It is very much part of a bank’s business to issue and/or confirm letters of credit for its customers or its banking relationships.

Letters of credit, if used to pay for goods or services, are usually issued pursuant to UCP 600. These are called documentary letters of credit. Letters of credit in support of a payment obligation of another party are issued either pursuant to UCP 600 or pursuant to ISP 98. In each case these are called standby letters of credit. In either case the issuing bank irrevocably agrees that it will make a payment to the beneficiary of the letter of credit of an amount it is required to pay following a complying presentation of documents. In the case of a documentary letter of credit this can be a number of documents, each of which requires checking. In the case of a standby letter of credit the document presented is often just a demand for payment. Where a bank has agreed to confirm the letter of credit, the confirming bank then pays the requisite amount against a complying presentation of documents and claims the amount paid from the issuing bank.

The relationship between the issuing and confirming banks is covered in the relevant rules and may be supplemented by specific terms of the letter of credit. The beneficiary of the letter of credit acquires its rights pursuant to the letter of credit and the relevant rules. Other arrangements, including the relationship that the issuing bank has with the applicant (the party who wants the letter of credit issued) are not covered in the relevant rules. Indeed, any other arrangements regarding or surrounding the letter of credit are not covered in the rules and need to be documented separately. There are challenges here.

One particular issue that needs to be considered is the governing law of the arrangements. It has become market practice, particularly with documentary letters of credit, that there is no governing law of the letter of credit. There is also no agreed forum for determining disputes, so there is no designated jurisdiction for any court procedure or arbitration. The consequence is that these difficult issues are dealt with only at the time of a dispute.

What is in a letter of credit?
The upshot of all of this is that letters of credit can be quite short documents. They need to cover the who, why, what and when of the payment. Who? – is the beneficiary. Why? – is the applicant and the underlying contract. What? – are the documents needed to make the claim. Where? – is the place for presentation. When? – is the expiry date of the letter of credit.

Once this is achieved there is an irrevocable payment undertaking from the bank to make payment against documents presented. There is nothing that the bank can or should do to prevent this. It can agree to delay (called defer) payment by an arrangement with the beneficiary or another party.

However, protections have to be built around other documentary relationships.

The Contractual Matrix
There are a number of key basic relationships to consider in relation to any letter of credit. The first is between the applicant and the issuing bank. The second is between the issuing bank and the confirming bank and the third is between the confirming bank and the beneficiary. In the absence of a governing law clause in the letter of credit, each of these relationships could be governed by a different law. This depends on who and where the parties are and where obligations are to be performed.

If there is a dispute between any of the parties about what has happened in relation to a specific letter of credit, then the claiming party (perhaps the beneficiary against the confirming bank or the confirming bank against the issuing bank) will want to commence proceedings.
to seek payment. Without any other arrangement, it will be necessary to persuade a particular court to accept that it has jurisdiction and then for that court to agree what is the governing law of the relationship being tested. At that point a decision will then be made by the court, based on the documents and relevant set of rules, as to who is in the right. It is interesting to consider the cost of not having a governing law against which to test the claim at the outset.

It is unlikely in the short term for this position to change in relation to the letter of credit itself. However, there may well be a further document to govern one of the relationships referred to and that arrangement may well have a choice of law.

**The law of the contracts**

Each of the relationships referred to above could well have an underlying document as the basis for the action being taken.

The issuing bank should only be issuing letters of credit when it has a sound legal basis for doing so. It may well be that the arrangement with the applicant is simply governed by an application form for the issuance of a letter of credit. That form would request the issuance and set out the terms required. Ideally it would contain representations about the transaction to protect the issuing bank regarding matters such as breaches of law and regulation including sanctions, anti-money laundering and not using the proceeds of crime. Most importantly the applicant would agree to cover the issuing bank for any claim made under the letter of credit with an indemnity in favour of the issuing bank in paying against a claim made under the letter of credit.

Where there is likely to be a series of transactions between the issuing bank and the applicant, the situation described above can be covered in a facility letter for the issuance of a number of letters of credit. If the issuing bank wants security for the reimbursement obligation, it can provide for it here. Sometimes the issuing bank issues a letter of credit against cash placed with it. This is a cash-backed letter of credit. Care must be taken to protect the cash from the claims of others. Also, the right to use the cash in covering any payment made under the letter of credit needs to be provided. If this is all done, then the risks associated with a lack of governing law for the letter of credit can be mitigated.

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Where there is a confirming bank, it could rely on the provisions of the relevant rules to cover its relationship with the issuing bank and indeed with the beneficiary. The beneficiary is often quite happy with this. However, where it wants to obtain money more quickly, it might enter into some form of discounting agreement with the confirming bank to be paid earlier than the letter of credit allows. Here again, having an agreement with a governing law helps.

Similarly, the confirming bank can rely on the rules to claim its reimbursement from the issuing bank. Changes made to the most recent UCP rules (UCP 600) have helped in relation to the time for determining any fraud. However, where the confirming bank gives the issuing bank time to pay then again, a separate document is useful to set out what had been done and the liability of the parties to each other.

There are variations on the above that should be documented separately. These include who takes what risk in respect of an issuing bank not making payment after the confirming bank has done so. The parties need to consider who takes non-payment risk and who takes the risk in documents not being correct.

**Sharing the risks**

There can be a simple contractual arrangement where a seller of goods requires from the buyer of those goods a third party to agree to make payment. The buyer becomes the applicant and asks its bank to be the issuing bank of a letter of credit for the payment. The letter of credit is in favour of the seller who is then the beneficiary of the letter of credit. The transaction could proceed at that point. However, the issuing bank and beneficiary can seek to share the risk under the letter of credit with others. The beneficiary might ask for the letter of credit to be confirmed as outlined above. However, it might prefer that this is not known by the issuing bank. It may ask its own bank to “guarantee” the obligations of the issuing bank. This is often through a mechanism called a silent confirmation. The silent confirmer agrees to make a payment if the documents presented to it are correct. It then seeks to obtain the right to be paid by the issuing bank. As this is outside the letter of credit rules there needs to be a document to cover all these arrangements.

Banks often want to share the risk in letter of credit transactions with other banks. A common way to share the risk is to use a Risk Participation Agreement (RPA). This agreement will be governed by either English law or New York law (if the US BAFT form of document is used). Where a letter of credit is the subject of a participation then the parties might consider who takes the risk of fraud in the documents presented under the letter of credit. Is the risk shared or does the grantor of the participation accept that it is its risk to check documents? Both options are available in the English law BAFT.

It is an interesting issue as to whether or not there is a greater risk where the underlying letter of credit has no governing law. Certainly, and despite recent (failed) attempts in cases to widen the fraud exemption, English law is very clear that the fraud exemption is very narrow.

**Other uses for letters of credit**

The above has covered using letters of credit to pay for goods and services or as standby letters of credit to support non-
performance. Indeed, the standby letter of credit is a very useful way to achieve a direct obligation from the issuing bank to make payment rather than relying on a guarantee which might be subject to conditions or defences for not paying.

Letters of credit can also be used as a basis to provide deferred payment arrangements and these can extend to deferred payment terms for the issuing bank to make its reimbursement to the confirming bank. In some cases there is a structure called a synthetic letter of credit where goods are involved but the payment for the goods may not in reality be the true subject of the letter of credit. Thus, the issuing bank receives cash and an extended time to repay the cash in the form of a payment under the synthetic letter of credit. The validity of the arrangement has been accepted certainly as a matter of English law. In these circumstances, it would be better to have the synthetic letter of credit governed by English law to achieve the certainty of payment.

Some trip wires in letters of credit
UCP 600 includes the concept of a complying presentation, meaning that all documents to be presented under the letter of credit must comply with what is required. A letter of credit is a transaction in documents. This puts an onus on the confirming bank and/or the issuing bank not to make payment if the documents do not comply.

The problem, certainly in documentary letters of credit, is that the documents to be produced are often quite technical. That means that mistakes can occur although these may be minor. Often the parties can agree to waive such discrepancies. Sometimes one party, usually the applicant, may not want the goods paid for or may be unable to reimburse the issuing bank. In these circumstances, there can be a dispute as to whether payment should be made and a technicality of minor proportions becomes the basis of non-payment. Again, there are cases which sometimes create surprise results such as a party being excused from payment. The debate can be sophisticated with reference to previous similar cases and determinations. The position would be helped by a governing law, especially English law, where there are experts. This is not always the case and there are disputes about the governing law and the jurisdiction as to where a claim should be heard.

To avoid some of these issues the use of matching data has been suggested and the Bank Payment Obligation (BPO) exists as one way to help deal with this. It will be seen how successful this may be in the future. Indeed, the world of digitalisation is yet to bring new challenges to the paper world of letters of credit.

Summary
There is much life left in the letters of credit world. They would be improved by the inclusion a governing law but as that is not to be, documenting around some of the relationships with good documents will have to suffice.