

10 Things for Exporters to Keep in Mind When Arranging Standby Letters of Credit

Tips, Tricks, and Facts Regarding Bid and Performance Bonds and Advance Payment Guarantees

1. A letter of credit is a bank's agreement to pay a specified amount of money upon presentation to them of documents specified in the letter of credit.

Think of it as a certified check that can be cashed by presenting it back to the bank with a few documents stapled to it. The documents can be anything you, the applicant, have the L/C specify, but the bank must be able to examine them quickly and determine whether or not they comply. Of course, your customer, the beneficiary, must agree to the documents you require or they may reject the L/C at the outset. For example, it is allowable for the L/C to require documents that purport to be signed by you, but doubtful the beneficiary will accept such a letter of credit.

Tip: In addition to documents, letters of credit may include "modalities." These are facts the bank can verify from their internal records. For example, the requirement that documents be presented at a specified place by a stated date is a modality. There may come a time where you may find yourself in the "advance payment impasse." This is where the customer refuses to give you the advance, or down, payment until you provide a guarantee and you

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refuse to provide a guarantee until you get the advance payment. To cut through this impasse, the letter of credit may state it only becomes effective upon the bank's receipt of the advance payment (citing the letter of credit number).

2. As long as the engagement the bank writes meets the above requirement, it is a letter of credit.

If it makes someone happy, it can be called a demand guarantee, a bank guarantee, a bid or performance bond, or something else. Letters of credit and conditions beyond required documents (and modalities as described above) do not mix. If you receive something that contains non-documentary conditions, either it is not a letter of credit



(no matter what it calls itself) or the non-documentary conditions are unenforceable, but you may not know which until you get to court.

3. A contract guarantee is not a letter of credit.

It is more like a parent guarantee or a surety bond issued by insurance companies. The guarantor, in this case, is effectively co-signing the contract. If there is a claim, the guarantor may refuse to pay until they see an arbitration award or at least conduct an inquiry into the facts supporting the claim before paying. This makes contract guarantees generally unacceptable in trade transactions. When someone says they want a bank guarantee or a local guarantee, they almost always mean a standby letter of credit.

4. U.S. banks are prohibited by U.S. regulators from issuing contract guarantees.

They are, however, free to *call* their letters of credit "guarantees" (although this tends to make them uncomfortable). The key is to make the instrument issued completely documentary and, for the sake of comfort, subject to rules (see point #6). Banks in other countries are comfortable issuing guarantees, but these are, as a rule, demand guarantees payable upon presentation of documents, i.e., they are letters of credit traveling incognito. A common problem, however, is that they

are not subject to any international rules, but rather to local laws.

5. Avoid making your letters of credit subject to the laws of the country of the beneficiary.

Unless they state otherwise, letters of credit are subject to the laws of the country of the issuing bank. If you ask this bank to subject their engagement to laws they are not familiar with, they will ask for extra indemnities that may be very open-ended and expansive and may block your credit line indefinitely. The laws of the beneficiary's country may say, for example, that expiration dates are meaningless (and that the letter of credit must always be returned in order to be cancelled), or that documents do not have to fully comply.

6. Try to make sure your letters of credit are subject to some set of internationally recognized rules.

In the order of preference, these are the International Standby Practices (International Chamber of Commerce publication 590, or "ISP98"), the Uniform Customs and Practice for Documentary Credits (ICC publication 600, or "UCP600"), and the Uniform Rules for Demand Guarantees (ICC publication 458, or "URDG"). Despite what your customers may tell you, these rules can all be invoked even if your letters of credit are called guarantees.

7. Although it may not be possible, try to avoid the structure of using a standby letter of credit issued as a counter-guarantee to a foreign bank in order to get the foreign bank to issue a local guarantee.

A far better structure is confirmation by the foreign bank of a letter of credit (possibly called a guarantee) issued by your bank. The counter-guarantee structure only provides partial insulation from foreign laws; the foreign bank's guarantee will be subject to local laws, which may allow capricious drawings. The letter of credit will only require a statement from the foreign bank that they have paid

8. Letters of credit are payable against presentation to the bank of the documents required.

Truth is not part of the equation. The issuing bank is legally prohibited from refusing to pay compliant documents even if you tell them the beneficiary is lying and not entitled to the money. The motto in the courts is, "Pay first, litigate later." The slogan, which is like unto it, is, "The purpose of a letter of credit is to change who is holding on to the money when the litigation comes."

9. Do not try to use a letter of credit as a substitute for terms that belong in a contract with the beneficiary.

If the L/C is drawn on and the bank pays, the contract is your basis for recovering payment, not the L/C. The contract should specify under what conditions the beneficiary is entitled to draw, so you have clear grounds for recovery if they draw abusively. The documents required under the L/C should certainly contain a statement as to why the beneficiary is entitled to draw, but do not expect this to protect you from abusive drawings. Do not try to include non-documentary conditions, like, "This letter of credit is payable in the event of a default by [your company] in the performance of contract 12345." By law, non-documentary conditions in a letter of credit get ignored.

10. Letters of credit use your line of credit and cost money.

Do not use them lightly. When possible, ask for them to be returned for cancellation as soon as the obligations they are assuring are discharged rather than waiting for them to expire.

Tip (bonus): Most drawings under standby letters of credit are the result of misunderstandings. You can include a requirement in a letter of credit that documents be presented in 2 stages, say 30 days apart. The first set of documents would just be a statement of intent to draw on the L/C in 30 days, giving reasons, and the second would be the actual demand for payment. The bank will notify you of presentation of the intent to draw, giving you time to remedy the reason for drawing and convince the customer not to present the demand for payment. A less effective alternative is, rather than calling for presentation in 2 stages, to require that the demand for payment to be accompanied by a certification that the customer notified you directly, 30 days earlier, of their intent to draw and that you failed to remedy the situation—keep in mind that the bank will not listen to you if you claim you received no such notification. Ineffective: A requirement in the letter of credit that the customer must actually notify you of their intent to draw. Such a requirement is non-documentary and cannot be enforced—the bank is looking for a document of some sort. ●

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The letter of credit will only require a statement from the foreign bank that they have paid under the local guarantee.

under the local guarantee. Furthermore, foreign laws may not allow the local guarantee to be cancelled until returned, leading to the guarantor drawing under the standby when the expiration comes near. (This is called the "extend or pay" dilemma.) Do not expect the foreign bank to take any special steps to try to get the guarantee returned for cancellation—your customer may not be their customer and they have no reason to know when the guarantee is no longer needed. If necessary, have one of your employees visit the customer and accompany the customer to the bank to get the guarantee cancelled. A confirmed letter of credit (or guarantee) avoids these problems.