

Chapter 11

Methods of Payment

The rapid growth and expansion in global trade cannot be sustained without efficient and timely payment arrangements. Nonpayment or delays in payment for imports could tie up limited credit facilities and create liquidity problems for many exporting companies. Advance payments by overseas customers would similarly tie up a buyers' limited resources and do not necessarily guarantee delivery of agreed merchandise. The ideal payment method is one that protects the contending interests of both sellers and buyers.

Exporters often seek to develop foreign markets by using payment arrangements that are less costly to the buyer, such as consignment sales, open accounts, and documentary drafts, whereby the seller is paid by the foreign wholesaler or retailer, only after the goods have been received or sold. It is estimated that approximately 35 to 50 percent of exports from the United States and the United Kingdom are sold on open account and/or consignment (Cheeseright, 1994). This means that the risk of delay in payment or nonpayment could have a crucial effect on cash flow and profits (see Figure 11.1).

Export companies need access to credit reports on a global basis. There is a need to increase the existing database on companies in different parts of the world to ensure that formal reviews on credit decisions are based on current and reliable information. It is also important to consider credit insurance and other safeguards.

CONSIGNMENT SALES

This is a method in which the exporter sends the product to an importer on a deferred payment basis; that is, the importer does not pay for the merchandise until it is sold to a third party. Title to the merchandise passes to the importer only when payment is made to the exporter (Shapiro, 2006).



FIGURE 11.1. Export Payment Terms Risk/Cost Tradeoff

Consignment is rarely used between unrelated parties, for example, independent exporters and importers (Goldsmith, 1989). It is best used in cases involving an increasing demand for a product for which a proportioned stock is required to meet such need (Tuller, 1994). It is also used when a seller wants to test-market new products, or test the market in a new country.

For the exporter, consignment is the least desirable form of selling and receiving payment. The problems associated with this method include the following:

- *Delays in payment:* Buyer bears little or no risk, and payment to seller is delayed until the goods are sold to a third party. This ties up limited credit facilities and often creates liquidity problems for many exporting firms.
- *Risk of nonpayment:* Even though title to the goods does not pass until payment is made, the seller has to acquire possession of merchandise (to sell in the importer's country or ship back to the home country) in the event of nonpayment. This involves litigation in the importer's country, which often is time-consuming and expensive.
- *Cost of returning merchandise:* If there is limited success in selling the product, there is a need to ship it back to the exporter. It is costly to arrange for the return of merchandise that is unsold.
- *Limited sales effort by importers:* Importers may not be highly motivated to sell merchandise on consignment because their money is not tied up in inventory. They are likely to give priority to products in which they have some financial involvement.

In view of these risks, consignment sales should be used with overseas customers that have extremely good credit ratings and are well known to the exporter. They would also be satisfactory when the sale involves an affiliated

firm or the seller's own sales representative or dealer (Onkvisit and Shaw, 1997). This method is frequently used by multinational companies to sell goods to their subsidiaries.

A number of issues should be considered before goods are sold on consignment between independent exporters and importers. First, it is important to verify the creditworthiness of foreign importers, including data on how long particular companies take to settle bills. Credit agencies have invested heavily in technology to improve the quantity and quality of information they provide to their clients (Kelley, 1995). Exporters can have instant access to information on overseas customers from such credit agencies. No exporting company should consider itself too small to take advice on credit matters. Bad and overdue debts erode profit margins and can jeopardize the viability of an otherwise successful company.

Information on credit worthiness should also include analysis of commercial or country risk factors such as economic and political stability as well as availability of foreign currency to purchase imports. U.S. banks and their overseas correspondents and some government agencies have credit information on foreign customers.

It is also advisable to consider some form of credit insurance to protect against default by overseas customers. Outstanding debt often makes about 30 percent of an export company's assets, and it is important to take credit insurance to protect these assets. Credit insurance also helps exporters obtain access to a wide range of banking services and an improved rate of borrowing (Kelley, 1995). Financial institutions tend to look more favorably on businesses that are covered and are often prepared to lend more money at better terms. The parties should also agree on who will be responsible for risk insurance on merchandise until it is sold and payment is received by the seller, and who pays for freight charges for returned merchandise.

OPEN ACCOUNT

An open account is a contractual relationship between an exporter and importer in which a trade credit is extended by the former to the latter whereby payment is to be made to the exporter within an agreed period of time. The seller ships the merchandise to the buyer and separately mails the relevant shipping documents. Terms of payment range from 30 days to 120 days after date of shipping invoice or receipt of merchandise, depending on the country (Reynolds, 2003).

As in the case of consignment sales, open account is rarely used in international trade between independent exporters and importers. Exporters are

often apprehensive of potential defaults by overseas customers. They lack accurate information or may doubt the reliability of available data on foreign buyers to evaluate and determine their credit worthiness to purchase on open account. Unlike consignment sales, importers are expected to remit payment within a certain agreed-upon period regardless of whether they resold the product to third parties.

Open account is often used to increase sales by assisting foreign distributors to start new, or expand existing, product lines. It could also be used when a seller wants to test-market a new product or try a new market in a different country.

This arrangement gives the buyer/distributor enough time to resell the product to domestic customers and then pay the exporter, while generating business goodwill for future dealings. Many developing nations prohibit purchases on open account and consignment sales because of currency restrictions and lack of control over their balance of payments (Shapiro, 2006).

A major weakness of this method is that the importer could delay payment until merchandise is received, even when the importer is expected to pay within a specified period after shipment. There is also a greater risk of default or nonpayment by the buyer. This makes it difficult to sell the account receivable.

Open-account financing is often used for trade between parent and subsidiary companies. It is also used for sales to well-established customers with good credit ratings. When open-account sales to third parties are contemplated, it is important to verify the integrity of the buyers through a credit investigation. This should also take into account the importing country's political and economic conditions. Sources range from commercial credit agencies, such as Equifax and Dunn and Bradstreet, to chambers of commerce, trade associations, commercial banks, and public agencies, such as the Department of Commerce. It is advisable to insure trade debts to protect the seller against default by the importing company. Another safeguard would be to secure collateral to cover a transaction.

DOCUMENTARY COLLECTION (DOCUMENTARY DRAFT)

The documentary collection or documentary draft is one of the most customary methods of making payments in international trade. To facilitate the transaction, two banks are usually involved, one in the exporter's country and one in the buyer's country. The banks may be independent banks or branches of the same bank.

A draft can be drawn (documents payable) in the currency of the country of payment or in a foreign currency. This method of payment falls between the open account, which favors the buyer, and letter of credit, which protects the exporter. Bank fees are less expensive, usually a specific sum for each service, as opposed to a percentage of the transaction amount, which is used for letters of credit.

A typical documentary collection procedure includes the following steps (see also Figure 11.2):

- After the exporter (drawer) and overseas customer (drawee) agree on the terms of sale, the exporter arranges for shipment and prepares the necessary documents such as invoice, bill of lading, certificate of origin, and draft.
- The exporter forwards the documents to its bank (remitting bank) with instructions.
- The remitting bank then forwards the documents to its overseas correspondent bank (collecting bank) in the importer's country, with the exporter's instruction letter that authorizes release of documents against payment (D/P) or acceptance (D/A) or other terms.
- The collecting bank contacts the importer to effect or accept payment. If the instruction is documents against payment (D/P), the importer pays the collecting bank in exchange for the documents. The collecting bank will then send proceeds to the remitting bank for payment to the seller. If the instructions are documents against acceptance (D/A), the collecting bank will release documents to the overseas customer only upon formal acceptance of the draft. Once accepted, the collecting bank will release the documents to the buyer. On or before maturity, the collecting bank will present the accepted draft for payment. When the buyer pays, the collecting bank will remit the funds in accordance with instructions.

The basic instructions for collection of shipping documents (in addition to those pertaining to release of documents and remittance of funds) include the following:

- Procedures as to how nonpayment or nonacceptance is to be communicated to the remitting bank
- Instructions as to who pays the bank's collection charges
- Listing of documents enclosed
- Name of a party to be contacted in case a problem arises

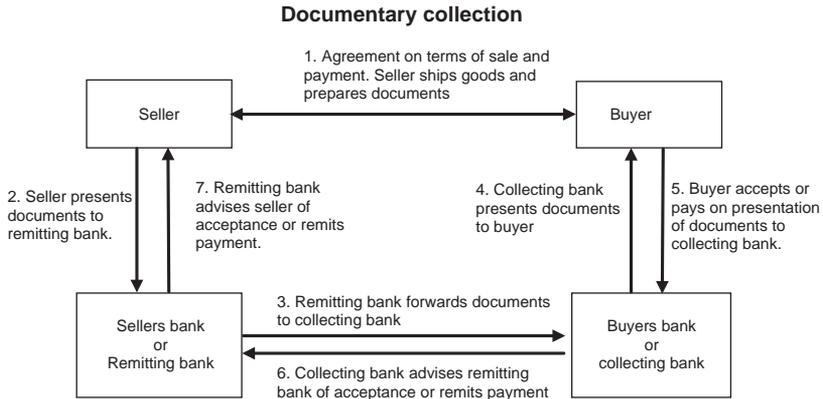


FIGURE 11.2. Documentary Collection

The banking practice relating to documentary draft is standardized by the Uniform Rules for Collections (International Chamber of Commerce [ICC], 1995). The uniform rules apply only when the parties to the contract agree to be governed by those standards. The rules set out the rights and duties of banks and users of documentary collections (Reynolds, 2003).

Documents against Payment

In a typical document against payment (D/P) transaction, the exporter draws a draft on the foreign buyer (drawee) through a foreign bank (collecting bank) that receives the collection documents from the exporter's remitting bank (Wells and Dulat, 1991). In this instance, a sight draft is presented with other documents specified by the buyer or the buyer's country and the collecting bank will provide these documents to the buyer upon payment. This means that the buyer does not receive the documents and thus will not obtain possession of the goods until payment is made to the collecting bank. This method is widely used in foreign trade and often designated as "sight draft, documents against payment" (S/D, D/P).

The original order bill of lading giving title to the goods is made out to the order of the shipper and is endorsed by the latter either in blank or the order of the collecting bank (Maggiori, 1992). This ensures that the seller retains title and control of the shipment until it reaches its destination and payment is made to the collecting bank. When the collecting bank is paid, it endorses the bill of lading and other documents to the buyer. The original

bill of lading must be properly endorsed by the buyer and surrendered to the carrier before buyer procures possession of the shipment.

Order bills of lading are not available with air shipments. If the importer's name is on the air waybill (not a negotiable document) as consignee, often nothing more is needed to hand over the merchandise to the buyer (importer) than the latter's identification, and that the importer could obtain the goods without payment. This problem can be resolved by designating a third party, such as a custom broker or, with prior permission, a collecting bank as consignee on the air waybill. The importer's name should be mentioned as the party to be notified for identification of shipment.

In using S/D, D/P, there remains the potential risk of nonpayment by importer. The buyer's ability or willingness to pay may change between the time the goods are shipped and the time the draft is presented for payment (McMahon et al., 1994). It could also be that the policy of the importing country may change (e.g., exchange controls), making it difficult for the importer to make payments. In the event of nonpayment by the buyer, the exporter has the choice of having the merchandise shipped back or selling it to another buyer in the importing country.

Documents against Acceptance

In this method, the exporter allows the overseas customer a certain period of time to effect payment for the shipment. The buyer receives the documents, and thus the title, to the goods in exchange for acceptance of the draft to pay at some determinable future date. A time draft is used to establish the time of payment; that is, that the payment is due within a certain time after the buyer accepts the draft. A date draft, which specifies the date of payment, is sometimes used. When a time draft is used, the customer can potentially delay payment by delaying acceptance of the draft. An exporter can prevent such delays by either using a date draft or tying the payment date to the date on the bill of lading (e.g., thirty days from the date of the bill of lading) or draft. The collecting bank holds the draft to present for payment on the maturity date.

This method offers less security than an S/D, D/P because documents that certify ownership of merchandise are transferred to an overseas customer prior to payment. Even when the customer is willing and able to pay, payment can be prolonged by delaying acceptance of the time draft. This method is quite similar to open-account sales in which the exporter extends a trade credit to an overseas customer in exchange for payment at some determinable future date. One major difference between the two methods is

that in the case of documents against acceptance (for which a time or date draft is used), the draft is a negotiable instrument (unlike an account receivable in an open account) that can be sold and easily converted into cash by the exporter before maturity.

A draft drawn on and accepted by a bank is called a banker's acceptance. Once accepted, the draft becomes a primary obligation of the accepting bank to pay at maturity. If the draft is accepted by nonbank entities, such as importers, it is known as a trade acceptance. The greater the credit worthiness of the party accepting the draft, the greater the marketability of the banker's or trade acceptance. They are important tools which can be negotiated or discounted to companies engaged in trade finance and which can serve the financing needs of exporters.

Direct Collection

Exporters can bypass the remitting bank and send documents directly to the foreign collecting bank for payment or acceptance. This reduces bank charges and speeds the collection process. In this case, the collecting bank acts as the exporter's agent for follow-up and collection without the involvement of the remitting bank.

Liability and Responsibility of the Banks

The Uniform Rules for Collections (ICC, 1995) distinguish two types of collection arrangements: clean collections and documentary collections. In the case of clean collections, a draft is presented to the overseas buyer for the purpose of obtaining payment or acceptance without being accompanied by shipping documents. Documentary collections, which is the subject of this chapter, however, involves the presentation of shipping (commercial) and financial documents (draft or promissory note) by the collecting bank to the buyer. In certain cases in which a collection is payable against shipping documents without a draft (invoice is used in lieu of a draft), it is termed cash against documents.

In documentary collections, banks act as agents for collection and assume no responsibility for the consequences arising out of delay or for loss in transit of any messages, letters, or documents (ICC, 1995). They do not question documents submitted for collection and are not responsible for their form and/or content or for the authenticity of any signatures for acceptance. However, they have to act in good faith and exercise reasonable care in

execution of the collection order. The bank's major responsibilities include the following:

- *Verification of documents received:* The banks check whether the documents appear to be as listed in the collection order and advises the party in the event of missing documents.
- *Compliance with instructions in the collection order:* The exporter instructs the remitting bank on payment whether the documents shall be handed to a representative in case of need and what to do in the event of nonpayment or nonacceptance of the draft. These instructions are then sent along with other documents by the remitting bank to the collecting bank. The latter is only permitted to act upon these instructions.

In case the buyer refuses to pay, accept the draft, or pay the accepted draft at maturity, exporters often instruct the collecting bank to (1) protest; that is, to present the dishonored draft again, (2) warehouse the merchandise, or (3) send the merchandise back to the exporter. The collecting bank may be requested to contact the exporter's agent for clearance of the merchandise. All charges for carrying out these instructions are borne by the exporter. If the collecting bank releases the documents to the overseas customer contrary to instructions, the bank is liable to the seller; it has to pay the seller and collect from the buyer (see International Perspective 11.1).

The use of documentary collections offers certain advantages. It reduces transaction costs for both parties, helps maintain suitable levels of control for exporters, and speeds up the flow of transactions. The major risk with this method, however, is the buyer being unable or unwilling to pay or accept the draft on presentation. It is thus important to check credit references, consider taking out credit insurance, or secure collateral to cover the transaction.

DOCUMENTARY LETTER OF CREDIT

A letter of credit (L/C) is a document in which a bank or other financial institution assumes liability for payment of the purchase price to the seller on behalf of the buyer. The bank could deal directly or through the intervention of a bank in the seller's country. In all types of letters of credit, the buyer arranges with a bank to provide finance for the exporter in exchange for certain documents. The bank makes its credit available to its client, the buyer in consideration of a security that often includes a pledge of the documents of title to the goods, or placement of funds in advance, or of a pledge to reimburse with a commission (Reynolds, 2003). The essential feature of this

INTERNATIONAL PERSPECTIVE 11.1. Protesting with Delinquent Overseas Customers

When a foreign buyer refuses to pay a sight collection or to accept a term draft, the collecting bank will advise the exporter and either proceed according to the collection instruction or new instruction from the exporter or its bank.

There are a number of reasons why buyers are unwilling to pay or accept a term draft.

- If the price of goods falls after order, buyers often try to find excuses to refuse the goods.
- The amount invoiced is higher than what was agreed in the contract or that the shipment was made earlier or later than the agreed date.
- The description of the goods is not consistent with what was agreed between the parties.
- Certain documents are missing to clear goods through customs or that import license was not obtained for the goods.

One course of action available to the exporter is to protest (through its bank) the customer's refusal to honor the sales contract (other available options include negotiating the terms, finding a new buyer or shipping the goods back to the exporter). Protest entails contacting a notary public or attorney (in the buyer's country) for the purpose of legally presenting a draft to the importer. It enables the exporter to maintain his or her right of recourse against the overseas buyer. There are a number of limitations to protest actions:

- Protests are not allowed in certain countries. In some countries such as Peru, a supplier must protest within seven days after the maturity date of the draft. This does not provide sufficient time to the exporter to assess the situation.
- Protests can be quite costly in some countries.
- Such actions may damage future business dealings with customers, especially if the exporter was partly responsible for the problem.

method, and its value to an exporter of goods, is that it superimposes upon the credit of the buyer the credit of a bank, often one carrying on business in the seller's country. The letter of credit is a legally enforceable commitment by a bank to pay money upon the performance of certain conditions, stipulated therein, to the seller (exporter or beneficiary) for the account of the buyer (importer or applicant).

A letter of credit (L/C) is considered an export or import L/C depending on the party. The same letter of credit is considered an export L/C by the

seller and an import L/C by the buyer. The steps involved in Figure 11.3 are as follows:

1. The Canadian buyer in Montreal contracts with the U.S. seller in New York. The agreement provides for the payment to be financed by means of a confirmed, irrevocable documentary credit for goods delivered CIF, port of Montreal.
2. The Canadian buyer applies to its bank (issuing bank), which issues the letter of credit with the U.S. seller as beneficiary.
3. Issuing bank sends the letter of credit to an advising bank in the United States, which also confirms the letter of credit.
4. The advising bank notifies the U.S. seller that a letter of credit has been issued on its behalf (confirmed by the advising bank) and is available on presentation of documents.
5. The U.S. seller scrutinizes the credit. When satisfied that the stipulations in the credit can be met, the U.S. seller will arrange for shipment and prepare the necessary documents, that is, commercial invoice, bill of lading, draft, insurance policy, and certificate of origin. Amendments may be necessary in cases in which the credit improperly describes the merchandise.
6. After shipment of merchandise, the U.S. seller submits relevant documents to the advising/confirming bank for payment. If the documents comply, the advising/confirming bank will pay the seller. (If the L/C provides for acceptance, the bank accepts the draft, signifying its commitment to pay the face value at maturity to the seller or bona fide holder of the draft—acceptance L/C. It is straight L/C if payment is made by the issuing bank or the bank designated in the credit at a determinable future date. If the credit provides for negotiation at any bank, it is negotiable L/C.)
7. The advising/confirming bank sends documents plus settlement instructions to the issuing bank.
8. On inspecting documents for compliance with instructions, the issuing bank reimburses/remits proceeds to the advising/confirming bank.
9. The issuing bank gives documents to the buyer and presents the term draft for acceptance. With a sight draft, the issuing bank will be paid by the buyer on presentation of documents.
10. The buyer arranges for clearance of the merchandise, that is, gives up the bill of lading and takes receipt of goods.
11. The buyer pays the issuing bank on or before the draft maturity date.

Issuing banks often verify receipt of full details of the L/C by the advising bank. This is done by using a private test code arrangement between banks.

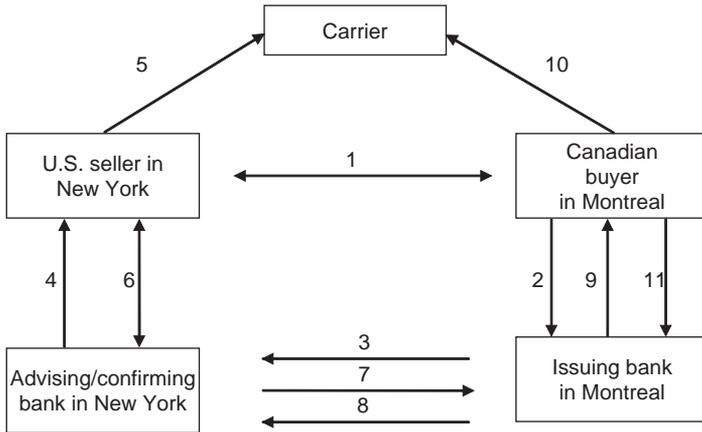


FIGURE 11.3. Documentary Letter of Credit

Credits are opened and forwarded to the advising/confirming bank by mail, telex, or cable. Issuing banks can also open credits by using the SWIFT system (Society for Worldwide Interbank Financial Telecommunications), which allows for faster transmission time. It also allows member banks to use automatic authentication (verification) of messages (Ruggiero, 1991).

The letter of credit consists of four separate and distinct bilateral contracts: (1) a sales contract between the buyer and seller; (2) a credit and reimbursement contract between the buyer and issuing bank, providing for the issuing bank to establish a letter of credit in favor of the seller and for reimbursement by the buyer; (3) a letter of credit contract between the issuing bank and the beneficiary (exporter), in which the bank will pay the seller on presentation of specified documents; and (4) the confirmed advice also signifies a contract between the advising/confirming bank and the seller, in which the bank will pay the seller on presentation of specified documents.

When the letter of credit is revocable, the issuing bank could amend or cancel the credit at any time after issue without consent from, or notice to, the seller. Revocable L/Cs are seldom used in international trade except in cases of trade between parent and subsidiary companies because they do not provide sufficient protection to the seller. Under the Uniform Customs and Practice for Documentary Credits (UCP), letters of credit are deemed irrevocable unless specifically marked revocable (ICC, 1993). Irrevocable credits cannot be amended or cancelled before their expiry date without

express consent of all parties to the credit. The terms revocable and irrevocable refer only to the issuing bank. In cases in which sellers do not know of, or have little confidence in, the financial strength of the buyer's country or the issuing bank, they often require a bank in their country to guarantee payment (i.e., confirm the L/C).

There are several advantages of using letters of credit. They accommodate the competing desires of the seller and overseas customer. The seller receives payment on presentation of documents to the bank after shipment of goods, unlike open-account sales or documentary collection. In cases in which the advising bank accepts the L/C for payment at a determinable future date, the seller can discount the L/C before maturity. Buyers also avoid the need to make prepayment or to establish an escrow account. Letters of credit also ensure that payment is not made until the goods are placed in possession of a carrier and that specified documents are presented to that effect (Shapiro, 2006).

One major disadvantage with an L/C for the buyer is that issuing banks often require cash or other collateral before they open an L/C, unless the buyer has a satisfactory credit rating. This could tie up the available credit line. In certain countries, buyers are also required to make a prior deposit before establishing an L/C. Letters of credit are complex transactions between different parties, and the smallest discrepancy between documents could require an amendment of the terms or lead to the invalidation of the credit. This may expose the seller to a risk of delay in payment or nonpayment in certain cases.

A letter of credit is a documentary payment obligation, and banks are required to pay or agree to pay on presentation of appropriate documents specified in the credit. This payment obligation applies even if a seller ships defective or nonexistent goods (empty crates/boxes). The buyer then has to sue for breach of contract. The interests of the buyer can be protected by structuring the L/C to require, as a condition of payment, the following:

- The presentation of a certificate of inspection executed by a third party certifying that the goods shipped conform to the terms of the contract of sale. If the goods are defective or nonconforming to the terms of the contract, the third party will refuse to sign the certificate and the seller will not receive payment. In such cases, it is preferable to use a revocable L/C.
- The presentation of a certificate of inspection executed or countersigned by the buyer. It is preferable to use a revocable L/C to allow the bank to cancel the credit.

- A reciprocal standby L/C issued in favor of the buyer in which the latter could draw on this credit and obtain a return of the purchase price if the seller shipped nonconforming goods (McLaughlin, 1989).

Governing Law

The rights and duties of parties to a letter of credit issued or confirmed in the United States are determined by reference to three different sources:

- *The Uniform Commercial Code (UCC)*: The basic law on letter of credit is codified in article 5-101 to 5-117 of the Uniform Commercial Code. This article has been adopted in all states of the Union. However, some states (New York, Missouri, Alabama) have introduced an amendment providing that article 5 will not apply if the letter of credit is subject, in whole or in part, to the Uniform Customs and Practice for Documentary Credits.
- *The Uniform Customs and Practice for Documentary Credits (UCP)*: Parties to the letter of credit frequently agree to be governed by the rules of the UCP, which is a result of collaboration between the International Chamber of Commerce, the United Nations, and many international trade banks. The UCP is periodically revised to take into account new developments in international trade and credit (the latest revision was in 1993). The Uniform Commercial Code provision on letters of credit and the UCP complement each other in many areas. Under both the UCC and UCP, the terms of the credit can be altered by agreement of the parties.
- *General principles of law*: In cases in which the UCC or UCP provisions are not sufficient to resolve a dispute, courts apply general principles of law insofar as they do not conflict with the governing law (UCC or UCP) or agreement of the parties.

Role of Banks under Letters of Credit

The buyer's bank issues the letter of credit at the request of the buyer. The details of the credit are normally specified by the buyer. Since the seller wants a local bank available to which the seller can present the letter of credit for payment, an additional bank often becomes involved in the transaction. The second bank usually either "advises" or "confirms" the letter of credit. A bank that advises on the L/C gives notification of the terms and conditions of the credit issued by another bank to the seller. It assumes no liability for paying the letter of credit. Its only obligation is to ensure that the beneficiary

(seller) is advised, credit delivered, and to ensure the apparent authenticity of the credit.

An issuing bank may also request a bank to confirm the letter of credit. A confirming bank promises to honor a letter of credit already issued by another bank and becomes directly obligated to the beneficiary (seller), as though it had issued the letter of credit itself. It will pay, accept, or negotiate a letter of credit upon presentation of specific documents that comply with the terms and conditions of the credit. A confirming bank is entitled to reimbursement by the issuing bank, assuming that the latter's instructions have been properly executed. It, however, faces the risk of nonpayment if the issuing bank or the buyer is unable or unwilling to pay the confirming bank, in which case it will be left with title to the goods and obliged to liquidate them to offset its losses.

Both the confirming and issuing banks have an obligation toward the exporter (beneficiary) and the buyer to act in good faith and with reasonable care in examining the documents. The basic rule pertaining to a bank's liability to a beneficiary is that the bank should honor the L/C if the documents presented comply with the terms of the credit. The following circumstances cannot be used by banks as a basis to dishonor (refusal to pay or accept a draft) letters of credit:

- *Dishonor to serve the buyer's interests:* In this case, claims are made by a bank's customer (buyer) that the beneficiary has breached the sales contract or that the underlying agreement has been modified or amended in some way in the face of complying documents. This includes cases of dishonor based on the bank's knowledge or reasonable belief that the goods do not conform to the underlying contract of sale.
- *Dishonor to serve the bank's own interests:* This occurs when the sole reason for dishonor is the bank's belief that it would not obtain reimbursement from its insolvent customer. This involves situations in which the buyer becomes insolvent after the L/C is issued and before the beneficiary's draft is honored.
- *Dishonor after express waiver of a particular discrepancy:* A bank dishonors an L/C after it has expressly agreed to disregard a particular discrepancy.
- *Dishonor without giving the beneficiary an opportunity to correct the discrepancy:* If the issuing bank decides to refuse the documents, it must give notice to that effect, stating the discrepancy without delay, and must also state whether it is holding the documents at the disposal of and returning them to the remitting bank or beneficiary, as the case may be (Arzt, 1991; Rosenblith, 1991).

Banks may properly dishonor a letter of credit in cases of fraud or forgery, even if the documents presented to the beneficiary appear to comply with the terms of credit. This assumes that there are no innocent parties involved in the presentation of the letter of credit to the bank. Banks are subject to two principles in the conduct of their letter-of-credit transactions: the independent principle and the rule of strict compliance.

The Independent Principle

The letter of credit is separate from, and independent of, other contracts relating to the transaction. Each of the four contracts in a letter-of-credit transaction is entirely independent. It is irrelevant to the bank whether the seller/buyer has fully carried out its part of the contract with the buyer/seller. The bank's duty is to establish whether the stipulated documents have been presented in order to pay (accept to pay) the exporter. It is not the bank's duty to ascertain whether the goods mentioned in the documents have been shipped or whether they conform to the terms of the contract. Article 3 of the UCP states:

Credits by their nature are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the credit. (ICC, 1993, p. 11)

The independent principle is subject to a fraud exception. A bank can refuse payment if it has been informed that there has been fraud or forgery in connection with the letter-of-credit transaction and the person presenting the documents is not a holder in due course (as third party who took the draft for value, in good faith, and without knowledge of the fraud). In one case, for example, a buyer notified the issuing bank not to pay the seller under the letter of credit, alleging that the seller had intentionally shipped fifty crates of rubbish in place of fifty crates of bristles. The bank's refusal of payment was accepted by the court as a justifiable reason in view of fraud in the underlying transaction (Ryan, 1990). U.S. courts have held in several cases that banks are justified in dishonoring L/Cs when the documents are forged or fraudulent. The UCP is silent on the question of fraud. Article 15 of the UCP states that banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, or legal effect of any documents. Article 9 also states that the obligation to honor an irrevocable L/C exists provided the stipulated documents are presented (ICC, 1993, p. 12). In credit operations, all parties concerned deal in documents and not in the goods to which

the documents relate. Thus, when the L/C is governed by the UCP, it appears that the bank must pay, regardless of any underlying fraud. A bank would, however, be liable for the money paid out if it participated in the fraud.

The Rule of Strict Compliance

The general rule is that an exporter cannot compel payment unless it strictly complies with the conditions specified in the credit (Rosenblith, 1991). When conforming documents are presented, the advising bank must pay, the issuing bank must reimburse, and the buyer is obliged to pay the issuing bank. In certain cases, courts have refused to recognize the substantial-compliance argument by banks to recover their payments from buyers (unless it involves minor spelling errors or insignificant additions or abbreviations in drafts) (Rubenstein, 1994). The reason behind the doctrine of strict compliance is that the advising bank is an agent of the issuing bank and the latter is a special agent of the buyer. This means that banks have limited authority and have to bear the commercial risk of the transaction if they act outside the scope of their mandate (Macintosh, 1992; Barnes, 1994). In addition, in times of falling demand, the buyer may be tempted to reject documents that the bank accepted, alleging that they are not in strict compliance with the terms of the credit.

Two assumptions underlie the doctrine of strict compliance:

1. *Linkage of documents*: The documents (bill of lading, draft, invoice, insurance certificate) are linked by an unambiguous reference to the same merchandise.
2. *Description of goods*: The goods must be fully described in the invoice, but the same details are not necessary in all the other documents. What is important is that the documents, when taken together, contain the particulars required under the L/C. This means that the invoice could include more details than the bill of lading as long as the enlarged descriptions are essentially consistent with those contained in the bill of lading (Schmitthoff, 1986).

Discrepancies

Discrepancies occur when documents submitted contain language or terms different from the letter of credit or some other apparent irregularity. Most discrepancies occur because the exporter does not present all the documents required under the letter of credit or because the documents do not strictly conform to the L/C requirements (Reynolds, 2003).

Example

Dushkin Bank issued an irrevocable L/C on behalf of its customer (buyer), John Textiles, Incorporated. It promised to honor a draft of KG Company (exporter) for \$250,000, covering shipment of “100 percent acrylic yarn.” KG Company presented its draft with a commercial invoice describing the merchandise as “imported acrylic yarns.”

Discrepancy: The description of the goods in the invoice does not match that stated in the letter of credit. Dushkin Bank could refuse to honor the draft and return the documents to the exporter.

To receive payment under the credit, the exporter must present documents that are in strict accord with the terms of the letter of credit. It is estimated that over 50 percent of documents presented under L/Cs contain some discrepancy.

There are three types of discrepancies:

- *Accidental discrepancies:* These are discrepancies that can easily be corrected by the exporter (beneficiary) or the issuing bank. Such discrepancies include typographical errors, omission to state the L/C number, errors in arithmetic, and improper endorsement or signature on the draft. Once these discrepancies are corrected (within a reasonable period of time: twenty-one days after shipment of merchandise and before the expiry date of the L/C), the bank will accept the documents and pay the exporter.
- *Minor discrepancies:* These are minor errors in documents that contain the essential particulars required in the L/C and can be corrected by obtaining a written waiver from the buyer. Such errors include failure to legalize documents, nonpresentation of all documents required under the L/C, and discrepancy between the wording on the invoice and the L/C. Once these discrepancies are waived by buyer, the transaction will proceed as anticipated.
- *Major discrepancies:* These are discrepancies that fundamentally affect the essential nature of the L/C. Certain discrepancies cannot be corrected under any circumstances: presentation of documents after the expiry date of the L/C, shipment of merchandise later than the specified date under the L/C, or expiration of the L/C. However, other major discrepancies can be corrected by an amendment of the L/C. Amendments require the approval of the issuing bank, the confirming bank (in the case of a confirmed L/C), and the exporter. Examples of discrepancies that can be amended include presentation of an incorrect

bill of lading, a draft in excess of the amount specified in the credit, and making partial shipments not allowed under the credit.

Discrepancies that can be corrected (accidental, minor, and certain major discrepancies) must be rectified within a reasonable period of time after shipment and before the expiry of the letter of credit. Most letters of credit require that the document be submitted within a reasonable period of time after the date of the bill of lading. If no time is specified, the UCP requires submission of shipping documents to banks within twenty-one days (see International Perspective 11.2 for common discrepancies in letters of credit).

In cases in which the buyer is looking for an excuse to reject the documents (when the price of the product is falling, the product is destroyed on shipment, etc.), the buyer may not accede to a waiver or amendment of the discrepancy or may do so in consideration for a huge discount off the contract price. The buyer could also delay correction, in which case the exporter loses the use of the proceeds for a certain period of time. Besides incurring further bank charges to correct the discrepancy, the seller also faces the risk that the credit will expire before the discrepancies are corrected.

INTERNATIONAL PERSPECTIVE 11.2. Common Discrepancies in Letters of Credit

Over 80 percent of letters of credit documents are rejected by the bank upon presentation. It is thus important to ensure that errors are avoided or detected, and appropriate corrections made to avoid (nonpayment) delays in payments. Here are some of the common discrepancies:

- Draft is not signed, or it is not consistent with the letter of credit (in terms of the amount, maturity date, etc.) and shows evidence of forgery or alteration.
- Insurance policy is not consistent with the invoice, letter of credit dated after the date of bill of lading or not endorsed.
- Commercial invoice does not conform to description of goods (including quantity, measurements, etc.) in draft or letter of credit and fails to show terms of shipment.
- Bill of lading/air waybills differ from the letter of credit, show evidence of forgery or alteration, or not endorsed. It may also be that onboard notations are not dated or signed and that the bill of lading is incomplete (missing originals).
- Incomplete documentation, description of merchandise not consistent between documents, letter of credit overdrawn/expired, or the draft and documents presented after time called for in the letter of credit.

When the discrepancy stands (the discrepancy cannot be corrected or the buyer refuses to waive or amend the terms of the credit), the seller can still attempt to obtain payment by requesting the bank to obtain authority to pay or send the documents for collection (documentary collection) outside the terms of the L/C. If the buyer refuses to accept the documents, the bank will not pay the seller (exporter) and the exporter has to either find a buyer abroad or have the merchandise returned. If the confirming/issuing bank accepts documents that contain a discrepancy, then it cannot seek reimbursement from its respective customers (issuing bank/buyer, respectively).

When the issuing bank decides to refuse the document, it must notify the party from which it obtained the document (the remitting bank or the exporter) without delay, stating the reasons for the rejection and whether it holds the documents at the disposal of, or is returning them to the presenter (see International Perspective 11.3 for unworkable terms in letters of credit).

CASH IN ADVANCE

This method of payment requires the buyer to pay before shipment is effected. The seller assumes no risk of bad debt and/or delays in payment because advance payment is a precondition to shipment.

INTERNATIONAL PERSPECTIVE 11.3. Unworkable Terms in Letters of Credit

Compliance with certain national policies: Some Middle Eastern countries require a document certifying that the ship carrying the merchandise destined to them will not make stops at Israeli ports. Complying with such requirements, for example, will violate the antiboycott provisions of U.S. law.

Contradictory/different terms: The requirement of the use of the term FOB (free on board) with an additional statement that freight be prepaid to destination, requiring the beneficiary to submit a certificate providing the origin of each component in an assembled product, (chambers of commerce will only certify local, not foreign, components) and requiring carrier's insurance policy (as opposed to certificate of insurance) will make it difficult for buyers to comply.

Setting unrealistic performance conditions: Different motivations often lead to the setting of shipping dates, expiration dates, or presentation dates for payments that are not realistic and often difficult to comply.

Sellers often require advance payment in cases in which the creditworthiness of the overseas customer is poor or unknown and/or the political/economic conditions of the buyer's country are unstable. Cash in advance is sometimes used between related companies. It is also common to require money in advance for samples.

OTHER LETTERS OF CREDIT

Transferable Letter of Credit

Exporters often use transferable L/C to pay a supplier, while keeping the identity of the supplier and the foreign customer from each other, lest they conduct the next transaction without the exporter. This method is often used when the exporter acts as an agent or intermediary. Under a transferable L/C, the exporter (beneficiary) transfers the rights and certain duties, such as shipment, under the credit to another person, usually its supplier (transferee), who receives payment, provided that the conditions of the original credit are met. The bank requested by the beneficiary to effect the transfer is under no obligation to do so, unless it has expressly consented to it.

It is important to note the following with respect to such letters of credit:

- A credit is transferred only if it is expressly designated as “transferable” by the issuing bank.
- It can be transferred only once. The credit is automatically divisible and can be transferred in fractions, provided that partial shipments are not excluded.
- The name and address of the first beneficiary may be substituted for that of the buyer. This would mask the identity of the true suppliers of the merchandise from the buyer.
- The transferee receives rights under this type of L/C. Such a transfer requires the consent of the buyer and of the issuing bank.
- The supplier might demand that the exporter actually transfer the letter of credit in its entirety, without substitution of invoices. The beneficiary (exporter) will receive a commission independent of the L/C transaction.

Example 1: A Canadian bank opens a transferable credit in the amount of \$90,000 in favor of a U.S. exporter in Florida for a shipment of tomatoes. The exporter had located a supplier in Texas and had decided to use \$85,000 of the credit to pay the supplier. The exporter asks the advising bank in Florida to effect a transfer in favor of the supplier. The supplier is advised of the transfer by the advising bank. The new credit does not men-

tion the amount of the original credit or the name of the foreign buyer but substitutes the name of the exporter (original beneficiary) as the buyer. When the supplier presents conforming documents to the advising bank in Florida, the bank substitutes the exporter's invoice for that of the supplier, pays \$85,000 to the supplier, and pays the difference to the exporter. The advising bank forwards the documents to the Canadian bank, which has no knowledge of the transfer for reimbursement.

Transferable L/C is different from assignment of proceeds under the credit. In assignment, the exporter asks the bank holding the L/C to pay either the entire amount or a percentage of the proceeds to a specified third party, usually a supplier. This allows the exporter to make domestic purchases with limited capital by using the overseas buyer's credit. This is done by assigning the proceeds from the buyer's L/C. The beneficiary (exporter) of a letter of credit may assign its rights to the proceeds of the L/C, even if the L/C expressly states that it is nontransferable. Only the beneficiary (not assignee) has rights under the credit, and the overseas buyer, as well as the issuing bank, often has no knowledge of the assignment.

Example 2: A U.S. exporter has a letter of credit for \$40,000 from a buyer in Brazil. The exporter had located a supplier within the United States that will sell the product for \$25,000. However, the supplier would not release the product for shipment without some down payment or collateral. The exporter (assignor) could assign part of the proceeds (\$25,000) from the L/C to the supplier (assignee). The assignee will then provide the merchandise to the exporter, who will arrange shipment. The exporter (assignor) must submit documents that comply with the credit in order for the advising bank to pay the assignee (supplier). The remainder (\$15,000) will be paid to the exporter.

Back-to-Back Letter of Credit

This is a letter of credit that is issued on the strength of another letter of credit. Such credits are issued when suppliers or subcontractors demand payment from the exporter before collections are received from the customer. The back-to-back L/C is separate from the original L/C, and the bank that issued the former is obligated to make payment to suppliers regardless of the outcome of the latter. If there is a default on the original L/C, the bank is left with worthless collateral.

Example: A Japanese manufacturer (exporter) of cars has a letter of credit issued for 1,000 cars by a buyer in New York. Payment is to be made ninety days after shipment. However, subcontractors require payment to be made for spare parts purchased in ten days (earlier than the date of payment

provided under the L/C). The Japanese exporter presents the buyer's L/C to the advising bank in Tokyo and asks the bank to issue a new L/C to the subcontractor, payable in ten days. The first L/C is used as collateral to issue the second L/C in favor of the subcontractor.

Revolving Letter of Credit

Banks make available letters of credit with a set limit for their customers that allow for a free flow of merchandise until the expiry date of the credit. This avoids the need to open credits for each shipment. The value of the credit allowed can be reinstated automatically or by amendment. If credits designated for use during one period can be carried over to the next period, they are termed as cumulative. They are noncumulative if any unused amount is no longer available.

Example 1: Queen's Bank in Fort Lauderdale opens a revolving line of credit for up to \$150,000 in favor of Kegan Enterprises, Incorporated, for the importation of handicrafts. Kegan Enterprises agrees to purchase toys (for \$50,000) from Korea and requests Queen's Bank to open an L/C for \$50,000 in favor of the seller in South Korea. If the credit provides for automatic reinstatement, \$100,000 will be readily available for other purchases. In other cases, Kegan Enterprises will have to wait for approval from the bank, reinstating the credit (\$100,000) to use for another shipment.

Example 2: Suppose Queen's Bank opens a letter of credit of up to \$15,000 a month for six months in favor of Kegan Enterprises. If the credit states that it is cumulative, \$30,000 credit not used during the first two months could still be used during the next four months. If it is noncumulative, the credit not used during the two-month period cannot be carried over for use in the next four months.

Red-Clause Credit

Such credits provide for advance payment to an exporter before presentation of shipping documents. It is intended to provide pre-export financing to an agent or distributor for purchase of the merchandise from a supplier. When financing is conditional on presentation of negotiable warehouse receipts issued in favor of the advising bank, it is termed green-clause credit.

Deferred-Payment Credit

This is a letter of credit whereby the bank undertakes an obligation to pay at a future date stipulated on the credit, provided that the terms and conditions of the credit are met.

Example: Suppose a U.S. buyer agrees to buy lumber valued at \$40 million from a Canadian seller. The parties agree to use a deferred-payment credit. In this case, the U.S. buyer asks its bank to open (issue) a letter of credit obligating itself to pay the seller sixty days after the date of the bill of lading. If the documents are as stipulated in the credit, the bank undertakes an obligation to pay the Canadian seller sixty days after the date of the bill of lading. No draft, however, need accompany the documents.

What are the major differences between an acceptance letter of credit and a deferred-payment credit? In the case of acceptance credits, the bank undertakes an obligation to accept drafts drawn on itself provided that stipulated documents are presented. Assume that a Canadian seller and a U.S. buyer agreed to use an acceptance credit payable sixty days after presentation of shipping documents. Once the Canadian seller presents the requisite shipping documents and draft of the advising bank, the bank will stamp the draft “accepted,” if it is in strict compliance with the credit. This represents the bank’s obligation to pay on the maturity date of the draft. Once accepted by the bank, the draft becomes a negotiable instrument that can be discounted by the accepting bank, enabling the seller to receive payment for the goods in advance of the maturity date of the acceptance. In the case of deferred-payment credits, no draft accompanies the documents. The agreement providing for the Canadian bank to pay the seller sixty days after the date of the bill of lading represents the bank’s undertaking of a deferred-payment obligation. In this case, no negotiable draft is generated and there is no way to discount the bank’s deferred payment obligation. Any advance payment by the bank to the seller often requires a collateral or security interest in the proceeds of the deferred credit. Such credits developed primarily as a way of avoiding charges and fees associated with acceptance credits.

Standby Letter of Credit

The standby letter of credit is generally used to guarantee that a party will fulfill its obligation under a contract. Such credits are opened to cover the account party’s business obligations to the beneficiary. A standby letter of credit is thus a bank’s guarantee to the beneficiary that a specific sum of the money will be received by the beneficiary in the event of default or nonperformance by the account party under a sales or service contract (Reynolds, 2003). Similar to the documentary letter of credit, a standby credit is payable against presentation of documents that comply with the terms of the standby credit. The documents required to be presented by the beneficiary often include a sight draft and the beneficiary’s written statement of default by the account party.

A major problem with such credits is that payments are often required to be made upon the issuing bank's receipt of a signed statement by the beneficiary that the account party did not perform under the contract and that the credit is currently due and payable. There is a possibility of unfair and capricious calling in of the credit, despite the absence of default or nonperformance by the account party. To protect account parties under a standby credit from such unjustified demand by beneficiaries, the following steps are often recommended:

- Include a clause under the credit requiring that the beneficiary present certification by a third party or court that default has occurred.
- Take out an insurance policy that covers commercial and political risk. This would cover exporters against, inter alia, contract repudiation as well as unfair callings by private entities or governments.
- Take out a surety bond issued by an insurance company (instead of a performance bond issued by a bank) to guarantee performance under the contract. Whereas banks honor a drawing under a standby letter of credit based on the face value of the beneficiary's statement of default, insurance companies verify the validity of the claim before payment. If the claim is unfounded, the insurance company will deny payment. However, if the insured's default is proven, payment is made under the credit and thereafter the company will recover from the insured (Kozolchyk, 1996).

The standby letter of credit is commonly used in the case of contractor bids and performance bonds, advance payments, open account sales, and loan guarantees.

Contractor Bids and Performance Bonds

Bid bonds are issued to a customer to show the seller's real interest and ability to undertake the resulting contract. This is intended to protect buyers from losses incurred in accepting invalid bids. The bid would be legitimately called in if a successful bidder failed to accept the contract.

Example: The Ministry of Defense of the state of Urbania want to buy 400,000 pairs of winter boots for the military. They invite domestic and foreign manufacturers to submit bids. All bidders are also required to submit a bid bond issued by a reputable surety company or a bank. Nunez Shoes, Limited, a U.S. footwear company, is awarded the contract. A few days later, Nunez Shoes writes a letter to the Ministry of Urbania, stating that it cannot carry out the contract because the company does not have enough

supplies and an adequate labor force. Based on the contract, the ministry will be entitled to draw under the credit.

Standby credits are also issued to guarantee performance under a sales and service contract. Using the previous example, suppose Nunez Shoes signs the contract to deliver 400,000 winter boots to Urbania. The ministry could require Nunez Shoes to post a performance bond issued by a reputable bank as guarantee that it will live up to the terms of the sales contract. Performance bond credits are issued for a percentage of the total contract value. Suppose Nunez Shoes manages to deliver only 50 percent of the shoes before the expiry of the sales contract. The ministry will then be entitled to draw under the credit on presentation of the necessary documents.

Performance Guarantees against Advance Payments

These are bonds issued to guarantee the return of cash advanced by the customer if the seller does not comply with the terms of the contract.

Example: Using the previous example, suppose Nunez Shoes signs the contract with the Ministry of Urbania to supply the winter boots but requires an advance payment of \$40,000. The ministry, in turn, could require Nunez Shoes to post an advance payment bond (a standby L/C with a bank to guarantee the return of money advanced by the ministry in the event of default by the seller). In the event that Nunez Shoes does not deliver the product as agreed under the contract, the ministry would be entitled to call in the credit, that is, to recover its advance payment on presentation of complying documents.

Guarantee against Payments on Open Account

This type of credit protects the seller in the event that the buyer fails to pay or delays payment. The seller asks the buyer to have a standby letter of credit issued in its favor. Suppose payment is to be made within ninety days to the seller under an open account transaction and the buyer fails to pay. The seller could then request payment under the credit against presentation of stipulated documents, such as a sight draft, commercial invoice, and the seller's signed written statement.

Loan Guarantees

Standby credits are often issued by banks when an applicant guarantees repayment of a loan taken by another party. Suppose a subsidiary of Nunez Shoes, in England, borrows 200,000 British pounds from a bank in London.

If the applicant's financial position is not well-known to the bank, the bank could agree to extend the loan, provided the parent company (Nunez Shoes in the United States) guarantees payment. Under this arrangement, Nunez Shoes, United States, would have a standby L/C issued in favor of the bank in London. Upon receiving the credit, the London bank will grant the loan to the subsidiary. If Nunez Shoes, England, defaults in repaying the loan, the bank will draw on the credit. In addition to this situation, standby credits are employed to cover rental payments, customs duties, royalties, and tax shelter transactions.

CHAPTER SUMMARY

Consignment Sales

Exporter sends product to importer on a deferred-payment basis. Importer pays seller upon sale of product to a third party. Exporter retains title to goods until payment.

Open-Account Sales

Exporter ships merchandise to overseas customer on credit. Payment is to be made within an agreed time after receipt of merchandise.

Documentary Draft

This is a service offered by banks to sellers to facilitate payment of a sale of merchandise on an international basis. Under this method, the exporter draws a draft on a buyer after shipment of the merchandise, requesting payment on presentation of documents (documents against payment) or acceptance of the draft to pay at some future determinable date (documents against acceptance).

Banker's (Trade) Acceptance

If a draft is drawn on and accepted by a bank, it is called banker's acceptance. If a draft is accepted by nonbank entities, such as importers, it is trade acceptance.

Role of Banks

1. *Verification of documents:* This is to determine whether the documents appear as listed in the collection order and to advise the party in the event of missing documents.
2. Compliance with instructions in the collection order.
3. Act as agents for collection and assume no responsibility for damages arising out of delay or for the substance and form of documents. However, they have to act in good faith.

Clean Collections

This is a documentary draft presented to buyer for payment of acceptance without being accompanied by shipping documents.

Documentary Collections

This is a documentary draft accompanied by shipping documents.

International Rules Governing Documentary Collections

Uniform Rules for Collections, 1995, International Chamber of Commerce Publication No. 522.

Documentary Letter of Credit (L/C)

This is a document in which a bank or other financial institution assumes liability for payment of the purchase price to exporter on behalf of overseas customer.

Parties to the L/C Contract

1. *Sales contract:* Exporter (beneficiary) and importer (account party).
2. *Credit reimbursement contract:* Importer and issuing bank.
3. *L/C contract:* Opening bank and beneficiary.
4. *Confirmation agreement:* Confirming bank and beneficiary.

International Rules on L/C

The Uniform Customs Practices for Documentary Credits (UCP), 1993 revision, International Chamber of Commerce Publication No. 500.

Role of Banks

1. Banks should act equitably and in good faith.
2. *Independent principle*: Credits are separate transactions from sales or other contracts, and banks are in no way concerned with, or bound by, such contracts. The independent principle is subject to a fraud exception.
3. *Rule of strict compliance*: Exporter cannot compel payment by banks unless the documents presented strictly comply with the terms specified in the credit.

Discrepancies

Accidental Discrepancies

Discrepancies that can easily be corrected by the beneficiary or the issuing bank.

Minor Discrepancies

Discrepancies that can be corrected by a written waiver from the buyer.

Major Discrepancies

Discrepancies that either cannot be corrected or can only be corrected by an amendment to the L/C.

Cash in Advance

A method of payment requiring the buyer to pay before shipment is effected.

Letters of Credit

1. *Irrevocable*. L/Cs that cannot be amended or canceled without the agreement of all parties to the credit, that is, the beneficiary, the buyer, and the issuing bank.
2. *Revocable*. L/Cs that may be amended or canceled by issuing bank without prior notice to the exporter (beneficiary). However, issuing banks must honor drafts duly negotiated by other banks prior to revocation.

3. *Confirmed.* A credit in which another bank, usually the advising bank, confirms its obligation to honor drafts and documents presented by the beneficiary, in accordance with the terms of the credit. This applies only to an irrevocable L/C, as the revocable L/C would become irrevocable if another bank added its confirmation.
4. *Transferable.* L/Cs that permit a beneficiary to transfer the credit to a second beneficiary. Similar to back-to-back L/Cs, but only one credit is issued.
5. *Back-to-back.* A letter of credit that is issued on the strength of another L/C.
6. *Revolving.* An agreement in which the buyer is allowed to replenish the credit after it is drawn down by a seller.
7. *Red-clause credit.* Advances or pre-export financing provided to an agent or distributor for the purchase of merchandise from a supplier. Such advances are made without presentation of documents.
8. *Green-clause credit.* When advances are made on presentation of warehouse receipts.
9. *Deferred-payment credit.* The seller agrees not to present a sight draft until after a specified period following presentation of documents. No draft need accompany the documents. When it is accompanied by a draft, it becomes an acceptance L/C.
10. *Standby.* A credit used to guarantee that a party will fulfill its obligation under a sales or service contract. Types of standby L/Cs: contractor bids and performance bonds, performance guarantees against advance payments, guarantee against payments on open account, and loan guarantee.
11. *Straight.* An L/C that is payable at the issuing bank or at a designated bank nominated in the letter of credit.
12. *Negotiable.* An L/C that can be negotiated at any bank. This means that the issuing bank will reimburse any bank that pays against the documents stipulated in the credit.

REVIEW QUESTIONS

1. Discuss the distribution of risk in the following export payment terms: consignment, time draft.
2. What are the advantages and disadvantages of these payment terms: documentary collections, open account sales, revocable letters of credit?

3. State the different steps involved in a confirmed documentary letter of credit, with payment terms of ninety days sight.
4. Compare and contrast documentary collections and documentary letter of credit.
5. The manager of the letter of credit division of Citibank in Chicago learns that the ship on which a local exporter shipped goods to Yokahama, Japan, was destroyed by fire. He knows that the buyer in Yokahama will never receive the goods. The manager, however, received all the documents required under the letter of credit. Should the manager pay the exporter or withhold payment and notify the overseas customer in Japan?
6. Compare the role and responsibility of banks in documentary collections and letters of credit.
7. What is the independent principle?
8. Discuss the rule of strict compliance.
9. Provide an example of a major discrepancy in letters of credit.
10. Briefly describe the following: transferable L/C, back-to-back L/C, deferred L/C, standby L/C.

CASE 11.1. DISHONORING LETTERS OF CREDIT

In June 2005, JFTC, a Chinese company, agreed to purchase 1,000 metric tons of fertilizers from VA Trading Corporation (VATC) located in Houston, Texas. JFTC obtained a letter of credit from the Bank of China (BC) for the purchase price of \$1.2 million. Payment was to be made to VATC after delivery of the merchandise and presentation of requisite documents to the Bank of China in accordance with UCP 500.

The market price of fertilizers had declined significantly and the buyer requested for a concession. VATC refused to reduce the price. VATC presented the documents specified under the letter of credit (after shipping the goods to JFTC) to Texas Commerce Bank (TCB) which would forward the documents to the BC. Although TCB pointed out certain discrepancies between the documents and letter of credit, it did not believe that they would lead to any problems.

The Bank of China notified TCB of the discrepancies and indicated its willingness to contact the buyer (JFTC) about acceptance. JFTC refused to waive the discrepancies and the Bank of China returned the documents to TCB. VATC was not paid for the shipment.

Questions

1. Discuss the various options available to VATC.
2. Do you think the alleged discrepancies between the documents and letter of credit could be adequate grounds for dishonoring the letter of credit?
3. Do you think JFTC or its bank provided adequate notice to VATC according to UCP 500?

***CASE 11.2. THE INDEPENDENT PRINCIPLE
IN LETTERS OF CREDIT***

A bank in New York issued a letter of credit to a beneficiary (seller) in Spain at the request of the buyer covering the shipment of building products. When the seller presented the documents to the bank for payment, the bank declined to pay on the ground that it had no opportunity to test the quality of the products. The letter of credit did not require that a testing certificate from an independent laboratory accompany the documents.

Questions

1. Was the bank justified in withholding payment?
2. Does the buyer or the bank have the right to demand inspection of the quality of the merchandise?
3. What is the importance of the independent principle for this case?