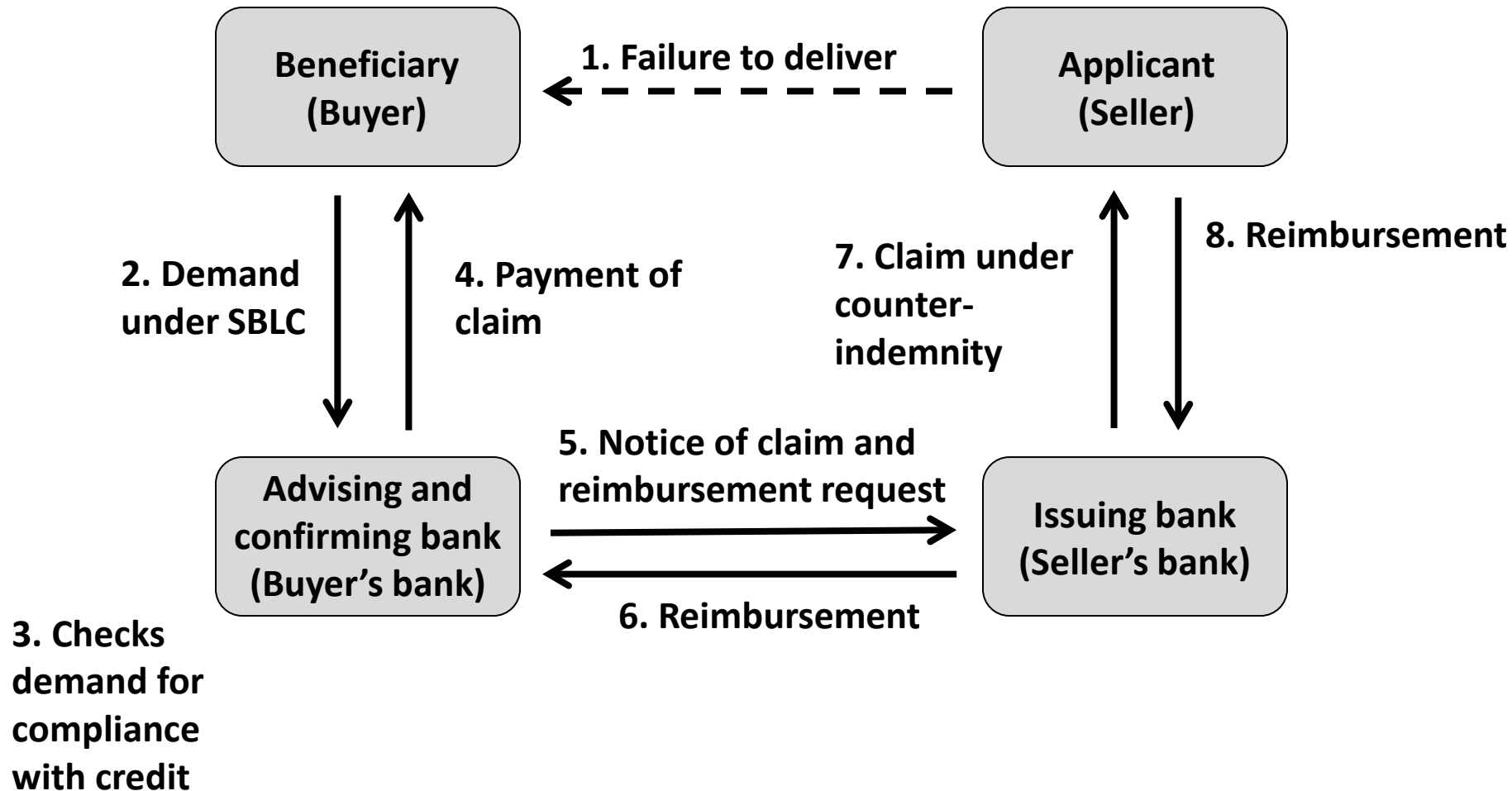
# Roles and key terms – SBLCs

- Roles
  - › Applicant, issuer, beneficiary
- Key terms
  - › Amount, expiry, place for presentation
  - › Documents required for presentation
  - › Other terms?
- Governing rules
  - › International Standby Practices ICC Publication No 590 (ISP 98)
  - › Specially designed set of rules for SBLCs
  - › UCP 600 or ISP 98?

# Process for issuance – SBLCs



# Process for claim – SBLCs



# Process for issuance and claim – SBLCs

- Buyer and seller enter a contract for the sale and purchase of goods, requiring advance payment by buyer
- Buyer requires SBLC to protect against risk of non-delivery
- Seller (applicant) requests its bank (issuing bank) to issue an SBLC in favour of the buyer (beneficiary)
- Applicant enters into a counter-indemnity with the issuing bank and pays issuance fee
- Issuing bank issues SBLC and asks buyer's bank (the advising bank) to advise the buyer that SBLC has been issued and of its terms
- Advising bank adds its "confirmation" to the SBLC, and becomes confirming bank
- Buyer makes advance payment to seller
- If seller delivers in accordance with the contract, no claim made on SBLC
- If seller fails to deliver, buyer makes demand under SBLC on confirming bank
- Confirming bank checks demand against the SBLC and, if it complies, pays beneficiary
- Confirming bank claims reimbursement from issuing bank and issuing bank reimburses confirming bank
- Issuing bank claims reimbursement from applicant under its counter-indemnity
- Applicant reimburses issuing bank

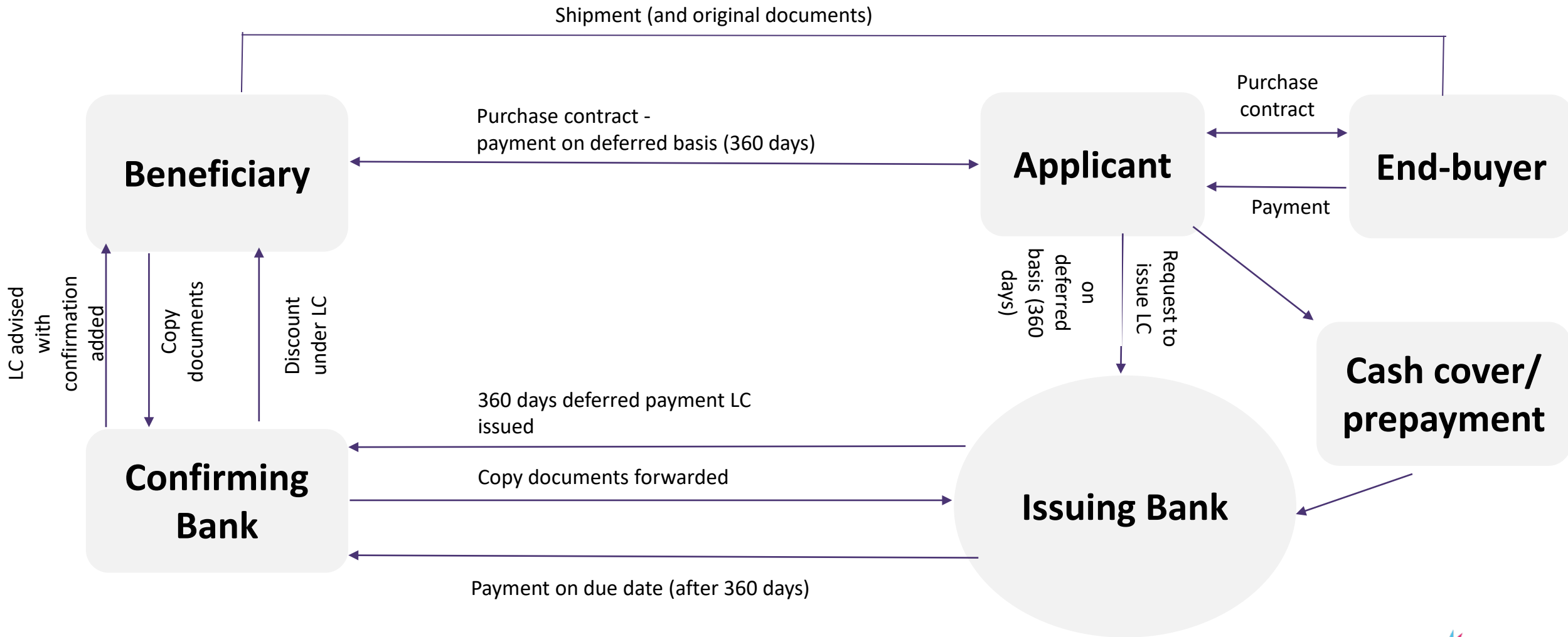
# PART 2: KEY ISSUES



# Structured LCs (1)

- This is a variation of a documentary letter of credit used primarily as a means of raising financing
- Significant overlap with 'normal' documentary letters of credit but with some key structural differences
  - › Structured LCs will be payable on a deferred basis
  - › Discounting bank (typically confirming bank) will be involved
  - › Related parties as applicant and beneficiary
  - › Cash cover or prepayment to issuing bank
  - › Use of copy documents
- Transparency
- Importance of underlying trade transaction

# Structured LCs (2)



# Silent confirmations

- A silent confirmation is a promise to negotiate document presented under an LC or to pay the amount of a claim if the issuing or confirming bank fails to do so
- Outside the scope of UCP – documented between silent confirmer and beneficiary
- Silent confirmer does not have same protections as bank that adds its confirmation within scope of UCP
  - › Beneficiary may assign its rights against issuing bank to silent confirmer
  - › If bank that has committed to negotiate is a nominated bank, it will become negotiating bank within scope of UCP once it honours the credit
  - › Fraud risk

# Governing law of LCs

- Importance of governing law of a contract
  - › Specifies the system of law that applies in the interpretation of the contract
  - › In context of LCs, this includes the interpretation of governing rules incorporated into the contract
  - › Conflict of law rules: test that courts will apply to determine substantive law of a contract – will vary between jurisdictions
  - › Determining the substantive law, absent express choice of law agreement, likely to be complex
  - › Dispute about governing law could be lengthy and expensive
  - › Many jurisdictions give effect to governing law expressly chosen by parties in the contract
- Relationships of different parties under LCs – matrix of separate contracts
  - › Applicant and issuing bank – reimbursement agreement will typically specify governing law
  - › Issuing bank and confirming bank
  - › Issuing / confirming bank and beneficiary
  - › LCs generally cross-border and thus multi-jurisdictional
  - › Governing law of the various contracts may be different
- UCP does not contain any governing law provisions
- Preferable to include express choice whenever possible

# Disputes under LCs – jurisdiction

- Governing law does not specify how the disputes are to be resolved
- For LCs with no effective jurisdiction clause, the appropriate forum for the settlement of disputes determined by the rules of private international law
  - › Courts in different jurisdictions likely to adopt a different approach
  - › Example: domicile/seat of party being sued
  - › Example: service of legal process
- Risks of not having express choice of jurisdiction:
  - › Resolving disputes may be problematic
  - › Opportunity to resolve dispute by alternative means, such as arbitration, likely to be limited
  - › Risks of counterparty forum shopping for “friendlier” jurisdictions, or of inconsistent decisions on proceedings commenced elsewhere
  - › Uncertainty and complexity can result in costs and delays
  - › Acceptable commercial risk?

# Sanctions (1)

- Sanctions may restrict a bank's ability to perform under an LC
- Banks' internal policies may require standard sanctions clauses to be incorporated into LCs
  - › Clauses may aim to address conflicting regulatory requirements under different sanctions regimes
  - › Is clause merely informational or does it allow element of discretion whether to honour payment based on internal sanctions policies?
  - › Sanctions clauses with broader scope call into question irrevocable and documentary nature of LC
- ICC guidance published 2014 and updated 2020
  - › Recommends avoiding including in LCs any sanctions clauses that purport to impose restrictions beyond, or conflict with, the applicable statutory or regulatory requirements
  - › Where bank requires sanctions clause, ICC recommends that the clause should be drafted in clear terms, restrictively, to limit the reference only to mandatory law applicable to the bank
  - › Example clause: *"[notwithstanding anything to the contrary in the applicable ICC Rules or in this undertaking,] We disclaim liability for delay, non-return of documents, non-payment, or other action or inaction compelled by restrictive measures, counter-measures or sanctions laws or regulations mandatorily applicable to us or to [our correspondent banks in] the relevant transaction."*

# Sanctions (2)

- ICC guidance (continued)
  - › Clauses should not be included routinely, but on a case-by-case basis
  - › Sanctions referred to in clause should be limited to those regulations directly and mandatorily apply to the bank
  - › Clauses should refrain from including unparticularised references to laws generally (e.g. “any applicable local and foreign laws”)
  - › Avoid any references to a bank’s internal policies or procedures
  - › Consider application of anti-boycott laws that might prevent inclusion of sanctions clause
  - › Consider position of correspondent bank located in a different jurisdiction from issuing bank – e.g. US bank clearing USD payments will be subject to US sanctions

# SBLCs – UCP 600 vs ISP 98

- SBLCs are often subject to UCP 600 – users may be more familiar with UCP 600 than ISP 98
- UCP 600 primarily aimed at documentary LCs and not always suitable for the peculiarities of SBLCs
  - › UCP 600 does not deal with extend or pay requests (which allow the beneficiary to request an extension of the expiry date if, for example, the transaction is delayed, rather than having to make a demand or risk losing its protection) or SBLCs without stated expiry date
  - › Payment in instalments
  - › Some articles will be irrelevant – negotiation, transferability, provisions relating to transport documents
  - › ISP 98 more comprehensive for use with SBLCs
- Where UCP used for SBLCs, consider whether any provisions need to be modified to accommodate operation of the SBLC



# Reimbursement agreements

- Applicant and issuing bank enter into reimbursement agreement
- Key terms
  - › Authorisation of bank to make payment under LC as autonomous instrument independent of underlying transaction
  - › Agreement to reimburse issuing bank for amount of any claim
  - › Allocation of risk in respect of bank's responsibility to ensure presentation compliant
  - › Indemnity for losses incurred by issuing bank
- Cash cover or prepayment of LC
- Security over documents and underlying goods
  - › Effectiveness will depend on location and type of goods, and applicable local legal requirements
  - › Generic security clauses may have limited value in practice

# Dealing with issues around presentations (1)

- Discrepancies
  - › High percentage of presentations rejected first time – estimated up to 80%
    - Examples: missing documents, inconsistent data, goods or shipping details not matching credit requirements
    - Results in delays and additional fees
    - What if no time to make new presentation before expiry?
  - › Risk of dispute between confirming bank that has accepted a presentation and issuing bank that raises a discrepancy
  - › UCP 600 and ISBP contain rules on how documents should be examined
    - Human element to the checking process
    - Term “strict compliance” not used in UCP – scope for minor discrepancies to be accepted without need for waiver
    - When is a discrepancy “immaterial”?
  - › Importance of clear and precise drafting of LCs and familiarity of document checkers with applicable rules and standards
  - › Avoid excluding sub-articles of UCP – can have unintended consequences on standards that apply to checking a presentation

# Dealing with issues around presentations (2)

- Non-documentary conditions
  - › Condition that does not stipulate a required document evidencing compliance with the condition
  - › Can be disregarded in some cases (UCP Art 14(h))
  - › However, documents presented must be consistent with the condition (ISBP A26)
    - E.g. “*origin of goods – China*”
    - No stated requirement to present certificate of origin and so condition can be disregarded
    - However, any documents presented as part of the presentation must not indicate inconsistent origin
  - › Avoid non-documentary conditions as they can lead to unnecessary disputes or mistaken identification of discrepancies
- Presentation and force majeure
  - › ICC guidance published in 2020 in response to Covid 19
  - › Considered position under ICC rules in relation to place for presentation, document examination periods, definition of banking/business day and force majeure
  - › General position at law – common law requires contractual provision whereas many civil law jurisdictions provide for force majeure under civil code

# Dealing with issues around presentations (3)

- Presentation and force majeure (continued)
  - › What amounts to force majeure is question of interpretation under applicable law
  - › Occurrence of force majeure may excuse performance
  - › UCP 600 (article 36), URDG 458 (article 13) and URC 522 (article 15) contain force majeure provisions
  - › ISP 98 contains provision extending last day of presentation for 30 days if place for presentation closed on last business day for presentation, or enabling issuer to authorise another reasonable place for presentation
  - › Under governing rules, banks not liable for delays in transit of documents
  - › Possibility of modifying ICC rules applicable to LCs to accommodate extraordinary circumstances:
    - Extend period for examination of documents
    - Incorporate eUCP to enable presentation of electronic documents
- Fraud

# Future of LCs in a digital world

- UCP 600 designed for paper-based use of LCs
  - › Envisages a physical place for presentation
  - › Does not address requirements for electronic documents and the issues that might arise in relation to electronic presentations
- eUCP
  - › 12 articles that supplement UCP 600 – must be expressly incorporated
  - › Allows presentation in different formats and provides for “place” of presentation for electronic records
  - › Document may be presented via hyperlink
  - › Different documents can be presented at different times with requirement for notice of complete presentation
- Fraud risk
  - › Banks should ensure any authentication requirements for documents form part of the specified requirements for the documents to be presented
  - › Verification processes (such as call backs) outside scope of credit are problematic – failure to independently verify a document that complies with requirements of credit will not excuse bank’s liability to honour

# AUDIENCE QUESTIONS

# Awards & Recognition

## **Chambers UK, 2022**

Chambers UK, 2022 ranked Sullivan in Commodities: Trade Finance (UK-wide)  
Geoffrey Wynne and Simon Cook are Ranked Lawyers in Tier 1 and Tier 2 respectively  
Sam Fowler-Holmes is recognised as an “Up and Coming” lawyer

## **The Legal 500 UK, 2022**

Sullivan ranked in Tier 1 for Trade Finance by *The Legal 500 UK, 2022* for the eighth year running  
Partner Geoffrey Wynne is included as a Leading Individual for Trade Finance in the “Hall of Fame”  
Simon Cook and Mark Norris are recognised as Leading Individuals  
Sam Fowler-Holmes is recognised as a Next Generation Partner and Hannah Fearn as a Rising Star

## **IFLR1000 Banking and Finance Guide, 2023 (32<sup>nd</sup> edition)**

Sullivan recognised for Banking Lending - Lender Side, United Kingdom, in *IFLR1000's Banking and Finance Guide, 2023*  
Partner Geoffrey Wynne is ranked as a Leading Lawyer – Highly Regarded in the United Kingdom

## **Global Trade Review (GTR) “Best Trade or Supply Chain Finance Law Firm”, 2022**

GTR named Sullivan “Best Trade or Supply Chain Finance Law Firm” at the GTR Leaders in Trade Awards in 2022

## **Trade Finance Global “Best Trade Finance Law Firm” 2022**

Sullivan named “Best Trade Finance Law Firm” 2022 by *Trade Finance Global* (in connection with BAFT) at its International Trade Awards, 2022

## **In 2021, 2020 and 2019, GTR named Sullivan**

The firm was named “Law Firm of the Year” in the category “Leaders in Trade for Innovation” at the 2021 GTR Leaders in Trade Awards and “Best Trade Finance Law Firm” at the GTR Leaders in Trade Awards in 2020 and 2019

## **2021 Lexology “Client Choice” award for Banking, United Kingdom**

Geoffrey Wynne named a recipient of the Lexology “Client Choice” Award 2021 for Banking, United Kingdom

## **Trade Finance Global “Best Trade Finance Law Firm” 2019**

Sullivan named “Best Trade Finance Law Firm” 2019 by *Trade Finance Global* at its International Trade Finance Awards, 2019





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