

A Guide to

Documentary Payments



Short-Term Trade Finance

**A Primer on Letters of Credit,
Import and Export Financing, and
Other Banking Services for
Exporters and Importers**

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DOCUMENTARY PAYMENTS & SHORT-TERM TRADE FINANCE

A Primer on Letters of Credit, Documentary Draft Collections, Import and Export Financing, and Other Banking Services for Exporters and Importers

CHAPTER ONE: INTRODUCTION

It is, of course, an understatement to say that doing business with someone in another country is more complicated than just finding ways to transport goods over long distances. One of the most obvious differences from doing business domestically is the fact that goods must clear customs when crossing international boundaries. This requires documentation of merchandise type and value.

Another difference is the fact that steamship companies traditionally issue bills of lading as receipts for the goods they transport and require that the party who comes to the port of destination to claim goods surrender an original copy of the bill of lading to prove he has proper title to the goods—more documentation. Indeed, international trade revolves around documentation—documentation that the exporter of goods originates or obtains and that the importer of goods needs in order to gain possession of those goods. Because of this, buying and selling goods that cross national borders revolves around exchanging documents for payment.

Risks Involved in International Trade

International trade presents uncertainties not found in domestic trade. First, there is political risk associated with the government in the buyer's country. This covers possibilities such as the imposition of foreign exchange controls and expropriation. Second, there is transfer risk involving the economy of the buyer's country. Transfer risk is the risk that, due to the fact his country has a negative balance of payments, no foreign exchange (U.S. dollars or other "hard" currency) may be available to the buyer when he is ready to pay for the goods he has purchased. The final uncertainty involves commercial risk, the normal risk, also found in domestic sales, of whether the buyer can and will pay the seller when payment is due. But in an international sale, because the buyer is in another country, the seller generally not only has less reliable information regarding his financial

condition and integrity but also typically has fewer avenues of redress should the buyer fail to pay or otherwise violate the agreed-upon terms of sale. The existence of these political, transfer, and commercial risks explains why only about half of international sales are made on an open account basis.

Despite these risks, the competitiveness of the international market often precludes insistence upon cash in advance. Just as in domestic trade transactions, the buyer's preference is to take as long as possible before paying. He will ask the seller to allow him some time to resell the goods or use them to otherwise generate the cash needed to pay for them. And, whereas North American companies are used to dealing with each other on open account terms of 30 days from invoice date, in international transactions it is not uncommon to see "supplier financing" of 60, 90, or even 180 days and more, depending on the goods. Thus a company is likely to experience ballooning of its accounts receivable and its "days-sales-outstanding" ratio due to export activity even as it is incurring increased risks.

But, because international trade revolves around documentation, some middle ground exists between open account and cash in advance—middle ground in which intermediaries conduct the exchange of documents for payment and may even provide pre-export financing for the seller and post-import financing for the buyer. ([*See the chart at the end of this chapter for a comparison of international credit terms.*](#)) The choice of credit terms will depend on many factors including industry norms, country practices, anticipated frequency and value of shipments, profit margin, payment history, and whether any bank financing is involved. We find two mechanisms, documentary draft collections and letters of credit, predominate in international trade.

Documentary Draft Collections—An Overview

In a documentary draft collection, documents are entrusted to a bank for delivery only after the seller's collection instructions are met. Normally, these documents include the commercial invoice, the bill of lading, and any paperwork needed by the buyer to clear customs in his country. The bank acts only as a collection agent and does not assume any liability for payment. Neither the commercial risk associated with the buyer nor the political and transfer risks associated with the buyer's country are eliminated. When asked for payment by a bank, the buyer could simply refuse or the situation in his country could make payment impossible. Using a sight draft accompanied by properly consigned ocean bills of lading, however, ensures that title to the goods will not legally pass if the buyer refuses or is unable to pay, since documents will not be delivered until payment is tendered. Such control of title depends on having a title document, as in most ocean shipments, which is released to the buyer only after he has made payment; this control is not available when making air shipments or when using time drafts or clean drafts for any type of shipment.

Export collections require that the seller (exporter) forward documents with collection instructions to his bank which will, in turn, pass them on to a foreign bank for collection. To facilitate these transactions, most banks will provide a direct collection service for their exporting customers. Under this method, rather than sending documents to his bank for processing, the exporter or his agent uses a special form provided by his bank to send the documents directly to the buyer's bank. The exporter sends a copy of this form to his own bank, who will follow up from there.

This booklet contains a [chapter on documentary draft collections](#) in general, of interest to importers and exporters alike, and a [chapter on direct collections](#) in particular, for exporters.

Commercial Letters of Credit—An Overview

A commercial letter of credit replaces the commercial risk associated with the buyer with that of the bank issuing the letter of credit. In a letter of credit transaction, the issuing bank commits up front to pay a specified amount of money to the seller when presented with a specified set of documents. Hence, the seller is no longer relying upon the buyer's promise to pay—with the confidence he can produce the required documents, he is relying upon the promise and ability to pay of the buyer's bank. If the seller wishes to reduce further the risks of non-payment, he can request that a bank in his own country be authorized to confirm the letter of credit. A bank which confirms a letter of credit undertakes to honor the credit as though it had issued it themselves.

Alternative risk-reducing structures might involve arranging a pre-committed sale of the anticipated receivable or taking out credit insurance covering non-payment. Although the exact protection differs (for example, credit insurance will not pay when there is a contractual dispute), from the seller's viewpoint, any of these alternatives would reduce or eliminate the foreign political and transfer risks and replace the commercial risk of the buyer and his bank with that of the confirming bank, receivable purchaser, or insurance company. In some cases, banks providing working capital or accounts receivable financing for goods being exported will require that the exporter obtain either letters of credit or credit insurance for all sales being financed. Sometimes insurance companies themselves will require letters of credit from specified buyers before granting coverage.

It is crucial to understand that a letter of credit is neither an unconditional guarantee of payment to the seller nor a means of assuring the buyer that goods paid for will be satisfactory—rather, payment will be rendered if and only if the documents required by the letter of credit precisely comply with the terms and conditions of the credit. Anyone selling on a letter-of-credit basis should read very carefully each one received to be certain the terms and conditions can and will be complied with. Discrepancies can delay or even preclude payment. And anyone buying on a letter-of-credit basis needs to understand that payment will be affected despite any disputes with the seller over compliance with the underlying contract just as long as the documents meet the letter of credit requirements.

Commercial letters of credit are often referred to as import credits and export credits. This division reflects only a difference of perspective, not different instruments. One company's export credit is another's import credit. This booklet contains a [chapter on import letters of credit](#) and a [chapter on export letters of credit](#), each written from the relevant perspective.

Standby Letters of Credit—An Overview

Standby letters of credit do not cover the direct purchase of merchandise. Rather, they are based on the underlying principle of letters of credit that payment is made against presentation of documents—not necessarily shipping documents but whatever documents the applicant, beneficiary, and issuing bank may agree to. The party requesting a bank to issue a standby letter of credit (the applicant) need not be involved in a commercial transaction at all. In fact, most standby letters of credit are payable against the presentation of documents as simple as a certificate from the beneficiary stating that the applicant has not performed some act, has not complied with a specific contract or other

agreement, or has defaulted either in payment for certain goods and services or in making repayment on a loan. These are highly versatile instruments whose range of uses seems to be limited only by the imagination. This booklet contains a [chapter describing some of the ways standby letters of credit are commonly used by importers and exporters](#).

Bankers' Acceptances—An Overview

Bankers' acceptances arise from the drafts covering certain international and domestic trade transactions. A banker's acceptance is a time draft "accepted" by the bank upon whom it is drawn. Once accepted, it constitutes an unconditional obligation on the part of the accepting bank to pay the draft at maturity (out of funds it expects to receive at that point in time—by creating the acceptance, the bank intermediates the risk of receiving these funds). There is a large market in the U.S. in which bankers' acceptances can be bought and sold in the months between their creation and maturity. Bankers' acceptances can arise from transactions involving letters of credit, documentary draft collections, or contractual sales and purchases. They are used by importers mainly as a low-cost alternative to loans: The importer asks the bank to create an acceptance which the importer then immediately sells, at a discount, to generate funds to pay for goods purchased; at maturity the importer must repay the amount of the acceptance to the bank. The investor earns the amount of the discount. Bankers' acceptances can be used by exporters in much the same way, to bridge the time between shipment of goods and receipt of payment, and they can even be used to sell receivables to a bank: The bank disburses funds to the exporter immediately after shipment of goods but obtains payment at maturity from the buyer of the goods. Their use by exporters is discussed further in the chapters on [draft collections](#) and [export letters of credit](#).

International Credit Terms/Payment Methods

The following table covers the spectrum of credit terms offered in international trade transactions. It is arranged in order of risk: from highest risk to the exporter (which is lowest risk to the importer) to lowest risk to the exporter (highest risk to the importer).

TERM	DEFINITION	APPLICATIONS	ADVANTAGES	DISADVANTAGES
Extended Terms	Importer pays for goods over period of time during which they are used by importer, often 3 to 10 years. A set of promissory notes is normally issued upon shipment, payable at 6-month or 1-year intervals.	<ol style="list-style-type: none"> 1. Sale of machinery or other capital goods importer is using rather than reselling. 2. Importer located in country with limited hard currency but importer makes something that is sold into hard currency countries. 3. Goods among equipment and materials being acquired for major project. 	<ol style="list-style-type: none"> 1. Competitive. 2. Importer gets to pay out of earnings generated by the goods purchased. 3. It is possible to sell notes on the secondary debt market, although this probably requires importer's bank's "aval" (a type of payment guarantee) on the notes. 4. Government loan guarantees (e.g., U.S. Eximbank) may be available for a major portion of transaction. 	<ol style="list-style-type: none"> 1. Risk of importer's willingness and ability to pay and to obtain hard currency extends over a period of years. 2. Deep discounts may be necessary to sell notes on secondary market. 3. Government loan guarantees may be expensive. 4. Extensive structuring often required.
Open Account, Clean Draft	Exporter makes shipment and awaits payment direct from importer. Any documents needed by importer sent directly by exporter when sale is invoiced.	<ol style="list-style-type: none"> 1. Importer has excellent credit rating. 2. Importer is long-time, well-known customer. 3. Importer is subsidiary of exporter or vice versa. 4. Small shipments with good profit margins. 5. Low-risk country. 	<ol style="list-style-type: none"> 1. Simple bookkeeping for exporter. 2. Easy documentation. 3. Competitive. 4. Low cost. 5. With prior approval, may be insured or factored, but exporter is still at risk in the event of a contract dispute. 	<ol style="list-style-type: none"> 1. Exporter assumes credit risk of importer, including simple refusal to pay, and risk of importer's country's political condition. 2. Full brunt of financing falls on exporter. 3. Problems of availability of hard currency. 4. In matters of dispute, no interested third party is involved. 5. Exporter vulnerable to slow payment.
Time or Date Draft, Documents against Acceptance (D/A)	Exporter makes shipment and presents draft and documents to bank with instructions that documents are to be released to importer upon importer's acceptance of the draft (importer's acknowledgment of his debt and promise to pay at a future date).	<ol style="list-style-type: none"> 1. Importer has established a good payment history with exporter and is being considered for open account terms. 2. Low-risk country. 3. Country requires drafts in order to instigate legal collection proceedings and/or there is no legal framework for granting a security interest in accounts receivable. 4. Short-term financing necessary to make sale. 	<ol style="list-style-type: none"> 1. Draft is evidence of indebtedness. 2. Receivable may be financed by exporter's bank or possibly sold without recourse (importer's bank's guarantee or "aval" may be required). 3. Gives importer time to resell goods before having to pay for them. 4. Interested third party involved in case of dispute (bank). 5. Low cost. 6. With prior approval, may be insured. 	<ol style="list-style-type: none"> 1. Exporter assumes credit risk of importer and risk of importer's country's political condition. 2. Exporter is financing shipment until maturity of draft. 3. Problems of availability of hard currency. 4. Exporter assumes risk of refused shipment and contract disputes (even if insured). 5. Exporter vulnerable to slow payment.
Consignment, Retention of Title	Exporter makes shipment and receives payment as goods are sold by importer. Sales contract and/or other legal documentation gives exporter right to repossess any unsold goods.	<ol style="list-style-type: none"> 1. Goods sold to a distributor or other company for resale rather than consumption. 2. Countries that allow retention of title and have a legal framework for repossession of goods. 	<ol style="list-style-type: none"> 1. Exporter may recover goods not sold and paid for. 2. Competitive. 	<ol style="list-style-type: none"> 1. Same as Open Account. 2. Subject to local laws and customs. 3. Legal expenses. 4. Requires periodic inventorying of goods.
Sight Draft, Documents against Payment (D/P), Cash against Documents (C.A.D.)	Exporter makes shipment and entrusts documents to a bank with instructions that documents be released to importer only upon payment of draft.	<ol style="list-style-type: none"> 1. Importer has good or excellent credit rating. 2. Small shipments of goods with broad demand (not custom made for importer). 3. Goods shipped by ocean carrier issuing negotiable bills of lading. 4. Medium volume. 5. Low-risk country. 6. May be required in countries having foreign exchange restrictions not allowing open account purchases/sales. 	<ol style="list-style-type: none"> 1. Draft is evidence of indebtedness. 2. Documents not released to importer before payment. (Exporter may retain title to merchandise by controlling bill of lading until paid.) 3. Interested third party involved (bank). 4. Low cost. 5. With prior approval, may be insured. 	<ol style="list-style-type: none"> 1. Exporter assumes credit risk of importer and risk of importer's country's political condition. 2. Exporter must wait until draft has been received and paid. 3. Problems of availability of hard currency. 4. Exporter assumes risk of refused shipment (even if insured).

TERM	DEFINITION	APPLICATIONS	ADVANTAGES	DISADVANTAGES
Cash against Goods, Shipment into Bonded Warehouse	As opposed to traditional C.O.D., usually involves shipping goods to a warehouse operated by exporter in importer's country. Goods are released in relatively small amounts from warehouse by exporter's local agent.	<ol style="list-style-type: none"> Multiple potential buyers in country where goods are warehoused. Importer wants "just-in-time" delivery. 	<ol style="list-style-type: none"> Exporter assured of payment before delivery of goods to importer. 	<ol style="list-style-type: none"> Importer must have cash available. Warehousing agreements must be set up. Warehousing and inventory financing expenses. Exporter may be required to pay foreign taxes for running an operation in the importer's country.
Irrevocable L/C	Instrument issued by importer's bank in favor of exporter, payable against presentation to the issuing bank of specified documents. May be payable at sight or may incorporate bank-guaranteed financing.	<ol style="list-style-type: none"> Importer's credit rating may be excellent, good, fair, or unknown. First-time sale. Large sale or custom-made goods. Low-risk country. Country that requires L/Cs. 	<ol style="list-style-type: none"> Exporter looks to foreign issuing bank for payment if documents are proper and in order. Irrevocable L/C can be amended only upon concurrence of all parties. May be insured at preferred rate. Collection of all L/C payments easy to centralize. Quick payment possible. Banks may be willing to issue engagements to purchase documents without recourse. Payment despite contract disputes. 	<ol style="list-style-type: none"> Cost of L/C. Documents must be carefully prepared by exporter. Exporter's credit risk is the foreign bank; country risks still exist. Importer exposed to possibilities of fraud.
Confirmed Irrevocable L/C	Same as above, except importer's bank asks advising bank to add its confirmation. Payable upon presentation of compliant documents to the confirming bank. May be payable at sight or may incorporate bank-guaranteed financing.	Same as above but high-risk country.	<ol style="list-style-type: none"> Exporter looks to confirming bank for payment immediately upon shipment if documents are proper. Irrevocable L/C can be amended only upon concurrence of all parties. Exporter's credit risk is the confirming bank; country risk eliminated (confirming bank must not be just another office of issuing bank). Payment despite contract disputes. 	<ol style="list-style-type: none"> Cost of L/C and confirmation. Documents must be carefully prepared by exporter. Confirming banks chosen by foreign issuing banks, making it difficult for exporter to centralize or obtain consistent service. Importer exposed to possibilities of fraud.
Cash in Advance	Importer sends good funds before exporter ships.	<ol style="list-style-type: none"> Importer is good, fair, or unknown credit risk. One-time sale. Custom-made goods. Small shipment. High-risk country. Exporter may offer a discount for advance payment. 	<ol style="list-style-type: none"> Exporter may use funds to prepare shipment. No risk to exporter. Low cost. 	<ol style="list-style-type: none"> Importer bears costs of financing as well as risk of never receiving goods. Uncompetitive; may preclude repeat business. Some countries prohibit payment in advance.



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CHAPTER TWO: DRAFT COLLECTIONS

How Draft Collections Work

Operationally, an international draft collection is quite simple. A draft is a very short form, resembling a check, which serves as a legal demand for payment. It is also known as a “bill of exchange” or just a “bill.” (Although most North Americans think of bills as invoices, in other countries the term refers to drafts. In such countries, it is the draft, not the invoice, that represents a legal demand for payment, and it may be difficult to sue for payment without having presented one.) The seller completes the draft together with a letter of instructions and sends them to his bank along with any documents he wants to have delivered. *(An example of a combined draft and draft-collection-instructions-letter form appears on the next page. The top part of the form is the draft.)* The letter of instructions indicates how the transaction is to be handled, who is to pay which fees and charges, and what procedures should be followed in the event difficulties should arise.

Any documents requiring endorsement, such as a negotiable (“to order”) bill of lading or insurance certificate, should be endorsed prior to sending them to the bank. Although the seller relinquishes title by this endorsement, he does so to the bank that is acting as his collection agent and that will authorize delivery of the documents to the buyer only in accordance with the seller’s instructions.

The flexibility of the collection method is apparent from the number and variety of basic instructions. For example, the seller may include special instructions to allow a discount for prompt payment, in which case the amount of the discount and the terms under which it may be granted should be clearly specified. Similarly, interest for delayed payment may be charged. In the event difficulties not covered in the seller’s instructions should arise, the collecting bank must revert to the seller for additional instructions. However, if the seller has an agent or representative in the country involved who is authorized to act on his behalf, his name, address, and should be included in the collectio

One of the most commonly used methods of obtaining payment in international sales transactions is the collection of drafts drawn by the seller on the buyer. There are two broad classifications of draft collections: documentary and clean. Either can be drawn at sight (demanding immediate payment) or on a time basis.

	U.S. \$ _____ 19 _____	
	of this <i>First</i> of Exchange (Second unpaid)	
	Pay to the Order of _____	
	United States Dollars	
	for Value received and charge the same to account of _____	
	To _____	
	No. _____	<small>Article 4 Copy</small>

D-

Gentlemen
We enclose Draft Number _____ and documents listed below

for collection,
 for _____
 for payment negotiation under LIC

BILLS OF LADING	B/L COPY	COMM. # V	#6. CTF	CTE ORG.	COMM. # V	P&G. LIST	INST. CTF	OTH. ER. DOCUMENTS
Please handle in accordance with instructions marked "X"								
<input type="checkbox"/> Deliver all documents in one mailing. <input type="checkbox"/> Deliver documents in two mailings. <input type="checkbox"/> Deliver documents against payment if sight draft, or acceptance if time draft. <input type="checkbox"/> All charges for account of drawer. <input type="checkbox"/> Do not make charges. <input type="checkbox"/> Protest for <u>non-payment</u> non-acceptance <input type="checkbox"/> Do not protest. <input type="checkbox"/> Present on arrival of goods. <input type="checkbox"/> Advise <u>non-payment</u> by <u>airmail</u> giving reasons, non-acceptance cable <input type="checkbox"/> Advise <u>payment</u> by <u>airmail</u> acceptance cable					<input type="checkbox"/> C/P & O/P & EED refer to: Name _____ Address _____ Who is empowered by us: a <input type="checkbox"/> To act full, on our behalf i.e. authorize reductions; extensions, free delivery, making of protest, etc. b <input type="checkbox"/> To assist in obtaining acceptance or payment of draft, as drawn, but not to alter its terms in any way.			
OTH. ER. INSTRUCTIONS:								

Please refer all questions concerning this collection to

Shipper _____
 Freight Forwarder: _____

Article 4 Copy

A Draft Collection Instructions Letter

permission to contact him “in case of need.” Whether the collection charges levied by the banks involved are to be borne by the seller (the “principal”) or by the buyer (the “drawee”) should be agreed upon in advance and indicated in the instructions letter. If the matter of charges has not been settled, the seller may instruct the banks to ask the buyer to pay them, although he should allow the banks to waive the charges if refused (in which event the seller must then pay them) so as not to delay payment or acceptance of the draft.

Although they can be numerous, collection instructions are generally simple, clear, and straightforward. It is important to understand that the seller’s bank, as a collecting agent, acts only in accordance with the instructions received from the seller.

Upon receiving the draft and documents, the seller’s bank (known as the “remitting bank”) will review the letter of instructions for correctness and then mail the draft and documents to a bank in the buyer’s country (known as the “collecting bank” or the “presenting bank”) under its own transmittal letter, essentially transcribing the seller’s collection instructions. The instructions concerning when documents may be released to the buyer should agree with the tenor of the draft. In the case of a documentary sight draft, the overseas bank will deliver the draft and documents upon collection of payment. For a documentary time draft, documents will be given to the buyer against his acceptance of (written promise to pay) the draft; collection of payment of the accepted draft will be attempted when it is due. A clean draft has no accompanying documents; the overseas bank will simply ask the buyer for payment when due (immediately if the draft is drawn at sight). *The differences among these three types of draft collection are further discussed in subsequent parts of this chapter.*

The overseas bank will forward payment or advice of acceptance (and maturity date) to the seller’s bank by airmail unless it has been instructed to do so by cable. It is recommended that payment always be requested to be effected by wire transfer. In the event of dishonor (refusal of payment or acceptance) of the draft, the seller must decide whether to “protest.” This decision should be made based on an understanding of the relevant laws in the buyer’s country. Protest is the legal means of proving presentation and dishonor. In some foreign countries the protest process is expensive, and its application and necessity depend upon the specific laws of the importer’s country.

To lessen the difficulties likely to be encountered by both banks and customers through differences in banking terminology and practices, the International Chamber of Commerce has developed a set of rules applying to collections. These rules, the [Uniform Rules for Collections](#) (1995 revision, International Chamber of Commerce Publication No. 522), have been adopted by banks in the United States and most countries of the world. The rules are short and easy to understand. Any exporter using a draft collection service should thoroughly familiarize himself with these rules to avoid errors in completing his letters of instructions.

Problems in collecting payment of drafts can be avoided only if the seller obtains sufficient information as to the reliability and credit standing of his buyers. The seller must also stay informed of problems beyond the control of the buyers which could restrict their ability to pay, such as shortages of foreign exchange or other economic and political risks in the countries involved.

Documentary Sight Drafts

Under a documentary sight draft, the seller entrusts his invoice, bill of lading, and other documentation required by the buyer to clear customs in his country and for any other purpose, together with a draft calling for payment “at sight,” drawn by the seller on the buyer, to his bank for collection of payment. The seller’s bank forwards the draft and documents to its overseas correspondent bank with instructions that the documents may be delivered to the buyer only upon his payment of the draft (commonly described as “documents against payment,” “cash against documents,” or just “D/P” or “C.A.D.”). Furthermore, unless instructed otherwise, the Uniform Rules for Collections dictate that the documents may be released only if payment can be sent out of the country immediately (*i.e.*, foreign exchange is approved). The security of the sight draft lies in the buyer’s need to have the collection documents in order to pick up the goods and clear customs. The seller must be aware that this security exists only with ocean shipments, wherein the documents include a negotiable bill of lading. When shipment is made by air, truck, or rail, a non-negotiable “waybill” is used rather than a bill of lading and the carrier will simply deliver goods to the address specified by the shipper. For ocean shipments, however, this method often works as a good compromise between the desires of the buyer and those of the seller; (1) title and control generally remain with the seller until the draft has been paid and (2) the buyer is not required to pay for the merchandise until he receives documents showing goods have been shipped and giving him title upon payment.

In an air, truck, or rail shipment, the seller risks losing his merchandise and never being paid—essentially the same risk as selling open account. Even with a negotiable bill of lading involved, the risk remains that an untrustworthy buyer may refuse to accept the shipment for some reason (such as a price decline) or that the buyer becomes unable to pay because of his own cash flow problems, a major swing in foreign exchange rates or complete unavailability of hard currency, or a change in government regulations in the buyer’s country. If the shipment is refused, the seller or his agent must store the merchandise in the foreign country somehow and try to arrange for the return of the merchandise or find another buyer, possibly in another country. Either alternative can be very costly.

As has been pointed out, in air, truck, and rail shipments, the carriers involved require the shipper to name a consignee to whom goods will be delivered forthwith. In an attempt to keep the buyer from obtaining goods prior to paying for them, some sellers will ship goods consigned to the buyer’s bank. Goods should not, however, be consigned to a bank without prior agreement on the part of that bank as this may force the bank to give the carrier alternative delivery instructions or even cause the goods actually to be delivered to the bank. Banks are not responsible for the goods themselves, only for documents. In ocean shipments—and only in ocean shipments—the bill of lading is normally a title document (and even then, only so long as it is consigned “to order of” someone rather than just “to” someone), and delivery of goods will be made to whoever possesses the original. Even shipping goods to order of a bank is discouraged by the Uniform Rules for Collections as this may lead to situations in which the bank is called upon to assume undesired responsibilities.

Documentary Time Drafts

Under a documentary time draft, the seller draws a draft on the buyer payable a certain number of days after sight or after the date of draft, invoice, or bill of lading. The “tenor” of the draft must be

negotiated and agreed to between the buyer and seller ahead of time. Note that the maturity of a “days-date” draft is known to the seller at the time the draft is completed; the maturity of a “days-sight” draft will be determined by the buyer based on the date he acknowledges as “sight” of the draft. It is highly recommended that drafts be made payable on a “days-date” basis rather than “days-sight” in order that the seller can properly age his receivables; otherwise there are often disputes about whether buyers are past due in their payments.

The draft and documents are sent by the seller’s bank to the overseas collecting bank with instructions to “deliver documents against acceptance.” The collecting bank will obtain the buyer’s signed acceptance on the face of the draft before delivering the documents to him. (Be aware that the bank that obtains acceptance is generally not responsible for the genuineness of signatures or for verifying the authority of any signatory to sign and accept the draft.) Once accepted, the draft is equivalent to a promissory note, with a fixed amount and maturity. At maturity, the collecting bank will attempt to collect payment of the accepted draft in the currency of the draft.

Although it may seem that time-draft terms are only a short distance, risk-wise, from sight-draft terms, use of a time draft allows the buyer to obtain the documents—and, thereby, the goods—before paying. The seller finds himself in a less favorable position because now he is relying entirely upon the buyer’s ability and willingness to pay as promised in his acceptance of the draft. Non-payment of the draft by the buyer at maturity may necessitate legal action to collect since the buyer has already taken possession and may have disposed of the merchandise. But for the fact the seller will have an accepted draft, which may simplify the ensuing lawsuit, time draft transactions differ very little in terms of credit risk from open account transactions. As in open account sales, payment at maturity may be beyond the control of the buyer, lying instead with government authorities in his country.

Avalized Drafts

An important variation on the time draft is the “avalized” draft. An avalized draft combines many of the features of a sight draft with those of a time draft and throws in a bit of the protection found in a letter of credit. The twist is that a bank is asked to add its guarantee, or “aval,” to the time draft after obtaining the buyer’s acceptance but before releasing the documents. The bank then assumes responsibility for the proper authority of the individual(s) accepting the draft and, more importantly, undertakes to pay the draft themselves if the buyer fails to do so at maturity. (Different countries have different practices regarding the number of days the buyer may go past due before being judged in default and triggering the bank to step up. This interim period is referred to as the “grace period” or “days of grace.”) Even with avalized-draft terms, the seller continues to take the same risk as with a sight draft that the buyer may simply refuse to accept the draft. There is also the chance the buyer will accept the draft but the bank will refuse to add its aval. If the buyer refuses to accept the draft or the bank refuses to add its aval, the seller retains control of the documents, as with a sight draft. The bank could be asked to write a commitment ahead of time to guarantee payment of drafts which are expected to be accepted by the buyer (sometimes referred to as a “letter of guarantee”), but this is likely to cost just as much as a letter of credit while leaving a great deal of opportunity for misunderstandings between parties. If this degree of protection is what is desired, it is recommended that the seller simply ask for a letter of credit.

Once the draft has been avalized, the risk becomes foreign bank risk, as on a letter of credit. Furthermore, there is an active market for avalized drafts and the seller can most likely sell the draft at an attractive discount rate for immediate cash, close the receivable, and eliminate all political and transfer risks. The purchaser of the draft accepts the risks of collecting payment at maturity. Banks that buy avalized drafts are called “forfaiters” and are often willing to quote indicative discount rates for acceptable foreign banks and even to lock in these rates in advance, for a nominal fee. This provides the seller with the ability to build the discount into the price of the goods when offering extended terms of payment. Note that the buyer must also pay a fee, to the avalizing bank (usually a per annum percentage), greatly increasing his expense over the fees he would pay for a simple time draft. Nonetheless, it is still quite possible the all-in cost to the buyer of “offshore supplier financing” of this sort will be lower than if he borrowed from his bank (probably in local currency, at local rates) in order to pay for his purchases at sight.

Choosing Among the Different Types of Documentary Drafts

Documentary sight or time drafts are typically used when the exporter considers the purchaser a good credit risk. Avalized drafts are used when the exporter is willing to take the risks of producing and shipping the goods, as with a sight draft, but does not wish to carry the financing risk normally involved with a time draft. In general, an exporter will use documentary draft collections with clients with whom he has prior experience, who are located in stable countries. In the absence of substantial evidence of creditworthiness, a new exporter would be well advised to seek more secure terms, such as a letter of credit, which provide protection against the buyer’s inability or plain refusal to pay. Nonetheless, if drafts are the customary terms of trade for the goods involved, then the exporter will most likely have to assume the buyer’s commercial risk, along with the political and transfer risks of the buyer’s country, to acquire the account. The decision of whether to use a documentary sight or time draft, an avalized draft, or a letter of credit is simply one of risk *vs.* cost. Time drafts, as previously noted, are riskier than sight drafts or avalized drafts. A letter of credit is clearly less risky, yet insisting upon one may cause the exporter to lose the sale.

Clean Drafts

Under a clean draft, the seller sends the shipping documents directly to the buyer and submits only his draft drawn on the buyer, and/or possibly an invoice, to his bank for collection. This procedure should, of course, be used only when the seller has complete confidence in the buyer because control of the merchandise is surrendered to the buyer independently from his payment or acceptance of the draft.

Clean drafts are generally used between affiliated companies (*e.g.*, parents and subsidiaries) and companies with long-standing relationships. The purpose is normally just to satisfy some regulatory formality in the buyer’s country before he is allowed to pay for goods in a foreign currency. An advantage of the clean draft over a documentary draft is that documents get to the importer faster than if they went through bank channels.

It should be noted that a corporate check received in payment for an export sale is considered a clean draft. A check is nothing more than a sight draft drawn on a bank where funds are presumably on

deposit. It constitutes the drawer's instructions to the drawee bank to pay the named payee. A check must be presented to the drawee bank for collection of payment. As a bank will not honor a check if the customer tells it not to (*i.e.*, stops payment) or if he does not have sufficient funds or if foreign exchange controls prohibit payment, an exporter can place no more confidence in being able to collect a check than any other clean draft. If asking for cash in advance, the seller should specify that payment should be made by wire transfer or, at least, a bank draft (essentially a check or money order written by a bank) drawn on a U.S. bank.

Borrowing Against Draft Collections

Some banks are willing to lend money to their exporting customers against foreign receivables, including those covered by drafts in the process of collection. This is commonly done with bankers' acceptances and it may involve arranging and assigning credit insurance against commercial, political, and transfer risks and executing an agreement pledging to the bank the proceeds of these drafts. Transactions may be aggregated or financed individually. If the drafts have been insured or avalized, or if the bank knows the foreign buyer, the bank may even be willing to purchase the drafts without recourse, similar to factoring of receivables.

CHAPTER THREE: **DIRECT COLLECTIONS**

How Direct Collections Work

Direct collections speed up the collection process. They allow the seller to send documents with collection instructions directly to the buyer's bank. Since the form used is filled out by the seller, or his freight forwarder, processing at the seller's bank is lessened, the possibility of transcription errors is eliminated, and documents are received sooner at the buyer's bank for collection from the buyer.

Direct collection service, primarily for regular draft collection users, enables the seller or his freight forwarding agent to forward the collection instructions and documents directly to the buyer's bank rather than present them to the seller's bank for processing. Airmailing documents and instructions directly to the overseas bank speeds up the collection process. Procedurally, the same information must be specified in a direct collection form as in a standard documentary draft collection instructions letter. *(An example of a direct collection form can be found on the facing page.)* A bank that is lending to an exporter against documents in the process of collection, however, is likely to require the exporter to submit all documents through them (rather than send the documents directly to any foreign bank) in order to maintain maximum control over the collection process.

In order for a seller to start using a bank's direct collection service, the bank will provide him with a supply of direct collection forms or software for creating these forms. Forms usually have four parts: the original is to be mailed to the overseas bank with the documents, part 2 is to be mailed (or electronically transmitted) to the seller's bank, and parts 3 and 4 are to be retained by the seller and/or his freight forwarder. Because the form is on the letterhead of the seller's bank, the overseas collecting bank will treat the documents and the instructions as though received from the seller's bank. Because the form is filled out by the seller or his forwarder and sent straight to the buyer's bank, processing at the seller's bank is lessened, the possibility of transcription errors is eliminated, and documents are received sooner at the buyer's bank. The seller's bank will charge a lower fee and payment may be collected faster. The seller's bank, however, does not check the collection instructions for correctness. If there are any problems, the overseas bank will revert to the seller's bank for instructions just as it would on any other draft collection. And from the point at which the seller's bank receives its copy of the direct collection form, it

LaSalle Bank N.A.
International Trade Services

200 W. Monroe Street, Suite 1100
 Chicago, Illinois 60606-5002
 (312) 904-8462
 SWIFT Address LASLUS44
 Telex No. 6737792

Always Quote Our Number D903733
Date

DIRECT COLLECTION LETTER

Original 1

To be airmailed by Shipper, Forwarder or U.S. Correspondent to bank abroad along with all original shipping documents.

We enclose for collection and remittance the item described below. Please process this collection for the account of LaSalle Bank N.A., International Trade Services. Kindly acknowledge receipt and advise us promptly of acceptance, maturity or payment as instructed below:

Subject to the Uniform Rules for Collections 1995 Revision, International Chamber of Commerce Publication No. 522.											
Airmail to Collecting Bank						Drawer and Address, Telephone, Fax					
<input type="checkbox"/> Presentation is restricted to this Collecting Bank											
Date of Draft			Tenor			Amount			Invoice No.		
Drawee Name and Address, Telephone, Fax						Other Reference No(s).					
						Description of Merchandise					
Bill of Lading Orig		Copies		Air Waybill Orig (#3)		Copies		For. Cargo Receipt Orig		Copies	
										Invoice	
										Insur. Cert.	
										Packing List	
										Cert. of Origin	
										Other Documents	
Deliver documents against						Advise acceptance/avalization and maturity by:					
<input type="checkbox"/> Acceptance						<input type="checkbox"/> Cable					
<input type="checkbox"/> Acceptance and avalization by yourselves (contact us immediately if clarification is desired)						<input type="checkbox"/> Airmail					
<input type="checkbox"/> Payment											
All charges including stamps, exchange, taxes, your collections fees, avalization (if requested), etc. should be charged to drawee plus our charge of:						Advise non-acceptance/non-avalization by:					
<input type="checkbox"/> Waive charges if refused						<input type="checkbox"/> Cable					
<input type="checkbox"/> Yours						<input type="checkbox"/> Airmail					
<input type="checkbox"/> Ours						Advise payment by:					
<input type="checkbox"/> Do not waive charges						<input type="checkbox"/> Cable					
<input type="checkbox"/> Protest for: <input type="checkbox"/> Non-acceptance <input type="checkbox"/> Non-payment						<input type="checkbox"/> Airmail					
if not accepted/paid within _____ days of first presentation						Advise non-payment by:					
<input type="checkbox"/> You may hold for arrival of merchandise without protesting						indicating reasons given for non-acceptance/non-avalization					
<input type="checkbox"/> Do not protest						Advise payment by:					
						<input type="checkbox"/> Cable					
						<input type="checkbox"/> Airmail					
						... all such advices at:					
						<input type="checkbox"/> Drawee's expense					
						<input type="checkbox"/> Our expense					
						<input type="checkbox"/> Hold accepted/avalized drafts for collection of payment at maturity					
						<input type="checkbox"/> Return duly accepted/avalized drafts to us					
<input type="checkbox"/> If dollar exchange is not immediately available on presentation (if drawn at sight), you may release documents against provisional payment in local currency pending availability of dollar exchange. At time of deposit of local currency obtain from drawees their written undertaking to be responsible for any exchange differences. The draft must not be surrendered to drawees until payment is remitted for face amount in U.S. dollar exchange (or the currency of the draft).											
<input type="checkbox"/> Allow a discount of _____ if paid											
<input type="checkbox"/> Collect interest at the rate of _____ % per annum based on _____ from _____ until _____											
<input type="checkbox"/> actual days/360 days per year <input type="checkbox"/> other _____ <input type="checkbox"/> date of first presentation <input type="checkbox"/> other _____ <input type="checkbox"/> date of local payment <input type="checkbox"/> other _____											
In case of need refer to						<input type="checkbox"/> Who is empowered by us to act fully on our behalf, i.e., authorize reductions, extensions, free delivery, waiving of protest, etc.					
						<input type="checkbox"/> Who may assist in obtaining acceptance or payment of draft, as drawn, but is not to alter its terms or other instructions given here in any way.					
Other instructions											

PLEASE REMIT ALL PROCEEDS BY CABLE TO LASALLE BANK, N.A. ATTN: IBD COLL. DEPT., FED ROUTING NUMBER 071000505 UNDER SWIFT (LASLUS44) OR TELEX (49650512 LASBNK UI) ADVICE TO US, QUOTING OUR REF: **D903733**

<p>LaSalle Bank N.A. 200 W. Monroe Street, Suite 1100 Chicago, Illinois 60606-5002</p> <p>Exchange for</p> <p>U.S. \$ _____ U.S.A. _____ 1999</p> <p>At _____ of this SOLE of Exchange</p> <p>pay to the order of LaSalle Bank N.A., Chicago, Illinois</p> <p>the sum of _____ United States Dollars</p> <p>To _____</p> <p>No. _____ By _____</p>	<p>Bill of Exchange</p>
---	--------------------------------

A Direct Collection Form

will treat the transaction just as it would any other documentary draft collection, sending out tracers, generating reports, *etc.*

The most common errors in using direct collections include the following:

1. Bills of lading and insurance certificates are not endorsed as required.
2. Drafts are incorrectly drawn or not signed by drawer.
3. Instructions regarding who will be responsible for the payment of collection charges are absent.
4. The amounts of the commercial invoice and the draft are different.
5. “Case-of-need’s” authority is not clearly defined.

Individuals familiar with the mechanics of documentary draft collections and the Uniform Rules for Collections find direct collections highly preferable to “normal” collections.

CHAPTER FOUR: LETTERS OF CREDIT

How Letters of Credit Work

A letter of credit can be thought of as a certified check payable by attaching specified documents and presenting it back to the issuing bank.

Like a certified check, a letter of credit is normally obtained by someone ordering goods and sent to the seller, thus providing the seller a bank's assurance of payment.

But, unlike a certified check, the seller must present some evidence that the contract of sale has been fulfilled before he can cash the letter of credit. Letters of credit are also used in many circumstances not involving the purchase and sale of goods.

A documentary letter of credit ("L/C") is an instrument issued by a bank, at the request of an applicant, in which that bank promises to pay a specified amount of money to the named beneficiary upon his presentation of documents as stipulated in the credit. In a commercial transaction, the buyer (importer) of merchandise becomes the L/C applicant and asks that the seller (exporter) be named the beneficiary. The buyer's bank's promise to pay reduces the commercial risk incurred by the seller. Because the seller cannot receive payment until he presents the required documents and because these documents provide evidence that the desired goods have been shipped, the buyer receives some (but not total) assurance that the seller will comply with the agreed-upon terms of sale before being paid.

Two key points must be emphasized. First, a letter of credit does not guarantee payment to the seller regardless of circumstances. Rather, payment will be assured only if the seller complies exactly with the terms of the letter of credit and, even then, only if the issuing bank is willing and able to honor its obligation to pay. Second, because banks deal in documents and not in merchandise, a bank cannot assure the buyer that the goods shipped are, in fact, what the documents describe. A letter of credit cannot protect the buyer from fraud on the part of an unscrupulous seller. On the other hand, a letter of credit does protect a seller from an unscrupulous buyer who might fabricate a contract dispute and demand a price adjustment or refuse to pay.

Letters of credit can be issued in either revocable or irrevocable form. A revocable credit, once established, can be modified or canceled at any time without notice to or consent of the seller. Because an irrevocable letter of credit is a binding commitment, any change or amendment to the credit desired by the buyer or seller must be agreed to by all parties concerned. Nearly all credits are issued in irrevocable form. A revocable credit is properly regarded only as a notice from a bank that it is authorized to make payments on the buyer's behalf against certain documents. Thus it serves as a medium to expedite payment but it does not shift credit risk to

the issuing bank. As it does not serve the traditional purpose of a letter of credit, a revocable credit should be rejected by the seller unless he totally understands what he is doing. Likewise, buyers (particularly new ones) should avoid the use of revocable letters of credit. Note that frequently the term “advising bank” is used for both the advising and the negotiating banks. Basically, the advising bank is the bank through which the letter of credit is delivered to the seller; the negotiating bank is the bank to whom documents are presented by the seller for collection of payment and is not necessarily the advising bank.

The negotiating bank will collect payment from the issuing bank according to the terms of the credit. Payment may be available immediately or the L/C may promise payment a set number of days after shipment or after presentation of the documents. Although the negotiating bank may be willing to advance proceeds to the seller prior to receipt of payment, this is viewed as a loan either to the seller or to the issuing bank. In fact, the term “negotiate” refers to advancing funds in this way, although it is at the negotiating bank’s discretion whether or not to do so. (*Further information about [selecting negotiating banks](#) can be found in Chapter 6: Export Letters of Credit.*) Ultimately, it is the issuing bank that is obligated to make payment.

Parties to the Letter of Credit

There are three independent parties in the prototypical L/C transaction: the applicant (buyer/importer), the issuing bank (buyer’s bank), and the beneficiary (seller/exporter). Likewise, there are three contracts: the purchase order or sale contract (buyer-seller), the letter of credit application/agreement (buyer-issuing bank), and the letter of credit itself (issuing bank-seller). Other parties act as agents for these three. For example, the advising bank is actually just the issuing bank’s agent for the purpose of authenticating and delivering the letter of credit to the seller and the negotiating bank is, in effect, “hired” by the seller to examine documents and collect under the L/C.

The seller may wish to have the advising bank add its irrevocable promise to pay to that of the issuing bank. If the advising bank agrees, and obtains the issuing bank’s permission to do so, it becomes the confirming bank and a legal party to the transaction. An advising bank that has confirmed a letter of credit is obligated to pay the seller upon his complying with the terms of the letter of credit. On an unconfirmed letter of credit, the negotiating bank will commonly pay the seller only after it obtains funds from the issuing bank’s account. (This account may be at yet another bank whose role is to act as the issuing bank’s paying or reimbursing agent.) If immediate payment is desired, the seller may enter into an immediate-funds-availability agreement with the negotiating bank or request that the bank purchase the documents without recourse.

Contents of the Letter of Credit

Banks normally issue letters of credit in computerized formats that clearly indicate the bank’s name and the extent of the bank’s obligation under the credit. In general, letters of credit contain the following information:

Whether the credit is *revocable* or *irrevocable*

Expiry date, which specifies the latest date for presentation of documents (In this manner, or by including a latest shipping date, the buyer may exercise control over the date of shipment.)

Name of the seller, who is also known as the *beneficiary*

Name of the buyer, who is also known as the *applicant* or *account party*

Amount of the credit, which should be the value of the merchandise plus any other charges intended to be paid under the credit

Tenor of the draft, such as sight, 90 days bill of lading date, *etc.*, which is normally dictated by the terms of the sale contract or purchase order

General description of the merchandise, which briefly and in only a general manner describes the merchandise covered by the letter of credit

Shipping terms such as FOB Rotterdam, FCA Chicago, CIP Pittsburgh, *etc.*, indicating whether the price includes freight and insurance, where responsibility for the goods changes, who is to arrange transportation, and so forth

Documents required, which will normally include commercial invoices, original bills of lading, consular or customs invoices, packing lists, and, if the insurance is to be effected by the seller, insurance policies or certificates

Further details about [letter of credit contents](#) can be found in Chapter 5: Import Letters of Credit.

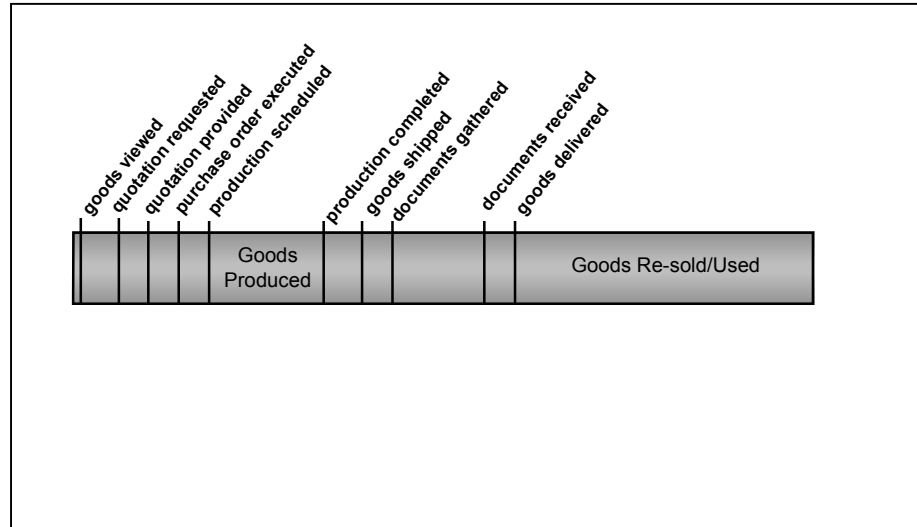
Some Uses of Letters of Credit

Letters of credit are versatile instruments. They may provide for advance or down payments, progress payments, and payments for repairs during a warranty period. They do not always involve international trade. Unusual uses have included alimony payments and the awarding of prize fight money to the winner of the fight (against presentation of a newspaper clipping as documentation). Standby letters of credit have become very popular as “backing” for bonds and other commercial paper. It is not even necessary that letters of credit be payable in money. A bank may engage in a credit to deliver an item of value, such as title to a building or stock certificates it is holding for the applicant, against presentation of stipulated documents, much like an escrow arrangement.

In subsequent sections, “[revolving](#),” “[installment](#),” “[clean](#),” and “[evergreen](#)” credits will be discussed as well as [letter of credit transfers](#), [assignments of letter of credit proceeds](#), and some [special uses of standby letters of credit to support trade transactions](#).

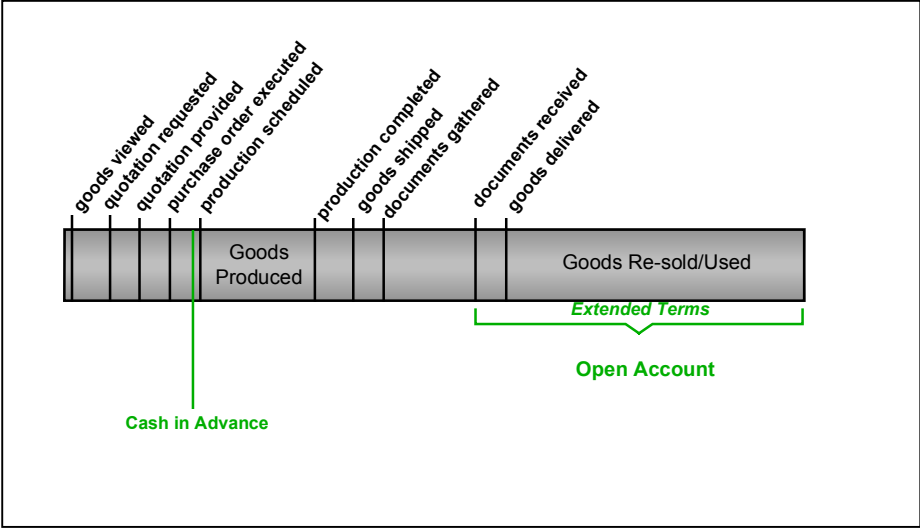
Why Use Letters of Credit

Commercial letters of credit are used in a wide variety of circumstances. Certain countries require that all international trade be conducted on a letter-of-credit basis. Some companies make a policy of selling goods to foreign buyers only against letters of credit. Letters of credit often provide a mechanism for obtaining bank financing covering the entire life of a commercial transaction, from the accumulation of raw materials and production of goods, to the time goods are shipped by the seller, to the time goods are resold by the buyer.

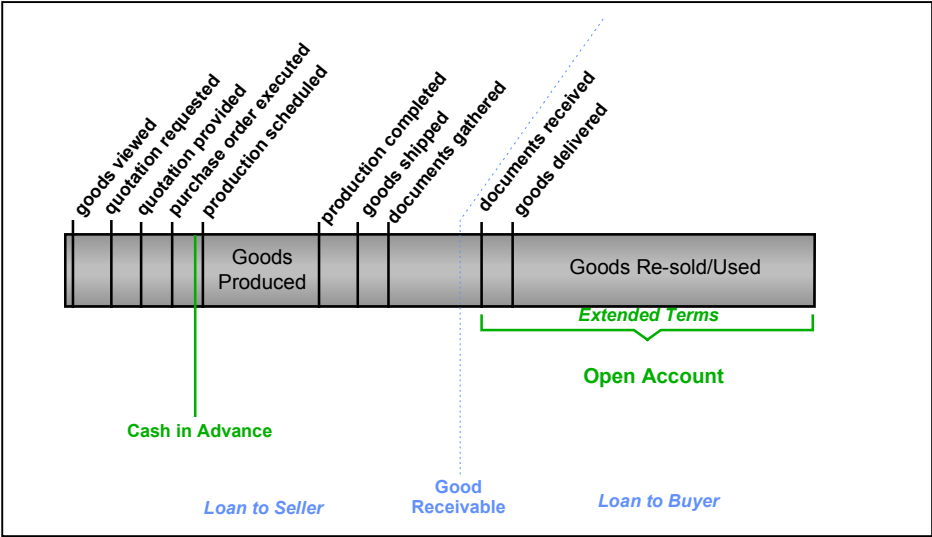


The key advantage to the seller is that a letter of credit reduces commercial risk, both pre-shipment (contract risk) and post-shipment (financing risk). Whereas a collection requires assuming the commercial risk associated with the buyer, a letter of credit requires assuming only the commercial risk associated with the issuing bank. In both cases, the seller assumes foreign political and transfer risks. If the letter of credit is confirmed (or covered by a so-called “silent confirmation”), the relevant commercial risk is that of the confirming bank and the political and transfer risks are those of the confirming bank’s country. When a letter of credit includes post-shipment “supplier financing” (*i.e.*, payment a set period of time after either shipment or presentation of documents rather than at sight), the issuing and/or confirming banks will generally give the seller the option of immediate payment if desired. The seller can thus obtain immediate payment, close the receivable, and eliminate all further risk, even while providing financing desired by the buyer, who will pay the banks at the agreed due date. (*Further information on [confirmed L/Cs](#), [“silent confirmation,”](#) and [“supplier financing”](#) can be found in Chapter 6: Export Letters of Credit.*)

The buyer under a letter of credit also receives some protection. Having a bank examine the documents increases the likelihood of detecting errors in the shipment. It does not, however, ensure that

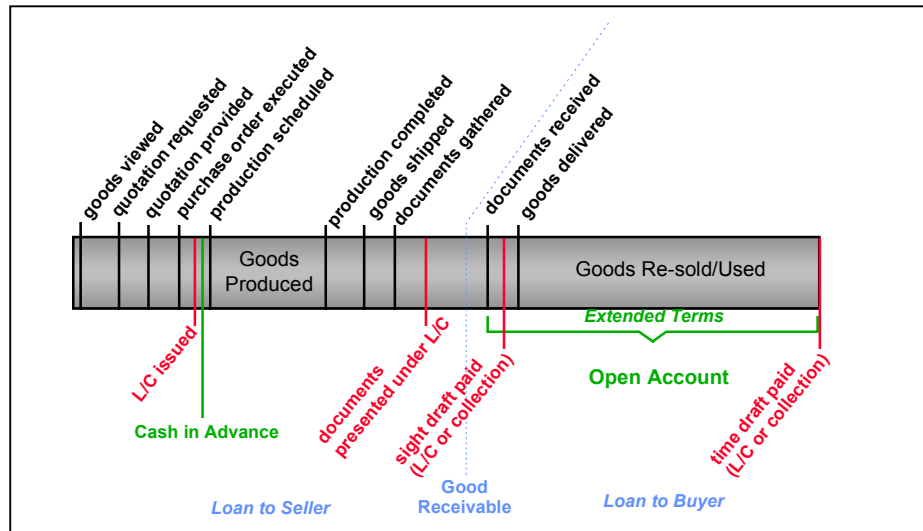


the goods actually shipped are in the quantity or of the quality described in the documents. Another important reason for a buyer without experience in international trade to use a letter of credit is to eliminate delays involved in establishing his own credibility. In fact, new buyers are generally required



to obtain letters of credit because suppliers are not willing to sell to them on more liberal terms. Sometimes, even established buyers use letters of credit because they provide their suppliers with something they can take to their banks to obtain financing. This depends on a bank’s willingness to take the risk that if it provides a seller with pre-export funding to produce and ship the goods, the seller will do so properly and perform according to the letter of credit requirements to obtain the money

needed to repay the loan. This is less risky to the buyer than sending the seller cash in advance since the local bank takes on the performance risk of the seller. Also, because there is a built-in source of repayment, it is less risky to the local bank than simply lending working capital to the seller.



A letter of credit may also contain built-in financing for the buyer. When the goods are shipped and the proper documents presented, the issuing bank may have agreed with its customer, the buyer, to pay the seller immediately but defer obtaining reimbursement from the buyer. This can allow the buyer to resell the goods or use them to produce other goods which can be sold to generate the cash necessary to reimburse the bank. Thus, letters of credit can be used to reconcile the desire of an exporter to receive cash in advance and cover all production costs with the desire of an importer to obtain extended payment terms allowing him to sell the goods before paying for them.

It is worth emphasizing that a letter of credit is not a substitute for good business judgment. The buyer must trust the seller. A letter of credit will not prevent a seller from invoicing goods as called for in the credit and shipping goods of a different nature. In addition, the seller needs to understand the political and economic situation in the buyer's country, particularly in the area of foreign exchange.

The Letter of Credit Cycle

Although the letter of credit cycle appears quite complex at first, it is not difficult to understand. This cycle merely involves the exchange of documents (and money) through intermediaries. The diagrams on the next three pages depict the cycle in a pictorial way.

The Letter of Credit Cycle

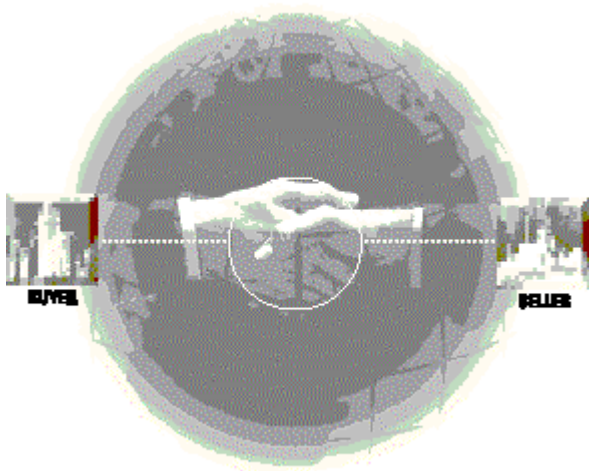


FIGURE 1.
The buyer agrees to purchase goods from the seller using a letter of credit as the mechanism of payment.

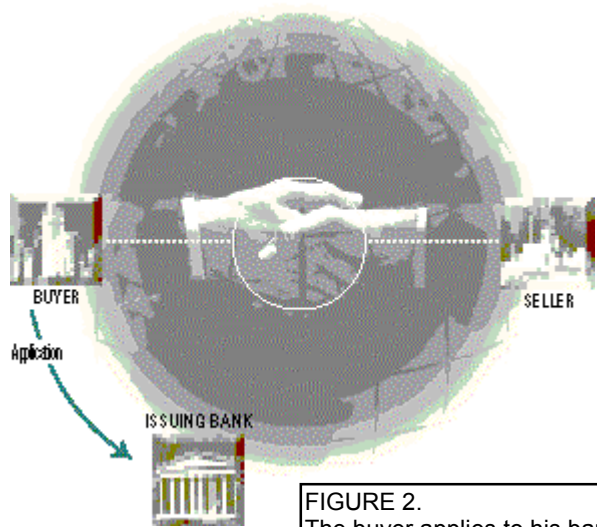


FIGURE 2.
The buyer applies to his bank for a letter of credit, signing the bank's letter of credit application/agreement form.

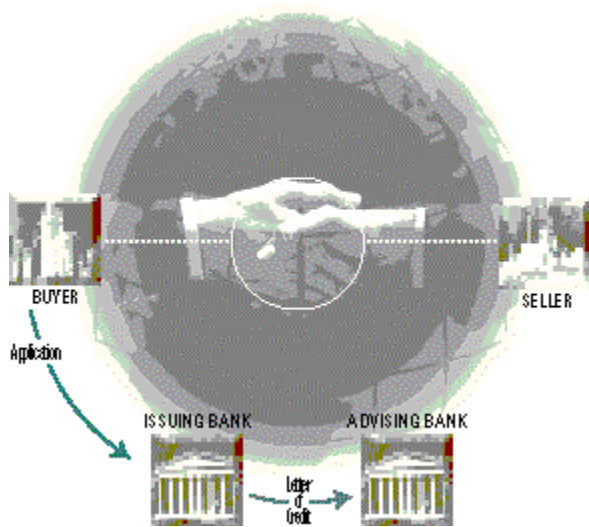


FIGURE 3.
After approving the application, the issuing bank issues the actual letter of credit instrument and forwards it to the advising bank.

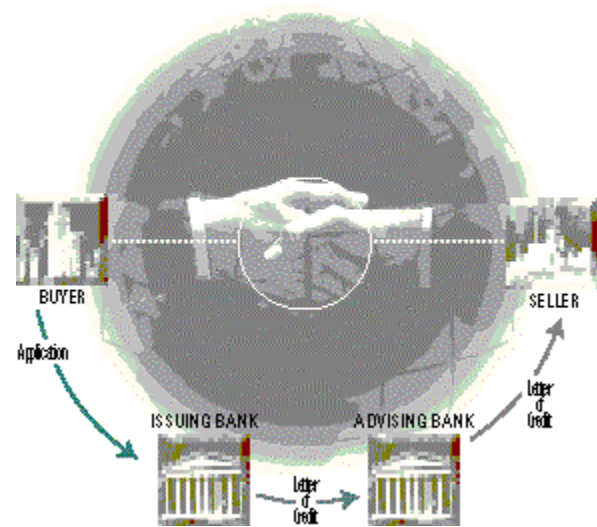


FIGURE 4.
The advising bank authenticates the letter of credit and delivers it to the beneficiary (the seller).

The Letter of Credit Cycle

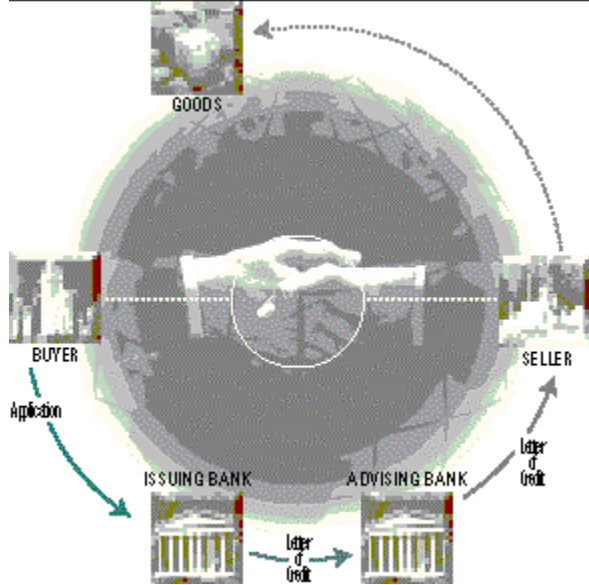


FIGURE 5. Having received the issuing bank's assurance of payment, the beneficiary (seller) ships the merchandise to the applicant (buyer).

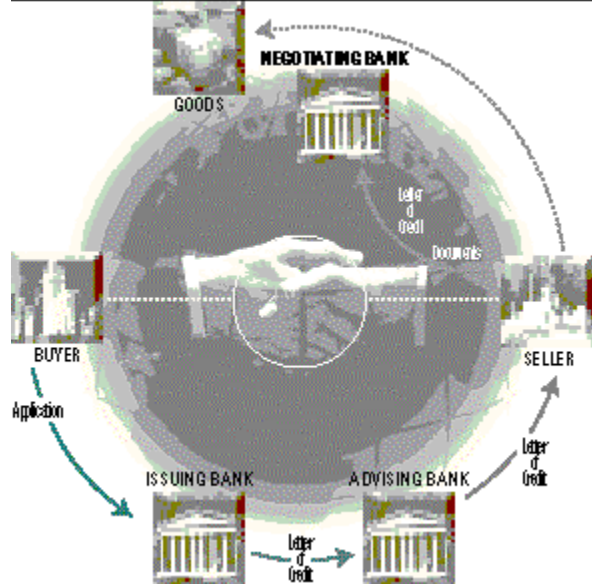


FIGURE 6. The beneficiary (seller) prepares the documents called for in the letter of credit and presents them to the negotiating bank. The letter of credit may specify a negotiating bank or it may say it is "available with any bank," giving the beneficiary the freedom to choose.

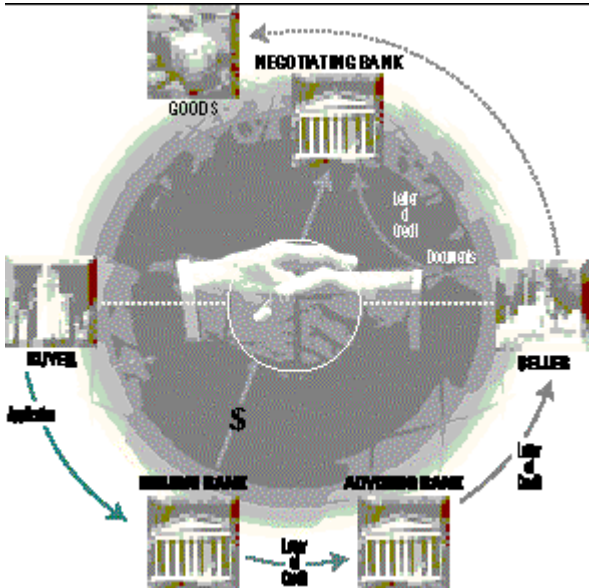


FIGURE 7. The negotiating bank examines the documents and, if they comply, obtains funds for payment to the beneficiary in accordance with the terms of the letter of credit.

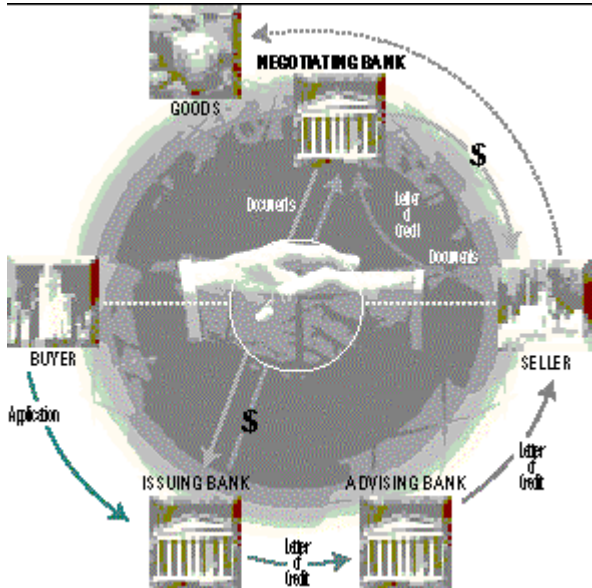


FIGURE 8. The negotiating bank transfers payment to the beneficiary (seller) and forwards the documents to the issuing bank.

The Letter of Credit Cycle

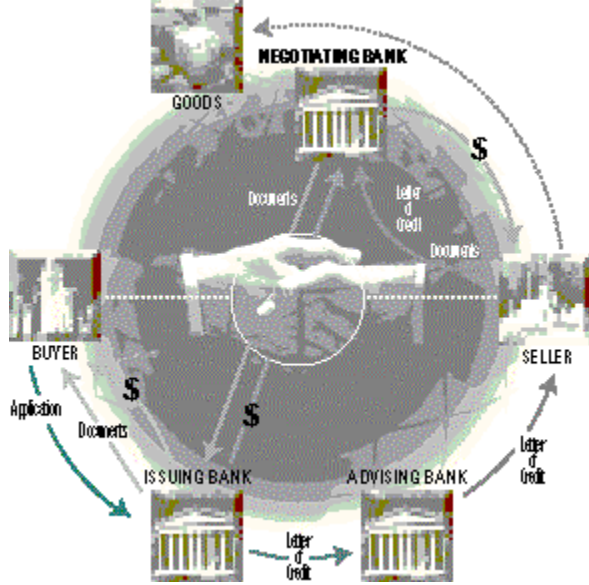


FIGURE 9.
The issuing bank examines the documents. If it agrees with the negotiating bank that the documents comply with the letter of credit, the issuing bank obtains payment from the applicant (buyer) in accordance with the terms of the applicant's letter of credit agreement and forwards the documents to the applicant.

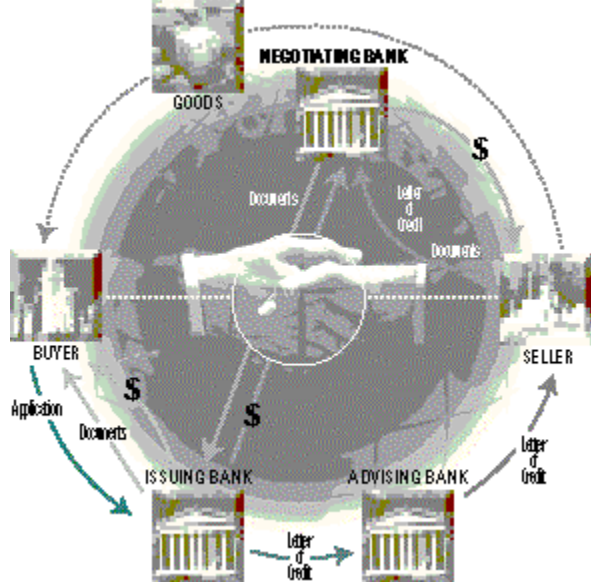


FIGURE 10.
The applicant (buyer) uses the documents to pick up the merchandise from the carrier, completing the letter of credit cycle.

**CHAPTER FIVE:
IMPORT LETTERS OF CREDIT**

Letter of Credit Mechanics on the Import Side

An import letter of credit is a very common means of paying for goods ordered from someone in another country. It is important for the importer to understand that the issuing bank will be committing to pay the amount requested upon presentation of certain documentation. This documentation should be clearly described for the bank by the importer and should reflect the contract of sale. Since the bank asked to issue the letter of credit will be undertaking to make a payment on behalf of the importer, the decision of whether or not to do so is similar to the loan approval process.

Once an importer and a foreign seller have established a contract of sale and have decided that payment is to be effected through a letter of credit, the importer will submit an application for a commercial letter of credit to his bank. (*See the example of a letter of credit application on the facing page.*) The credit is prepared from this application; hence, the information included in the application must not be inconsistent with the terms of the underlying sales contract. It must also be consistent with the [Uniform Customs and Practice for Documentary Credits](#) (the international standards of practice established for bankers by the International Chamber of Commerce), local law (the [Uniform Commercial Code](#) is the law in the United States), and ordinary practices of banks dealing with letters of credit. Because the application is a legal agreement between the bank and the applicant, it must be signed or made subject to a separate, signed agreement. (A separate agreement is normally used to allow for transmission of L/C applications electronically.) To avoid amending the letter of credit, the importer should ensure the letter of credit terms and required documents are consistent with the seller's needs as well as his own country's import regulations. The key items in the application are as follows:

- Applicant:* Name and address to be shown on the L/C for the importer, sometimes also referred to as the account party
- Beneficiary:* Name and complete address of the seller
- Amount:* The total of the value of the merchandise and any shipping charges, *etc.*, intended to be paid under the credit

LaSalle Bank N.A.

International Trade Services

200 W. Monroe Street, Suite 1100
 Chicago, Illinois 60606-5002
 (312) 904-8462 fax (312) 904-6303

LASALLE BANKS

Date: _____
 L/C no. _____
 (For Bank Use)

APPLICATION FOR IRREVOCABLE COMMERCIAL LETTER OF CREDIT

Subject to our Master Letter of Credit Agreement with yourselves, please issue an irrevocable Commercial Letter of Credit (L/C) substantially as set forth below, and

- send the original L/C directly to the Beneficiary
- send the L/C to the Advising Bank indicated or your chosen correspondent, as applicable (for delivery to the Beneficiary)
- by airmail. courier. cable (SWIFT/telex/cablegram). other: _____

Advising Bank (optional)	Applicant (name & address)
Beneficiary of L/C (name & address expected to appear on invoices)	Amount (U.S. dollars unless otherwise indicated) up to: _____ plus or minus ____ % Expiry Date of L/C (month in words, day, year) _____ in the country of the Beneficiary unless otherwise indicated

Please make the L/C subject to the Uniform Customs and Practice for Documentary Credits (UCP) currently in effect.
 Documents must be presented within _____ days after shipment (21 days if not otherwise specified) but, in any case, within the validity of the credit.
 Draft(s) must be drawn at (specify "sight" or other tenor) _____ for _____ % (100% unless otherwise specified) of Commercial Invoice value drawn on you or (specify other drawee) _____ and accompanied by the following documents:

- Original and _____ copy(ies) of Commercial Invoice covering (describe goods as in the Beneficiary's proforma invoice but only in generic terms, omitting details as to grade, quality, etc.):
 - EXW (Ex Works, Ex Factory At) _____ (place)
 - FCA (Free Carrier At) _____ (place)
 - CPT (Carriage Paid To) _____ (place)
 - CIP (Carriage & Insurance Paid To) _____ (place)
 - FOB (Free On Board At) _____ (port of loading) (for port-to-port ocean shipments only; otherwise use FCA)
 - CFR (Cost & Freight Paid To) _____ (port of discharge) (for port-to-port ocean shipments only; otherwise use CPT)
 - CIF (Cost, Insurance & Freight Paid To) _____ (port of discharge) (for port-to-port ocean shipments only; otherwise use CIP)
 - Other terms _____
 - Marine Cargo Insurance Policy or Certificate (for CIP and CIF shipments) in negotiable form for at least _____ % (110% unless otherwise specified) of Commercial Invoice value, endorsed in blank and covering the following risks:
 - All risks warehouse-to-warehouse
 - All risks warehouse-to-warehouse including war risks and strikes, riots and civil commotions
 - Other (specify) _____
 - Copy of a cable or fax message addressed to the Applicant giving date and means of shipment and description and value of the goods shipped, bearing the Beneficiary's original signed certification that "This is a true and accurate copy of a message sent as addressed within two days of shipment of the described goods" (for insurance purposes on EXW, FCA, CPT, FOB, and CFR shipments).
 - Full set of Multimodal Transport (Door-to-Door) Bills of Lading showing place of receipt as _____ and place of delivery or final destination as _____ consigned to the order of the shipper, endorsed in blank.
 - Full set of Port-to-Port Bills of Lading showing port of loading as _____ and port of discharge as _____, consigned to order of shipper, endorsed in blank.
 - Transshipment prohibited (only applies to Port-to-Port Bills of Lading).
 - Original Shipper's Copy of Air Waybill, showing airport of departure as _____ and airport of destination as _____, consigned to _____
 - Beneficiary's certificate that "one extra set of documents is accompanying the air shipment" (not applicable to ocean shipments).
- The above Bills of Lading, Air Waybill or other transport documents are to be marked and evidence:
 Freight: Collect Prepaid Notify Party: _____
 Partial shipments: Allowed Not allowed Shipment not later than: _____
- Forwarder's Cargo Receipt issued by _____ showing merchandise received no later than _____, consigned to or held at the disposal of the Applicant.
 - Original and _____ copy(ies) of Packing List.
 - Original and _____ copy(ies) of Certificate of Origin.
 - Original and _____ copy(ies) of _____

SPECIAL CONDITIONS/INSTRUCTIONS

- Please make the L/C transferable in full or in parts by any bank.
- All bank charges other than those of the Issuing Bank are for the account of the Beneficiary. All bank charges are for the account of the Applicant.
- Discount charges, if any (applicable only to drafts other than "sight"), are for the account of the Beneficiary. Applicant.
- All documents are to be sent to you in one lot by Courier. Airmail.
- Other conditions/instructions: _____

Account Party name (if different from Applicant name above) _____

Authorized signature _____ phone number _____ fax number _____

A Letter of Credit Application Form

<i>Expiry date:</i>	Latest date documents may be presented for negotiation, payment, or acceptance
<i>Tenor of draft:</i>	Whether draft should be drawn at sight or a certain number of days (e.g., 30, 90, 180) after sight or after the date of one of the documents
<i>Documents required:</i>	Documents and number of originals and copies required by the importer including those necessary to clear merchandise through customs
<i>Covering:</i>	General description of the merchandise, unit price, if any, and shipping terms (CPT [“Carriage Paid to”] Atlanta, <i>etc.</i>) as defined in the Incoterms
<i>Insurance:</i>	The application should indicate whether insurance is to be effected by the importer or by the seller. Indication should also be given as to the coverage required if insurance is to be covered by the seller (e.g., “marine and war risks for at least 110% of the CIP value”). If the seller is arranging transportation, it is generally a good idea to let him also arrange insurance in order to avoid miscommunications that may result in no one’s obtaining insurance. Nonetheless, many importers negotiate to arrange for insurance; then, in the event of loss or damage, they will be dealing with insurance companies and coverage of their own choosing.
<i>Multimodal Transport (door- to-door) Bills of Lading:</i>	Transport document required when the seller is to arrange shipment including both inland transportation and an ocean leg, and payment is to take place as soon as the merchandise is picked up by the carrier (consistent with shipping terms of FCA [“Free Carrier”], CPT [“Carriage Paid to...”], and CIP [“Carriage and Insurance Paid to...”]).
<i>Air Waybill:</i>	Transport document required when shipment is to be made by air. An air waybill is <u>not</u> a title document; goods will be delivered to the importer regardless of whether he has obtained an original copy.
<i>Forwarder’s Cargo Receipt:</i>	Document required when the importer is arranging all transportation through his own freight forwarder with offices in the seller’s country. Seller’s responsibility for the goods ends with delivery to the forwarder (consistent with shipping terms of “Ex

Works”).

Notify party: It is customary to indicate in the transport document a party to be notified by the carrier upon arrival of the goods at their place of destination. Normally the notify party is the custom house broker and/or the importer.

Partial shipments: Unless specifically indicated otherwise, partial shipments will be permitted. If the importer desires one shipment only, the application should be marked “partial shipments not allowed.”

Please note: Some importers believe they can ensure performance by the seller under the sales contract by asking their banks to include numerous details and a lengthy description of the merchandise in the letter of credit. The insertion of these details, however, serves only to impede and hamper the effectiveness of the letter of credit. It will not prevent a seller intent upon fraud from invoicing goods and forging other documents as called for in the credit and shipping material of an entirely different nature (or none at all). As the conditions become more numerous and complex, the likelihood of trivial discrepancies increases, resulting in delays, cable expenses, *etc.*, and annoyances to both the importer and the seller trying to do business legitimately.

The issuance of a letter of credit constitutes a credit exposure on the part of the issuing bank to the importer since the bank will have to pay regardless of the importer’s financial ability at the time documents are presented. Therefore, the credit will be issued only if the credit standing of the importer is satisfactory to the issuing bank. Collateral may be required but it would be very unusual for this to be in the form of cash. The application will be reviewed for completeness, consistency, and appropriateness. Upon approving the application, the bank will issue the letter of credit.

The importer must instruct the issuing bank how the credit is to be transmitted to the seller. It is customary to have the issuing bank forward the letter of credit to the seller through one of its branches or correspondents located near the seller. In some cases, usually with domestic letters of credit, the buyer may choose to have the letter of credit sent directly to the seller. Most letters of credit nowadays are transmitted by the issuing bank to the advising bank by electronic data interchange. The advising bank is responsible for authenticating the credit and delivering it to the seller.

Upon receipt of a credit, the seller sometimes finds that he will not be able to meet its terms. He will then generally ask the importer to amend the letter of credit. It is crucial to note that any modifications agreed to between the importer and seller must also be agreed to by the issuing bank and incorporated into the letter of credit through amendments.

After shipping the goods and completing the documentation required by the letter of credit, the seller presents documents to a negotiating bank for collection and payment. The negotiating bank sends the documents to the issuing bank which will also scrutinize them before paying the negotiating bank. If the documents satisfy the terms of the letter of credit, the issuing bank must pay. Letters of credit may specify that they are payable immediately or on a deferred basis (*e.g.*, 90 days after the bill of lading date). The importer’s agreement with the bank may call for immediate reimbursement upon payment or deferred reimbursement.

In the event the documents are not correct, the issuing bank will have to decide whether or not to waive discrepancies. Normally, this involves discussions with the importer. The importer may wish

the bank to waive the discrepancies or to refuse the documents. In the former case, the bank may nonetheless refuse the documents but will more likely proceed as if the letter of credit terms have been satisfied. In the event the importer wants the bank to refuse the documents, he may ask the bank to relay to the seller the terms under which he will accept the merchandise. The seller is, however, free in these circumstances to try to find another buyer.

Revolving Letters of Credit

Revolving letters of credit revert to their original amounts at certain specified intervals. For example, a credit may be revolving for US\$5,000 weekly, which would mean that the seller could draw drafts for up to US\$5,000 every week prior to the expiry date of the credit. The periods during which the amount of the credit could be drawn, or in other words revolve, might be daily, weekly, monthly, *etc.*

The importer should exercise a great deal of caution before providing the seller with an irrevocable revolving letter of credit. The maximum exposure of the importer under an irrevocable revolving credit is not the amount of the credit, but the amount of the credit multiplied by the number of periods the credit is to revolve. For this reason, some revolving letters of credit are issued in quasi-revocable form, indicating that they are available for a specified amount which will be reinstated automatically unless the issuing bank notifies the seller that further reinstatement is canceled. Such credits are very difficult to control, however.

Revolving letters of credit can be either cumulative or non-cumulative, but nearly all such credits are non-cumulative. Any amount the seller does not draw under a revolving, non-cumulative letter of credit during a given period may not be drawn in a later period. For example, if a revolving credit has been issued for US\$5,000 weekly, non-cumulative, and the seller draws only US\$2,000 in one week, he may still draw only US\$5,000 in each succeeding week. The revolving, cumulative letter of credit, on the other hand, permits the seller to carry over any amounts not drawn in previous periods. For example, if a revolving credit has been issued for US\$5,000 weekly, cumulative, and the seller draws only US\$2,000 in one week, the unused amount may be carried over and added to the amounts available in subsequent periods: the sum of US\$8,000 becomes available the next week or, if not used in that week, in any of the succeeding weeks.

Revolving credits are used by companies with repetitive sales or purchases. The most common users are retailers. For example, an importer of skis may be able to sell up to US\$10,000-worth each week from October through December. The non-cumulative letter guarantees that he will never have to pay for more than US\$10,000 of skis each week. In this manner the purchaser can exercise control over his inventory and warehousing costs. Such credits are also used by companies with buying agents overseas (in this case, the credits are generally issued in favor of the agents themselves but the agents are allowed to transfer the credits to other parties, namely the suppliers they locate).

Installment Letters of Credit

An installment letter of credit is similar to a revolving, non-cumulative letter of credit with one key exception: once the seller misses a shipment, the credit ceases to be in effect. To take the previous

example of the ski importer, the installment letter of credit ensures that the retailer will receive US\$10,000 of skis every week until the seller fails to make a shipment. If this happens, a new letter of credit must be opened to import more skis, or the existing credit reinstated by an amendment. An installment credit normally includes a detailed shipping schedule and the amount and duration of each installment may vary. Obviously, the installment letter enables the retailer to formulate his sales plans more effectively than a revolving credit.

CHAPTER SIX:
EXPORT LETTERS OF CREDIT

Letter of Credit Mechanics on the Export Side

An export letter of credit provides an exporter with a bank's commitment to pay the amount specified upon presentation to the bank of the documentation described in the letter of credit. The exporter must be sure to clearly communicate to the importer the terms of sale and what documents he expects to present in order to demonstrate fulfillment of the sale contract. As long as the letter of credit calls for the documents the exporter intends to produce, the exporter can consider his risk to have shifted from the buyer to the buyer's bank.

Once an exporter and a foreign buyer have agreed upon the terms of sale (including payment on a letter-of-credit basis), the foreign buyer submits an application for a letter of credit to his bank. This process is generally the same as that followed by a North American buyer, as explained in the previous chapter. (There is a common misconception that at this point the buyer gives his bank the cash needed eventually to pay the L/C and that these funds are then placed on deposit at the advising bank. While regulations in a few countries may require a partial or full cash deposit, this is, in fact, not only unusual but contrary to the normal reasons the buyer wants to use a letter of credit. If he had to put up cash in order to obtain an L/C, he might well consider paying cash in advance and trying to negotiate a lower price.) To avoid the need to obtain amendments to the L/C, the exporter should consider providing the importer with explicit guidelines for what documents to require. (*A format for developing a letter of credit instructions form appears pages 33-35.*)

The issuing bank forwards the letter of credit to an advising bank in the exporter's vicinity. The role of the advising bank is to verify the authenticity of the letter of credit and then relay it to the exporter. The advising bank has no obligation to pay the credit unless it adds its confirmation.

The exporter may ask the buyer to specify the advising bank and, if the exporter wants to have the letter of credit confirmed, he must also have the buyer include the request for confirmation on the application for the letter of credit. The advising bank is not authorized to confirm a letter of credit without specific authority from the issuing bank and has no obligation to do so even if requested.

The exporter must be aware, however, that the issuing bank will generally consider that it has the prerogative to choose the advising/confirming bank. This has caused great dissatisfaction among exporters, especially in recent years, as the confirming bank chosen is often a branch or affiliate of

This format is for use in designing a Letter of Credit Instructions form appropriate for your own company.

LETTER OF CREDIT INSTRUCTIONS

Date: _____

To: _____

From _____
Address _____
City & State _____
Country _____ Zip Code _____
Attn _____
Telephone _____
Fax _____

RE: Our Pro-Forma Invoice# _____ Dated _____
 Your Purchase Order# _____ Dated _____
 Commercial Contract# _____ Dated _____

Gentlemen:

In connection with your above-referenced purchase, the following terms and conditions are for inclusion in your irrevocable letter of credit. We are providing you with these details as a confirmation of our understanding of the terms of sale covering this transaction. If these details do not agree with your understanding or if you are unable to comply with these terms and conditions, please notify us prior to the issuance of your letter of credit to avoid unnecessary delays and costs. Thank you for your patronage and cooperation.

1. The letter of credit must be issued no later than _____ by a bank acceptable to us.
2. The letter of credit must be irrevocable, state that it is available with any bank by negotiation, and be subject to the 1993 Revision of the Uniform Customs and Practice for Documentary Credits published by the International Chamber of Commerce (UCP500).
3. The letter of credit must be opened with full details by SWIFT or tested telex

In favor of: _____ [indicate the company name and address you will use in your invoices; if this is not the address you want your
Attn: _____ L/Cs mailed to, give separate instructions for where this
Telephone: _____ L/C is to be sent]

We will not initiate shipment until the actual letter of credit is received but it may expedite processing if you will fax a copy of the letter of credit to [name] at [fax number]. This must be a copy of your bank's actual SWIFT message sent to the advising bank. A copy of your letter of credit application is not sufficient.

4. The letter of credit must be payable in U.S. dollars for
 up to an amount of _____
 an approximate amount of _____
5. The letter of credit must be advised through an acceptable, "prime" U.S. or European bank such as:

[list your preferred letter of credit advising banks]
6. The letter of credit must authorize the advising bank to add its confirmation only if requested to do so by beneficiary.
7. The letter of credit must authorize the negotiating bank to debit the issuing bank's account with a U.S. reimbursing bank with no deductions. It will expedite processing, and possibly reduce the reimbursing bank's charges, if your bank indicates their account number with the reimbursing bank in the L/C.
8. The letter of credit must be payable against drafts drawn, at the beneficiary's option, on the issuing bank, on the advising bank, or on the reimbursing bank. Drafts must be
 at sight
 at _____ days from the date of the transport document/forwarder's receipt.
 at _____ days from the date of the invoice.
9. The letter of credit must indicate:
- All banking charges outside the applicant's country, including any amendment charges, are for the account of the applicant beneficiary.
 - Discount and acceptance charges for time drafts shall be for the account of the applicant beneficiary.
 - Reimbursement related charges must be for the account of the issuing bank. Please instruct your bank to reflect this in their reimbursement authorization as well as in the letter of credit.
10. The letter of credit must be transferable by any bank.
11. The letter of credit must allow partial shipments.
12. The latest shipping date in the letter of credit must be at least _____ days after the issuance date of the L/C.
13. The letter of credit must allow a minimum of _____ days after the date of transport document/forwarder's receipt for presentation of documents. Add 14 days if any documents required must be consularized or legalized or if they include an inspection certificate issued by S.G.S. or similar inspection service. Expiration should be this same number of days after the latest shipment date at the counters of the negotiating bank.

14. The letter of credit must require the commercial invoice to describe the merchandise, in accordance with our pro-forma invoice, as (use only generic terms, avoiding details as to grade, quality, etc.):

- | | |
|---|---|
| <input type="checkbox"/> EXW (Ex Works, Ex Factory) | <input type="checkbox"/> cleared for export
<input type="checkbox"/> loaded on departing vehicle |
| <input type="checkbox"/> FCA (Free Carrier At) | <input type="checkbox"/> Seller's premises
<input type="checkbox"/> Consolidator's terminal in Seller's country
<input type="checkbox"/> Carrier's terminal
<input type="checkbox"/> Airport of departure |
| <input type="checkbox"/> CPT (Carriage Paid To) | <input type="checkbox"/> Customs terminal in Buyer's country
<input type="checkbox"/> Consolidator's terminal in Buyer's country
<input type="checkbox"/> Buyer's premises
<input type="checkbox"/> Airport of destination |
| <input type="checkbox"/> CIP (Carriage & Insurance Paid To) | <input type="checkbox"/> Customs terminal in Buyer's country
<input type="checkbox"/> Consolidator's terminal in Buyer's country
<input type="checkbox"/> Buyer's premises
<input type="checkbox"/> Airport of destination |

15. If you have selected a freight forwarder who will be receiving the goods for consolidation and/or shipment, payment must be available against a Forwarder's Cargo Receipt showing merchandise consigned to/at disposal of yourselves. Otherwise the L/C must require either a multimodal transport document consigned to order of the issuing bank showing place of receipt as _____ and place of delivery or final destination as _____ or an air waybill consigned to yourselves showing airport of departure as _____ and airport of destination as _____. L/C must require the multimodal transport document or air waybill be marked "Freight Prepaid" if terms are CIP or CPT or "Freight Collect" if terms are EXW or FCA.

16. If terms are CIP, you may require a marine cargo insurance certificate covering
 All risks warehouse to warehouse
 All risks warehouse to warehouse including SRCC & War Risks

If terms are EXW, FCA, or CPT and we are arranging the shipment, you may require a copy of a cable or fax message to yourselves giving date and means of shipment and description and value of the goods shipped, certified by the beneficiary (ourselves) to be true and accurate and to have been sent no later than two days after shipment.

We anticipate receipt of your letter of credit conforming to these requirements.

the issuing bank. Normally, the seller should expect that confirmation will be added by a bank in his home country, thus eliminating political and transfer risks. At the very least, the seller who wants a confirmed letter of credit should expect the confirming bank to be in a different country from the issuing bank. If the confirming bank is a branch or subsidiary of the issuing bank or another bank in the buyer's country, the political and transfer risks are not reduced at all, and the confirmation should not be accepted. The seller must carefully evaluate the acceptability of the confirming bank since this is whose risk he is assuming. Even when the confirming bank is a major U.S. or European bank, some confirming banks have a disturbing tendency to charge large fees for what they view as captive business. Furthermore, even though the confirming bank may "second advise" the L/C through the bank the exporter asked to have confirm the credit. Unnecessary delays and charges can result, not only when the L/C is opened but with any amendments as well.

Due to the difficulties of getting the issuing bank to nominate an acceptable confirming bank, the seller should consider alternative ways to obtain protection against political and transfer risks. A "freely negotiable" letter of credit is one that allows the seller to go to the bank of his choice to collect payment. Upon receipt of a freely negotiable credit, the seller may ask his bank for a commitment to negotiate (*i.e.*, purchase) documents without recourse. This arrangement, often referred to as "silent confirmation," provides the seller with the same protections as letter of credit confirmation, but also provides the freedom to choose "confirming" banks. Another means of protection is to take out credit insurance with an insurance company offering such policies. Normally, credit insurance is not taken out for a single L/C but for all of a company's export sales, letter of credit and otherwise.

Whether or not the letter of credit is confirmed, the exporter is entitled to payment only if he complies with the requirements of the L/C. It is, therefore, important that the exporter examine the letter of credit carefully to ensure that it is consistent with the agreed-upon terms of sale and that he can meet its terms and conditions. (*A sample letter of credit appears on the opposite page.*) To make certain this examination catches all potential problems, the L/C should be reviewed by the exporter's credit manager, traffic/logistics department, freight forwarder, and negotiating bank. All parties should conduct their reviews as early as possible, before any customized goods are put into production and certainly before any goods are shipped. If changes are needed, the exporter should contact the buyer immediately to request an amendment to the letter of credit, prior to taking any action on the order. Otherwise, the exporter may incur the cost of acquiring, manufacturing, and shipping the merchandise only to have a request for a needed amendment refused.

An exporter may benefit from presenting documents to his own bank in order to centralize his business as well as to take advantage of special services and discounted pricing it may offer relationship customers. Exporters in most countries centralize presentation of all their letter of credit documents for these reasons. As previously described, this can be accomplished by asking for freely negotiable letters of credit and replacing confirmation with other alternatives. North American exporters, however, probably because letters of credit have traditionally represented a smaller percentage of their business than for their foreign counterparts, have not been as concerned about the service they receive and still customarily present their documents to the advising banks for collection of payment.

A negotiating bank effects normally effects payment under a letter of credit by obtaining funds from the issuing bank's account at its bank of deposit. (Authorization to do so must be contained in the

Prepared MAR08/99 14:21

KEY: SWIN 9603000708914700 SEQ NO: 960308500050

RECEIVED FROM: ABN AMRO BANK N.V., SINGAPORE BRANCH
SINGAPORE

Authentication: CORRECT

1 :basic header : F 01 LASLUS44BXXX 1448 170261
2 :application : 0 700 1519 968300 ABNASCSCAXXX 2456 743J92 960308 0709 N
message type : 700-Issue of Documentary Credit N-Normal Message
4 :message text :
:27 :sequence of total : 1/1
:40A:form of doc credit : IRREVOCABLE
:20 :doc credit number : L960477
:31C:date of issue : 990308
:31D:date/place of expiry : 990430 IN U.S.A.
:50 :applicant : ABC COMPANY
21 ANY STREET
SINGAPORE 659539
:59 :beneficiary : XYZ COMPANY
52 ANY STREET
GREENWOOD, IN 48182
USA
:32B:currency/amount : USD10,000.00
:41D:available with..by... : ANY BANK
BY NEGOTIATION
:42C:drafts at : SIGHT
:42D:drawee : ABN AMRO BANK N.V., SINGAPORE BRANCH
:43P:partial shipments : NOT ALLOWED
:43T:transshipment : ALLOWED
:44A:load/disp/take at/from : USA PORT
:44B:for transportation to : SINGAPORE
:44C:latest date of shipment : 990415
:45A:description of goods : 1 (ONE) UNIT - PORTABLE CHILLER, MODEL : MX-7, SAYR 415/
50 AS PER APPLICANT'S P/O NO. 2075 FOB USA PORT
:46A:documents required : ++ BENEFICIARY'S SIGNED COMMERCIAL INVOICE IN ONE ORIGINAL AND
THREE COPIES
++ FULL SET ORIGINAL CLEAN ON BOARD PORT TO PORT BILLS OF LADING
AND ONE N.N. COPY MADE OUT TO ORDER OF SHIPPER
BLANK ENDORSED MARKED FREIGHT COLLECT AND NOTIFY APPLICANT
INDICATING THIS CREDIT NUMBER.
++CERTIFICATE OF USA ORIGIN IN ONE ORIGINAL AND ONE COPY ISSUED
BY BENEFICIARY/CHAMBER OF COMMERCE
++ PACKING LIST IN ONE ORIGINAL AND ONE COPY
:47A:additional conditions : +ALL DOCUMENTS MUST BE DISPATCHED TO US IN ONE LOT BY
REGISTERED AIRMAIL + INSURANCE WILL BE COVERED BY APPLICANT
+ THIS CREDIT IS SUBJECT TO UCP 500.
:71B:charges : ALL BANK CHARGES AND COMMISSIONS OUTSIDE SINGAPORE INCLUDING
REIMBURSEMENT CHARGES ARE FOR BENEFICIARY'S ACCOUNT
:49 :confirmation instructions : WITHOUT
:53A:reimbursing bank : ABN AMRO BANK N.V.
NEW YORK, NY
:78 :instr to nominated bank : REIMBURSEMENT : PLEASE REIMBURSE YOURSELVES TO THE DEBIT
OF OUR ACCOUNT WITH ABN AMRO BANK NV, NEW YORK, UNDER TESTED
TELEX ADVICE TO US. A DISCREPANCY FEE OF USD40.00 (OR ITS
EQUIVALENT) SHALL BE DEDUCTED FROM THE REIMBURSEMENT CLAIM/
PROCEEDS UPON EACH PRESENTATION OF DISCREPANT DOCUMENTS AND THE
LEVY OF THE DISCREPANCY FEE DOES NOT IN ANY WAY ALTER THE TERMS
AND CONDITIONS OF THIS CREDIT.
-
5 :trailer :
MAC : OC867BADE
CHK : 05257AASDC1E
DLM :

An Export Letter of Credit

L/C.) Thus the exporter is often paid before the issuing bank even sees the documents. Nonetheless, upon receipt of documents, the issuing bank will still examine them and, if they do not conform strictly to the terms of the credit, it may refuse them and demand a refund of the amount paid (plus interest). It follows, therefore, that a negotiating bank will pay an exporter only upon the presentation of documents which it feels certain will not be refused by the issuing bank. Because any discrepancy is grounds for refusal, the negotiating bank will insist the documents strictly comply with the terms of the letter of credit. In fact, over 60% of all documents are found to contain discrepancies.

While the documents required under letters of credit may vary, most credits commonly call for the presentation of a draft, commercial invoices, and bills of lading. The bank making payment is expected to examine these documents and any others specified with care to be certain they appear on their face to comply with the terms and conditions of the credit. It must be understood that in documentary credit operations all parties concerned deal in documents and not in goods. Since credits are almost always subject to the Uniform Customs and Practice for Documentary Credits, its provisions will be applied to documents presented under such credits in determining whether payment will be made.

Three common problems can be avoided if the exporter carefully checks the following:

1. The credit amount is sufficient to cover the shipment (particularly if the terms are CIF or CIP).
2. Documents will be available and can be presented before the expiry date of the credit.
3. The latest shipment date (if there is one) specified in the letter of credit can be met.

Common discrepancies encountered by banks examining documents under letters of credit include the following:

1. Documents are inconsistent with each other.
2. Documents were presented more than 21 days after date of shipment (or other presentation period specified in the L/C).
3. Full set of bills of lading was not presented or other required documents are missing.
4. Draft is drawn incorrectly or for the wrong amount.
5. Draft is not signed or not endorsed.
6. Invoice does not describe merchandise in exact accordance with the letter of credit. *Note:* If the letter of credit describes merchandise in a foreign language, then the exporter must describe the merchandise in that language in the invoice; translations are not acceptable.
7. Invoice does not show the same shipping terms as specified in the L/C.
8. Invoice includes charges inconsistent with the shipping terms in the L/C.
9. Invoice is not made out in the name of the applicant shown in the L/C.
10. Insurance coverage is insufficient or does not include the risks specified by the L/C.
11. Insurance certificate or policy is not endorsed.
12. Insurance certificate is dated later than the shipment date (acceptable if coverage is warehouse-to-warehouse).
13. Bill of lading is not clean (defective condition of goods or packaging is indicated).

14. Bill of lading does not clearly indicate the name and capacity of the signer and who the carrier is (must be signed “ABC Co. as carrier” or “XYZ Co. as agent for ABC Co., the carrier”).
15. Bill of lading is not consigned correctly or is not endorsed (if endorsement is required).
16. Multimodal bill of lading was presented when L/C calls for port-to-port, or simply “ocean,” bill of lading (acceptable if “on board” notation includes the name of the vessel and the port of loading).
17. Multimodal bill of lading was presented when shipping terms are FOB (*i.e.*, port to port) and does not indicate inland freight has been prepaid or otherwise fails to meet requirements for port-to-port shipment.
18. Bill of lading is not marked “freight prepaid” or “freight collect” as required under the credit or in agreement with the invoice and shipping terms.
19. Not all documents show license numbers, letter of credit numbers, or other identification required in the credit.
20. Documents are not signed in accordance with L/C terms (any document called a “certificate” must be signed).

If the exporter’s documents cannot be corrected to comply with the credit terms, he has various alternatives available to still collect payment. It should be noted, however, that he has lost a key element of the letter of credit: the issuing bank’s obligation to pay. Even if the issuing bank waives discrepancies, the confirming bank may choose not to extend its confirmation to cover the waiver, which is, in essence, an amendment to the credit. The most common course of action, despite the fact that it is expensive and time consuming, is that the exporter asks the negotiating bank to cable the issuing bank indicating the discrepancies and requesting authority to pay. The issuing bank will then contact the buyer and, if the buyer agrees to pay in spite of the discrepancies, the issuing bank will then cable the negotiating bank giving the authority to make payment. Alternatively, if the exporter is comfortable with his relationship with the buyer and thinks that there is no real danger the buyer will refuse to pay, the exporter can direct the negotiating bank to forward the documents with the discrepancies to the issuing bank for approval. The exporter may further request that the negotiating bank go ahead and pay against his indemnity. Under such an arrangement the exporter agrees to indemnify the negotiating bank against any loss or damage it may sustain in the unlikely event such payment is not approved by the issuing bank.

Although the use of such “shippers’ indemnities” is infrequent in North America, banks are generally willing to accept such indemnities from their own customers so long as the credit standing of the customer is satisfactory. Despite the high discrepancy rate, the actual incidence of issuing banks’ refusing documents is very low. (This is due to the facts that buyers who can obtain letters of credit to begin with are normally good credit risks, they want the merchandise that was shipped and will therefore agree to pay even though documents do not comply, they wish to remain on good terms with their suppliers, and, unless the underlying contract of sale has been violated, they are legally obligated to pay anyway.) The use of shippers’ indemnities is highly recommended as a way to obtain payment days or weeks sooner as well as avoid cable expenses. Because indemnities will be accepted only by banks with whom the exporter has credit lines, beneficiaries wishing to make use of such arrangements should present documents to their own banks for negotiation rather than following the common, but often unfavorable, practice of submitting documents to the advising banks.

Once the negotiating bank is satisfied that the exporter has complied with the issuing bank's requirements (or has a satisfactory indemnity), it will trigger the payment mechanism outlined in the L/C. In the case of a sight draft, it will seek to collect funds from the issuing bank's account at the designated paying ("reimbursing") bank. If the seller is a relationship customer, the negotiating bank may be willing to advance funds to him prior to receipt of payment from the issuing bank.

In the case of a time draft, the negotiating bank will submit the draft to the drawee bank specified in the L/C for "acceptance" (a special form of endorsement similar to certifying a check). Once a bank officially accepts a time draft, it is legally obligated to pay the draft at maturity regardless of its role under the initial letter of credit. An accepted time draft is known as a "banker's acceptance" and may be held until maturity by the exporter or sold to the negotiating bank or any other bank that participates in the buying and selling of bankers' acceptances. The discount rate for such bank obligations (called the "banker's acceptance" or "B/A" rate) is usually much less than the company's normal borrowing rate (often even lower than the U.S. Fed Funds and international LIBOR rates at which banks lend money to each other), making such discounting an attractive alternative. A banker's acceptance is very similar to an avalized draft, as described in the chapter on draft collections, but a sale on avalized-draft terms does not include the pre-shipment risk protection of a letter of credit.

The exporter should indicate to the negotiating bank whether or not to mail the documents out before payment is received (or the draft is accepted).

Transfers Under Letters of Credit

As already stated, letters of credit are versatile instruments. Use of a transferable letter of credit allows a middleman to put together a deal where he buys goods from one party and sells them to another. The ultimate buyer asks his bank to issue a transferable letter of credit to the middleman and the middleman asks his bank to issue a transfer of the letter of credit to the ultimate seller. The transfer will require all the same documents as the letter of credit itself. Thus, the ultimate seller will be called upon to perform the actual shipment of goods to the place at which they will be picked up by the ultimate buyer; *i.e.*, the transferee will be the actual exporter. Transfers do not work if the middleman will take possession of the goods or be responsible for their shipment in any way.

A letter of credit may be transferred only if it is expressly designated as "transferable." By this designation, the ultimate buyer acknowledges that he is dealing with a middleman and agrees, if necessary, to accept documents produced by someone other than the middleman from whom he has contracted to purchase goods. Although this makes "third-party" invoices acceptable under the L/C (normally they would not be acceptable), the bank that handles the transfer will give the middleman an opportunity to substitute his invoices for those of the transferee. By transferring the same description of merchandise but at a lesser value, the middleman can take a mark-up on the goods. Effectively, he can interject himself as buyer of the goods from the ultimate seller at the lower price and seller of the goods to the ultimate buyer at the higher price—all without ever taking possession of the goods. As the ultimate seller will never see the original L/C, only the transfer, and the ultimate buyer will never see the ultimate seller's invoices, ideally neither party will learn the other's identity.

Transferable credits are often used when a manufacturing company lacks the market knowledge and personnel necessary to sell its products in other countries. The manufacturer, therefore, agrees to work with another company that has the needed marketing capabilities. ("Export management

consultants” and “export trading companies” specialize in such business.) The company that obtains the sales may do so in its own name (this is the *modus operandi* for an export trading company) and will therefore be the first beneficiary of the letters of credit it generates; it will ask its bank to transfer the L/Cs to the manufacturer. The manufacturer ships the goods and presents the documents called for to the transferring bank. After the middleman is given the opportunity to substitute his invoices into the documents, they are then submitted by the transferring bank to the issuing bank for payment. Upon receipt of funds, the transferring bank pays both the middleman and the manufacturer.

As with all letters of credit, the obligation to effect payment lies with the bank that issued the L/C. The transferee should not expect the transferring bank to pay against documents that comply with the transfer unless the transferring bank has confirmed the credit. If documents do not comply with the transfer, matters quickly become quite complicated. It is recommended that companies contemplating using transferable letters of credit develop a thorough understanding of the rights and responsibilities of the various parties before commencing this sometimes tricky method of dealing.

Assignments of Proceeds Under Letters of Credit

By assigning the proceeds of a letter of credit, the beneficiary of the credit can pledge the credit as collateral to another party. An assignment of proceeds may be made against any letter of credit; it does not have to be expressly designated as “transferable” or “assignable.” An assignment of the proceeds of a letter of credit is most often used by the beneficiary of the L/C to purchase, from another company, the goods he is shipping under the credit. Thus, an assignment of proceeds may be used in a situation similar to the normal one in which a transfer would be used but where a transfer won’t work. The most common reason a transfer cannot be used is that the company that obtained the sale (and the L/C) will be taking physical possession of the goods and making the shipping arrangements. To illustrate, a company with expertise in marketing in a certain country (*e.g.*, an export trading company) may obtain a contract to supply goods to an overseas buyer at a CIF price. He may then negotiate with the manufacturer of the goods to purchase them Ex Factory. Because the manufacturer will not be performing the shipment of the goods overseas, he will not be generating the documents needed to draw under the L/C. Hence the letter of credit cannot be transferred to him. Companies that specialize in marketing other companies’ products often are not cash rich and must therefore convince the manufacturers they are dealing with to sell them goods on open account terms, allowing them to take possession of the goods and ship them overseas before paying for them. To reassure the manufacturer that payment will be forthcoming, the middleman may show his contract of sale and his letter of credit, and he may actually pledge the proceeds of the L/C, to the manufacturer (with an assignment of proceeds) as security.

It must be recognized that the rights and responsibilities of the middleman and the manufacturer are very different under an assignment of proceeds than under a transfer of a letter of credit. By an assignment of proceeds, the beneficiary directs the bank involved in the payment or negotiation of documents to pay the assignee a certain portion of the beneficiary’s proceeds only after the documents have been presented and payment received. The middleman beneficiary retains responsibility for presenting all documents; the assignee obtains no rights to present documents and obtain payment himself. The assignment of proceeds has no monetary value until the proceeds actually come into existence. In other words, receipt of an assignment of proceeds does not guarantee payment; it ensures

that proceeds will be distributed in a certain way if the beneficiary presents the documents against the credit as required and the issuing bank pays. The assignee should view the assignment for exactly what it is: a security interest in an asset held by the beneficiary of the L/C.

For the assignee to receive payment from a particular bank, the assignment of proceeds must be made through that bank. To effect an assignment of proceeds the beneficiary must submit a written notice of the assignment (together with the original credit) to a bank authorized to negotiate or pay the credit. This bank will, upon receipt of such notice and agreement to handle the transaction, record the assignment of proceeds on the original letter of credit and advise the assignee by letter. This letter should indicate that the bank handling the assignment of proceeds is holding the letter of credit on behalf of the assignee as this is the procedure required to “legally perfect” his security interest in the credit.

CHAPTER SEVEN: STANDBY LETTERS OF CREDIT

How Standby Letters of Credit Work

Standby letters of credit are remarkably versatile instruments for a bank to represent to a third party that they are willing to make payments on their customer's behalf, if and when called for. Most often, these payments are to be made when the customer has failed or refused to do so themselves. The value of the bank's commitment lies in the fact the bank is obligated to pay, even in the event of a dispute, as long as the documents specified in the L/C are presented as required.

Federal regulations prohibit most banks in the U.S. from issuing guarantees. To fill this void, American banks developed the standby letter of credit as a means of financial support for a variety of trade and investment needs. Originally, these same regulations even required that all letters of credit be “conspicuously titled” as letters of credit. Banks in other countries have long issued letters of credit that they have designated to be “demand guarantees” or “independent guarantees.” These are not to be confused with “ancillary” or “contract” guarantees, which are not letters of credit. As U.S. banks are now, as of 1996, free to use any desired designation, the important thing to keep in mind is not what the arrangement is called, but how it works. Any letter of credit should state that it is subject to the [Uniform Customs and Practice for Documentary Credits](#) to ensure that it will work as expected.

Regardless of what it's called, a letter of credit represents the issuing bank's undertaking to pay the named beneficiary a sum of money upon presentation of specified documents conforming to the terms and conditions of the credit. As with a commercial L/C, the intent of a standby letter of credit is to substitute the creditworthiness of the bank for that of its customer, the applicant. The commercial letter of credit facilitates a commercial transaction through the use of shipping documents and negotiable drafts. A standby letter of credit, however, often takes the form of an obligation by the issuer to the beneficiary (1) to repay money borrowed by or advanced to or for the applicant, (2) to make payment of an indebtedness of the applicant, or (3) to make payment because of a claimed default by the applicant in the performance of an obligation. As such, it may require documents are simple as a statement signed by the beneficiary attesting to the existence of one of these types of situations.

Note that although the beneficiary of a standby credit may be required by the L/C to present a written statement claiming that some sort of default has occurred, in no case does the issuing bank agree to guarantee the completion of

any project or contract nor is it bound to make determinations of fact regarding the underlying transaction (as is generally the case with a “contract” or “ancillary” guarantee). The bank’s responsibilities and liabilities are financial only. If the beneficiary presents documents that comply with the letter of credit requirements, the bank must pay regardless of any assertions of fraud or non-validity made by the applicant. Furthermore, the applicant is legally bound to reimburse the bank. For this reason, the applicant for a standby letter of credit must trust the beneficiary not to draw improperly under the L/C.

The applicant for a standby letter of credit should consider the risks involved in having a bank issue a standby letter of credit for its account and can take two important steps to minimize these risks. The applicant should, just as in the commercial letter of credit transaction, know the beneficiary and be comfortable with the beneficiary’s character and business reputation. Many sources can assist the applicant: trade associations, credit reporting firms, chambers of commerce, *etc.* Second, the applicant and the beneficiary should negotiate and document the terms of the underlying transaction. This may take the form of a written contract or be as simple as a purchase order or pro forma invoice. Once the issuing bank has made payment, the applicant’s recourse to recover the payment through legal channels is only as strong as his ability to prove that the beneficiary has violated the contract.

If the beneficiary of a standby letter of credit is in a foreign country and the letter of credit is to remedy non-performance, the applicant should be sure that his contract with the beneficiary relieves the applicant from responsibility for non-performance due to *force majeure*. Strikes, military coups, hurricanes, and other events beyond the control of the applicant which prevent the applicant from fulfilling the contract should not constitute non-performance of the applicant’s obligations.

Bid Bonds

Government buyers and buyers involved in sizable projects frequently request suppliers and contractors who are bidding on a sale or project to post “bid bonds” in the form of standby letters of credit, usually for a percentage of the contract amount. These are used for the bidding process only and assure the buyer that the original bid will be honored by the bidder selected. The winning bidder is commonly required to post a “performance bond” (*see below*) to prove his ability to honor his bid. If the performance bond is not posted in a timely manner, the amount of the bid bond will be forfeited as a penalty.

Performance Bonds

When a buyer awards a large contract for goods and/or supplies, especially commodities like oil and grain, to a particular seller, he wants assurance that the agreed price will be honored and that the seller will not otherwise default on the contract. Similarly, throughout the life of a project, the contracting party is interested in ensuring that the project will in fact be completed in accordance with the terms and conditions of the contract. In cases like these, a standby letter of credit may be required to provide financial compensation in the event of default. These are generally designed to decrease in amount over the life of the contract until completion.

Performance bonds are also used to back up international warranties that machinery or other goods will work properly for a certain period of time. If the machinery breaks down and the manufacturer fails to provide timely repairs, the buyer may arrange repairs himself and draw on the L/C for costs incurred and/or a penalty.

Advance Payment Bonds

When the manufacturer who has been awarded a sale begins work, partial payment may be required in advance for materials, start-up costs, or general working capital. The buyer often requests a bond or standby letter of credit for assurance that such advances will be used for the project. In the event of contract default, the advance can be recovered from the bank that issued the standby letter of credit. These standby L/Cs can be issued to decrease in amount progressively as shipments take place.

Credit Line Support

When a buyer and seller agree to an “open account” or “cash-in-advance” relationship, a standby letter of credit can be used as financial security. In these situations, payments are made directly between the buyer and seller, but, in the event of default (*e.g.*, non-payment in an open account transaction or defective goods in a cash-in-advance transaction), the affected party has recourse to a commercial bank.

Evergreen Letters of Credit

Sometimes a standby letter of credit will be issued with an initial expiration date but containing a clause that states that it will be automatically extended for additional periods unless the issuing bank provides notice to the beneficiary stating otherwise. Such a clause is called an “evergreen clause.” Such a credit, in effect, has no expiration date and will remain open until the beneficiary returns it for cancellation since the beneficiary will simply draw the full amount of the credit if he receives notice from the bank that it is not going to extend it. Of course, the applicant’s obligation to reimburse the issuing bank remains in effect as long as the credit is open.

Clean Letters of Credit

In some instances, the beneficiary will request a letter of credit in which the only document required is a draft drawn on the issuing bank. This is sometimes called a “clean letter of credit.” The issuing bank is required to pay, and the applicant in turn is required to reimburse, once the draft is presented. Such a letter of credit is very open and the beneficiary’s ability to draw is limited only by the amount and expiration date of the letter of credit; it may be thought of as giving the beneficiary a cashier’s check and asking him not to cash it unless necessary.

UCC 5 Revised

Uniform Commercial Code (United States of America)
Revised Article 5. Letters of Credit

SECTION 5-101. SHORT TITLE. This article may be cited as Uniform Commercial Code—Letters of Credit.

SECTION 5-102. DEFINITIONS.

(a) In this article:

(1) "Adviser" means a person who, at the request of the issuer, a confirmer, or another adviser, notifies or requests another adviser to notify the beneficiary that a letter of credit has been issued, confirmed, or amended.

(2) "Applicant" means a person at whose request or for whose account a letter of credit is issued. The term includes a person who requests an issuer to issue a letter of credit on behalf of another if the person making the request undertakes an obligation to reimburse the issuer.

(3) "Beneficiary" means a person who under the terms of a letter of credit is entitled to have its complying presentation honored. The term includes a person to whom drawing rights have been transferred under a transferable letter of credit.

(4) "Confirmer" means a nominated person who undertakes, at the request or with the consent of the issuer, to honor a presentation under a letter of credit issued by another.

(5) "Dishonor" of a letter of credit means failure timely to honor or to take an interim action, such as acceptance of a draft, that may be required by the letter of credit.

(6) "Document" means a draft or other demand, document of title, investment security, certificate, invoice, or other record, statement, or representation of fact, law, right, or opinion (i) which is presented in a written or other medium permitted by the letter of credit or, unless prohibited by the letter of credit, by the standard practice referred to in Section 5-108(e) and (ii) which is capable of being examined for compliance with the terms and conditions of the letter of credit. A document may not be oral.

(7) "Good faith" means honesty in fact in the conduct or transaction concerned.

(8) "Honor" of a letter of credit means performance of the issuer's undertaking in the letter of credit to pay or deliver an item of value. Unless the letter of credit otherwise provides, "honor" occurs

(i) upon payment,

(ii) if the letter of credit provides for acceptance, upon acceptance of a draft and, at maturity, its payment, or

(iii) if the letter of credit provides for incurring a deferred obligation, upon incurring the obligation and, at maturity, its performance.

(9) "Issuer" means a bank or other person that issues a letter of credit, but does not include an individual who makes an engagement for personal, family, or household purposes.

(10) "Letter of credit" means a definite undertaking that satisfies the requirements of Section 5-104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.

(11) "Nominated person" means a person whom the issuer (i) designates or authorizes to pay, accept, negotiate, or otherwise give value under a letter of credit and (ii) undertakes by agreement or custom and practice to reimburse.

(12) "Presentation" means delivery of a document to an issuer or nominated person for honor or giving of value under a letter of credit.

(13) "Presenter" means a person making a presentation as or on behalf of a beneficiary or nominated person.

(14) "Record" means information that is inscribed on a tangible medium, or that is stored in an electronic or other medium and is retrievable in perceivable form.

(15) "Successor of a beneficiary" means a person who succeeds to substantially all of the rights of a beneficiary by operation of law, including a corporation with or into which the beneficiary has been merged or consolidated, an administrator, executor, personal representative, trustee in bankruptcy, debtor in possession, liquidator, and receiver.

(b) Definitions in other Articles applying to this article and the sections in which they appear are:

"Accept" or "Acceptance" Section 3-409

"Value" Sections 3-303, 4-211

(c) Article 1 contains certain additional general definitions and principles of construction and interpretation applicable throughout this article.

SECTION 5-103. SCOPE.

(a) This article applies to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit.

(b) The statement of a rule in this article does not by itself require, imply, or negate application of the same or a different rule to a situation not provided for, or to a person not specified, in this article.

(c) With the exception of this subsection, subsections (a) and (d), Sections 5-102(a)(9) and (10), 5-106(d), and 5-114(d), and except to the extent prohibited in Sections 1-102(3) and 5-117(d), the effect of this article may be varied by agreement or by a provision stated or incorporated by reference in an undertaking. A term in an agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by this article.

(d) Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.

SECTION 5-104. FORMAL REQUIREMENTS. A letter of credit, confirmation, advice, transfer, amendment, or cancellation may be issued in any form that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties or the standard practice referred to in Section 5-108(e).

SECTION 5-105. CONSIDERATION. Consideration is not required to issue, amend, transfer, or cancel a letter of credit, advice, or confirmation.

SECTION 5-106. ISSUANCE, AMENDMENT, CANCELLATION, AND DURATION.

(a) A letter of credit is issued and becomes enforceable according to its terms against the issuer when the issuer sends or otherwise transmits it to the person requested to advise or to the beneficiary. A letter of credit is revocable only if it so provides.

(b) After a letter of credit is issued, rights and obligations of a beneficiary, applicant, confirmer, and issuer are not affected by an amendment or cancellation to which that person has not consented except to the extent the letter of credit provides that it is revocable or that the issuer may amend or cancel the letter of credit without that consent.

(c) If there is no stated expiration date or other provision that determines its duration, a letter of credit expires one year after its stated date of issuance or, if none is stated, after the date on which it is issued.

(d) A letter of credit that states that it is perpetual expires five years after its stated date of issuance, or if none is stated, after the date on which it is issued.

SECTION 5-107. CONFIRMER, NOMINATED PERSON, AND ADVISER.

(a) A confirmer is directly obligated on a letter of credit and has the rights and obligations of an issuer to the extent of its confirmation. The confirmer also has rights against and obligations to the issuer as if the issuer were an applicant and the confirmer had issued the letter of credit at the request and for the account of the issuer.

(b) A nominated person who is not a confirmer is not obligated to honor or otherwise give value for a presentation.

(c) A person requested to advise may decline to act as an adviser. An adviser that is not a confirmer is not obligated to honor or give value for a presentation. An adviser undertakes to the issuer and to the beneficiary accurately to advise the terms of the letter of credit, confirmation, amendment, or advice received by that person and undertakes to the beneficiary to check the apparent authenticity of the request to advise. Even if the advice is inaccurate, the letter of credit, confirmation, or amendment is enforceable as issued.

(d) A person who notifies a transferee beneficiary of the terms of a letter of credit, confirmation, amendment, or advice has the rights and obligations of an adviser under subsection (c). The terms in the notice to the transferee beneficiary may differ from the terms in any notice to the transferor beneficiary to the extent permitted by the letter of credit, confirmation, amendment, or advice received by the person who so notifies.

SECTION 5-108. ISSUER'S RIGHTS AND OBLIGATIONS.

(a) Except as otherwise provided in Section 5-109, an issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face strictly to comply with the terms and conditions of the

letter of credit. Except as otherwise provided in Section 5-113 and unless otherwise agreed with the applicant, an issuer shall dishonor a presentation that does not appear so to comply.

(b) An issuer has a reasonable time after presentation, but not beyond the end of the seventh business day of the issuer after the day of its receipt of documents:

(1) to honor,

(2) if the letter of credit provides for honor to be completed more than seven business days after presentation, to accept a draft or incur a deferred obligation, or

(3) to give notice to the presenter of discrepancies in the presentation.

(c) Except as otherwise provided in subsection (d), an issuer is precluded from asserting as a basis for dishonor any discrepancy if timely notice is not given, or any discrepancy not stated in the notice if timely notice is given.

(d) Failure to give the notice specified in subsection (b) or to mention fraud, forgery, or expiration in the notice does not preclude the issuer from asserting as a basis for dishonor fraud or forgery as described in Section 5-109(a) or expiration of the letter of credit before presentation.

(e) An issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination of the issuer's observance of the standard practice is a matter of interpretation for the court. The court shall offer the parties a reasonable opportunity to present evidence of the standard practice.

(f) An issuer is not responsible for:

(1) the performance or nonperformance of the underlying contract, arrangement, or transaction,

(2) an act or omission of others, or

(3) observance or knowledge of the usage of a particular trade other than the standard practice referred to in subsection (e).

(g) If an undertaking constituting a letter of credit under Section 5-102(a)(10) contains nondocumentary conditions, an issuer shall disregard the nondocumentary conditions and treat them as if they were not stated.

(h) An issuer that has dishonored a presentation shall return the documents or hold them at the disposal of, and send advice to that effect to, the presenter.

(i) An issuer that has honored a presentation as permitted or required by this article:

(1) is entitled to be reimbursed by the applicant in immediately available funds not later than the date of its payment of funds;

(2) takes the documents free of claims of the beneficiary or presenter;

(3) is precluded from asserting a right of recourse on a draft under Sections 3-414 and 3-415;

(4) except as otherwise provided in Sections 5-110 and 5-117, is precluded from restitution of money paid or other value given by mistake to the extent the mistake concerns discrepancies in the documents or tender which are apparent on the face of the presentation; and

(5) is discharged to the extent of its performance under the letter of credit unless the issuer honored a presentation in which a required signature of a beneficiary was forged.

SECTION 5-109. FRAUD AND FORGERY.

(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and

(2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:

(1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;

(2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;

(3) all of the conditions to entitle a person to the relief under the law of this State have been met; and

(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).

SECTION 5-110. WARRANTIES.

(a) If its presentation is honored, the beneficiary warrants:

(1) to the issuer, any other person to whom presentation is made, and the applicant that there is no fraud or forgery of the kind described in Section 5-109(a); and

(2) to the applicant that the drawing does not violate any agreement between the applicant and beneficiary or any other agreement intended by them to be augmented by the letter of credit.

(b) The warranties in subsection (a) are in addition to warranties arising under Article 3, 4, 7, and 8 because of the presentation or transfer of documents covered by any of those articles.

SECTION 5-111. REMEDIES.

(a) If an issuer wrongfully dishonors or repudiates its obligation to pay money under a letter of credit before presentation, the beneficiary, successor, or nominated person presenting on its own behalf may recover from the issuer the amount that is the subject of the dishonor or repudiation. If the issuer's obligation under the letter of credit is not for the payment of money, the claimant may obtain specific performance or, at the claimant's election, recover an amount equal to the value of performance from the issuer. In either case, the claimant may also recover incidental but not consequential damages. The claimant is not obligated to take action to avoid damages that might be due from the issuer under this subsection. If, although not obligated to do so, the claimant avoids damages, the claimant's recovery from the issuer must be reduced by the amount of damages avoided. The issuer has the burden of proving the amount of damages avoided. In the case of repudiation the claimant need not present any document.

(b) If an issuer wrongfully dishonors a draft or demand presented under a letter of credit or honors a draft or demand in breach of its obligation to the applicant, the applicant may recover damages resulting from the breach, including incidental but not consequential damages, less any amount saved as a result of the breach.

(c) If an adviser or nominated person other than a confirmer breaches an obligation under this article or an issuer breaches an obligation not covered in subsection (a) or (b), a person to whom the obligation is owed may recover damages resulting from the breach, including incidental but not consequential damages, less any amount saved as a result of the breach. To the extent of the confirmation, a confirmer has the liability of an issuer specified in this subsection and subsections (a) and (b).

(d) An issuer, nominated person, or adviser who is found liable under subsection (a), (b), or (c) shall pay interest on the amount owed thereunder from the date of wrongful dishonor or other appropriate date.

(e) Reasonable attorney's fees and other expenses of litigation must be awarded to the prevailing party in an action in which a remedy is sought under this article.

(f) Damages that would otherwise be payable by a party for breach of an obligation under this article may be liquidated by agreement or undertaking, but only in an amount or by a formula that is reasonable in light of the harm anticipated.

SECTION 5-112. TRANSFER OF LETTER OF CREDIT.

(a) Except as otherwise provided in Section 5-113, unless a letter of credit provides that it is transferable, the right of a beneficiary to draw or otherwise demand performance under a letter of credit may not be transferred.

(b) Even if a letter of credit provides that it is transferable, the issuer may refuse to recognize or carry out a transfer if:

(1) the transfer would violate applicable law; or

(2) the transferor or transferee has failed to comply with any requirement stated in the letter of credit or any other requirement relating to transfer imposed by the issuer which is within the standard practice referred to in Section 5-108(e) or is otherwise reasonable under the circumstances.

SECTION 5-113. TRANSFER BY OPERATION OF LAW.

(a) A successor of a beneficiary may consent to amendments, sign and present documents, and receive payment or other items of value in the name of the beneficiary without disclosing its status as a successor.

(b) A successor of a beneficiary may consent to amendments, sign and present documents, and receive payment or other items of value in its own name as the disclosed successor of the beneficiary. Except as otherwise provided in subsection (e), an issuer shall recognize a disclosed successor of a beneficiary as

beneficiary in full substitution for its predecessor upon compliance with the requirements for recognition by the issuer of a transfer of drawing rights by operation of law under the standard practice referred to in Section 5-108(e) or, in the absence of such a practice, compliance with other reasonable procedures sufficient to protect the issuer.

(c) An issuer is not obliged to determine whether a purported successor is a successor of a beneficiary or whether the signature of a purported successor is genuine or authorized.

(d) Honor of a purported successor's apparently complying presentation under subsection (a) or (b) has the consequences specified in Section 5-108(i) even if the purported successor is not the successor of a beneficiary. Documents signed in the name of the beneficiary or of a disclosed successor by a person who is neither the beneficiary nor the successor of the beneficiary are forged documents for the purposes of Section 5-109.

(e) An issuer whose rights of reimbursement are not covered by subsection (d) or substantially similar law and any confirmer or nominated person may decline to recognize a presentation under subsection (b).

(f) A beneficiary whose name is changed after the issuance of a letter of credit has the same rights and obligations as a successor of a beneficiary under this section.

SECTION 5-114. ASSIGNMENT OF PROCEEDS.

(a) In this section, "proceeds of a letter of credit" means the cash, check, accepted draft, or other item of value paid or delivered upon honor or giving of value by the issuer or any nominated person under the letter of credit. The term does not include a beneficiary's drawing rights or documents presented by the beneficiary.

(b) A beneficiary may assign its right to part or all of the proceeds of a letter of credit. The beneficiary may do so before presentation as a present assignment of its right to receive proceeds contingent upon its compliance with the terms and conditions of the letter of credit.

(c) An issuer or nominated person need not recognize an assignment of proceeds of a letter of credit until it consents to the assignment.

(d) An issuer or nominated person has no obligation to give or withhold its consent to an assignment of proceeds of a letter of credit, but consent may not be unreasonably withheld if the assignee possesses and exhibits the letter of credit and presentation of the letter of credit is a condition to honor.

(e) Rights of a transferee beneficiary or nominated person are independent of the beneficiary's assignment of the proceeds of a letter of credit and are superior to the assignee's right to the proceeds.

(f) Neither the rights recognized by this section between an assignee and an issuer, transferee beneficiary, or nominated person nor the issuer's or nominated person's payment of proceeds to an assignee or a third person affect the rights between the assignee and any person other than the issuer, transferee beneficiary, or nominated person. The mode of creating and perfecting a security interest in or granting an assignment of a beneficiary's rights to proceeds is governed by Article 9 or other law. Against persons other than the issuer, transferee beneficiary, or nominated person, the rights and obligations arising upon the creation of a security interest or other assignment of a beneficiary's right to proceeds and its perfection are governed by Article 9 or other law.

SECTION 5-115. STATUTE OF LIMITATIONS. An action to enforce a right or obligation arising under this article must be commenced within one year after the expiration date of the relevant letter of credit or one year after the [claim for relief] [cause of action] accrues, whichever occurs later. A [claim for relief] [cause of action] accrues when the breach occurs, regardless of the aggrieved party's lack of knowledge of the breach.

SECTION 5-116. CHOICE OF LAW AND FORUM.

(a) The liability of an issuer, nominated person, or adviser for action or omission is governed by the law of the jurisdiction chosen by an agreement in the form of a record signed or otherwise authenticated by the affected parties in the manner provided in Section 5-104 or by a provision in the person's letter of credit, confirmation, or other undertaking. The jurisdiction whose law is chosen need not bear any relation to the transaction.

(b) Unless subsection (a) applies, the liability of an issuer, nominated person, or adviser for action or omission is governed by the law of the jurisdiction in which the person is located. The person is considered to be located at the address indicated in the person's undertaking. If more than one address is indicated, the person is considered to be located at the address from which the person's undertaking was issued. For the purpose of jurisdiction, choice of law, and recognition of interbranch letters of credit, but not enforcement of a judgment, all branches of a bank are considered separate juridical entities and a bank is considered to be located at the place where its relevant branch is considered to be located under this subsection.

(c) Except as otherwise provided in this subsection, the liability of an issuer, nominated person, or adviser is governed by any rules of custom or practice, such as the Uniform Customs and Practice for Documentary Credits, to which the letter of credit, confirmation, or other undertaking is expressly made subject. If (i) this article would govern the liability of an issuer, nominated person, or adviser under subsection (a) or (b), (ii) the relevant undertaking incorporates rules of custom or practice, and (iii) there is conflict between this article and those rules as applied to that undertaking, those rules govern except to the extent of any conflict with the nonvariable provisions specified in Section 5-103(c).

(d) If there is conflict between this article and Article 3, 4, 4A, or 9, this article governs.

(e) The forum for settling disputes arising out of an undertaking within this article may be chosen in the manner and with the binding effect that governing law may be chosen in accordance with subsection (a).

SECTION 5-117. SUBROGATION OF ISSUER, APPLICANT, AND NOMINATED PERSON.

(a) An issuer that honors a beneficiary's presentation is subrogated to the rights of the beneficiary to the same extent as if the issuer were a secondary obligor of the underlying obligation owed to the beneficiary and of the applicant to the same extent as if the issuer were the secondary obligor of the underlying obligation owed to the applicant.

(b) An applicant that reimburses an issuer is subrogated to the rights of the issuer against any beneficiary, presenter, or nominated person to the same extent as if the applicant were the secondary obligor of the obligations owed to the issuer and has the rights of subrogation of the issuer to the rights of the beneficiary stated in subsection (a).

(c) A nominated person who pays or gives value against a draft or demand presented under a letter of credit is subrogated to the rights of:

(1) the issuer against the applicant to the same extent as if the nominated person were a secondary obligor of the obligation owed to the issuer by the applicant;

(2) the beneficiary to the same extent as if the nominated person were a secondary obligor of the underlying obligation owed to the beneficiary; and

(3) the applicant to same extent as if the nominated person were a secondary obligor of the underlying obligation owed to the applicant.

(d) Notwithstanding any agreement or term to the contrary, the rights of subrogation stated in subsections (a) and (b) do not arise until the issuer honors the letter of credit or otherwise pays and the rights in subsection (c) do not arise until the nominated person pays or otherwise gives value. Until then, the issuer, nominated person, and the applicant do not derive under this section present or prospective rights forming the basis of a claim, defense, or excuse.

GLOSSARY

abusive draw drawing on a standby letter of credit/demand guarantee when no violation of the underlying contract has occurred.

acceptance time draft “accepted” by the party upon whom it is drawn by so endorsing the front of the draft. Acceptance constitutes an unconditional obligation on the part of the accepting party to pay the draft at maturity. A draft accepted by a bank is called a “banker’s acceptance” whereas one accepted by a company is called a “trade acceptance.”

account party party for whom a letter of credit is opened. “Account party” and “applicant” are generally synonymous, but sometimes one party will agree with the issuing bank to make all payments under a letter of credit showing the name of another party (often two affiliated companies). Banks may refer to one of these parties as the applicant and the other as the account party, but there is no consistency among banks regarding which is which.

advance payment funds given by the buyer of goods to the seller prior to shipment, often just a percentage of the value of the goods with the remainder paid after shipment.

advance payment bond bond, guarantee, or standby letter of credit given by a seller receiving an advance payment to the buyer to assure that the funds will be returned if goods are never shipped.

advising bank bank that receives a letter of credit from the issuing bank for authentication and delivery to the beneficiary. The advising bank is usually a correspondent of the issuing bank located in the vicinity of the beneficiary.

air waybill document signed by an airline to show receipt of goods for air transportation from and to the airports indicated.

ancillary guarantee type of guarantee where the guarantor joins with one of the parties to the contract and agrees to fulfill that party’s obligations if necessary, effectively co-signing the contract. As opposed to an independent or demand guarantee, under an ancillary guarantee the guarantor also acquires rights under the contract and may resort to terms in the contract to dispute claims against the guarantee. Also called a “contract guarantee.” Although banks in the U.S. are generally prohibited by law from issuing ancillary guarantees, banks in other countries are not. U.S. banks instead issue demand guarantees or standby letters of credit.

applicant party requesting that a letter of credit be opened.

approval, documents sent on treatment of letter of credit documents wherein the negotiating bank does not certify that the documents meet the requirements of the L/C, but rather forwards the documents to the issuing bank with a request that it examine the documents, obtain waiver of any discrepancies, and pay.

assignment of proceeds legal mechanism by which the beneficiary of a letter of credit may pledge the proceeds of future drawings to a third party. Assigning proceeds involves giving the letter of credit to a bank, which will hold the L/C until drawn upon, along with irrevocable instructions to the bank to disburse proceeds, when generated, in a specified way, *e.g.*, “pay 75% of each drawing to XYZ Company.” The bank will acknowledge the assignment to the assignee but has no obligation actually to pay any funds to the assignee unless the L/C is drawn upon by the beneficiary and

payment is received from the issuing or confirming bank. An assignment of proceeds is not an assignment or transfer of the letter of credit and the assignee acquires no rights to perform under the L/C in order to generate funds.

authority to pay *see* “[cable for authority to pay.](#)”

aval guarantee added by a bank to an accepted time draft by endorsing the front of the draft “per aval.” The avalizing bank becomes obligated to pay the draft at maturity if the drawee/acceptor fails to do so.

avalized draft trade acceptance to which an aval has been added.

B/A abbreviation for “[banker’s acceptance.](#)”

B/L abbreviation for “[bill of lading.](#)”

banker’s acceptance time draft that has been drawn on and accepted by a bank. In a large and active market, investors buy and sell bankers’ acceptances at rates similar to, and often below, LIBOR. Rates are low due to the low risk of default on the part of a bank and the fact that there is generally an underlying trade transaction, the proceeds of which are pledged to cover the acceptance when it matures.

beneficiary party in whose favor a letter of credit is issued, who is entitled to present documents required by the L/C and receive payment.

bid bond bond, guarantee, or standby letter of credit that accompanies a bid, issued for an amount that will be forfeited if the bidder wins the bid but then reneges.

bill of exchange a [draft.](#)

bill of lading document signed by a transportation company (“carrier”) to show receipt of goods for transportation from and to the points indicated. Although U.S. law recognizes such a thing as a non-negotiable bill of lading, international law distinguishes bills of lading from waybills in that a bill of lading is a title document issued to order of a “consignee,” who can then transfer title (legal ownership of the goods) by endorsement and delivery (“negotiation”) of the bill of lading. Someone must present the bill of lading at the point of delivery in order to claim the goods. A waybill is not negotiable in this way and the transportation company will simply deliver the goods to the consignee. A transport document issued “consigned to order of...” is a negotiable bill of lading; one issued simply “consigned to...” is a non-negotiable waybill. *See also* “[multimodal bill of lading,](#)” “[ocean bill of lading,](#)” “[port-to-port bill of lading.](#)”

bond *see specific types:* “[advance payment bond,](#)” “[bid bond,](#)” “[performance bond.](#)”

C&F abbreviation for “[cost and freight \(...named port of destination\).](#)” Also CFR.

C.A.D. abbreviation for “[cash against documents.](#)”

CFR abbreviation for “[cost and freight \(...named port of destination\).](#)” Also C&F.

CIF abbreviation for “[cost, insurance, and freight \(...named port of destination\).](#)”

CIP abbreviation for “[carriage and insurance paid to \(...named place of destination\).](#)”

CPT abbreviation for “[carriage paid to \(...named place of destination\).](#)”

cable for authority to pay request for permission to pay a letter of credit drawing despite

discrepancies, sent electronically by the negotiating bank to the issuing bank.

carriage and insurance paid to (...named place of destination) shipping term included in a contract of sale (abbreviated as CIP) meaning that the seller agrees to arrange and pay for transportation and cargo insurance over the goods to the named destination, such costs being included in the price of the goods. Nonetheless, all risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered to the carrier, is transferred from the seller to the buyer when the goods have been delivered into the custody of the carrier.

carriage paid to (...named place of destination) shipping term included in a contract of sale (abbreviated as CPT) meaning that the seller agrees to arrange and pay for transportation of the goods to the named destination, such costs being included in the price of the goods. Nonetheless, all risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered to the carrier, is transferred from the seller to the buyer when the goods have been delivered into the custody of the carrier. It is up to the buyer to arrange cargo insurance.

carrier any person who, in a contract of transportation, undertakes to perform, or to procure at his own responsibility the performance of, transportation by rail, road, sea, air, inland waterway or by a combination of such modes. See "[multimodal bill of lading](#)" for further discussion.

case-of-need agent of the exporter located in the country of the importer who is to be notified by the presenting bank under a draft collection of any difficulties in collecting payment. The case-of-need may be given the power to change the collection instructions or even the draft amount, or may just be expected to make arrangements to store the goods and locate an alternate buyer. Whatever authority the case-of-need has should be specified in the collection instructions letter.

cash against documents term (abbreviated as C.A.D.) for documentary collection instructions requesting the presenting bank to deliver documents only upon receipt of payment from the drawee/importer. Synonymous with "documents against payment."

clean bill of lading bill of lading that bears no clause or notation which expressly declares a defective condition of the goods and/or the packaging.

clean draft draft which is not accompanied by documents.

clean letter of credit letter of credit that calls for presentation of nothing more than a draft to trigger payment. The term is sometimes used (incorrectly) to mean "[standby letter of credit](#)."

collecting bank any bank other than the remitting bank involved in the collection of a draft and/or documents.

combined transport see "[multimodal bill of lading](#)."

commercial letter of credit letter of credit intended to act as the vehicle of payment for goods sold by one party to another.

commercial risk risk that the buyer of goods cannot or will not pay the seller when payment is due.

confirmed letter of credit letter of credit to which the advising bank has added its own, independent undertaking to honor presentation of the required documents, *i.e.*, pay the beneficiary at

sight or at maturity, as specified by the L/C. *See also* “[silent confirmation](#).”

confirming bank bank that has added its confirmation to a letter of credit. This term is also sometimes used loosely to refer to a bank that has issued a commitment to purchase letter of credit documents without recourse, a practice called “silent confirmation.”

consignee party into whose possession goods are to be delivered. *See also* “[bill of lading](#).”

consignment term of sale wherein a seller delivers goods to the buyer but retains legal ownership of the goods until they are re-sold by the buyer. The buyer is responsible for remitting payment to the seller at time of re-sale to the end-buyer.

contract guarantee *see* “[ancillary guarantee](#).”

contract risk risk that the buyer of goods will renege on the contract (as opposed to simply being unable to pay).

cost and freight (...named port of destination) shipping term included in a contract of sale (abbreviated as CFR or C&F) meaning that the seller agrees to take full responsibility for delivering the goods to the port of loading, clear the goods for export, and arrange and pay for transportation of the goods to the named port of discharge, such costs being included in the price of the goods. Nonetheless, all risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered on board the vessel, is transferred from the seller to the buyer when the goods pass the ship’s rail at the port of loading. It is up to the buyer to arrange marine insurance for the ocean voyage and transportation from the port of discharge.

cost, insurance and freight (...named port of destination) shipping term included in a contract of sale (abbreviated as CIF) meaning that the seller agrees to take full responsibility for delivering the goods to the port of loading, clear the goods for export, and arrange and pay for transportation and marine insurance over the goods to the named port of discharge, such costs being included in the price of the goods. Nonetheless, all risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered on board the vessel, is transferred from the seller to the buyer when the goods pass the ship’s rail at the port of loading. It is up to the buyer to arrange transportation from the port of discharge.

country risk risk incurred by a seller of goods that a buyer in a different country will not be able to pay for the goods due to political or economic conditions in his country. The two components of country risk are “[political risk](#)” and “[transfer risk](#).”

credit insurance insurance against losses due to inability or failure of the insured’s customers to pay for goods sold by the insured. The insurance normally covers a specified percentage of each loss beyond a deductible indicated in the policy. Insurance is available covering a variety of risks, *e.g.*, political and transfer risks (“country risks”) and financial risks (called “commercial risks”). Even “comprehensive” insurance, however, will not cover non-payment for contract disputes.

credit risk risk incurred by a seller of goods that the buyer cannot or will not pay for them. *See also* “[commercial risk](#),” “[contract risk](#),” “[financing risk](#),” “[political risk](#),” “[transfer risk](#).”

cumulative revolving letter of credit revolving letter of credit that permits the seller to carry over any amounts not drawn into successive periods.

D/A abbreviation for “[documents against acceptance.](#)”

D/P abbreviation for “[documents against payment.](#)”

days of grace the number of days the acceptor of a draft may go past due before being judged in default and triggering any guarantor to pay on the acceptor’s behalf. When an avalized draft is sold to a forfaiter, the forfaiter will impute the days of grace into the financing period.

deferred payment payment a set period of time after shipment or presentation of shipping documents, as opposed to immediately or “at sight.” A distinction is drawn between a letter of credit that is available for deferred payment and one that is available for acceptance of time drafts in that no drafts are involved under a deferred payment L/C. Without accepted drafts, the beneficiary’s ability to sell, or “discount,” his right to payment to a lender or investor is restricted.

deferred reimbursement arrangement under a letter of credit where the issuing bank agrees up front with its customer, the applicant, to pay the beneficiary upon presentation of the documents required in the L/C but to defer charging the applicant until a later date, thereby financing the purchase of goods under the L/C, usually for the expected amount of time the applicant needs in order to re-sell the goods.

demand guarantee type of guarantee that is payable immediately upon presentation of documents specified, without inquiry as to the validity of the documents or into compliance with the underlying contract, as opposed to an “ancillary guarantee.” Also called an “independent guarantee.” Although there are separate rules of practice for demand guarantees and letters of credit, they are both considered letters of credit under U.S. law.

direct collection service for handling export draft collections in which the exporter’s bank provides him with forms that bear the bank’s own letterhead for mailing documents to the buyer’s bank for collection. To the buyer’s bank, it will appear that the documents were sent from the exporter’s bank, but time and expense are saved by bypassing unnecessary processing at the exporter’s bank.

discrepancies in the context of letters of credit, term used to describe deviations between documents presented and requirements set in the letter of credit or inconsistencies among the documents themselves.

dishonor failure or refusal by the drawee to accept a draft presented for acceptance or to pay a draft presented for payment.

documentary credit synonymous with “[letter of credit.](#)”

documentary draft collection process for collecting payment in a sale of goods wherein a legal demand for payment from the buyer is made by a bank acting as collecting agent for the seller. Demand is made by presenting a draft. The collecting bank is also entrusted with documents to deliver in accordance with accompanying instructions, usually once the draft is either paid or accepted. These documents are generally needed by the buyer to show title to the goods and/or to clear customs.

documentary letter of credit term sometimes used (incorrectly) to refer to commercial letters of credit—the term is redundant in that all letters of credit are documentary. See “[letter of credit](#)” and “[commercial letter of credit.](#)”

documents against acceptance term for documentary draft collection instructions requesting the presenting bank to deliver documents only upon acceptance of the draft by the drawee/importer. *See also* “[acceptance](#).”

documents against payment term for documentary collection instructions requesting the presenting bank to deliver documents only upon receipt of payment from the drawee/importer. Synonymous with “cash against documents.”

draft written demand for payment of a specified amount addressed to a named party, called the “drawee,” and signed by the “drawer.” A draft may demand payment immediately upon presentation (“at sight”) or on a specified maturity date and must also specify a party to be paid (the “payee”). Most drafts are “negotiable,” meaning the payee’s right to payment can be transferred by the payee to another party by endorsement and delivery of the draft.

draft collection process for collecting payment in a sale of goods wherein a legal demand for payment from the buyer is made by a bank acting as collecting agent for the seller. Demand is made by presenting a draft. *See also* “[draft](#)” and “[documentary draft collection](#).”

drawee party to whom a draft is addressed and from whom payment is demanded, or, in a documentary collection with no draft, party from whom payment is requested in exchange for delivery of documents.

EMC abbreviation for “[export management consultant](#).”

ETC abbreviation for “[export trading company](#).”

EXW abbreviation for “[ex works \(...named place\)](#).”

evergreen letter of credit letter of credit with an initial expiration date but containing a clause that states that it will be automatically extended for additional periods unless the issuing bank provides notice to the beneficiary stating otherwise.

ex factory synonymous with “[ex works](#).”

ex works (...named place) shipping term included in a contract of sale (abbreviated as EXW) meaning that the seller fulfills his obligation to deliver when he has made the goods available at his premises (*i.e.*, works, factory, warehouse, *etc.*) to the buyer. In particular, he is not responsible for loading the goods for export, unless otherwise agreed. The buyer bears all costs and risks involved in taking the goods from the seller’s premises to the desired destination.

expiry date last date on which documents may be presented or corrected in order to comply with a letter of credit. Presentation must be made to the bank indicated in the L/C.

export letter of credit term used by an exporter to describe a commercial letter of credit in his favor or by a bank to describe a letter of credit issued by a bank other than itself. The same L/C will be called an “import letter of credit” by the importer and the issuing bank.

export management consultant individual or company that assists other companies in identifying potential foreign markets for their goods, often named as a sales agent or representative of the company being served and paid a commission for each sale.

export trading company company that buys and sells goods with the objective of taking advantage

of market opportunities around the world.

FCA abbreviation for “[free carrier \(...named place\)](#).”

FCR abbreviation for “[forwarder’s cargo receipt](#).”

FOB abbreviation for “[free on board \(...named port of shipment\)](#).”

factoring service of assuming the credit risk of another party’s sales, generally including collecting payment when due. Factors often provide or arrange limited-recourse financing against the accounts receivable they are guaranteeing, referred to as “purchasing receivables.”

Fed Funds rate interest rate at which banks in the United States lend each other dollars for next-day repayment (“overnight loans”).

financing risk term used to describe the increasing uncertainty that the buyer of goods will have the capacity to pay when payment is due the longer the time period he is given to make payment.

forfait purchase of negotiable instruments, most often avalized drafts, without recourse. The forfaiter assumes the credit risk of being able to collect payment when due.

forwarder’s cargo receipt document issued by a freight forwarder or freight consolidator indicating goods have been received from the seller and are being held at the disposal of the buyer. Goods are generally received in the seller’s country and the forwarder/consolidator will arrange shipment, and possibly consolidation with other goods, to the buyer according to the buyer’s instructions.

free carrier (...named place) shipping term included in a contract of sale (abbreviated as FCA) meaning that the seller fulfills his obligation to deliver when he has handed over the goods, cleared for export, into the charge of the carrier, freight consolidator, or freight forwarder named by the buyer at the named place or point.

free on board (...named port of shipment) shipping term included in a contract of sale (abbreviated as FOB) meaning that the seller fulfills his obligation to deliver when the goods have passed over the ship’s rail at the named port of shipment, all costs of inland transportation and loading being included in the price of the goods. The buyer has to bear all costs and risks of loss of or damage to the goods from that point.

freely negotiable letter of credit letter of credit that indicates it is “available with any bank by negotiation.” By including this wording, the issuing bank authorizes the beneficiary to present documents to the bank of his choice for examination and collection of payment.

freight forwarder company that, as an agent for the shipper, arranges transportation for goods. Many freight forwarders offer additional services such as preparing export documentation, arranging for goods to be packed into shipping containers, arranging for goods to clear customs, *etc.*

full set all signed originals of a document. For example, bills of lading are often issued in three originals, all having the same validity for claiming goods at the place of delivery.

grace period *see* “[days of grace](#).”

import letter of credit term used by an importer to describe a commercial letter of credit he has asked a bank to issue or by a bank to describe a letter of credit it has issued. The same L/C will be called an “export letter of credit” by the exporter and all other banks.

independent guarantee synonymous with “[demand guarantee](#).”

installment letter of credit letter of credit calling for multiple shipments within specified date ranges.

insurance *see* “[credit insurance](#)” and “[marine cargo insurance](#).”

irrevocable letter of credit letter of credit that cannot be amended or canceled without agreement of both the beneficiary and the issuing bank. Any letter of credit subject to the UCP500 or to U.S. law is irrevocable unless it specifies otherwise.

issuing bank bank that has issued a letter of credit. The issuing bank is obligated to pay if documents are presented that comply with the L/C requirements.

letter of credit undertaking, usually on the part of a bank and at the request of one of the bank’s customers, to pay a named beneficiary a specified amount of money (or to deliver an item of value) if the beneficiary presents documents in accordance with the terms and conditions specified in the letter of credit.

letter of guarantee undertaking, usually on the part of a bank, either to fulfill the obligations of another party (*see* “[ancillary guarantee](#)”) or to pay a specified amount of money upon presentation of specified documents stating that the party being guaranteed has defaulted on certain obligations (*see* “[demand guarantee](#)”). One must be careful to discern which type of guarantee one is dealing with as they both require presentation of documents but work very differently thereafter.

LIBOR acronym for the London Interbank Offered Rate. The interest rate at which banks in London place Eurocurrency/Eurodollar deposits with each other for specified, fixed periods of time, most commonly six months.

marine cargo insurance insurance covering loss of or damage to goods in the course of international transportation. The term is anachronistic in that such insurance is used for air and land transportation as well as ocean transportation, but many of the concepts are based on perils of the sea.

marine bill of lading synonymous with “[ocean bill of lading](#).”

multimodal bill of lading bill of lading covering shipment of goods by more than one means of transportation but including an ocean leg. The two major forms of multimodal bill of lading are the combined transport bill of lading and the through bill of lading. Under the former, the carrier signing the bill of lading (the “contractual carrier”) frequently subcontracts the various legs to other carriers (the “actual carriers”), but still takes responsibility for delivery of the goods to the “place of delivery” and for any damage that might occur during carriage. Under the latter, the carrier takes responsibility for the goods only up to a specified point (still called the “place of delivery”) and then passes responsibility to a second carrier for “on-carriage” to the “final destination.”

multimodal transport shipment of goods by more than one means of transportation but including an ocean leg (*see* “[multimodal bill of lading](#)”).

negotiable quality belonging to a document of being able to transfer ownership of money, goods, or other items of value specified in the document by endorsement and/or delivery of the document. Checks, drafts, promissory notes, bonds, stock certificates, bills of lading, and warehouse receipts are

examples of documents often issued in negotiable form.

negotiate to “buy” documents representing ownership of money, goods, or other items of value. The seller is also said to “negotiate to” the buyer. Unless otherwise agreed between the buyer and seller (*e.g.*, by negotiating “without recourse”), the seller continues to be fully responsible for the enforceability of the documents. A bank that negotiates documents under a letter of credit advances funds to the presenter before submitting the documents to the issuing bank for payment.

negotiating bank bank to which letter of credit documents are presented by the beneficiary for collection of payment. The name derives from the fact that the negotiating bank is normally authorized by the issuing bank to negotiate documents (*see* “[negotiate](#)”), but it may or may not choose actually to do so. Furthermore, recognizing that this bank may be authorized to pay or accept drafts, rather than negotiate them, UCP500 now uses the term “nominated bank” rather than “negotiating bank.” Unless otherwise instructed, negotiating banks in North America generally examine the documents for discrepancies before forwarding them to the issuing bank, but this is properly viewed as a service separate from negotiating and is not even necessary when negotiating with recourse.

non-cumulative revolving letter of credit revolving letter of credit that does not permit the seller to carry over any amounts not drawn upon in previous periods.

notify party party to be notified by the carrier of arrival of the goods at their destination. Normally the notify party is the importer and/or the importer’s agent for clearing goods through customs.

ocean bill of lading bill of lading including shipment on an ocean vessel, also called a “marine bill of lading.” Although port-to-port, multimodal, and charter party bills of lading are all ocean bills of lading, many banks persist in issuing letters of credit that call simply for ocean bills of lading and then applying the requirements for port-to-port bills of lading. *See also* “[bill of lading](#),” “[port-to-port bill of lading](#),” “[multimodal bill of lading](#).”

performance bond bond issued at the request of one party to a contract in favor of the other party to the contract to protect the other party against loss in the event of default on the contract by the requesting party. The bonding agent may undertake to fulfill the contract or may simply undertake to pay a specific amount in monetary damages. A standby letter of credit or demand guarantee is often used as a performance bond with the latter characteristics.

political risk risk in a sale of goods that the government in the buyer’s country may take some action that prevents the buyer from paying. This covers possibilities such as the imposition of foreign exchange controls and expropriation as well as non-payment due to war or insurrections.

port-to-port bill of lading bill of lading covering shipment by ocean only. The shipper/seller is responsible for transporting the goods to the port of loading and the buyer for picking the goods up at the port of discharge. Multimodal, rather than port-to-port, bills of lading should generally be used for containerized shipments and other shipments where the place of receipt and/or the place of delivery is inland.

pre-export financing specific form of working capital lending in which the borrower is given funds needed to obtain or manufacture goods that have been ordered by a buyer in another country. As such financing is normally earmarked to individual sales, documentation of each sale must be provided to the lender, often in the form of a letter of credit with proceeds assigned to the lender.

Generally only a percentage of the sale value is lent.

presenting bank in a draft collection transaction, the bank that contacts the drawee, generally the buyer of goods, for acceptance and/or payment.

principal party entrusting a draft and/or documents to a bank for collection of payment, generally the seller of goods.

progress payment one in a series of payments made at stages in the performance of a contract of sale, *e.g.*, up front to obtain materials, after completion of manufacturing, upon shipment, upon installation, and upon final inspection.

protest in a draft collection transaction, the formal legal process of registering that payment or acceptance of the draft has been demanded but the drawee has refused to pay or accept the draft.

reimbursing bank in a letter of credit transaction, the bank with which the issuing bank maintains an account and which is authorized by the issuing bank to charge that account to pay claims received from the negotiating bank for documents that have been presented.

remitting bank in a draft collection transaction, the first bank in the chain of collection, *i.e.*, the principal's or seller's bank.

retention of title legal arrangement under which a seller of goods delivers these goods "on consignment" into someone's custody but ownership remains with the seller until he is paid. Retention of title allows the seller to repossess the goods whenever desired and to establish a claim against the custodian if the goods are sold or used without being paid for.

revocable letter of credit letter of credit that can be amended or canceled at any time without notice to or consent of the beneficiary. A letter of credit that is subject to the UCP500 or to U.S. law is revocable only if it clearly specifies so.

revolving letter of credit letter of credit that reverts to its original amount at specified intervals, *e.g.*, monthly, thereby preventing drawing too much in any one period. *See also* "[cumulative revolving letter of credit](#)" and "[non-cumulative revolving letter of credit](#)."

shipper's indemnity indemnity given by the beneficiary of a letter of credit to the negotiating bank to induce payment despite any discrepancies that may exist in the documents.

shipping terms that part of a contract of sale that specifies who, between the buyer and the seller, is responsible for each aspect of shipping the goods, *e.g.*, for packing, arranging and paying for transportation and insurance, clearing customs, *etc.*

sight time of presentation, as in a draft payable "at sight" or "90 days after sight."

sight draft draft that demands payment "at sight," or immediately, as opposed to a time draft, which may be payable "90 days after sight" or "30 days after bill of lading date."

silent confirmation term used for a bank's commitment to negotiate (*i.e.*, purchase) documents under a letter of credit without recourse at a future date. A silent confirmation is not a confirmation in the true sense, and will not use the word "confirm," but is rather an equivalent form of protection for the beneficiary. The bank will require that the letter of credit be negotiable or payable by itself in order to be able to establish holder-in-due-course rights equivalent to those of a confirming bank.

standby letter of credit as opposed to a commercial letter of credit, a letter of credit that does not cover the direct purchase of merchandise, so called because it is often intended to be drawn on only when the applicant for whom it is issued fails to perform an obligation. There is, nonetheless, a type of standby letter of credit that is intended to be drawn on, referred to as a “direct pay letter of credit.”

Standby letters of credit are based on the underlying principle of letters of credit that payment is made against presentation of documents—whatever documents the applicant, beneficiary, and issuing bank may agree to, not necessarily documents showing shipment of goods.

supplier financing arrangement where the seller/supplier of goods allows the buyer an extended period of time after shipment to pay for the goods.

tenor time at which a draft indicates it is payable, *e.g.*, “at sight,” “60 days after the bill of lading date,” or “on May 31, 2001.”

time draft draft that demands payment at a specified future date rather than immediately upon presentation.

trade terms synonymous with “[shipping terms](#).”

transfer risk risk incurred by the seller of goods that, due to the fact that his country has a negative balance of payments, no foreign exchange (U.S. dollars or other “hard” currency) may be available to the buyer when he is ready to pay for the goods.

transferable letter of credit type of letter of credit that names a middleman as beneficiary and allows him to give another party, the actual supplier, certain rights to present documents and receive payment under the letter of credit. Transfer must be effected by a bank authorized to do so by the issuing bank and involves notifying the transferee (called the “second beneficiary”) of what documents he must present. The documents must be the same as those required in the letter of credit itself but the price of the goods may be reduced and the middleman’s name may be required to be listed in the transferee’s invoices as the buyer, thereby allowing the middleman to substitute invoices at a higher price and receive the difference without disclosing the name of the actual end-buyer. The transferring bank is not obligated to pay documents presented under the transfer—such obligation remains with the issuing bank.

UCC abbreviation for “[Uniform Commercial Code](#).”

UCP abbreviation for “[Uniform Customs and Practice for Documentary Credits](#).” The 1993 revision is referred to as “UCP500” as it is publication number 500 of the International Chamber of Commerce.

unconfirmed letter of credit letter of credit that has not been confirmed (*see* “[confirmed letter of credit](#)”).

Uniform Commercial Code United States statute covering the rights and obligations of the various parties involved in the purchase and sale of goods. The UCC includes coverage of drafts and other negotiable instruments, documents of title, transfers of funds between banks, and security interests in assets as well as draft collections (in Article 4) and letters of credit (in Article 5).

Uniform Customs and Practice for Documentary Credits international standards of letter of credit practice established for bankers by the International Chamber of Commerce. Historically, the

UCP has been revised about every ten years to keep up with changing practice, the most recent revision, UCP500, having been completed in 1993. Although the UCP defines rights and obligations of the various parties in a letter of credit transaction, it is not law and any given letter of credit is subject to the UCP only to the extent indicated in the letter of credit itself.

Uniform Rules for Collections international standards of draft collection practice established for bankers by the International Chamber of Commerce. The Uniform Rules are not law but are more properly viewed as a handbook for banks used to establish common understanding of terminology and expectations.

without recourse negotiation of a draft, or other negotiable instrument, or letter of credit documents without the normal warranty on the part of the seller of the instrument/documents that the obligor named in the instrument (the “drawee,” “payor,” or “maker”) will pay. Although the seller is still responsible for the genuineness of the instrument and documents, the purchaser takes on the credit risk of being able to collect payment from the obligor when due. Unless negotiation is without recourse, the purchaser of the instrument/documents has the right to recover the face amount from the seller if the obligor fails or refuses to pay for any reason.