



Standby Letters of Credit Bootcamp



Presented by

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Agenda

- ▶ Standby Letters of Credit
- ▶ Documentary Letters of Credit
- ▶ Provisions Common to Letters of Credit
- ▶ Intersection of Letters of Credit and Bankruptcy

What is a Letter of Credit?

- **General Definition:** An undertaking issued by a bank for the account of the applicant (buyer) to pay to the beneficiary (seller) the value of the **letter of credit (LOC)**, provided that the terms and conditions are complied with
- In other words, a **LOC** substitutes (or supplements) a bank's creditworthiness (which is generally known or ascertainable) for that of its customer, which may be less well known.

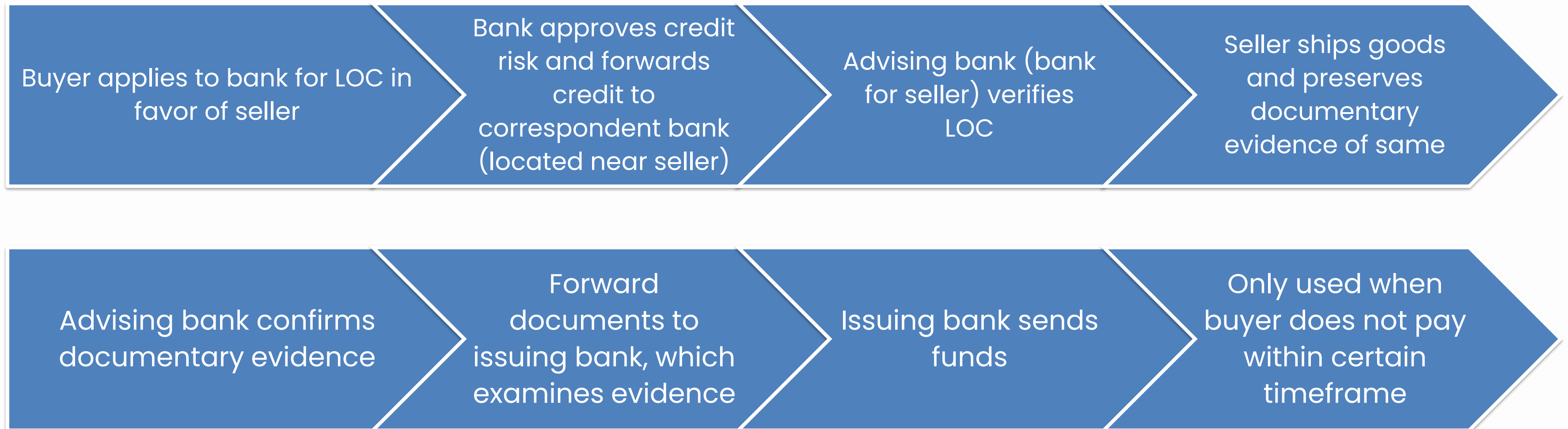
What is a Letter of Credit?

- Two primary types of **LOCs**, both of which serve very different purposes:
 - ✓ **Commercial** (or Documentary)
 - ✓ **Standby**

Standby Letters of Credit

- **Standby letters of credit** are intended to be a secondary payment mechanism, issued by a bank on behalf of a customer to provide assurance of ability to perform under a contract with the seller.
- Typically, **standby LOCs** have an expiration date.

Standby Letters of Credit



Standby Letters of Credit

- **Evidence required:**
 - ✓ Commercial invoices
 - ✓ Bills of lading
 - ✓ Warranty of title
 - ✓ Letter of Indemnity
 - ✓ Can be other documentation as specified by issuing bank

Standby Letters of Credit

- **Common defects:**
 - ✓ LOC has expired
 - ✓ Bills of lading evidence delivery outside of date range stated in credit
 - ✓ Changes in invoice are not authorized in the credit
 - ✓ Inconsistent description of goods (volume, price, quality)
 - ✓ Invoice amount not equal to draft amount
 - ✓ Ports of loading/destination inconsistent with LOC
 - ✓ Lack of documentation or improper naming of documents
 - ✓ Improper names on documents
 - ✓ No signatures as required

Commercial Letters of Credit

- Serves a different purpose than a **standby LOC** – is intended to be the primary payment mechanism for a transaction
- Have been used for centuries to facilitate payment in international trade

Commercial Letters of Credit

- A **commercial LOC** is a contractual agreement between an “issuing bank,” on behalf of one of its customers, authorizing another bank, known as the “advising” or “confirming” bank, to make payment to the beneficiary (i.e., the seller).
- Issuing bank makes a commitment to honor drawings under the LOC
- Issuing bank essentially replaces the bank’s customer as payor

Commercial Letters of Credit

- **Elements of a commercial LOC:**
 - ✓ Payment undertaking given by issuing bank
 - ✓ On behalf of a buyer (applicant)
 - ✓ To pay a seller for a given amount of money
 - ✓ On presentation of specified documents representing the supply of goods
 - ✓ Within specified time limits
 - ✓ Documents must conform to terms and conditions set out in the LOC
 - ✓ Documents to be presented at a specified place

Commercial Letters of Credit

- **Documents that may be requested:**
 - ✓ Draft (written order to another party to pay money to a third party, also called bill of exchange)
 - ✓ Bills of lading/delivery documents
 - ✓ Warranty of title (from seller to buyer, stating that good title is being conveyed)
 - ✓ Invoices
 - ✓ Insurance policies/certificates
 - ✓ Packing lists
 - ✓ Consular/Customs invoice
 - ✓ Certificate of Origin
 - ✓ Weight certificate
 - ✓ Inspection certificate
- Look to your freight forwarder for guidance on which documents are required by country.

Commercial Letters of Credit



Issuing Bank has obligation to **Seller** to pay once it complies with all terms and conditions in the LOC.

Commercial Letters of Credit

Advised vs. Confirmed

- **Advised**
 - Advising bank's responsibility limited to authentication of LOC; has no independent payment obligation
 - Seller bears credit risk of issuing bank and country risk of transaction
- **Confirmed**
 - If issuing bank's LOC is confirmed, confirming bank substitutes its creditworthiness for that of issuing bank and takes on duties and responsibilities of an issuing bank.
 - Must be requested by issuing bank to confirm credit

Provisions Common to Letters of Credit

Negotiability

- A LOC is a negotiable instrument, which means that the issuing bank's obligation to pay is transferable to another bank nominated by the seller/beneficiary.
- Article 3 of the Uniform Commercial Code governs the requirements for negotiation of a LOC and other negotiable instruments.

Provisions Common to Letters of Credit

Revocability

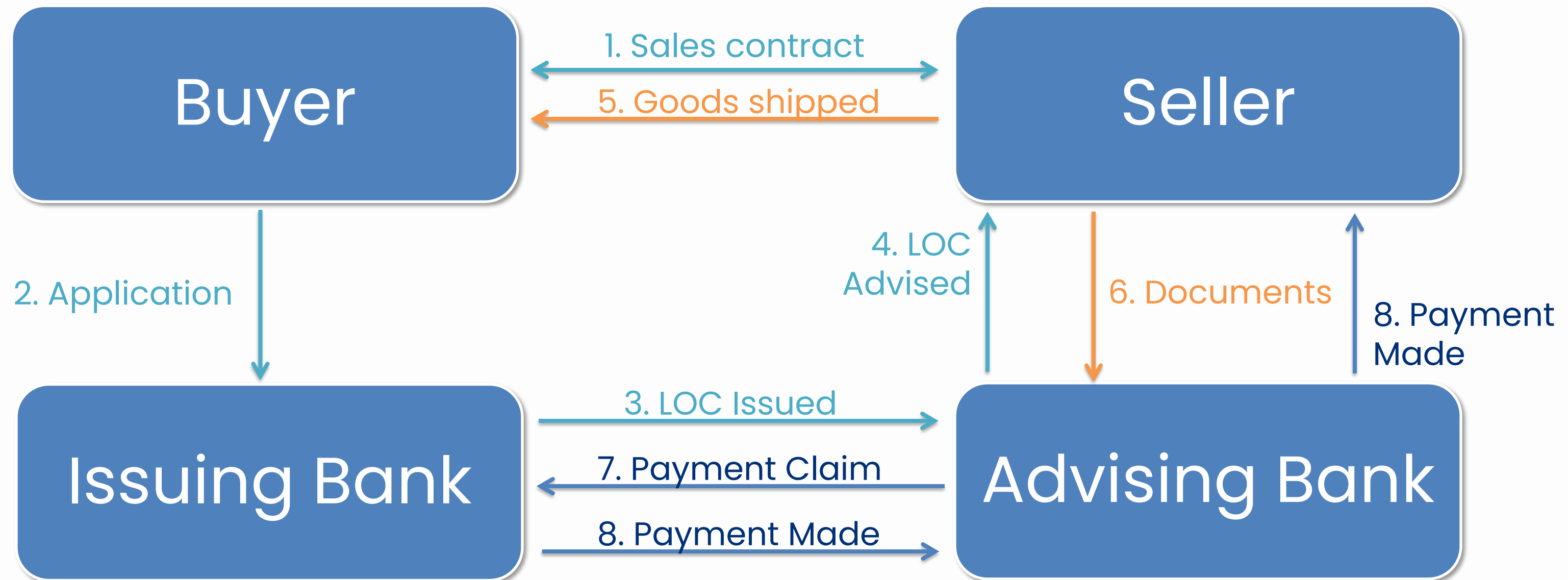
- **LOCs may be either revocable or irrevocable.**
 - **Revocable:** May be revoked or modified for any reason, at any time, by the issuing bank without notification
 - However, once documents have been presented and meet the terms and conditions of the LOC, the LOC cannot be revoked.
 - **Irrevocable** (more common): May not be revoked or canceled absent agreement of all parties
- *Ensure that your LOCs are irrevocable!*

Provisions Common to Letters of Credit

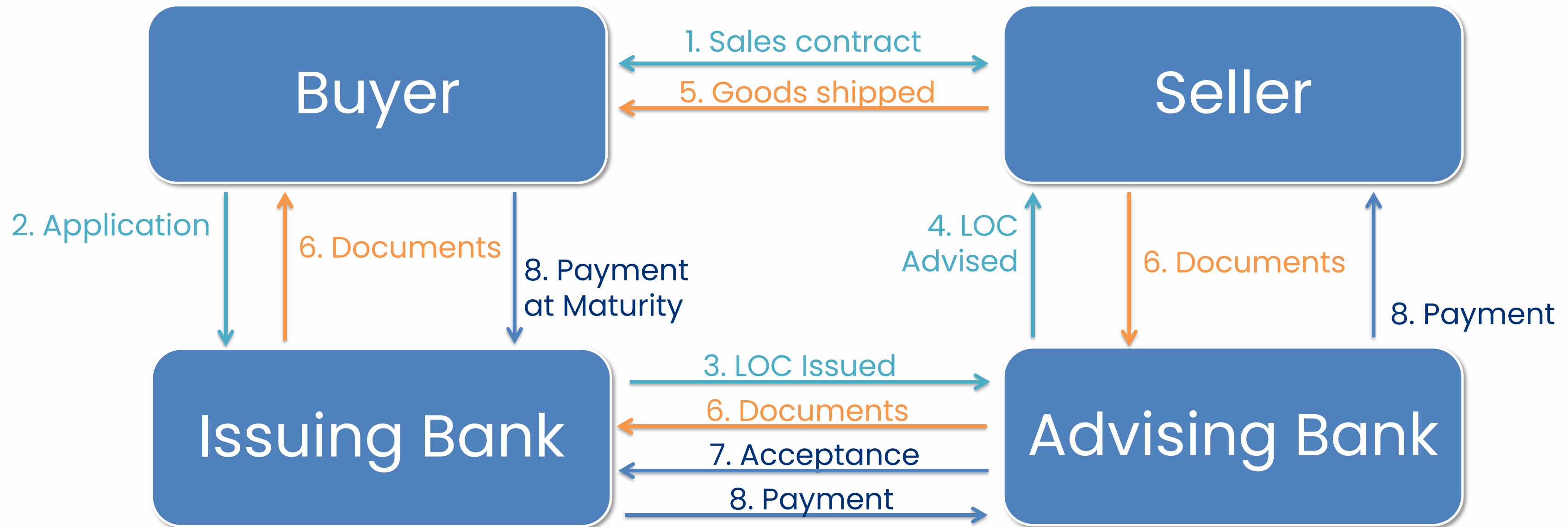
Sight and Time Drafts

- **Sight draft:** Payable as soon as it is presented for payment (though bank is allowed reasonable time to review documents before paying)
- **Time draft:** Not payable until lapse of particular time period stated on the draft

Sight LOC Transaction Flow



Time LOC Transaction Flow



Letters of Credit and Bankruptcy

- The most significant advantage of a LOC is that it is not considered property of a bankruptcy estate, and may therefore be drawn upon notwithstanding the imposition of the automatic stay.
- Structured properly, a letter of credit will provide a high level of payment assurance by placing the funds outside the reach of the counterparty, its creditors, and the bankruptcy court.

Letters of Credit and Bankruptcy

- *The reason a LOC is “bankruptcy-proof”?*
- The payment obligation comes from a non-debtor third party (the bank), and therefore, a draw request under a LOC is not considered an attempt to collect a debt or enforce against a debtor’s property.

Letters of Credit and Bankruptcy

- Furthermore, it is generally the case that a payment to a creditor by an issuing bank on a LOC is not subject to preference attack in the buyer's bankruptcy because payment did not come from the debtor, but rather was based upon an independent obligation of a third party.
- *However:* If the LOC was issued during the preference period, the issuance itself could be considered a preferential transfer.

Letters of Credit and Bankruptcy

- **But what if a creditor that holds a standby LOC is paid directly by the debtor within 90 days of the bankruptcy?**
 - This would be a preference that may be recoverable by the debtor's bankruptcy estate.
 - If the LOC expires before the return of the preference, the creditor will be barred from drawing on the LOC.
 - *However:* A "new value" defense may exist to the extent that the LOC was collateralized.

Presenters



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