BASIC UNDERSTANDING OF STANDBY LETTERS OF CREDIT

A letter of credit (LC) is a bank instrument that is issued to protect the beneficiary in a transaction. It is not a contract although there are usually contractual undertakings that underlie the credit. *(It is important to reserve in your mind that the contract on which the credit is based cannot be referenced in the credit itself and cannot be a decisive factor when the credit is presented for payment. This is "The Independence Rule" which will be discussed later.)*

Technically a letter of credit is not a guarantee although it does, in fact, guarantee payment of an obligation to a beneficiary.

There are laws and rules that govern letters of credit. The Uniform Commercial Code (UCC) Article 5 covers letters of credit and is *law*. The Uniform Customs and Practice (UCP), which is distributed by the International Chamber of Commerce (ICC), has a series of publications that are the accepted *rules* for credits. The ICC/UCP500 and the ISP98 are their two most current publications for letters of credit. The ICC/UCP500 is entitled, *ICC Uniform Customs and Practice for Documentary Credits* and has been in force as of January 1, 1994. The ISP98 is called the *International Standby Practices ISP98* reflects generally accepted practice, custom and usage of *standby letters of credit* and has been in force since January 1, 1999.There are three basic parts to a letter of credit transaction.

First, there is an agreement between the customer (other names for the *customer: applicant, account party, buyer, debtor, importer, client*) who will open the letter of credit at the bank and the beneficiary (other names for the *beneficiary: creditor, exporter, seller, supplier, manufacturer*) who will be allowed to draw down the letter of credit. Their agreement outlines the transaction between them and specifies the obligation the customer will have to the beneficiary allowing him to receive payment under the letter of credit.

Second, there is an agreement between the account party and the issuer of the credit, which is usually a bank. This agreement specifies the obligation of the bank to pay and how the account party will collateralize the credit with the issuer, which is usually in cash or property.

Third, the letter of credit obligation is drafted in accordance with the rules of an ICC/UCP publication, or the UCC. The credit therefore, obligates the issuer to pay or honor the drafts attached to the credit when presented by the beneficiary in accordance with the *terms*, *conditions* and *procedures* outlined in the credit.

Following are the parties to a letter of credit transaction with relevant terms and convenient definitions.

Issuer – This is the entity that will issue the credit. It usually is a bank but it can be any financial institution of substance. The issuer assumes the full obligation to pay the beneficiary upon the presentation of the documents specified in the credit.

Applicant – The applicant is also known as the account party or customer. He requests from the issuer the credit he wants for his beneficiary. He pays the issuer for the credit with cash or collateral so as to secure the issuer the funds necessary for the reimbursement obligation to the beneficiary.

Beneficiary – The beneficiary is the party that will be identified in the credit as the entity entitled to draw or demand payment under the letter of credit.

Advising Bank – The role of the advising bank is to notify the beneficiary that a credit has been issued by another bank. It assumes no responsibility other than notifying the beneficiary. However, its obligation is limited to accurately advising the terms of the credit that has been issued. In this capacity it is only playing "post office". (UCP500 Article 7).

Confirming Bank – The responsibility of the confirming bank is that it becomes directly obligated on the credit and now assumes the rights and obligations of the issuer. (UCP500 Article 9, a, b, c, d). Typically the confirming bank's role is one for geographic convenience, i.e., a bank located close to the beneficiary. However, it can also be a well-known bank, that will assume the responsibility for a lesser known bank by confirming their credit, therefore, rendering the credit more acceptable to the beneficiary.

Independence Rule – This principle of independence clearly states that the obligation of the paying bank is in reading the text of the credit which is wholly independent from sales or other contracts on which the credit may be based. The issuing bank is not required to evaluate if the beneficiary has performed under the underlying contract or if it is contractually entitled to payment. The issuer is only obligated to pay upon presentation of documents that conform to the requirements of the letter of credit. (UCP500 Article 3, a, b, Article 4).

Strict Compliance Rule – The beneficiary must make presentment in strict compliance with the terms, conditions and procedures of the credit. Further to this, since the adherence of the requirements must be strictly applied to the beneficiary, the beneficiary must know precisely and unequivocally what those requirements are. Although the *Independence Rule* above, is "rule" the *Strict Compliance Rule* is considered "law" since this standard has been applied and followed by a majority of federal jurisdictions and state courts.

Transferable Credit – A transferable credit is a credit under which the first beneficiary requests the paying bank to make the credit available in whole or in part to one or more beneficiaries. A credit can be transferred only if the text clearly states that it is transferable. (UCP500, Article 48, a-j; ISP98, Rule 6.0-6.05).

Every letter of credit must address the following:

***Terms**:* Dollar amount to be paid for the transaction by the applicant to the beneficiary in accordance with the specifications listed in the letter of credit within the period of validity and date of expiration.

***Conditions**:* Beneficiary must satisfy the terms above in order to qualify and to be able to draw the proceeds on the credit.

***Procedures**:* Applicant opens the letter of credit with the issuing bank. Issuing bank advises beneficiary that the credit is available to his account. Particulars of underlying contract must be clearly stated in credit (although contract itself is not cited nor will it be evaluated when credit is presented to bank for payment – "Independence Rule".

QUANTIFIERS

Every letter of credit, as with all contracts, must address the following quantifiers.

Who – The parties involved with the transaction (applicant, beneficiary, issuing bank, confirming bank).

What - Type or name of transaction (commodities, supplies, services, funding).

Why – Needs on both ends of transaction (buyer, seller, lender, borrower).

Where – Banks involved (where credit is to be opened, confirming bank, paying bank, jurisdiction of applicant and beneficiary).

When – Time frames (date credit is issued, periods of validity and expiration, ETD for shipment or release of funds, ETA for shipment or draw of funds, partial or full shipments allowed).

How Much – Amount of transaction, if partial draws allowed

THERE ARE TWO CATEGORIES OF LETTERS OF CREDIT USED TODAY

1 Documentary Letter of Credit (DLC or L/C)
2 Standby Letter of Credit (SBLC or SLC)

The *Documentary Letter of Credit* is conditioned on *performance* by the supplier, whose acceptable and satisfactory performance makes him the beneficiary of the credit.

The Standby Letter of Credit is conditioned on *default or non-performance* by the account party or applicant who opened the standby letter of credit.

Now consider this:

A documentary letter of credit is issued with the expectation that it *would* be drawn on by the beneficiary.

A standby letter of credit is issued with the expectation that it *will not* be drawn on by the beneficiary.

Although there is misuse and manipulation of documentary letters of credit by crafty businessmen, this article will deal only with standby letters of credit, the instrument which fraudsters use to dupe the uninformed and inexperienced investor.

Standby letters of credit are sometimes referred to as "sui generis" (of their own kind, or "beasts unto themselves"). They are flexible and their versatility is virtually limitless.

The premise or the essence of a standby letter of credit is that the issuer will "stand by" to perform in the event of the account party's *non-performance or default.*

One distinguishing characteristic with standby letters of credit is that documentation of *non-performance or default* is required for the beneficiary to obtain payment. This documentation must be precise and strict adherence to the language of the credit and satisfying whatever is called for in the credit indicating non-performance by the issuer. This could include, submitting drafts and perhaps a statement indicating that the account party has defaulted in accordance with the text of the credit. (*Strict Compliance Rule*).

Standby letters of credit are a type of IOU. More closely related to a co-signer on a loan. That is to say, if you default or don't perform in accordance with your agreement with the lender, the "co-signer" is responsible for you and your debt and pays on your behalf. In reality, he is standing by for you.

Following are some examples of its flexibility. Always keep in mind *non-performance or default.*

Example One

A contract requires goods of a certain quality to be delivered. Some or all of the goods are subquality or substandard. A standby letter of credit, either separately as

a companion credit or as the primary credit, could provide funds for replacing substandard goods independent of the contract requirements in the event there is a compromise in the quality of the produce.

Example Two

As a performance guarantee. Suppose a contract requires performance by a certain date and the completion is late. The primary contractor could require a series or standby letters of credit from subcontractors to help pay delay penalties under the master contract.

Example Three

Goods are to be delivered to a specific location on a certain date and they are delivered to the wrong place. Payment under a standby letter of credit could provide funds for transportation costs to the specified location.

Example Four

Perishable foods arrive late (fruits and vegetables). A standby letter of credit could enable the beneficiary to replace those items that rotted.

Example Five

Party A promises to repay Party B $10,000 for a loan by a certain date. That certain date arrives and Party A defaults, he does not perform. Party B, the beneficiary takes the letter of credit to the bank with the required documents, statements, evidence and the attached draft and receives the funds due to him which the bank was standing by to make good for Party A in the event of his default.

Now here is where fraudsters use this same standby letter of credit and prey upon the uninformed investor.

Following is a descriptive example of a standby letter of credit being issued as a form of guarantee for payment to a beneficiary due to non-performance or default by the applicant.

A standby letter of credit is issued by ABC's bank to XYZ as beneficiary. The standby letter of credit states that on December 10, 1999, ABC is to remit to XYZ $100,000. In the event ABC does not honor the text of responsibility as indicated in the credit, XYZ is to submit the credit and what ever evidence or documentation is required as per the language of the credit to the bank for payment.

Now two important factors come into play. *One*, XYZ could not submit the credit to the bank for payment before the due date, and if ABC paid XYZ prior to the due

date then the credit would have no surrender value. That means that the credit only has value, in this instance, upon default by ABC, the applicant.

Consider this, how would someone (the beneficiary) be able to discount a credit to a third party if, first of all, the credit would have absolutely no value prior to the due date, and, secondly, if the applicant (ABC) met his obligation and paid the beneficiary (XYZ) prior to the due date (expiration), the credit could never be called and, therefore, with no surrender value.

Secondly, the credit must state that the credit is transferable partially or in its entirety and, as stated in the ISP98, (Rule 6.02 a,b) "A standby is

not transferable unless it so states"... and "may not be transferred unless the issuer (including the confirmer) or another person specifically nominated in the standby agrees to and effects the transfer requested by the beneficiary". The UCP500 (Article 48 a-j) also states, "A credit can be transferred only if it is expressly designated as transferable by the issuing bank."

Now let's assume that the credit could be transferred and it was sold at a discount to a third party. But, unbeknown to the third party the original beneficiary (XYZ) received his $100,000 payment from the applicant. The credit, although having been transferred, cannot be presented for payment because it was only valid in the event of default. The applicant honored his obligation and although the credit was discounted the transferee now has a worthless document. Such a scenario could in fact become a reality and oftentimes it is one of the schemes and scams of fraudsters.

Fraudsters also create schemes whereby they represent to have standby letters of credit from lesser-known banks. In reality these credits are usually worthless since the rating of the banks issuing them are unknown or that a prominent bank will not confirm their credit. If they did have a standby letter of credit (already issued) your first step is to see if the credit was key tested and if yes, does the text state that mail copy is to follow. It is not customary for individuals, outside banks or financial institutions, to have a hard copy of a credit unless it is stated that such copy is to follow or to be made available to the beneficiary. So if a statement does *not* appear at the bottom of an electronically transmitted credit indicating that a copy is to be mailed and a credit in hard copy is presented to you, you must consider withdrawing from that transaction without further delay.

If a statement indicating that a hard copy will follow and such copy is presented to you, then here is a series of questions you should raise:

First, to whom is the credit issued (the beneficiary)?
Second, why is it being issued and for what reason?
Third, if credits are not issued in "blank" so to write how can this be genuine or valid?

Fourth, is it transferable, and if yes, to whom is it transferable? Just asking those simple questions should help you pave a path leading in the opposite direction from the fraudster, in almost every instance.

There are other times when fraudsters will produce an electronically transmitted credit which contain a provision for authorized signatures of bank officers to appear at the bottom of the credit. It is highly unlikely that a reputable bank would issue a document with this kind of error.

If you receive an investment proposal that offers standby letters of credit at discount and you are not sufficiently convinced that after reading the above that most if not all discounted standby letters of credit are questionable, STOP! It is strongly recommended that you check with Thompson Financial Bankwatch at www.bankwatch.com or 708 933 8069 or 800 321 3373 where hundreds of banks are listed and rated. With the information you obtain from Bankwatch, you can always ask the issuing bank to confirm the validity of the credit. A simple step easily taken.

You could also visit the website of International Chamber of Commerce at www.iccwbo.org or 212 206 1150 or the US Consulate for International Business 212 354 4839/354 4480 or London 44 171 823 2811 or ICC Commercial Crime Services, London 44 181 591 3000.

Not all banking instruments, and especially standby letters of credit, have any marketable value. It is with this fact, "marketable value" that frauds are perpetrated, perpetuated and the uninformed and unsuspecting investor is victimized. Usually they are told that they have bought an irrevocable negotiable instrument when in fact, the only irrevocable element is that they cannot recall their investment funds from the fraudster.

Here is a mental check-off list that will help you to identify basic flaws in a standby letter of credit:

- Misspellings
- Missing dates of issue and expiration (maturity)
- Incorrect naming of ICC publication numbers
- Citing ICC publication numbers that are obsolete (ICC400 has been replaced by the ICC500 and ISP98, or even more commonly, the citing of the ICC600, which does not exist)
- Reference to ICC Non-Disclosure/Non-Circumvention (ND/NC) agreements, while the ICC has never issued such ND/NC agreements (refer to ICC 460/434 Statement of Policy articles which refutes the existence of such agreements).
- Being unfamiliar with the name of the bank issuing the instrument and cannot confirm a satisfactory rating through Thompson or another source

- Lesser known bank's instrument is not confirmed by well known correspondent bank
- Use of general terms and conditions when specifics will be required to encash the instrument
- Lack of transferability clauses in letter of credit document
- Looking carefully for illogical statements, for example, requesting the signatures of bank officers on an electronically issued instrument

If the basics are flawed and fundamentals are questionable, remember that if the premise is fallacious then no matter how much you manipulate it, the conclusion will most likely be fallacious, too.

Robert Alden wrote, *"There is not enough darkness in the all the world to put out the light of even one small candle".* To which we add, there is not enough light in all the world to illuminate and authenticate that which is obscured in a bogus bank instrument.