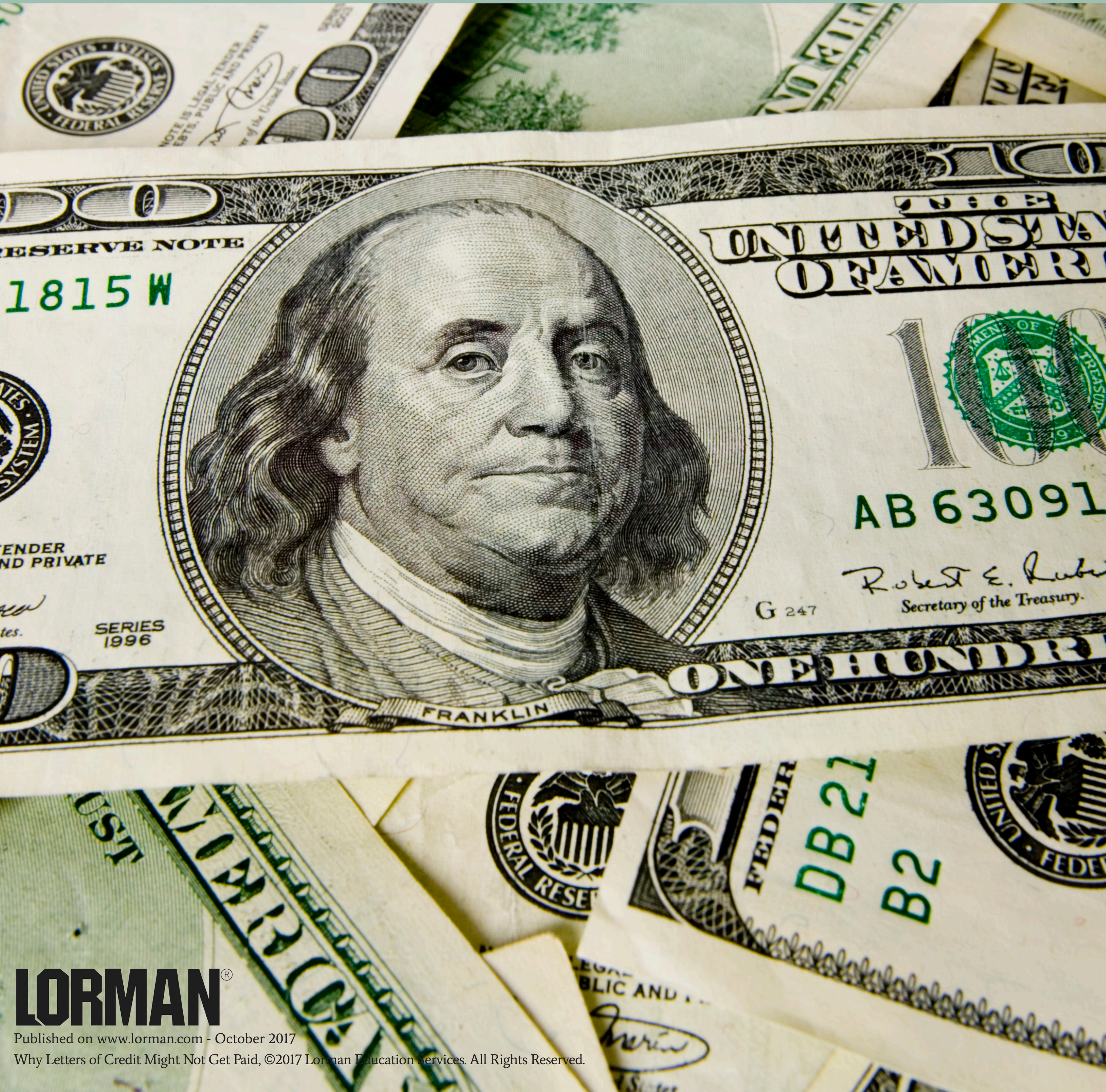
Why Letters of Credit Might Not Get Paid



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Thousands of companies rely on commercial Letters of Credit each year to ensure payment. Ideally, a Letter of Credit works by passing the payment requirement for a service or sale to the bank issuing the Letter. The LC's issuing bank must execute the contract and pay the debt if the seller meets the Letter of Credit's terms.

This arrangement has distinct advantages for both the seller and the buyer, but some sellers deal with serious nonpayment issues when accepting Letters of Credit. In most cases, fundamental misunderstandings of the usage and terms of an LC cause the nonpayment.

In order to understand the potential risks of an LC, we must first understand the purpose and function of this unique financial device.

When And Why Letters Of Credit Are Necessary

International trade and many government contracting jobs use commercial Letters of Credit to ensure that goods are shipped or that services are completed before a company (referred to in an LC as a beneficiary) receives payment for said goods or services. LCs are flexible and can be both revocable and irrevocable, and because they transfer payment duty from a seller to a bank, they can add payment security to a transaction without limiting the abilities of the seller.

There are several common reasons for using a Letter of Credit:

- International trade. A Letter of Credit is necessary when the seller needs to guarantee payment before shipping goods or starting work, but the buyer cannot pay without facing substantial risk.

This makes LCs particularly well-suited for international payments. The seller can often handle multiple international transactions from different buyers through the same issuing and advising banks, which can simplify transactions significantly, and the buyer also gains additional delivery/work completion security from the LC.

- Government work. Governments often require contracting work or products on a relatively large scale, and a Letter of Credit can quickly provide a seller with the assurance that they need to begin work. Many of these LCs have rigid work time frame requirements, which we will discuss later in this paper.

- Large business work. Most sellers do not use Letters of Credit for business work, as other options provide more security and more appropriate payment systems for both buyers and sellers. However, some large business contracts are well-suited to Letters of Credit.

Regardless of why a seller agrees to a Letter of Credit, these contracts have several notable problems.

Understanding The Inherent Dangers Of A Letter Of Credit

The most significant problem with a Letter of Credit is its main strength; an LC is not dependent on any other contracts, only its own terms. Many contractors and vendors do not realize this and logically assume that if the terms of the initial sale or service contract are not met, the issuer will not pay.

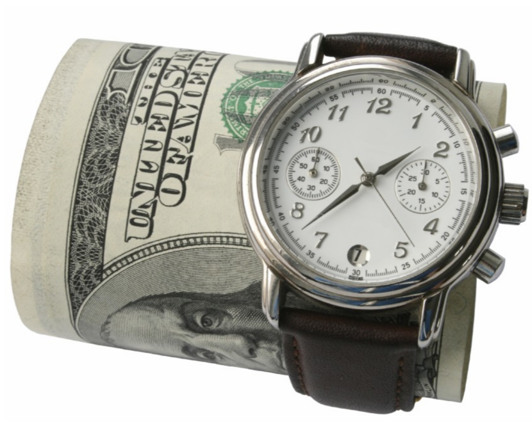
In most instances, the abstract nature of an LC benefits the seller. However, sellers occasionally fail to fulfill the terms of an LC after other contracts are fulfilled, resulting in a nonpayment. In other words, the seller has completed the required work or delivered the requested products, but some term of the Letter of Credit precludes payment.

Many Letters of Credit for international trade depend on documentary collection, so the most common reason for nonpayment is the absence of relevant documentation. Many LCs require:

- Insurance documents for shipped products
- International trade documents and inspection checklists
- Shipping documents

If a seller does not forward the proper paperwork to the advising bank or if the advising bank does not send the paperwork to the issuing bank within a set time frame, the seller can face lengthy delays or face nonpayment.

Of course, this is dependent on the terms of the Letter, but many LCs include strict time-sensitive document submission requirements. Failure to get documents to an issuing bank by the dates and times listed on an LC is one of the most common causes of nonpayment. Sellers should always make sure that they understand the time requirements of an LC before agreeing to the contract, but even with a clear understanding of contract terms, a single mistake can have major consequences.



International law can also lead to payment complications. Some international governments will not compel payment, so issuing banks may use narrow interpretations of the Letter of Credit's terms to avoid paying the beneficiary.

The issuing bank may also legitimately misunderstand the function and terms of the contract.

In either case, there is no consideration involved in a Letter of Credit and the seller may not have any viable options for seeking payment. Even with a domestic commercial LC, a local government office might try to impede payment due to a fundamental misunderstanding of the purpose of Letters of Credit (although domestic courts will uphold the seller's right to seek payment from the issuing bank provided that the LC is fulfilled).

These complications are why sellers should always insist on an experienced issuing bank that has dependably met their LC executions requirements. Sellers use advising banks to gain information about their issuing banks' credentials. The advising bank will decide whether the issuing bank is reliable enough to justify the terms of the Letter of Credit and will eventually submit the seller's portion of the LC's documentation, so sellers should work with well-qualified advising institutions.

The Legal Complexities Of Letters Of Credit

Although Letters of Credit are treated as a type of contract under U.S. law, the necessary ambiguity of the payment type often puts the buyer at risk should a nonpayment case go to court.

A court will rarely examine any documents other than the Letter of Credit and any documents listed directly in the LC itself. Furthermore, if the issuing bank does not pay the beneficiary, no other party is required to pay. This includes the advising bank, much to the surprise of many beneficiaries.

Even if an advising bank makes a serious mistake that leads directly to the non-execution of the LC, the LC itself will not compel the advising bank to pay. However, sellers may still be able to seek damages from the advising bank, although this is unrelated to the Letter of Credit and carries its own complications (not the least of which include high legal fees and heavy delays).

Revocable LCs pose more challenges, since the issuing institution can change the terms of payment or cancel the letter entirely under certain circumstances. Most sellers insist on irrevocable LCs that are payable on sight, meaning that the issuer will execute the Letter as soon as the seller submits the relevant documentation. Unfortunately, inexperienced sellers may unwittingly agree to a revocable LC with unfair terms, but these situations are rare. Revocable LCs are typically placeholders for other payment methods and usually do not end in nonpayment, but sellers should still exercise caution when using them.

Documentation On Sight

As mentioned earlier, Letters of Credit can also include rigid time requirements. If a seller cannot deliver a certain document within the period of time stated on the LC, the issuing bank can rightfully refuse to execute the contract--even if the buyer is completely satisfied with the products or services. The seller has limited legal recourse and will often need to work with the issuing bank to get paid. Sellers often fail to understand that the LC shifts payment requirements to a bank and essentially removes the buyer from the equation for better and for worse.

However, we should still note that a Letter of Credit is a firm legal document if the terms of the letter are adequately fulfilled. The courts are under no obligation to consider any unrelated when deciding whether a nonpayment on a Letter of Credit is acceptable, so an issuing bank cannot refuse to execute the letter due to an unrelated dispute from the buyer. After all, the entire purpose of the LC is to remove the potential complications from dealing directly with a buyer, so issuing banks must honor the terms of the LC before their other agreements.

Avoiding Some Of The Risks

There are certainly ways to minimize the risks of a Letter of Credit. A beneficiary should always choose a capable local institution as its advising bank, as the advising bank can verify the legitimacy of the Letter of Credit and can occasionally provide some insight as to the capabilities of the issuing bank. Beneficiaries can also add special terms to a Letter of Credit. For instance, by ensuring that partial delivery of goods or partially completed services fulfill the requirements for payment of the letter, beneficiaries can guard themselves from potentially complex and unreasonable terms.

Ultimately, Letters of Credit are necessary risks under certain circumstances, but due to their often ambiguous nature, nonpayment is more likely than with some other types of contracts. Beneficiaries should try to limit their risks by working with experienced banks and by carefully considering the terms of LCs before agreeing to accept them.