

Documentary Credits An Introductory Guide

Introduction

The usual mode of transacting international business involves one or more of the following:

- **advance payment** (payment is effected before goods are shipped)
- **open account terms** (CAD – Cash Against Documents)
- **documentary collections** (CAD or D/A – Documents against Acceptance *of a draft*)
- **documentary credits (“LC”)** (stand-by credits are included under this heading)

What is a documentary credit (LC)

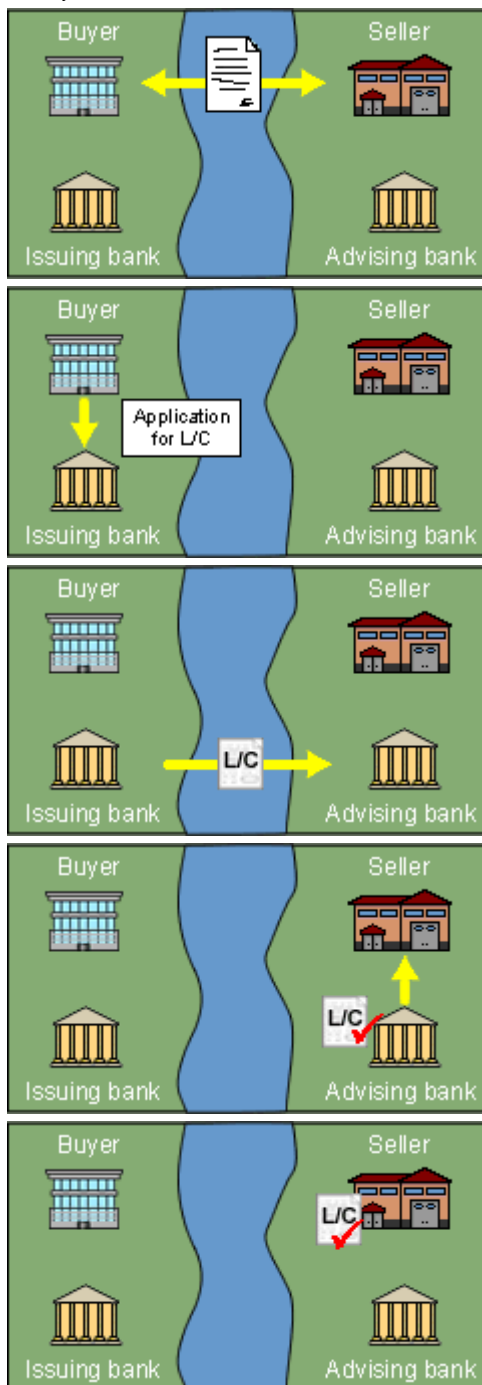
In simple language, an LC represents a more secure form of doing business than all but one (this being advance payment) of the other methods noted above. It is evidence of a four party agreement to pay against documents presented in conformity with the LC requirements. This agreement is supported by various separate contracts. These exist between applicant & issuing bank, between the banks themselves and the advising / confirming bank and the beneficiary. Thus the main parties involved are:

1. the LC applicant – this is the primary buyer of the goods
2. the LC beneficiary – this is the primary seller of the goods
3. the LC issuing bank – who gives effect to the buyer’s instructions
4. the LC advising and/or confirming bank(s) – who transmit the LC to the seller

It is critical to remember that banks deal only with documents. They give no regard to the underlying transaction or goods. Provided the documents presented comply with the LC requirements, the paying bank must fulfil its independent payment undertaking. This means that the seller will be paid regardless of the buyer’s ability or willingness to take up and pay for the documents. Exceptions to this general rule are referred to in a later section.

The Letter of Credit process

The process described below is for a sight letter of credit, with negotiation of documents by the Advising bank. Settlement procedures in letters of credit can be complex, and there are many variations on this.



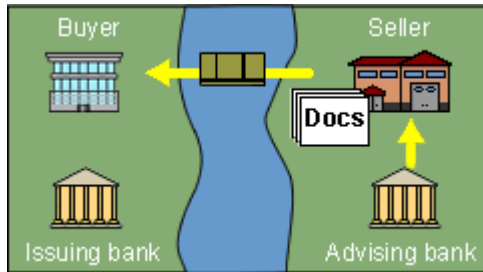
Buyer and seller agree terms, including means of transport, period of credit offered (if any), latest date of shipment, Incoterm (*) to be used.

Buyer applies to bank for issue of letter of credit. Bank will evaluate buyer's credit standing, and may require cash cover and/or reduction of other lending limits.

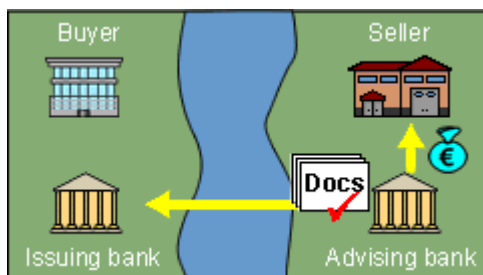
Issuing bank issues letter of credit, sending it to the Advising bank by airmail or (more commonly) electronic means such as SWIFT.

Advising bank establishes authenticity of the letter of credit using signature books or test codes, then informs seller (beneficiary). Advising bank MAY confirm letter of credit, i.e. add its own payment undertaking.

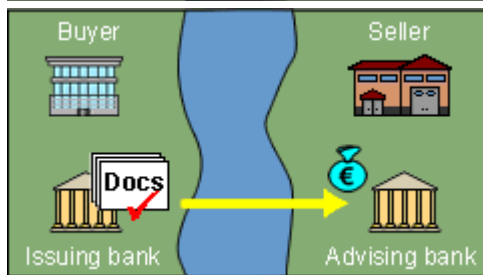
Seller should now check that letter of credit matches commercial agreement, and that all its terms and conditions can be satisfied, (e.g. all documents can be obtained in good time.) If there is anything that may cause a problem, an AMENDMENT must be requested.



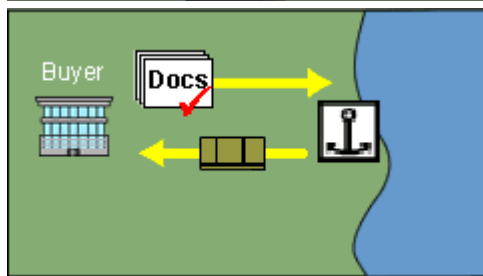
Seller ships the goods, then assembles the documents called for in the L/C (invoice, transport document etc.) Before presenting the documents to the bank, the seller should **check them for discrepancies (**)** with the letter of credit, and correct the documents where necessary.



The documents are presented to a bank, often the Advising bank. The Advising bank checks the documents against the L/C (**). If the documents are compliant, the bank pays the seller and forwards the documents to the Issuing bank.



The Issuing bank now checks the documents itself. If they are in order, then (for sight letters of credit) it reimburses the seller's bank immediately. For term letters of credit, settlement will be later.



The Issuing bank debits the buyer and releases the documents (including transport document), so that the buyer can claim the goods from the carrier.

Different Types of Letter of Credit

Irrevocable credit

Irrevocable credit means the credit cannot be amended or cancelled without the agreement of all parties (the beneficiary, the applicant and the issuing bank). A credit therefore should clearly indicate whether it is revocable or irrevocable. In the absence of such indication, the credit shall be deemed to be irrevocable.

Revocable credit

This type of credit may be amended or cancelled without the beneficiary's consent. Although rare, such LCs are sometimes seen because the cost of issuing them is lower due to their contingent (rather than unconditional) nature. It is generally used when the applicant and the beneficiary are members of the same group of companies or where a high degree of trust exists between the contracting parties.

Confirmed credit

The strength of a documentary credit is related to the financial standing of the bank that issues it. The economic strength of the country of the issuing bank is also a factor. In cases where the financial strength of the issuing country and/or bank is in doubt, the exporter may require another bank, preferably in the exporter's country, to provide its undertaking that the credit will be honoured. Consequently, the exporter is assured that drawings will be paid by the confirming bank in the event the issuing bank cannot do so, provided the terms and conditions of the credit are met. Remember, only the issuing bank may request another bank to add its confirmation. The common exception to this rule is that of a “silent confirmation” whereby the advising / confirming bank guarantees payment at the request of the beneficiary without any request by or knowledge of same by the issuing bank.

Transferable Credit

A transferable credit is a credit under which the beneficiary (first beneficiary) may request the transferring bank, or in the case of a freely negotiable credit, the bank specifically authorized in the credit as a transferring bank, to make the credit amount available in whole or in part to other beneficiary(ies). Only credits designated as transferable by the issuing bank can be transferred. Terms such as *divisible*, *fractionable*, *assignable* and *transmissible* do not render the credit transferable. If such terms are used, they will be disregarded.

Standby Letter of Credit

The standby letter of credit serves a different function than the commercial letter of credit. The commercial letter of credit is the primary payment mechanism for a transaction. The standby letter of credit serves as a secondary payment mechanism. A bank will issue a standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiary. The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon.

The standby letter of credit assures the beneficiary of the performance of the customer's obligation. The beneficiary is able to draw under the credit by presenting a draft, copies of invoices, with evidence that the customer has not performed its obligation. The bank is obligated to make payment if the documents presented comply with the terms of the letter of credit.

Standby letters of credit are issued by banks to stand behind monetary obligations, to ensure the refund of advance payment, to support performance and bid obligations, and to ensure the completion of a sales contract. The credit has an expiration date.

The standby letter of credit is often used to guarantee performance or to strengthen the credit worthiness of a customer. In the above example, the letter of credit is issued by the bank and held by the supplier. The customer is provided open account terms. If payments are made in accordance with the suppliers' terms, the letter of credit would not be drawn on. The seller pursues the customer for payment directly. If the customer is unable to pay, the seller presents a draft and copies of invoices to the bank for payment.

A standby letter of credit issued in the USA is governed by the Uniform Commercial Code. Under these provisions, the bank is given until the close of the third banking day after receipt of the documents to honour the draft.

Back-to-Back Letter of Credit

This is a new letter of credit opened based on an already existing, non-transferrable credit used as collateral. Traders often use back-to-back arrangements to pay the ultimate supplier. A trader receives a letter of credit from the buyer and then opens another letter of credit in favour of the supplier. The first letter of credit serves as collateral for the second credit.

Deferred Payment (Usance) Letter of Credit

In Deferred Payment Letters of Credit, the buyer accepts the documents related to the letter of credit and agrees to pay the issuing bank after a fixed period. This credit gives the buyer a grace period for payment. The beneficiary can seek to transform this into a "sight" credit by obtaining an LC confirmation and then having the proceeds discounted. There are also cases (especially in Korea) of a deferred payment reimbursement but with the LC providing for sight payment to the beneficiary. Thus, the advising bank can pay the beneficiary at sight but will claim reimbursement for the documents face value plus interest at a later date.

Red Clause Letter of Credit

This name derives from historic LCs wherein the specific wording was shown in red to draw the banks' attention to the clause. Originally, such LCs were used to finance Australian wool producers. Red Clause Letters of Credit provide the seller with cash prior to shipment to finance production of the goods. The buyer's issuing bank may advance some or all of the funds. The buyer, in essence, extends financing to the seller and incurs the risk for all advanced credits. Quite often (especially with China) such LCs are linked to advance payment guarantees. These secure reimbursement of the advanced funds if documents, evidencing that goods have been shipped, are not presented within a certain time. Invoice values are paid on a pro rata basis so that the advanced funds, plus interest, are deducted on a running basis. Although rather complex, these LCs are a useful means of securing and documenting the funds advanced to the producer.

Green Clause Letter of Credit

This is a refinement of the RCLC whereby pre-shipment advances are made to the supplier but provides for storage of the delivered goods for and on behalf of the bank. This gives the bank collateral security for the funds advanced. Goods are then held on warehouse certificates to order of the bank which are only released against payment by the ultimate buyer(s).

Revolving Letter of Credit

With a Revolving Letter of Credit, the issuing bank restores the credit to its original amount once it has been used or drawn down. Usually, these arrangements limit the number of times the buyer may draw down its line over a predetermined period. There are apparent advantages to these regarding limiting line utilisation, but invariably a bank will multiply the number of rolls and block the line with this value.

Transferable Letter of Credit (I)

This type of credit allows the seller to transfer all or part of the proceeds of the original letter of credit to one or more second beneficiaries, usually the ultimate supplier of the goods. It is most common for just one second beneficiary to be used. When several suppliers are involved the exercise becomes quite complex and ensuring provision of LC conform documents is itself a demanding exercise. The letter of credit must clearly state that it is transferable. This is a common financing tactic for middlemen and is common in East Asia.

Assignment of Proceeds (II)

This achieves the same object as the transferable credit but in a much simpler fashion. The beneficiary of a letter of credit may assign all or part of the proceeds under a credit to a third party (the assignee). However, unlike a transferred credit, the beneficiary maintains sole rights to the credit and is solely responsible for complying with its terms and conditions. For the assignee, an assignment only means that the paying bank, once it receives notice of the assignment, undertakes to follow the assignment instructions, if and when payment is made. The assignee is dependent upon the beneficiary for compliance, and thus this arrangement is riskier than a transferred credit. Before agreeing to an assignment of proceeds arrangement, the assignee should carefully review the original letter of credit.

Parties to a Letter of Credit

Beneficiary

The beneficiary is entitled to payment as long as he can provide the documentary evidence required by the letter of credit. The letter of credit is a distinct and separate transaction from the contract on which it is based. All parties deal in documents and not in goods. The issuing bank is not liable for performance of the underlying contract between the customer and beneficiary. The issuing bank's obligation to the buyer is to examine all documents to ensure that they meet all the terms and conditions of the credit. Upon requesting demand for payment the beneficiary warrants that all conditions of the agreement have been complied with. If the beneficiary (seller) is the party stipulated in the letter of credit, the seller must be paid by the bank.

Issuing Bank

The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits (UCP 500), the bank is given a reasonable amount of time after receipt of the documents to honour the draft. Otherwise it must expressly reject the documents within 7 bank working days after receipt of same. The issuing bank's role is to provide a guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due and to examine the documents, and only pay if these documents comply with the terms and conditions set out in the letter of credit. Typically the documents requested will include a commercial invoice, a transport document such as a bill of lading or airway bill and an insurance document; but there are many others. Parties to letters of credit deal strictly in documents, not the underlying goods.

Advising Bank

An advising bank, usually a foreign correspondent bank of the issuing bank, will advise the LC to the beneficiary. Generally, the beneficiary would want to use a local bank to ensure that the letter of credit is valid and binding. Hence LCs are transmitted by SWIFT or telex. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

Confirming Bank

The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to ensure payment under the letter of credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

Checking a Standard LC Text

Field Comment(s)

- 21 Issuing bank's reference no. often required to be shown in some/all documents
- 31D Ensure the place of expiry accords with domicile of confirming bank and that the date of expiry permits sufficient time to present documents within LC validity (one sometimes sees "in beneficiary's country" which could be wrong & needs amendment)
- 50 Applicant's address should be correctly written as this is the invoicing address and any serious misspelling(s) should be correspondingly amended
- 59 Beneficiary's address should be checked for any errors due to pre-determined invoice / other documents letter heading (potential problem re. consignor in BL)
- 32B Currency and amount must be that contractually agreed to ensure all goods can be shipped and claimed for under the LC
- 39A Tolerance to check vs contract if any agreed
- 39C Additional amounts covered refers to financing costs / usance interest etc. which is to be paid by the applicant and is added to the nominal invoice amount
- 41A The bank to which documents should be presented, this should ideally read "any bank by negotiation" as otherwise LC could be wrongly restricted to a bank other than that confirming the LC which will require subsequent amendment
- 42A The party upon whom drafts are to be drawn, preferably call for NO drafts!
- 42P If usance terms agreed e.g. 30/90/120/180 days etc. and to check vs contract
- 43P Are partial shipments needed to deliver full contract quantity, check vs contract
- 43T Even if transshipment is prohibited, this is allowed if container shipments made
- 44A Port(s) of loading contractually agreed, note the wording e.g. "Keelung and Taipei" means that goods must be shipped from both ports (and not possible if partial shipments are prohibited!) whereas "Keelung / Taipei" permits shipment from either one or the other port (ditto for "and/or" – "or" & similar phrases). BL must show only one port of loading, "any Taiwanese port" is forbidden
- 44B Port and/or inland destination agreed in contract, Charter Party B/Ls showing e.g. "any Taiwanese port" or "Keelung and/or Taipei" is allowed!

- 44C Ensure latest date of shipment can be complied with, otherwise have amended
- 44D Sometimes shows “X days after LC issuance” or similar, ensure compliance is possible or have LC amended
- 45A The description shown here must be given verbatim in the invoice, if partial shipment effected then re-state the quantity shipped elsewhere in the invoice. All other documents may show a more concise goods description that permits a link to be formed between all documents presented.
- 46A Enumerates the documents required and must be studied carefully to ensure that all documents called for can actually be presented. This applies especially to certain 3rd party documents: “Producer’s / Mill’s / Independent Surveyor’s” certificates and the like. These usually take longer to obtain than one thinks and can contain typing / content errors which cannot easily be corrected and could cause discrepancies and thus prevent payment and/or acceptance of all documents presented.
- An LC calling for e.g. “Lloyds Maritime Registration certificate or similar” re. the vessel’s age demands a document of equal value, a shipping co. certificate will not suffice unless confirming bank agrees to accept such (preferably a priori).
 - Does the LC permit / prohibit a Charter Party BL, make sure how goods are going to be shipped to prevent an automatic, external reserve!
 - If the LC calls for an Insurance Policy have this amended, do not use our standard forms and change “Certificate” to “Policy” as these documents are fundamentally different. Will inevitably attract a (usually external) reserve.
- 47A Additional Conditions must be read carefully upon receipt of LC as they often require presentation of further documents e.g. fax shipment advice, N.O.R. etc. and sometimes contain “Stop Clauses” preventing independent utilisation of LC
- 71B Charges are normally split equitably between applicant and beneficiary but if the issuing bank’s charges are shown to be for our account beware, this can be very expensive! Have amended if not contractually agreed to.
- 48 The no. of days after shipment within which documents have to be presented, so make sure one has sufficient time to collate and present all necessary docs.
- 49 Confirmation instructions must show “to add” or “may add” etc. if a confirmed LC has been agreed upon.
-

Some Common Issues which can Destroy the Value of a Letter of Credit

- Letter of Credit has expired prior to presentation of draft.
- Letter of Credit is over or under-drawn e.g. invoice error or partial shipment made
- Bill of Lading evidences delivery prior to or after the date range stated in the credit.
- Bill of Lading is claused re. quality of goods and/or packing, unverified alterations.
- Stale dated documents e.g. presented later than 21 days after issuance.
- Changes included in the invoice not authorized in the credit.
- Documents evidence inconsistent description of goods between themselves.
- Insurance document errors e.g. over/under insuring the goods, date not as per BL.
- Invoice amount not equal to draft amount.
- Ports of loading and destination not as specified in the credit.
- Description of merchandise is not as stated in credit.
- A document required by the credit is not presented.
- Documents are inconsistent as to general information such as volume, quality, etc.
- Names of documents not exactly as described in the credit.
- Combined documents e.g. one Weight **and** Quality certificate presented instead of two separate documents (the LC wording is important in this respect)
- Beneficiary information must be exact.
- Invoice or statement is not signed as stipulated in the letter of credit.
- The Reimbursement Authorisation is withdrawn or expires.

Supporting the Parties to an LC in Setting Up the Framework

Seller

1. Before signing a sales contract, the seller should make inquiries about the buyer's creditworthiness and business practices. The seller's bank will generally assist in this investigation.
2. In many cases, the issuing bank will specify the advising and/or confirming bank. These designations are usually based on the issuing bank's established correspondent relationships. The seller should ensure that the advising/confirming bank is a financially sound institution.
3. The seller should confirm the good standing of the buyer's issuing bank if the letter of credit is unconfirmed.
4. For confirmed letters of credit, the seller's advising bank should be willing to confirm the letter of credit issued by the buyer's bank. If the advising bank refuses to do so, the seller should request another issuing bank as the current bank may be or is in the process of becoming insolvent.
5. The seller should carefully review the letter of credit to ensure its conditions can be met. All documents must conform to the terms of the letter of credit. The seller must comply with every detail of the letter of credit specifications; otherwise the security given by the credit is lost.
6. The seller should ensure that the letter of credit is irrevocable.
7. If amendments are necessary, the seller should contact the buyer immediately so that the buyer can instruct the issuing bank to make the necessary changes quickly. The seller should keep the letter of credit's expiration date in mind throughout the amendment process.
8. The seller should confirm with the insurance company that it can provide the coverage specified in the letter of credit and that insurance charges listed in the letter of credit are correct. Typical insurance coverage is for CIF (cost, insurance and freight) often the value of the goods plus about 10 percent.
9. The seller must ensure that the goods match the description in the letter of credit and the invoice description.
10. The seller should be familiar with foreign exchange limitations in the buyer's country that could hinder payment procedures.

Buyer

1. When choosing the type of letter of credit, the buyer should consider the standard payment methods in the seller's country.
2. The buyer should keep the details of the purchase short and concise.
3. The buyer should be prepared to amend or re-negotiate terms of the letter of credit with the seller. This is a common procedure in international trade. With irrevocable letters of credit, the most common type, all parties must agree to amend the document.
4. The buyer can reduce the foreign exchange risk by buying forward currency contracts.
5. The buyer should use a bank experienced in foreign trade as its issuing bank.
6. The validation time stated on the letter of credit should give the seller ample time to produce the goods or to pull them out of stock.
7. A letter of credit is not fail-safe. Banks are only responsible for the documents exchanged and not the goods shipped. Documents in conformity with the letter of credit specifications cannot be rejected on grounds that the goods were not delivered as specified in the contract. The goods shipped may not in fact be the goods ordered and paid for.
8. Purchase contracts and other agreements pertaining to the sale between the buyer and seller are not the concern of the issuing bank. Only the letter of credit terms are binding on the bank.
9. Documents specified in the letter of credit should include those the buyer requires for customs clearance.

Tips for Exporters

- Communicate with your customers in detail before they apply for letters of credit.
- Consider whether a confirmed letter of credit is needed.
- Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
- Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits.
- Many presentations of documents run into problems with time limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
- If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete.
- Check out the supply chain parties, with new deals and unknown partners the risk of collusion leading to fraud and loss can never be completely ignored.

After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency.

Some Examples of LC Issues and Problems

Sovereign Risk

This should not be underestimated. In 1989 Brazil introduced a new currency and limited foreign currency remittances to \$ 1'200.- per year for non-recognised payments. Using LCs eliminated this particular risk.

Venezuela nationalised various companies at one time thus freezing the assets of foreign companies. An American oil company shipped sundry broken and rusty tools, called it "oil drilling equipment" and presented LC conform documents. By this means, and using a confirmed LC, they could reduce their losses of \$30 mio. (frozen assets) by \$ 7 mio.

In the 1970's Nigeria erroneously ordered 22 mio. tons of cement, this was 5 times more than was required. The government instructed Nigerian banks who had issued LCs for cement not to pay against them. They complied and several foreign suppliers and banks suffered heavy losses.

Several countries still use LCs to control and monitor foreign the flow of external payments, India and China amongst them.

Banks will compare, not interpret, the goods description and other terms

A buyer ordered Scotch Whiskey. The LC goods description stipulated this term. The seller's invoice showed "Scotch-type Whiskey." The bank called the applicant, the applicant called the beneficiary but he declined to change the invoice. Documents were rejected and goods returned. Who knows what was actually shipped?!

In another case, the LC called for No. 2 Yellow Corn or Better. The sales invoice showed "No. 1 Yellow Corn." The bank rejected the documents. Banks cannot be expected to know that No. 1 Yellow Corn is indeed better than No. 2. Always ensure the goods description is unambiguous!

Once upon a time, a huge global trading company learnt how picky banks can be. A Chinese buyer's LC called for one particular set of documents to be "original." All three (a set) documents were identical, all bearing an original signature. To avoid payment, the bank (acting for the buyer of course) said that none of the documents was marked original so they were discrepant and thus rejected. The English High Court found in favour of the Chinese bank. From that day on, every trading dept. ordered "original" and "copy" stamps and every bank cast a wary eye over the documents presented

A very frequent "killer" in LC transactions is 3rd party documents. Encourage your clients to obtain draft copies of these **before** they are issued, stamped and signed. Amending them is usually difficult or impossible, always time-consuming and can incur horrendous logistical losses.

Incoterms and Transport Documents

If the sales contract stipulates Ex Works or FOB, ensure the LC does not call for an ocean bill of lading! If the client is unsure which delivery term is best advise them to refer to Incoterms 2000 which lists and defines all the commercially common delivery modes.

Given the choice, always opt upon a negotiable bill of lading (issued to order & blank endorsed) as this gives greatest flexibility and control over the goods. A “straight” bill of lading is consigned to the receiver and only he can take over and dispose of the goods. If at all possible, in export deals avoid bills of lading issued to order of another bank, they may decline to endorse it and thus incur delays and considerable expense, especially in demurrage and subsequent storage.

If your client sells Ex Works he loses control over and title to the goods as soon as they are loaded. This can have dire results when trying to collect payment and an unscrupulous buyer can wreak havoc with a seller’s cash flows by prevarication or simple fraud. For such sales, watertight payment methods have to be agreed.

Why go for CIF (Carriage Insurance & Freight) rather than FOB (Free On Board) sales terms? In a nutshell, the classic FOB sale requires the buyer to nominate the vessel. If he’s late in doing so, this can destroy the value of the LC because it will probably cause a “late shipment.” If the seller does not act promptly and seek an amendment (to both shipment **and** expiry dates!) he can be heading for a serious problem if his buyer is unreliable or is looking to set off old debts

In a CIF contract the seller has more control over shipment of and securing (by insuring them) the goods. The LC terms can be independently complied with and any losses will be covered. In a FOB contract there is a risk of under-insurance (or none at all!) which, in the event of a total loss, could affect the buyer’s ability to pay for the goods. Advise the client to obtain contingency cover from his marine cargo insurer where there is any doubt, it can save a great deal of anguish.

Getting Paid for the Documents

Bearing in mind that between 50 – 80% of all document sets are discrepant, the chances of having documents rejected is considerable. This is an important consideration in any LC but especially when dealing with back-to-back and transferable LCs.

In a falling market a buyer may instruct his bank to find a discrepancy at any price. This happens more often than one would like to think! From personal experience I have seen multi million dollar deals turn into significant loss makers due to incompetent document preparation and failure to comply with basic LC requirements. The company managers were not pleased and revenge was invariably wrought at the next annual bonus allocation

Talking of revenge and discrepant documents, a company importing cue sticks (for billiards) had as a supplier a company that always presented discrepant documents. The applicant invariably contacted the seller to negotiate a discount before accepting the documents. Finally, tiring of this procedure, the seller presented exactly LC conform documents and the bank paid without contacting the applicant. When the buyer inspected the cartons, they contained not cue sticks but freshly cut branches! This illustrates two points: banks deal in documents not goods and companies often deal with rogues

Make sure documents are sent to the right bank. You think this is obvious? Asian LCs often require original documents to be sent to a designated branch whereas the reimbursement claim is to be handled by a 3rd party bank. Payment will be made without the issuing bank ever seeing the original documents. I have seen instances of avoidable delays due to misrouting of documents and large demurrage claims due to vessels arriving before the documents. This usually happens when the client tells the bank that the transit time is short and handling speed is of the essence ...

For custom-made or perishable goods one should be wary of using a documentary collection as it does not provide an independent means of obtaining payment. An unscrupulous buyer can hold the seller to ransom and re-negotiate the contract terms, knowing that goods are in transit and thus more difficult to sell elsewhere. For such commodities, a more secure payment method will have to be discussed and contractually agreed. Being pro-active in agreeing the ideal instrument before signing a contract can save a great many tears (and unpaid shipments) later on

And in Closing, Please Advise your Clients to:

- be proactive in setting up the LC, provide a tailored template to eliminate avoidable errors
- get a draft copy of the proposed LC **before** it goes to the issuing bank and check it well
- the LC should not contain any “stop clauses” or require documents the seller cannot get
- in LC texts, like President Clinton, remember **KISS** = Keep It Simple Stupid or;
- for the Swedes amongst us, remember **SAS** = Short And Sweet
- the LC should require the minimum of documents and shortest possible goods description
- ensure the LC is advised to a preferred bank, preferably not a branch of the issuing bank
- check in advance that the advising bank can confirm the LC if this is required
- ensure the LC “availability” (where the LC is payable) is with the advising/confirming bank
- upon receipt, always have the LC checked by the bank & client for any amendments needed
- keep sight of the overall picture including bid / tender bonds and warranties as avoid a claim after the transaction has in effect been correctly executed and concluded, this does happen!



Summary Overview of Drafts and Promissory Notes (PNs)

After the fall of the Roman Empire banking¹ was forgotten but re-emerged in Europe at about the time of the Crusades. In Italian city states such as Rome, Venice and Genoa, and in the fairs of medieval France, the need to transfer sums of money for trading purposes led to the development of financial services including *bills of exchange*.

Although it is possible that such bills had been used by the Arabs in the eighth century and the Jews in the tenth, the first for which definite evidence exists was a contract issued in Genoa in 1156 to enable two brothers who had borrowed 115 Genoese pounds to reimburse the bank's agents in Constantinople by paying them 460 bezants one month after their arrival.

With the revival of banking in western Europe, stimulated by the Crusades, written instructions in the form of bills of exchange, came to be used as a means of transferring large sums of money and the Knights Templars and Hospitallers functioned as bankers.

So, moving on to modern times, what is a draft and what does it do? The classic definition² says it is "... ① *an unconditional order in writing*, ② *addressed by one person* ③ *to another*, ④ *signed by the person giving it*, ⑤ *requiring the person to whom it is addressed* ⑥ *to pay* ⑦ *on demand or at a fixed or determinable future time* ⑧ *a sum certain in money* ⑨ *to or the order of a specified person, or to bearer.*"

Although not legally required, the bill should ideally stipulate the place of payment e.g. indicate the nominated bank's full name and address.³

Zürich, April 2006

⑦ On Demand* ① pay ⑥ to ⑨ Exporters AG or Order the sum of ③ \$ 10'000.-
(in words United States Dollars ten thousand 00/100) for value received.

③ To: (*Drawee*) ⑤
Importers Ltd.
ECI London, England

② For and on Behalf of: (*Drawer*)
Exporters AG
8001 Zürich, Switzerland

④ signature(s)

¹ The invention of banking preceded that of coinage. Banking originated in Ancient Mesopotamia where the royal palaces and temples provided secure places for the safe-keeping of grain and other commodities. Receipts came to be used for transfers not only to the original depositors but also to third parties. Eventually private houses in Mesopotamia also got involved in these banking operations and laws regulating them were included in the code of Hammurabi.

² Extracted from the Bills of Exchange Act 1882

³ The place of payment is not exclusive unless so stipulated: *Bank Polski v K.J. Mulder & Co.* (1942) 1 K.B. 497

In general, drafts are superfluous respectively should ideally not be used in LC transactions. This is because some drafts duplicate the payment undertaking of the buyer and/or their bank and will thus not be returned to the drawer. What sorts of drafts are there? These can be broken down into the following:

➤ **Sight Drafts**

As the name suggests, these are due “at sight” that is immediately upon presentation to the drawee. These have limited usefulness in commercial transactions and none whatsoever in LC transactions. This is because a sight draft will not be “accepted” by the drawee nor “avalised” by a third person e.g. a bank. Payment is either made, or not, upon presentation of the commercial documents. At most, the failure to honour the draft can be protested which might give the unpaid seller some additional leverage or additional rights e.g. seeking summary insolvency.

➤ **Usance / Term / Tenor Drafts (bills)**

These are bills which mature “...at a fixed or determinable future time...” for instance 90 days after bill of lading date or 60 days after sight. The former do not strictly require acceptance but this should always be sought. The latter bills must be “accepted” by the drawee in order that the due date can be calculated. In some cases, where the creditworthiness of the drawee/buyer is in doubt, avalisation (bon pour aval) is advisable whereby an acceptable third party, either commercial or financial, adds its aval (payment guarantee) to a usance bill thus securing payment of same at maturity. Such accepted and/or avalised bills can then be forfeited and/or sold into the secondary⁴ market. In this way the face value can be discounted at sight on a non-recourse basis which is beneficial to a company’s cash flows.

➤ **Claused bills**

Such bills bear clauses relating to interest, exchange rates and/or charges. There are sundry such clauses, however clauses or indorsements relating to exchange rates should be specific to avoid losses arising at maturity⁵ deriving from *inter alia* currency devaluations and/or exchange rates.

➤ **Documentary bills**

As the name suggests, these bills are attached to documents, especially bills of lading, to ensure that the goods are not obtained by the buyer/drawee until the bill has been paid or accepted. If the bill is dishonoured then the buyer must return the documents, failure to do so implies that property in the goods has not passed. Release of documents under such bills can be made subject to the drawee obtaining an aval, making the transaction similar to the LC procedure.

Unlike LCs, which are contingent payment undertakings, drafts are abstract, unconditional and negotiable instruments which can be used to make or obtain payment independently of the underlying commercial transaction. This is especially important in both the primary and secondary markets wherein forfaiting companies can trade bills without concerning themselves with any potential risks or disputes attaching to the underlying commercial transaction. This is due also to the fact that, exceptionally, a transferee can obtain a better title than the transferor. This is so even if fraud has occurred and the bill holder shows that he gave value in good faith.

⁴ one distinguishes between primary and secondary markets, primary markets source the bills and if discounted remain on the books of the purchaser, if such bills are sold to another party(ies) they enter the secondary market.

⁵ Tropic Plastic and Packaging Industry v Standard Bank of South Africa Ltd. 1969 (4) S.A.L.R. 108

Negotiation of Bills

In general this can be defined as the non-recourse sale of an accepted bill to an intermediary. What usually happens is that the bill is sold at a discount (hence “discounting” of bills) to the bill face value, with the intermediary calculating the deduction based on the corresponding Libor plus a discounting margin to compensate for the perceived risk premium.

An alternative method is for the intermediary to “purchase” the bill. In this procedure the buyer bears the interest element hence the intermediary pays the face value of the bill to the seller and claims this plus the agreed interest at maturity. The bill will be claused to specify the relevant interest based on a pre-agreed calculation basis.

In law no distinction is made between the two methods as in both the bill is negotiated to the intermediary by means of indorsement and delivery of the bill, thus giving the indorsee i.e. the intermediary recourse to the drawer. Usually however a non-recourse payment is agreed in a separate purchase arrangement. These can be simple one-page documents or full-blooded and comprehensive documentation. It is advisable to check this out in advance to ensure that all documentary requirements can be met.

Protesting Bills

In the event of dishonour, either of acceptance and/or payment, a foreign⁶ bill must be protested a bill holder to maintain the liability of the drawer and indorsees. The BEA⁷ requires that noting or protesting is done on the day of dishonour or latest on the next business day. The bill must be protested at the place where it is dishonoured. A protest must contain a copy of the bill, be signed by the notary making it and specify: (a) the person requesting the protest (b) the place and date of protest, the reason therefore, the demand made and answer given, if any, and whether the drawee or acceptor could not be found. A typical protest could be worded thus:

PROTEST	London 200X
To the Exporter (drawer)	
On 200X at the request of xxxxx Ltd., the holder of the original bill of exchange, I, Mr., a Notary Public by lawful authority and duly sworn did exhibit the original of the said bill to xxxxx Ltd. (drawee) the person on whom the same is drawn at their offices in London, the place of payment specified in the said bill and demanded acceptance of it to which I received an answer that they would not accept the same, WHEREFORE I, the said Mr., at the request of xxxxx Ltd. Did and do by these presents protest against the drawer of the said bill and all other parties to it for all costs of exchange and re-exchange and all costs, damages an interest present to come for want of acceptance of the said bill. Thus protested in the presence of two witnesses.	
Which I attest	
Mr.	(copy of bill attached)
Notary Public	

If the bill has been lost or destroyed, or is wrongly withheld, protest can be made on a copy or written particulars of the bill.

⁶ a domestic bill need not be protested, a foreign bill must be – the difference between the two is that a foreign bill will either indicate a non-domestic drawer and/or a non-domestic drawee and place of payment

⁷ Bills of Exchange Act 1882, Art. 51 (4)

Proceedings on Bills

This is the process of suing on a dishonoured bill. Under English law courts are unwilling to allow defences to actions on such bills. The holder of a bill is entitled to bring an action for summary judgment⁸ and, save in exceptional circumstances, a defendant (e.g. a non-paying drawee) may not establish a counterclaim or set off for unliquidated damages for breach of the underlying contract. This is an important safety mechanism for intermediary financiers. Lord Wilberforce stated in one case⁹ that since a bill is an "... unconditional order in writing English law ... does not allow cross-claims, or defences, except such limited defences as those based on fraud, invalidity or failure of consideration, to be made."

A Summary Judgment is defined as "a procedure by which the court may decide a claim or a particular issue without a trial"¹⁰ which may now be given if:

- (a) the court considers that;
 - (i) the claimant has no real prospect of succeeding on the claim or issue; or
 - (ii) the defendant has no real prospect of successfully defending the claim or issue;and
- (b) there is no other reason why the case or issue should be disposed of at a trial.**

** The prior "no triable issue" test has now been replaced by the *Saudi Eagle*¹¹ test which is that "the defendant has no real prospect of success".

The respondent (non-paying party) has to have at least 14 days' notice of the hearing and the application must be supported by evidence (e.g. *inter alia* the protest notice). Any evidence from the respondent must be filed and served at least 7 days before the hearing date and evidence in reply must be served 3 clear days before the summary judgment hearing. This will now usually be in the form of witness statements (rather than by affidavit as previously) and/or by a verified statement of case.

This is the procedure under English law which is the model for many other jurisdictions. In case of doubt, a qualified specialist lawyer should be contacted to ensure that one's rights and obligations are correctly observed and secured.

⁸ most other jurisdictions also provide for summary proceedings for default of a bill of exchange

⁹ *Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GmbH* (1977) 2 All E.R. 593 C.A.

¹⁰ Civil Procedure Rules Part 24.1

¹¹ *Alpine Bulk Transport Co Inc v Saudi Eagle Shipping Company Ltd; The Saudi Eagle* (1986) 2 Lloyd's Rep.

Appendix I

A Sight Draft

Zürich, April 2006	
On Demand* pay Exporters AG** or Order the sum of \$ 10'000.- (United States Dollars ten thousand 00/100) for value received.	
To: (<i>Drawee</i>) Importers Ltd. ECI London, England	For and on Behalf of: (<i>Drawer</i>) Exporters AG 8001 Zürich, Switzerland

A Usance or Term Draft

Zürich, April 2006	
Ninety days after Bill of Lading date* (BL date being April 2006) pay this first bill of exchange (second of the same date and tenor being unpaid) to Exporters AG** or Order the sum of \$ 10'000.- (United States Dollars ten thousand 00/100) for value received.	
To: (<i>Drawee</i>) Importers Ltd. ECI London, England	For and on Behalf of: (<i>Drawer</i>) Exporters AG 8001 Zürich, Switzerland

Some alternative modes of tenor and payee

- * at Sight (such a draft will not usually be accepted by the drawee)
- * at Ninety days after Sight (this requires drawee's dated acceptance to calculate due date)
- * Ninety days after Bill of Lading date (BL date April 2006)
- * at July 2006 (i.e. 90 days after BL date)

- ** or Bearer (such bills require no indorsement, delivery and possession suffices)
- ** Finter Bank AG (requires indorsement if negotiated to another party for value)

Appendix II

PROMISSORY NOTE

Place: Itajuba Minas Gerais, MG – Brazil

US\$.....

Date: May 2006

On November 2002 fixed for value received, we do Brasil Ltda. promise to pay against this Promissory Note to the order of SWITZERLAND the sum of effective US\$ (United States Dollars)

.....

without deduction for and free of any tax, impost, levy or duty present and future of any nature under the laws of Brazil or any political subdivision thereof or therein.

For and on behalf of, (full address details)

..... do Brasil S/A

Covering shipment of 200 metric tons of copper cathodes strapped in bundles ex bonded warehouse Terca/Vitoria – Brazil as per Bill of Lading date.....2001.

Promissory Notes

This is defined as “... an unconditional promise in writing made by one person to another signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to, or to the order of, a specified person to to bearer.”¹² So we see that the essential characteristics are similar to those of a bill of exchange. Once an “on demand” PN has been indorsed it must be presented within a reasonable time thereof, failing which the indorser, but not the maker/issuer, is discharged. A PN is incomplete (incohate) until delivery to the Payee or Bearer. A so called foreign note, whereby the maker and indorser are domiciled in different countries, if dishonoured does not need to be protested. PNs are sometimes used instead of bills because they are not always subject to the same duties and costs and are thus cheaper to execute and fulfil.

¹² The Bills of Exchange Act 1882, Part IV, section 83

Incidents of Fraud in Trade Finance Transactions¹³

As a general rule one should, unless one is dealing with established partners who can demonstrate a regular and correct flow of transactions, avoid Nigerian deals, Sugar cargoes, Oil transactions. It is well known that for many bulk goods (grain / rice / soya / oil) the markets are “wrapped up” by a handful of multinational companies. It is difficult to break into such markets and “cheap” cargoes are automatically suspect. First time partners should be checked thoroughly before any contract is signed, background checks are essential to protect unwitting potential victims.



A chemical trader set up a trading company in Vaduz using a firm of lawyers in Lugano, which lawyers, acting as fiduciaries, also introduced this company to their own bankers in Lugano. So, the trader now had a company, using a good address in Lugano, and a bank account. The trader entered an won a tender for caustic soda valued at \$2.5 mio. He prepared the false documents and had his lawyers present them to the Lugano LC confirming bank. The documents were taken up and paid for, the trader quickly disposed of the funds. Some months later the buyer commenced investigations. It transpired the bill of lading was fraudulent, the vessel had never been at or near the loadport at the time in question nor was there any trace of the goods. A preliminary check on the seller’s company could have avoided the fraud



A West Asian government trading organisation was buying 20’000 mt of sugar under a LC to be negotiated in Jordan. This bank dealt with many such shipments of sugar and knew how the documents should look and be issued. The LC in question mis-spelled the surveyors’ name. As the fraudsters knew they had to present LC compliant documents, they presented a forged surveyor’s certificate indicating the mis-spelt name. The bank became immediately suspicious and checked with the IMB¹⁴ who confirmed that the goods in question had not been loaded. The bank refused to pay and asked the beneficiary to visit them in Amman, Jordan to discuss the negotiation, a request the beneficiary declined to accept



A european company which had built up its business over 20 years, mainly with Russian clients, was asked to source 11’000 mt of bagged sugar. In a rising market this was not possible from the usual sources however a US “broker” led to a Thai counterparty which said they could supply the goods, but against a LC. The intermediary insisted upon “documents against acceptance” and a personal visit to the supplier’s to check on same and the cargo. He also insisted that the transaction was routed via a european seller who in turn would send their trader to personally oversee the transaction. All this did was extend the supply chain, the underlying risk remained the same.

¹³ the cases used herein are all extracted from *Trade Finance Fraud*, ICC publication No 643

¹⁴ ICC International Maritime Bureau which specialises in fraud

The intermediary went to Thailand, met the supplier and visited a warehouse which was full of bagged sugar. A surveyor in the warehouse assured him the sugar belonged to the Thai supplier. He returned to Europe and subsequently documents were presented to his bank. The European seller confirmed the documents were correct and that their trader had been on board the vessel during loading. So, the intermediary paid for the documents, sent them to his Russian buyer who reimbursed him. The cargo however never arrived despite all the checks. The European seller had been corrupted by the Thai supplier to obtain his statement that documents were in order. The Russian buyer sued and bankrupted the intermediary who had to close his business. This shows the need for reliable independent verification of documents, parties and procedures.



LCs invariably include a “latest date of shipment” clause. To comply with this it sometimes happens that a bill of lading is pre-dated. This practice is illegal. It exposes both the seller and the carrier / agent to the risk of legal proceedings being instigated by the buyer. It exposes the LC bank(s) to the risk of non-payment due to fraud. This can have both a reputational as well as a commercial impact as the buyer could decline to pay and claim damages or seek repayment of funds paid out plus damages. There are simple means to check upon vessel details re. load-disport, position, size, arrival & departure dates etc. which Compass Assoc. can assist with.



Transfereable LCs can be used to facilitate fraud. An unscrupulous 1st beneficiary can have the LC transferred to a 2nd beneficiary in another country, hiding the fact that both companies belong to the same party. When the 2nd beneficiary commits the fraud, the 1st beneficiary claims to have been a victim himself! It can be very difficult to discover the beneficial ownership of companies in some countries and this can facilitate the fraudulent transaction because by the time the true picture is revealed, both parties have disappeared.



The bill of lading is one of the most important documents handled by trade finance banks due to its title document characteristics. Some liner companies fail to exercise proper controls over their blank books of bills of lading, this can lead to abuse and/or fraud. To aid a preliminary check, the BL details should be sent through (fax copy is preferable) which can then be subjected to a plausibility check. BLs issued by NVOCC (non vessel owning common carrier) parties are more susceptible to fraud hence particular care is needed with these. Compass can assist in this also.



“Switching” BLs can be problematic. It is not common but sometimes used in back to back LC transactions where the intermediary wants to obtain payment under the “back” LC before having to pay under the “base” LC. There are legal issues in having two sets of BLs circulating for the same cargo. This procedure can also be used to obscure the goods’ origin, break import quotas or embargoes. The following questions have to be asked: are two sets of BLS in circulation at the same time / who issues them and when / does the beneficiary have sufficient independent collateral to secure the potential liabilities / does the cargo exist, if not one could get involved in a scam or indeed be linked to money laundering activities.



Deferred Payment LCs are sometimes a source of anguish for banks in the event of fraud. This is because of the Santander¹⁵ decision which held that an issuing bank could decline payment at the maturity date due to fraud in the underlying transaction. The fraud was discovered after the confirming bank had discounted the proceeds but before reimbursement had been claimed. It is now the case that many banks will only discount such LCs for clients of good standing whose account can, in the event of dispute, be debited thus securing the bank's potential exposure.



Odd Documents:

One fraudulent seller obtained a Combined Transport BL (multi-modal) from a NVOCC in England covering 70'000 tons of crude oil said to be held in a tank in Kazakhstan. The LC conform documents were presented to the bank and paid for under the LC. The goods never existed and when the buyer sought recompense neither the seller nor the NVOCC were of sufficient substance to warrant litigation. It is most unlikely that such a bl would be issued to cover goods destined to move by pipeline to a Latvian port, hence care is needed in analysing a transaction and the corresponding documents.

Insurance Matters:

When dealing with (relatively) new buyers of less than blue chip status, it is advisable in strongly fluctuating market conditions to take out a Seller's Interest Insurance Policy structured to cover also buyer's rejection of documents under the LC in addition to the loss of goods in the event the buyer has failed to insure the goods satisfactorily, or even at all. This is applicable in non-CIF contracts where the seller has no control over the correct insurance of goods in transit. The bank can take out such cover to secure the risk of fraud but care must be taken to ensure the policy also covers the risk of fraudulent documents being presented, this is not always the case.

Furthermore, the bank or seller can take out del credere insurance to cover the risk of buyer's default resp. non-payment in the event that documents tendered under the LC are not paid. It needs to be noted that insurers only pay out once all the usual legal avenues (arbitration and/or court hearings) have been fully exhausted and will invariably seek all means to avoid so doing. To this end they will scrutinise the underlying contract and all documents to check for loopholes.

Money Laundering:

Because trade finance banks deal exclusively with documents, often of high value, there is a risk of abuse in using this channel for washing large sums of money. The IMB has seen cases of a company being approached by a new shareholder willing to invest cash in the company. The new shareholder has then (ab)used this company's bank relationships to process fraudulent documents, the bank has raised no objections due to their long-standing and orderly relationship with the victim company. In most cases very simple documentation was used, invariably copies instead of originals etc. By the time the fraud(s) is exposed, the investment has been more than recouped by the new shareholder, leaving only the victim company and the bank to suffer losses.



¹⁵ Banco Santander SA v Bayfern Ltd [2000] 1 All ER (Comm) 776

The cost/benefit rationale of a Serial Fraudster

Many banks and companies are reluctant to follow up on frauds for “small” amounts, these being between \$100’000 - \$200’000 per case. Legal fees, management time, bad publicity etc. often mitigate against such losses being pursued through the courts. A Scottish fraudster who is still very active and dealing often in lentils and agri-products sold to Asian buyers pitches the scams at this level. In many cases a legitimate businessman is persuaded to put his bank account at the fraudster’s disposal for a commission. The funds paid in are quickly transferred, often to a Spanish bank account or to cover credit card payments. There is even a photograph of this individual, who uses a number of aliases, in the hands of the IMB. Although he’s been arrested on at least one occasion, he remains at large and continues to defraud unwary banks and buyers.