

Commercial Letters of Credit USA (National/Federal)

Related Content

A Practice Note providing an overview of commercial letters of credit, also known as documentary credits, frequently used in transactions for the sale of goods and services, especially in cross-border transactions. This Note examines the structure of letter of credit transactions and the independence principle that defines the relationship between the letter of credit and the underlying sale transaction, as well as detailing the provisions of the Uniform Commercial Code (UCC) and the Uniform Customs and Practice for Documentary Credits (UCP) that commonly apply. It focuses on the parties, process, and documents involved, and includes a detailed analysis of the terms of a letter of credit.

A [commercial letter of credit](#) is a payment mechanism developed for use in trade transactions, especially cross-border trade. In an international sale transaction, a commercial letter of credit allows the seller (exporter) in one country to ship its goods to the buyer (importer) in another country, confident that it will receive payment in full. The letter of credit also allows the buyer to ensure that payment is not made until the exporter has complied with its obligations under the sales contract. These obligations normally include:

- Shipping the goods specified, in the quantity and quality specified.
- Ensuring that the goods are shipped in the manner and by the time specified.
- Insuring the goods against damage or loss.
- Obtaining any official documents required by governments regulating the movement of goods across their borders.

A commercial letter of credit is also known as a documentary credit or commercial credit, or simply credit. In international trade, when the term letter of credit is used it is generally understood to mean a commercial letter of credit. When the term is used in this Note, it also refers to a commercial letter of credit.

A standby letter of credit, though similar in form to a commercial letter of credit, is fundamentally different (see [Practice Note, Letters of Credit in Financing Transactions: Overview](#)). For more information on drafting and negotiating standby letters of credit in commercial transactions, see [Standard Document, Standby Letter of Credit for Commercial Transactions](#).

This Note provides parties involved in domestic and international trade with important information on letters of credit, including the basic requirements of a letter of credit and the processes and practice of using letters of credit in trade transactions.

Basic Structure of a Commercial Letter of Credit

In its simplest form, a commercial letter of credit involves three parties:

- The **applicant** is the buyer in the sale transaction, using the letter of credit to make payment.
- The [issuing bank](#), also known as the issuer, issues the letter of credit to the seller.
- The [beneficiary](#) is the seller in the sale transaction, and is the recipient of the letter of credit and of the payment made under the credit.

The applicant applies to the issuing bank for the issuance of a letter of credit in favor of the beneficiary and in the amount of the purchase price of the goods (see [Buyer's Application for the Letter of Credit](#)). The issuing bank issues the letter of credit to the beneficiary. The letter of credit provides that, on the beneficiary's presentation of certain specified documents to the bank, the issuer will make the payment to the beneficiary in the manner stated in the letter of credit. Letter of credit transactions often involve a fourth party, the [confirming bank](#), a bank usually located in the beneficiary's country and known to the beneficiary. The confirming bank agrees to perform the same duties as the issuing bank, that is, to receive the beneficiary's documents and to make the payment to the beneficiary (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit: Confirmed Letter of Credit](#)). The letter of credit substitutes the creditworthiness and reliability of the issuing bank and confirming bank for that of the buyer.

The beneficiary must present whatever documents the letter of credit specifies, independent of the underlying sales contract. However, when the applicant applies for the letter of credit, the documents that it specifies for inclusion in the letter of credit are documents that:

- Evidence that the beneficiary, as seller, has met the conditions necessary for payment under the sales contract.
- Confer on the applicant title to the goods that are the subject of the sales contract.

These documents typically include a commercial invoice, evidence of insurance, and a bill of lading or other transport documents that confer title to the goods on the buyer (see [Documents to Be Presented](#)).

The beneficiary's delivery of the required documents is referred to as [presentation](#) (see [Presentation and Honor](#)). The confirming bank, if there is one, or the issuing bank must review the presentation to determine whether it complies with the requirements of the letter of credit, that is, whether the beneficiary has made a complying presentation (see [Examination of Documents Presented](#)). This includes determining that the beneficiary has made its presentation within the time limits specified in the letter of credit.

If the bank determines that the beneficiary's presentation does not comply, it may refuse to perform its own obligations under the letter of credit, including its obligation to make payment. The bank's performance of these obligations is referred to as honor; refusal is referred to as dishonor. If the bank dishonors the presentation, it must promptly notify the beneficiary. If the timing requirements of the letter of credit permit, the beneficiary may cure the deficiencies in its non-complying presentation and make another attempt at a complying presentation.

If the bank determines that the documents do comply, the bank must honor the presentation, usually by making the payment specified in the letter of credit (see [Honor](#)). If the credit is unconfirmed, it may specify a paying bank in the seller's city to make the payment to the beneficiary. The paying bank is then entitled to reimbursement from the issuing bank.

Fundamental Principles of Letters of Credit

The effectiveness of the letter of credit and its success as a tool of international trade depend on two fundamental and interrelated principles:

- [Independence principle](#) (see [Independence Principle](#)).
- Strict compliance principle (see [Strict Compliance Principle](#)).

Independence Principle

Letter of credit practice is based on the principle that the relationship created by the letter of credit is independent of the underlying sale transaction or any other relationship among the applicant, the issuing bank, and the beneficiary.

The letter of credit creates and defines the entire relationship between the issuing bank and the beneficiary. The beneficiary must present the documents specified in the letter of credit. If it does so, and the documents comply precisely, the issuing bank is required to honor. The issuing bank is not expected to inquire into whether the seller has actually complied with its obligations under the sales contract. In fact, once the issuing bank has received complying documents, it is not permitted to undertake any independent examination of the genuineness or veracity of those documents. Its obligation to pay is independent of any other issues that might arise, such as:

- Changes to the sales contract.
- The quality or condition of the merchandise.
- Disputes between the buyer and the seller.
- Whether the buyer will be able to reimburse the bank for the bank's payment under the letter of credit.

The Fraud Exception

The only exception to the independence principle is material fraud. [UCC § 5-109\(a\)](#) ([Uniform Commercial Code \(UCC\)](#)) specifies two circumstances under which the issuing bank may dishonor a presentation that appears on its face to comply with the requirements of the letter of credit:

- A required document is "forged or materially fraudulent."
- Honoring the presentation would "facilitate a material fraud" by the beneficiary on the applicant or the issuing bank.

If the issuing bank merely suspects fraud or the applicant merely claims fraud, this is insufficient to dishonor the presentation. In practice, issuing banks dishonor based on an applicant's claim of fraud only when the applicant has secured an injunction from a court of competent jurisdiction under [UCC § 5-109\(b\)](#).

Strict Compliance Principle

Closely related to the independence principle is the principle of strict compliance. Letters of credit are documentary transactions. They deal with documents, not services or goods. Both the beneficiary and the issuing bank must comply strictly with the documentary requirements in the letter of credit. The beneficiary must present to the bank exactly the documents specified in the letter of credit. If the documents are in strict compliance, the issuing bank must pay.

The principle of strict compliance ensures that letters of credit are a reliable and efficient payment mechanism in international sale transactions. For example, if a letter of credit requires the invoice to state a quantity of 100, but the invoice presented by the beneficiary states a quantity of 1,000, strict compliance requires the bank to dishonor the presentation. If banks were obligated to inquire into this sort of discrepancy, it would delay payment for even routine transactions, make the cost of the credit prohibitive, and almost certainly discourage banks from providing the facility. Instead, the issuing bank simply ascertains whether the documents strictly comply with the letter of credit. If they do not comply, the bank is not obligated to pay. If they do, the bank must pay.

Relationship Between the Sales Contract and the Letter of Credit

The commercial process that leads to the issuance of a letter of credit involves three steps:

- The execution of the sales contract between the buyer and seller (see [Sales Contract Between the Buyer and the Seller](#)).
- The submission of the buyer's application to the bank for a letter of credit (see [Buyer's Application for the Letter of Credit](#)).
- The execution of the reimbursement agreement between the buyer (applicant) and the issuing bank (see [Reimbursement Agreement Between the Applicant and the Bank](#)).

Sales Contract Between the Buyer and the Seller

The sales contract sets out all the commercial terms of the sale, including price, quantity, quality, shipment details, insurance, and often other matters. It also often includes the requirement that payment be made by commercial letter of credit.

Even though the sales contract is not part of the letter of credit, or vice-versa, the parties should consider the letter of credit requirements when they negotiate the sales contract. The specificity with which documents must be identified in the letter of credit, and the potential difficulties in making a complying presentation, make it desirable that the sales contract itself provide specificity and clarity on all these matters.

The seller is familiar with its merchandise, how it is packaged, and often how it will be shipped. It is not unusual for the seller's contract to include a sample letter of credit or written guidelines on what the letter of credit should contain. This sample or these guidelines should reflect the documents that the seller will be able to provide when it makes the presentation to the issuing bank.

Anticipating these documentary issues when the sales contract is negotiated, before the buyer applies for the letter of credit, helps avoid costly amendments and delays later (see [Amendment](#)).

Buyer's Application for the Letter of Credit

A buyer (applicant) seeking to pay by letter of credit usually begins with its own bank. A bank's application form for a letter of credit asks for information about the transaction, including:

- The name and address of the beneficiary (seller).
- The name and address of the party to whom payment will be made, if other than the beneficiary.

- The beneficiary's bank, which normally notifies the beneficiary of the letter of credit (see [The Advising Bank](#)).
- The currency in which payment must be made.
- The amount of the payment or limits on payment amounts.
- The effective date and expiry date of the letter of credit. The buyer should ensure that the term of the credit gives the beneficiary sufficient time to ship the goods and to assemble and prepare all required documents.
- Whether the letter of credit should include an evergreen clause. An [evergreen letter of credit](#) is one that renews automatically when it reaches its expiry date unless the issuing bank previously notifies the beneficiary that the credit will not be renewed.
- Required documents. These normally include:
 - a commercial invoice;
 - a bill of lading;
 - an insurance certificate; and
 - a certificate of origin.
- A description of the goods.
- Whether the letter of credit should be:
 - confirmed;
 - a revolving credit and, if so, information about when payments are to be made (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit: Revolving Letter of Credit](#)); or
 - transferable (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit: Transferable Letter of Credit](#)).

The bank incorporates this information into the letter of credit, so it is important that the buyer (applicant) verify its accuracy.

If the applicant is a customer, the bank reviews its creditworthiness and their relationship, including:

- Accounts that the applicant has with the bank.
- Activity in those accounts.
- Other assets of the applicant held by the bank.

The applicant must reimburse the bank for the payments it makes under a letter of credit. The bank's review assesses the applicant's ability to reimburse. If the applicant fails to reimburse, the bank exercises set-off rights against the applicant's accounts. If these accounts do not provide adequate security, the bank can ask for additional collateral to secure the applicant's reimbursement obligation.

For an applicant that is not a customer, the bank requires the applicant to provide collateral to secure its reimbursement obligation.

Reimbursement Agreement Between the Applicant and the Bank

A form of the reimbursement agreement that the applicant (buyer) will enter into with the bank is often attached to the application that the applicant fills out. This agreement memorializes the applicant's obligation to reimburse the bank for payments made under the letter of credit. The reimbursement agreement also:

- References any related security arrangements supporting the applicant's reimbursement obligations (see [Practice Note, Security Agreement: Overview](#)).
- Specifies the steps the applicant must take to have the bank issue a letter of credit.
- Specifies the currencies in which credits may be issued.
- Specifies when the applicant may be required to provide additional security.
- Sets out the fees to be paid by the applicant.

- Requires the applicant to notify the bank of any events affecting its credit or its ability to satisfy its reimbursement obligations.
- Sets out the bank's remedies if the applicant fails to reimburse. These remedies may include:
 - set-off rights against the applicant's accounts with the bank (see [Practice Note, Loan Agreement: Set-Off Rights](#));
 - a security interest in collateral provided by the applicant (see [Practice Note, UCC Creation, Perfection, and Priority of Security Interests](#)); and
 - the right to sell the goods that are the subject of the sales contract and for which the letter of credit provides payment.

For a form of commercial letter of credit reimbursement agreement, see [Commercial Letter of Credit Reimbursement Agreement](#).

The Terms of a Letter of Credit

The bank uses the information in the application to prepare the letter of credit. A letter of credit typically includes:

- The name of the issuing bank.
- The name and address of:
 - the [advising bank](#) (see [The Advising Bank](#));
 - the applicant; and
 - the beneficiary.
- Whether the credit is revocable or irrevocable (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit: Revocable Letter of Credit](#)).
- The date the credit is issued.
- The date of expiry. [UCC § 5-106\(d\)](#) provides that a letter of credit without an expiration date expires one year after its date of issuance (see [UCC Article 5](#)). [UCC § 5-106\(d\)](#) also states that a letter of credit that purports to be perpetual expires five years after its date of issuance. A letter of credit that contains an [evergreen clause](#) renews automatically on its stated expiry date and continues to renew for an indefinite number of periods until the issuing bank notifies the beneficiary that it will not be renewed.
- The currency and amount of the credit. This might be expressed as:
 - a precise amount, which is exactly what the beneficiary is entitled to draw;
 - an amount not to exceed; or
 - an approximate amount, which allows a tolerance of plus or minus 10%.

An approximate amount might be used if the price cannot be determined until the date of shipment. For example, if the sales contract calls for 1,000 pounds of soy beans at the current market price on the date of shipment, the sales contract and the letter of credit would use the term "about" or "approximately" to state the purchase price.

- Whether the beneficiary's draft will be honored by payment at sight or by deferred payment (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit: Letter of Credit Payable at Sight or by Deferred Payment](#)).
- The name and address of the bank or banks with which the credit is available, that is, where the beneficiary can make its presentation and obtain payment. Article 6(b) of UCP 600 (see [UCP 600](#)) provides, "A credit must state whether it is available by sight payment, deferred payment, acceptance or negotiation." For example:
 - a confirmed letter of credit payable at sight is available at the counters of the confirming bank and the issuing bank;
 - a confirmed letter of credit payable by deferred payment is available by acceptance with the confirming bank and the issuing bank; and
 - a letter of credit payable by deferred payment might also be available by negotiation with a particular nominated bank or with "any bank," meaning that the issuer will reimburse any bank that negotiates.
- Whether the letter of credit is confirmed and, if so, the name and address of the confirming bank.
- A list of the documents the beneficiary must present for payment.

- A description of the goods.
- Shipping terms. Incoterms® shipping terms such as CFR, CIF, FOB, and EXW determine whether arranging for and paying freight and insurance costs are the responsibilities of the buyer or the seller (see [Box: Glossary of Additional Letter of Credit Terms](#)).
- Whether partial shipments are allowed. If the sales contract and letter of credit cover goods that will be delivered in two or more shipments, with a corresponding number of draws on the letter of credit, the credit will state that partial shipments are allowed.
- Whether transshipment is allowed. Transshipment is the delivery of goods to an intermediate destination, often to change the means of transport, before the goods are sent on to their final destination. For example, a shipment from China to Portland, Oregon, might require transshipment in Vancouver, Canada, for the goods to be transferred from a container ship to railway cars.
- Allocation of bank fees between the applicant and beneficiary. UCP Article 37(c) provides that the bank instructing another bank is liable for the fees and expenses of the bank taking instruction. UCP Article 37(a) provides that when a bank uses the services of another bank, it does so for the account of the applicant. As a result, unless the letter of credit provides otherwise, the applicant is liable for all bank fees. In practice, the applicant and beneficiary negotiate an allocation of these fees between the two, often in the sales contract. The fees of the issuing bank are usually paid by the applicant and the fees of other banks involved in the letter of credit, including the confirming bank, are usually paid by the beneficiary.
- Whether the letter of credit is transferable (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit: Transferable Letter of Credit](#)).
- Instructions to all nominated banks:
 - specifying where the beneficiary's presentation documents should be sent;
 - specifying how the beneficiary's presentation documents should be sent, for example, by courier;
 - to confirm when the beneficiary has complied with all terms and conditions in the credit; and
 - to provide settlement instructions so that the issuing bank can reimburse a payment made by a nominated bank under the letter of credit.
- A governing law provision (see [Laws and Rules Governing Commercial Letters of Credit](#) and [UCC Article 5](#)).
- A provision that states that the letter of credit is subject to UCP 600 (see [UCP 600](#)).

Laws and Rules Governing Commercial Letters of Credit

A letter of credit practitioner must understand the interplay between the statutes and other texts that make up the law of commercial letters of credit.

The statute governing commercial letters of credit in each state is Article 5 of that state's Uniform Commercial Code (UCC). [UCC § 5-116\(c\)](#) explicitly permits the parties to a letter of credit to make the credit subject to "any rules of custom or practice, such as the Uniform Customs and Practice for Documentary Credits."

UCP 600

The [Uniform Customs and Practice for Documentary Credits \(UCP\)](#) is a detailed set of rules governing commercial letters of credit developed by the [International Chamber of Commerce \(ICC\)](#) and first issued in 1933. These rules have been periodically revised and updated to reflect the international and domestic experience of letter of credit practitioners. The current version, published in 2007, is ICC Publication No. 600, commonly referred to as UCP 600. Banks and business people engaged in domestic and international trade overwhelmingly choose UCP 600 to govern commercial letters of credit.

To be governed by the rules of UCP 600, the text of a letter of credit must specifically state that the credit is subject to UCP 600 (or similar words).

UCP 600 does not replace the governing law of a letter of credit transaction but supplements it. For example, a letter of credit governed by New York law and subject to UCP 600 is still governed by Article 5 of the New York UCC. But the parties to the credit must also follow the 20 pages of rules that make up UCP 600. If there is conflict, the provisions of UCP 600 prevail unless the conflict involves one of the UCC provisions listed in [UCC § 5-103\(c\)](#) that may not be varied (see [UCC Article 5](#)).

The drafters recognized that the UCP's rules could not anticipate every variation that might arise in letter of credit transactions. They therefore designed the UCP to be flexible. Article 1 permits the parties to a letter of credit to modify or exclude the UCP's rules by express agreement in the

credit.

UCP 600 should not be confused with the International Standby Practices ([ISP98](#)), a separate set of rules governing standby letters of credit, published by the ICC in 1998 as ICC Publication No. 590. Commercial letters of credit occasionally provide that they are subject to ISP98. This is not necessarily an error, but more likely a reflection of decades of banking custom that has been slow to change after UCP 600 was published in 2007. The use of ISP98 for commercial letters of credit is risky, however, and may produce undesirable results in how the letter of credit is interpreted.

eUCP

The growth of electronic communications and records has also affected letter of credit practice. Banks customarily issue, amend, and authenticate letters of credit by electronic means. The leading system for international payments is the bank-to-bank telecommunications system of the [Society for Worldwide Interbank Financial Telecommunication](#) (SWIFT). The ICC responded to this trend in 2002 by issuing the [Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation \(eUCP\)](#). In 2007, when UCP 600 was issued, the eUCP was updated to eUCP version 1.1.

The eUCP applies to letter of credit transactions that involve some or all electronic documents and it automatically incorporates UCP 600. That is, if a letter of credit indicates that it is subject to the eUCP, it is also subject to UCP 600. If there is conflict between the two, the provisions of the eUCP prevail. UCP 600 does not, however, incorporate the eUCP. A letter of credit subject to UCP 600 that involves electronic documents is not also subject to the eUCP. An amendment to the original letter of credit would be necessary to replace the reference to UCP 600 with a reference to the eUCP.

UCC Article 5

When a letter of credit specifies a governing law, Article 5 of that state's UCC governs the credit. [UCC § 5-116\(a\)](#) provides that the jurisdiction whose law is chosen need not have any connection to the parties' transaction. For this reason, letters of credit issued by US banks often specify as governing law the law of a handful of states, including New York and California. These states have a well-developed letter of credit jurisprudence, which makes disputes less unpredictable.

If the parties make their letter of credit subject to UCP 600, the UCC defers to that choice. If a provision of UCP 600 conflicts with the UCC, the UCC provides that the conflicting term of the UCC is deemed to be varied to accommodate the conflicting provision of the UCP. However, [UCC § 5-103\(c\)](#) sets out a list of UCC provisions that may not be varied:

- [UCC § 1-302](#) prohibits disclaiming the obligations of good faith, diligence, reasonableness, and care imposed by the UCC.
- [UCC §§ 5-102\(a\)\(9\) and \(10\)](#) define the terms issuer and letter of credit.
- [UCC § 5-103\(a\)](#) limits the scope of UCC Article 5 to letters of credit and transactions involving letters of credit.
- [UCC § 5-103\(c\)](#) provides that an agreement excusing liability for failure to perform obligations under a letter of credit will not prevail over the obligations imposed by UCC Article 5.
- [UCC § 5-103\(d\)](#) restates the independence principle.
- [UCC § 5-106\(d\)](#) limits the duration of a perpetual letter of credit to five years.
- [UCC § 5-114\(d\)](#) provides that an issuing bank is not obligated to consent to an assignment of proceeds, but may not unreasonably refuse to consent in certain cases.
- [UCC § 5-117\(d\)](#) provides that the right of subrogation of a party to a letter of credit does not arise until that party has completed its performance. For example, an issuing bank may not dishonor a presentation and then assert set-off rights on the ground that it is subrogated to the rights of another party.

The incorporation of UCP 600 in the letter of credit, and any modifications expressly agreed by the parties, cannot override these protected provisions of the UCC.

Letter of Credit Issuance, Review, and Amendment

Issuance

The issuing bank prepares the letter of credit in accordance with the buyer's (applicant's) application. There is no requirement for the bank to share the letter of credit with the applicant before issuance. But it is prudent for the applicant and beneficiary to review the letter of credit before it is issued, especially if they are not accustomed to doing business together. This avoids errors in the letter of credit that can only be corrected by amendment, which requires time and adds to its cost. The bank issues the letter of credit and forwards it to the advising bank with instructions to advise the credit, meaning to notify the beneficiary about the issuance of the letter of credit.

The Advising Bank

The advising bank, also known as the notifying bank, is usually located in the country or city of the beneficiary. It is normally either a branch of the issuing bank or a correspondent bank. A correspondent bank is a bank with which the issuing bank has a long-standing relationship and that provides local banking services on behalf of the issuing bank. An advising bank may use the services of another bank (the second advising bank) to advise the credit.

The advising bank confirms the authenticity of the credit and that the advice (notice to the beneficiary) accurately reflects the terms of the letter of credit. By authenticating the credit, the advising bank helps protect the beneficiary against fraud. When it is satisfied regarding authenticity, it advises the credit to the beneficiary.

The role of the advising bank is essentially to provide a secure means of communication between the issuing bank and the beneficiary. If there are amendments or other modifications to the credit, the advising bank is also responsible for communicating these to the beneficiary.

If the buyer has requested a confirmed letter of credit, the issuing bank may also nominate (authorize) the advising bank to confirm the letter of credit. If it agrees to do so, the advising bank is also the confirming bank.

Beneficiary's Review

The beneficiary (seller) should review the letter of credit promptly after receiving it from the advising bank. The beneficiary should ascertain that:

- The letter of credit accurately reflects the terms of the sales contract.
- The beneficiary will be able to meet all the documentary requirements set out in the letter of credit.

Inaccuracies or errors in the credit can only be corrected through an amendment, potentially a time-consuming process, so it is important that the beneficiary notify the advising bank of any inaccuracies immediately. If they are not corrected, it may make it impossible for the beneficiary to obtain payment later.

For example, if the sales contract calls for the seller (beneficiary) to ship 100 units of merchandise but the letter of credit erroneously requires the beneficiary to present a bill of lading that shows 1,000 units, then when the beneficiary makes a presentation that includes a bill of lading showing 100 units, the issuing bank may properly refuse to honor the presentation as non-complying.

Amendment

The parties may wish to amend the letter of credit for several reasons, including:

- The letter of credit inaccurately reflects the underlying sales contract.
- The letter of credit contains an error.
- The buyer and seller need to modify the sales contract.
- Exchange rate fluctuations have adversely affected the value of the letter of credit payment.

Amendments must be requested by the applicant. They require the agreement of the beneficiary, the issuing bank, and the confirming bank, if there is one. These parties normally agree in principle to the amendment before the applicant formally starts the amendment process.

The process for amending a letter of credit is similar to its issuance in that:

- The applicant applies to the issuing bank for an amendment.
- The issuing bank issues the amendment.
- The issuing bank requests that the advising bank notify the beneficiary of the amendment.
- The advising bank advises the amendment to the beneficiary.

- The beneficiary notifies the advising bank that it accepts the amendment.

Until the beneficiary notifies the advising bank that it accepts, the terms and conditions of the original letter of credit remain in effect.

Each of the banks involved in the letter of credit charges a separate fee for an amendment.

Presentation and Honor

Documents to Be Presented

In satisfying its obligations under the sales contract, the seller (beneficiary) should ensure that the documents it obtains comply precisely with the requirements of the letter of credit. These documents generally must be originals and include:

- The commercial invoice, which provides the buyer assurance that the goods shipped by the seller are the same as those covered by the sales contract. The invoice contains:
 - the name and address of the seller;
 - the name and address of the buyer;
 - the seller's description of the merchandise, its quantity, and weight; and
 - the price of the merchandise in the currency specified by the sales contract and the letter of credit.
- The bill of lading or other transport documents evidencing that the goods have been shipped. The bill of lading is a document of title. It is issued by the carrier responsible for shipping the goods and includes:
 - a description of the merchandise, including quantity, weight, and condition;
 - the points of loading and discharge;
 - a statement about whether freight charges have been prepaid; and
 - the name of the consignee, that is, the party to whom the shipper must deliver the goods at the point of discharge, as specified by the seller (beneficiary).

If the goods are consigned directly to the buyer, it is a straight bill of lading and is non-negotiable. From the issuing bank's perspective, the more desirable form for a letter of credit transaction is an order bill of lading, which allows the shipper to deliver the goods to the bank. The bank retains control of the goods until the buyer (applicant) has paid.

- Evidence of insurance. The sales contract specifies whether the buyer or seller is responsible for obtaining insurance. The insurance documents usually consist of an insurance policy or insurance certificate, including:
 - the amount of the coverage, typically 110% of the price of the goods; and
 - a description of the merchandise covered by the insurance.
- The certificates of origin and inspection.

Draft

The beneficiary prepares a draft, drawn on the issuing bank or the confirming bank if there is one, demanding payment of the amount due under the letter of credit. The beneficiary (the seller) is referred to as the drawer and the bank as the drawee. The draft is similar to a check and includes:

- The payment term, that is, whether the draft is payable at sight or by deferred payment.
- The date of presentation.
- The currency and amount of the draft.
- The letter of credit number assigned by the issuing bank.
- The date the letter of credit was issued.

- The name and address of the issuing bank.
- The name and address of the bank on which drafts are to be drawn (the drawee), which may be the issuing bank or the confirming bank if there is one.
- The name of the beneficiary (the drawer) and the signature of an authorized officer of the drawer.

See [Standard Documents](#), [Sight Draft for Commercial Letter of Credit](#) and [Time Draft for Commercial Letter of Credit](#). The beneficiary then presents the draft in accordance with the terms of the letter of credit.

Honor

The advice of the letter of credit states where the credit is available, that is, where the beneficiary must make its presentation. A credit is always available at the issuing bank. If it is a confirmed letter of credit, it is also available at the confirming bank and the beneficiary may make its presentation at either the confirming bank or the issuing bank.

After presentation, the bank has no more than five banking days to determine if the presentation is complying. If it is complying, the bank must honor the presentation.

What the bank must do to honor the presentation depends on the tenor of the letter of credit. If the credit is available at sight, the bank honors the presentation by immediately making payment to the beneficiary. If the credit is available by deferred payment, that is, if the credit is a time or usance letter of credit, the bank honors a complying presentation by accepting the beneficiary's time draft and paying it at maturity.

Negotiation

If the letter of credit is available by deferred payment, the issuing bank may stipulate in the letter of credit that it is also available by negotiation (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit: Negotiable Letter of Credit](#)). Negotiation allows the beneficiary to take the accepted time draft (referred to as a banker's acceptance) to the negotiating bank and sell it at a discount, that is, sell for an amount less than its face value based on the time value of money and the creditworthiness of the accepting bank. The bank nominated to negotiate is not required to do so, but, because it knows the banker's acceptance will be paid at maturity, usually agrees to negotiate.

The issuing bank can either nominate a specific bank to negotiate or it can nominate any bank, meaning that any bank that is willing to, and does, negotiate will be reimbursed by the issuing bank.

Issuing a letter of credit that is available by deferred payment and also available by negotiation serves to:

- Effectively provide the applicant (buyer) short-term financing in the case of a deferred payment.
- Allow the beneficiary (seller) of a time letter of credit to be paid immediately through negotiation.

Examination of Documents Presented

Standards for Examination of Documents

There are differences in the document examination standards under UCP 600 and UCC Article 5. A letter of credit practitioner must understand the interplay between these two standards.

UCC Section 5-108

[UCC § 5-108\(a\)](#) provides in relevant part: "[A]n 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." The standard practice referred to in subsection (e) of [UCC § 5-108](#) is the following: "An issuer shall observe standard practice of financial institutions that regularly issue letters of credit."

[UCC § 5-108](#) therefore reiterates the principle of strict compliance that underlies letter of credit practice. But it also acknowledges that document examination standards have evolved, and standard practice has become somewhat less strict. The Official Comment to [UCC § 5-108](#) clarifies that the "standard practice" to which subsections (a) and (e) refer includes UCP 600.

UCP 600 Article 14

UCP 600 represents the "standard practice of financial institutions that regularly issue letters of credit," referred to in [UCC § 5-108](#).

The standard for examination of documents in UCP 600 is set out in a series of rules in Article 14:

- The bank must examine only the documents to determine whether or not they appear on their face to constitute a complying presentation (Art. 14(a)).
- Data in a document does not have to be identical to data in another document if, when read in context, they do not conflict (Art. 14(d)).
- Except in a commercial invoice, the description of the goods, services, or performance may be stated in general terms so long as the description does not conflict with their description in the letter of credit (Art. 14(e)).
- If a letter of credit requires a document other than a transport document, insurance document, or commercial invoice, without specifying who must issue the document or what data it must contain, banks will accept whatever document is presented if its contents appear to fulfill the function of the required document (Art. 14(f)).
- The addresses of the beneficiary and the applicant in a document need not be identical to their addresses in the letter of credit, as long as the address in the document is in the same country mentioned in the letter of credit. But if the applicant is the consignee in a transport document, its address must be identical to its address in the letter of credit (Art. 14(j)).

Discrepancies in Presented Documents

When a presentation is non-complying because the documents are inconsistent with the requirements of the letter of credit and fail to satisfy the document examination rules set out in Article 14 of UCP 600, the inconsistency is referred to as a discrepancy and the documents are discrepant documents. The bank may refuse to honor or negotiate the non-complying presentation, or in its sole judgment it may approach the applicant for a waiver of the discrepancies.

If the bank decides to refuse to honor or negotiate, it must notify the party that has made the presentation. This notice must:

- State that it is refusing to honor.
- Specify each discrepancy in the presentation. Failure to specify a discrepancy precludes the bank from raising that discrepancy later.
- State whether the bank is:
 - holding the documents pending further instructions from the presenter;
 - holding the documents until it receives a waiver from the applicant; or
 - returning the documents to the presenter.
- Be given by electronic or other expeditious communication.
- Be given within five banking days of presentation.

Failure to provide this notice precludes the bank from claiming that the documents do not constitute a complying presentation.

Despite these procedural requirements, as long as there is sufficient time before the letter of credit expires, it is customary for the bank to notify both the applicant and the beneficiary and allow the parties to determine whether the beneficiary will cure the discrepancy or the applicant will waive it.

Neither UCP 600 Article 15 nor [UCC § 5-108](#) requires the bank to give notice of dishonor to any party other than the presenter unless otherwise requested by the presenter. It is not unusual in multi-jurisdictional transactions for the beneficiary to use a third party to make the presentation. In that situation, the beneficiary may want the letter of credit to provide that any notice to the presenter be delivered concurrently to the beneficiary.

Common Document Discrepancies

Commercial Invoice

Common discrepancies in the commercial invoice include that:

- The name and address do not agree with the letter of credit.
- Sales terms required by the credit, including price, are omitted or are incorrect.
- Certifications required by the credit are missing.

- The shipment quantity is greater or smaller than required by the credit.

Bill of Lading

Common discrepancies in the bill of lading include that:

- The bill of lading is unclean or claused, meaning that there are irregularities in the goods or packaging received by the shipper, such as damaged or wet goods.
- The description of the merchandise is materially inconsistent with other documents.
- Ports of loading or destination are different from those set out in the letter of credit.
- The shipment date is later than permitted by the credit.

Insurance Documents

Common discrepancies in the insurance documents include that:

- The insurance coverage differs from what is required by the letter of credit.
- The letter of credit requires an insurance policy, but the document presented is an insurance certificate.
- The description of the merchandise is materially inconsistent with other documents.
- For goods that are being transshipped, the insurance does not cover the entire journey.

Draft and Other Documents

Common discrepancies in the draft and other documents include that:

- The draft is drawn on the buyer instead of the issuing or confirming bank.
- The drawer's name does not match the seller's name on the commercial invoice.
- The amount of the draft does not correspond to the amount of the letter of credit.
- The certificate of origin does not meet the requirements of the credit.

Payment and Release of the Goods

After presentation and honor, and immediately after the draft has been paid by the issuing bank, the issuing bank seeks reimbursement from the applicant (buyer). If the applicant fails to pay, the issuing bank may exercise the remedies provided for in the reimbursement agreement (see [Standard Document, Commercial Letter of Credit Reimbursement Agreement: Drafting Note: Events of Default and Remedies](#)). If for any reason these remedies fail, the issuing bank usually holds title to the goods under an order bill of lading and can sell the goods to recover the payment.

When the issuing bank has been paid by the applicant it turns over the documents, including the bill of lading, to the applicant. This allows the applicant to take control of the goods.

Different Types of Commercial Letters of Credit

Letter of credit practice has adapted to meet various needs of both the buyer and the seller in the underlying sale transaction. Other banks besides the issuing bank may be involved in the issuance or payment of letters of credit. These banks are referred to as nominated banks because they are nominated by the issuing bank in the letter of credit to perform these tasks. Among the variations on the basic commercial letter of credit, the most important are:

- A confirmed letter of credit.
- A negotiable letter of credit.
- A letter of credit payable at sight or by deferred payment.
- A banker's acceptance.

- A transferable letter of credit.
- Back-to-back letters of credit.
- A revolving letter of credit.
- A revocable letter of credit.

These types of letters of credit are discussed in a separate practice note (see [Practice Note, Letters of Credit: Types of Commercial Letters of Credit](#)).

Glossary of Additional Letter of Credit Terms

Letter of credit practice has a rich vocabulary. A single party or action can often be referred to using several different terms. The Note covers the terminology used most frequently in contemporary letter of credit practice. The following terms also appear in letter of credit transactions, but less frequently:

- **Abstraction principle:** The independence principle.
- **Account party:** Applicant.
- **Adviser:** Advising bank.
- **CFR:** Incoterms® shipping term (abbreviation for cost and freight) in which the seller bears the cost of transporting the goods to a named destination, for example, CFR Lisbon.
- **CIF:** Incoterms® shipping term (abbreviation for cost, insurance, and freight) in which the seller bears the cost of transporting the goods to a named destination and the cost of insuring the goods during that transport, for example, CIF Lisbon.
- **Clean bill of lading:** Bill of lading in which the carrier describes the goods as having been received in apparent good order and condition, without qualification.
- **Combined transport document:** Document of title issued by a shipper when goods will be transported by more than one mode of transportation, for example, by container ship and railroad.
- **Confirmer:** Confirming bank.
- **Deferred letter of credit:** Time letter of credit or usance letter of credit.
- **Dishonor:** Refusal by the confirming bank or the issuing bank to honor the beneficiary's presentation.
- **EXW:** Incoterms® shipping term (abbreviation for ex works) that requires the seller to make the goods available to the buyer at the seller's premises.
- **FAS:** Incoterms® shipping term (abbreviation for free alongside ship) in which the seller bears the cost of transporting the goods to the loading dock, within reach of a ship's lifting tackle, with all other costs for the account of the buyer, for example, FAS Lisbon.
- **FOB:** Incoterms® shipping term (abbreviation for free on board) in which the seller bears the cost of transporting the goods to the loading dock and loading them onto the vessel, for example, FOB Lisbon.
- **Freely negotiable credit:** Letter of credit that is available by negotiation at any bank.
- **Notifying bank:** Advising bank.
- **Opening bank:** Issuing bank.
- **Paying bank:** Bank designated in a letter of credit as the party that will honor drafts drawn under the credit. This might be the issuing bank, the confirming bank, or any negotiating bank.
- **Presenter:** The person or party that makes the presentation.
- **Red clause:** Clause in a letter of credit that authorizes the negotiating bank to pay a fixed sum to the beneficiary, before presentation of shipping documents, usually against a simple receipt. The buyer is effectively making an unsecured loan to the seller.
- **Reimbursement:** Reimbursement of the paying bank by the issuing bank for sums paid under the letter of credit.

- **Reimbursing bank:** The issuing bank sometimes directs the paying bank to seek reimbursement from a branch of the issuing bank or from a third bank, which is referred to as the reimbursing bank.
- **Remitting bank:** The bank that forwards the documents to the issuing bank, usually the bank to which the presentation is made.

PRODUCTS

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